

LIFE INSURANCE
—
MODIFIED ENDOWMENTS

Under Internal Revenue Code Sections 7702 and 7702A

Second Edition

2018 Supplement

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INTRODUCTION

This supplement addresses issues that have arisen since the 2015 publication of the second edition of our textbook, *LIFE INSURANCE & MODIFIED ENDOWMENTS*, and clarifies certain items that were addressed in the book. This supplement supersedes and replaces a similar supplement published by the Society of Actuaries (SOA) in 2017. Some of the material here was originally presented in articles we wrote for *Taxing Times*, the newsletter of the SOA's Taxation Section.

This supplement is organized according to the order in which the discussion would appear in the textbook. Some of the information in this supplement supersedes material that appears in the textbook.

APPENDIX 1.1. SUMMARY OF OTHER LIFE INSURANCE TAX RULES (Chapter 1, Page 10)

Death Benefits (Chapter 1, Page 11)

Transfer for value rule, sections 101(a)(2) and (3): Section 101(a)(3), added by the Tax Cuts and Jobs Act of 2017 (TCJA, also referred to as the Act),¹ limited the long-standing exceptions to the application of the section 101(a)(2) transfer for value rule. Those exceptions provide that the rule, which otherwise renders the death benefit partially taxable, apply where the transfer is made to the insured, a partner of the insured, a partnership in which the insured is a partner, a corporation in which the insured is an officer or shareholder or in circumstances where the contract's tax basis in the hands of the transferee carries over to the transferor (in whole or in part). Pursuant to section 101(a)(3), these exceptions do not apply where the transfer is a "reportable policy sale," which is defined in the statute as the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business or financial relationship with the insured apart from the acquirer's interest in that contract. In this definition, the term *indirectly* applies to the acquisition of an interest in a partnership, trust or other entity that holds an interest in the life insurance contract. This rule was added to the Code to subject life insurance contract sales in all forms of life settlement transactions to taxation under section 101(a)(2). In Notice 2018-41,² the Treasury Department and the

¹ The formal name of this legislation is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." Enacted as H.R. 1 on December 22, 2017, and assigned Public Law No. 115-97, the legislation was originally known as the Tax Cuts and Jobs Act, but that title was removed due to a Senate parliamentary rule prior to final enactment. It continues to be referred to by its original, if now informal, name.

² 2018-20 I.R.B. 584.

IRS stated their intention to issue regulations implementing the new rule, described some of the content of proposed regulations in general terms and requested public comment on a number of related questions.

Other Rules (Chapter 1, Page 17)

Contract sales, section 1001: Prior to the TCJA, there was an issue about whether a taxpayer's basis in a life insurance contract should be reduced by any cost of insurance provided through the date of the sale of the contract, with the IRS taking the position in Revenue Ruling 2009-13³ that, in many instances, it should. The Act clarified that there should not be any such reduction. It did so by amending section 1016(a)(1), which governs adjustments to tax basis, to provide in new subparagraph (B) that "no adjustment [to basis] shall be made . . . for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract."⁴ The legislative history of the Act briefly elaborates on the meaning of this clarification, saying that the mortality, expense and other reasonable charges just referred to are "known as 'cost of insurance'" and observing that the addition of the new rule "reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance."⁵

APPENDIX 1.2. A NOTE ON TAX AUTHORITIES (Chapter 1, Page 18)

On page 19, footnote 96 should read: *United States v. Woods*, 571 U.S. 31, 134 S. Ct. 557 (2013).

CASH VALUE ACCUMULATION TEST (Chapter 2, Page 23)

Net Single Premium (Chapter 2, Page 24)

Prior to the TCJA, the NSP under the CVAT was determined, according to section 7702(b)(2), assuming the following mortality charges as specified in section 7702(c)(3)(B)(i):

- For **contracts entered into before October 21, 1988**, the mortality charges specified in the contract or, if none is specified, the mortality charges used in determining the reserves for the contract.

³ 2009-21 I.R.B. 1029 (situation 2).

⁴ TCJA § 13521 amending section 1016(a)(1).

⁵ H.R. Rep. No. 115-466 (2017) (Conference Report) at 486.

- For **contracts entered into on or after October 21, 1988**, “reasonable” mortality charges that, except as provided in regulations, do not exceed the mortality charges specified in the “prevailing commissioners’ standard tables” as defined in section 807(d)(5) as of the time the contract is issued.

