Part III - Administrative, Procedural, and Miscellaneous

Application of Sections 7702 and 7702A to Life Insurance Contracts that Mature After Age 100

Notice 2009-47

SECTION 1. PURPOSE

The purpose of this notice is to request comments on a proposed safe harbor addressing the application of §§ 7702 and 7702A of the Internal Revenue Code to life insurance contracts that mature after the insured individual ("the insured") attains age 100. This notice also requests comments on the treatment of amounts received under a life insurance contract after it has matured.

SECTION 2. BACKGROUND

.01 Section 7702 of the Code defines the term "life insurance contract" for purposes of the Code. Section 7702(a) provides that a "life insurance contract" is any contract that is a life insurance contract under the applicable law, but only if such contract either (1) meets the cash value accumulation test of § 7702(b), or (2) both meets the guideline premium requirements of § 7702(c) and falls within the cash value corridor of § 7702(d). Section 7702 was added to the Code by the Deficit Reduction Act of 1984, P.L. 98-369.

.02 A contract meets the cash value accumulation test of § 7702(b) if, by the terms of the contract, the cash surrender value of the contract may not at any time exceed the net single premium that would have to be paid at that time to fund future benefits under the contract.

.03 A contract meets the guideline premium requirements of § 7702(c) if the sum of the premiums paid under the contract does not at any time exceed the guideline premium limitation as of that time. The guideline premium limitation as of any date is the greater of the guideline single premium, or the sum of the guideline level premiums to that date. The guideline single premium is the premium that would be required on the date the contract is issued to fund the future benefits under the contract.

.04 A contract falls within the cash value corridor of § 7702(d) if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value, as determined under the table set forth in § 7702(d)(2). Under that table, the applicable percentage for an insured with an attained age of 95 is 100 percent.

.05 Section 7702(e) provides computational rules that must be used for purposes of § 7702, other than for purposes of applying the cash value corridor. In particular, under § 7702(e)(1)(B) the maturity date (including the date on which any death benefit is payable) under a contract is 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. Section 1.7702-2 of the Income Tax Regulations provides guidance on determining the attained age of the insured for this purpose.

.06 Section 7702A(a) provides that a life insurance contract is a modified endowment contract (MEC) if the contract is entered into on or after June 21, 1988, and fails to meet the 7-pay test, or is received in exchange for a contract which is a MEC. A contract fails to meet the 7-pay test if the accumulated amount paid under the contract at any time during the first 7 contract years exceeds the sum of the net level premiums that would have to be paid on or before such time if the contract were to provide for paid-up future benefits (including death benefits) after the payment of 7 level annual premiums. Under § 7702A(c)(1)(B), the determination of the 7 level annual premiums generally is made by applying the computational rules of § 7702(e), including the rule requiring a deemed maturity date 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.

.07 The 2001 Commissioners' Standard Ordinary mortality and morbidity tables (2001 CSO tables) prescribed by the NAIC became the prevailing commissioners' standard tables within the meaning of § 807(d)(5) during calendar year 2004, and have been adopted by all 50 states. For tax purposes, the 2001 CSO mortality tables generally must be used for purposes of applying the reasonable mortality charge requirements of § 7702(c)(3)(B)(i) with regard to contracts issued after December 31, 2008. See Notice 2006-95, 2006-2 C.B. 848, modifying and superseding Notice 2004-61, 2004-2 C.B. 596, supplementing Notice 88-128, 88-2 C.B. 540.

.08 Unlike the 1958 Commissioners Standard Ordinary Mortality Tables (1958 CSO Tables) and the 1980 Commissioners Standard Ordinary Mortality Tables (1980 CSO Tables), the 2001 CSO tables extend to age 121. As a result, an increasing number of issuers now develop contracts with maturity dates beyond age 100, even though the qualification of the contracts as life insurance contracts (and as MECs) is tested using computational rules that deem the contracts to mature between the date the insured attains age 95 and the date the insured attains age 100. The 2001 Maturity Age Task Force of the Taxation Section of the Society of Actuaries has proposed a series of recommendations to comply with the requirements of §§ 7702 and 7702A in a manner that is actuarially sound. <u>See</u> <u>2001 CSO Implementation Under IRC Sections 7702 and 7702A</u>, 2 Taxing Times 23 (May 2006). The proposed safe harbor in section 3 of this notice is drawn from that proposal, with modifications. Section 4 of this notice requests comments on the proposed safe harbor.

.09 In addition to the application of the definitional rules of §§ 7702 and 7702A, other issues arise with regard to contracts that, by their terms, mature while the insured is still alive. For example, a contract that matures at age 100 may have a cash value equal to the contract's death benefit. Pre-1984 federal tax case law, however, requires that a life insurance contract involve "risk shifting" in order to qualify as such for federal income tax purposes. <u>See, e.g.</u>, <u>Helvering v. Le Gierse</u>, 312 U.S. 531 (1941) (even though a contract is in the form of a life insurance contract, it is not treated as such for federal income tax purposes unless the requirements of risk shifting and risk distribution are met); <u>Evans v. Commissioner</u>, 56 T.C. 1142 (1971) (contracts that previously qualified as life insurance contracts were not so treated where the cash surrender value of the contracts exceeded their face amount). Moreover, even if such a contract were to satisfy the definition of a life insurance contract under the literal terms of § 7702, the fact that the contract has fully matured may affect the treatment of the holder of the contract under the doctrine of constructive receipt, or may affect the treatment of a beneficiary under the contract if amounts are received not by reason of the death of the insured, but by reason of the insured's attainment of age 100. Section 4 requests comments on these issues as well.

