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TAX ISSUES

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- How do I design products so they comply with all federal income tax requirements?
- After I've done that, what do I do with the policies that fail, anyway?

MR. BRUCE E. BOOKER: Our speakers are Doug Hertz, Vice President and Actuary at Mass Mutual Life Insurance Company and John Adney, a partner in the law firm of Davis & Harman in Washington. Doug will tell us everything we need to know to be sure that we have policies which comply with all the various income tax laws.

MR. DOUGLAS N. HERTZ: Compliance with Sections 7702 and 7702A, the definition of life insurance and the modified endowment definition, needs to be taken seriously. To date there's been very little by way of auditing or checking of compliance by the Internal Revenue Service. Quite frankly, most Internal Revenue agents simply wouldn't know where to begin, but the fact is they're learning and we're not accustomed to being checked. This is all going to change soon.

The Internal Revenue Service has decided to take 7702 and 7702A seriously. When the IRS decides to move, it moves slowly, but it moves very thoroughly. To date, the national law office is simply trying to get agents to at least ask you if you have some system in place to monitor compliance with these rules. If your answer to that question is no, you have trouble coming. If your answer is yes, the auditing agent might come back with a question asking you if your products actually passed your system's tests. Again, if the products don't, you may have some trouble. About all the IRS can do right now is ask you if your products passed your tests because the IRS doesn't know anything more about it. At some point, efforts are going to be made to assure that your system's tests conform with the law. Right now, the IRS really can't do that.

Aside from the very serious matter of policyholder relations, companies must take care because the IRS has plenty of authority to inflict company level pain if compliance is poor. If you don't believe me, read Revenue Ruling 91-17. I should note the Internal Revenue Service has no more desire to chase after your policyholders than you have a desire to see the IRS do it. The IRS will come after you at the company level. All companies have recordkeeping, reporting, withholding, and deposit obligations. Failure to fulfill those obligations will lead to a whole panoply of penalties that John Adney will cheerfully discuss with you in a little while.

Not only is compliance serious, I must further note to you that you can't buy your way out of this responsibility. Private Letter Ruling 9202008 discusses a situation in which there was a computer system of purchased software. The system

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systematically failed to notice unscheduled premiums coming into the contract and thus allowed some excessive premium into guideline premium tested contracts. The company failed in its responsibility to demonstrate that this was a "reasonable error." The moral of this story is that errors in purchased systems do not automatically qualify for relief under the Relief Provision of 7702(f)(8).

For any compliance system there are certain steps that you should be taking. You're going to have to make a lot of choices in setting up any compliance system interpreting the requirements of the Internal Revenue Code. First, choose carefully. Then document the decision that was made and the reasoning for the authority behind it, if there is any. Remember that the person who makes the decision may not be around to explain it when questions are asked. It's good to have a memo turning yellow in a file somewhere so that you can haul it out when the revenue agent gets around to asking his questions. Whether it's purchased software, developed software, in-house, or simply instructions to people, test your system on a variety of cases. Try to make sure that it's doing what you want it to do, then document your tests and the results that you got. Some day you're going to want evidence that you made a good faith effort to monitor compliance.

With matters of interpretation, the most important message that I can give you is one of attitude. The attitude is, be reasonable. There's very little that you can gain by stretching the rules. Very few interpretive choices that you can make will have any substantial impact on the investment characteristics of your product. For those choices that would have a substantial impact, I would caution you that, if it looks too good to be true, it probably isn't true. I realize there is a major motive for cutting corners, and that is to hold down the administrative burden. These rules are insanely complex and difficult to administer. All I can say in this regard is good luck and remember that cleaning up the mess afterward will be a far greater burden than complying up-front.

There isn't much out there to provide guidance on interpretive matters. First, I'll mention a few things about mortality assumptions using computing definitional limitations. Notice 88-128 gives us the 1980 CSO tables as a safe harbor, the sex distinct tables without select factors. That's a safe harbor for reasonable mortality for contracts issued before ninety days after the issuance of temporary regulations on the subject. We now have proposed, but not temporary regulations (Notice 88-128 is still out there) that give the 1980 CSO as a safe harbor, but give it only to single life insurance contracts. The unisex and smoker/nonsmoker variants are also allowed. Denial of the safe harbor to first to die contracts and to contracts with a spouse rider was probably inadvertent. In limiting it to single life contracts, the target was second to die or last to die contracts. Quite frankly, there are those in the Internal Revenue Service who view second to die contracts as the equivalent of deferred annuities because they have very low mortality charges. Some would say somewhere between infinitesimal and negligible. Those at the Service want these contracts all to be nixed, and denial of the safe harbor was a crude communication device to let the industry know the IRS thought there was something wrong there.

For substandards, guaranteed issuance and second to die contracts, there is no special safe harbor. The general standard for mortality is that you may take into account the charges actually expected to be imposed. The ACLI has asked for some

limited safe harbors in these areas, and we eagerly await the IRS decision on the matter. Official sources of interpretive guidance other than Notice 88-128 and the proposed regulation are important. The House and Senate Committee Reports for the 1984 Act are absolutely essential. Any choice that you make must be reviewed against these reports if for no other reason than just to be sure the choice you've made is not expressly banned.

The 1984 Blue Book is the general explanation of the law prepared by the Joint Committee Staff. It's called the Blue Book because it's published with a blue cover. It addresses issues not addressed by the committee reports. Lawyers will tell you that the Blue Book is not officially part of the legislative history, but when there's nothing else to go on, everybody relies on it and it's treated as a reliable source by most people.

The 1986 Blue Book for the technical corrections contains a helpful discussion of the attained age decrement method of adjusting guideline premium limitations. It was probably written by John Adney.

