

LIFE INSURANCE & MODIFIED ENDOWMENTS

Under Internal Revenue Code Sections 7702 and 7702A

Second Edition

2021 Supplement



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PREFACE

This supplement addresses issues that have arisen since the 2015 publication of the second edition of our textbook, *Life Insurance & Modified Endowments*, and clarifies certain items that were addressed in the book. This supplement supersedes and replaces a similar supplement published by the Society of Actuaries (SOA) in 2018. Some of the information in this supplement supersedes material that appears in the textbook.

This supplement is organized according to the order in which the discussion would appear in the textbook. The chapter titles correspond to the chapter titles in the textbook. The subheads identify and provide starting page numbers for the material in the textbook to be supplemented, updated or replaced.

A significant update, discussed throughout this supplement, is that the Consolidated Appropriations Act, 2021¹ (CAA) amended section 7702, changing the interest rate assumptions underlying the calculation of the section 7702 net single premium (NSP), guideline single premium (GSP) and guideline level premium (GLP), as well as the section 7702A 7-pay premium. These changes, as discussed in more detail in Chapter 2, allow the floor interest rates used in the calculation of these values to vary based on underlying market interest rates, subject to maximum floor interest rates. The maximum floor interest rates under the amendment are consistent with the floor interest rates in effect pre-CAA, i.e., a 4 percent rate for NSPs, GLPs and 7-pay premiums and a 6 percent rate for the GSPs. Throughout the second edition of *Life Insurance & Modified Endowments*, there are numerous charts, tables, and graphs that include NSPs, GLPs and 7-pay premiums calculated using a 4 percent rate and GSPs calculated using a 6 percent rate. These values should be interpreted as employing the CAA's new maximum floor interest rates for the NSP, GSP, GLP and 7-pay premium as applicable, even though the floor rates for contracts issued in a given year may be less (which is the case for contracts issued in 2021 and 2022).

Some of the material here was originally presented in articles we wrote for *Taxing Times*, the newsletter of the SOA's Taxation Section.

¹ Pub. L. No. 116-260, signed into law on December 27, 2020.

ABOUT THE AUTHORS

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Chapter 1

INTRODUCTION

Appendix 1.1. Summary of Other Life Insurance Tax Rules (page 10)

Death Benefits (page 11)

Transfer for value rule, sections 101(a)(2) and (3): Section 101(a)(3), added by the Tax Cuts and Jobs Act of 2017 (TCJA),² limited the long-standing exceptions to the application of the section 101(a)(2) transfer for value rule. Those exceptions provide that the rule, which otherwise renders the death benefit partially taxable, apply where the transfer is made to the insured, a partner of the insured, a partnership in which the insured is a partner, a corporation in which the insured is an officer or shareholder or in circumstances where the contract's tax basis in the hands of the transferee carries over to the transferor (in whole or in part). Pursuant to section 101(a)(3), these exceptions do not apply where the transfer is a "reportable policy sale," which is defined in the statute as the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business or financial relationship with the insured apart from the acquirer's interest in that contract. In this definition, the term *indirectly* applies to the acquisition of an interest in a partnership, trust or other entity that holds an interest in the life insurance contract. This rule was added to the Code to subject life insurance contract sales in all forms of life settlement transactions to taxation under section 101(a)(2). In regulations finalized in 2019,³ the Treasury Department and the IRS elaborated on these restrictions and on the reporting obligations imposed to enforce them, including description of the manner in which the rules interact with section 1035 exchanges, gifts of life insurance contracts, and contracts obtained in connection with acquisitions of business interests.

Other Rules (page 17)

Contract sales, section 1001: Prior to the TCJA, there was an issue about whether a taxpayer's basis in a life insurance contract should be reduced by any cost of insurance provided through the date of the sale of the contract. The IRS took the position in Revenue Rulings 2009-13⁴ and 2009-14⁵ that, in many instances, it should. The TCJA clarified that there should not be any such reduction. It did so by amending section 1016(a)(1), which

² The formal name of this legislation is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." Enacted as H.R. 1 on December 22, 2017, and assigned Public Law No. 115-97, the legislation was originally known as the Tax Cuts and Jobs Act, but that title was removed due to a Senate parliamentary rule prior to final enactment. It continues to be referred to by its original, if now informal, name.

³ Treas. Reg. § 1.101-1 as amended by T.D. 9879, 84 Fed. Reg. 58460 (Oct. 31, 2019), as corrected by 84 Fed. Reg. 68042 (Dec. 13, 2019); Treas. Reg. § 1.6050Y, as added by T.D. 9879.

⁴ 2009-21 I.R.B. 1029 (situations 2 and 3).

⁵ 2009-21 I.R.B. 1031 (situation 2).

governs adjustments to tax basis, to provide in new subparagraph (B) that “no adjustment [to basis] shall be made . . . for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract.”⁶ The legislative history of the TCJA briefly elaborates on the meaning of this clarification, saying that the mortality, expense and other reasonable charges just referred to are “known as ‘cost of insurance’” and observing that the addition of the new rule “reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured’s (seller’s) basis is reduced by the cost of insurance.”⁷ Consistently with the TCJA’s amendment, the IRS in Revenue Ruling 2020-5 modified its analysis and conclusion in Revenue Ruling 2009-13 and its analysis in Revenue Ruling 2009-14.⁸

Appendix 1.2. A Note on Tax Authorities (page 18)

On page 19, footnote 96 should read: *United States v. Woods*, 571 U.S. 31, 134 S. Ct. 557 (2013).

⁶ TCJA § 13521, amending section 1016(a)(1).

⁷ H.R. Rep. No. 115-466 (2017) (Conference Report) at 486.

⁸ 2020-9 I.R.B. 454.

Chapter 2

INTRODUCTION TO SECTIONS 7702 AND 7702A

Cash Value Accumulation Test (page 23)

Net Single Premium (page 24)

Prior to the TCJA, the NSP) under the cash value accumulation test (CVAT) was determined, according to section 7702(b)(2), assuming the following mortality charges as specified in section 7702(c)(3)(B)(i):

- **Contracts entered into before October 21, 1988:** The mortality charges specified in the contract or, if none is specified, the mortality charges used in determining the reserves for the contract;
- **Contracts entered into on or after October 21, 1988:** “Reasonable” mortality charges that, except as provided in regulations, do not exceed the mortality charges specified in the “prevailing commissioners’ standard tables,” as defined in section 807(d)(5) as of the time the contract is issued.

The TCJA amended section 7702(c)(3)(B)(i) to provide that the NSP calculation assumes “reasonable mortality charges which meet the requirements prescribed in regulations” or that do not exceed the mortality charges specified in the prevailing commissioners’ standard tables as defined in new section 7702(f)(10).⁹ The definition of the prevailing tables in new section 7702(f)(10) replicates the definition previously found in section 807(d)(5)(A) and (B), which were repealed by the TCJA.¹⁰ The import of the amendment of section 7702(c)(3)(B)(i), which applies in taxable years beginning after December 31, 2017,¹¹ is discussed further later in this chapter.

Also, prior to the Consolidated Appropriations Act, 2021 (CAA), the calculation of a contract’s NSP was based on the greater of an annual effective interest rate of 4 percent (i.e., the floor interest rate specified in section 7702(b)(2)(A)) or any higher interest rate(s) guaranteed on issuance of the contract. Under the CAA, the CVAT’s new floor interest rate is the “applicable accumulation test minimum rate,” defined as the lesser of 4 percent or the “insurance interest rate” at the time the contract is issued.¹² The insurance interest rate is described under “Interest” below. Further, pursuant to a statutory transition rule, the new CVAT floor rate is 2 percent for contracts issued in 2021.¹³ However, if the contract’s guaranteed interest rate(s) are higher than the new floor rate, those higher

⁹ TCJA § 13517(a)(4)(A).

¹⁰ TCJA § 13517(a)(4)(B).

¹¹ TCJA § 13517(c)(1).

¹² CAA § 205(a), amending IRC § 7702(b), and CAA § 205(d), adding IRC § 7702(f)(11).

¹³ IRC § 7702(f)(11)(E).

guaranteed rate(s) must be used in the calculation. The CAA's amendments to section 7702 apply to contracts issued on or after January 1, 2021.¹⁴

In view of the CAA's amendments, Figure 2.1 (page 24) and Table 2.1 (page 25) should be read as employing the new maximum floor interest rate for the NSP.

Guideline Premium/Cash Value Corridor Test (page 26)

Guideline Single and Guideline Level Premiums (pages 26–27)

Prior to the TCJA, the GSP and GLP were computed assuming the following mortality charges as specified in section 7702(c)(3)(B)(i):

- **Contracts entered into before October 21, 1988:** The mortality charges specified in the contract or, if none is specified, the mortality charges used in determining the reserves for the contract;
- **Contracts entered into on or after October 21, 1988:** "Reasonable" mortality charges that, except as provided in regulations, do not exceed the mortality charges specified in the "prevailing commissioners' standard tables" as defined in section 807(d)(5) as of the time the contract is issued.

The TCJA amended section 7702(c)(3)(B)(i) to provide that the GSP and GLP calculations assume "reasonable mortality charges which meet the requirements prescribed in regulations" or that do not exceed the mortality charges specified in the prevailing commissioners' standard tables as defined in new section 7702(f)(10).¹⁵ (As noted above, the definition of the prevailing tables in new section 7702(f)(10) replicates the definition in former section 807(d)(5)(A) and (B).) The import of this amendment, applicable in taxable years beginning after December 31, 2017,¹⁶ is discussed further later in this chapter.

Also, prior to the CAA, the calculation of a contract's GSP was based on the greater of an annual effective interest rate of 6 percent (i.e., the GSP floor interest rate specified in section 7702(c)(3)(B)(iii)) or any higher interest rate(s) guaranteed on issuance of the contract, and the contract's GLP was calculated on the same basis but using 4 percent as the GLP floor rate pursuant to section 7702(c)(4). Under the CAA, the new floor interest rate for the GLP calculation, like that for the NSP calculation, is the "applicable accumulation test minimum rate," i.e., the lesser of 4 percent or the "insurance interest rate" at the time the contract is issued.¹⁷ (The insurance interest rate is described under "Interest" below.) For the GSP calculation, the new floor interest rate is the "applicable guideline premium interest rate," which is defined as the applicable accumulation test minimum rate plus two percentage points; thus, the new GSP floor rate—the lesser of 6 percent and the applicable accumulation test minimum rate plus 2 percent—maintains its

¹⁴ CAA § 205(e).

¹⁵ TCJA § 13517(a)(4)(A).

¹⁶ TCJA § 13517(c)(1).

¹⁷ CAA § 205(c), amending IRC § 7702(c); CAA § 205(d), adding IRC § 7702(f)(11).

historic differential of 2 percent above the GLP floor rate.¹⁸ Further, pursuant to a statutory transition rule, the new GLP floor rate is 2 percent for contracts issued in 2021, while the new GSP floor rate is 4 percent for contracts issued in that year.¹⁹ In any event, as with the NSP, if the contract's guaranteed interest rate(s) are higher than the new floor rate, those higher guaranteed rate(s) must be used in the calculation. The CAA's amendments to section 7702 apply to contracts issued on or after January 1, 2021.²⁰

In view of the CAA's amendments, Figure 2.2 (page 26), Table 2.2 (page 28), and Figure 2.3 (page 29) should be read as employing the new maximum floor interest rates for the section 7702 calculations.

