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ACLI Update

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HOUSE PASSES BILL THAT WOULD MODIFY INTERNAL REVENUE CODE SECTION 7702

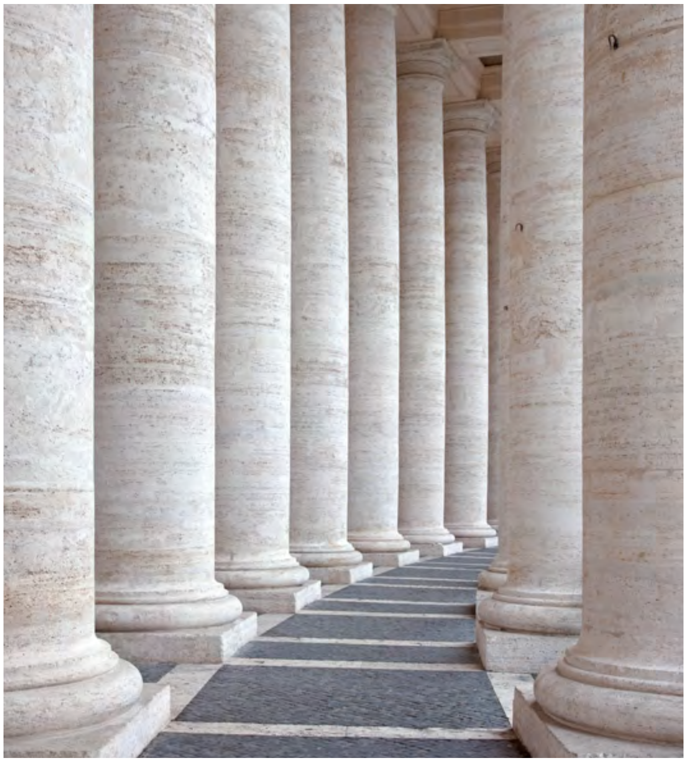
On May 12, 2020, Democrats in the U.S. House of Representatives released the Health and Economic Recovery Omnibus Emergency Solutions Act (HEROES Act; H.R. 6800), which was passed by the House on May 15, 2020. Section 40308 of the Heroes Act, titled the Minimum Rate of Interest for Certain Determinations Related to Life Insurance Contracts, modifies the fixed 4 percent and 6 percent minimum annual effective interest rates in Section 7702 of the Internal Revenue Code to refer to a market-based rate called the Insurance Interest Rate. The rates in Section 7702 are used to apply the cash value accumulation test and guideline premium test for purposes of determining whether a contract is a life insurance contract for tax purposes. The provision retains the current law requirement to use the rate or rates guaranteed under the contract if higher than the rates prescribed in Section 7702. Additionally, the 4 percent and 6 percent rates currently prescribed in Section 7702 are retained as a cap on the Insurance Interest Rate. The Insurance Interest Rate that applies to a contract is the rate in effect as of the time the contract is originally issued.[1] The proposal does not affect when a contract is treated as issued or entered into.

The Insurance Interest Rate is equal to the lesser of two alternative rates.[2] The first rate is the Section 7702 Valuation Interest Rate, which is the prescribed maximum valuation interest rate used for computing statutory reserves for life insurance contracts with a guarantee duration of more than 20 years, as defined in the National Association of Insurance Commissioners' Standard Valuation Law.[3] The rate is partially based on composite yields on seasoned corporate bonds. The second rate is the Section 7702 Applicable Federal Interest Rate, which is the average of the applicable federal midterm rates (as defined in Section 1274(d) but based on annual compounding) over a 60-month period, rounded to the nearest whole percentage. This rate is based on market yields on outstanding marketable obligations of the United States. Thus, the Insurance Interest Rate reflects yields on both government and corporate debt.

Under the provision, in determining the net single premium and guideline level premium under Section 7702, and the seven-pay premium under Section 7702A, the computation reflects interest at the lesser of the Insurance Interest Rate in effect as of the time the contract is issued, or an annual effective rate of 4 percent, but not less than the rate or rates guaranteed on issuance of the contract. Similarly, in determining the guideline single premium, the computation reflects interest at the lesser of 2 percent plus the Insurance Interest Rate in effect at the time the contract is issued, or an annual effective rate of 6 percent, but not less than the rate or rates guaranteed on issuance of the contract.

CHANGES IN INSURANCE INTEREST RATE

For contracts issued in 2021, the Insurance Interest Rate is defined as 2 percent, which is the Section 7702 Applicable Federal



Interest Rate based on the 60-month period ending in December 2018. This rate is lower than the Section 7702 Valuation Interest Rate in effect for 2020.