The Act amended section 7702(c)(3)(B)(i) to provide that the NSP calculation assumes reasonable mortality charges which meet the requirements prescribed in regulations or that do not exceed the mortality charges specified in the prevailing commissioners’ standard tables as defined in new section 7702(f)(10).⁶ The definition of the prevailing tables in new section 7702(f)(10) replicates the definition previously found in section 807(d)(5)(A) and (B), which were repealed by the Act.⁷ The import of the amendment of section 7702(c)(3)(B)(i), which applies in taxable years beginning after December 31, 2017,⁸ is discussed further below.

GUIDELINE PREMIUM/CASH VALUE CORRIDOR TEST (Chapter 2, Page 26)

Guideline Single and Guideline Level Premiums (Chapter 2, Pages 26–27)

Prior to the TCJA, the GSP and GLP were computed assuming the following mortality charges as specified in section 7702(c)(3)(B)(i):

- For **contracts entered into before October 21, 1988**, the mortality charges specified in the contract or, if none is specified, the mortality charges used in determining the reserves for the contract.
- For **contracts entered into on or after October 21, 1988**, “reasonable” mortality charges that, except as provided in regulations, do not exceed the mortality charges specified in the “prevailing commissioners’ standard tables” as defined in section 807(d)(5) as of the time the contract is issued.

The Act amended section 7702(c)(3)(B)(i) to provide that the GSP and GLP calculations assume reasonable mortality charges which meet the requirements prescribed in regulations or that do not exceed the mortality charges specified in the prevailing commissioners’ standard tables as defined in new section 7702(f)(10).⁹ (As noted above, the definition of the prevailing tables in new section 7702(f)(10) replicates the definition in former section 807(d)(5)(A) and (B).) The import of this amendment, applicable in taxable years beginning after December 31, 2017,¹⁰ is discussed further below.

⁶ TCJA § 13517(a)(4)(A).

⁷ TCJA § 13517(a)(4)(B).

⁸ TCJA § 13517(c)(1).

⁹ TCJA § 13517(a)(4)(A).

¹⁰ TCJA § 13517(c)(1).

MODIFIED ENDOWMENT CONTRACTS UNDER SECTION 7702A

The 7-Pay Test

Prior to the TCJA, the 7-pay premium for a contract was determined assuming—as prescribed in section 7702A(c)(1), which incorporated section 7702(c)(3)(B)(i) before its amendment—reasonable mortality charges that, except as provided in regulations, do not exceed the mortality charges specified in the prevailing commissioners’ standard tables as defined in section 807(d)(5) as of the time the contract is issued. Applying section 7702(c)(3)(B)(i) as amended by the Act, the 7-pay premium is computed assuming reasonable mortality charges which meet the requirements prescribed in regulations or that do not exceed the mortality charges specified in the prevailing commissioners’ standard tables as defined in new section 7702(f)(10).¹¹ (As noted above, the definition of the prevailing tables in new section 7702(f)(10) replicates the definition in former section 807(d)(5)(A) and (B).) The import of this amendment, applicable in taxable years beginning after December 31, 2017,¹² is discussed further below.

MORTALITY (Chapter 2, Page 41)

The Permanent Mortality Rule (Chapter 2, Page 42)

Two significant changes for the permanent mortality rule specified in section 7702(c)(3)(B)(i) have occurred since the 2015 publication of the second edition of LIFE INSURANCE & MODIFIED ENDOWMENTS: the revision of the permanent mortality rule itself and the advent of the 2017 Commissioners’ Standard Ordinary Mortality Tables (2017 CSO Tables).

Revision of the permanent mortality rule

Revised wording of the rule. The TCJA revised the permanent mortality rule to require that the section 7702 (and 7702A) premium computations be based on:

- (i) reasonable mortality charges which meet the requirements prescribed in regulations to be promulgated by the Secretary or that do not exceed the mortality charges specified in the prevailing commissioners’ standard tables as defined in subsection (f)(10) [of section 7702]¹³

¹¹ TCJA § 13517(a)(4)(A).

¹² TCJA § 13517(c)(1).

¹³ TCJA § 13517(a)(4)(A).