Unofficial sources are not legally authoritative, but they can certainly provide hindsight and help you to make a case. Certain papers are especially helpful. Chris DesRochers' paper, "The Definition of Life Insurance under Section 7702 of the Internal Revenue Code, (*TSA* XL, page 209), provides useful actuarial insight into questions about Section 7702, and I heartily recommend it to those of you who have responsibilities in the area. Andy Pike wrote a paper, "Reflections on the Meaning of Life" in the *Tax Law Review*, in 1988. It's a comprehensive discussion. It sort of earned the nickname, Pike's Pique because of its attack on the inside buildup and its attack on the Byzantine complexities of 7702. The author was the Treasury Department representative in the development of Section 7702, but you'd certainly never guess that from reading the paper. Jeff Hahn and John Adney published in the *Journal of the Society of CLU* a discussion of the new federal tax definition of life insurance contracts in 1984, and in 1989 Adney and Griffin produced three papers on the modified endowment contract legislation. Generally, anything Adney writes is useful and authoritative.

The ACLI over the years has distributed many papers on the definition and on modified endowment contracts. The ACLI put these papers out as general bulletins. These are presented as interpretations and also requests to the IRS for clarification of various points. These papers lack any official standing, but on the other hand, the IRS might find it a bit awkward trying to attack interpretations that the industry has forewarned the IRS that we are making. Your notes contain the list of the ACLI general bulletins. If you want them, copies of these bulletins can be obtained from the ACLI.

A further way of getting some help in coping with your responsibilities to administer the definition of life insurance is to talk to people you know. After all, misery loves company and there's safety in numbers. Your friends might actually be right. If they aren't right, but everybody's doing it, the chances for a grandfather rule are a lot better than if you're out there alone. On the other hand, remember the primary rule, and that is, be reasonable. If the crowd's approach fails this test, think twice about it. You might also try your company's lawyers as a source of interpretive help.

Unfortunately, unless you're at a large company or you get exceedingly lucky, this isn't going to help much. Most lawyers simply won't understand the question, much less have an answer. Nothing in legal education prepares anyone for the fundamentally actuarial nightmare of Sections 7702 and 7702A. This isn't simple lawyer bashing. It's a comment on 7702 and 7702A. I'm reminded of a comment published by a leading jurist back in the days of the 1959 Act. He said that this Act seemed to him to be a conspiracy in restraint of understanding. I do wish I knew what he would say if he looked at Section 7702. My point here is even more than usual, you're going to have to help your lawyer to help you.

To give you fair warning, there's trouble coming. A new audit tool is emerging. The Internal Revenue Service is going to have, at some point, the capacity to check on you. The ACLI has been developing a Lotus spreadsheet which, on one set of interpretations, computes the net single premiums, guideline premiums, seven pay premiums, and so on. This is all being developed in response to an Internal Revenue Service request. Why?

Well, the deal is either we help the Internal Revenue Service or the IRS will go do it, or, worse yet, the IRS will go to Congress asking for simplifying legislation on the grounds that it simply can't administer this law. It seems that it's in the industry's best interest to make this law work and that we can do a better job of developing a computer program to monitor compliance than the Internal Revenue Service can.

If, as expected, the industry in fact goes ahead and provides such a program to the Internal Revenue Service, it'll be an event of major importance. Agents will then be able to check the accuracy of your work by testing it against a copy of the program. The intent of this program is to serve as a screening device. That is to say, to identify cases that need further checking or explanation, but be warned. As a practical matter, your auditing agent isn't going to understand anything. You can explain until you're blue in the face, it isn't going to matter. If your contract flunks the computer program, your only hope then is going to be to go to the national office with an explanation.

So, as a practical matter, if this matter goes through, we're probably all going to wind up designing our contracts around the computer program just as if Congress had enacted a diskette back in 1984. You may want to review the contents of this diskette before it goes to the Internal Revenue Service. If it does become an audit tool, you owe it to your company to check carefully how your products, new, and those in force issued since 1984, compare to the results of this program. If you have a product that fails the test, you're going to want to know why. Copies of this diskette have been floating around the industry now for about a year with increasingly urgent requests for people like you to give feedback where you think the diskette may not be doing the job right. So far, response and input from the industry has been minimal.

What sort of interpretations of 7702 am I talking about? Here I have a bunch of questions and really very little by way of answers. On reasonable mortality, one of the questions for which we have no good answer is what to do about substandard contracts. Most companies have simply kept on doing whatever it was they were doing, and they're just hoping for the best. The ACLI has requested some specific

but rather limited safe harbors, and the IRS is thinking about that. When the regulations become final, grandfathering will become an issue. Guaranteed issue contracts are a special problem. After all, it was abuse of this very legitimate concept that got us where we are.

Age rate up on second to die contracts is a traditional and practical response to a real problem, and that is the proliferation of values you get if you do anything else for substandards with second to die contracts, but the status of age rate up is unclear. Is the mortality implicitly resulting reasonable? We don't know. Does maturity of the contract at ages less than 95 automatically cause a contract to fail? Again, we don't know. We have no safe harbor for multiple life contracts under the proposed regulations, but so far we have the Notice and the 1980 CSO safe harbor for all products.

To what extent can we assume that there is a *de minimis* rule allowing us to ignore initial interest guarantees? The 1984 Blue Book told us that we could do this for short-term, that is, no more than one year, guarantees in calculation of the guideline level premium, but not the guideline single or the net single premium. What about seven pay? Nothing's ever been said. Is there really no exception at all for single premiums? We don't know.

How would you apply the 7702 corridor part of the guideline premium test to a multiple life contract? Your choices are, use the older, use the younger, use an average or joint equal age. Here, I would be conservative, but fortunately, it's just not my problem. My company deals only with cash-value-test contracts.

