Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:FI&P:4-PLR-100011-99
Date:
April 27, 1999

Legend

Date 1 =

Date 2 =

Company =

State A =

<u>aa</u> =

<u>bb</u> =

<u>cc</u> =

<u>Formula</u> =

Region B =

Month/Year =

Year =

Year 1 =

Dear

This is in reply to your letter of Date 1. You ask whether annual interest crediting rates ("Annual Rates") on flexible premium adjustable life insurance policies ("Policies") issued by the Company which come into effect after a Policy's issue date are taken into account for purposes of determining the net single premium for the Policy under section 101(f)(1)(B) or 7702(b) of the Internal Revenue Code.

Facts

Company is a stock life insurance company organized and operated under the laws of State A. Company is licensed to engage in the life insurance business in aa states and Region B. The Policies are flexible premium adjustable life insurance policies. The Policies provide a minimum guaranteed interest rate of bb percent per month (equivalent to cc percent per year) on the Policy value. The Policies have been endorsed with an interest rate endorsement ("Interest Endorsement"). The Interest Endorsement, like the Policies, provides a minimum guaranteed interest rate of bb percent per month (equivalent to cc percent per year) on the Policy value, including any Policy value that represents collateral for a policy loan. The Interest Endorsement also states that the Company will declare annually, on Date 2, a rate of interest effective for the following 12 months ("Annual Rate") on the non-borrowed policy values. The Annual Rate is based upon Formula. At issue, the minimum guaranteed interest rate applicable to a Policy is bb percent per month (equivalent to cc percent per year). Subsequently, after the declaration occurring on Date 2, the Annual Rate, if higher than the minimum guaranteed interest rate, will apply to such Policy.

The provisions of the Interest Endorsement which define the Formula on which the Annual Rate is based remain in effect for the life of the policy unless the Company's Board of Directors elects to amend or revoke the provisions of the Interest Endorsement which define the Formula by duly adopted resolution. Any such resolution would take effect one year from the date of the resolution. For Policies issued during and after Month/Year, the Interest Endorsement was part of the Policy as issued. For Policies issued prior to Month/Year, the Interest Endorsement was added in Month/Year. The Policies were last issued in Year 1.

Company makes the following representations:

1. The Policies constitute life insurance contracts under applicable State law; and

2. Apart from the issue raised herein, the Policies comply with sections 101(f) and 7702, as applicable.

Law and Analysis

In order for a contract to be treated as life insurance for Federal tax purposes, the contract must satisfy the requirements of section 101(f) or section 7702, as applicable. Sections 101(f) and 7702 each set forth two alternative tests, only one of which needs to be satisfied in order for a contract to receive the tax treatment generally accorded to life insurance under the Code. One of these tests is satisfied, in part, if certain guideline premium requirements are met, and the other alternative test is satisfied if the contract, by its terms, meets the requirements of the "cash value accumulation" ("CVA") test.

The limitations of section 101(f) are applicable generally only to contracts issued before January 1, 1985. Section 101(f) was added to the Code by section 221 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), 1982-2 C.B. 462. Under section 101(f), any amount paid by reason of the death of the insured under a life insurance contract described as a flexible premium contract is excluded from gross income only if the contract satisfies either (1) the guideline premium limitation and the applicable percentage of cash value test of section 101(f)(1)(A)(i) and (ii), respectively, or (2) the cash value test of section 101(f)(1)(B).

In regard to a contract subject to section 101(f), the CVA test is satisfied by the contract if:

> by the terms of such contract, the cash value of such contract may not at any time exceed the net single premium with respect to the amount payable by reason of the death of the insured (determined without regard to any qualified additional benefit) at such time.

Section 101(f)(1)(B).

Section 101(f)(3)(G) provides that in computing the net single premium under paragraph (1)(B), the mortality basis shall be that guaranteed under the contract and the interest rate shall be based on the greater of an annual effective rate of 4 percent (3 percent for contracts issued before July 1, 1983), or the minimum rate or rates guaranteed upon issue of the contract. The computational rules of paragraph (2)(D) apply, except that the maturity date referred to in clause (ii) thereof shall not be earlier than age 95.