Modified Endowment Contracts Under Section 7702A (page 34)

The 7-Pay Test (page 34)

Prior to the TCJA, the 7-pay premium for a contract was determined assuming—as prescribed in section 7702A(c)(1), which incorporated section 7702(c)(3)(B)(i) before its amendment—reasonable mortality charges that, except as provided in regulations, do not exceed the mortality charges specified in the prevailing commissioners' standard tables as defined in section 807(d)(5) as of the time the contract is issued. Applying section 7702(c)(3)(B)(i) as amended by the TCJA, the 7-pay premium is computed assuming “reasonable mortality charges which meet the requirements prescribed in regulations” or that do not exceed the mortality charges specified in the prevailing commissioners' standard tables as defined in new section 7702(f)(10).²¹ (As noted above, the definition of the prevailing tables in new section 7702(f)(10) replicates the definition in former section 807(d)(5)(A) and (B).) The import of this amendment, applicable in taxable years beginning after December 31, 2017,²² is discussed further later in this chapter.

Also, prior to the CAA, the calculation of a contract's 7-pay premium, as required by the cross-reference in the section 7702A(c)(1)(B) computational rule to the CVAT's interest rate rule under section 7702(b)(2), was based on the greater of an annual effective interest rate of 4 percent or any higher interest rate(s) guaranteed on issuance of the contract. Under the CAA, the cross-reference remains, so the new floor interest rate for the 7-pay premium is the “applicable accumulation test minimum rate,” i.e., the lesser of 4 percent or the “insurance interest rate” at the time the contract is issued.²³ (The insurance interest rate is described under “Interest” below.) Further, as is the case with the NSP and GLP, the new section 7702A floor rate is 2 percent for contracts issued in 2021 pursuant to a statutory transition rule.²⁴ As before, however, if the contract's guaranteed interest rate(s) are higher than the new floor rate, those higher guaranteed rate(s) must be used in

¹⁸ CAA § 205(b), amending IRC § 7702(c).

¹⁹ IRC § 7702(f)(11)(E).

²⁰ CAA § 205(e).

²¹ TCJA § 13517(a)(4)(A).

²² TCJA § 13517(c)(1).

²³ CAA § 205(a), amending IRC § 7702(b); CAA § 205(d), adding IRC § 7702(f)(11).

²⁴ IRC § 7702(f)(11)(E).

the calculation. The CAA's amendments to section 7702, and by cross-reference to section 7702A, apply to contracts issued on or after January 1, 2021.²⁵

In view of the CAA's amendments, Table 2.4 (page 36) should be read as employing the new maximum floor interest rate for the section 7702A calculations.

Interest (page 37)

Floor Interest Rates Under the CAA Amendments

As described above, significant changes have been made in the section 7702 and 7702A floor interest rates since the 2015 publication of the second edition of *Life Insurance & Modified Endowments*. Prior to the enactment of the CAA, the floor interest rate for the NSP, the GLP, and the 7-pay premium had always been 4 percent (or any higher contractually guaranteed rate), and the GSP's floor rate had always been 6 percent (or any higher contract rate). These rates reflected the relatively high interest rate environment of the 1980s, when section 7702 (and its predecessor section 101(f)) and section 7702A were enacted. A substantial disconnect arose, however, between those rates and the current low-interest environment, the rates of which have persisted well below long-term averages for more than a decade.

To alleviate this divergence in rates, better allow for adequate funding of universal life insurance contracts so that they may mature on their guarantees, and allow insurance companies to lower interest rate guarantees on whole life insurance contracts, Congress altered the section 7702 and 7702A floor interest rates in the CAA. Under the CAA, these rates are now as follows:

- **For the NSP, GLP, and 7-pay premium:** The rate is the lesser of an annual effective rate of 4 percent or the applicable accumulation test minimum rate (but not less than the contractually guaranteed rate).
- **For the GSP:** The rate is the lesser of an annual effective rate of 6 percent or the applicable accumulation test minimum rate plus two percentage points (but not less than the contractually guaranteed rate).

As previously noted, the applicable accumulation test minimum rate depends on the "insurance interest rate." The insurance interest rate, a dynamic rate based on the calendar year during which a contract is issued, is defined as the lesser of the "section 7702 valuation interest rate" (7702 VIR) or the "section 7702 applicable Federal interest rate" (7702 AFR) that applies for such year.²⁶ In turn, the applicable 7702 VIR and 7702 AFR are determined by reference to such rates for the calendar year during which the contract was issued if it is an "adjustment year," or if not, for the most recent adjustment year, as follows:

- The 7702 VIR is defined with respect to any adjustment year as the prescribed U.S. valuation interest rate for life insurance with guaranteed durations of more than 20 years, determined in accordance with the Standard Valuation Law (MDL-820) promulgated by the National Association of Insurance

²⁵ CAA § 205(e).

²⁶ IRC § 7702(f)(11)(A) as added by CAA § 205(d).

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- Commissioners (NAIC), as effective in the calendar year immediately preceding such adjustment year.²⁷ The methodology for determining this rate is now prescribed in the NAIC's *Valuation Manual*.²⁸
- The 7702 AFR is defined with respect to any adjustment year as “the average (rounded to the nearest whole percentage point) of the applicable Federal mid-term rates (as defined in section 1274(d) but based on annual compounding) effective as of the beginning of each of the calendar months in the most recent 60-month period ending before the second calendar year prior to such adjustment year.”²⁹ This rate is comparable (although not identical) to the rate determined under prior law section 846(c)(2) for discounting the unpaid losses of insurance companies for federal income tax purposes.³⁰
 - “Adjustment year” is defined as the calendar year following any calendar year that includes the effective date of a change in the prescribed U.S. valuation interest rate for life insurance with guaranteed durations of more than 20 years, determined in accordance with the Standard Valuation Law (which is prescribed in the *Valuation Manual*).³¹

The year 2022 will be an adjustment year because of a prescheduled decrease in the 7702 VIR for contracts issued in 2021. Because the 7702 VIR and 7702 AFR are based on rates from prior years, it already is known that a 2 percent insurance interest rate will apply for contracts issued in 2022. Also, as indicated above, a special transition rule enacted by the CAA prescribes use of an insurance interest rate of 2 percent for contracts issued in 2021. The result is that a 2 percent floor rate will apply for the NSP, GLP, and 7-pay premiums and a 4 percent floor rate will apply for the GSP in both 2021 and 2022.³²

The previously described mechanics of how the floor interest rates will change mean that insurers will have around 18 months' notice before any future change, providing insurers a reasonable period of time to prepare for future floor rate changes. However, unlike transitions in CSO tables or nonforfeiture law interest rates, there will be no transition period of a year or more during which either the old or new rules may be used. Rather, changes in the floor rates in response to an adjustment year will be point in time: contracts issued before the transition date will be subject to the old rules, and those issued on and after that date will be subject to the new rules. Company procedures will need to carefully control the assignment of issue dates to contracts during such transitions to ensure that foot-fault errors do not arise.

In the past, the IRS annually published the rate previously described as the 7702 VIR for the guidance of insurers seeking to comply with the rules of section 807(d) prior to its amendment in 2017. Also, to aid compliance with the tax law's unpaid loss

²⁷ IRC § 7702(f)(11)(B) as added by CAA § 205(d).

²⁸ *Valuation Manual*, VM-20, § 3.C.2 (Washington, DC: National Association of Insurance Commissioners, Jan. 1, 2021).

²⁹ IRC § 7702(f)(11)(C) as added by CAA § 205(d).

³⁰ See IRC § 846(c)(2) prior to its amendment by TCJA § 13523(a).

³¹ IRC § 7702(f)(11)(D) as added by CAA § 205(d).

³² IRC § 7702(f)(11)(E).

discounting rules, the IRS annually published the section 846(c)(2) rate, which was comparable to the 7702 AFR. Hence, in parallel with past practice, the IRS may find it appropriate to publish the new section 7702 floor rates and their determinants.

The CAA's amendments will increase the federal tax law's funding limits for life insurance contracts issued beginning in 2021. Although the degree of increase will vary based on issue age, sex, and other factors, NSPs and GSPs typically will increase from around 35 percent to 100 percent, with increases being the most substantial at younger issue ages. Also, increases for GLPs typically will range from 20 percent to 70 percent. Insofar as these amendments alleviate the divergence between the prior law's floor rates and the current, persistent low interest rate environment, they will enable contracts to be funded so that they may mature on their guarantees. Thus, there likely will be less need for contracts to rely upon no-lapse or similar secondary guarantees or on the rules of section 7702(f)(6) (see Chapter 2, page 33) in order to remain in force in the future.³³

As previously noted, the CAA's amendments apply to contracts issued on or after January 1, 2021, rendering them effective for contracts now being issued.³⁴ It is important to note that the new floor rates under sections 7702 and 7702A may go down or up. That is, in a rising interest rate environment, the floor rates will adjust up at some point in time, which would mean that less premium and accumulated cash value would be allowed for newly issued contracts. The new adjustment rules are expected to go in both directions, which makes sense in terms of allowing appropriate funding of life insurance for the economic environment in which the contract is issued. The new floor rates will not, however, exceed those that applied when section 7702 was enacted, which also makes sense in that those floor rates were established in an environment of historically high interest rates.

While it is uncertain how frequently adjustment years will occur in the future and how the floor rates will change over time, Table 2.5.1 illustrates how the floor rates would have developed if the CAA's rules had been included in section 7702 as originally enacted. It is noteworthy that, while the valuation rate has changed and such changes would have resulted in adjustment years, the actual floor rates to be used for testing would have changed only twice, once in 2014 and again in 2022.

³³ The NAIC's *Valuation Manual* has been revised to remove a 4 percent floor nonforfeiture interest rate that previously has been implemented to prevent a conflict with the prior CVAT floor rate. The *Manual* now specifies a nonforfeiture floor rate equal to the new CVAT floor rate. See NAIC *Valuation Manual*, VM-02, § 3A (Jan. 1, 2021).

³⁴ CAA § 205(e).

Adjustment year	Prescribed U.S. valuation interest rate for life insurance with guaranteed durations >20 yrs.		7702 VIR	7702 AFR	Insurance interest rate	CVAT, GLP and MEC floor rates	GSP floor rate
	Rate	Year of change					
1988	5.50%	1987	5.50%	N/A	5.50%	4.00%	6.00%
1994	5.00%	1993	5.00%	8.00%	5.00%	4.00%	6.00%
1996	4.50%	1995	4.50%	7.00%	4.50%	4.00%	6.00%
2007	4.00%	2006	4.00%	4.00%	4.00%	4.00%	6.00%
2014	3.50%	2013	3.50%	3.00%	3.00%	3.00%	5.00%
2022	3.00%	2021	3.00%	2.00%	2.00%	2.00%	4.00%

Table 2.5 has been updated to include the NSP, NLP and 7-pay premium calculated with a 2% interest rate.

Interest	NSP	Ratio	NLP	Ratio	7-pay	Ratio
2%	491.21	—	18.93	—	74.99	—
3%	353.33	71.93%	15.91	84.05%	55.48	73.98%
4%	258.83	73.25%	13.43	84.41%	41.78	75.31%
5%	193.20	74.64%	11.40	84.88%	32.04	76.69%
6%	147.00	76.09%	9.75	85.53%	25.02	78.09%

Assumptions: 2017 CSO aggregate, ANB, endowment at age 100, curtate

Mortality (page 41)

The Permanent Mortality Rule (page 42)

Two significant changes for the permanent mortality rule specified in section 7702(c)(3)(B)(i) have occurred since the 2015 publication of the second edition of *Life Insurance & Modified Endowments*: the revision of the permanent mortality rule itself and the advent of the 2017 Commissioners' Standard Ordinary Mortality Tables (2017 CSO Tables).

