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FAILED CONTRACTS UNDER INTERNAL REVENUE CODE (IRC) SECTION 7702

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This session will address the consequences of a contract or a group of contracts failing to comply with Section 7702 of the IRC. Issues to be covered include:

- *How failed contracts are identified*
- *Consequences of "failing" Section 7702*
- *Alternate courses of action available to companies*
- *Methods of correcting failed contracts*
- *American Council of Life Insurance (ACLI) efforts to implement a voluntary compliance resolution (VCR) program*

MR. CHRISTIAN J. DESROCHERS: Issues under IRC Section 7702 have generally been considered product development concerns. Our focus is not on product development, however. If I could, I would subtitle this presentation "Handling Toxic Waste Within Life Insurance Companies," or "How Do You Tell the President and The Board That It's Really the IRS That Owns the Company?"

I've started looking at Section 7702 as a risk management or contingent liability issue, rather than as a pure product development concern. Failure of life insurance contracts to qualify under 7702 can cause serious problems for the company, not only in dealing with the IRS but also in dealing with policyholders, state regulators, and others.

Within the life insurance industry, we have typically thought of our contracts as life insurance under the IRC until they fail the Section 7702 definition. I don't think that's the way that we should be looking at it. If we change our view a little bit, I think that we, as an industry, may take compliance a little bit more seriously. Until a company can prove that its policies qualify under 7702, it is selling a taxable instrument in which the income is determined under Section 7702(g). Rather than starting with the assumption that a policy qualifies as life insurance, look at it the other way. Start with the assumption that what you have sold is a taxable instrument until it meets the Section 7702 rules. If you look at it that way, you may have a different view of the issues under 7702.

One thing we've come to realize over the years is that "in the neighborhood of compliance" is not enough. It's enough if you're passing on that side, but it's certainly not enough if you're over the other side. Actuaries have long had a view of the nonforfeiture law that if you could qualify with the spirit of the law, then normally you could work your way through most state insurance departments. Any of us who have spent any amount of time in product development have faced this situation. The IRS is a little bit more serious about things, and it has enforcement powers beyond those of the state insurance departments.

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Under Section 7702, if you are even slightly out of compliance, then you are out of compliance and you have a fully taxable policy. The Section 7702 qualification standard is not a slope. It's a cliff. If you find yourself on the wrong side of the cliff, then you can have some serious problems.

There's no statute of limitations under Section 7702. A contract issued as early as 1982 can still be out of compliance. If you consider the penalties for being out of compliance in terms of income on the contract (which we'll discuss later, but think of that as all of the inside buildup on that contract and also think about deficiency interest since 1982), you can see that some large liabilities can arise. Deficiency interest rates, I'll remind you, in the mid-1980s were in double digits, and so if you need to bring a liability forward from 1982 to 1995 at those interest rates, we can be talking significant liabilities.

Recently, I have noticed that compliance activity under Section 7702 is increasing. We're entering an era in which there's a lot more awareness of compliance generally, not only in market conduct and sales illustrations but in the tax area. As the word has gone forth through the industry that companies have gone into the IRS and have written checks for several million dollars to the IRS to solve some of these problems, other people have looked around at their own companies and concluded that perhaps they should be looking at some things with respect to compliance.

On that note, we're going to focus on contracts that have failed Section 7702. For purposes of discussion, we're going to assume that failures occurred. Note, however, that's not always the case. There are many cases in which it's not clear that a failure has actually occurred. One frustrating thing in dealing with 7702 is that the rules are not clear. There are no regulations, as has often been pointed out to the IRS, and often practice and understanding changes. So, what we might have thought was acceptable a few years ago is viewed to be not acceptable now. In that respect, it's a very difficult arena to play in.

UNCOVERING FAILURES

Our focus is on contracts that we assume have failed, however. We're going to talk about the federal income tax and other liabilities that can occur from failure and how to go about fixing failures.

We would like to think that all life insurance companies have highly effective compliance systems that ensure that each and every one of their policies complies with Section 7702. For those of you who work at companies that don't have highly effective compliance systems, let me describe ways in which failures are detected. A very common way is through the sale of a company or block of business. We've seen changes recently in the way indemnification agreements are written among companies simply to cover the potential Section 7702 liability. More often than not, blocks of business that are sold that subsequently are discovered not to have passed 7702 either end up in some settlement between the parties or end up in court where it's determined who is going to pay the tax that's due.

Another way that failure can be discovered occurs when contracts are sold through third parties. For example, if a brokerage firm or sales organization is selling your company's contracts, it will often try to go through some due diligence with respect to

Section 7702. Those organizations don't want to be in the position of selling anything to their clients that they thought was tax-deferred but, in fact, was a taxable instrument.

Problems also arise under variable contracts when they're being examined either through the prospectus process when the securities lawyers are looking at it or when they're going through due diligence. There have also been failed contracts that outside accountants or advisors have identified; an individual sale may cause an outside advisor to look at it.

A company doesn't always have control over when its contracts might go into the IRS to be reviewed. There have been at least one or two incidents when a policyholder had a particular tax situation, and part of the situation that went in for a private letter ruling was the contract. Well, imagine a situation in which your company has a contract in at the IRS and others have asked the IRS to rule on the tax treatment of them. You can get a rather surprising phone call from someone saying that your company's contract was taken to the IRS, and the IRS has expressed some reservations about whether it qualifies under Section 7702.

We're also seeing more activity in internal reviews. As I said earlier, compliance is picking up. Many insurance companies, having looked at some of these settlements with the IRS, are starting to go back and look at their procedures. This is happening not only on new contracts (which is the product development focus, where a great deal of 7702 compliance has been conducted) but on in-force policies as well. What did the Section 7792 compliance system do? What did we think the system did versus what it does? We know of companies that have been surprised when they looked at what they thought their compliance system was doing and then figured out that what it was doing was actually quite different.

Policyholder complaints are another potential issue. Earlier, I alluded to policyholders going into the IRS, but even having policyholders come into the company with administrative questions can uncover (or cause) problems.