After 2021, the Insurance Interest Rate is redetermined only in an Adjustment Year and only with respect to contracts issued during or after such adjustment year. An Adjustment Year is the year following the year that includes the effective date of a change in the statutory valuation interest rate used to determine the Section 7702 Valuation Interest Rate. The Section 7702 Valuation Interest Rate is determined with respect to the calendar year prior to the Adjustment Year, whereas the Section 7702 Applicable Federal Interest Rate is determined with respect to the 60-month period ending in the month immediately before the start of the second calendar year prior to the Adjustment Year. The requirements for determining whether a year is an Adjustment Year, and the periods for determining rates applicable in a particular Adjustment Year, are intended to allow issuers sufficient time to carry out necessary pricing and design activities, to obtain state regulators' approval for product revisions, and to implement necessary administrative system changes upon a change in rates.

If enacted, the provision would apply to life insurance contracts issued after Dec. 31, 2020.

TREASURY AND IRS PROPOSE UPDATING LIFE EXPECTANCY AND DISTRIBUTION PERIOD TABLES

On Aug. 31, 2018, President Trump issued Executive Order 13847, which, among other things, directed the Department of the Treasury (Treasury) to examine the life expectancy and distribution period tables in the regulations on required minimum distributions from retirement plans and determine whether they should be updated to reflect current mortality data and whether such updates should be made annually or on another periodic basis. In a press release, the president described that the goal of the review was to "help workers better prepare for their financial futures," to "see if retirees could keep more money in 401(k)s and Individual Retirement Accounts for longer," and to "allow retirees to spread retirement savings over a longer period of time."

On Nov. 8, 2019, Treasury and the Internal Revenue Service (IRS) proposed revising the life expectancy tables used to calculate minimum required distributions under Internal Revenue Code Section 401(a)(9). The proposal would replace the existing life tables with the 2012 Individual Annuity Mortality tables adjusted for mortality improvements projected through 2021.[4]

ACLI filed a comment letter expressing strong support and alignment with the views and recommendations expressed by the Committee of Annuity Insurers in its comment letter to the IRS and Treasury. In that letter, the committee noted that the proposal would not meet the president's goal for individuals at later ages, those age 92 through 103. Individuals at those ages would be required to exhaust their retirement savings even faster than under the current life tables. The committee recommended the IRS and Treasury instead adopt the 2012 Individual Annuity Reserving Table. Use of this table would provide longer life expectancy assumptions and meet the president's goal to allow retirees to "spread retirement savings over a longer period of time." The 2012 Individual Annuity Reserving Table is published by the Society of Actuaries (SOA). It reflects the longest life expectancies and is used principally in determining required reserves for life insurance companies under state law.

The committee also recommended IRS and Treasury take the opportunity to correct the minimum income threshold test under the regulations. Under this test, it is becoming increasingly difficult for retirees to protect their retirement savings through annuities that provide inflation protection or certain death benefits. The test is designed to prevent the backloading of payments. However, the test was developed without consideration of what are now historically low interest rates. Low interest rates, coupled with the regulation's older life expectancy tables, leads to odd results in which an annuity will fail to meet the test, but only at certain ages. What might pass the test at age 72 may fail at 73 but pass at 74. To mitigate this effect, the committee urged the use of the Uniform Lifetime Table in applying the rules in the regulations governing "increasing" annuity payments, subject to a fixed percentage cap of 5 percent on the amount of any scheduled payment increases to prevent backloading payments to later ages. Pension payments from defined benefit plans are permitted to increase up to 5 percent each year under the current regulations without the need to apply the minimum income threshold test.[5]

The Treasury and IRS proposed changes will take effect for distribution calendar years beginning on or after Jan. 1, 2021. There is no indication yet whether the effective date will be extended to provide more time to taxpayers and service providers challenged by the COVID-19 pandemic to implement the final rule or whether changes will be made to the proposed revision of the life expectancy tables as a result of comments from the Committee of Annuity Insurers and ACLI. ■

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ENDNOTES

1 Similar to the effective date provisions for the original enactment of Section 7702 by the Deficit Reduction Act of 1984, the issue date of a contract for this purpose is generally the date on the policy assigned by the insurance company, which is on or after the date the application was signed, as long as the period between the date of application and the date on which the policy is actually placed in force is not substantially longer than under the company's usual business practice. *See* Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84 (Dec. 31, 1984), at 655.

2 Both rates were historically used for determining life insurance reserves for tax purposes for taxable years beginning before Jan. 1, 2018.

3 The Standard Valuation Law defines the minimum statutory (annual statement) reserving requirements for various types of insurance contracts issued by life insurance companies. The Section 7702 Valuation Interest Rate is determined on the basis of a guarantee duration of more than 20 years regardless of the guarantee duration of the particular life insurance contract as determined under the Standard Valuation Law.

4 The experience tables and the 2012 Individual Annuity Mortality tables can be found at *https://www.actuary.org/sites/default/files/files/publications/Payout_Annuity_Report_09-28-11.pdf*. The Mortality Improvement Scale MP-2018 can be found at *https://www.soa.org/experience-studies/2018/mortality-improvement-scale-mp-2018/*.

5 *See* Treas. Reg. § 1.401(a)(9)-6, Q&A-14(d)