TAXATION SECTION

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SUPPLEMENT

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Note from the Editor

Welcome readers to this special supplement of *TAXING TIMES*. In this issue we present information on the five revenue procedures released by the Internal Revenue Service on June 30, 2008 dealing with contract corrections. The issue begins with an article offering an historic perspective on contract corrections and then presents a separate detailed article for each of the five revenue procedures. In addition, the supplement includes brief write-ups on the history of the use of tax rates in sections 7702 and 7702A closing agreements and a discussion of the earnings rates used under two of the new revenue procedures. We hope this information provides useful insights into these important revenue procedures.

Enjoy!
Brian G. King

The Road to the Remediation Revolution: A Short History of the Correction Procedures for Life Insurance and Annuity Contracts

by John T. Adney, Walter C. Welsh and Alison L. Reynolds

I. Release of the New Correction Procedures

On June 30, 2008, after a year of intensive effort following on more than a decade of incremental development, the Internal Revenue Service (the "Service") and the Department of the Treasury (the "Treasury") released five revenue procedures comprehensively addressing the correction of failures to comply with four provisions of the Internal Revenue Code: sections 101(f), 7702, 7702A, and 817(h).[1] Previously, in Notice 2007-15,[2] the Service and the Treasury requested comments on improvements that life insurers and others thought should be made to the procedures to correct the following: life insurance contracts that failed to satisfy the requirements of section 101(f) or 7702 (as applicable); contracts that inadvertently failed the "7-pay test" of section 7702A(b) and thus became modified endowment contracts ("MECs"); and failures to diversify variable separate account investments as required by section 817(h). In response to extensive comments submitted by the life insurance community, and in an effort to streamline tax administration and compliance, the government agencies completed new procedures—within the timeframe projected—and published the procedures in the Internal Revenue Bulletin last July.[3]

- Revenue Procedure 2008-38, elaborating on the "Alternative C" correction procedure under Revenue Ruling 2005-6 for errors relating to qualified additional benefits as defined in section 7702(f)(5) ("QABs").
- Revenue Procedure 2008-39, revising the correction procedure for inadvertent MECs.

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- Revenue Procedure 2008-40, addressing closing agreements for contracts failing to comply with section 101(f) or 7702.
- Revenue Procedure 2008-41, revising the closing agreement procedure for section 817(h) diversification failures.
- Revenue Procedure 2008-42, providing an automatic procedure for obtaining a waiver of clerical-type errors under section 101(f)(3)(H) or 7702(f)(8), as applicable.

These new revenue procedures represent a virtual revolution in the government's approach to the correction of contract and separate account errors, emphasizing simplification, cost reduction, and more generally, the enabling of compliance with complex tax rules. The new procedures also entail a shifting of audit-type responsibility from the Service's National Office to its field auditors; in most cases, this would be the Large and Mid-Size Business Division (LMSB) of the Service. Overall, in consequence of a useful collaboration between government and industry, the new procedures set forth a plan for tax compliance that is fair, equitable and beneficial to all parties.

In what follows, we provide a short history of the correction procedures previously developed to address compliance failures and the shortcomings of those procedures, laying the foundation for this sea change in the correction process. We end with a roadmap to the remaining articles in this special supplement of *TAXING TIMES*, which describe and provide commentary on the five new revenue procedures in detail.

II. History of the Correction Process

A. Enactment of Definitions and Waivers for Reasonable Errors

In 1982, in enacting section 101(f) as part of the Tax Equity and Fiscal Responsibility Act ("TEFRA"),[4] Congress established the first statutory definition of a life insurance contract for federal tax purposes. This definition limited the investment orientation of flexible premium life insurance contracts by requiring them to meet one of two actuarially based tests—a "guideline premium limitation" (coupled with a required risk corridor) or a "cash value" test—as a prerequisite to obtaining the tax-free death benefit accorded to life insurance contracts under section 101(a)(1). In the course of enacting section 101(f), Congress recognized that life insurance companies could well encounter trouble applying those tests, and so it included a rule, in section 101(f)(3)(H), permitting the Service to waive compliance errors if they were "reasonable" and if reasonable steps were being taken to remedy the errors. Also, with respect to the guideline premium limitation, section 101(f)(3)(A) provided that premiums paid in excess of the limitation that were returned to the policyholder with interest within 60 days of the end of the contract year would not be counted against the limitation (the "60-day rule"). Significantly, the interest returned with the excess premiums would be includible in the policyholder's income, without regard to the rules of section 72(e) that normally govern the taxation of predeath distributions from life insurance contracts. In this manner, the excess inside buildup would be returned and income tax would be paid on it.

Following the enactment of section 101(f), which was intentionally a temporary measure, Congress decided to expand the definitional requirements to cover all new life insurance contracts. Thus, in passing the Deficit Reduction Act of 1984 ("DEFRA"),[5] Congress added a new section to the Code, section 7702, which contained a definition of "life insurance contract" applicable to new contracts for all purposes of the Internal Revenue Code. The two tests of the temporary provision were carried forward into the new section, albeit with significant modifications. Further, in the case of a contract that did not satisfy either of the tests, the interest or earnings increments to the contract's cash value (the "inside buildup"), referred to as the "income on the contract," were expressly subjected to accrual taxation annually under the terms of new section 7702(g). At the same time, in section 7702(f)(8), Congress continued the policy of permitting the Service to waive reasonable errors that

led to failures to satisfy the definition's requirements. Congress also continued the 60-day rule, permitting the retroactive correction of guideline premium test failures by distributions that returned the excess inside buildup as taxable amounts.

B. Diversification Requirements

As part of DEFRA, Congress also enacted section 817(h), effectively codifying the diversification tests for variable annuities and variable life insurance contracts set forth in private letter rulings issued in the early 1980s.[6] Prior to the issuance of these rulings, in the late 1970s and early 1980s[7] the Service issued rulings that held that the owner of a deferred variable annuity contract who was viewed as controlling the investments of the underlying separate account was to be taxed as if the owner held the separate account investments directly, essentially meaning that the contract's inside buildup would be taxable more or less on a current basis. In particular, Revenue Ruling 81-225 held that the owner of a deferred variable annuity contract based on a separate account or subaccount investing solely in the shares of a single mutual fund that were also available for purchase by the general public would be taxed as if those shares were owned by the contract owner. Section 817(h) required the investments of separate accounts supporting nonqualified variable life insurance and annuity contracts to be "adequately diversified," and authorized the issuance of regulations prescribing the specifics of the diversification to be required. According to section 817(h)(1), contracts based on a separate account not compliant with the diversification requirements are treated as noncompliant with section 7702 (in the case of life insurance) or section 72 (in the case of annuities), resulting in the current taxation of their inside buildup.

The regulations authorized under section 817(h), completed in 1989, provided for a correction procedure for separate accounts that failed to be adequately diversified.[8] The consequences of failing to meet the diversification requirements were unnecessarily harsh. When a separate account (or subaccount) did not meet any aspect of the requirements at the end of a quarterly period, contracts which offered that separate account as an investment option would not be treated as life insurance or annuity contracts at any time thereafter, even if the separate account returned to compliance in a subsequent period. For such contracts, according to the regulations, the "income on the contract" for any taxable year is treated as ordinary income of the contract owner under section 7702(g). The regulations, however, went on to provide relief from this income inclusion in the case of inadvertent failures to satisfy the diversification requirements. Specifically, the diversification failure could be remedied if the insurer (or a contract holder) demonstrated to the Service that the failure to diversify was inadvertent and if, within a reasonable time after discovery of the failure, the separate account investments were brought into compliance with the diversification requirements. Further, under the regulations as originally issued, the insurer (or holder) must agree to pay to the Service "an amount based upon the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract" as defined in section 7702(g) (except for the income arising in periods prior to the beginning of the diversification failure).[9] This "toll charge," equating to tax on the inside buildup of the affected contracts during the period of nondiversification, was described as "making the government whole."

C. Modified Endowment Contracts

The next significant legislative enactment affecting life insurance policyholder taxation occurred in 1988. In the Technical and Miscellaneous Revenue Act ("TAMRA"),[10] Congress made more onerous the tax treatment of predeath distributions from a life insurance contract for which premiums were paid in, as it were, too rapidly. Under section 7702A as enacted by TAMRA, a contract meeting the requirements of section 7702 but failing the 7-pay test is considered to be a MEC,[11] with the result that distributions from the contract during the lifetime of the insured (including policy loans) are taxed on an income-first basis[12] and may be subject to a 10 percent penalty tax.[13] The 7-pay test provides, in essence, that the premiums paid for the contract during each of its first seven years cannot exceed the level annual amount necessary to fund the life insurance contract fully, disregarding expense charges. In other words, predeath distributions from a section 7702-compliant contract that is more investment-oriented than allowed by the 7-pay test are taxed under rules applicable to deferred annuities, not life insurance, although the death benefit paid from such a contract remains tax free under section 101(a)(1).

The 7-pay test came onto the life insurance scene rather abruptly, effective for contracts issued after June 20, 1988 even though TAMRA was not signed into law until the following November. At the time, life insurance companies were continuing to refine their contract administration systems to assure that proper section 7702 testing was being performed, and to comply with this new 7-pay test, companies

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needed to implement (quickly) still newer administration systems, applying the subtle complexities of section 7702A's premium limit even to the most traditional whole life contracts. As with section 7702(f)(1)(B), section 7702A(e)(1)(B) contained a 60-day rule, under which excess premiums returned with interest would not be counted under the 7-pay test, but the TAMRA statute made no provision for the waiver of reasonable errors.