Significantly, prior to this change, the reasonable mortality rule read differently. Below is the wording of the former rule with the Act's deletions shown by strikethroughs and the Act's additions shown in italics:

(i) reasonable mortality charges which meet the requirements ~~(if any)~~ prescribed in regulations *to be promulgated by the Secretary* ~~and which (except as provided in regulations)~~ *or that* do not exceed the mortality charges specified in the prevailing commissioners' standard tables ~~(as defined in section 807(d)(5)) as of the time the contract is issued~~ *subsection (f)(10)*

As enacted by TAMRA in 1988, section 7702(c)(3)(B)(i) expressly gave the Treasury Department regulatory authority (a) to prescribe requirements that mortality charges would need to meet, in addition to not exceeding the charges specified in the prevailing standard tables, in order to be considered reasonable mortality charges, and (b) to expand the scope of reasonable mortality charges to encompass charges exceeding those of the prevailing standard tables. With the wording changes just noted, and more specifically the replacement of "and which" with "or that," the revised rule removes the prior express authority of regulations to limit the mortality assumptions used in the premium computations to amounts less than those in the prevailing standard tables. Ultimately that authority, contemplated for use in regulations proposed in July 1991, was never exercised, particularly in light of objections that any such requirement would have made the section 7702 compliance of whole life insurance difficult if not impossible. The Treasury Department presumably retains authority, under its general authorization to issue interpretive guidance, to determine the meaning of "reasonable mortality charges . . . that do not exceed the mortality charges specified in the prevailing commissioners' standard tables. . . ." Notice 2016-63, discussed below, is an example of such guidance, although that notice may need to be updated to reflect the TCJA's changes.

The revised permanent mortality rule leaves in place the Treasury's express authority to define the circumstances in which mortality assumptions that exceed those in the prevailing standard tables are "reasonable" and thus may be used in the section 7702 and 7702A premium computations. These circumstances would occur, for example, under contracts insuring lives that are rated as substandard risks, and they could also arise under contracts issued in guaranteed-issue or simplified-issue cases. Substandard-risk and guaranteed-issue (common for group) contracts typically experience worse mortality than those that are fully underwritten, and efforts to streamline the underwriting and issuance of contracts in the individual market through the use of simplified techniques could result in some deterioration of mortality experience. In such cases, where mortality experience for these types of contracts exceeds the mortality in the prevailing tables, there is justification for Treasury guidance permitting the use of higher mortality assumptions in establishing compliance with sections 7702 and 7702A. Such guidance also would be appropriate in view of the historic role of the interim rule for mortality charges in TAMRA section 5011(c)(2), which presumably remains in effect in the absence of regulations. The exercise of the Treasury's authority also could be called upon, as has been the case in the

past, to align the requirements of the reasonable mortality rule with the advent of new tables in circumstances where the three-year transition rule of new section 7702(f)(10) (discussed below) is inadequate to do so.

New section 7702(f)(10). While the wording of the reasonable mortality rule itself no longer refers to the use of the prevailing standard tables in effect “as of the time the contract is issued,” the wording just quoted still applies to determine the tables to be used in the section 7702 and 7702A premium calculations. This is brought about by the wording imported into new section 7702(f)(10) from former section 807(d)(5)(A), which the Act repealed in connection with a rewrite of the life insurance reserve deduction rules. The new section 7702(f)(10), mirroring the wording of its predecessor, states that the prevailing standard tables are

the most recent commissioners’ standard tables prescribed by the National Association of Insurance Commissioners which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued.¹⁴

Section 7702(f)(10) then goes on to incorporate the three-year transition rule that previously appeared in section 807(d)(5)(B), also repealed by the Act, into the new section 7702-based definition of prevailing standard tables. The three-year rule enabled the former reserve deduction limit to be computed using a preexisting mortality table for three years after a new table had met the requirements to be considered “prevailing.” To preserve this rule for the section 7702 and 7702A premium computations, the second sentence of new section 7702(f)(10) reads as follows:

If the prevailing commissioners’ standard tables as of the beginning of any calendar year (hereinafter in this paragraph referred to as the “year of change”) are different from the prevailing commissioners’ standard tables as of the beginning of the preceding calendar year, the issuer may use the prevailing commissioners’ standard tables as of the beginning of the preceding calendar year with respect to any contract issued after the change and before the close of the 3-year period beginning on the first day of the year of change.¹⁵

While the Act brought the basic definition needed to allow the reasonable mortality rule to operate over to section 7702, it did not continue the “lowest reserves” rule of former section 807(d)(5)(E). That provision required insurers, in computing the limit on deductible reserves where more than one mortality table (or options under a table) met the prevailing standard tables definition, to use the table (and option) that “generally yields the lowest reserves. . . .” This additional requirement, coupled with the instruction in section 7702 to use the prevailing standard tables in the premium computations, caused

¹⁴ As added to IRC § 7702 by TCJA § 13517(a)(4)(A).

