



rate to be used in the determinations under §§ 807(c)(3), 807(d)(2)(B), and 812 for a “modified guaranteed contract,” as defined in § 817A(d). It also describes the manner in which § 811(d) is to be applied to these contracts. Section 817A was added by § 1612 of the Small Business Job Protection Act of 1996, Pub. L. 104–188, 110 Stat. 1755. Section 817A is effective for taxable years beginning after December 31, 1995. *See* Small Business Job Protection Act § 1612(c)(1). This notice is effective pending the publication of further guidance.

**BACKGROUND:** Life insurance companies issue modified guaranteed annuity and life insurance contracts. A modified guaranteed contract temporarily guarantees a higher return than the permanently guaranteed crediting rate, in exchange for shifting additional investment risk to the policyholder in the form of a market value adjustment. The temporary guarantee may be a fixed rate or a rate based on bond or equity yields, such as a percentage of an increase in the S&P 500 index. During the temporary guarantee period, the amount paid to the policyholder upon surrender is increased or decreased by the market value adjustment, which is determined by a formula in the modified guaranteed contract. The market value adjustment generally is based on a published bond index. Modified guaranteed contracts can be issued out of a life insurance company’s general account or segregated account. Section 817A provides special tax treatment for certain modified guaranteed contracts issued out of a segregated account.

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

The tax reserves for an MGC are computed under either § 807(c)(3) or

§ 807(d). Section 807(c)(3) provides that reserves for obligations under insurance and annuity contracts not involving life, accident, or health contingencies are computed using an appropriate rate of interest. The appropriate rate of interest is the highest (as of the time the obligation first did not involve life, accident, or health contingencies) of the following rates: (1) the “applicable Federal interest rate” (as defined in § 807(d)(2)(B)(i)); (2) the “prevailing State assumed interest rate” (as defined in § 807(d)(2)(B)(ii)); or (3) the rate of interest assumed by the insurance company to determine the contract’s guaranteed benefit. Section 807(c) also provides that the reserves computed under § 807(c)(3) are never less than the net surrender value of the contract.<sup>1</sup>

For an MGC that gives rise to life insurance reserves, as defined in § 816(b), reserves are computed under § 807(d). Under § 807(d)(1), the life insurance reserves for a contract cannot exceed the statutory reserves (as defined in § 809(b)(4)(B)) for the contract. Subject to that cap, a contract’s life insurance reserves equal the greater of: (1) the contract’s net surrender value; or (2) the contract’s Federally prescribed reserve determined under § 807(d)(2).

Section 807(d)(2) provides that the Federally prescribed reserves for a contract are determined using: (1) the tax reserve method applicable to the contract; (2) the greater of the applicable Federal interest rate or the prevailing State assumed interest rate in effect on the date of the issuance of the contract; and (3) the prevailing commissioners’ standard tables for mortality and morbidity. In the case of a life insurance contract covered by the Commissioners’ Reserve Valuation Method (“CRVM”) or an annuity contract covered by the Commissioners’ Annuities Reserve Valuation Method (“CARVM”), § 807(d)(3) provides that the tax reserve method applicable to a contract is the CRVM or CARVM prescribed by the National Association of Insurance Commissioners (“NAIC”), which is in effect on the date of the issuance of the contract.

Section 811(d) imposes an additional reserve computation restriction for contracts that guarantee beyond the end of

<sup>1</sup>For contracts other than MGCs, § 807(e)(1) provides that net surrender value is determined taking into account any penalty or charge which would be imposed upon surrender but ignoring any market value adjustment. The net surrender values of MGCs, however, take into account market value adjustments. § 817A(a).

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(Also Part I, sections 807, 812, 817A)

## Modified Guaranteed Contracts

### Notice 97–32

**SUMMARY:** This notice provides interim rules with regard to the interest

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, § 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.

Section 812 prorates the dividends received deduction and the exclusion for tax exempt interest between a life insurance company and its policyholders to prevent the company from receiving a double tax benefit for amounts added to reserves. See also §§ 805(a)(4), 807(a) and 807(b). The proration is based on the company's share of "net investment income" (as defined in § 812(c)) for the taxable year. The company's share of net investment income equals the excess, if any, of the net investment income over the sum of the "policy interest" (as defined in § 812(b)(2)) and "gross investment income's proportionate share of policyholder dividends" (as defined in § 812(b)(3)) for the taxable year. Policy interest includes "required interest" (at the greater of the prevailing State assumed rate or the applicable Federal interest rate) on reserves under § 807(c) (other than § 807(c)(2)). See § 812(b)(2)(A). If neither the prevailing State assumed rate nor the applicable Federal interest rate is used, another appropriate rate is used to calculate required interest. Thus, for a contract described in § 807(c)(3), if the rate of interest assumed by an insurance company in determining the contract's guaranteed benefit exceeds the applicable Federal interest rate and the State assumed rate, required interest is computed using the assumed interest rate.