D. Round One: Early Waivers and Closing Agreements

During the late 1980s, private letter rulings waiving errors under section 7702, of both a clerical and an interpretative nature, began to appear. Even so, there was little such activity, as life insurers were still contemplating the interpretation of sections 7702 and 7702A and developing administration systems to implement them fully, and in any event the guideline single premium rule of section 7702 (and section 101(f)) adequately covered the premiums paid for flexible premium contracts for the time being. In some instances, however, insurers requested waivers for compliance errors that, in the eyes of the Service, were not thought to be "reasonable." The fallback solution in such instances involved resort to a general provision in the Code, section 7121, which permitted the Service to enter into a so-called closing agreement, *i.e.*, "an agreement in writing with any person relating to the liability of such person … in respect of any internal revenue tax for any taxable period." When a section 7121 closing agreement was used to resolve errors under sections 101(f) and 7702, the life insurers that issued the "failed" contracts were required by the Service to pay a toll charge not unlike that described in the section 817(h) regulations, although in this case the toll charge would equate to a tax on all of the income on the contract (including income arising in years prior to the failure) accruing until the closing agreement was completed. In addition, whether a waiver was granted by the Service or a closing agreement was entered into, the contracts involved needed to be corrected in some fashion, such as by increasing death benefits or returning excess premiums to the policyholders who paid them. The problem that arose during this time period was that the Service began construing the waiver provisions quite narrowly, finding a good many errors voluntarily brought to the Service's attention to be unreasonable and thus not waivable. To correct the compliance failures in such cases, the Service required insurers to enter into closing agreements bearing toll charges that often were excessive in proportion to the errors committed.

In 1991, cognizant of the process being used to address section 7702 failures, and after a dialogue with certain life insurance industry representatives, the Service issued Revenue Ruling 91-17.[14] This revenue ruling described the income tax reporting and withholding obligations that the Service believed applicable to life insurers with in-force contracts that failed to comply with section 7702 or that were based on nondiversified separate accounts. It recited the penalties for failing such obligations, and observed that the penalties would not be applied if the failures were waived under section 7702(f)(8). The ruling publicly acknowledged the existence of the closing agreement process correcting fatal errors in contracts and offered a waiver of the reporting and withholding failure penalties for closing agreement submissions that were made prior to June 3, 1991, a date that allowed less than three months to prepare and make submissions. Under such a closing agreement, according to the ruling, the insurer must agree to pay to the Service an amount based on (i) the amount of tax that would have been owed by the policyholders if they were treated as receiving the income on the contracts, and (ii) deficiency interest with regard to such tax. This formula described the toll charge on which the Service insisted to "make the government whole."

After the issuance of Revenue Ruling 91-17, the Service saw an increase in waiver ruling requests and closing agreement offers, although the three-month window for submissions permitted by the ruling was quite short. Even for life insurers that already had identified section 101(f) or 7702 errors, the three-month window was a difficult challenge given the information required for such a submission. At that time, the government may not have understood the full nature of the tasks required to complete a submission. To be sure, however, the ruling and its aftermath—in which the Service applied strict but somewhat case-by-case standards in determining what errors were waivable, and required insurers in nonwaivable cases to enter into expensive closing agreements—did leave a lasting impression on the life insurance industry. From that time forward, insurers tended to pay more attention to administering the Code's definitional requirements while scrutinizing with utmost care, and endeavoring to limit, the circumstances in which a submission to the Service under waiver or closing agreement procedures was considered necessary. The ruling did, however, introduce two concepts that helped pave the road to contract remediation. First, the ruling systematized the use of closing agreements to remedy compliance failures. While that step may not seem significant to insurers striving hard

and incurring very substantial costs to achieve compliance, it was a significant step in tax administration, for it allowed insurers to stand in the shoes of their policyholders to resolve what were, in the eyes of the law, the tax liabilities of the latter. (And at times those were expensive shoes to wear.) Second, the ruling made use of the carrot along with the stick: the Service's offer of a blanket (albeit time-limited) waiver of penalties.

Approximately one year later, the Service released more guidance regarding remediation closing agreements, this time relating to section 817(h) failures. Revenue Procedure 92-25[15] laid out the process by which an insurer could request relief for a diversification failure as outlined in the section 817(h) regulations. Repeating the requirements for relief contained in the regulations, the revenue procedure said that the failure must have been inadvertent and the separate account must be (or have been) brought into compliance with the diversification standards within a reasonable time after discovery of the failure. Further, according to the revenue procedure, the insurer requesting relief must pay a toll charge based on the income on the failed contracts (failed, that is, due to the diversification error), the calculation of which generally follows the rules of section 7702(g). Significantly, Revenue Procedure 92-25 exposed to public view the first model closing agreement available for contract remediation proceedings.

E. Round Two: MEC Closing Agreements and Two Special Notices

As noted above, the rules of section 7702A sprang to life rather suddenly, in the summer of 1988, bringing with them substantial challenges to life insurers' contract administration capabilities. These new rules turned out to be dauntingly complex, introducing the net annual (7-pay) premium concept intended to limit gross modal premiums and benefit reduction and material change rules intended to support the 7-pay limit. Material changes were broadly defined, and when they occurred they started new contract years, requiring administration systems to keep track of a new set of annual start and end dates while maintaining the old ones for section 7702 and other purposes. At the same time, the universe of material changes was circumscribed by application of a "necessary premium" concept, which introduced yet another, albeit subtle, form of premium limitation. Not surprisingly, as life insurers came to grips with the new statute, they found that in a significant and growing number of cases a variety of errors—programming errors, administration errors and plain old human errors—inadvertently caused life insurance

contracts to become MECs. Unfortunately, insurers were limited in their recourse, for section 7702A made no provision for waivers of reasonable errors, and while it contained a 60-day rule, the compliance problems were detected by insurers, often long after the 60-day period had expired.

In or about 1995, taking account of the growing population of inadvertent MECs as well as the difficulties insurers were encountering in administering the requirements of sections 101(f), 7702, and 817(h), life insurance industry representatives met with senior Treasury and Service officials to request the establishment of a broad-ranging program for the correction of errors involving life insurance and annuity contracts. The industry's request built on the correction programs announced in Revenue Ruling 91-17 and Revenue Procedure 92-25, analogized to similar programs in place in connection with qualified retirement plans, and drew on the concept at the base of the long-standing 60-day rule, *i.e.*, that the government was sufficiently "made whole" through the payment of tax on the interest associated with excess premiums. In this regard, the industry specifically asked that the toll charge required for the remediation of failures be re-examined, for in many cases it was excessive by all counts and it may not have encouraged compliance. By 1997, the Service had in hand several offers for closing agreements relating to section 7702A, and general agreement had been reached between the government and the industry that the MEC problems should be addressed first, as it was thought that those problems were both compelling—no

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correction procedure existed, unlike the case with section 7702 or section 817(h)—and perhaps more readily capable of being addressed, since administrative precedent was lacking.

If there was a sense that the problem of inadvertent MECs could be dispatched expeditiously and rather easily, that sense was soon dispelled. The Treasury and the Service devoted significant time to the matter, with their work culminating in the issuance of Revenue Procedure 99-27.[16] This revenue procedure enabled insurers, as requested, to correct inadvertent "nonegregious" failures to comply with section 7702A. Further, both the toll charge and the corrective actions that the procedure required for closing agreements were generally thought to be reasonable. The toll charge amounted to the sum of (1) tax at prescribed rates on unreported distributions (whether received or deemed received as in the case of loans) from inadvertent MECs, (2) deficiency interest on such tax amounts, and (3) a tax on the earnings (at imputed rates) on premiums paid in excess of the 7-pay limit. And the required corrective action followed what was by then customary under section 7702 closing agreements, *i.e.*, return of the excess premium payments and earnings thereon to policyholders or increases in the death benefits, as applicable in the 7-pay test context. In this manner, the revenue procedure enabled the remediation of inadvertent MECs with an appropriate level of toll charge.

Unfortunately, and despite the foregoing, Revenue Procedure 99-27 was not received by the life insurance industry with equanimity. This was due to limitations placed on the relief that the revenue procedure would provide and on when that relief would be available, and also to what were perceived as the procedure's unduly burdensome information-gathering requirements. By way of example, the revenue procedure did not apply to corporate owned life insurance ("COLI") contracts, and the procedure was made unavailable, through certain mechanical rules, with respect to contracts that were said to be designed or marketed as heavily investment-oriented contracts. Unfortunately, the mechanical rules often rendered relief unavailable to rather ordinary looking contracts innocently swept into the MEC net, and the anti-COLI rule did not seem to make sense. Additionally, the revenue procedure limited the time that the correction process was available: it applied only to requests received by the Service on or before May 31, 2001, and generally insurers had but one opportunity to submit contracts for correction under the revenue procedure.

Despite the dissatisfaction with the provisions of Revenue Procedure 99-27, life insurers proceeded to make the filings that the procedure permitted—and the Service found itself inundated with closing agreement offers and with the voluminous paper stacks required to accompany them. After the May 2001 due date of the one-time correction offer, the Service issued Revenue Procedure 2001-42.[17] The new revenue procedure formally superceded but largely repeated the provisions of Revenue Procedure 99-27, while also eliminating both the time limit for seeking a closing agreement and the restrictions on the types of life insurance contracts and related categories of error that could be covered by the closing agreement. Thus, the new revenue procedure effectively established a permanent process for the correction of inadvertent MECs, and it enabled the correction of inadvertent MECs that were COLI contracts or that had funding levels above the limits provided in its predecessor. Although the new revenue procedure continued to require voluminous information, many viewed its arrival as a positive step.