Next, there is an IRS audit. We had a very interesting discussion at the Society of Actuaries seminar in Washington a few weeks ago at which the IRS was represented. They were asked about the issue of auditing—whether they were doing any, if the IRS has any organized program of auditing? Their answer was, "No, not at this point, but we've been spending time educating the IRS agents." Further they expected that the company audit activity would pick up with respect to issues on Section 7702. The IRS has discovered that even asking very simple questions can turn up issues of noncompliance. One question might be, do you reflect the initial interest rate guarantees in computing your guideline premiums or your net single premiums? You'd be surprised how many people don't. Just the very simple questions can turn up some potential problems, without even worrying about the more exotic issues.

There have been various reports that perhaps the IRS was retaining consultants or doing other things related to Section 7702 auditing. I'm certainly not aware of that happening, and at the seminar they were very clear that at least the national office wasn't doing it. We certainly would expect activity to pick up.

With regard to auditing, the issue of the "ACLI spreadsheet" often arises. Two or three years ago—in connection with what the industry hoped would be some discussions of a regulation program—the ACLI developed a Section 7702 calculation spreadsheet that it gave to the IRS. If you're ever involved in Section 7702 work, the ACLI spreadsheet is a handy calculation device, but it's little else. The IRS has said that simply because you comply with the ACLI spreadsheet doesn't mean that it considers that you comply, and if you don't comply with the spreadsheet, it doesn't mean that you're out of compliance.

The final area to mention where we realize that failures are occurring is simply through loss of "grandfathering" through administrative practices. Several companies that I'm aware of have changed in-force policy administration because of their concern over loss of grandfathering. For example, what happens to a contract that was issued in 1978, and in 1995 the policyholder adds a rider to that contract? Many people would consider that a loss of grandfathering on the contract, requiring the contract to be retested under Section 7702. As the current mortality is the 1980 CSO, it doesn't work so well if it's a 1958 CSO contract being tested. Consequently, one thing that companies are becoming more aware of is that every day they may administer one or two contracts out of compliance.

LIABILITIES IN THE EVENT OF FAILURE

John will talk about various liabilities in the event of failure. Those fall into three categories.

The first are policyholder tax liabilities, including taxation on the inside buildup. If a policyholder has a contract that does not qualify with the definition of life insurance, then the contract is a taxable instrument. The policyholder owes tax on the inside buildup every year that it occurs.

That would be simple enough if it wasn't for the fact that you also have liabilities as a company, not only indirectly through the policyholder but also very directly. If you are selling taxable instruments, 1099s need to be sent out at the end of the year. Therefore, failure to withhold and report income can cause some rather severe penalties.

Beyond simply the tax liabilities, we're increasingly aware of market conduct issues, of plaintiffs' lawyers, of illustration issues. Imagine finding yourself in a situation in which you have a very large block of policies that's out of compliance. You then need to figure out ways to deal with the public—policyholders, state insurance departments, plaintiffs' lawyers, and the like—on those contracts. Simply beyond the policyholder and company tax liabilities, there's other exposure.

There's also an audit issue with respect to financial reporting and disclosure. If you have a large contingent liability, what is your responsibility to disclose that? What does it mean for the valuation actuary signing a statement if you're aware that you have a large block of business that perhaps doesn't qualify as life insurance? How do you reflect that in your statement reporting, and how does that work through valuation issues? Those are some things that we often don't focus on when we look at Section 7702 in terms of product development.

MR. JOHN T. ADNEY: Chris you cautioned us about taking account of these liabilities when a company is dealing with its financial statements, the role of the valuation actuary, dealing with the outside accountants, and certifying the audit of the company—all of that is important to take into account. We want to discuss the various sources of liabilities so that you have a sense of what those are. There will be many instances when all this cannot be considered sufficiently small that it is immaterial. There are going to be a number of instances when we're going above materiality thresholds, particularly when talking about a situation of company knowledge and inaction that can lead to some very severe penalties under the IRC.

We want to talk about policyholder tax liabilities. We call them policyholder tax liabilities because under the IRC they are, by law and at least theoretically, the responsibility of the policyholder. But the insurers need to be aware of them simply because, in fact, they are the insurers' responsibility and problem. No policyholder who buys a life insurance contract is going to expect to pay the tax that is occurring on that contract when it has failed to be life insurance. A policyholder will look right back to the company and say, well, I thought you sold me a qualifying contract. If the company does not agree, there probably would be litigation ensuing at a very nasty level between the policyholder and the company. No company's going to want to do that. The risk is just too great. So the liability for the policyholder's tax really does rest with the insurance company, absent some extraordinary case with all sorts of disclaimers, and even then it might not work.

INCOME ON THE CONTRACT UNDER SECTION 7702(G)

Under Section 7702(g), the inside buildup of a failed life insurance contract is taxed currently. By the way, I think that the structure of the statute, Chris, adds some credence to your belief that the IRS view is that unless one does have a contract that complies, one is simply selling a currently taxable instrument, and Section 7702(g) is telling us how to calculate that tax.

First, as 7702(g) says and as is documented in Revenue Ruling 91-17—that's one of the few rulings issued thus far dealing with Section 7702—the income on the contract for the taxable year is includable in the policyholder's gross income for tax purposes. The income on the contract is calculated as the increase in the contract's net surrender value (net surrender value is code language for the cash surrender value net of surrender charges) and the deemed cost of insurance. That calculation is run year by year. Frequently, in the first year of a contract, due to loading and similar kinds of costs or large surrender charges, there isn't any income. In fact, there may be a deficit created in the first year or first couple years of a contract. There is no provision under the statute for the carry-forward of that deficit. You simply begin picking up the calculation whenever it turns positive and run forward with it.