¹⁵ As added to IRC § 7702 by TCJA § 13517(a)(4)(B).

some speculation about whether the version of the prevailing standard tables that yielded the lowest reserves needed to be used for satisfying the reasonable mortality requirements of section 7702(c)(3)(B)(i) in the absence of the safe harbor notices published by the IRS.

In choosing to retain the concept of “prevailing commissioners’ standard tables” in the operation of the reasonable mortality rule, the Act seemingly took notice of the continuing use of such tables in the net premium reserve component of the annual statement “reported reserve” computed in accordance with chapter 20 of the new NAIC Valuation Manual, i.e., VM-20 (discussed further below). Under VM-20, life insurance companies are generally required to calculate a net premium reserve for all life insurance contracts as part of the process for determining the reported reserve. Therefore, as long as the net premium reserve remains as a component of the calculation of the reported reserve for a life insurance contract under VM-20, and as long as the prevailing standard tables as defined in new section 7702(f)(10) are used in computing that component, the reasonable mortality rule should continue to function as it has over the past three decades.

Effective date of legislative changes. The change made to section 7702(c)(3)(B)(i) and the addition of section 7702(f)(10) “apply to taxable years beginning after December 31, 2017.”¹⁶ Hence, these changes are now in effect. There could be questions about how this rule interacts with the original effective date of TAMRA’s reasonable mortality rule, which included the interim mortality rule. TAMRA’s effective date rules, for both section 7702 and section 7702A, were quite elaborate, and in the absence of any indication to the contrary—there is no legislative history associated with the permanent mortality rule change made by the Act—the interim mortality rule should continue to be in effect unless and until regulations are issued.

Advent of the 2017 CSO Tables

The 2017 CSO Tables became the “prevailing commissioners’ standard tables” under former section 807(d)(5)(A) effective January 1, 2017. The NAIC adopted the new tables as part of the Valuation Manual implemented under revisions made to the Standard Valuation Law in 2016. Under applicable state law, the 2017 CSO Tables *are permitted to be* used for contracts issued on or after January 1, 2017, and *must* be used for contracts issued on and after January 1, 2020. Section 7702(f)(10)—like its predecessor, former section 807(d)(5)—generally defines the prevailing commissioners’ standard tables as the most recent tables prescribed by the NAIC that are permitted to be used in computing reserves for the type of contract involved under the insurance laws of at least 26 states when the contract was issued; however, the revised Standard Valuation Law and the Valuation Manual adopted under it render the 26-state approval automatic when the NAIC adopts a new table, as explained further in the paragraphs that follow. Hence, subject to the three-year transition rule that is now contained in section 7702(f)(10), the 2017 CSO Tables now serve as the limit under the permanent “reasonable mortality” rule of section

¹⁶ TCJA § 13517(c)(1).

7702(c)(3)(B)(i) for the purposes of section 7702 and 7702A calculations in standard risk cases.

By way of background, a fundamental change in approach for establishing valuation standards for life insurance products, due in large part to the advent of principle-based reserving, was initiated by the NAIC's 2009 adoption of revisions to the Standard Valuation Law.¹⁷ This was followed in December 2012 by the NAIC's adoption of the Valuation Manual, a technical how-to guide with specifics that allow actuaries and senior corporate management to implement principle-based reserving. After a lengthy state approval process that required adoption by a supermajority of NAIC jurisdictions (i.e., at least 42 eligible jurisdictions, including the states, the District of Columbia and certain U.S. territories) representing 75 percent of direct written premium, the Valuation Manual became operative on January 1, 2017. At the beginning of 2018, it was in effect in 47 states.

The Valuation Manual changes the process used by the NAIC and the states for adopting new mortality tables. In the past, new tables were recognized by state legislation or regulatory action. For example, for the 2001 CSO Tables, the NAIC adopted a regulation titled *Recognition of the 2001 CSO Mortality Table for Use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits Model Regulation*¹⁸ in 2002 that required individual state approval; thus, there was a lengthy approval process before a majority of the states had adopted the 2001 CSO Tables by mid-2004. Under the new approach, the NAIC will adopt new mortality tables via amendments to the Valuation Manual without the need for legislation or a regulatory proceeding in each state, significantly shortening the duration of the process for introducing new mortality tables.¹⁹ In particular, the Valuation Manual as presently adopted anticipates that such amendments will take effect automatically, so a change in mortality tables would be implemented based on the effective date of the Valuation Manual amendment, with no need for any state action.

The 2017 CSO Tables are the first standard mortality tables following the new adoption process.²⁰ Because the Valuation Manual, including its incorporation of the 2017 CSO

¹⁷ MDL-820 (2010).