Around the same time that Revenue Procedure 99-27 was issued, the Service also released Notice 99-48.[18] This notice announced that the Service would continue to enter into closing agreements to correct errors under section 7702, and that it would continue the practice of waiving penalties that had been observed with closing agreements under Revenue Ruling 91-17. In addition, the notice introduced for section 7702 closing agreements the use of the same tax rate structure that was employed in Revenue Procedure 99-27. This was a three-tiered rate structure based on, for a given contract undergoing the correction process, the amount of the death benefit under that contract as of any date within 120 days of the submission of the closing agreement offer, or as of the last day the contract was in force.

Also in the late 1990s, the Service and the Treasury became aware that certain variable annuity contract fund managers were mistakenly using an alternative diversification standard provided under the section 817(h) regulations. Under that alternative, separate accounts or their underlying funds supporting life insurance contracts—but not annuity contracts—could invest in Treasury securities without regard to the diversification requirements generally imposed under the regulations,[19] and the actions of the fund managers in contravention of those general requirements resulted in diversification failures. While closing agreements under Revenue Procedure 92-25 were available to the affected life insurers in order to correct the failures, the

insurers demonstrated to the Service and the Treasury that highly excessive toll charges would be assessed for such closing agreements. Hence, to allow this situation to be rectified in an equitable manner, the Service issued Notice 2000-9,[20] both to remind insurers and fund managers of the scope of the alternative diversification standard and to provide, for a limited time, a process to remedy the diversification failures utilizing Revenue Procedure 92-25 closing agreements with reduced tax rates. In this fashion, by means of special relief provided under the notice, the exaction of penalties disproportionate to the "offense" was avoided.

F. Round Three: Closing Agreements with Special Relief

Beginning in 2001, the Service received requests for waivers of section 7702 failures from life insurers that mistakenly had reflected in their guideline premium calculations charges for QABs using the mortality charge rule of section 7702(c)(3)(B)(i) instead of the expense charge rule of section 7702(c)(3)(B)(ii). The Service, which agreed that the expense charge rule should have been used in the calculations, issued the waivers as requested, but this turned out not to address the full scope of the compliance problem presented by the mistaken (but reasonable) interpretation. That interpretation was imbedded in a number of older, "legacy" computer-based administration systems that tested large blocks of contracts for compliance with section 7702 and 7702A, and it would have been prohibitively expensive for insurers to adapt those systems to what the Service considered the proper interpretation of the statutes. To deal with this conundrum, a group of insurers with legacy systems approached the Service and the Treasury to make a special request: publish guidance on the QAB issue and provide a mechanism for achieving compliance without undue cost. In response, the Service issued Revenue Ruling 2005-6,[21] holding that QAB charges should be taken into account under the expense charge rule of section 7702(c)(3)(B)(ii) for purposes of the sections 7702 and 7702A calculations. In connection with this guidance, the Service provided three alternative courses of action for insurers with tax compliance systems that did not account for QAB charges using the expense charge rule. "Alternative A" stated that if the insurer's compliance system did not properly account for the charges, but no contracts failed to satisfy the statutory requirements, the insurer could correct its system without the need to contact the Service. This may have stated the obvious, but in this complex area of the law, the obvious sometimes bears repeating. "Alternative B" under the ruling gave insurers a limited amount of time—a one-year period ending on February 7, 2006—to request a closing agreement under which the insurer was required to bring neither its contracts nor its administration system into compliance with the holding of the revenue ruling. In the case of the legacy systems, this made particular sense, for

To deal with this conundrum, a group of insurers with legacy systems approached the Service and the Treasury to make a special request. …

without incurring the excessive cost of modifying the systems, the contracts that were out of compliance with section 7702 or 7702A could not even be determined, much less corrected. In return for its agreement with this novel approach, the Service required the payment of a toll charge, but the toll charge rates provided under the ruling proved to be appropriate because they were based on the number of contracts involved in the corrective action rather than the income on the contracts, and the toll charge was capped at $50,000 per insurer seeking relief. The ruling's "Alternative C" was similar to its Alternative B, including the use of the special toll charge rates, but with the important exception that the insurer was required to correct its failed contracts and the flaw in its administration system.

G. The Final Round: Notice 2007-15 and the New Procedures

If Revenue Ruling 91-17 began the long march toward an improved approach to contract remediation by systematizing the use of closing agreements and waiving insurer-level penalties for reporting and withholding failures, and if Revenue Procedures 99-27 and 2001-42 laid the foundation for a fairer approach to toll charges by applying the tax policy underlying the 60-day rule (*i.e.*, taxing the earnings on the excess premiums), the issuance of Revenue Ruling 2005-6 amounted to the breakthrough event, ushering in a new era for contract corrections. Following the issuance of Revenue Ruling 2005-6, many in the life insurance industry, along with a number of government officials, both recognized the need and perceived the opportunity to undertake fundamental revisions in the contract correction procedures then in place.

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This time, the focus of the reform effort was twofold—rendering the toll charges for closing agreements more commensurate with the damage to the tax revenues arising from acts of noncompliance (as some said it, "making the punishment fit the crime"), and streamlining the correction process from the government's standpoint as well as that of taxpayers. As to the former, evidence mounted that toll charges based on the section 7702(g) income on the contract at times bordered on the ridiculous, such as when excess premium amounts residing in contracts for only a few days, thereby giving rise to excess inside buildup in relatively small amounts, led to closing agreements costing insurers millions of dollars. Some noted that the government's confiscation of the excess premiums, *i.e.*, exacting a penalty of 100 percent of the excess premiums, would be less punitive than the toll charges sometimes required under the existing closing agreement process. As to the latter, the valuable time of staffs of lawyers in the Service's Office of Chief Counsel was taken up with determining whether simple clerical mistakes constituted "reasonable errors" waivable under section 7702(f)(8). Insurers seeking such waivers were required to engage in the near equivalent of archeological digs for information about decisions made and actions taken long ago (often by former employees). Those in the industry seeking to use the correction mechanism for inadvertent MECs, like those in the government charged with processing the MEC correction requests, were burdened with paperwork mandates that no one could justify. Bringing efficiency to the remediation process, along with greater fairness, was high atop the lists of all involved.

Bringing efficiency to the remediation process, along with greater fairness, was high atop the lists of all involved.

To this end, the government took two actions in 2007. First, the Service issued Revenue Procedure 2007-19.[22] In this procedure, the Service observed that it had become aware of a number of changes that could be made to Revenue Procedure 2001-42 to make it easier for insurers to use that process in correcting inadvertent MECs. The new revenue procedure thus implemented changes to (1) specify new indices on which the imputed earnings rates were based, (2) alter the address to which toll charge payments under Revenue Procedure 2001-42 needed to be sent, and (3) permit insurers to submit exhibits in an electronic format (*e.g.*, on CD-ROM) in connection with their closing agreement offers.

At the same time, the Treasury and the Service released Notice 2007-15. This landmark notice requested public input on a variety of issues that the notice identified, mostly relating to procedures for obtaining closing agreements to correct inadvertent failures of life insurance or annuity contracts to satisfy section 817(h), 7702, or 7702A, as applicable. Also released, in draft form, were four model closing agreements on which the public was invited to comment. In response, the government received several sets of detailed comment letters—from the American Council of Life Insurers (the "ACLI"), from MassMutual, and from Davis & Harman LLP on behalf of the firm, the Committee of Annuity Insurers, and a life insurance company client of the firm—providing information and suggestions that ultimately helped to shape the new correction procedures. Following the receipt and review of the formal comment letters, the Treasury and the Service engaged in intensive discussions with the industry representatives offering comments and internally within the agencies.

On May 6, 2008, draft copies of the five new revenue procedures were posted on the Web site of the Office of Management and Budget ("OMB").[23] Shortly thereafter, following discussions during a meeting of the Section of Taxation of the American Bar Association in which representatives of the Treasury and the Service participated, the ACLI and other industry representatives submitted informal comments intended to refine the draft revenue procedures. A few weeks later, on June 30, 2008, the Service released the five revenue procedures, including the model closing agreements, in final form. In short, under Notice 2007-15, a process was followed that should serve as a model for securing suggestions and vetting changes intended to improve tax compliance and administration. Not surprisingly, this model process produced results of legal excellence, equity, and fairness.

III. A Roadmap to the Ensuing Articles

Inside this issue of *TAXING TIMES* are articles which describe in more detail, and provide useful commentary on, the five new revenue procedures. The subject and author(s) of each of these articles are, in order:

(1) Revenue Procedure 2008-38, providing the procedure for Alternative C closing agreements under Revenue Ruling 2005-6—article authored by Daniela Stoia and Craig R. Springfield.

(2) Revenue Procedure 2008-39, providing a revised procedure to remedy inadvertent MECs—article authored by Daniela Stoia and Craig R. Springfield.

(3) Revenue Procedure 2008-40, providing a closing agreement procedure to correct life insurance contracts that fail to meet the requirements of section 101(f) or 7702, as applicable—article authored by Craig R. Springfield and Daniela Stoia.

(4) Revenue Procedure 2008-41, providing a procedure to correct the inadvertent failure of a variable contract separate account to satisfy the section 817(h) diversification requirements—article authored by Joseph F. McKeever, III and Bryan W. Keene.