Revision of the Permanent Mortality Rule

Revised wording of the rule: The TCJA revised the permanent mortality rule to require that the section 7702 (and 7702A) premium computations be based on:

(i) reasonable mortality charges which meet the requirements prescribed in regulations to be promulgated by the Secretary or that do not exceed the mortality charges specified in the prevailing commissioners' standard tables as defined in subsection (f)(10) [of section 7702]³⁵

Significantly, prior to this change, the reasonable mortality rule read differently. Below is the wording of the former rule with the TCJA's deletions shown by strikethroughs and the TCJA's additions shown in italics:

(i) reasonable mortality charges which meet the requirements ~~(if any)~~ prescribed in regulations *to be promulgated by the Secretary* ~~and which~~ ~~(except as provided in regulations)~~ *or that* do not exceed the mortality charges specified in the prevailing commissioners' standard tables ~~(as defined in section 807(d)(5)) as of the time the contract is issued~~ *subsection (f)(10)*

As enacted by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), section 7702(c)(3)(B)(i) expressly gave the Treasury Department regulatory authority (a) to prescribe requirements that mortality charges would need to meet, in addition to not exceeding the charges specified in the prevailing standard tables, in order to be considered reasonable mortality charges, and (b) to expand the scope of reasonable mortality charges to encompass charges exceeding those of the prevailing standard tables. With the wording changes just noted – specifically, the replacement of “and which” with “or that” – the revised rule removes the prior express authority of regulations to limit the mortality assumptions used in the premium computations to amounts less than those in the prevailing standard tables. Ultimately that authority, contemplated for use in regulations proposed in July 1991, was never exercised, particularly in light of objections that any such requirement would have made the section 7702 compliance of whole life insurance difficult if not impossible. The Treasury Department presumably retains authority, under its general authorization to issue interpretive guidance, to determine the meaning of “reasonable mortality charges . . . that do not exceed the mortality charges specified in the prevailing commissioners' standard tables.” Notice 2016-63, discussed later in this chapter, is an example of such guidance, although that notice may need to be updated to reflect the TCJA's changes.

The revised permanent mortality rule leaves in place the Treasury's express authority to define the circumstances in which mortality assumptions that exceed those in the prevailing standard tables are “reasonable” and thus may be used in the section 7702 and 7702A premium computations. These circumstances would occur, for example, under contracts insuring lives that are rated as substandard risks, and they could also arise under contracts issued in guaranteed-issue or simplified-issue cases. Substandard-risk and guaranteed-issue (common for group) contracts typically experience worse mortality than those that are fully underwritten, and efforts to streamline the underwriting and issuance of contracts in the individual market through the use of simplified techniques could result in some deterioration of mortality experience. In such cases, where mortality experience for these types of contracts exceeds the mortality in the prevailing tables, there is justification for Treasury guidance permitting the use of higher

³⁵ TCJA § 13517(a)(4)(A).

mortality assumptions in establishing compliance with sections 7702 and 7702A. Such guidance also would be appropriate in view of the historic role of the interim rule for mortality charges in TAMRA section 5011(c)(2), which presumably remains in effect in the absence of regulations. The exercise of the Treasury's authority also could be called upon, as has been the case in the past, to align the requirements of the reasonable mortality rule with the advent of new tables in circumstances where the three-year transition rule of new section 7702(f)(10) (discussed next) is inadequate to do so.

New section 7702(f)(10): While the wording of the reasonable mortality rule itself no longer refers to the use of the prevailing standard tables in effect "as of the time the contract is issued," the wording just quoted still applies to determine the tables to be used in the section 7702 and 7702A premium calculations. This is brought about by the wording imported into new section 7702(f)(10) from former section 807(d)(5)(A), which the TCJA repealed in connection with a rewrite of the life insurance reserve deduction rules. The new section 7702(f)(10), mirroring the wording of its predecessor, states that the prevailing standard tables are

the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued.³⁶

Section 7702(f)(10) then goes on to incorporate the three-year transition rule that previously appeared in section 807(d)(5)(B), also repealed by the TCJA, into the new section 7702-based definition of prevailing standard tables. The three-year rule enabled the former reserve deduction limit to be computed using a preexisting mortality table for three years after a new table had met the requirements to be considered "prevailing." To preserve this rule for the section 7702 and 7702A premium computations, the second sentence of new section 7702(f)(10) reads as follows:

If the prevailing commissioners' standard tables as of the beginning of any calendar year (hereinafter in this paragraph referred to as the "year of change") are different from the prevailing commissioners' standard tables as of the beginning of the preceding calendar year, the issuer may use the prevailing commissioners' standard tables as of the beginning of the preceding calendar year with respect to any contract issued after the change and before the close of the 3-year period beginning on the first day of the year of change.³⁷

While the TCJA brought the basic definition needed to allow the reasonable mortality rule to operate over to section 7702, it did not continue the "lowest reserves" rule of former section 807(d)(5)(E). That provision required insurers, in computing the limit on deductible reserves where more than one mortality table (or options under a table) met the prevailing standard tables definition, to use the table (and option) that "generally yields the lowest reserves." This additional requirement, coupled with the

³⁶ As added to IRC § 7702 by TCJA § 13517(a)(4)(A).

³⁷ As added to IRC § 7702 by TCJA § 13517(a)(4)(B).

instruction in section 7702 to use the prevailing standard tables in the premium computations, caused some speculation about whether the version of the prevailing standard tables that yielded the lowest reserves needed to be used for satisfying the reasonable mortality requirements of section 7702(c)(3)(B)(i) in the absence of the safe harbor notices published by the IRS.

In choosing to retain the concept of “prevailing commissioners’ standard tables” in the operation of the reasonable mortality rule, the TCJA seemingly took notice of the continuing use of such tables in the net premium reserve component of the annual statement “reported reserve” computed in accordance with chapter 20 of the new NAIC *Valuation Manual*, i.e., minimum reserve standards set forth in VM-20 (discussed further later in this chapter). Under VM-20, life insurance companies are generally required to calculate a net premium reserve for all life insurance contracts as part of the process for determining the reported reserve. Therefore, as long as the net premium reserve remains as a component of the calculation of the reported reserve for a life insurance contract under VM-20, and as long as the prevailing standard tables as defined in new section 7702(f)(10) are used in computing that component, the reasonable mortality rule should continue to function as it has over the past three decades.

Effective date of legislative changes: The change made to section 7702(c)(3)(B)(i) and the addition of section 7702(f)(10) “apply to taxable years beginning after December 31, 2017.”³⁸ Hence, these changes are now in effect. There could be questions about how this rule interacts with the original effective date of TAMRA’s reasonable mortality rule, which included the interim mortality rule. TAMRA’s effective date rules, for both section 7702 and section 7702A, were quite elaborate, and in the absence of any indication to the contrary—there is no legislative history associated with the permanent mortality rule change made by the TCJA—the interim mortality rule should continue to be in effect unless and until regulations are issued.

Advent of the 2017 CSO Tables

The 2017 CSO Tables became the “prevailing commissioners’ standard tables” under former section 807(d)(5)(A) effective January 1, 2017. The NAIC adopted the new tables as part of the *Valuation Manual* implemented under revisions made to the Standard Valuation Law in 2016. Under applicable state law, the 2017 CSO Tables *are permitted to be used* for contracts issued on or after January 1, 2017, and *must be used* for contracts issued on and after January 1, 2020. Section 7702(f)(10)—like its predecessor, former section 807(d)(5)—generally defines the prevailing commissioners’ standard tables as the most recent tables prescribed by the NAIC that are permitted to be used in computing reserves for the type of contract involved under the insurance laws of at least 26 states when the contract was issued; however, the revised Standard Valuation Law and the *Valuation Manual* adopted under it render the 26-state approval automatic when the NAIC adopts a new table, as explained further in the paragraphs that follow. Hence, the 2017 CSO Tables now serve as the limit under the permanent “reasonable mortality” rule of section 7702(c)(3)(B)(i) for the purposes of section 7702 and 7702A calculations in standard risk cases.

³⁸ TCJA § 13517(c)(1).

By way of background, a fundamental change in approach for establishing valuation standards for life insurance products, due in large part to the advent of principle-based reserving, was initiated by the NAIC's 2009 adoption of revisions to the Standard Valuation Law.³⁹ This was followed in December 2012 by the NAIC's adoption of the *Valuation Manual*, a technical how-to guide with specifics that allow actuaries and senior corporate management to implement principle-based reserving. After a lengthy state approval process that required adoption by a supermajority of NAIC jurisdictions (i.e., at least 42 eligible jurisdictions, including the states, the District of Columbia and certain U.S. territories) representing 75 percent of direct written premium, the *Valuation Manual* became operative on January 1, 2017.

The *Valuation Manual* changes the process used by the NAIC and the states for adopting new mortality tables. In the past, new tables were recognized by state legislation or regulatory action. For example, for the 2001 CSO Tables, the NAIC in 2002 adopted a regulation titled Recognition of the 2001 CSO Mortality Table for Use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits Model Regulation,⁴⁰ which required individual state approval; thus, there was a lengthy approval process before a majority of the states adopted the 2001 CSO Tables by mid-2004. Under the new approach, the NAIC will adopt new mortality tables via amendments to the *Valuation Manual* without the need for legislation or a regulatory proceeding in each state, significantly shortening the duration of the process for introducing new mortality tables.⁴¹ In particular, the *Valuation Manual* as currently adopted anticipates that such amendments will take effect automatically, so a change in mortality tables would be implemented based on the effective date of the *Valuation Manual* amendment, with no need for any state action.

The 2017 CSO Tables are the first standard mortality tables following the new adoption process.⁴² Because the *Valuation Manual*, including its incorporation of the 2017 CSO Tables, is in effect in more than 26 states, the 26-state approval requirement for the new tables was met when the *Valuation Manual* took effect on January 1, 2017. Hence, the new tables became "prevailing" within the meaning of section 7702(f)(10) (and former section 807(d)(5)(A)) and applicable under the permanent mortality rule for contracts

³⁹ MDL-820 (2010).

⁴⁰ MDL-814 (2003).

⁴¹ See § 11B and 11C of the Standard Valuation Law and the drafting note thereto; § 5cH(6) of the Standard Nonforfeiture Law for Life Insurance, MDL-808 (2014).

⁴² While the accelerated adoption process provided by the *Valuation Manual* is beneficial from an efficiency perspective, it raises concerns that it may not provide sufficient time for insurers to develop products and conform valuation and administrative systems to new tables. There also may be less time for the IRS to provide any needed guidance on new tables from both a valuation and product tax perspective. To alleviate some of these concerns, guidance notes were added to VM-02 and VM-20 of the *Valuation Manual* that recommend a time frame for new table adoption. For the 2017 CSO Tables, however, the permitted and mandatory use dates that were ultimately adopted did not adhere to this time frame, due in part to the NAIC's desire to have the permitted date for the 2017 CSO Tables coincide with the operative date of the *Valuation Manual*. As discussed next, this has not created a problem under section 7702 or 7702A due to the structure of the tax statutes and prompt action undertaken by the IRS.

issued on or after that date, subject to the three-year transition rule. The IRS has recognized this development, as discussed in the next part.