The Joint Committee on Taxation's explanation of section 101(f) includes the following discussion regarding similarly defined interest assumptions with respect to the calculation of the guideline single premium[1]:

> In defining the guideline single premium the statute refers . . . to interest at the minimum rate or rates guaranteed upon issue of the contract. . . . the term "minimum rate or rates" means the floor rate or rates of interest guaranteed at issue of the contract. Thus, *although the company may guarantee a higher interest rate from time to time, either by contractual declaration or by operation of a formula or index, the minimum rate still should be taken to be the floor rate, that is, the rate below which the interest credited to the contract cannot fall.* The statutory reference to minimum rate or rates recognizes that a contract may guarantee different floor rates for different periods of the contract, although each is guaranteed at issue and remains fixed for the applicable period for the life of the contract. However, it should be noted that where the initial interest rate guaranteed to be credited to the contract is in excess of the generally applicable floor rate assumed in the contract, the higher initial interest rate is the minimum or floor rate with respect to the initial period of that guarantee. This is because that rate is guaranteed at issue and, for the initial period the interest rate cannot fall below that guaranteed rate. . . . *Aside from taking into account initial guarantees that are different from the generally applicable charges and interest rates assumed in the contract, the Act does not require that any "excess interest" (interest credited at a rate in excess of any rate or rates guaranteed in the contract at the time of issue) . . . be taken into account in the computation of the guideline premiums.*

Staff of the Joint Committee on Taxation, 97th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, at 369-370 (1982) (1982 Blue Book) (emphasis added).

The legislative history for section 101 states that the net single premium is to be computed using an assumed rate of interest that is the greater of four percent or "the

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[1]Shortly after enactment of section 7702, the Joint Committee on Taxation prepared an explanation which indicates that the statutory reference to the "rate or rates of interest guaranteed on issuance of the contract" should be interpreted in the same manner for purposes of both the guideline premium limitation and the cash value accumulation test. *See* Joint Committee on Taxation Staff, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 98th Cong., 2d Sess. 648 n. 51 (1984).

minimum rate or rates guaranteed in the contract." S. Rep. 494, 97th Cong., 2d Sess. 353 (1982) (1982 Senate Report); H.R. Conf. Rep. 760, 97th Cong., 2d Sess. 648-649 (1982) (1982 Conference Report). Neither section 101(f) nor its legislative history explains what is meant by the term "excess interest." However, elsewhere in the TEFRA legislative history, the term is explained as follows:

> [L]ife insurance companies have credited interest at rates in excess of the relatively low rate that is assumed in the contracts for State law purposes. This "excess interest" is typically credited at a rate that is guaranteed, in advance, for a temporary future period.

1982 Senate Report at 346.

The Service has addressed whether amounts credited to deferred annuity contracts are similar to policyholder dividends under section 811(a) (as in effect prior to the DEFRA amendments).[2] In Rev. Rul. 82-133, 1982-1 C.B. 119, insurance companies issued annuity contracts which credited 8½ percent interest during the first contract year and 4 percent in later contract years, but the company retained the right to change the guaranteed rate. Any such change would have to be for at least a one-year period and could not be at a rate less than 4 percent per annum. The change also had to be declared in advance. The contract did not explain on what basis a higher rate might be declared. The insurance companies used 4 percent as the assumed interest rate for purposes of calculating reserves. Section 809(f), as in effect prior to DEFRA, limited the deduction which an insurance company could take for policyholder dividends. The ruling observes that, under Treas. Reg. section 1.811-2(a), interest amounts that are "fixed" in the contract are treated differently than "amounts that may be returned to policyholders depending upon the experience of the company or based on the discretion of management." The ruling points out that the policyholder is in the same economic position he or she would have been in if the policyholder had received a dividend and immediately paid it to the insurance company as a premium for an additional benefit. The ruling concludes that "amounts in excess of the assumed rate of interest that are credited under the contracts are distributions similar to dividends to policyholders under sections 811(a) and 809(d)(3) of the Code." 1982-1 C.B. 120, 121.