The cost of insurance may or may not be disclosed and quantified in the contract. If we're talking about universal life, you can typically find the amount of the cost of insurance or derive it from the terms of the contract. In a contract with no stated charge for cost of insurance, such as a traditional whole-life contract, the charge would have to be imputed. In the 7702(g) calculation, the IRS has usually pointed to the guarantees under the contract rather than to the current cost of insurance charges in coming up with this imputation. We could have tax on slightly more than the inside buildup of the contract from this calculation.

Then you move forward and you find out that if a contract fails not at issuance but some years after issuance, 7702(g) will, beginning in the year of failure, pick up the inside buildup tax for all the prior years, as well as from that point going forward. It is certainly the IRS's view that once such a failure occurs, the liability for the tax will keep on running, and will not stop unless and until a company works out an agreement with the IRS.

We will talk about one of the two kinds of agreements that are possible, a waiver ruling or a closing agreement, to stop the running of the tax. Conceivably, there are other ways to stop that clock from ticking forward forever. We will talk a little bit about potential self-help remedies. The problem with self-help remedies, though, is that people who are dealing with this situation and in the face of the large penalties frequently find that the only resort, unfortunately, is to take the matter to the IRS national office. So that is a quick run-through of the 7702(g) tax. It's a tax on the inside buildup.

DEFICIENCY INTEREST

Besides that, when the failure occurred in a past year, and usually these things are found out years after they have occurred, there would also be deficiency interest. Deficiency interest will be running at rates prescribed in the IRC. Right now, for current deficiency interest, the rate is around 9%. Since the current rules went into effect in 1987, these rates have ranged from 7% to 12%. They're determined on a simple interest basis, and they're redetermined annually and announced by the IRS. Deficiency interest would be added from the point of failure for the income on the contract that year. The following-year deficiency interest would run from the due date of the tax return and so forth.

The death benefit, to the extent it consists of a net amount at risk, will still pass tax-free under Section 101(a). The government views that as simply a transfer payment of sorts. So there is no adverse consequence to the net amount at risk, but certainly when all the inside buildup tax is triggered, that is a very adverse consequence.

The real problem with all this is that everyone expects in the design of the contract, in the pricing of the contract and in the reserving for the contract, that no tax would be paid on this inside buildup, or certainly no tax would be paid by the insurance company. If a policyholder chose to surrender and there was a gain in the contract, the policyholder could pay that tax. When the tax is triggered in a 7702 failure situation, we're talking about the payment of amounts that are totally unreserved for. They usually come in as a big surprise. That's the very situation that led Chris to open up by saying that at some point one may have to tell management that the IRS owns the company. The inside buildup tax can run to very large amounts; it can run to a significant portion of the company's surplus. We've seen situations such as that, and when you get into talking about penalties, it can get much worse.

WITHHOLDING AND REPORTING PENALTIES

At this point we're not going to talk about the derivative liability because of taxing the policyholder but the actual obligation, the tax-related obligations of the insurance company. Revenue Ruling 91-17 held that the income on a failed life insurance contract is currently reportable by the insurance company and is also subject to a

withholding obligation, just like any other designated distribution or deemed designated distribution under a life insurance contract, an annuity contract, a pension plan contract. These withholding rules were put into the code in 1982 to require reporting and optional withholding in cases of actual distributions from life insurance, annuity, and pension contracts. With the advent of Section 101(f) and then Section 7702, however, Congress provided in the legislative committee reports that the withholding reporting requirements would be extended to failed contracts. In the 1991 Revenue Ruling (91-17), the IRS made the point to the public, announcing for all the world to see that was the view of the IRS.

Although the failure may not be discovered until years after it occurs, there is a withholding and reporting obligation currently on the income on the contract. These are considered deemed nonperiodic distributions for purposes of Section 3405 withholding and Section 6047(b) reporting. The company is required in those situations to give notice to the policyholder of the option to elect out of withholding. Now, that's fine, except for the fact that a company may not know that it has a failed contract at that point. That, too, would have been missed. There's another failure. In the absence of a withholding notice, withholding election out by the policyholder, the company is required to withhold 10% of the income on the contract, calculated under 7702(g), as its withholding obligation, and then the company must pay that 10% to the IRS or face further penalties.

The Section 1099R reporting was also dealt with in the 1991 revenue ruling. The reporting requirement is one that seems fairly simple. It's also the one that nobody wants to do in the case of a failed contract because the last thing the policyholder is going to want to receive in the mail in January is a 1099 for the income on the contract that he or she thought wasn't taxable.

The problem is a conflict between what the company's required to do in the failed contract situation and what it naturally wants to do to keep the policyholder happy. The reason we mention reporting is that the penalty for failure to report, which we'll talk about in just a minute, is an enormous penalty. That's the one to keep your eye on. In fact, why don't we move ahead to penalties and then come back?

I mentioned that there's a requirement to notify the policyholder of the right to elect out of withholding on a failed contract. I doubt that's a notice an insurer has ever sent out or will ever want to send out, but there is a penalty for failure to notify. It is not a very large penalty, $10 for each failure to give the payee timely notice of the right to elect out of withholding, but that would apply to each failed contract each year. There is a $5,000-per-calendar-year aggregate limit on the insurer. That penalty alone doesn't amount to a great deal. There is also a reasonable cause exception. Penalties can be waived if the failure was due to reasonable cause and not willful neglect, and we'll talk about what those are.

There's also the requirement to pay over that 10% withholding tax that wasn't collected. That is to be done on the IRS form 945, previously the form 941, the employment tax return. Since 1994, it has been the form 945. Failure to file that form will result in a penalty of 5% of the tax required to be shown on the form, the 10% of the income on the contract for each month that the return is not filed, capped at 25% for the entire return. So we can now say that instead of 10%, we're talking

about 12.5% of the income on the contract each year as the total amount if that penalty is applied.

We then come to the penalty that gets everyone's attention. That's the failure to report under Section 6652(e) of the IRC. This penalty is $25 per day per return that was required to be filed, and the problem is that because the $25 per day runs on each failed contract, the total amount of that penalty per return per year is $15,000. That penalty is reached in 600 days, but it starts again every year. There's no aggregate limit with respect to all returns that are due by the company. I'm talking about the 1099R, which is reportable to the policyholder and to the IRS.