On an option two contract, do you count the initial cash value in the benefits taken into account or do you deal only with the amount at risk? Different companies have made different choices here. The ACLI has argued to the IRS for regulations that would allow either way, but we have no response. Section 7702(e)(1)c deems the death benefit to last until the deemed maturity of the contract. The Senate Report for the 1986 Act indicated that this would allow contracts to endow before age 95 provided they were endowed for less than the full face amount. Does this provision apply in other circumstances? The intent was clear to those of us who were in on it when the deal was done, but given the statute and the legislative history, I'd say the situation is quite unclear at the moment.

The question has been raised as to the meaning of the phrase "the rate or rates guaranteed on the issuance of the contract." Reference in the 1984 Blue Book to the rates implicit in cash values as opposed to the rates stated in the contract has caused some confusion primarily, I might say, at the Internal Revenue Service. The IRS simply isn't sure that the rate or rates guaranteed at the issuance of the contract are the rates stated in the contract and used. We'll have to see just how that emerges.

With large qualified additional benefits it is possible to have a contract "go corridor" on a guaranteed basis. How do you apply the rule deeming death benefits not to increase in such a case? In extreme cases, a mindlessly literal reading of the rule would cause you to take into account negative costs of mortality on negative amounts at risk. That is, the actual cash value winds up exceeding the deemed death benefit. As a practical matter, what do you do with such a circumstance?

Can Section 7702 tests be switched in a contract exchange? As a practical matter, where you have a new issuing company it's a practical necessity, but is it a legal reality? Is an intracompany exchange any different? Is there a possibility for abuse here? The IRS is concerned about the matter but hasn't said much of anything about it.

Regarding 7702A, we have a private letter ruling, 9106050, that held that a term rider providing coverage on the primary insured was not simply extra death benefit but rather a qualified additional benefit. The charges for the rider, not the benefit, would then be taken into account in your computations under 7702 and 7702A. It's a rather arcane interpretation. Why is it important? The reason is that under 7702A(c)(1)(B), the death benefit is deemed to be provided until the maturity of the contract. There is no corresponding deemed extension of qualified additional benefits. So the issue comes down to this. If I have a $100,000 base contract and I put onto it a $50,000 ten-year term rider, do I get a seven-pay premium that's roughly one and one-half times as large as the base contract seven-pay premium? Or, is the seven-pay premium for the total contract basically equal to that of the base contract? It depends on whether the rider counts as additional death benefit or whether it's treated as a qualified additional benefit. So far, the IRS has said it's a qualified additional benefit, but the ACLI has gone back and pointed out that it has much larger consequences than people thought when they were writing that ruling and maybe we can get it changed.

How do we handle cost of living increases in 7702A? Are they material changes? The statute gives regulatory authority to cause some such increases to be ignored. Unfortunately, that regulatory authority has never been exercised. So what do you do? My understanding is the companies that have cost of living increases are acting as if the regulatory authority had been exercised. I wish them good luck.

Finally, how do you know if a grandfather has been lost or a test must be redone? If we have a grandfather contract and it's exchanged, the new contract is subject to Section 7702 and possibly the testing under the seven-pay test. The problem is, there is no clear answer to the question. When does a modification of a contract rise to the level of creating a deemed exchange? Some modifications are merely exercises of contract rights. For example, consider application of dividends to purchase paid-up additions. For instance, some changes, such as an underwritten substantial increase in contract benefits, are clearly exchanges, but then there's a large gray area in between. Examples would be the addition of a waiver or an accidental death benefit rider. Addition of an accelerated death benefit rider is another example.

We all think of the exercise of a contractual right as something that couldn't ever be an exchange. The IRS may see exercises of some contract rights as creating an exchange. Substitution of insureds is a good example. Revenue ruling 91-09 seems to have held that substitution of insureds always creates an exchange (interestingly, one not protected by Section 1035), and it may not make any difference whether the substitution is done pursuant to contract rights or not.

On the other hand, the Internal Revenue Service does seem prepared to ignore some contract transactions. Assumption reinsurance appears to many to be a contract novation and that would be an exchange, but several letter rulings have held that

Section 7702 grandfather is not lost. Private letter ruling 9034014 is an example of that. The Cottage Savings case decided by the Supreme Court in 1991 may create a new standard for what is an exchange. In that case, the Supreme Court said that two properties are materially different under regulation 1.1001-1 so long as their possessors enjoy legal entitlements that are different in kind or extent. Such an interpretation, if carried over into life insurance, would create a very broad and unworkable concept of an exchange.

I point this case out to you because you may want to read it and then review your policyholder service practices in order to evaluate the risk of contract changes that you routinely perform. You wouldn't want to have an old 1975 contract deemed to be exchanged in 1992 and fail the definition of life insurance. That's the potential. Now John will tell you what happens when contracts fail.

MR. JOHN T. ADNEY: I will try to be as cheerful as I can, per Doug's instructions, with this. But, as you will see, this is not a particularly cheerful subject. It's largely a matter of damage control. We want to talk about the tax consequences of failure as well as the correction of failed life insurance contracts.

I want to give a brief overview of the rest of the topic. We're going to focus on the life insurance contracts that fail the definition of life insurance -- simply fail to meet the cash value accumulation test or the guideline premium test of Section 7702.

A contract designed to comply with the cash value accumulation test, if it does not by its terms comply with that test at all times, fails that test at its inception. That's an important thing to keep in mind. Such a contract, however, like one that is not designed to meet the cash value accumulation test, may qualify under the guideline premium test. Under that test, the failure is said to occur not at the inception of the contract but only at the point of violation of the provision not complied with.