(5) Revenue Procedure 2008-42, providing for automatic waivers of clerical-type errors under section 101(f)(3)(H) or 7702(f)(8), as applicable—article authored by Stephen P. Dicke.

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End Notes

1 All references to "section" are to sections of the Internal Revenue Code of 1986 (the "Code"), as amended.
2 2007-1 C.B. 503.
3 Rev. Proc. 2008-38, 2008-29 I.R.B. 139; Rev. Proc. 2008-39, 2008-29 I.R.B. 143; Rev. Proc. 2008-40, 2008-29 I.R.B. 151; Rev. Proc. 2008-41, 2008-29 I.R.B. 155; Rev. Proc. 2008-42, 2008-29 I.R.B. 160.
4 Pub. L. No. 97-248.
5 Pub. L. No. 98-369.
6 *See, e.g.*, PLR 8403081 (October 20, 1983). A private letter ruling is issued to a particular taxpayer and can be relied upon only by that taxpayer. *See* section 6110(k)(3).
7 Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12.
8 T.D. 8242, 1989-1 C.B. 215.
9 Treas. Reg. section 1.817-5(a)(2).
10 Pub. L. No. 100-647.
11 Section 7702A(b).
12 Section 72(e)(10).
13 Section 72(v).
14 1991-1 C.B. 190.
15 1992-1 C.B. 741.
16 1999-1 C.B. 1186.
17 2001-2 C.B. 212.
18 1999-2 C.B. 429.
19 Treas. Reg. section 1.817-5(b)(3).
20 2000-1 C.B. 449.
21 2005-1 C.B. 471.
22 2007-1 C.B. 515.
23 Pursuant to the Paperwork Reduction Act, guidance released by the Service generally undergoes an approval process at OMB. In some cases, draft copies of guidance can be obtained through the Web site managed by OMB.

Rev. Proc. 2008-38—"Alternative C" QAB Closing Agreements

by Daniela Stoia and Craig R. Springfield

Rev. Proc. 2008-38[1] provides greater specificity regarding how a taxpayer may seek an "Alternative C" closing agreement pursuant to Rev. Rul. 2005-6 to correct contracts that do not satisfy the requirements of section 7702[2] ("failed contracts") and section 7702A ("inadvertent MECs") due to a failure to properly account for charges for qualified additional benefits ("QABs") under section 7702(c)(3)(B)(ii).

This article begins with a brief review of the treatment of QAB charges under the Code and the guidance the Internal Revenue Service (the "Service") has issued regarding the manner in which taxpayers should account for QAB charges (Part I). The article then describes Rev. Rul. 2005-6's three alternatives for addressing improper accounting for QAB charges (Part II). The article concludes with a discussion of the general requirements for entering into an Alternative C closing agreement, which are set forth in Rev. Proc. 2008-38 (Part III).

I. Accounting for QAB Charges

Section 7702 contains a definition of a "life insurance contract" for purposes of the Code. In order to be considered a life insurance contract under section 7702(a), a contract that is a life insurance contract under applicable law (*e.g.*, state law) must either satisfy the "cash value accumulation test" set forth in section 7702(a)(1) and (b) (the "CVAT"), or both meet the "guideline premium requirements" set forth in section 7702(a)(2)(A) and (c) and fall within the "cash value corridor" pursuant to section 7702(a)(2)(B) and (d) (the "GPT"). Additionally, a contract that constitutes a life insurance contract under section 7702 will be characterized as a modified endowment contract ("MEC") if it fails to meet the "7-pay test" of section 7702A(b) (or is received in exchange for a contract that is a MEC).[3]

The Code prescribes rules regarding the mortality and expense charge assumptions that must be used in determining net single premiums under the CVAT, guideline premiums under the GPT, and 7-pay premiums under the 7-pay test. Specifically, such determinations must be made in accordance with the reasonable mortality charge rule of section 7702(c)(3)(B)(i) and the reasonable expense charge rule of section 7702(c)(3)(B)(ii). The reasonable mortality charge rule provides, in part, that the determinations must be based on reasonable mortality charges that do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued. The reasonable expense charge rule provides that determinations under sections 7702 and 7702A must be based on "any reasonable charges (other than mortality charges) which (on the basis of the company's experience, if any, with respect to similar contracts) are reasonably expected to be actually paid."

Determinations of guideline premiums, net single premiums and 7-pay premiums under sections 7702 and 7702A generally are made with respect to the "future benefits" provided under a contract. Such benefits include the amount of any death or endowment benefit. In addition, reasonable expenses other than with respect to QABs may be taken into account in determinations of guideline premiums, but not for net single premiums or 7-pay premiums. Under section 7702(f)(5)(B), the *charges* for QABs are treated as future benefits that can be reflected in the determinations, rather than the benefits actually provided by a QAB. Section 7702(f)(5)(A) defines QABs as any: (i) guaranteed insurability benefit, (ii) accidental death or disability benefit, (iii) family term coverage, (iv) disability waiver benefit, or (v) other

benefit prescribed under regulations (although no such regulations have been issued to date).

While section 7702(f)(5)(B) clearly provides that QAB charges are treated as "future benefits," rather than the QABs themselves, section 7702 is ambiguous about whether such charges are subject to the reasonable mortality charge rule or the reasonable expense charge rule. If such charges were subject to the reasonable mortality charge rule, it typically would be permissible for the guaranteed charges for the QAB to be reflected in the determinations by virtue of the operation of that rule. If, on the other hand, such charges were subject to the reasonable expense charge rule, only such charges that are reasonably expected to be actually paid could be reflected.[4]

Beginning in 2001, the Service issued four private letter rulings waiving, pursuant to section 7702(f)(8), the failure of life insurance contracts to satisfy the requirements of section 7702 due to improper accounting for QAB charges (the "QAB Error").[5] In those private letter rulings, the taxpayers incorrectly accounted for QAB charges under the reasonable mortality charge rule set forth in section 7702(c)(3)(B)(i) instead of the reasonable expense charge rule set forth in section 7702(c)(3)(B)(ii). Subsequently, the Service provided precedential guidance on this issue in the form of Rev. Rul. 2005-6. The revenue ruling holds that "[c]harges for QABs should be taken into account under the expense charge rule of § 7702(c)(3)(B)(ii) for purposes of determining whether a contract qualifies as a life insurance contract under § 7702 or as a MEC under § 7702A."[6]

II. Rev. Rul. 2005-6's Alternatives for Addressing the QAB Error

Rev. Rul. 2005-6 provides three separate and distinct alternatives to taxpayers whose compliance systems do not account for QAB charges in a manner consistent with the holding of that revenue ruling. Each of these three alternatives is discussed below. However, only two of the alternatives are available to taxpayers currently.

- *Alternative A.* Alternative A is available to taxpayers if none of their contracts fail to satisfy the requirements of section 7702 or are inadvertent MECs due to the QAB Error. Under Alternative A, taxpayers may correct their compliance systems to properly account for QAB charges without contacting the Service.[7]
- *Alternative B.* Alternative B is no longer available to taxpayers. Under Alternative B, taxpayers with failed contracts or inadvertent MECs resulting from the QAB Error were permitted to treat such contracts as complying (and they were not required to correct the contracts and their compliance system) if they (i) submitted a closing agreement offer to the Service on or before February 7, 2006, which identified all of the contracts administered on the taxpayers' compliance system, and (ii) entered into a closing agreement with the Service that required the payment of a specified amount based on the number of contracts on the system, subject to a $50,000 cap.
- *Alternative C.* Alternative C is the only alternative that remains in effect for taxpayers if they identify failed contracts or inadvertent MECs resulting from the QAB Error. However, Rev. Rul. 2005-6 does not provide much specificity regarding the requirements that taxpayers must satisfy to be eligible for this alternative. The revenue ruling merely requires taxpayers to request a closing agreement under the terms and conditions that were applicable with respect to Alternative B. However, such a closing agreement must (1) identify the failed contracts and inadvertent MECs arising from the QAB Error, and (2) require the taxpayer to correct its compliance system and to bring the failed contracts and the inadvertent MECs into compliance with the requirements of section 7702 or 7702A, as applicable.

III. Rev. Proc. 2008-38 and the Requirements for an Alternative C Closing Agreement

A. Request to the Service

Taxpayers that seek an Alternative C closing agreement must satisfy a number of requirements which are set forth in Rev. Proc. 2008-38. Specifically, those taxpayers must submit to the National Office of the Service a request for a ruling that satisfies the requirements of Rev. Proc. 2008-1,[8] or any successor revenue procedure issued by the Service, and contains each of the three items discussed below (the "Request").

- *Policy numbers.* The Request must include an exhibit setting forth the policy number of each contract for which relief is sought.[9] Taxpayers may submit this exhibit in read-only format on a CD-ROM and must include three copies of the CD-ROM.[10]

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- *Representations.* The Request must include a representation by the taxpayer that it is within the scope of section 3 of Rev. Proc. 2008-38 and that the amount required to be paid under the closing agreement (the "toll charge"[11]) was computed correctly under section 4.03 of Rev. Proc. 2008-38.[12] A taxpayer is within the scope of section 3 of Rev. Proc. 2008-38 if the taxpayer is an "issuer" of one or more failed contracts or inadvertent MECs that resulted from the QAB Error. Section 3 of Rev. Proc. 2008-38 defines the term "issuer" as "any company that issues a contract that is intended to satisfy the definition of a life insurance contract under § 7702" and "any company that insures a contract holder under a contract originally issued by another company." As a result of this expansive definition of "issuer," not only may original issuers use Rev. Proc. 2008-38 to correct failed contracts and inadvertent MECs resulting from the QAB Error, but also coinsurers may avail themselves of the revenue procedure.
- *Executed closing agreement.* The Request must include an executed proposed closing agreement that is in the same form as the model closing agreement in section 5 of Rev. Proc. 2008-38.[13]

If a contract is affected by the QAB Error but also fails due to a separate error, Rev. Proc. 2008-38 and its model closing agreement do not provide for remediation of that other error.