¹⁸ MDL-814 (2003).

¹⁹ See § 11B and 11C of the Standard Valuation Law and the drafting note thereto; § 5cH(6) of the Standard Nonforfeiture Law for Life Insurance, MDL-808 (2014).

²⁰ While the accelerated adoption process provided by the Valuation Manual is beneficial from an efficiency perspective, it raises concerns that it may not provide sufficient time for insurers to develop products and conform valuation and administrative systems to new tables. There also may be less time for the IRS to provide any needed guidance on new tables from both a valuation and product tax perspective. To alleviate some of these concerns, guidance notes were added to VM-02 and VM-20 of the Valuation Manual that recommend a time frame for new table adoption. For the 2017 CSO Tables, however, the permitted and mandatory use dates that were ultimately adopted did not adhere to this time frame, due in part to the NAIC's desire to have the permitted date for

Tables, is in effect in more than 26 states, the 26-state approval requirement for the new tables was met when the Valuation Manual took effect on January 1, 2017. Hence, the new tables became “prevailing” within the meaning of section 7702(f)(10) (and former section 807(d)(5)(A)) and applicable under the permanent mortality rule for contracts issued on or after that date, subject to the three-year transition rule. The IRS has recognized this development, as discussed in the next part.

As illustrated in Table 1, mortality rates under the 2017 CSO Tables generally reflect an overall improvement in mortality relative to the 2001 CSO Tables, with improvements varying across attained age and risk class.

the 2017 CSO Tables coincide with the operative date of the Valuation Manual. As discussed next, this has not created a problem under section 7702 or 7702A due to the structure of the tax statutes and prompt action undertaken by the IRS.

Table 1. Select mortality rates						
No. of deaths per 1,000 – age last birthday (ALB)						
Attained age	Male nonsmoker			Female nonsmoker		
	2017 CSO	2001 CSO	%	2017 CSO	2001 CSO	%
25	0.79	1.00	79%	0.32	0.51	63%
45	1.87	2.44	77%	1.07	1.79	60%
65	8.39	16.23	52%	5.90	11.52	51%
85	87.97	119.83	73%	65.39	75.99	86%
	Male smoker			Female smoker		
25	1.01	1.67	60%	0.40	0.79	51%
45	3.46	4.78	72%	2.32	3.28	71%
65	20.79	27.69	75%	16.62	21.10	79%
85	117.49	146.24	80%	107.44	108.60	99%

As expected, the mortality improvements underlying the development of the 2017 CSO Tables will reduce funding limitations under sections 7702 and 7702A, with reductions to guideline, 7-pay and net single premiums generally in the range of 10–20 percent relative to their 2001 CSO Table counterparts. Table 2 illustrates the relative reduction in the guideline single premium (GSP) for a sample contract across several different issue ages and risk classes. Insurers should expect reductions in the guideline level, 7-pay and net single premiums to be comparable to those for the GSP for most issue ages and risk classes.

Table 2. GSP per \$1,000 of death benefit						
Annual curtate calculations, 6% interest, no expenses and an endowment age of 100						
Issue age	Male nonsmoker			Female nonsmoker		
	2017 CSO	2001 CSO	%	2017 CSO	2001 CSO	%
25	51.59	65.62	79%	41.85	54.42	77%
45	135.21	171.20	79%	113.60	146.58	78%
65	342.24	409.05	84%	300.25	349.52	86%
85	702.95	733.77	96%	661.37	668.86	99%
	Male smoker			Female smoker		
	2017 CSO	2001 CSO	%	2017 CSO	2001 CSO	%
25	74.47	90.36	82%	62.11	75.73	82%
45	192.11	221.52	87%	170.86	197.38	87%
65	438.70	470.37	93%	402.35	425.78	94%
85	731.37	758.00	96%	718.40	708.85	101%

IRS Notice 2016-63 (Chapter 2, Page 47)

Prior to the change made to the permanent mortality rule by the TCJA, the Treasury Department and the IRS issued Notice 2016-63²¹ in the fall of 2016 in response to the life insurance industry's request for guidance on the transition to the 2017 CSO Tables. Notice 2016-63—after recognizing that the new tables would become the prevailing commissioners' standard tables under former section 807(d)(5)(A) on January 1, 2017—restated the safe harbors established by Notices 88-128 and 2006-95. It generally retained the structure and rules of the latter notice, including the rules for the use of unisex/sex-distinct mortality tables and for unismoke/smoker-distinct mortality tables. Most significantly, Notice 2016-63 provided a new safe harbor enabling use of the 2017 CSO Tables, stating,