We're going to assume the existence of failure. I should point out, in light of all the good advice that Doug gave, that that is a major assumption to be made, as we will discuss, given the possibly severe penalties and complications of failure to pass muster under the definition of life insurance. An allegation of failure is one that needs to be examined very, very carefully and not taken or assumed lightly at all. In particular, it's important to distinguish between situations of clear violations of the statute and situations that are not so clear. Both of those you will want to address in some fashion. However, in our case, because of the penalties that are involved, we're going to focus on a clear case of failure. We will discuss a bit later the significance of the distinction between clear and unclear failure situations.

In doing the 7702 calculations, let us assume, for example, a violation of the rule in Section 7702(e)(1)A, which is said to be the heart of the statute, the rule that precludes the assumption of increasing death benefits on a guaranteed basis. The Internal Revenue Service considers that to be a clear rule in Section 7702. The IRS has hinted that it may be the only clear rule in Section 7702, and my experience is that it's not the most clear rule you can imagine. However, because it is at the heart of the legislative purpose, a violation of that rule in the mind of the Internal Revenue

Service would trigger the sorts of consequences we are going to talk about. Then we will proceed to identify federal tax and other liabilities from the failure, focusing on tax, and then try to identify and evaluate the possible remedies.

The liabilities in the event of failure may be put into three categories, and I'm viewing this as the liabilities of the insurance company. As you'll see, technically some of the liabilities are for policyholders, but I think our working assumption is that it all comes home to roost at the insurance company level.

There are policyholder level tax liabilities. There are company level tax liabilities of a rather impressive sort, and then there are other potential company exposures. I'm not going to go in depth with these nontax exposures, but that is not to minimize their significance. For example, if a contract is sold that fails the definition of life insurance, there can be liability on the part of the company to the policyholders in contract or in tort, say, for misrepresentation of the tax consequence, as we'll be seeing in our discussion. Sometimes efforts on the part of the company to correct problems that have been identified can notify the policyholders of the existence of the problem, thereby triggering questions in the policyholders' minds whether they should assert some kind of tortious liability against the insurance company. This is almost a catch-22 situation for the company.

We will now proceed to focus on the tax consequences. The first set of consequences we mentioned, the policyholder level tax liabilities, falls into just a few categories. Basically the main consequence that we should focus on is the inclusion in current taxable income of the income on the contract or, loosely speaking, the inside buildup of the contract. The penalty under Section 7702(g) for failure to comply with the definition of life insurance is taxation of the inside buildup of the life insurance contract to the policyholder. The income on the contract is the key feature here, and for that, one needs to consult Revenue Ruling 91-17 as the ruling that notified the public of the existence of these liabilities. The ruling repeats the content of the statute. What I'm going to do for convenience is consult the statute.

Section 7702(g)(1)(A) says that the income on the contract, which it later defines, is treated as ordinary income received or accrued by the policyholder in the year in which the income arises. That's the general inside buildup tax penalty rule of Section 7702. The income on the contract is defined by 7702(g)(1)(B) for any taxable year as the increase in the net surrender value of the contract plus the cost of insurance less any premiums paid for the contract that year. That's a very significant rule. It's not a well-phrased rule, but it's a very significant one. The first thing one must focus on is net surrender value. This is not gross surrender value before the application of surrender charges, but net surrender value. The income on the contract to begin with is simply the increase from January 1 until December 31 of the taxable year, assuming a calendar year taxpayer, of the net surrender value. To that is added cost of insurance. There is no shelter in this provision for cost of insurance charges as there is generally under the statute.

The cost of insurance is supposed to be the lesser of an amount specified in the contract or an amount that the commissioner will prescribe in regulations. There have been no regulations prescribed on this subject, therefore, one would need to consult the mortality charts stated in the contract. That basically is the income on the

contract except that one is allowed to subtract out, of course, the premium paid during the year. This gives us a year-by-year calculation of the income on the contract, and that can produce some rather strange consequences.

Section 72(e) of the Code, which we're more familiar with as defining taxable income gain under a contract, is basically accumulative in nature. It follows the rule of taking the amount receivable under a contract on a net basis, subtracting all of the premiums paid for it that have not by then been returned without taxation and saying that the difference is the gain in the contract. That is not the way Section 7702(g) works.

The year-by-year calculation method of Section 7702(g) can cause tax on more than the Section 72(e) gain on the contract quite apart from the lack of sheltering of the cost of the insurance charges. It does this by denying a credit for any expense loading. Let me give you an example dealing with the single premium contract. I'll stop right here to say I'm very proud of the numbers I'm going to give you. They were done using a pencil and a piece of paper and a simple interest calculation. They do not extend beyond two years for a good reason.

I'm going to assume that $1,000 has been paid as a single premium into a contract, and that a $50 load charge was taken off on day one of the contract. I'm going to assume the contract was sold January 1. I'm further going to assume that interest at the rate of 5% was actually credited during the year on a simple basis. By the end of year one, the net surrender value should have risen to $997.50. That's $1,000 premium less the $50 load plus $47.50 in interest. At that point, the statute says take that net surrender value. I'm going to ignore the cost of the insurance charge at the moment. Subtract from it the premium paid, $1,000, and report the difference as the income on the contract. Well, the difference is a negative $2.50. That is not income on the contract. It is not a deduction. It is nothing as far as the Internal Revenue Service is concerned. So, you pass by year one.

In year two, the net surrender value will open up at $997.50 where it left off. It will then rise by $49.88 worth of interest. Again, I'm ignoring cost of insurance charges. The net surrender value at the end of year two will be $1,047.38. The increase during the year was simply the interest credit, the inside buildup, $49.88. That is the increase that Section 7702(g) would include in income in year two with no credit for the negative in year one.