As illustrated in Table 2.A, mortality rates under the 2017 CSO Tables generally reflect an overall improvement in mortality relative to the 2001 CSO Tables, with improvements varying across attained age and risk class.

Attained age	Male nonsmoker			Female nonsmoker		
	2017 CSO	2001 CSO	%	2017 CSO	2001 CSO	%
25	0.79	1.00	79%	0.32	0.51	63%
45	1.87	2.44	77%	1.07	1.79	60%
65	8.39	16.23	52%	5.90	11.52	51%
85	87.97	119.83	73%	65.39	75.99	86%
	Male smoker			Female smoker		
25	1.01	1.67	60%	0.40	0.79	51%
45	3.46	4.78	72%	2.32	3.28	71%
65	20.79	27.69	75%	16.62	21.10	79%
85	117.49	146.24	80%	107.44	108.60	99%

As expected, the mortality improvements underlying the development of the 2017 CSO Tables reduce funding limitations under sections 7702 and 7702A relative to use of 2001 CSO Tables, with reductions to guideline, 7-pay and net single premiums generally in the range of 10–20 percent relative to their 2001 CSO Table counterparts (assuming consistent assumptions apply otherwise, including for interest). Table 2.B illustrates the relative reduction in the guideline single premium (GSP) for a sample contract across several different issue ages and risk classes assuming use of 6 percent interest (i.e., not reflecting changes to the floor interest rules made by the CAA). Insurers should expect reductions in the guideline level, 7-pay and net single premiums to be comparable to those for the GSP for most issue ages and risk classes.

Table 2.B. GSP per \$1,000 of death benefit						
Issue age	Male nonsmoker			Female nonsmoker		
	2017 CSO	2001 CSO	%	2017 CSO	2001 CSO	%
25	51.59	65.62	79%	41.85	54.42	77%
45	135.21	171.20	79%	113.60	146.58	78%
65	342.24	409.05	84%	300.25	349.52	86%
85	702.95	733.77	96%	661.37	668.86	99%
	Male smoker			Female smoker		
	2017 CSO	2001 CSO	%	2017 CSO	2001 CSO	%
25	74.47	90.36	82%	62.11	75.73	82%
45	192.11	221.52	87%	170.86	197.38	87%
65	438.70	470.37	93%	402.35	425.78	94%
85	731.37	758.00	96%	718.40	708.85	101%
<i>Assumptions: Annual curtate calculations, 6% interest, no expenses and an endowment age of 100</i>						

Table 2.6 (page 48 of the textbook) has been updated to reflect mortality rates from the 2017 CSO Tables.

Table 2.6. Comparison of mortality assumptions, 2017 CSO male aggregate, ANB						
Age	Annual mortality rate (1)	Monthly mortality rates		Annualized mortality rates		Ratio annualized arithmetic to exponential (4)/(5)
		Arithmetic method (2)	Exponential method (3)	Arithmetic method (4)	Exponential method (5)	
25	0.00106	0.000088	0.000088	0.001059	0.001060	100.0%
35	0.00139	0.000116	0.000116	0.001389	0.001390	99.9%
45	0.00254	0.000212	0.000212	0.002537	0.002540	99.9%
55	0.00405	0.000338	0.000338	0.004042	0.004050	99.8%
65	0.01064	0.000887	0.000891	0.010588	0.010640	99.5%
75	0.03006	0.002505	0.002540	0.029649	0.030060	98.6%
85	0.09127	0.007606	0.007944	0.087547	0.091270	95.9%
95	0.24714	0.020595	0.023379	0.220981	0.247140	89.4%

IRS Notice 2016-63 (page 47)

In the fall of 2016, before the TCJA amended the permanent mortality rule, the Treasury Department and the IRS issued Notice 2016-63⁴³ in response to the life insurance industry's request for guidance on the transition to the 2017 CSO Tables. Notice 2016-63—after recognizing that the new tables would become the prevailing commissioners' standard tables under former section 807(d)(5)(A) on January 1, 2017—restated the safe harbors established by Notices 88-128 and 2006-95. It generally retained the structure and rules of the latter notice, including the rules for the use of unisex/sex-distinct mortality tables and for unismoker/smoker-distinct mortality tables. Most significantly, Notice 2016-63 provided a new safe harbor enabling use of the 2017 CSO Tables, stating,

A mortality charge with respect to a life insurance contract will satisfy the requirements of § 7702(c)(3)(B)(i) [i.e., the permanent reasonable mortality rule] so long as (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 2017 CSO tables; (2) the mortality charge does not exceed the mortality charge specified in the contract at issuance; and (3) either (a) the contract is issued after December 31, 2019, or (b) the contract is issued before January 1, 2020, in a state that permits or requires the use of the 2017 CSO tables at the time the contract is issued.⁴⁴

Under this new safe harbor rule, the effective dates for use of the 2017 CSO Tables—permitted for contracts issued on or after January 1, 2017, and required for contracts issued on or after January 1, 2020—align perfectly with those under the *Valuation Manual*. This was not the case with the 2001 CSO Tables, and IRS action (via Notices 2004-61 and 2006-95) was needed to align the effective dates for section 7702 and 7702A purposes with those under state law. For the 2017 CSO Tables, the effective dates under the *Valuation Manual* were designed in light of the rules of former sections 807(d)(5)(A) and (B) (now section 7702(f)(10)).

With respect to the material-change rules that apply in determining a contract's issue date under the safe harbor rules, Notice 2016-63 also generally retained the structure and rules of Notice 2006-95. Thus, for purposes of the notice, contracts that are received in exchange for existing contracts will generally be treated as new contracts that are issued on the date of the exchange.⁴⁵ However, similar to Notice 2006-95, the new notice provided that a change in an existing contract is not considered to result in an exchange if the terms of the resulting contract (i.e., the amount and pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract and mortality and expense charges) are the same as the terms of the contract prior to the change.⁴⁶ Also, section 5.02 of the notice continued the rule from section 5.02 of Notice 2006-95, with modifications to take account of the 2017 CSO Tables, under which

⁴³ 2016-45 I.R.B. 683.

⁴⁴ Notice 2016-63 § 4.04.

⁴⁵ Notice 2016-63 § 5.01.

⁴⁶ *Id.*

if a life insurance contract satisfied [a safe harbor of the notice] when originally issued, a change from the previous tables to the 2001 or 2017 CSO tables is not required if: (1) the change, modification, or exercise of a right to modify or add benefits is pursuant to the terms of the contract; (2) the state in which the contract is issued does not require use of the 2001 or 2017 CSO tables for that contract under its standard valuation and minimum nonforfeiture laws; and (3) the contract continues upon the same policy form or blank.⁴⁷

The latter two requirements under this rule pertain to whether a contract is new under applicable law, which is relevant to the applicable law requirement of section 7702(a). The first requirement, relating to whether a change is “pursuant to the terms of the contract” has been criticized as unnecessarily restrictive, but in issuing the new notice, the IRS chose not to reconsider the prior rule generally at the present time. That said, the IRS implemented two significant modifications in Notice 2016-63 relative to the material-change rules of its predecessor:

- Notice 2016-63 provided that if the only change to an existing contract is a reduction or deletion of benefits provided under that contract, such a change will not affect the contract’s issue date for purposes of the notice’s safe harbors.⁴⁸ Thus, for example, if a life insurance contract does not provide a contractual right to reduce or decrease benefits (as is common with respect to the face amount of death benefit under ordinary whole life insurance contracts) and the insurer decides to permit such reductions or decreases, the change will not result in the contract being treated as a new issue for purposes of the notice.
- The examples in section 5.03 of Notice 2006-95 that illustrated the operation of section 5.02 of that same notice were modified in Notice 2016-63 to provide that the “changes, modifications, or exercises of contractual provisions referred to in section 5.02 of this notice include . . . reinstatement of a policy within 90 days after its lapse *or reinstatement of a policy as required under applicable state or foreign law*” (emphasis added).⁴⁹ The italicized language was not included in Notice 2006-95 and removes any implication that exercises of contractual rights as required by applicable law to reinstate benefits beyond the 90-day period referenced in the prior notice could result in new issue treatment.

Since the publication of Notice 2016-63 preceded the enactment of the TCJA, it does not reflect the change made to the section 7702(c)(3)(B)(i) permanent mortality rule.

Mortality Tables for Guaranteed Issue Contracts

The 2017 CSO Tables, as adopted, applied to all ordinary life insurance contracts, including those issued with limited underwriting. At the time of adoption, insurance companies raised concerns that the mortality rates in the 2017 CSO Tables were insufficient to cover the mortality risks associated with products involving limited

⁴⁷ Notice 2016-63 § 5.02.

⁴⁸ *Id.* This effectively reverses the result in PLR 201230009 (Jan. 30, 2012).

⁴⁹ Notice 2016-63 § 5.03.

underwriting, particularly guaranteed issue (GI) business.⁵⁰ In response, the SOA was tasked with developing a mortality table reflective of mortality experience for GI life business, resulting in the development of the 2017 Commissioners Standard Guaranteed Issue (CSGI) Mortality Table. Following its development, the NAIC amended VM-02 in August 2018, approving the 2017 CSGI Mortality Table for guaranteed issue life business. However, regulators expressed concerns over the use of the 2017 CSGI Tables resulting in the NAIC reversing course with the 2017 CSGI Table and reverting to the 2001 CSO ultimate table for guaranteed issue life business. As amended in August 2019, VM-02 now requires the 2001 CSO ultimate table to be used for GI policies issued starting January 1, 2020.

As a result of the changes to VM-02, the valuation mortality tables for GI life business has taken a somewhat circuitous path after the adoption of the 2017 CSO Tables, both starting with and ending with the 2001 CSO ultimate tables. To summarize, the prevailing mortality tables under section 7702(f)(10) (and former section 807(d)(5)(A)) for guaranteed issue life business are as follows:

- For guaranteed issue life business issued January 1, 2017 through December 31, 2019, the company may elect to use the 2017 CSO Tables instead of the 2001 CSO ultimate tables, consistent with the transition rules applicable to non-guaranteed issue life business.
- For policies issued in 2019, a company may elect to use the 2017 CSGI Tables instead of the 2001 CSO ultimate tables.
- For policies issued after December 31, 2019, a company is required to use the ultimate form of the 2001 CSO Table.

In 2020, the NAIC formed a Guaranteed Issue Life Valuation Subgroup to provide recommendations regarding the valuation requirements for GI life business,

⁵⁰ The *Valuation Manual*, at VM-01, defines the term “guaranteed issue (GI) life insurance policy” to mean a life insurance policy or certificate where the applicant must be accepted for coverage if the applicant is eligible. Additionally, the following must hold:

- Eligibility requirements may include being within a specified age range and/or being an active member in an eligible group (e.g., group solicitation in direct marketing).
- Inclusion of any of the following characteristics or product types disqualifies the policy as GI:
 - Actively-at-work requirement
 - Employer groups
 - Acceptance based on any health-related questions or information
 - Waiving of underwriting requirements based on minimum participation thresholds, such as for worksite marketing
 - Corporate-owned life insurance (COLI) or bank-owned life insurance (BOLI)
 - Credit life insurance
 - Juvenile-only products (e.g., under age 15)
 - Prenatal life insurance
 - Policies and certificates issued as a result of exercising a provision (e.g., conversion or guaranteed insurability option riders) from a policy, rider or certificate that do not qualify as GI life insurance.

including any appropriate mortality table(s) for valuation as well as nonforfeiture. Initial recommendations are expected in the summer of 2021.