A mortality charge with respect to a life insurance contract will satisfy the requirements of § 7702(c)(3)(B)(i) [i.e., the permanent reasonable mortality rule] so long as (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 2017 CSO tables; (2) the mortality charge does not exceed the mortality charge specified in the contract at issuance; and (3) either (a) the contract is issued after December 31, 2019, or (b) the contract is issued before January 1, 2020, in a state that permits or requires the use of the 2017 CSO tables at the time the contract is issued.²²

Under this new safe harbor rule, the effective dates for use of the 2017 CSO Tables—permitted for contracts issued on or after January 1, 2017, and required for contracts issued on or after January 1, 2020—align perfectly with those under the Valuation Manual. This was not the case with the 2001 CSO Tables, and IRS action (via Notices 2004-61 and 2006-95) was needed to align the effective dates for section 7702 and 7702A purposes with those under state law. For the 2017 CSO Tables, the effective dates under the Valuation Manual were designed with the rules of former sections 807(d)(5)(A) and (B) in mind (now section 7702(f)(10)).

With respect to the material change rules that apply in determining a contract's issue date under the safe harbor rules, Notice 2016-63 also generally retained the structure and rules of Notice 2006-95. Thus, for purposes of the notice, contracts that are received in exchange for existing contracts will generally be treated as new contracts that are issued on the date of the exchange.²³ On the other hand, similar to Notice 2006-95, the new notice provided that a change in an existing contract is not considered to result in an exchange if the terms of the resulting contract (i.e., the amount and pattern of death benefit, the premium

²¹ 2016-45 I.R.B. 683.

²² Notice 2016-63 § 4.04.

²³ Notice 2016-63 § 5.01.

pattern, the rate or rates guaranteed on issuance of the contract and mortality and expense charges) are the same as the terms of the contract prior to the change.²⁴ Also, section 5.02 of the notice continued the rule from section 5.02 of Notice 2006-95, with modifications to take account of the 2017 CSO Tables, under which

if a life insurance contract satisfied [a safe harbor of the notice] when originally issued, a change from the previous tables to the 2001 or 2017 CSO tables is not required if: (1) the change, modification, or exercise of a right to modify or add benefits is pursuant to the terms of the contract; (2) the state in which the contract is issued does not require use of the 2001 or 2017 CSO tables for that contract under its standard valuation and minimum nonforfeiture laws; and (3) the contract continues upon the same policy form or blank.²⁵

The latter two requirements under this rule pertain to whether a contract is new under applicable law, which is relevant to the applicable law requirement of section 7702(a). The first requirement, relating to whether a change is “pursuant to the terms of the contract” has been criticized as unnecessarily restrictive, but in issuing the new notice, the IRS chose not to reconsider the prior rule generally at the present time. That said, the IRS implemented two significant modifications in Notice 2016-63 relative to the material change rules of its predecessor:

- Notice 2016-63 provided that if the only change to an existing contract is a reduction or deletion of benefits provided under that contract, such a change will not affect the contract’s issue date for purposes of the notice’s safe harbors.²⁶ Thus, for example, if a life insurance contract does not provide a contractual right to reduce or decrease benefits (as is common with respect to the face amount of death benefit under ordinary whole life insurance contracts) and the insurer decides to permit such reductions or decreases, the change will not result in the contract being treated as a new issue for purposes of the notice.
- The examples in section 5.03 of Notice 2006-95 that illustrated the operation of section 5.02 of that same notice were modified in Notice 2016-63 to provide that the “changes, modifications, or exercises of contractual provisions referred to in section 5.02 of this notice include . . . reinstatement of a policy within 90 days after its lapse *or reinstatement of a policy as required under applicable state or foreign law*” [emphasis added].²⁷ The italicized language was not included in Notice 2006-

²⁴ *Id.*

²⁵ Notice 2016-63 § 5.02.

²⁶ *Id.* This effectively reverses the result in PLR 201230009 (January 30, 2012).

²⁷ Notice 2016-63 § 5.03.

95 and removes any implication that exercises of contractual rights as required by applicable law to reinstate benefits beyond the 90-day period referenced in the prior notice could result in new issue treatment.

Since the publication of Notice 2016-63 preceded the enactment of the TCJA, it does not reflect the change made to the section 7702(c)(3)(B)(i) permanent mortality rule.