Under Section 72(e), if the contract had been surrendered at the end of year two, assuming it was a complying contract under Section 7702, the total income would only have been $47.38. So, the Internal Revenue Service is collecting tax on an additional $2.50. This can be quite pernicious. In the case, particularly, of single premium or early paid-up business, it can cause a substantial increase in the income on the contract. The Internal Revenue Service has even suggested that the statute is not drafted properly and needs to be revisited, but so far no one has been anxious to do that.

Section 7702(g) also requires in the case of a failure beyond the date of inception of the contract that past income on the contract also be included in income in the year of the failure. So, for example, a contract might have been going along (this would apply to a guideline premium test contract) for ten years doing just fine under the

definition of life insurance, and then in year eleven someone forgets to return the excessive premium within 60 days beyond the close of the policy year. At that point, the contract fails the definition, and absent relief from the Internal Revenue Service, all of the income on the contract for the prior ten years plus for the eleventh year is includable in the policyholders income in year eleven. That is the catch-up rule of Section 7702(g)(1)(C). In addition to paying tax on the income on the contract, there would also be deficiency interest if the Internal Revenue Service found out about this after the fact. The treatment of the death benefit is also governed by Section 7702(g)(2), and what that section says is that at the time the death benefit passes under a failed contract, the net amount of risk in the contract will pass free of tax as a Section 101(a) insurance benefit. There will be no tax on that. Up to that point, the policyholder presumably would have paid tax on the income on the contract on an accrual basis. So, assuming the policyholder has paid that, the contract is sitting there with tax-free term insurance, with a tax-paid cash value except for the cash-value increment, for the year of death, which would be taxed as income in respect to the decedent under Section 691 of the Code. That is, I believe, the way that would work.

That's the easy story. Then we have the company tax liabilities. Doug told you this was the cheerful set. The company is in something of a catch-22 position where it does not know that there is a failed life insurance contract, in that the company should have been withholding and giving notice of an ability to elect out of withholding all along from the point of failure forward. The company may not know that until after the fact. If there is a failed life insurance contract, technically there is a withholding tax obligation on the insurance company under Section 3405 of the Code, the general rule for withholding on commercial annuities. Revenue Ruling 91-17 was promulgated to make this point clear and to warn everyone of the other penalties associated with noncompliance. There is also a 1099R reporting required. This is under Section 6047(d). In normal reporting, that would follow for a commercial annuity. All of this is done on the assumption that the income on the contract is a nonperiodic designated distribution as defined in Section 3405.

Then we come to this impressive list of penalties. Now, the purpose of the penalties in the Internal Revenue Code is, of course, to enforce compliance and to strongly urge voluntary compliance. That's what they're doing there. The IRS does not routinely go about asserting penalties except in cases where it finds someone that it truly believes is trying to hide from tax liability. So, those who are forthcoming are unlikely to have these penalties, and as we shall see, if the Internal Revenue Service grants a waiver of noncompliance under Section 7702(f)(8), then together with that waiver all of these penalties go away.

There is the penalty for failure to pay to withholding tax imposed by Section 6651. This penalty is 5% of the tax that should have been paid. Each month that the tax remains unpaid, the penalty rises to a maximum of 25% of the tax that should have been paid. The minimum income on the contract that will trigger application as penalty is $200 for the year, per individual. Failure to deposit the tax is cause for another penalty that's imposed under Section 6656(a). This penalty generally is imposed at the rate of 10%. It can rise to 15%. That is 10% of that withholding tax that should have been deposited. There is a penalty under Section 6652(h) for failure to notify the policyholder that he could have elected out of withholding. Now,

this again is a catch-22 type of situation. The penalty is not particularly large unless you have a great many policies that fail. It's $10 per failure to notify and that's a failure per policyholder. The maximum penalty in any year is $5,000 on the taxpayer.

Then we come to the most marvelous penalty in the list, the penalty for failure to report. This is the failure to send the 1099R. It is imposed under Section 6652(e), and it can be large. One has to marvel at how large it can be. The penalty is $25 per day per failure. It maxes out after 600 days at the princely sum of $15,000 per failure per policyholder. So, if a great many policies fail and are not caught or remedied within 600 days, count the number of contracts, multiply it by $15,000. That is the nature of the penalty. It would be extraordinary for the Internal Revenue Service to impose it, but if the IRS caught a case of egregious noncompliance, it's not out of the question. Then there are other penalties under the Code for various failures and violations. If records are not kept, that can be penalized to the tune of $50 per policyholder per year. There are penalties for negligence. There are penalties for civil fraud. There are penalties for criminal fraud.

So, it depends on how creative and noncompliant one wants to get before getting into more and more penalties. There is a reasonable cause exception for all these penalties. Revenue Ruling 91-17 records this on page 192. It just simply says, if you have reasonable cause, you can get out of the penalties. Reasonable cause does not mean you had a violation. Reasonable cause would, I think, bring along with it the notion of a showing of due diligence. It is necessary that there be reasonable cause and not willful neglect for these various failures in order to get a waiver of the penalty.

These penalties are pending revision by Congress, particularly 6652(e), the very large one. The Simplification Bill, which is pending on the Hill right now and which was part of the package that was vetoed in March 1992, and that will rise again at some point, will contain some amelioration of these penalties, but they will remain significant even under that revision. Of course, if there is a withholding failure, there would be deficiency interest assessable by the Internal Revenue Service under the normal rules. Finally, there can be an effect on the company's tax reserves. The legislative history of Section 7702 says that life insurance reserve status is denied in the case of a failed life insurance contract. In that case the net surrender value would be allowable as a Section 807(c)(4) reserve for tax purposes. One could argue for some kind of reserve for the term insurance element as well, but I think that may be a hard argument at the Internal Revenue Service. That is the sum total of the company's liabilities for tax.