Appendix 2.3. Payment of Death Claims (page 63)

In view of the CAA's amendments, Tables 2.9 (page 64) and 2.10 (page 65) should be read as employing the new maximum floor interest rates for the section 7702 and 7702A calculations.

Chapter 3

COMPONENTS OF SECTION 7702 AND 7702A CALCULATIONS

Section 7702(e)(2)(A) and (B) Alternative Death Benefit Rules (page 79)

In view of the CAA's amendments, Table 3.1 (page 80) should be read as employing the new maximum floor interest rates for the section 7702 and 7702A calculations.

Qualified Additional Benefits (page 84)

In view of the CAA's amendments, Table 3.4 (page 88) should be read as employing the new maximum floor interest rates for the section 7702 calculations.

Mortality Rates Beyond Age 100 (page 92)

Revenue Procedure 2010-28 (page 93)

In February 2018, the IRS issued Revenue Procedure 2018-20⁵¹ to update the safe harbor rules established in Revenue Procedure 2010-28 in light of the advent of the 2017 CSO Tables. The 2010 revenue procedure's safe harbor rules addressed calculations of net single premiums and guideline premiums under section 7702 and 7-pay premiums and necessary premiums under section 7702A in the case of life insurance contracts that (1) have mortality guarantees based on the 2001 CSO Tables and (2) may continue in force after the day on which the insured attains age 100. Under Revenue Procedure 2018-20, these safe harbor rules are extended to "life insurance contracts that have mortality guarantees based upon not only the 2001 CSO tables, but also upon the 2017 CSO tables and any other prevailing commissioners' standard tables that extend beyond age 100."⁵²

The issuance of Revenue Procedure 2010-28 had seemingly settled questions regarding section 7702's age 100 maximum maturity date requirement under contracts based on the 2001 CSO Tables. However, with the advent of the 2017 CSO Tables when VM-20 became effective on January 1, 2017, the earlier questions again became pertinent because the terms of the 2010 revenue procedure addressed only contracts based on the 2001 CSO Tables.

Revenue Procedure 2018-20 recites the history of and rationale for the issuance of the 2010 revenue procedure, again acknowledging (as did its predecessor) the role played by the SOA Task Force in formulating the Age 100 Safe Harbor Testing Methodologies. The new procedure restates all those methodologies in full, as it now (effective February 23, 2018) replaces its predecessor as the official statement of the age 100 testing methodologies; that is, Revenue Procedure 2018-20 "modifies and supersedes" Revenue

⁵¹ 2018-11 I.R.B. 427.

⁵² Rev. Proc. 2018-20 § 1.

Procedure 2010-28.⁵³ Additionally, the new procedure repeats verbatim the “no inference” provision of its predecessor.⁵⁴

Of most importance, Revenue Procedure 2018-20 extends the Age 100 Safe Harbor Testing Methodologies and the “no inference” provision to the 2017 CSO Tables and to all future CSO tables that provide mortality rates beyond age 100. To quote from the operative wording of the new procedure, the safe harbor provided under its predecessor is made available “to life insurance contracts that (1) have mortality guarantees based upon prevailing commissioners’ standard tables that extend beyond age 100, such as the 2001 CSO tables and the 2017 CSO tables, and (2) may continue in force after the day on which the insured individual attains age 100.”⁵⁵ In this connection, Revenue Procedure 2018-20 cites to the meaning of “prevailing commissioners’ standard tables” as defined in section 7702(f)(10) as added by the TCJA.⁵⁶

Substandard Mortality (page 97)

For the continuing effect of the interim mortality rule after the amendment of section 7702(c)(3)(B)(i) by the TCJA, see the earlier discussion regarding the effective date of the changes made to the permanent mortality rule.

⁵³ See *id.* §§ 4 and 5.

⁵⁴ See Rev. Proc. 2018-20 § 3.03.

⁵⁵ Rev. Proc. § 2.12.

⁵⁶ *Id.* § 1.

ADJUSTING THE LIMITATIONS UNDER SECTIONS 7702 AND 7702A

Guideline Premium Test Adjustments (page 105)

Section 7702 Adjustment Method: The Attained Age Increment and Decrement Rule (page 109)

In view of the CAA's amendments, Figure 4.1 (page 110) should be read as employing the new maximum floor interest rates for the section 7702 calculations.

Timing of Adjustments to the Guideline Premiums (page 112)

Equation 4.4 on page 114, which details formulas for one version of the "exact approach" for adjusting guideline premiums, should read as follows:

- A "level" premium P is computed so that the future contract benefits are funded by the combination of (a) and (b), where
 - (a) equals $(n/12)$ times P , assumed to be paid at time of adjustment, and
 - (b) equals P , assumed to be paid at each subsequent anniversary.

P is then found by solving:

$$\left(\frac{n}{12}\right) \times P + \frac{(1-q^m)^n}{(1+im)^n} \times (P \times \ddot{a}_{x+t}) = NSP_{x+t-n} \text{ (as defined above)} \quad (4.4)$$

Chapter 5

**STATUTORY EFFECTIVE DATES AND THE
IMPACT OF MATERIAL CHANGES**

Material Changes and the Section 7702 Effective Date Rule (page 155)

Footnote 28 on page 156 should be updated to include PLR 201736019 (June 15, 2017) and PLR 202018003 (Jan. 31, 2020).

Chapter 6

PRODUCT-SPECIFIC ISSUES

Multiple-Life Plans (page 180)

In view of the CAA's amendments, Table 6.1 (page 182) should be read as employing the new maximum floor interest rate for the NSPs.

Chapter 7

**LONG-TERM CARE INSURANCE RIDERS
AND ACCELERATED DEATH BENEFITS**

No updates have been made to this chapter.

Chapter 8

FAILED CONTRACTS AND INADVERTENT MODIFIED ENDOWMENT CONTRACTS

Correction of Inadvertent MECs (page 286)

Table 8.3. Earnings Rates to Be Used to Calculate Either Excess Earnings or Overage Earnings (pages 290–91)

Table 8.3 updates the table published in the textbook and contains the earnings rates for years 1982–2021. The earnings rates for years 1982–1987 and 2008–2020 are based on the application of the formulas contained in Revenue Procedure 2008-39, while the earnings rate for 2021 is based on the arithmetic average of the earnings rates for the prior three years (i.e., 2018–2020).

Table 8.3. Earnings rates to be used to calculate either excess earnings or overage earnings			
Year	Contracts other than variable contracts	Variable contracts	Source
1982	15.0%	21.8%	Application of Rev. Proc. 2008-39 section 3.07 formulas
1983	12.8%	16.4%	
1984	13.5%	7.0%	
1985	12.0%	26.1%	
1986	9.7%	15.0%	
1987	10.0%	2.7%	
1988	10.2%	13.5%	Rev. Proc. 2008-39
1989	9.7%	17.4%	
1990	9.8%	1.4%	
1991	9.2%	25.4%	
1992	8.6%	5.9%	
1993	7.5%	13.9%	
1994	8.3%	-1.0%	
1995	7.8%	23.0%	
1996	7.7%	14.3%	
1997	7.6%	17.8%	
1998	6.9%	19.7%	

1999	7.4%	12.8%	
2000	8.0%	-5.5%	
2001	7.5%	-7.1%	
2002	7.2%	-14.1%	
2003	6.2%	19.6%	
2004	6.1%	6.9%	
2005	5.6%	2.1%	
2006	6.0%	10.0%	
2007	6.0%	3.6%	
2008	6.5%	-28.1%	
2009	6.3%	20.7%	
2010	5.5%	10.6%	
2011	5.2%	1.4%	
2012	4.3%	11.3%	
2013	4.7%	19.8%	
2014	4.5%	9.2%	
2015	4.4%	-1.0%	
2016	4.2%	7.6%	
2017	4.1%	14.4%	
2018	4.4%	-5.3%	
2019	3.9%	22.6%	
2020	3.0%	12.7%	
2021	3.8%	10.0%	Average of prior 3 years

Table 8.4. Sample Calculations of Overage Earnings (page 291)

Table 8.4 illustrates the calculation of overage earnings. The example details the calculation of the overage earnings through the end of the 7-pay test period, which expired on December 31, 2004. (The table that follows corrects a numerical error in Table 8.4 as published in the textbook.)

Table 8.4. Sample calculations of overage earnings, Rev. Proc. 2008-39 closing agreement								
Policy number: ABC123				Death benefit: 10,000.00				
Original issue date: 1/1/1998				Reason for MEC failure: Early premium				
Beginning of contract year	7-pay year	Transaction date	Transaction amount	Cumulative amounts paid	Cumulative 7-pay premium	Overage	Earnings rate	Overage earnings
1/1/1998	1	1/1/1998	1,142.00	1,142.00	1,142.00	0.00	6.9%	0.00
1/1/1998	1	12/26/1998	1,142.00	2,284.00	1,142.00	1,142.00	6.9%	1.25
1/1/1999	2	1/1/1999	0.00	2,284.00	2,284.00	0.00	7.4%	0.09
1/1/2000	3	1/1/2000	1,142.00	3,426.00	3,426.00	0.00	8.0%	0.11
1/1/2000	3	12/25/2000	1,142.00	4,568.00	3,426.00	1,142.00	8.0%	1.69
1/1/2001	4	1/1/2001	0.00	4,568.00	4,568.00	0.00	7.5%	0.24
1/1/2002	5	1/1/2002	1,142.00	5,710.00	5,710.00	0.00	7.2%	0.24
1/1/2002	5	12/30/2002	1,142.00	6,852.00	5,710.00	1,142.00	7.2%	0.44
1/1/2003	6	1/1/2003	0.00	6,852.00	6,852.00	0.00	6.2%	0.25
1/1/2004	7	1/1/2004	1,142.00	7,994.00	7,994.00	0.00	6.1%	0.26
Income on the contract:			0.00	Income tax:			0.00	
Total taxable distributions:			0.00	Penalty tax:			0.00	
Overage earnings allocated to prior distribution:			0.00	Deficiency interest:			0.00	
Distribution frequency factor:			0.80					
Applicable percentage:			15%	Total overage earnings:			4.57	

Chapter 9

THE DEVELOPMENT OF THE TAX LAW'S LIMITATIONS ON LIFE INSURANCE

The Development of the Tax Law's Limitations on Life Insurance: History and Precedents (page 295)

As discussed in the update to Chapter 2, the TCJA altered the wording of the permanent mortality rule in section 7702(c)(3)(B)(i). The TCJA also imported into new section 7702(f)(10) the provisions regarding the prevailing commissioners' standard tables previously found in section 807(d)(5)(A) and (B). Further, the CAA altered the floor interest rates for the section 7702 and 7702A calculations to address the disparity between the floor rates enacted in the 1980s and the interest rate environment circa 2020.