Under § 817A(e)(2), the Service is authorized to determine annually with regard to MGCs the interest rates applicable under §§ 807(c)(3), 807(d)(2)(B) and 812. The Service is authorized to exercise this authority by issuing a periodic announcement of the appropriate market interest rates or formula for determining such rates. H.R. Conf. Rept. No. 737, 104th Cong. 2d Sess. 313 (1996). Section 817A(e) also authorizes the Service to modify or waive the application of § 811(d) (relating to interest guaranteed beyond the end of the taxable year), and to prescribe other

regulations that are necessary or appropriate to carry out the purposes of § 817A.

The legislative history of § 817A indicates that an appropriate interest rate is a current market rate. H.R. Conf. Rep. No. 737, at 313. The interest rate may be determined, for example, using either a rate that is appropriate for the obligations under the contract to which the reserve relates or the yield on the assets underlying the MGCs. *Id.*

**INTERIM RULES FOR MGCs:** Pending the publication of further guidance, an insurance company is required to determine under §§ 807(c)(3) or 807(d)(2) the reserves for a MGC using, with regard to the contract's temporary guarantee period, an annual interest rate equal to the greater of—

(a) the interest rate assumed by the insurance company to determine future guaranteed benefits under the applicable tax reserve method for the contract or, for reserves computed under § 807(c)(3), the interest rate assumed by the company to determine the contract's guaranteed benefit; or

(b) the Moody's Corporate Bond Yield Average-Monthly Average Corporates ("Moody's rate") as published by Moody's Investors Service, Inc., or any successor thereto, for the month that includes the last day of the taxable year, multiplied by:

(i) 1.1 if the MGC provides for a market value adjustment or a guaranteed return based in whole or in part on the performance of stocks, other equity instruments or equity-based derivatives, including but not limited to a contract which guarantees a return based on the S&P 500 index; and

(ii) 1.0 for all other MGCs.

With respect to an MGC's temporary guarantee period, section 811(d) shall be applied by substituting the rate of interest applicable to the contract's temporary guarantee period under this notice for the applicable Federal interest rate and the prevailing State assumed interest rate. During the temporary guarantee period, the interest rate to be used to determine required interest under § 812(b)(2)(A) is the rate that applies with regard to that period for purposes of §§ 807(c)(3) or 807(d)(2)(B).

For periods outside the temporary guarantee period, §§ 807(c)(3), 807(d)(2), 811(d) and 812(b)(2)(A) continue to apply without modification.

## EXAMPLE 1

IC, a life insurance company as defined in § 816, issued an MGC on July 1, 1996. The MGC is an annuity contract that gives rise to life insurance reserves, as defined in § 816(b). IC is a calendar year taxpayer. The MGC guarantees that interest will be credited at 8% per year for the first 5 contract years and 4% per year thereafter. During the 5 year temporary guarantee period, the MGC 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. The Moody's rate for December 1996 is 7.5%. The applicable Federal interest rate and the prevailing State assumed interest rate for 1996 are 6.63% and 5.75%, respectively.

To determine under § 807(d)(2) the end of year 1996 reserves for the MGC, IC must use a discount interest rate of 8% (the interest rate assumed by the insurance company to determine future guaranteed benefits during the 5 year temporary guarantee period) with regard to the unexpired portion of the temporary guarantee period. The discount rate applicable to periods outside the 5 year temporary guarantee period is 6.63%. The interest rate to be used in computing required interest under § 812(b)(2)-(A) for 1996 is 8%.

## EXAMPLE 2

The facts are the same as in Example 1, except that the MGC guarantees that interest will be credited at 7% per year for the first 5 contract years. To determine under § 807(d)(2) the end of year 1996 reserves for the MGC, IC must use a discount interest rate of 7.5% (Moody's rate multiplied by 1.0) with regard to the unexpired portion of the 5 year temporary guarantee period. The discount rate applicable to periods outside the 5 year temporary guarantee period is 6.63%. The interest rate to be used in computing required interest under § 812(b)(2)(A) for 1996 is 7.5% (Moody's rate multiplied by 1.0).

**COMMENTS REQUESTED:** The Internal Revenue Service invites comments concerning the application of new § 817A and the application of this notice to various types of MGCs, including equity indexed annuities and life insurance contracts. Specifically, comments are requested regarding whether different interest rates should apply to equity indexed contracts based upon the differ-

ent participation rates, guarantees, market value adjustments, or other pertinent factors under the contracts. Written comments should be sent to Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Notice 97-32), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Finally, taxpayers may submit comments electronically via the Internal Revenue Service INTERNET site at [http://www.irs.ustreas.gov/prod/tax\\_regs/comments.html](http://www.irs.ustreas.gov/prod/tax_regs/comments.html). All submitted comments will be available for public inspection and copying.

**FURTHER INFORMATION:** For further information regarding this notice, contact Ms. Katherine A. Hossofsky at (202) 622-3970 (not a toll-free call).

**PROCEDURAL INFORMATION:** This document serves as an "administrative pronouncement" as that term is defined in § 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

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