Now, suppose you have a failure. What can you do? Who are you going to call if you have a failure of a life insurance contract?

You can proceed to apply for waiver under Section 7702(f)(8). This waiver is applied for by the company. Theoretically, the policyholder could apply for it, but the IRS administers it when companies request.

One could ask for an IRS closing agreement. This is a typical settlement of tax liabilities not specific to Section 7702. That the Internal Revenue Service can and will engage in closing agreements in the Section 7702 area was announced in Revenue

Ruling 91-17. It will do this as a matter of convenience to collect tax from the company. We will get into some details on that.

By the way, neither of these reliefs are available in the case of a failure of Section 7702A. The Internal Revenue Service's view of that is, as long as the contract is there, it will remain a modified endowment contract, and there's just nothing anybody can do about it.

Self-help is a possibility. The real question there, is that available? We will discuss that.

Then finally, there's the great challenge of correcting failed contracts. To obtain a waiver under Section 7702, one must have a reasonable error. I think it's worth quoting from the statute on this. Section 7702(f)(8) provides that if the taxpayer, in this case the insurance company, establishes to the satisfaction of the Secretary then the IRS may waive the failure to satisfy such requirements. This means the Internal Revenue Service Insurance Ruling requirements described in Section 7702 were not satisfied due to reasonable error, but reasonable steps are being taken to remedy the error. This is very simple, very elegant, very appealing, and not used very often.

The key word in this statute is reasonable, of course. The minimum requirement in the IRS's view, and I think it's a justifiable view for reasonable error, are that the error must have been inadvertent, not intentional, and there must have been an adequate Section 7702 compliance system in place of some sort. It will be up to the IRS to judge adequacy on a case by case basis. This could be a manual system, a computerized system, a combination of the two, or some written set of instructions, as Doug suggested. The requirement of this is seen in one of the private letter rulings that Doug mentioned, 9144009. You will see in that ruling that the IRS observed that there had been efforts made at compliance and further efforts would be made in the future after the waiver was granted. This is very important. The key thing is to follow Doug's advice. Think about it and document it. Show the IRS that you care. Show the IRS that you're prepared, and that will maybe get you over the first hurdle.

A very significant thing is that you cannot rely on purchased software. First of all, any software vendor worth its salt will have you sign numerous disclaimer forms saying that it basically had nothing to do with the software from a tax compliance basis. Even if it doesn't do that, the Internal Revenue Service will take the position that that's the case. The IRS believes the company is responsible for making sure that the software adequately complies. The IRS's point is very simple. The vendor doesn't know what your contracts look like, really. You must be responsible. The company is the one that can take the final action to prevent a failure, and therefore, the ball is clearly in the company's court. The IRS insists that you get the basics right.

There must also be reasonable steps to correct the failure. We'll talk about correction of contracts. Basically, the IRS insists that the correction occur within the 30-90 day period following the closing agreement or grant of the waiver request. There's nothing stopping a company from correcting it earlier. There's nothing stopping a company from initiating corrections at the point the error is detected and then going in

to see the Internal Revenue Service to apply for a waiver or a closing agreement, and in fact, that's probably advisable.

Section 101(f)(3)(H) had essentially the same rule as 7702(f)(8), and the point about IRS discretion is a simple and obvious one. There is much discretion in the IRS in interpreting this rule. It's very difficult to ever have something like the IRS's discretion at administering it challenged in court. It's difficult to get it into court let alone to prove abuse of discretion. So, once you're there, you're there. The form the waiver request takes is very simple. It's a ruling request filed using the normal procedures. It is necessary to include in the request document a list of all the failed contracts so that you tell the IRS up-front the problem, and a $3,000 filing fee must accompany it as well. The results of the favorable ruling are simple and elegant. The failures are waived. No tax is due. No penalties are due, and the contracts are considered as if in compliance from the time they went out of compliance forward.

The rulings issued to date show the position of the IRS. Basically, the position is that clerical errors are waivable. These are errors of a keypunch nature, a failure of internal communication, the mail room lost the piece of paper, the policyholder lost the piece of paper. Something that can be shown to rise to the level of human error. At one point we had a debate with the IRS about whether mistakes made by actuaries were in the nature of human error. The IRS was not amused by that. In fact, to show you what they think of you, they did not really waive programming errors. They believe, again, that it's necessary for a system at a very basic level to work properly. So, a programming error is a very difficult one to get a waiver on. To get a waiver it would be necessary to show, going back to what we had talked about very early on, clear rules versus unclear situations or statutory ambiguities; it would be necessary to show that the error was a result of an ambiguity in the statute.

Now, there are a great many ambiguities in Section 7702. My experience with it has been that that's not usually the cause of failure. It can be a contributing factor, but typically something else is going on. Unfortunately, we'll brush up against a clearer rule that will make a waiver of a programming error very difficult. This raises an interesting question, has Congress taxed the inside buildup of life insurance really? We think it has not because Section 7702 exists to draw a line, to say what you need to do in order to avoid that tax of inside buildup. But since it is possible for an error, a simple error, to cause the inside buildup to become taxable simply because the Internal Revenue Service will not waive the error, I think it's possible to say that in the IRS's view, unless everything is working perfectly in the contract, Congress really has taxed the inside buildup. It's the IRS's view that the government must be made whole by the companies if there is not either a clerical error or a programming error based on something that is ambiguous.

What do you do if the waiver is denied? Seeking a waiver can be a traumatic experience simply because the waiver might be denied. You'll see in the ruling Doug referred to, 9202008, there is a denial of a waiver on a number of contracts in that rule. It's possible to enter into a closing agreement, which is our next subject. It's possible to try to walk away, but the Internal Revenue Service now has your list of noncomplying contracts and the IRS will pursue that. It's impossible to sue the IRS for denial of the waiver under the Declaratory Judgment Act. Therefore, once the

waiver has been sought, the Internal Revenue Service converts into being the 800-pound gorilla that you must deal with and cannot get away from.