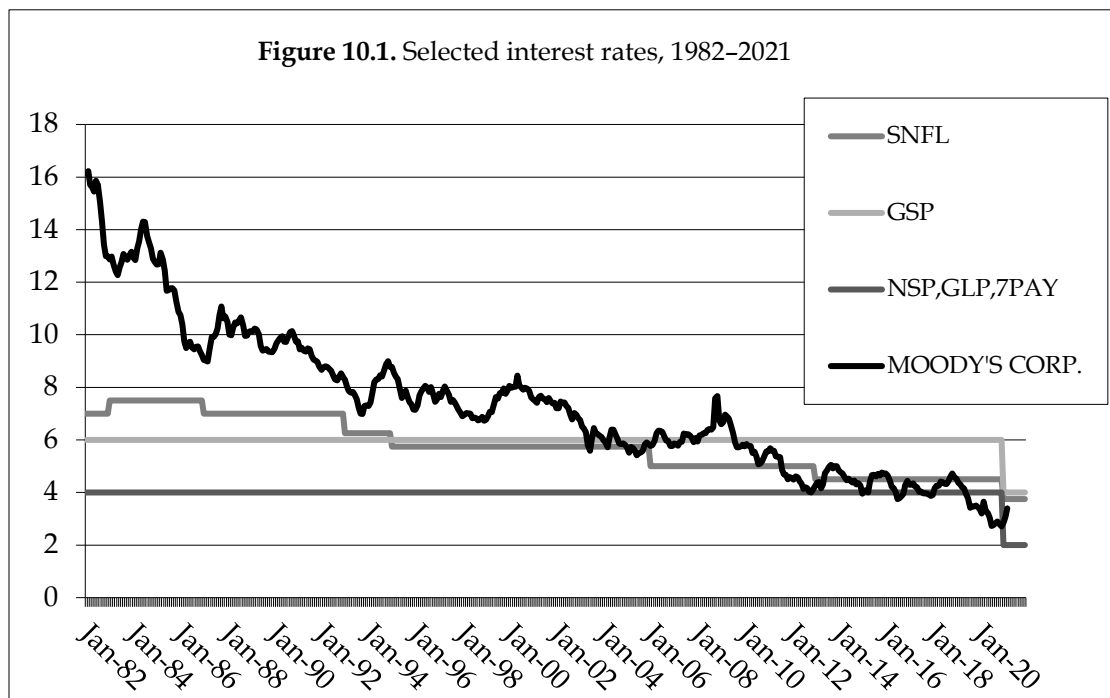
Chapter 10

TAX POLICY AND THE TAXATION OF LIFE INSURANCE CONTRACTS

The Limitations on Inside Buildup (page 326)

Table 10.1 (page 330) and Figure 10.1 (page 330) have been updated to reflect CAA's amendments, in addition to the other applicable interest rates.

Years	Nonforfeiture rates	GSP floor rate	GLP, NSP and 7-pay floor rate
1982	7.00%	6.00%	4.00%
1983-1986	7.50%	6.00%	4.00%
1987-1992	7.00%	6.00%	4.00%
1993-1994	6.25%	6.00%	4.00%
1995-2005	5.75%	6.00%	4.00%
2006-2012	5.00%	6.00%	4.00%
2013-2020	4.50%	6.00%	4.00%
2021	3.75%	4.00%	2.00%



In view of the CAA's amendments, Figure 10.2 (page 331) should be read as employing the new maximum floor interest rate for the NSPs.

GLOSSARY

ACTUARIAL ASSUMPTIONS (page 338): The second and third sentences are replaced by the discussions of interest rates and mortality assumptions under Chapter 2 above.

PERMANENT MORTALITY RULE (page 347): The definition is replaced by the discussion of the mortality rule under Chapter 2 above.

PREVAILING TABLES (page 348): The 2001 CSO Tables were replaced as the prevailing tables by the 2017 CSO Tables as discussed under Chapter 2 above.

REV. PROC. 2010-28 (page 350): This Revenue Procedure was updated and superseded by Rev. Proc. 2018-20 as discussed under Chapter 3 above.

Appendix A
IRC SECTION 7702

Appendix A has been updated in its entirety to reflect the changes made to section 7702 since the 2015 publication of the second edition of *Life Insurance & Modified Endowments*.

SECTION 7702. LIFE INSURANCE CONTRACT DEFINED

(a) **GENERAL RULE.** – For purposes of this title, the term “life insurance contract” means any contract which is a life insurance contract under the applicable law, but only if such contract –

(1) meets the cash value accumulation test of subsection (b), or

(2)
(A) meets the guideline premium requirements of subsection (c), and

(B) falls within the cash value corridor of subsection (d).

(b) **CASH VALUE ACCUMULATION TEST FOR SUBSECTION (a)(1)** –

(1) **IN GENERAL.** – A contract meets the cash value accumulation test of this subsection if, by the terms of the contract, the cash surrender value of such contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.

(2) **RULES FOR APPLYING PARAGRAPH (1).** – Determinations under paragraph (1) shall be made –

(A) on the basis of interest at the greater of the applicable accumulation test minimum rate or the rate or rates guaranteed on issuance of the contract,

(B) on the basis of the rules of subparagraph (B)(i) (and, in the case of qualified additional benefits, subparagraph (B)(ii)) of subsection (c)(3), and

(C) by taking into account under subparagraphs (A) and (D) of subsection (e)(1) only current and future death benefits and qualified additional benefits.

(3) **APPLICABLE ACCUMULATION TEST MINIMUM RATE.** – For purposes of paragraph (2)(A), the term “applicable accumulation test minimum rate” means the lesser of –

(A) an annual effective rate of 4 percent, or

(B) the insurance interest rate (as defined in subsection (f)(11)) in effect at the time the contract is issued.

(c) GUIDELINE PREMIUM REQUIREMENTS. — For purposes of this section —

(1) IN GENERAL. — A contract meets the guideline premium requirements of this subsection if the sum of the premiums paid under such contract does not at any time exceed the guideline premium limitation as of such time.

(2) GUIDELINE PREMIUM LIMITATION. — The term “guideline premium limitation” means, as of any date, the greater of —

(A) the guideline single premium, or

(B) the sum of the guideline level premiums to such date.

(3) GUIDELINE SINGLE PREMIUM. —

(A) IN GENERAL. — The term “guideline single premium” means the premium at issue with respect to future benefits under the contract.

(B) BASIS ON WHICH DETERMINATION IS MADE. — The determination under subparagraph (A) shall be based on —

(i) reasonable mortality charges which meet the requirements prescribed in regulations to be promulgated by the Secretary or that do not exceed the mortality charges specified in the prevailing commissioners’ standard tables as defined in subsection (f)(10),

(ii) any reasonable charges (other than mortality charges) which (on the basis of the company's experience, if any, with respect to similar contracts) are reasonably expected to be actually paid, and

(iii) interest at the greater of the applicable guideline premium minimum rate or the rate or rates guaranteed on issuance of the contract.

(C) WHEN DETERMINATION MADE. — Except as provided in subsection (f)(7), the determination under subparagraph (A) shall be made as of the time the contract is issued.

(D) SPECIAL RULES FOR SUBPARAGRAPH (B)(ii). —

(i) CHARGES NOT SPECIFIED IN THE CONTRACT. — If any charge is not specified in the contract, the amount taken into account under subparagraph (B)(ii) for such charge shall be zero.

(ii) NEW COMPANIES, ETC. — If any company does not have adequate experience for purposes of the determination under subparagraph (B)(ii),

to the extent provided in regulations, such determination shall be made on the basis of the industry-wide experience.

(E) **APPLICABLE GUIDELINE PREMIUM MINIMUM RATE.**—For purposes of subparagraph (B)(iii), the term “applicable guideline premium minimum rate” means the applicable accumulation test minimum rate (as defined in subsection (b)(3)) plus 2 percentage points.

(4) **GUIDELINE LEVEL PREMIUM.**—The term “guideline level premium” means the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis as the guideline single premium, except that paragraph (3)(B)(iii) shall be applied by substituting “the applicable accumulation test minimum rate” for “the applicable guideline premium minimum rate”.

(d) **CASH VALUE CORRIDOR FOR PURPOSES OF SUBSECTION (a)(2)(B).**—For purposes of this section—

(1) **IN GENERAL.**—A contract falls within the cash value corridor of this subsection if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value.

(2) **APPLICABLE PERCENTAGE.**—

In the case of an insured with an attained age as of the beginning of the contract year of:		The applicable percentage shall decrease by a ratable portion for each full year:	
More than:	But not more than:	From:	To:
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

(e) COMPUTATIONAL RULES. —

- (1) IN GENERAL. — For purposes of this section (other than subsection (d)) —
 - (A) the death benefit (and any qualified additional benefit) shall be deemed not to increase,
 - (B) the maturity date, including the date on which any benefit described in subparagraph (C) is payable, shall be deemed to be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100,
 - (C) the death benefits shall be deemed to be provided until the maturity date determined by taking into account subparagraph (B), and
 - (D) the amount of any endowment benefit (or sum of endowment benefits, including any cash surrender value on the maturity date determined by taking into account subparagraph (B)) shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract.
- (2) LIMITED INCREASES IN DEATH BENEFIT PERMITTED. — Notwithstanding paragraph (1)(A) —
 - (A) for purposes of computing the guideline level premium, an increase in the death benefit which is provided in the contract may be taken into account but only to the extent necessary to prevent a decrease in the excess of the death benefit over the cash surrender value of the contract,
 - (B) for purposes of the cash value accumulation test, the increase described in subparagraph (A) may be taken into account if the contract will meet such test at all times assuming that the net level reserve (determined as if level annual premiums were paid for the contract over a period not ending before the insured attains age 95) is substituted for the net single premium,
 - (C) for purposes of the cash value accumulation test, the death benefit increases may be taken into account if the contract —
 - (i) has an initial death benefit of \$5,000 or less and a maximum death benefit of \$25,000 or less,
 - (ii) provides for a fixed predetermined annual increase not to exceed 10 percent of the initial death benefit or 8 percent of the death benefit at the end of the preceding year, and
 - (iii) was purchased to cover payment of burial expenses or in connection with prearranged funeral expenses.

For purposes of subparagraph (C), the initial death benefit of a contract shall be determined by treating all contracts issued to the same contract owner as 1 contract.

(f) OTHER DEFINITIONS AND SPECIAL RULES. — For purposes of this section —

(1) PREMIUMS PAID. —

(A) IN GENERAL. — The term “premiums paid” means the premiums paid under the contract less amounts (other than amounts includible in gross income) to which section 72(e) applies and less any excess premiums with respect to which there is a distribution described in subparagraph (B) or (E) of paragraph (7) and any other amounts received with respect to the contract which are specified in regulations.

(B) TREATMENT OF CERTAIN PREMIUMS RETURNED TO POLICYHOLDER. — If, in order to comply with the requirements of subsection (a)(2)(A), any portion of any premium paid during any contract year is returned by the insurance company (with interest) within 60 days after the end of a contract year, the amount so returned (excluding interest) shall be deemed to reduce the sum of the premiums paid under the contract during such year.

(C) INTEREST RETURNED INCLUDIBLE IN GROSS INCOME. — Notwithstanding the provisions of section 72(e), the amount of any interest returned as provided in subparagraph (B) shall be includible in the gross income of the recipient.

(2) CASH VALUES. —

(A) CASH SURRENDER VALUE. — The cash surrender value of any contract shall be its cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends.

(B) NET SURRENDER VALUE. — The net surrender value of any contract shall be determined with regard to surrender charges but without regard to any policy loan.

