[4830-01-p] Published May 7, 2003

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9058]

RIN 1545-AY48

Guidance Under Section 817A Regarding Modified Guaranteed Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations affecting insurance companies that define the interest rate to be used with respect to certain insurance contracts that guarantee higher returns for an initial, temporary period. Specifically, the final regulations define the appropriate interest rate to be used in the determination of tax reserves and required interest for certain modified guaranteed contracts. The final regulations also address how temporary guarantee periods that extend past the end of a taxable year are to be taken into account.

DATES: Effective Date: These regulations are effective as of May 7, 2003.

Applicability Date: For dates of applicability, see '1.817A-1(d).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Ann H. Logan, 202-622-3970 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On June 3, 2002, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-248110-96) under section 817A of the Internal Revenue Code (Code) in the **Federal Register** (67 FR 38214). The notice was corrected in the **Federal Register** (67 FR 41653) on June 19, 2002. The proposed regulations were designed, in part, to reflect the addition of section 817A to the Code by section 1612 of the Small Business Job Protection Act of 1996, Public Law 104-188 (110 Stat. 1755). No one requested to speak at the public hearing scheduled for August 27, 2002. Accordingly, the public hearing was canceled on August 15, 2002 (67 FR 53327). Comments in response to the notice of proposed rulemaking were received and are addressed in the following Explanation and Summary of Comments. After consideration of all the comments, this document adopts the proposed regulations as revised by this Treasury decision. In addition, previous guidance under section 817A is revoked.

Explanation and Summary of Comments

Two comments were filed with the Office of the Chief Counsel of the Internal Revenue Service. Both commentators generally agreed with the decisions incorporated in the proposed regulations. However, both commentators raised concern as to the interaction of the interest rates to be used for the reserve computations for modified guaranteed contracts (MGCs) with the reserve computation rules of section 811(d). That provision imposes an additional reserve computation rule for contracts that guarantee beyond the end of the taxable year payment or crediting of amounts in the nature of interest in excess of the greater of the prevailing state assumed interest rate or the applicable Federal interest rate. In those circumstances, section 811(d) requires that the contract's future guaranteed benefits be determined as though the interest in excess of the greater of the prevailing state assumed interest rate or the applicable Federal rate were guaranteed only to the end of the taxable year.

Material was submitted as to the possible distortion of taxable income with respect to MGCs in declining interest rate environments. Notably, in cases where the interest rate required to be used under the regulations as proposed falls below the contract crediting rate during the guarantee period, section 811(d) will operate in a manner that does not match taxable income to actual income. As section 811(d) precludes taking future guaranteed interest amounts into account, examples showed that income distortion could occur under this fact pattern.

After review of the comments, the proposed regulations have been amended to waive section 811(d) throughout the guarantee period of non-equity-indexed MGCs.

Effect on Other Documents

Notice 97-32 is revoked as of May 7, 2003**.** Accordingly, the Notice may continue to be used by taxpayers if they wish through the effective date of these final regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking were submitted to the Small Business Administration for comment on the regulations' impact on small business.

Drafting Information

The principal author of these proposed regulations is Ann H. Logan, Office of the Associate Chief Counsel (Financial Institutions and Products), Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part I

Income taxes, reporting and record keeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAX

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.807-2 also issued under 26 U.S.C. 817A(e) * * *
Section 1.811-3 also issued under 26 U.S.C. 817A(e) * * *
Section 1.812-9 also issued under 26 U.S.C. 817A(e) * * *

Section 1.817A-1 also issued under 26 U.S.C. 817A(e) * * *

Par. 2. Section 1.807-2 is added to read as follows:

'1.807-2 Cross-Reference.

For special rules regarding the treatment of modified guaranteed contracts (as defined in section 817A and '1.817A-1(a)(1)), see '1.817A-1.

Par. 3. Section 1.811-3 is added to read as follows:

'1.811-3 Cross-Reference.