In the absence of the aggregate limit on the payer, the amount comes down to $15,000 per failed contract per year, if it's not detected quickly. Thus for, a block involving 10,000 contracts that have failed (and that's not hard to come by if there's a cash value accumulation test failure), the penalty for each year's failure to report could reach $150 million. Here we're talking money. If the reports were not filed for many years, perhaps ten years, the size of the penalty will reach astronomical levels. None of this has been reserved for. Nobody ever intended to pay this penalty. The penalty is variable due to reasonable cause and not willful neglect and, again, we'll define that.

The IRC is not short of penalties. There's a slew of other penalties that we could talk about—failure to make timely deposits of taxes, accuracy and fraud-related penalties, failure to keep records, penalty for filing false returns, willful failure to pay over the tax. The penalties can also bridge over from the civil side into the criminal side. The reason that we talk about the penalties is simply that if a company detects a problem, the problem typically will arise from an accident. Somebody didn't think about something. Something was wrong in the software. There was an interpretation that went one way, and it should have gone the other way. There are a couple proposed regulations, but nothing has been finalized. Usually the companies can rightly look at all this and say it's unfair to levy penalties, and the IRS would agree.

In a case in which a company has discovered something, and particularly if it's prepared to bring it to the attention of an auditing IRS agent or the national office of the IRS, it's very unlikely that these penalties would ever be assessed. The problem comes in when the failure is detected. There is the natural human tendency to go sweep it under the rug, and that's where this panoply of penalties can be used by the tax regulators. These penalties in aggregate are more powerful than what the insurance regulators have at their disposal as far as fines and criminal penalties are concerned.

The IRS could impose very significant amounts of civil penalties and refer to the Justice Department willful failures for prosecution under the criminal laws. This would likely happen if the IRS detected that the failure was known and nothing was done about it. That is precisely the kind of situation that the penalties were put together to deal with. We have never heard of a situation in which these penalties have been asserted in a 7702 failure case. Certainly they have not been asserted if the company brought the problem to the attention of the IRS. That may be the only break someone can get from taking the matter to the IRS, but, given the amounts involved, that can be a substantial break.

The penalties, including the large one under 6652(e), has a reasonable cause exception. The penalty is waived upon a showing of reasonable cause and where the failure is not due to willful neglect. Those terms are as malleable as they sound. They have been interpreted by the courts. The courts have interpreted reasonable cause to mean a cause that would prompt an ordinarily intelligent person to act under similar circumstances. In a corporate environment that probably means exercise ordinary business care and prudence.

All the facts and circumstances are used to judge where there was reasonable cause, and the IRS probably would look at most failures and say whether it was human error or simply complexity in the law. That's reasonable cause for waiving the penalty, but if the failure is detected and nothing is done with it, and it's simply allowed to go on and fester, then we get over to the other branch, which is willful neglect. The penalty will not be waived in the case of willful neglect, and neglect is the failure to use reasonable care in the filing of a tax return.

So in cases of willful neglect, and certainly a pattern of conduct showing that failures once detected had not been addressed would be viewed as willful neglect, the penalties would not be waived. The IRS certainly can mitigate the amounts of the penalties. It has discretion in this area. Nevertheless, this is a long way of saying that the stakes are high enough to get people's attention.

Some of these penalties are currently being reviewed in Congress. The simplification bill that the House of Representatives is moving on into the budget reconciliation effort has changes proposed to the 6652(e) penalty to conform it to the penalty relating to failure to report in the case of interest and dividends. That penalty was revised a number of years ago and lowered so that, assuming that the bill becomes law at some point, some of these penalties will leave the astronomical regions and perhaps come back down closer to earth. They are always going to be significant amounts, and the willful failure case is something that a company's always going to have to worry about.

OTHER CORPORATE LIABILITIES

We talked about deficiency interest on the policyholder side. There's deficiency interest on the withholding obligation as well when that has not been paid.

The effect on the company's tax reserves will usually not be that dramatic in the case of a 7702 failure. It is clear that the reserves will not be life insurance reserves, absent a waiver or closing agreement with the IRS to put it all back together. Under 7702's legislative history, the reserve—basically the net surrender value of the policy—would be considered a Section 807(c)(3) or (4) reserve. So the company would, nonetheless, get credit for the cash value in the contract, just not the higher amount of the federally prescribed reserve. So here the downside is just not as draconian, unless the company is in a marginal situation as far as membership in Part I of Subchapter L is concerned, and then the loss of life insurance reserve status could send the company into Part II of Subchapter L.

The contracts, by the way, are specifically considered by 7702(g) to be insurance contracts, even though they have failed the test of 7702. So there's still insurance for

purposes of Subchapter L, just not life insurance. I'll mention that all that is assuming that the contracts are life insurance under local law. You can get into some fascinating debates about life insurance under local law when dealing with foreign subsidiaries that are controlled foreign corporations that have to figure out their U.S. taxes. They get some interesting questions about what life insurance is under local law. As we know, practices vary around the world as far as life insurance and annuities are concerned.

MR. DESROCHERS: I was just thinking that John has probably already done enough damage, but when dealing with failed contract cases, other things beyond the IRS need to be considered. We point these out more to raise awareness of other issues that need to be managed as part of the overall process.

The first we've called class action lawsuits; this deals with the issue of policyholder relations. In many cases, when coming out of a "failed contract" settlement with the IRS, the company simply cannot provide the same structure of financial instrument that it could going in. In general, contracts fail because they're more investment-oriented than is permitted by the statute, and so, as a result, something needs to change. Often the insurance that's provided is increased, or some amount of premium may be refunded.

Typically, an insurer simply cannot provide the policyholders as favorable a deal as they had going in. Part of the problem of the failed contracts is considering policyholder relations and how you're going to reduce the potential liability of lawsuits.