When the legislative history and the 1982 Blue Book discussion relating to section 101(f) are read in the context of the contemporaneous developments regarding

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[2]Prior to DEFRA, section 811(a) read as follows:

> For purposes of this part, the term "dividends to policyholders" means dividends and similar distributions to policyholders in their capacity as such. Such term does not include interest paid (as defined in section 805(e)).

the treatment of excess interest for life insurance company tax purposes, one can reasonably infer that the drafters of section 101(f) viewed excess interest credits that vary from year to year as economically equivalent to policyholder dividends. Since the declaration of a policyholder dividend has no effect on a contract's net single premium computation under section 101(f), one also might reasonably infer that the annual declaration of an excess interest rate, such as the Annual Rate of the Interest Endorsement, should likewise not have any effect on a contract's net single premium computation.

In general, section 7702 applies to all life insurance contracts issued after December 31, 1984. Section 7702 was enacted as part of the Deficit Reduction Act of 1984, Pub.L. No. 98-369 ("DEFRA") and contains a definition of "life insurance contract" for all purposes of the Code. Section 7702 also contains a CVA test that applies to contracts issued after the effective date of this provision. Under section 7702(b)(1), this test is satisfied if by the terms of the contract, the cash surrender value of the contract may not at any time exceed the net single premium which would have to be paid at that time to fund future benefits under the contract.

Section 7702(b)(2) sets forth certain computational rules that must be followed for purposes of applying the CVA test. Specifically, this provision states that:

> Determinations under paragraph (1) shall be made –
> (A) on the basis of interest at the greater of an annual effective rate of 4 percent 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.

The DEFRA legislative history discusses the above language regarding the interest rates to be taken into account for purposes of the CVA test as follows:

> In making the determination that a life insurance contract meets the cash value accumulation test, the net single premium for any time will be computed using a rate of interest that is the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on the issuance of the contract. To be consistent with the definitional test reference to the cash surrender value, the "rate or rates guaranteed on issuance of the contract" means the interest rate or rates reflected in the contract's nonforfeiture values.

H.R. Rep. No. 432, pt. 2, 98th Cong. 1444 (1984).

The legislative history of section 7702 indicates that the statutory phrase "rate or rates guaranteed on issuance of the contract" refers to "the minimum rate or rates guaranteed on issuance of the contract." H.R. Rep. 432 (Part 2), 98th Cong., 2d Sess. 1445 (1984) (1984 House Report); 1 Senate Comm. on Finance, *Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984*, 98th Cong., 2d Sess. I-574 (S. Comm. Prt. 169) (1984) (1984 Senate Report).[3]

The CVA tests under both sections 101(f) and 7702 require the computation of the net single premium using as a factor interest at the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on issuance of the contract. Although the specific language of the two statutes differs slightly, analysis of the legislative histories establishes that the differences in language are not relevant to the case at hand. Because the Annual Rates of the Interest Endorsement guarantee excess interest for periods of one year or less, and are subject to change by the Company under the terms of the Interest Endorsement, the Annual Rates are similar economically to policyholder dividends. Thus, although the Company may guarantee a higher interest rate from time to time by operation of the Formula contained in the Interest Endorsement, the minimum rate that should be taken into account is the floor rate, that is, the rate below which the interest credited to the Policy cannot fall, or bb percent per month (equivalent to cc percent per year) .

Conclusion

For purposes of determining whether a Policy satisfies the requirements of sections 101(f)(1)(B) or 7702(a)(1) and (b), as applicable, the Annual Rates established pursuant to the Interest Endorsement after a Policy's issue date are in the nature of policyholder dividends, and not interest rate guarantees, and thus should not be taken into account for purposes of determining the net single premium for the Policy under section 101(f)(1)(B) or 7702(b).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of

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[3] *See also* Joint Committee on Taxation Staff, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 98th Cong., 2d Sess. 648-649 (1984) (1984 Blue Book) ["The statutory reference to rate or rates of interest guaranteed on issuance of the contract serves the same role as the 'minimum rate or rates' referred to in the TEFRA provision of section 101(f)."].

the Code provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant. Finally, in accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

Assistant Chief Counsel
(Financial Institutions & Products)

By: ~~signed by Donald J. Drees, Jr.~~
Donald J. Drees,Jr.
Senior Technician Reviewer, Branch 4