For special rules regarding the treatment of modified guaranteed contracts (as defined in section 817A and '1.817A-1(a)(1)), see '1.817A-1.

Par. 4. Section '1.812-9 is added to read as follows:

'1.812-9 Cross-Reference.

For special rules regarding the treatment of modified guaranteed contracts (as defined in section 817A and '1.817A-1(a)(1)), see '1.817A-1.

Par. 5. Sections '1.817A-0 and '1.817A-1 are added to read as follows:

'1.817A-0 Table of contents.

This section lists the captions that appear in section '1.817A-1:

'1.817A-1 Certain modified guaranteed contracts.
(a) Definitions.
(1) Modified guaranteed contract.
(2) Temporary guarantee period.
(3) Equity-indexed modified guaranteed contract.
(4) Non-equity-indexed modified guaranteed contract.
(5) Current market rate for non-equity-indexed modified guaranteed contract.
(6) Current market rate for equity-indexed modified guaranteed contract.
[Reserved.]
(b) Applicable interest rates for non-equity-indexed modified guaranteed contracts.
(1) Tax reserves during temporary guarantee period.

(2) Required interest during temporary guarantee period.
(3) Application of section 811(d).
(4) Periods after the end of the temporary guarantee period.
(5) Examples.
(c) Applicable interest rates for equity-indexed modified guaranteed contracts. [Reserved.]
(d) Effective date.

'1.817A-1 Certain modified guaranteed contracts.

(a) Definitions--(1) Modified guaranteed contract. The term modified guaranteed contract (MGC) is defined in section 817A(d) as an annuity, life insurance, or pension plan contract (other than a variable contract described in section 817) under which all or parts of the amounts received under the contract are allocated to a segregated account. Assets and reserves in this segregated account must be valued from time to time with reference to market values for annual statement purposes. Further, an MGC must provide either for a net surrender value or for a policyholder's fund (as defined in section 807(e)(1)). If only a portion of a contract is not described in section 817, such portion is treated as a separate contract for purposes of applying section 817A.

(2) Temporary guarantee period. An MGC may temporarily guarantee a return other than the permanently guaranteed crediting rate for a period specified in the contract (the temporary guarantee period). During the temporary guarantee period, the amount paid to the policyholder upon surrender is usually increased or decreased by a market value adjustment, which is determined by a formula set forth under the terms of the MGC.

(3) <u>Equity-indexed modified guaranteed contract</u>. An equity-indexed MGC is an MGC, as defined in paragraph (a)(1) of this section, that provides a return during or at the end of the temporary guarantee period based on the performance of stocks, other equity instruments, or equity-based derivatives.

(4) <u>Non-equity-indexed modified guaranteed contract</u>. A non-equity-indexed MGC is an MGC, as defined in paragraph (a)(1) of this section, that provides a return during or at the end of the temporary guarantee period not based on the performance of stocks, other equity instruments, or equity-based derivatives.

(5) <u>Current market rate for non-equity-indexed modified guaranteed contracts</u>. The current market rate for a non-equity-indexed MGC issued by an insurer (whether issued in that tax year or a previous one) is the appropriate Treasury constant maturity interest rate published by the Board of Governors of the Federal Reserve System for the month containing the last day of the insurer's taxable year. The appropriate rate is that rate published for Treasury securities with the shortest published maturity that is greater than (or equal to) the remaining duration of the current temporary guarantee period under the MGC.

(6) <u>Current market rate for equity-indexed modified guaranteed contracts</u>. [Reserved]

(b) <u>Applicable interest rates for non-equity-indexed modified guaranteed contracts</u>--(1) <u>Tax reserves during temporary guarantee period</u>. An insurance company is required to determine the tax reserves for an MGC under sections 807(c)(3) or (d)(2). During a non-equity-indexed MGC's temporary guarantee period, the applicable interest rate to be used under sections 807(c)(3) and (d)(2)(B) is the current market rate, as defined in paragraph (a)(5) of this section.