B. Terms of the Model Alternative C Closing Agreement

The terms of the model Alternative C closing agreement provide that taxpayers must take the following actions. First, taxpayers must pay a toll charge to the Service within 60 calendar days of the date the Service executes the closing agreement. Second, if the sum of the premiums paid as of the effective date of the closing agreement exceeds "the amount necessary to keep the Contracts in compliance with the requirements of § 7702 ***[and § 7702A, if applicable]***," the taxpayer must either (1) "[i]ncrease the death benefit to not less than an amount that will ensure compliance with § 7702 ***[and § 7702A, if applicable]***," or (2) "[r]efund to the Contract holder the amount of such excess with interest."[14] If there are no such excess premiums as of the effective date of the closing agreement, then taxpayers are not required to take corrective action with respect to the contracts covered by the closing agreement. The model closing agreement also provides that if a contract terminated due to the death of the insured prior to the effective date of the closing agreement and at a time when the premiums paid exceeded the guideline premium limitation for the contract, taxpayers must pay the contract holder or the contract holder's estate such excess with interest. Third, taxpayers must correct their compliance systems to account properly for QAB charges as provided in Rev. Rul. 2005-6.[15] Taxpayers must complete the corrective actions described above no later than 90 calendar days from the date the Service executes the closing agreement. As a practical matter, if taxpayers anticipate that it will take them more than 90 days in which to correct their compliance systems, that work should be undertaken prior to the submission of the Request to the Service.

In exchange for a taxpayer's actions, the Service agrees under the terms of the closing agreement to treat the contracts that are in force on the effective date of the closing agreement as having satisfied the requirements of sections 7702 and 7702A during the period from the date of issuance of the contracts through and including the latest of (i) the effective date of the closing agreement, (ii) the date of any corrective action required with respect to in force contracts, or (iii) the date of any corrective action required with respect to the taxpayer's compliance system. Contracts that terminated prior to the effective date of the closing agreement are treated as complying with the requirements of sections 7702 and 7702A during the period from the date of issuance of such contracts through and including the date of the contracts' termination.

C. Calculation of the Toll Charge to be Paid under an Alternative C Closing Agreement

The toll charge that taxpayers must pay under an Alternative C closing agreement differs dramatically from the toll charges generally paid under closing agreements to correct failed contracts and inadvertent MECs. Under an Alternative C closing agreement, the toll charge is based on the aggregate number of contracts for which a taxpayer is seeking relief. In this regard, section 4.03 of Rev. Proc. 2008-38 provides a sliding scale that is to be used to determine the toll charge applicable under Alternative C closing agreements. The maximum toll charge that may be imposed under such a closing agreement is $50,000 for the correction of over 10,000 contracts.

IV. Conclusion

The additional specificity provided by the Service in Rev. Proc. 2008-38 regarding the requirements taxpayers must satisfy to enter into an Alternative C closing agreement and the model closing agreement set forth in that revenue procedure should make the process for obtaining such a closing agreement much more efficient for taxpayers. ◂

End Notes

[1] 2008-29 I.R.B. 139 *amplifying* Rev. Rul. 2005-6, 2005-1 C.B. 471.

[2] Unless otherwise indicated, all references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

[3] A life insurance contract that is a MEC within the meaning of section 7702A(a) is subject to less favorable rules than other life insurance contracts with respect to amounts considered distributed under the contract, *e.g.*, distributions under a MEC are treated first as distributing the income on the contract, to the extent thereof. *See* section 72(e)(10).

[4] *See* John T. Adney, Joseph F. McKeever, III, & Craig R. Springfield, *Revenue Ruling 2005-6: Guidance on QABs under IRC Sections 7702 and 7702A*, Vol, 1, Issue 1, *TAXING TIMES*, May 2005, at p. 14 (discussing in detail the rules relating to the treatment of QAB charges for purposes of sections 7702 and 7702A).

[5] *See* PLR 200320020 (Feb. 6, 2003); PLR 200227036 (Apr. 9, 2002); PLR 200150018 (Sept. 13, 2001); PLR 200150014 (Sept. 12, 2001). A private letter ruling is issued to a particular taxpayer and can be relied upon only by that taxpayer. *See* section 6110(k)(3).

[6] Rev. Rul. 2005-6.

[7] It was helpful for the Service to expressly state this point. Of course, even apart from this guidance, if there are no failed contracts or inadvertent MECs, it is permissible for an insurer to correct its administration systems to correctly apply the requirements of the statute without having to engage in a proceeding with the Service.

[8] 2008-1 I.R.B. 1.

[9] Rev. Proc. 2008-38 section 4.01.

[10] Rev. Proc. 2008-38 section 4.07.

[11] *See infra* Part III.C. (describing the calculation of the toll charge).

[12] Rev. Proc. 2008-38 section 4.06.

[13] Rev. Proc. 2008-38 section 4.02 (providing, *inter alia*, that the proposed closing agreement must be executed in triplicate). *See also* Daniela Stoia & Craig R. Springfield, *Rev. Proc. 2008-39 – Correction of Inadvertent MECs: Is the Third Time the Charm?, TAXING TIMES SUPPLEMENT*, February 2009, at p.14 (describing in Part IV.A.3. the Service's views regarding taxpayers modifying the model closing agreements that are set forth in revenue procedures such as Rev. Proc. 2008-38).

[14] Section 1(D) of the model closing agreement that is set forth in section 5 of Rev. Proc. 2008-38. *See also* Rev. Proc. 2008-38 section 4.05.

[15] *See* Rev. Proc. 2008-38 section 4.05.

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Rev. Proc. 2008-39—Correction of Inadvertent MECs: Is the Third Time the Charm?

by Daniela Stoia and Craig R. Springfield

I. Introduction

The Internal Revenue Service (the "Service") released Rev. Proc. 2008-39[1] after almost a decade of experience with procedures allowing taxpayers to correct contracts that inadvertently became "modified endowment contracts" (or "MECs") within the meaning of section 7702A(a).[2] Effective, July 21, 2008, Rev. Proc. 2008-39 provides the new procedures taxpayers must follow to correct their inadvertent MECs.

Often it is said that "the more things change, the more they stay the same." To the casual observer of the Service's procedures for correcting inadvertent MECs, Rev. Proc. 2008-39 may seem like more of the same. However, that is not the case. This new revenue procedure allows taxpayers a level of flexibility with respect to correcting their inadvertent MECs that in the foreground of Rev. Proc. 99-27,[3] Rev. Proc. 2001-42, and Rev. Proc. 2007-19 was unfathomable.

This article begins with a brief review of the general requirements of section 7702A and the consequences of MEC status for a life insurance contract (Part II). The article then briefly describes the evolution of the inadvertent MEC correction procedures over the past near decade (Part III) and after that it describes the general requirements for correcting inadvertent MECs under Rev. Proc. 2008-39 (Part IV.A.). The article concludes with a discussion of the most significant changes that were made by Rev. Proc. 2008-39 to Rev. Proc. 2001-42, as modified by Rev. Proc. 2007-19[4] (Part IV.B.) and our thoughts on the import of this guidance (Part V).

II. The General Requirements of Section 7702A and the Consequences of MEC Status

Section 7702A(a)(1) defines a MEC as any life insurance contract entered into on or after June 21, 1988, that meets the requirements of section 7702 and fails to meet the "7-pay test" of section 7702A(b). Section 7702A(a)(2) provides that any contract received in exchange for a MEC is also treated as a MEC. A contract fails the 7-pay test if the accumulated amount paid under the contract at any time during the first seven contract years exceeds the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums (the "7-pay premium"). The 7-pay premium is calculated as of the time the contract is issued and by applying the rules of section 7702(b)(2) and section 7702(e) (other than section 7702(e)(2)(C)), except that the death benefit provided for the first contract year is deemed to be provided until the maturity date without regard to any scheduled reduction after the first seven contract years.

Under the 7-pay test, special rules apply upon certain reductions in benefits or material changes to the terms or benefits under a contract. Specifically, if there is a reduction in the benefits provided under a contract within the first seven contract years, section 7702A is applied as if the contract had originally been issued at the reduced benefit level.[5] Further, if a contract provides a death benefit which is payable only upon the death of the second to die of two insureds and there is such a reduction at any time, section 7702A is applied as if the contract had originally been issued at the reduced benefit level.[6]

If there is a material change in the terms or benefits under a contract, the contract is treated as a new contract entered into on the day such material change takes effect, with appropriate adjustments made to take into account the cash surrender value under the contract.[7] The term "material change" is defined generally in section 7702A(c)(3)(B) to include "any increase in the death benefit under the contract or any increase

in, or addition of, a qualified additional benefit under the contract." The term "material change" does not include, however, "any increase which is attributable to the payment of premiums necessary to fund the lowest level of the death benefit and qualified additional benefits payable in the 1st 7 contract years…."[8]

Under section 7702A(e)(1)(B), an insurer may return premiums paid in any contract year (with interest) within 60 days after the end of a contract year if such return is necessary to meet the 7-pay test, and the premiums so returned will reduce amounts paid for that contract year. However, there is no other provision within section 7702A which provides for correction of the inadvertent MEC status of a life insurance contract.