What's the reaction of state insurance departments? This arises in two very practical ways. The first is if you go through an insurance department examination, a question you're sure to be asked is, do you have any material undisclosed liabilities? So if your company happens to be unlucky enough to be working through a large failed contracts case while you're working through a state audit, you can have some very interesting questions of disclosure. For obvious reasons, one of the things that companies do not like to do in this area is disclose. They hope to fix the problem with minimal cost so it will not be material. Nevertheless, it's not always clear that's going to be the case, and so the question is what to disclose and when.

A second insurance department issue is fixing the contracts. A company may have to deal with the insurance department on some type of exchange program. In my experience, insurance departments have generally been very sympathetic. However, a company could find itself in a situation in which it tells the IRS that it would do something to fix the contracts, and the insurance department then turns around and says that the company can't do that. Overall, though, our experience has been that the regulators have been very reasonable about this and when there have been problems, the departments have gone out of their way to try and help the company work through the situation.

Company ratings and evaluations are another concern, although the rating agencies have generally not been very concerned about this issue to date. As John said, in many cases substantial tax liabilities arise that were unanticipated and unreserved.

Finally, there's the competitive issue of company reputation. If it becomes known to your agents and your policyholders that, in fact, the reason that you're going through this exchange program is that some contracts that failed the definition of life insurance were issued, there could well be questions raised about why you didn't do it right.

How did you get yourself in this situation? This really raises questions, perhaps unfairly, about the credibility of the company and its ability to develop products. When talking with people in large failure cases, this issue is of great concern to them. Now, in some cases, if you simply mail refunds to everyone, you may find it enhances the company's reputation, but it's an issue that certainly needs to be considered. So when dealing with a large failed contracts case, there are issues beyond simply dealing with the penalties and the IRS that need to be considered.

REMEDYING FAILED CONTRACTS—WAIVERS AND CLOSING AGREEMENTS

I'm now going to turn to the issue of how to remedy failures. We've sort of finished the "scared straight" portion of the program where we've told you all the bad things that could happen if you do have a failure case. Now John will talk about the procedures and processes that are in place that will help you reduce the damages.

MR. ADNEY: This is an extremely depressing topic to deal with, but there is no good time to deal with it. Perhaps the silver lining around the cloud here is that there are procedures for remedying the failure that do not involve parting with an arm and a leg, and that's the Section 7702(f)(8) waiver provision. The problem with that has been that it has not been widely available. That requires us to also talk about the IRS closing agreement, which can put the pieces back together again and overcome the problem but at a substantial cost.

We also want to talk in that connection about the ACLI's request to the IRS that has been pending about a year now for a VCR program, and we'll assess that. We'll talk then a little bit about self-help and correcting failed contracts. Correcting failed contracts will be talked about here in the sense that after the IRS has blessed the matter and worked out with the company whatever has to be worked out, the errors that caused the problem still need to be corrected. It will be necessary to go back and fix the contracts in some fashion so that they are, in fact, qualifying.

When Section 7702 was enacted, it was recognized to be a complex statute. The Congress, actually dating from Section 101(f) and Section 101(f)(3)(h), provided some extraordinary power for the IRS to waive noncompliance with the statute due to complexity of the statute. That is to say, there was a recognition that there would be failures. One of my partners says it's akin to riding a motorcycle. It's not whether you will fall off; it's just when you will fall off. There can be expected problems of human origin, problems of systems origin, difficulties in interpretation, all of which can lead to the necessity for the IRS to be asked to waive noncompliance.

Now the Congress has laid down some conditions for the waiver, which the IRS has elaborated on for an error giving rise to noncompliance to be waivable by the IRS. It must be reasonable, and that's all the IRC says. It must be reasonable. So all that the debate has been about is what's reasonable. Many companies have concluded that the IRS is not reasonable, and the IRS has concluded that a number of the companies'

errors are not reasonable, but the contours of reasonable in this circumstance are still being debated. We'll talk about that when we talk about the rulings issued to date.

The error must be shown to be inadvertent. Now, I don't know that anyone has ever shown up confessing to one, but only a closing agreement can deal with willful errors. So the error must be inadvertent, and the IRS also says that as part of the overall reasonableness of the situation, the company must have an adequate compliance system in place. If the IRS looked into it and found that there was no compliance system or no effort being made, I think it would conclude that it was simply by the grace of God that all the other contracts were not in the IRS for examination also, and that would not be viewed as a context of reasonable error.

Reasonable steps must be taken to correct the failure. The company must tell the IRS going in that it will fix the failure. Sometimes it's necessary for the company to discuss the nature of the fix with the IRS, particularly in a fixed-premium kind of contract. In other situations the company can usually correct under one of several standard procedures. The IRS has a lot of discretion in this area. The courts have never ruled in this area, but in companion areas the courts have given the administrator considerable flexibility.

The waiver request is made as a request for a private letter ruling, which is a document submitted according to certain standard procedures. The payment of a user fee of $3,000 must accompany the request. If the waiver is granted, the company will still have to correct the contracts, but no penalties will be assessed, and none of the inside buildup tax will be due. There will be no direct tax obligation flowing to the IRS from the policyholders or the company if a waiver ruling is issued, and that's why these are prized possessions once they are obtained. The IRS has to this point issued only 15 waiver rulings since the waivers began to be issued in 1987.

What has been ruled on? Clerical errors, which the IRS sometimes calls mere human error, have been waived. The typical clerical error would be that the system generated a notice saying that the premium paid had exceeded the guideline premium limit, and the notice was being routed through the mail room to somebody else who never received it. Or the person who it had been sent to had been fired (perhaps because he or she hadn't acted on prior notices and was not just replaced), and so the notice winds up in the mail room.

You can think of many instances when clerical mistakes will lead to compliance failures. People have asked if this can happen under the cash-value accumulation test. In the cash-value accumulation test the contract meets the test by its term. However, there is a little thing called the administrative side of the company. If the contract is not being administered according to its terms that comply with the cash-value test, the contract is not complying with the cash-value test. The IRS has made that clear and, as a result, it is necessary for all the other processing that goes on in a contract to comply with the requirements of the law.