(3) DEATH BENEFIT. — The term “death benefit” means the amount payable by reason of the death of the insured (determined without regard to any qualified additional benefits).

(4) FUTURE BENEFITS. — The term “future benefits” means death benefits and endowment benefits.

(5) QUALIFIED ADDITIONAL BENEFITS. —

(A) IN GENERAL. — The term “qualified additional benefits” means any —

- (i) guaranteed insurability,
- (ii) accidental death or disability benefit,
- (iii) family term coverage,
- (iv) disability waiver benefit, or
- (v) other benefit prescribed under regulations.

(B) TREATMENT OF QUALIFIED ADDITIONAL BENEFITS. — For purposes of this section, qualified additional benefits shall not be treated as future benefits under the contract, but the charges for such benefits shall be treated as future benefits.

(C) TREATMENT OF OTHER ADDITIONAL BENEFITS. — In the case of any additional benefit which is not a qualified additional benefit —

- (i) such benefit shall not be treated as a future benefit, and
- (ii) any charge for such benefit which is not prefunded shall not be treated as a premium.

(6) PREMIUM PAYMENTS NOT DISQUALIFYING CONTRACT. — The payment of a premium which would result in the sum of the premiums paid exceeding the guideline premium limitation shall be disregarded for purposes of subsection (a)(2) if the amount of such premium does not exceed the amount necessary to prevent the termination of the contract on or before the end of the contract year (but only if the contract will have no cash surrender value at the end of such extension period).

(7) ADJUSTMENTS. —

(A) IN GENERAL. — If there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under this section, there shall be proper adjustments in future determinations made under this section.

(B) RULE FOR CERTAIN CHANGES DURING FIRST 15 YEARS. — If —

- (i) a change described in subparagraph (A) reduces benefits under the contract,

- (ii) the change occurs during the 15-year period beginning on the issue date of the contract, and
 - (iii) a cash distribution is made to the policyholder as a result of such change, section 72 (other than subsection (e)(5) thereof) shall apply to such cash distribution to the extent it does not exceed the recapture ceiling determined under subparagraph (C) or (D) (whichever applies).
- (C) RECAPTURE CEILING WHERE CHANGE OCCURS DURING FIRST 5 YEARS. — If the change referred to in subparagraph (B)(ii) occurs during the 5-year period beginning on the issue date of the contract, the recapture ceiling is —
- (i) in the case of a contract to which subsection (a)(1) applies, the excess of —
 - (I) the cash surrender value of the contract, immediately before the reduction, over
 - (II) the net single premium (determined under subsection (b)), immediately after the reduction, or
 - (ii) in the case of a contract to which subsection (a)(2) applies, the greater of —
 - (I) the excess of the aggregate premiums paid under the contract, immediately before the reduction, over the guideline premium limitation for the contract (determined under subsection (c)(2), taking into account the adjustment described in subparagraph (A)), or
 - (II) the excess of the cash surrender value of the contract, immediately before the reduction, over the cash value corridor of subsection (d) (determined immediately after the reduction).
- (D) RECAPTURE CEILING WHERE CHANGE OCCURS AFTER 5TH YEAR AND BEFORE 16TH YEAR. — If the change referred to in subparagraph (B) occurs after the 5-year period referred to under subparagraph (C), the recapture ceiling is the excess of the cash surrender value of the contract, immediately before the reduction, over the cash value corridor of subsection (d) (determined immediately after the reduction and whether or not subsection (d) applies to the contract).
- (E) TREATMENT OF CERTAIN DISTRIBUTIONS MADE IN ANTICIPATION OF BENEFIT REDUCTIONS. — Under regulations prescribed by the Secretary, subparagraph (B) shall apply also to any distribution made in anticipation of a reduction in benefits under the contract. For purposes of the preceding sentence, appropriate adjustments shall be made in the provisions of subparagraphs (C) and (D); and any distribution which reduces the cash surrender value of a contract and which is made within 2 years before a reduction in benefits under the contract shall be treated as made in anticipation of such reduction.

- (8) CORRECTION OF ERRORS.—If the taxpayer establishes to the satisfaction of the Secretary that—
- (A) the requirements described in subsection (a) for any contract year were not satisfied due to reasonable error, and
 - (B) reasonable steps are being taken to remedy the error,
- the Secretary may waive the failure to satisfy such requirements.
- (9) SPECIAL RULE FOR VARIABLE LIFE INSURANCE CONTRACTS.—In the case of any contract which is a variable contract (as defined in section 817), the determination of whether such contract meets the requirements of subsection (a) shall be made whenever the death benefits under such contract change but not less frequently than once during each 12-month period.
- (10) PREVAILING COMMISSIONERS' STANDARD TABLES.—For purposes of subsection (c)(3)(B)(i), the term “prevailing commissioners' standard tables” means the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued. If the prevailing commissioners' standard tables as of the beginning of any calendar year (hereinafter in this paragraph referred to as the “year of change”) are different from the prevailing commissioners' standard tables as of the beginning of the preceding calendar year, the issuer may use the prevailing commissioners' standard tables as of the beginning of the preceding calendar year with respect to any contract issued after the change and before the close of the 3-year period beginning on the first day of the year of change.
- (11) INSURANCE INTEREST RATE.—For purposes of this section—
- (A) IN GENERAL.—The term “insurance interest rate” means, with respect to any contract issued in any calendar year, the lesser of—
 - (i) the section 7702 valuation interest rate for such calendar year (or, if such calendar year is not an adjustment year, the most recent adjustment year), or
 - (ii) the section 7702 applicable Federal interest rate for such calendar year (or, if such calendar year is not an adjustment year, the most recent adjustment year).
 - (B) SECTION 7702 VALUATION INTEREST RATE.—The term “section 7702 valuation interest rate” means, with respect to any adjustment year, the prescribed U.S. valuation interest rate for life insurance with guaranteed durations of more than 20 years (as defined in the National Association of Insurance

Commissioners' Standard Valuation Law) as effective in the calendar year immediately preceding such adjustment year.

- (C) SECTION 7702 APPLICABLE FEDERAL INTEREST RATE.—The term “section 7702 applicable Federal interest rate” means, with respect to any adjustment year, the average (rounded to the nearest whole percentage point) of the applicable Federal mid-term rates (as defined in section 1274(d) but based on annual compounding) effective as of the beginning of each of the calendar months in the most recent 60-month period ending before the second calendar year prior to such adjustment year.
- (D) ADJUSTMENT YEAR.—The term “adjustment year” means the calendar year following any calendar year that includes the effective date of a change in the prescribed U.S. valuation interest rate for life insurance with guaranteed durations of more than 20 years (as defined in the National Association of Insurance Commissioners' Standard Valuation Law).
- (E) TRANSITION RULE.—Notwithstanding subparagraph (A), the insurance interest rate shall be 2 percent in the case of any contract which is issued during the period that
- (i) begins on January 1, 2021, and
 - (ii) ends immediately before the beginning of the first adjustment year that begins after December 31, 2021.
- (g) TREATMENT OF CONTRACTS WHICH DO NOT MEET SUBSECTION (a) TEST.—
- (1) INCOME INCLUSION.—
- (A) IN GENERAL.—If at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year.
- (B) INCOME ON THE CONTRACT.—For purposes of this paragraph, the term “income on the contract” means, with respect to any taxable year of the policyholder, the excess of—
- (i) the sum of—
 - (I) the increase in the net surrender value of the contract during the taxable year, and

- (II) the cost of life insurance protection provided under the contract during the taxable year, over
 - (ii) the premiums paid (as defined in subsection (f)(1)) under the contract during the taxable year.

- (C) CONTRACTS WHICH CEASE TO MEET DEFINITION. — If, during any taxable year of the policyholder, a contract which is a life insurance contract under the applicable law ceases to meet the definition of life insurance contract under subsection (a), the income on the contract for all prior taxable years shall be treated as received or accrued during the taxable year in which such cessation occurs.

- (D) COST OF LIFE INSURANCE PROTECTION. — For purposes of this paragraph, the cost of life insurance protection provided under the contract shall be the lesser of —
 - (i) the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums (computed on the basis of 5-year age brackets) prescribed by the Secretary by regulations, or
 - (ii) the mortality charge (if any) stated in the contract.

- (2) TREATMENT OF AMOUNT PAID ON DEATH OF INSURED. — If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the excess of the amount paid by the reason of the death of the insured over the net surrender value of the contract shall be deemed to be paid under a life insurance contract for purposes of section 101 and subtitle B.

- (3) CONTRACT CONTINUES TO BE TREATED AS INSURANCE CONTRACT. If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), such contract shall, notwithstanding such failure, be treated as an insurance contract for purposes of this title.

- (h) ENDOWMENT CONTRACTS RECEIVE SAME TREATMENT. —
 - (1) IN GENERAL. — References in subsections (a) and (g) to a life insurance contract shall be treated as including references to a contract which is an endowment contract under the applicable law.
 - (2) DEFINITION OF ENDOWMENT CONTRACT. — For purposes of this title (other than paragraph (1)), the term “endowment contract” means a contract which is an endowment contract under the applicable law and which meets the requirements of subsection (a).

- (i) TRANSITIONAL RULE FOR CERTAIN 20-PAY CONTRACTS. —
- (1) IN GENERAL. — In the case of a qualified 20-pay contract, this section shall be applied by substituting “3 percent” for “4 percent” in subsection (b)(2).
 - (2) QUALIFIED 20-PAY CONTRACT. — For purposes of paragraph (1), the term “qualified 20-pay contract” means any contract which—
 - (A) requires at least 20 nondecreasing annual premium payments, and
 - (B) is issued pursuant to an existing plan of insurance.
 - (3) EXISTING PLAN OF INSURANCE. — For purposes of this subsection, the term “existing plan of insurance” means, with respect to any contract, any plan of insurance which was filed by the company issuing such contract in 1 or more States before September 28, 1983, and is on file in the appropriate State for such contract.
- (j) CERTAIN CHURCH SELF-FUNDED DEATH BENEFIT PLANS TREATED AS LIFE INSURANCE. —
- (1) IN GENERAL. — In determining whether any plan or arrangement described in paragraph (2) is a life insurance contract, the requirement of subsection (a) that the contract be a life insurance contract under applicable law shall not apply.
 - (2) DESCRIPTION. — For purposes of this subsection, a plan or arrangement is described in this paragraph if—
 - (A) such plan or arrangement provides for the payment of benefits by reason of the death of the individuals covered under such plan or arrangement, and
 - (B) such plan or arrangement is provided by a church for the benefit of its employees and their beneficiaries, directly or through an organization described in section 414(e)(3)(A) or an organization described in section 414(e)(3)(B)(ii).
 - (3) DEFINITIONS. — For purposes of this subsection—
 - (A) CHURCH. — The term “church” means a church or a convention or association of churches.
 - (B) EMPLOYEE. — The term “employee” includes an employee described in section 414(e)(3)(B).
- (k) REGULATIONS. — The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.

SOURCE

(Added Pub. L. 98-369, div. A, title II, Sec. 221(a), July 18, 1984, 98 Stat. 767; amended Pub. L. 99-514, title XVIII, Sec. 1825(a)-(c), Oct. 22, 1986, 100 Stat. 2846-2848; Pub. L. 100-647, title V, Sec. 5011(a), (b), title VI, Sec. 6078(a), Nov. 10, 1988, 102 Stat. 3660, 3661, 3709; Pub. L. 115-97, Title I, Sec. 13517(a)(4), Dec. 22, 2017, 131 Stat. 2146; Pub. L. 116-260, Div. EE, Title II, Sec. 205, Dec. 27, 2020, 134 Stat. 3058.)