Under section 7702A and section 72, a contract that constitutes a MEC is subject to less favorable rules than other life insurance contracts with respect to amounts considered distributed under the contract. In particular, distributions under a MEC are treated first as distributing the income on the contract, to the extent thereof.[9] Such amounts may also be subject to a ten percent penalty tax.[10] For this purpose, certain amounts, such as amounts received as policy loans, are deemed to be distributions.

In light of the complexity of the section 7702A rules discussed only in brief above, it is not difficult to understand how a life insurance contract may inadvertently become a MEC.

III. Evolution of the Inadvertent MEC Correction Procedures

On May 18, 1999, the Service issued Rev. Proc. 99-27. This was the first of three revenue procedures ultimately issued by the Service that provided the means by which issuers of inadvertent MECs could correct such contracts. The first revenue procedure had four significant drawbacks that discouraged taxpayers from correcting their inadvertent MECs. First, the revenue procedure was available only for requests for relief that were received by the Service on or before May 31, 2001. Second, the revenue procedure prohibited certain types of inadvertent MECs from being corrected, *e.g.*, an inadvertent MEC with an assumed 7-pay premium that exceeded 150 percent of the correct 7-pay premium for such contract and a cash surrender value that exceeded the contract holder's investment in the contract within three years after the issuance of the contract (the "150 percent representation"). Third, with limited exceptions, taxpayers could only request relief from the Service for their inadvertent MECs once. Fourth, a great deal of information was required with respect to each inadvertent MEC to be corrected.

Subsequently, on Aug. 6, 2001, the Service issued Rev. Proc. 2001-42. This second revenue procedure greatly improved upon Rev. Proc. 99-27 by (1) providing a permanent procedure by which an issuer could remedy inadvertent MECs, (2) allowing taxpayers to seek relief from the Service for inadvertent MECs more than once, and (3) allowing taxpayers to correct all inadvertent MECs as long as they satisfied the general eligibility requirements of the revenue procedure (*e.g.*, the 150 percent representation was eliminated). However, Rev. Proc. 2001-42 continued to require taxpayers to submit a great deal of information for each inadvertent MEC to be corrected.

Under section 7702A and section 72, a contract that constitutes a MEC is subject to less favorable rules than other life insurance contracts with respect to amounts considered distributed under the contract.

On Jan. 26, 2007, the Service made some additional modifications to the MEC correction procedure when it issued Rev. Proc. 2007-19. The Service's modifications to Rev. Proc. 2001-42 further improved the MEC correction procedure by, for example, allowing taxpayers to submit to the Service the information required with respect to the inadvertent MECs electronically.

Finally, on June 30, 2008, the Service issued Rev. Proc. 2008-39, the third and currently effective MEC correction procedure.

IV. Rev. Proc. 2008-39

For the most part, Rev. Proc. 2008-39 retains the general structure of the Prior Correction Procedure with two very important changes that reflect the comments submitted to the Treasury Department and the Service in connection with Notice 2007-15.[11] First, the revenue procedure greatly reduces the items of information

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required about each inadvertent MEC to be corrected. Second, the revenue procedure provides for a much simpler alternative methodology for calculating the amount to be paid to correct an inadvertent MEC (the "toll charge"). Below is a brief overview of the general requirements for correcting inadvertent MECs under Rev. Proc. 2008-39, and a more detailed discussion of the two most significant changes that were made in Rev. Proc. 2008-39 to the Prior Correction Procedure.

A. General Requirements for Correcting Inadvertent MECs under Rev. Proc. 2008-39

As was the case under the Prior Correction Procedure, taxpayers seeking to correct inadvertent MECs must submit to the National Office of the Service a request for a ruling that satisfies the requirements of Rev. Proc. 2008-1,[12] or any successor revenue procedure issued by the Service.[13] (Hereinafter, such a submission to the National Office of the Service is referred to as the "Request" and a taxpayer filing a Request is referred to as the "Taxpayer.")

… Introducing management level reviews of the tasks performed by clerical employees as well as audits of their performance could reduce the possibility of additional clerical errors giving rise to inadvertent MECs in the future.

1. Information Required about the Inadvertent MECs to be Corrected

The Request must identify the policy number of each inadvertent MEC to be corrected.[14] As was the case under the Prior Correction Procedure, Taxpayers may submit to the Service the list identifying the policy numbers of the inadvertent MECs electronically.[15] That is, the information may be set forth in read-only format on a CD-ROM. In addition, Rev. Proc. 2008-39 section 5.07 states that "[t]he issuer must provide a total of three CD-ROMs, one for each of the three copies of the closing agreement." Each of the three CD-ROMs is to be attached as "Exhibit A" to the three original executed closing agreements that must be submitted with the Request, and which are described in Part IV.A.3. below.

In addition, the Request must describe what "defect[s]" caused the inadvertent MECs' failure to comply with the 7-pay test and explain how and why such defects arose.[16] For example, did the inadvertent MEC result from an error in the manner in which the Taxpayer interpreted the requirements of section 7702A, such as a failure to reflect the benefit reduction rule of section 7702A(c)(2)? Or, did the failure result from a clerical error in the manner in which the 7-pay test was administered, such as a failure to refund premium that exceeded the 7-pay premium in a timely manner pursuant to the 60 day rule of section 7702A(e)(1)(B)?

Finally, the Request must describe what administrative procedures the Taxpayer has implemented to ensure that none of its life insurance contracts will fail the 7-pay test inadvertently in the future.[17] For example, if the cause of the error that resulted in the inadvertent MECs was a failure to interpret the requirements of section 7702A properly in performing 7-pay testing, then the Taxpayer must correct those errors so that it is performing 7-pay testing correctly on a going forward basis. If, on the other hand, the error that resulted in the inadvertent MECs was a clerical error in the manner in which the 7-pay test was administered, then the Taxpayer must modify its procedures to ensure that similar clerical errors are less likely to cause inadvertent MECs in the future. In this regard, we note that it is helpful to evaluate first what specific changes, if any, can be made to existing procedures that would reduce the possibility of similar errors in the future. Once all of the specific changes have been implemented, we believe it is helpful to provide additional training to employees regarding the Taxpayer's 7-pay test compliance procedures. In addition, introducing management level reviews of the tasks performed by clerical employees as well as audits of their performance could reduce the possibility of additional clerical errors giving rise to inadvertent MECs in the future.

2. Required Representations

Unlike the Prior Correction Procedure, section 5.06 of Rev. Proc. 2008-39 requires Requests to include two explicit representations from Taxpayers seeking relief for their inadvertent MECs.

Within the scope of Rev. Proc. 2008-39 section 4. First, Taxpayers must represent that they are within the scope of section 4 of Rev. Proc. 2008-39. Section 4.01 of Rev. Proc. 2008-39 addresses the Taxpayers that may seek relief under Rev. Proc. 2008-39 and states that, except as provided in section 4.02 of Rev. Proc. 2008-39, the revenue procedure applies–

> to any issuer of one or more life insurance contracts that desires to remedy the inadvertent non-egregious failure of contracts to comply with the requirements of § 7702A. For this purpose, the term "issuer" means any company that issues a contract that is intended to satisfy the definition of a life insurance contract under § 7702 and comply with the MEC rules under § 7702A. The term also includes a company that insures a contract holder under a contract originally issued by another company.

In defining the term "issuer" broadly to include a company that insures a contract holder under a contract originally issued by another company, the Service has broadened the scope of the Prior Correction Procedure to allow, for example, coinsurers to correct inadvertent MECs they have become responsible for as a result of a coinsurance agreement.[18] In our experience, Taxpayers often determine after they become responsible for administering a group of life insurance contracts that some of those contracts may have inadvertently become MECs. For example, this discovery often occurs when the contracts are transferred (or "converted") from the original issuer's 7-pay test administration system to that of the coinsurer. Thus, allowing coinsurers to correct such contracts without the involvement of the original issuer, which may or may not be a going concern after the conversion of the contracts, will make the correction process much more efficient.

Section 4.02 of Rev. Proc. 2008-39 addresses the types of inadvertent MECs that the Service may not correct under the revenue procedure. Specifically, the Service may exclude from correction under the revenue procedure an inadvertent MEC that–

> (1) is attributable to one or more defective interpretations or positions that the Service determines to be a significant feature of a program to sell investment oriented contracts, or (2) arises where the controlling statutory provision, as supplemented by any legislative history or guidance published by the Service, is clear on its face and the Service determines that failure to follow the provision results in a significant increase in the investment orientation of a contract.[19]

It is noteworthy that the Service has not made any changes to the Prior Correction Procedure regarding the types of inadvertent MECs that the Service may exclude from correction under that revenue procedure.

Toll charge correctly calculated under Rev. Proc. 2008-39 section 5.03(1) or (2). Second, Taxpayers must represent that they have computed correctly under Rev. Proc. 2008-39 section 5.03(1) or (2), as applicable, the toll charge to be paid for the inadvertent MECs under the closing agreement. (Part IV.B.2. below describes the calculation of the toll charge.)