Clerical errors typically that have shown up in connection with the guideline premium test are waivable. The only requirement is that there be a compliance system in place and that once the error has been detected that something is done with that compliance system to make it a little more foolproof in the future.

Errors typically are picked up systematically when companies move to a new software system. Every system will think of 7702 a little differently, and the newer systems will often have more conservative calls or be more sophisticated in their structures. They will identify a number of contracts as noncomplying. It's usually necessary to go back and look and see whether that result is justifiable. If it is, that can often be taken into the IRS to say, "Well, we traced this out. We found out that there were x, y, and z clerical errors over here." A very specific showing to the IRS is necessary, and it's a very time-intensive, laborious process to go back and put the story together. But once the story is together, and then it can be told, and the new system can be cited as the reason why those old things won't happen anymore, then the clerical errors can be waived.

Programming errors are more difficult. There have been some instances when accidental inputs into programs have been waived. One waiver ruling came out when someone had accidentally doubled the expense charge. That was plugged into a program for 7702 testing. So the guideline premium was above what the company thought it should have been. The IRS waived that error.

The IRS has said, however, that if the fundamental design of the program is wrong, it will not waive the error. This is the bad side of this ruling program and the reason why the ACLI is now asking for a voluntary correction program. To date the IRS has been fairly unbending in holding companies to a standard of absolute liability in the construction of the basic compliance system. The IRS has said it doesn't have to be computerized, but it does have to be there, and it does have to be right.

If there were ambiguities in interpretation, if the statute wasn't clear, and in many instances it's not, if the IRS recognizes that its own regulations as proposed would change practices, it would not hold people retroactively to those practices. Certainly if a system was designed based on a possible interpretation but just not the one the IRS thinks is the best, the IRS has said it will waive that kind of error. It has done so in one ruling, the only one involving the cash-value accumulation test, a ruling that came out six to nine months ago.

There have been a number of instances in which the company was clear on what the rules were. The company intended to design a program to implement those rules, but due to the complexity of the system, it just didn't quite get there. In those cases, the IRS has said, no, that's not good enough. Yes, we recognize there were human beings trying to do this, but if they didn't do it, that's not legal. In the judgment of a number of us who work in this area, that is more harsh than Congress had intended.

The ACLI has asked that situations such as that be allowed to be dealt with in what it is calling a VCR program modeled on the pension area VCR program, and the program that the IRS just announced for voluntary compliance under Section 403(b). The ACLI has asked for this program to cover 7702 and 7702A, for which there is no procedure in place right now to correct a problem at all, failure to deal with 72(s) properly in an annuity contract, and 817(h), diversification failures for variable contracts. The IRS has met with the ACLI a couple times now. Let's just say that things are not progressing at a rapid clip. They never do with the IRS. However, I would have to say that on balance, from what I've heard, things are not looking terribly good in the 7702 realm. Under 7702A, we might get some favorable action

out of the IRS within the next year or two, which to them means tomorrow, but 7702 is an area where there is a lot of reluctance inside the IRS to issue something such as a VCR program for life insurers. As a result of that and disputes inside the agency, it's going to be difficult to get such a program in place. Yet, one is clearly necessary to deal with this harsh line that the IRS has taken in, things such as programming errors, which are the heart and soul of compliance with 7702.

What if the waiver is denied? As we said, that does happen. Well, a closing agreement is possible. A closing agreement is a contract between the taxpayer and the IRS that liquidates the taxpayer's liability and sets a straight path for the future and gets rid of all the prior problems.

The request for a closing agreement can be made as a request for a private letter ruling. It will typically arise after a waiver has been denied, and the waiver request is converted into a request for a closing agreement. The conditions of the agreement are that the tax must be paid. The tax rate used is 28%, unless you can prove that your policyholders are entitled to a 15% maximum rate, which is a difficult thing to prove. Deficiency interest must be paid. The company may not deduct the payment of the tax or the interest, nor may the company increase the policyholder's basis in the contract with respect to the tax paid.

Penalties are waived on the condition that the contracts be corrected, and the results of the agreement are simply that past and future failures are waived. The policyholders will not be audited, which is the bottom line that everyone is aiming at here. It's why the company is willing to enter into a closing agreement, to keep the policyholders from being audited and thereby complaining back at the company in a class action suit or otherwise that the company created a big problem. The waiver procedure and the closing agreement procedure are the two basic means the IRS has made available for dealing with failed contracts.

THE AVAILABILITY OF SELF-HELP

I'm going to let Chris talk a little bit about another one, self-help. People can get all excited about that saying, well, good, we don't have to go see the IRS, but the caution is to not get excited because self-help is probably a misnomer.

MR. DESROCHERS: The availability of self-help as a remedy is a common question. When a failure is first discovered, if it's a large and significant failure and the company's still in denial, the question is, can we simply fix it and make the problem go away? In the IRS's view the answer is clearly no. The only help available is through the waiver process or the closing agreement process, and any other course of action starts to run into some of the serious penalties that John talked about in which you can cross the line from reasonable to unreasonable in terms of penalties. So clearly the IRS's view is that if you're aware of a failure, the only way to get it fixed is to come in.

Now, in practice there are many instances where you go from what we would call a less restrictive view of the statute to perhaps a more restrictive view of the statute. There have been instances of companies doing certain things that involve changes that are not clearly failures. That is an important distinction to make. Where there is clearly a failure, then there is no other alternative but to go to the IRS. However,

where it's not clear that the contract has failed, then it may be possible to take some administrative action inside the company, perhaps tighten up compliance, change administrative procedures, or do other things.

A caution, though, is that we're also dealing in an area where self-help may cause more problems than it solves. There is the whole concept at play here of a deemed exchange and the loss of grandfathering under Section 7702. The grandfathering in 7702 is quite restricted. Administrative changes, changes in the death benefit, adding riders or other administrative actions can cause what is called a "deemed exchange." In that case there may be a loss of grandfathering. So a 1958 CSO contract at 3%, which on its original basis qualified, now needs to be treated as a 1980 CSO contract either at 4% for the cash value test or perhaps 6% for the guideline test. You could find that you actually have to retest those contracts and, as a result of trying to perform some self-help, in fact, force more contracts out of compliance.