AMENDMENTS

2020 – Subsec. (b)(2)(A). Pub. L. 116-260, Sec. 205(a)(1), struck “an annual effective rate of 4 percent” and inserted “the applicable accumulation test minimum rate”.

Subsec. (b)(3). Pub. L. 116-260, Sec. 205(a)(2), added paragraph (3).

Subsec. (c)(3)(B)(iii). Pub. L. 116-260, Sec. 205(b)(1), struck “an annual effective rate of 6 percent” and inserted “the applicable guideline premium minimum rate”.

Subsec. (c)(3)(E). Pub. L. 116-260, Sec. 205(b)(2), added subparagraph (E).

Subsec. (c)(4). Pub. L. 116-260, Sec. 205(c), struck “4 percent” and inserted “the applicable accumulation test minimum rate” and also struck “6 percent” and inserted “the applicable guideline premium minimum rate”.

Subsec. (f)(11). Pub. L. 116-260, Sec. 205(d), added paragraph (11).

2017 – Subsec. (c)(3)(B)(i). Pub. L. 115-97, Sec. 13517(a)(4)(A), amended clause (c)(3)(B)(i). Prior to the amendment, clause (c)(3)(B)(i) read as follows: “reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners’ standard tables (as defined in section 807(d)(5)) as of the time the contract is issued”.

Subsec. (f)(10). Pub. L. 115-97, Sec. 13517(a)(4)(B), added paragraph (f)(10).

1988 - Subsec. (c)(3)(B)(i), (ii). Pub. L. 100-647, Sec. 5011(a), added cls. (i) and (ii) and struck out former cls. (i) and (ii) which read as follows:

(i) the mortality charges specified in the contract (or, if none is specified, the mortality charges used in determining the statutory reserves for such contract),

(ii) any charges (not taken into account under clause (i)) specified in the contract (the amount of any charge not so specified shall be treated as zero), and.

Subsec. (c)(3)(D). Pub. L. 100-647, Sec. 5011(b), added subpar. (D).

Subsecs. (j), (k). Pub. L. 100-647, Sec. 6078(a), added subsec. (j) and redesignated former subsec. (j) as (k).

1986 - Subsec. (b)(2)(C). Pub. L. 99-514, Sec. 1825(a)(2), substituted “subparagraphs (A) and (D)” for “subparagraphs (A) and (C)”.

Subsec. (e)(1). Pub. L. 99-514, Sec. 1825(a)(3), inserted “(other than subsection (d))” after “section”.

Subsec. (e)(1)(B). Pub. L. 99-514, Sec. 1825(a)(1)(A), substituted “shall be deemed to be no earlier than” for “shall be no earlier than”.

Subsec. (e)(1)(C). Pub. L. 99-514, Sec. 1825(a)(1)(C), added subpar. (C). Former subpar. (C) redesignated (D).

Subsec. (e)(1)(D). Pub. L. 99-514, Sec. 1825(a)(1)(C), (D), redesignated subpar. (C) as (D) and substituted “the maturity date determined by taking into account subparagraph (B)” for “the maturity date described in subparagraph (B)”.

Subsec. (e)(2)(C). Pub. L. 99-514, Sec. 1825(a)(4), added subpar. (C).

Subsec. (f)(1)(A). Pub. L. 99-514, Sec. 1825(b)(2), substituted “less any excess premiums with respect to which there is a distribution described in subparagraph (B) or (E) of paragraph (7) and any other amounts received” for “less any other amounts received”.

Subsec. (f)(7). Pub. L. 99-514, Sec. 1825(b)(1), amended par. (7) generally. Prior to amendment, par. (7)(A), in general, read as follows: “In the event of a change in the future benefits or any qualified additional benefit (or in any other terms) under the contract which was not reflected in any previous determination made under this section, under regulations prescribed by the Secretary, there shall be proper adjustments in future determinations made under this section”, and par. (7)(B), certain changes treated as exchange, read as follows: “In the case of any change which reduces the future benefits under the contract, such change shall be treated as an exchange of the contract for another contract.”

Subsec. (g)(1)(B)(ii). Pub. L. 99-514, Sec. 1825(c), amended cl. (ii) generally. Prior to amendment, cl. (ii) read as follows “the amount of premiums paid under the contract during the taxable year reduced by any policyholder dividends received during such taxable year.”

EFFECTIVE DATES

2020 Amendment

Section 205(e) of Pub. L. 116-260 provided that: “The amendments made by this section shall apply to contracts issued after December 31, 2020.”

2017 Amendment

Section 13517(c)(1) of Pub. L. 115-97 provided that: “The amendments made by this section shall apply to taxable years beginning after December 31, 2017.”

1988 Amendment

Section 5011(d) of Pub. L. 100-647 provided that: “The amendments made by this section (amending this section) shall apply to contracts entered into on or after October 21, 1988.”

Section 6078(b) of Pub. L. 100-647 provided that: “The amendment made by subsection (a) (amending this section) shall take effect as if included in the amendment made by section 221(a) of the Tax Reform Act of 1984 (Pub. L. 98-369, which enacted this section).”

1986 Amendment

Section 1825(a)(4) of Pub. L. 99-514, as amended by Pub. L. 100-647, title I, Sec. 1018(j), Nov. 10, 1988, 102 Stat. 3583, provided that the amendment made by that section is effective with respect to contracts entered into after Oct. 22, 1986.

Amendment by section 1825(a)(1)-(3), (b), (c) of Pub. L. 99-514 effective, except as otherwise provided, as if included in the provisions of the Tax Reform Act of 1984, Pub. L. 98-369, div. A, to which such amendment relates; see section 1881 of Pub. L. 99-514, set out as a note under section 48 of this title.

Section 221(d) of Pub. L. 98-369, as amended by Pub. L. 99-514

Section 2, title XVIII, Sec. 1825(e), 1899A(69), Oct. 22, 1986, 100 Stat. 2095, 2848, 2962, provided that:

- (1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section (enacting this section and amending section 101 of this title and provisions set out as a note under section 101 of this title) shall apply to contracts issued after December 31, 1984, in taxable years ending after such date.
- (2) SPECIAL RULE FOR CERTAIN CONTRACTS ISSUED AFTER JUNE 30, 1984.—
 - (A) GENERAL RULE.—Except as otherwise provided in this paragraph, the amendments made by this section shall apply also to any contract issued after June 30, 1984, which provides an increasing death benefit and has premium funding more rapid than 10-year level premium payments.
 - (B) EXCEPTION FOR CERTAIN CONTRACTS.—Subparagraph (A) shall not apply to any contract if—
 - (i) such contract (whether or not a flexible premium contract) would meet the requirements of section 101(f) of the Internal Revenue Code of 1986 (formerly I.R.C. 1954),

- (ii) such contract is not a flexible premium life insurance contract (within the meaning of section 101(f) of such Code) and would meet the requirements of section 7702 of such Code determined by—
 - (I) substituting “3 percent” for “4 percent” in section 7702(b)(2) of such Code, and
 - (II) treating subparagraph (B) of section 7702(e)(1) of such Code as if it read as follows: “the maturity date shall be the latest maturity date permitted under the contract, but not less than 20 years after the date of issue or (if earlier) age 95” or
- (iii) under such contract—
 - (I) the premiums (including any policy fees) will be adjusted from time-to-time to reflect the level amount necessary (but not less than zero) at the time of such adjustment to provide a level death benefit assuming interest crediting and an annual effective interest rate of not less than 3 percent, or
 - (II) at the option of the insured, in lieu of an adjustment under subclause (I) there will be a comparable adjustment in the amount of the death benefit.
- (C) CERTAIN CONTRACTS ISSUED BEFORE OCTOBER 1, 1984. —
 - (i) IN GENERAL.—Subparagraph (A) shall be applied by substituting “September 30, 1984” for “June 30, 1984” in the case of a contract—
 - (I) which would meet the requirements of section 7702 of such Code if “3 percent” were substituted for “4 percent” in section 7702(b)(2) of such Code, and the rate or rates guaranteed on issuance of the contract were determined without regard to any mortality charges and any initial excess interest guarantees, and
 - (II) the cash surrender value of which does not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.
 - (ii) DEFINITIONS. — For purposes of clause (i) —
 - (I) IN GENERAL.—Except as provided in subclause (II), terms used in clause (i) shall have the same meaning as when used in section 7702 of the Code.

- (II) NET SINGLE PREMIUM.—The term “net single premium” shall be determined by substituting “3 percent” for “4 percent” in section 7702(b)(2) of such Code, by using the 1958 standard ordinary mortality and morbidity tables of the National Association of Insurance Commissioners, and by assuming a level death benefit.
- (3) TRANSITIONAL RULE FOR CERTAIN EXISTING PLANS OF INSURANCE.—A plan of insurance on file in 1 or more States before September 28, 1983, shall be treated for purposes of section 7702(i)(3) of such Code as a plan of insurance on file in 1 or more States before September 28, 1983, without regard to whether such plan of insurance is modified after September 28, 1983, to permit the crediting of excess interest or similar amounts annually and not monthly under contracts issued pursuant to such plan of insurance.
- (4) EXTENSION OF FLEXIBLE PREMIUM CONTRACT PROVISIONS.—The amendments made by subsection (b) (amending section 101 of this title and provisions set out as a note under section 101 of this title) shall take effect on January 1, 1984.
- (5) SPECIAL RULE FOR MASTER CONTRACT.—For purposes of this subsection, in the case of a master contract, the date taken into account with respect to any insured shall be the first date on which such insured is covered under such contract.

INTERIM RULES; REGULATIONS; STANDARDS BEFORE REGULATIONS TAKE EFFECT

Section 5011(c) of Pub. L. 100-647 provided that:

- (1) REGULATIONS.—Not later than January 1, 1990, the Secretary of the Treasury (or his delegate) shall issue regulations under section 7702(c)(3)(B)(i) of the 1986 Code (as amended by subsection (a)).
- (2) STANDARDS BEFORE REGULATIONS TAKE EFFECT.—In the case of any contract to which the amendments made by this section (amending this section) apply and which is issued before the effective date of the regulations required under paragraph (1), mortality charges which do not differ materially from the charges actually expected to be imposed by the company (taking into account any relevant characteristic of the insured of which the company is aware) shall be treated as meeting the requirements of clause (i) of section 7702(c)(3)(B) of the 1986 Code (as amended by subsection (a)).

TREATMENT OF FLEXIBLE PREMIUM CONTRACTS ISSUED DURING 1984 WHICH MEET NEW REQUIREMENTS

Section 221(b)(3) of Pub. L. 98-369, as added by Pub. L. 99-514, title XVIII, Sec. 1825(d), Oct. 22, 1986, 100 Stat. 2848, provided that: “Any flexible premium contract issued during 1984 which meets the requirements of section 7702 of the Internal Revenue Code of 1954

(now 1986) (as added by this section) shall be treated as meeting the requirements of section 101(f) of such Code.”

SECTION REFERRED TO IN OTHER SECTIONS

This section is referred to in sections 56, 72, 264, 817, 817A, 953, 7702A, 7702B of this title; title 15 section 6712.