MORTALITY RATES BEYOND AGE 100 (Chapter 3, Page 92)

Revenue Procedure 2010-28 (Chapter 3, Page 93)

In February 2018, the IRS issued Revenue Procedure 2018-20²⁸ to update the safe harbor rules established in Revenue Procedure 2010-28 in light of the advent of the 2017 CSO Tables. The 2010 revenue procedure's safe harbor rules addressed calculations of net single premiums and guideline premiums under section 7702 and 7-pay premiums and necessary premiums under section 7702A in the case of life insurance contracts that (1) have mortality guarantees based on the 2001 CSO Tables and (2) may continue in force after the day on which the insured attains age 100. Under Revenue Procedure 2018-20, these safe harbor rules are extended to "life insurance contracts that have mortality guarantees based upon not only the 2001 CSO tables, but also upon the 2017 CSO tables and any other prevailing commissioners' standard tables that extend beyond age 100."²⁹

The issuance of Revenue Procedure 2010-28 had seemingly settled questions regarding section 7702's age 100 maximum maturity date requirement under contracts based on the 2001 CSO Tables. However, with the advent of the 2017 CSO Tables when VM-20 became effective on January 1, 2017, the earlier questions again became pertinent because the terms of the 2010 revenue procedure addressed only contracts based on the 2001 CSO Tables.

Revenue Procedure 2018-20 recites the history of and rationale for the issuance of the 2010 revenue procedure, again acknowledging (as did its predecessor) the role played by the SOA Task Force in formulating the Age 100 Safe Harbor Testing Methodologies. The new procedure restates all of those methodologies in full, as it now (effective February 23, 2018) replaces its predecessor as the official statement of the age 100 testing methodologies; that is, Revenue Procedure 2018-20 "modifies and supersedes" Revenue Procedure 2010-28.³⁰ Additionally, the new procedure repeats *verbatim* the "no inference" provision of its predecessor.³¹

²⁸ 2018-11 I.R.B. 427.

²⁹ Rev. Proc. 2018-20 § 1.

³⁰ See *id.* §§ 4 and 5.

³¹ See Rev. Proc. 2018-20 § 3.03.

Of most importance, Revenue Procedure 2018-20 extends the Age 100 Safe Harbor Testing Methodologies and the “no inference” provision to the 2017 CSO Tables and to all future CSO tables that provide mortality rates beyond age 100. To quote from the operative wording of the new procedure, the safe harbor provided under its predecessor is made available “to life insurance contracts that (1) have mortality guarantees based upon prevailing commissioners’ standard tables that extend beyond age 100, such as the 2001 CSO tables and the 2017 CSO tables, and (2) may continue in force after the day on which the insured individual attains age 100.”³² In this connection, Revenue Procedure 2018-20 cites to the meaning of “prevailing commissioners’ standard tables” as defined in section 7702(f)(10) as added by the TCJA.³³

SUBSTANDARD MORTALITY (Chapter 3, Page 97)

For the continuing effect of the interim mortality rule after the amendment of section 7702(c)(3)(B)(i) by the TCJA, see the earlier discussion regarding the effective date of the changes made to the permanent mortality rule.

GUIDELINE PREMIUM TEST ADJUSTMENTS (Chapter 4, Page 105)

Timing of Adjustments to the Guideline Premiums (Chapter 4, Page 112)

Equation 4.4 on page 114, which details formulas for one version of the “exact approach” for adjusting guideline premiums, should read as follows:

- A “level” premium P is computed so that the future contract benefits are funded by the combination of (a) and (b), where
 - a) equals $(n/12)$ times P , assumed to be paid at time of adjustment, and
 - b) equals P , assumed to be paid at each subsequent anniversary.

P is then found by solving:

$$\left(\frac{n}{12}\right) \times P + \frac{(1-q^m)^n}{(1+i^m)^n} \times (P \times \ddot{a}_{x+t}) = NSP_{x+t-n} \text{ (as defined above)} \quad (4.4)$$

³² Rev. Proc. § 2.12.

³³ *Id.* § 1.

**MATERIAL CHANGES AND THE SECTION 7702 EFFECTIVE DATE RULE
 (Chapter 5, Page 155)**

Footnote 28 on page 156 should be updated to include PLR 201736019 (June 15, 2017).

CORRECTION OF INADVERTENT MECs (Chapter 8, Page 286)

*Table 8.3 Earnings Rates to Be Used to Calculate Either Excess Earnings or Overage Earnings
 (Chapter 8, Pages 290–291)*

Table 8.3 below updates the table published in the textbook and contains the earnings rates for years 1982 through 2018. The earnings rates for years 1982–1987 and 2008–2017 are based on the application of the formulas contained in Revenue Procedure 2008-39, while the earnings rate for 2018 is based on the arithmetic average of the earnings rates for the prior three years (i.e., 2015–2017).