You also could find yourself faced with some additional deferred acquisition cost (DAC) tax on those considering that they were new contracts, and you need to use a lot of due diligence and care in terms of what to actually do in terms of your administration to try and fix these contracts. Again I need to emphasize that these are situations where what you're doing is trying to tighten up administration or make changes to contracts that have not clearly failed. If a contract has clearly failed, self-help is simply not available.

Again, we talk a little bit about exposures and this is, what is the reaction of the policyholders once you're changing contracts? That can raise all sorts of questions about why you're doing it. Also, on audit it's very easy for the IRS to ask questions of—have you engaged in self-help? Do you have any contracts that you know have failed, or can you swear under penalties of perjury that you don't have any failed contracts? I guess I would argue that probably very few people here who would be willing to sign a statement for their company that they simply had no failed contracts. Self-help is an area that may be appealing on the surface. It may say, oh, we can solve this. We don't need to get involved in all these closing agreement or waiver processes. We'll simply just fix the problem and move on. Unfortunately, that is just not something that's available.

CORRECTING FAILED CONTRACTS

The second issue that we'd like to touch on briefly is the whole issue of correcting failed contracts. Having been through the waiver process or the closing agreement process, a key part of that is simply you need to go back and correct the contracts. The IRS would point out that the correction does not necessarily need to be done after you've reached agreement with it. If there's a failure, there's nothing preventing the company from fixing it now and then going into the IRS. As a practical matter, however, unless the correction is simply a refund of excess premium, then it is incorporated either into the waiver request or into the closing agreement. Corrective actions generally do not occur after all the issues have been resolved. At that point, a company will make an agreement with the IRS and go back and fix the contracts. As the IRS has pointed out on numerous occasions, there's nothing in its process that says correction has to wait until after everything is resolved.

Commonly it is like putting the feathers back into the pillow. In simple guideline cases it's easy. In cash-value test cases it may involve some very fundamental changes to the structure of the contract. These cases can involve issues of policyholder relations, of contract, of even profitability. After all is said and done, and this particularly happens and is contentious in acquisitions, the block of contracts that has been fixed has a much different profitability pattern than it had before it was fixed. There are some interesting questions about who might be responsible for that.

In terms of legal compliance, very few companies have the right to unilaterally change their contract. What do you do when the policyholder refuses the correction? You've gone into the IRS. You've entered into a closing agreement with the IRS, and one condition of the closing agreement is that you'll fix the contracts. Well, if you don't believe you have a unilateral right to simply adjust those contracts, a policyholder might say, "Well, I'd prefer to keep the contract as it is. I have it in a pension plan and honestly don't mind if you send me a 1099 because it's not taxable in any event."

How do you deal with your obligation to the IRS in that case, that as part of your closing agreement you committed to fixing all those contracts? So, it raises some rather interesting issues of what to do when the policyholder doesn't want the change. But if you simply go through and decide that you can amend the contracts by making a change that's simply just favorable to all the policyholders, what happens if you can't find everybody? These are some rather interesting administrative questions as to how to do it.

For flexible premium contracts, often the fix is simply to refund premium. That raises some issues about commissions. What happens on premium refunds? Do you adjust commissions? Do you get agents involved? Or do you simply just refund the premium and not worry about it? Fixed-premium contracts, as I said, can be very difficult structurally. You may have to make significant structural changes to those contracts that can involve changes in administration, changes in product design, filing with the insurance department, and other things.

As a practical matter, once you've gone through the process of correcting the contracts and you have made your agreement with the IRS, some other issues still need to be considered in terms of finishing up. It's not over simply because you've gotten a waiver or simply because you agreed. You do need to carry through on what you committed to the IRS to do. In some cases the tax lawyers make the commitment, and it falls to the administrative people to figure out how to do it, and we all know the reaction inside companies to that.

A waiver or closing agreement is very often something that a company doesn't want highly publicized. You certainly don't want to publicize the fact that you have this block of failed contracts to deal with. In many cases you have got just some issues inside the company as to what's the best way to handle it, not only externally with agents and policyholders but internally inside the company.

CONSEQUENCES OF INACTION

The last issue that we'll touch is, what are the consequences of inaction? What's the likelihood that the failure will be detected? Well, as a practical matter, Section 7702

has been self-policing. It's very difficult for someone to come in and look at a block of contracts for the IRS to audit or do other things.

It was feared a few years ago that the ACLI spreadsheet that was given to the IRS would end up in the agent's hands as an auditing tool, and IRS agents could come in and plug this diskette in and spew out all these failed contracts. I don't think that's the case. However, I think that everyone needs to be aware that compliance is increasing. Awareness is increasing at the IRS, particularly with the agents, and there are easier ways to do it than by simply looking at calculating guideline premiums and doing other things.

They can be very effective with questionnaires when they can enforce penalties on companies asking how you are doing your compliance or how you are handling this issue or that issue. There are several fairly simple things that are common mistakes that the IRS is well aware of from the closing agreement program. All it simply needs to do is take its most popular errors and develop a questionnaire to be used in connection with an audit; that is more likely how it will do it.

Closing agreements also go out to the district director. There have been some large closing agreements. The largest one that I'm aware of was about $10 million. As these closing agreements go out to the districts, the district directors and the agents see them as a source of revenue. Once these come out, the IRS becomes aware that companies have settled on this issue. It doesn't take long for the word to spread that perhaps some revenue can be gained simply by looking at 7702. As a practical matter, where it will come up in auditing is through questions. It will come up through more awareness and education by the national office.