Taxpayers must provide the two representations under penalties of perjury in accordance with the requirements of Rev. Proc. 2008-1, or any successor revenue procedure issued by the Service.[20] In addition, Taxpayers must retain documentation to support the representations if they were to be examined on audit.[21] Rev. Proc. 2008-39 does not provide any additional detail regarding the nature of the documentation that must be retained or the period for which such documentation must be retained. It seems prudent for a Taxpayer to retain documentation setting forth how the toll charge was determined for each inadvertent MEC covered by the closing agreement and, given the long-term nature of life insurance contracts, to retain that documentation for as long as the contract in question is in force, and for some reasonable period of time thereafter (perhaps reflecting the three year statute of limitations that typically would apply to contract holders and the Taxpayer's otherwise applicable document retention policies).

3. Executed Proposed Closing Agreement

As was the case under the Prior Correction Procedure, section 5.02 of Rev. Proc. 2008-39 requires the Taxpayer to submit a proposed closing agreement that is executed in triplicate by the Taxpayer and is in the same form as the model closing agreement set forth in section 6 of Rev. Proc. 2008-39. We note that various individuals from the Service have stated at a number of conferences this year, including the Society of Actuaries' Insurance Product Tax Seminar, which took place in Washington, D.C. in September, that changes to the model closing agreement set forth in section 6 of Rev. Proc. 2008-39 should not be made unless the Taxpayer's facts compellingly support a modification.

4. Terms of Closing Agreement

Predominantly, the model closing agreement set forth in section 6 of Rev. Proc. 2008-39 is the same as the model closing agreement provided under the Prior Correction Procedure. For example, the closing agreement continues to require Taxpayers to pay a toll charge to the Service for the inadvertent MECs that are subject

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to the closing agreement and to correct such inadvertent MECs, *i.e.*, to bring them back into compliance with the 7-pay test of section 7702A(b).

As was the case under the Prior Correction Procedure, the model closing agreement in Rev. Proc. 2008-39 states that the Taxpayer agrees "[t]o bring Contract[s] for which the testing period (as defined in Sec. 3.01 of Rev. Proc. 2008-39) will not have expired on or before the date 90 days after the execution of this Agreement into compliance with § 7702A, either by an increase in death benefit[s] or the return of the excess premiums and earnings thereon to the Contract holder[s]."[22] Thus, whether an inadvertent MEC requires corrective action under the closing agreement depends on whether the contract is in a 7-pay testing period on the date that is 90 days from the date the Service executes the closing agreement. If by that date, an inadvertent MEC's 7-pay testing period has expired, the Taxpayer is not required to take any corrective action under the closing agreement with respect to the inadvertent MEC.[23] If by that date, an inadvertent MEC's 7-pay testing period has not expired, the Taxpayer is required to bring the contract back into compliance with the 7-pay test either by increasing the contract's death benefit or returning to the contract holder the contract's excess premiums and earnings thereon.

Rev. Proc. 2008-39 does not provide any guidance on the meaning of the terms "excess premiums" and "earnings thereon." However, under the Prior Correction Procedure, some Taxpayers had taken the position that to the extent the "amount paid," within the meaning of section 7702A(e)(1), under an inadvertent MEC was in compliance with the 7-pay test *as of the effective date of the closing agreement*,[24] corrective action for such an inadvertent MEC was not required.[25] The Service accepted this approach under the Prior Correction Procedure, and we would anticipate that the same would be the case under Rev. Proc. 2008-39 because the requirements for correcting contracts has not changed under Rev. Proc. 2008-39.

Under the Prior Correction Procedure, some Taxpayers had taken the position that if the amounts paid *as of the effective date of the closing agreement* were greater than permitted by the 7-pay test, those excess premiums would need to be refunded with earnings thereon or the death benefit would need to be increased to bring the contracts back into compliance with the 7-pay test. In refunding such excess premiums, Taxpayers often determined the earnings thereon by reference to the cumulative "overage earnings"[26] that had accrued under the contract. We note that Taxpayers electing to pay the alternative toll charge under Rev. Proc. 2008-39 may not know the cumulative overage earnings for an inadvertent MEC. Thus, in such cases Taxpayers may want to use an alternative means of determining the earnings on the excess premiums.

Although the model closing agreement set forth in section 6 of Rev. Proc. 2008-39 is for the most part the same as the model closing agreement provided under the Prior Correction Procedure, the Service has made some procedural changes in Rev. Proc. 2008-39 with respect to the payment of the toll charge to the Service that will reduce the burden on Taxpayers obtaining such closing agreements.[27] First, Taxpayers have been provided an additional 30 calendar days in which to pay the toll charge to the Service. Thus, under the new model closing agreement, Taxpayers must pay the toll charge to the Service within 60 calendar days of the date the Service executes the closing agreement. Second, Taxpayers need only submit a copy of the executed closing agreement with their payments. Under the Prior Correction Procedure, Taxpayers were required to submit with the payment an original executed closing agreement. We are aware of some instances where the original executed closing agreements were delayed in reaching Taxpayers. Thus, modifying the procedures in this regard should make it easier for Taxpayers to satisfy the terms of their closing agreements in a timely manner.

B. The Two Most Significant Changes Made in Rev. Proc. 2008-39 to the Requirements for Correcting Inadvertent MECs

1. Information Required Regarding an Inadvertent MEC

The first of the two most significant changes to the Prior Correction Procedure is with respect to the amount of information the Service requires about each inadvertent MEC to be corrected. Under the Prior Correction Procedure, Taxpayers were required to submit to the Service 18 items of information about each inadvertent MEC to be corrected.[28] The Service eliminated in Rev. Proc. 2008-39 all of the Prior Information Requirements except for the three described above in Part IV.A.1.

The Prior Information Requirements can be grouped into the three categories described below.

Necessary to identify inadvertent MECs and the cause thereof. The first category of Prior Information Requirements

consists of items of information that were directed at identifying the inadvertent MECs to be corrected under the revenue procedure, how those inadvertent MECs arose, and what steps the Taxpayer has taken to ensure that no further inadvertent MECs would arise. The Service retained all of the Prior Information Requirements in this first category with the exception of requiring the taxpayer identification number (or TIN) of the contract holder of each inadvertent MEC to be corrected. This change is a welcome relief to the industry as under the Prior Correction Procedure Taxpayers were unable to correct inadvertent MECs in circumstances where contract holders were unwilling to provide their TINs or where contract holders were ineligible to obtain TINs due to their status.

Rev. Proc. 99-27 remnants. The second category of Prior Information Requirements consists of items of information that were necessary under Rev. Proc. 99-27 to be able to determine whether an inadvertent MEC was eligible for correction under that prior revenue procedure. For example, Rev. Proc. 99-27 section 5.01(13) required Taxpayers seeking to correct inadvertent MECs to make certain representations with respect to those inadvertent MECs (*e.g.*, the 150 percent representation). Consistently, the Service required certain data with respect to the inadvertent MECs (*e.g.*, the "assumed 7-pay premium" and the end of the contract year "cash surrender value") to be able to evaluate whether a contract in fact satisfied the required representations. The Prior Correction Procedure, which superseded Rev. Proc. 99-27, eliminated the representations required under Rev. Proc. 99-27. Nevertheless, the Prior Correction Procedure continued to require Taxpayers to collect and submit to the Service the information necessary for evaluating whether an inadvertent MEC satisfied the representations required under Rev. Proc. 99-27. We believe the elimination of the second category of Prior Information Requirements was appropriate and should greatly reduce the burden on Taxpayers seeking to correct inadvertent MECs.

Necessary for toll charge calculation. The third category of Prior Information Requirements consists of items of information that were required for purposes of calculating the toll charge applicable under the Prior Correction Procedure. An example of an item of information required for calculating the toll charge under the Prior Correction Procedure is the death benefit provided under an inadvertent MEC within 120 days of the date a Taxpayer submits a Request to the National Office.[29] Another example of an item of information

required for calculating the toll charge under the Prior Correction Procedure is the "template" that sets forth how the "overage earnings"[30] are calculated for an inadvertent MEC. As described in Part IV.B.2. below, Rev. Proc. 2008-39 generally retains the toll charge applicable under the Prior Correction Procedure. Thus, absent the introduction of an alternative toll charge calculation methodology, the elimination of the third category of Prior Information Requirements would be of only modest consequence to Taxpayers because they would still need to obtain such information to be able to calculate the toll charge for their inadvertent MECs.

2. Toll Charge Required to be Paid to Correct an Inadvertent MEC

The second of the two most significant changes made to the Prior Correction Procedure is with respect to the toll charge Taxpayers seeking to correct inadvertent MECs must pay. Under the Prior Correction Procedure, Taxpayers had to pay a toll charge to correct each inadvertent MEC that generally was equal to the sum of (a) the income tax and penalty tax (if applicable) on unreported distributions that had occurred under the inadvertent MEC starting two years before the contract became a MEC, (b) deficiency interest on (a), and (c) tax on the cumulative overage earnings under the inadvertent MEC. (This toll charge is described in greater detail below in Part IV.B.2.a.[31])

Generally, Rev. Proc. 2008-39 retains the complex toll charge applicable under the Prior Correction Procedure. However, Rev. Proc. 2008-39 allows Taxpayers to elect

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to pay an alternative toll charge that enables Taxpayers to avoid obtaining most of the historical information they would need to calculate the toll charge applicable under the Prior Correction Procedure. Specifically, Rev. Proc. 2008-39 section 5.03 requires a Taxpayer to pay with respect to an inadvertent MEC either (1) an amount determined based on "overage earnings"[32] under Rev. Proc. 2008-39 section 5.03(1) (the "Overage Earnings Toll Charge") or (2) at the election of the Taxpayer, an amount determined based on "overage" under Rev. Proc. 2008-39 section 5.03(2) (the "Overage Toll Charge"). The elements of these two alternative toll charges are described in brief below.

a. Overage Earnings Toll Charge

The manner in which the Overage Earnings Toll Charge is calculated depends upon the amount of overage earnings that accrue under an inadvertent MEC during a 7-pay testing period. If the overage earnings that accrue under an inadvertent MEC exceed $100 at any time during the testing period, the Overage Earnings Toll Charge for such an inadvertent MEC equals the sum of the three amounts described below.