Table 8.3. Earnings rates to be used to calculate either excess earnings or overage earnings			
Year	Contracts other than variable contracts	Variable contracts	Source
1982	15.0%	21.8%	Application of Rev. Proc. 2008-39 section 3.07 formulas
1983	12.8%	16.4%	
1984	13.5%	7.0%	
1985	12.0%	26.1%	
1986	9.7%	15.0%	
1987	10.0%	2.7%	
1988	10.2%	13.5%	
1989	9.7%	17.4%	
1990	9.8%	1.4%	
1991	9.2%	25.4%	
1992	8.6%	5.9%	
1993	7.5%	13.9%	

1994	8.3%	-1.0%	
1995	7.8%	23.0%	
1996	7.7%	14.3%	
1997	7.6%	17.8%	
1998	6.9%	19.7%	
1999	7.4%	12.8%	
2000	8.0%	-5.5%	
2001	7.5%	-7.1%	
2002	7.2%	-14.1%	
2003	6.2%	19.6%	
2004	6.1%	6.9%	
2005	5.6%	2.1%	
2006	6.0%	10.0%	
2007	6.0%	3.6%	
2008	6.5%	-28.1%	
2009	6.3%	20.7%	
2010	5.5%	10.6%	Application of
2011	5.2%	1.4%	Rev. Proc. 2008-39
2012	4.3%	11.3%	section 3.07 formulas
2013	4.7%	19.8%	
2014	4.5%	9.2%	
2015	4.4%	-1.0%	
2016	4.2%	7.6%	
2017	4.1%	14.4%	
2018	4.2%	7.0%	Average of prior 3 years

Table 8.4. Sample Calculations of Overage Earnings (Chapter 8, Page 291)

Table 8.4 illustrates the calculation of overage earnings. The example details the calculation of the overage earnings through the end of the 7-pay test period, which expired on December 31, 2004. (The table that follows corrects a numerical error in Table 8.4 as published in the textbook.)

Table 8.4. Sample calculations of overage earnings, Rev. Proc. 2008-39 closing agreement

Policy number:		ABC123		Death benefit:		10,000.00		
Original issue date:		1/1/1998		Reason for MEC failure:		Early premium		
Beginning of contract year	7-pay year	Transaction date	Transaction amount	Cumulative amounts paid	Cumulative 7-pay premium	Overage	Earnings rate	Overage earnings
1/1/1998	1	1/1/1998	1,142.00	1,142.00	1,142.00	0.00	6.9%	0.00
1/1/1998	1	12/26/1998	1,142.00	2,284.00	1,142.00	1,142.00	6.9%	1.25
1/1/1999	2	1/1/1999	0.00	2,284.00	2,284.00	0.00	7.4%	0.09
1/1/2000	3	1/1/2000	1,142.00	3,426.00	3,426.00	0.00	8.0%	0.11
1/1/2000	3	12/25/2000	1,142.00	4,568.00	3,426.00	1,142.00	8.0%	1.69
1/1/2001	4	1/1/2001	0.00	4,568.00	4,568.00	0.00	7.5%	0.24
1/1/2002	5	1/1/2002	1,142.00	5,710.00	5,710.00	0.00	7.2%	0.24
1/1/2002	5	12/30/2002	1,142.00	6,852.00	5,710.00	1,142.00	7.2%	0.44
1/1/2003	6	1/1/2003	0.00	6,852.00	6,852.00	0.00	6.2%	0.25
1/1/2004	7	1/1/2004	1,142.00	7,994.00	7,994.00	0.00	6.1%	0.26
Income on the contract:			0.00	Income tax:			0.00	
Total taxable distributions:			0.00	Penalty tax:			0.00	
Overage earnings allocated to prior distribution:			0.00	Deficiency interest:			0.00	
Distribution frequency factor:			0.80					
Applicable percentage:			15%	Total overage earnings:			4.57	

SECTION 7702 AND 7702A HISTORY (Chapter 9, Page 319)

As discussed in the update to Chapter 2, the TCJA altered the wording of the permanent mortality rule in section 7702(c)(3)(B)(i). The Act also imported into new section 7702(f)(10) the provisions regarding the prevailing commissioners' standard tables previously found in section 807(d)(5)(A) and (B).