Failed contracts can also arise in connection with the sale of a company. As I said earlier, people are much more aware of the liability and doing much more due diligence on Section 7702 in acquisitions. Which party to an acquisition takes the problem to the IRS is also an issue. If you simply bought a block of business that is questionable, and there is the potential that you can be indemnified, you get a different attitude about how to test compliance going into the IRS. If companies have found that they've sold blocks of business that the buyer is taking to the IRS, there are some interesting issues about who handles it and makes the decisions and who runs the case. More and more of that happens and as people become more aware of it, it kind of feeds on itself.

John went through a very detailed recitation of the penalties—the worst situation for a company is to be aware of a failure situation and simply not deal with it. I don't think any actuary has ever gone to jail for violating the nonforfeiture law, but certainly people can go to jail for violating the IRC. Compliance is taken seriously at the IRS, and the IRS has a track record of putting people in jail. Now I'm not going to suggest that anyone's going to go to jail for violating Section 7702, but if companies are aware that they have a failure and don't deal with it, then there are potentially some very serious consequences.

MR. ADNEY: We have found that buyers are very willing to turn in sellers. Will the failure be detected? Yes, it will be. We don't know when, and we don't know how or by whom, but there is a good chance that if a failure exists, it will come out. That

is why people need to try to put compliance programs into place. Then they can preclude the failures and address the failures when they do occur.

I'll make one concluding comment about approaching the IRS. The IRS's track record to date under the 7702 waiver program has not been very good as far as the industry is concerned, but I don't think I'd completely abandon hope on the question. The IRS may be unwilling to grant a VCR program; we still don't know about that, because that still is pending. I think that the chorus of complaints and the deluge of requests from the industry coming into the IRS for something better than the waiver program may produce at least a better waiver program, something closer to the original intent of Congress in having the waiver authority granted. For that to happen it will be necessary for more cases, particularly more sympathetic cases, to be brought into the IRS for examination. Maybe we can make greater progress, but it's a matter that must be handled because the exposures are simply too great to ignore.

MR. WILLIS B. HOWARD, JR: In general, you said that large blocks were troublesome. What's a large block? Is that a percentage of the number of policies in force, or is that just an absolute number? Is 1,000 policies out of 100,000 policies a large block?

MR. ADNEY: The IRS's position is that one contract that failed is a failed contract. Waiver requests have dealt with one contract or just a couple contracts. There have been closing agreements that have dealt with small quantities of contracts. However, there have also been closing agreements that have dealt with, in our experience, a couple thousand contracts.

MR. HOWARD: Have you seen one as large as 4,000?

MR. ADNEY: Yes.

MR. DESROCHERS: The number of failures may depend on the test. Cash-value test contracts have to qualify by the terms of the contract, and, therefore, if one of your cash- value test contracts is out of compliance, then, by definition, they're all out of compliance. In practice what happens in that case is that many of those contracts would pass the guideline test, and that would be how it would be applied, but with a design error a very large number of contracts could be out of compliance. As many as 4,000 contracts wouldn't surprise me. We worked on one case of about 2,000 contracts. It was a cash-value test case.

MR. ADNEY: As far as the amount of the liability that's arising from it, it doesn't take many contracts to put together a large inside buildup tax liability, particularly if we're dealing with some single-premium business sold in the 1980s that went awry. The inside buildup tax can be very large, and then when you start putting the prospective penalties on top of that, when someone's thinking about perhaps not going forward, 1,000 contracts or fewer than 1,000 contracts can generate very large amounts of penalties. So that's the kind of thing that needs to be reckoned with.

MR. HOWARD: Are you aware of any closing agreements involving companies in liquidation?

MR. ADNEY: Yes. The IRS has generally dealt with the companies in rehabilitation, the troubled companies, a little more gently than perhaps the fully functioning companies. The IRS has published a number of rulings to permit policyholders to move funds back and forth that would otherwise not be possible and still avoid taxes or tax penalties. I have not worked directly on any of the cases that are in rehabilitation where there have been closing agreements, but it wouldn't surprise me that it might come up.

MR. HOWARD: This may not be applicable because my interest is obviously in companies that are in liquidation, but how long does it take to get a closing agreement once you go to the IRS and say, "Oops, we've got some policies here where we believe that there was at least one case in each policy where there was not a reasonable error."

MR. DESROCHERS: That question actually came up at our seminar, and the answer may be anywhere from three weeks to two years, depending on how much you want to fight it. If you go into the IRS with a simple question with a check in hand, you can resolve it quickly. If you go in with a little more contentious attitude about what a reasonable error is, believing that you can convince the IRS that you don't have a problem and go in first for a waiver and then look for a closing agreement, it can run into two-plus years.

MR. WILLIAM JUAN TAYLOR: Chris or John, could you share with us some of the details involved in that $10 million payment situation, changing the names to protect the innocent or whatever?

MR. ADNEY: We can't speak to the $10 million. I'll give you an illustration, though, of when the IRS has required some closing agreements. It will give you a flavor for what's going on there. I mentioned one case earlier of a company having a programming error. The company knew what the right rule was. Section 7702 says that the calculations are generally done assuming a level amount of insurance, not an increasing amount, on the guarantees. The program, unfortunately, permitted certain increases to be taken into account. It was accidental, but the IRS said that was not a reasonable error. It held the company to a standard of absolute liability and required a closing agreement. That was a case where the closing agreement came in less than a million dollars.

Another multimillion dollar closing agreement involved that same rule. A company had issued single-premium contracts with guaranteed increasing face amounts, relying on a combination of rules inside Section 7702. The IRS did not agree with the company's reading of those rules and, in fact, believed that the company was stretching things just a bit and required a closing agreement. It declined to waive that error.

The most troublesome cases have been the ones in which increasing face policies have been sold on a limited or single-pay basis. The IRS has said that's the very thing Congress tried to stamp out when it enacted 7702, but it's on the wrong side and there is no hope for it. There will have to be a closing agreement and there may be questions about what is the right interest rate. That's difficult question to answer in 7702. What is the right interest rate to be used in a 7702 calculation? You'll find the IRS more reasonable and more willing to consider that a waivable error.