(2) Required interest during temporary guarantee period. During the temporary guarantee period of a non-equity-indexed MGC, the applicable interest rate to be used to determine required interest under section 812(b)(2)(A) is the same current market rate, defined in paragraph (a)(5) of this section, that applies for that period for purposes of sections 807(c)(3) or (d)(2)(B).

(3) Application of section 811(d). An additional reserve computation rule applies under section 811(d) for contracts that guarantee certain interest payments beyond the end of the taxable year. Section 811(d) is waived for non-equity-indexed MGCs.

(4) Periods after the end of the temporary guarantee period. For periods after the end of the temporary guarantee period, sections 807(c)(3), 807(d)(2)(B), 811(d) and 812(b)(2)(A) are not modified when applied to non-equity-indexed MGCs. None of these sections are affected by the definition of current market rate contained in paragraph (a)(5) of this section once the temporary guarantee period has expired.

(5) Examples. The following examples illustrate this paragraph (b):

Example 1. (i) IC, a life insurance company as defined in section 816, issues a MGC (the Contract) on August 1 of 1996. The Contract is an annuity contract that gives rise to life insurance reserves, as defined in section 816(b). IC is a calendar year taxpayer. The Contract guarantees that interest will be credited at 8 percent per year for the first 8 contract years and 4 percent per year thereafter. During the 8-year temporary guarantee period, the Contract provides for a market value adjustment based on changes in a published bond index and not on the performance of stocks, other equity instruments or equity based derivatives. IC has chosen to avail itself of the provisions of these regulations for 1996 and taxable years thereafter. The 10-year Treasury constant maturity interest rate published for December of 1996 was 6.30 percent. The next shortest maturity published for Treasury constant maturity interest rates is 7 years. As of the end of 1996, the remaining duration of the temporary guarantee period for the Contract was 7 years and 7 months.

(ii) To determine under section 807(d)(2) the end of 1996 reserves for the Contract, IC must use a discount interest rate of 6.30 percent for the temporary guarantee period. The interest rate to be used in computing required interest under section 812(b)(2)(A) for 1996 reserves is also 6.30 percent.

(iii) The discount rate applicable to periods outside the 8-year temporary guarantee period is determined under sections 807(c)(3), 807(d)(2)(B), 811(d) and 812(b)(2)(A) without regard to the current market rate.

Example 2. Assume the same facts as in Example 1 except that it is now the last day of 1998. The remaining duration of the temporary guarantee period under the Contract is now 5 years and 7 months. The 7-year Treasury constant maturity interest rate published for December of 1998 was 4.65 percent. The next shortest duration published for Treasury constant maturity interest rates is 5 years. A discount rate of 4.65 percent is used for the remaining duration of the temporary guarantee period for the purpose of determining a reserve under section 807(d) and for the purpose of determining required interest under section 812(b)(2)(A).

Example 3. Assume the same facts as in Example 1 except that it is now the last day of 2001. The remaining duration of the temporary guarantee period under the Contract is now 2 years and 7 months. The 3-year Treasury constant maturity interest rate published for December of 2001 was 3.62 percent. The next shortest duration published for Treasury constant maturity interest rates is 2 years. A discount rate of 3.62 percent is used for the remaining duration of the temporary guarantee period for the purpose of determining a reserve under section 807(d) and for the purpose of determining required interest under section 812(b)(2)(A).

(c) Applicable interest rates for equity-indexed modified guaranteed contracts. [Reserved.]

(d) Effective date. Paragraphs (a), (b) and (d) of this section are effective on May 7, 2003. However, pursuant to section 7805(b)(7), taxpayers may elect to apply those paragraphs retroactively for all taxable years beginning after December 31, 1995, the effective date of section 817A.

David A. Mader

Assistant Deputy Commissioner of Internal Revenue

Approved: April 25, 2003

Pamela F. Olson

Assistant Secretary of the Treasury