A closing agreement is used in the case of unreasonable error. It is basically a contract between the company and the Internal Revenue Service under which the company agrees to pay the tax and deficiency interest, and the IRS for its part agrees to waive the error. The form of the request is a ruling request. Typically a request for a waiver can be converted into a request for a closing agreement. That is a typical approach. Seek a waiver, and if it fails, ask for a closing agreement. If you want to look to see what one of these closing agreements look like, the closest we have to a publicly available agreement is in Revenue Procedure 92-25. You'll see it as a very simple little contract. In that case, it deals with Section 817(h) failures. The provisions are basically the same. The company agrees to pay tax and interest. A 28% interest rate is used for life insurance contract failures. People have tried to negotiate lower rates. That does not work. The Internal Revenue Service will simply stick it at 28% and may soon be going up to 31%.

The company in the tax calculation will get credit for any amounts of tax the policyholders will have paid as reported on Form 1099 in the case of previously surrendered contracts. So, it is possible to get a little offset there. The offset will not cover the expense load denial and the cost of insurance charges, and it's only available in surrender cases where there's actually been tax paid. The company will not be allowed to deduct the tax and the interest, and it will not be allowed to increase the basis of the policyholders. This tax is simply going to go down a hole somewhere in the Internal Revenue Service Center in Philadelphia.

It is possible under a closing agreement even after Revenue Ruling 91-17 for the IRS to waive penalties. Now, I think the IRS has indicated that it will proceed on its prior path of waiving penalties in closing agreement cases simply as a bonus for the company that is willing to show up and pay the tax and do what is necessary to correct contracts. The result of the agreement simply is, there's a waiver of past and future failures, continuing failure that is from the present case. There will be no policyholder audits, which is good. It will not be possible for the company or the IRS to attack the agreement. It is final.

Entering into a closing agreement is a very painful experience because a lot of tax can be due. So, is self-help available to avoid this? I can tell you what the Internal Revenue Service view of that is. No. The IRS believes that Section 7702(f)(8) and its closing agreement procedure is control. The IRS has threatened that if people hide and can be proven to be hiding, fraud and criminal penalties can be asserted and will be asserted. Hence, it's important to distinguish between clear and unclear situations. A clear situation is not one that you can easily sit on and ignore. It has to be dealt with.

An unclear situation is probably the only real candidate for self-help in that, if the company is concerned about the adequacy of compliance, then one can try to deal with it perhaps on the basis of conservatism and try to avoid seeing the IRS. It's very difficult, and it's doubtful whether that will work in all events. In order to say that you have fixed the contract by self-help, it will be necessary to establish that the contract after the correction is basically a new contract. Back tax would be due.

The new contract would have to be significantly changed from the old one. Even if self-help is engaged in, and a new contract is put forward, that does not wipe away any of the liabilities we talked about for the prior periods. The passage of time may wipe them away, but they are still there and can be asserted, particularly if the IRS finds it.

How might the IRS find it? The policyholders might tell the IRS. It's quite possible if you go and tell the policyholders that we have a problem, we're going to fix it. Or, even if you don't tell the policyholders the problem, you just tell them you're changing something. They could get very suspicious, could ask the state insurance department, which has the number of the Internal Revenue Service, and it might very well call. Or the policyholders could go there directly, and the IRS could pick up the existence of a problem. As Doug mentioned, the audit program of the IRS is picking up.

The changes made could trigger that and I think in that instance if the IRS found out that the company was engaging in self-help, it would assert penalties. It would be very difficult to convince the IRS that the reasonable cause exception would apply.

Correction of failed contracts is required no matter what you do if you have a failure. It's like putting the feathers back into the pillow after you've dumped it out the window in the wind. It's a very difficult process. It's challenging. Sometimes a painful one.

The legal compliance can be stated simply. It's necessary to refund premium or increase face amount. One could also simply give back the money and terminate the contract if the policyholder is willing to do that. Apply excess premium payments to annuities, whatever you want to do. There's several possibilities available. The need is to restore the contract to the situation as if the violation hadn't ever occurred. Can this be done unilaterally, or do you need the policyholders agreement? That will probably depend upon the contract form as well as the interpretations of the company's lawyers, as a matter of contract, and what the state insurance department would permit.

Correcting flexible premium contracts is a fairly easy task, but correcting a fixed premium contract is not an easy task. It's usually necessary to come out with a whole new policy form to deal with an inadequacy in a fixed premium contract. That's particularly true if we're talking about a contract tested under the cash value accumulation test. The interesting question is, who's going to pay for the difference in cost? Because typically this new contract with a higher death benefit for the same premium, or the same death benefit based on a now lower premium, will cost the company more. Who pays that difference?

The Internal Revenue Service has not inquired about that. The policyholders might. The state insurance department might. There are a number of practical considerations to a correction et al. It is necessary to march in together all of the company's resources -- legal staff, actuarial department, agencies, state insurance department, and relation system -- in order to have an effective solution put together. It is necessary to coordinate. It's always necessary to talk to your CEO because profits are going to be down a little bit as a result of the correction let alone any need to pay

the tax. The Internal Revenue Service for its part has not really engaged in oversight of corrections, but its interest is growing.