SECTION 3. PROPOSED SAFE HARBOR

.01 In general. Under the proposed safe harbor, the Service would not challenge the qualification of a contract as a life insurance contract under § 7702, or assert that a contract is a MEC under § 7702A, provided the contract satisfies the requirements of those provisions using all of the Age 100 Testing Methodologies of section 3.02 of this notice.

.02 Age 100 Testing Methodologies. The Age 100 Testing Methodologies of this section 3.02 are as follows:

(a) All determinations under §§ 7702 and 7702A (other than the cash value corridor) would assume that the contract will mature by the date the insured attains age 100, notwithstanding a later contractual maturity date (such as by reason of using the 2001 CSO mortality tables).

(b) The net single premium determined for purposes of the cash value accumulation test under § 7702(b), and the necessary premiums determined for purposes of § 7702A(c)(3)(B)(i), would assume an endowment on the date the insured attains age 100.

(c) The guideline level premium determined under § 7702(c)(4) would assume premium payments through the date the insured attains age 99.

(d) Under § 7702(c)(2)(B), the sum of the guideline level premiums would increase through a date no earlier than the date the insured attains age 95 and no later than the date the insured attains age 99. Thereafter, premium payments would be allowed and would be tested against this limit, but the sum of the guideline level premiums would not change.

(e) In the case of a contract issued or materially changed within fewer than 7 years of the insured's attaining age 100, the net level premium under § 7702A(b) would be computed assuming level annual premium payments over the number of years between the date the contract is issued or materially changed and the date the insured attains age 100.

(f) If the net level premium under § 7702A(b) is computed over a period of less than 7 years by reason of an issuance or material change within fewer than 7 years of the insured's attaining age 100, the sum of the net level premiums would increase through attained age 100. Thereafter, the sum of the net level premiums would not increase, but premium payments would be allowed and would be tested against this limit for the remainder of the 7-year period.

(g) The rules of § 7702A(c)(2) and (6) concerning reductions in benefits within the first 7 contract years would apply whether or not a contract is issued or materially changed fewer than 7 years before the date the insured attains age 100.

(h) A change in benefits under (or in other terms of) a life insurance contract that occurs on or after the date the insured attains age 100 would not be treated as a material change for purposes of § 7702A(c)(3) or as an adjustment event for purposes of § 7702(f)(7).

(i) Notwithstanding the methodologies of this section 3.02(a)-(h), a contract that remains in force would additionally be required to provide at all times a death benefit equal to or greater than 105 percent of the cash value.

.03 Effective date. The proposed safe harbor would be effective as of the date of publication in the Internal Revenue Bulletin.

.04 Status as administrative guidance. Until the proposed safe harbor is formally adopted by the Service, the proposed safe harbor is not an "administrative pronouncement" as that term is used in § 1.6662-4(d)(3)(iii) of the regulations; it may not be relied upon as an official interpretation of §§ 7702 or 7702A.

SECTION 4. REQUEST FOR COMMENTS

.01 In general. The Service requests comments on the proposed safe harbor described in Section 3 of this notice.

.02 Other matters. Comments are requested concerning additional issues that may arise in situations where a life insurance contract matures after the insured has attained age 100. For example--

(a) If an individual who already has attained age 100 purchases a contract that is a life insurance contract under the applicable state or foreign law, do the computational rules of § 7702(e) prevent the contract from qualifying as a life insurance contract for federal income tax purposes?

(b) If a preexisting contract actually matures at age 100, such that the cash surrender value and death benefit under the contract are the same, is the insured taxed at that time on the maturity value of the contract under the doctrine of constructive receipt?

(c) If a preexisting contract actually matures at age 100, such that the cash surrender value and the death benefit are the same, is an amount later received under the contract by a beneficiary upon the death of the insured ineligible for exclusion under § 101 because, in the absence of any amount at risk, the payment is not received "by reason of" the insured's death?

(d) In addition to the maturity age issues discussed in this notice, do other issues arise as a result of implementation of the 2001 CSO tables that would appropriately be addressed by published guidance?

.03 Comments should be submitted in writing on or before October 13, 2009 and should contain a reference to this Notice 2009-47. Comments may be submitted to CC:PA:LPD:PR (Notice 2009-47). Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, taxpayers may submit comments electronically to *Notice.Comments@irscounsel.treas.gov*. Please include "Notice 2009-47" in the subject line of any electronic communications.

.04 Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2009-47), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC 20224. All comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Donald J. Drees of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this Notice, contact Mr. Drees at (202) 622-3970 (not a toll-free call).