Policyholder reactions are probably difficult to gauge in this area, but the important point is, it's necessary to anticipate because you do not want large classes of dissatisfied policyholders roaming the face of the earth in search of plaintiff's lawyer. It is not a good situation for the company. It probably is also important to talk to the state insurance department in advance. Tell the department what you're doing so that it can anticipate it if any complaints arrive. If contracts have been surrendered prior to the violation being identified, it is not necessary to go back and correct them. If the policyholders have died, it probably would be necessary to go back and pay the increment in the death benefit that would have been there had the policy complied.

All of this suggests that people would probably just want to do nothing. Just remain inactive. What if you find a failure? Can't you simply ask, will it be detected? I would suggest, and I think Doug was suggesting to you that is a very high risk strategy. Hiding in the bushes is attractive until the Internal Revenue Service cuts up the bush and you're in it. The Internal Revenue Service has a much more effective audit program out now, and it will greatly improve once the ACLI spreadsheet on diskette comes into the IRS's possession in the near future. The IRS will in fact be asking, as Doug suggested, for companies to show auditing agents compliances. They will ask, are you aware of any noncompliant contracts? Please tell us under penalties of perjury.

Policyholder complaints can trigger a reaction in the Internal Revenue Service. The IRS even had one case where a company was sold, and the buyer got concerned about the contracts and turned them in to the Internal Revenue Service, and the seller is now dealing with that under the Tax Indemnity Agreement upon the sale. It's quite possible in a variety of circumstances for noncompliance to come to light, and if there is no action taken by the company, the tax penalties and other liabilities that we talked about could indeed be asserted, particularly in the case of a clear case affair. Therefore, it's necessary, as Doug said, to take compliance very seriously, to address the errors. The industry probably should consider a preregulation submission to the Internal Revenue Service arguing for more liberal use of the Section 7702(f)(8) waiver authority because that is why it is put there. This is a difficult area to be in.

MR. DAVID A. CHRISTOPHER: John, do you have any kind of update on the proposed deferred acquisition cost tax regulations, especially with regard to group insurance?

MR. ADNEY: The Internal Revenue Service has in fact discussed with the ACLI the idea of somewhat simplifying perhaps and liberalizing the deferred acquisition cost regulations on group. The IRS is considering a variety of alternatives that I think people will find helpful, but nothing is cast in stone yet. It's just that the IRS is open to dealing with it. For example, I think the IRS is considering the idea of relaxing underwriting in the case of new entrants into groups.

The one thing that the IRS is very suspicious of is cash value insurance written in a group form. The IRS does not want to see, again, the rise of the single premium

business, particularly with the break under the deffered acquisition cost (DAC) tax, and the IRS is very concerned about that happening.

Doug, can you think of other relief provisions that the IRS talked about under the DAC regulations?

MR. HERTZ: Oh, there was a whole list of things that the ACLI asked for, and I'm having difficulty remembering it. Some would be certainly late entrance, optional coverages, small group, and association group. There were more I know. As John indicated, for group term life insurance, the IRS seems to be indicating a fairly high level of flexibility. The cash value products troubled the IRS there. The IRS is concerned that there will be a general migration of individual life products over to the group life column, and it doesn't want to see that.

MR. ADNEY: The Treasury has said, and put in writing, that those regulations will be finalized in 1992. That was with the approval of the Assistant Secretary for Tax Policy. It is committed, and I think that the news really is that there will be good news in those final regulations as a set group. It may not be everything you want, but it will be a lot better than you currently have.

MR. WILBUR M. BOLTON: Doug, with interest rates coming down in the last couple of years, we may get to a situation where life companies no longer feel safe guaranteeing 4% or higher interest rates. If this happens, plain vanilla ordinary life level premium benefit contracts will begin to fail the modified endowment contract test because the cash values are too high. Does the IRS have authority to issue new regulations to recognize lower prevailing interest rates, or will the industry have to go back to Congress and get the modified endowment contract (MEC) definition cash value and single premium test modified to lower interest rates?

MR. HERTZ: Well, here I go practicing law again with John Adney sitting at my right hand. I don't believe that there is any authority for the IRS to modify a specific statutory provision such as the 4% interest rate minimum. It is a real problem. I shudder to think of the consequences of going back to our Congress to tinker with the definition of life insurance in any way, but that might in fact be what would have to be done.

MR. ADNEY: I certainly second that. If the 4% rate is not supportable, we would have to go back on the definition, and I think we could make a good case. The real problem is going back to reopen 7702A, the MEC rule. I think if that got reopened, it would probably be repealed and replaced with the annuity rules, the LIFO treatment, throughout. In other words, applying MEC treatment to all life insurance contracts. I think that is simply a ticking time bomb on Capitol Hill. They're just waiting for the next abuse to come along in order to do it. If interest rates happen to be the reason the industry went up, that would be as good as any. I think we're almost in an impossible situation as far as seeking an amendment to 7702A would be concerned. Of course, the relief you'd be seeking would be under the definition of life insurance. It would be more understandable and maybe that would just pass on through. That would be the way I think we'll have to go if we have to go to Congress.

MR. MARK D. GULAS: I wanted to ask about the calculation of the qualified additional benefits as far as the calculation being spread over the life of the contract as opposed to being spread over the term of the benefit. Do most companies follow one method as opposed to the other?

MR. ADNEY: The rule, as you know, in Section 7702 is that the qualified additional benefits can be funded over the life of the benefit. That is a rule that was recognized in the legislative history in order to avoid postfunding of the amount. For example, continuing to pay for the term insurance that expired.

The way the legislative history was written, it's almost as if the avoidance of post-funding is required, but I think people have interpreted it to be permissive so that it will be possible under the terms of the statute simply to spread the charges for the expiring qualified additional benefits (QAB) over the entire life of the contract. That's consistent with the statute, and it's consistent with the legislative history to simply spread them over the term of the benefit. I think people were doing both. I don't know where the majority is. The Internal Revenue Service has not yet spoken to this point.