- *Rev. Proc. 2008-39 section 5.03(1)(a)(i) amount – tax and penalty tax, if applicable, on unreported distributions.* The Rev. Proc. 2008-39 section 5.03(1)(a)(i) amount equals the income tax,[33] and, if applicable, the penalty tax, for unreported amounts[34] received (or deemed received) under the inadvertent MEC during the period starting with the date two years before the date on which the inadvertent MEC first failed to satisfy the MEC rules and ending on the effective date of the closing agreement.
- *Rev. Proc. 2008-39 section 5.03(1)(a)(ii) amount – deficiency interest on Rev. Proc. 2008-39 section 5.03(1)(a)(i) amount.* The Rev. Proc. 2008-39 section 5.03(1)(a)(ii) amount is deficiency interest determined pursuant to section 6621(a)(2) as if the Rev. Proc. 2008-39 section 5.03(1)(a)(i) amounts are underpayments by the contract holders for the tax years in which the amounts are received (or deemed received).
- *Rev. Proc. 2008-39 section 5.03(1)(a)(iii) amount – tax on overage earnings.* The Rev. Proc. 2008-39 section 5.03(1)(a)(iii) amount equals: (a) the excess, if any, of the inadvertent MEC's cumulative overage earnings over the proportionate share of overage earnings allocable to taxable distributions[35] from the inadvertent MEC; multiplied by (b) the applicable percentage for the inadvertent MEC; multiplied by (c) the distribution frequency factor[36] for the inadvertent MEC. This amount may not be less than zero.

If the overage earnings that accrue for an inadvertent MEC do not exceed $100 at all times during the 7-pay testing period (the "*de minimis* overage earnings rule"), then the Overage Earnings Toll Charge for such an inadvertent MEC is determined without regard to (1) the income tax and, if applicable, the penalty tax on unreported distributions and (2) the deficiency interest on (1).[37] Put differently, in cases where the *de minimis* overage earnings rule applies, Taxpayers are allowed to ignore the elements of the Overage Earnings Toll Charge that are attributable to unreported distributions. This result is appropriate because inadvertent MECs that are subject to the *de minimis* overage earnings rule have very little inside buildup associated with the premiums that were paid in excess of the 7-pay premium (generally, the "overage"), and thus, such inadvertent MECs have not received a significant economic tax benefit from being MECs.

As was the case under the Prior Correction Procedure, Rev. Proc. 2008-39 requires the filing of an executed closing agreement with the Request.[38] In processing submissions filed under the Prior Correction Procedure, the Service required the toll charge identified in the executed closing agreement submitted to the Service to be current as of the date the Service executed that closing agreement. Thus, in order for the toll charge to be current as of the date the closing agreement was executed by the Service, Taxpayers had to "project" the toll charge to a date into the future under the Prior Correction Procedure. For example, Taxpayers had to accrue the overage earnings and the deficiency interest for an additional period of time following the date they submitted their requests and the closing agreement they had executed to the Service.

Because Rev. Proc. 2008-39 continues to require the filing of an executed closing agreement with the Request, representatives of the Service stated at the Society of Actuaries' Insurance Product Tax Seminar that Taxpayers should accrue the Overage Earnings Toll Charge to a date after the date a Request is filed with the Service. Through what date Taxpayers should accrue the Overage Earnings Toll Charge is a little less clear. At this seminar, representatives of the Service indicated that accruing the Overage Earnings Toll Charge to a date 60 to 90 days after the date a Request is filed with the Service seemed reasonable. We caution Taxpayers

selecting a date through which to calculate the Overage Earnings Toll Charge that under the Prior Correction Procedure the Service required Taxpayers in certain circumstances to update the Overage Earnings Toll Charge if that toll charge was outdated by the time the Service was prepared to execute the closing agreement. At this juncture, it is unclear in what circumstances the Service may continue this practice.

b. Overage Toll Charge

As stated above, Rev. Proc. 2008-39 introduced an alternative toll charge, the Overage Toll Charge, to the Overage Earnings Toll Charge. Under Rev. Proc. 2008-39, Taxpayers may elect to pay with respect to an inadvertent MEC the Overage Toll Charge in lieu of the Overage Earnings Toll Charge. Such an election allows Taxpayers to avoid obtaining most of the historical information needed to calculate the Overage Earnings Toll Charge. In addition, depending upon the facts and circumstances, such an election may significantly reduce the toll charge for an inadvertent MEC.

Section 5.03(2) of Rev. Proc. 2008-39 provides that the Overage Toll Charge is "equal to 100% of the overage as defined in section 3.05" of that revenue procedure. Section 3.05 of Rev. Proc. 2008-39 in turn defines "overage" as "the amount of the excess, if any, of— (1) the sum of amounts paid under the contract during the testing period for the contract year and all prior contract years, over (2) the sum of the 7-pay premiums for the contract year and all prior contract years of the testing period [the "cumulative 7-pay premiums"]." Thus, the overage is the difference between two numbers at least one of which, the cumulative 7-pay premiums, will most often change over time. Consequently, to be able to determine the overage for purposes of calculating the Overage Toll Charge, Taxpayers must know as of what date that determination is to be made.

Rev. Proc. 2008-39 does not expressly state the date as of which the overage should be determined for purposes of calculating the Overage Toll Charge. However, the examples set forth in section 5.03(3)(a) and (b) of Rev. Proc. 2008-39 do address this issue for inadvertent MECs that are no longer in a 7-pay testing period. For such contracts, the examples indicate that the Overage Toll Charge is to be determined by reference to the overage that existed in the contracts at the end of their 7-pay testing periods. Specifically, example one, which is set forth in section 5.03(3)(a) of Rev. Proc. 2008-39, posits a contract with an overage at the end of its 7-pay testing period of $1,320.00. The example concludes that the Overage Toll Charge for that contract is $1,320.00.

Based on the examples in Rev. Proc. 2008-39, one could conclude that for inadvertent MECs outside of a 7-pay testing period, the overage is determined as of the end of such contracts' 7-pay testing period for purposes of calculating the Overage Toll Charge. Thus, for inadvertent MECs that are outside of a 7-pay testing period, Taxpayers trying to reduce their toll charge and the administrative burden associated with obtaining the historical information needed to calculate the Overage Earnings Toll Charge may be best served by first determining the overage that existed as of the end of that 7-pay testing period. We note that in many cases inadvertent MECs only have an overage early in their 7-pay testing periods and, if contract holders do not pay premiums continuously, that overage will decrease in each remaining contract year of the 7-pay testing period. Thus, in such cases, the Overage Toll Charge may be less than the Overage Earnings Toll Charge for an inadvertent MEC. This may be the case most often where inadvertent MECs are not subject to the *de minimis* overage earnings rule and they have significant unreported distributions.

The examples in Rev. Proc. 2008-39, however, do not specifically address as of what date the overage is to be determined for purposes of calculating the Overage Toll Charge in the case of inadvertent MECs that are still in a 7-pay testing period when a Taxpayer files a Request. In the absence of any specific guidance in Rev. Proc. 2008-39, it would seem to be reasonable for a Taxpayer to determine the Overage Toll Charge in such a case by reference to the overage that existed in the inadvertent MECs on the date as of which the Taxpayer obtained the data necessary to perform the toll charge calculations. For example, assume an inadvertent MEC is still in a 7-pay testing period as of the start of the current contract year. Assume further that as of the date as of which the Taxpayer obtained the data necessary to perform the toll charge calculations, the overage for the contract was $1,000.00. Thus, one interpretation of the Overage Toll Charge for an inadvertent MEC that is in a 7-pay testing period is that it would equal $1,000.00, the overage in the contract as of the date as of which the Taxpayer obtained the data necessary to perform the toll charge calculations. Representatives of the Service seemed receptive to such an approach when questioned about it at the Society of Actuaries' Insurance Product Tax Seminar.

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V. Conclusion

After nearly a decade of industry appeals for the Service and the Treasury Department to ease the administrative burden on Taxpayers seeking to correct inadvertent MECs, the Service has taken a big step forward in Rev. Proc. 2008-39. While the revenue procedure may superficially appear to be very much the same as the Prior Correction Procedure, we submit that this is not the case. Most significantly, we believe Rev. Proc. 2008-39 reduces the burden placed on Taxpayers by the Prior Correction Procedure not necessarily by reducing the items of information required to correct an inadvertent MEC, but rather by providing Taxpayers with an alternative toll charge, *i.e.*, the Overage Toll Charge. In particular, Taxpayers may elect to pay the Overage Toll Charge and avoid the administrative burden associated with collecting the information needed to calculate the Overage Earnings Toll Charge. ◂

End Notes

[1] 2008-29 I.R.B. 143, *superseding* Rev. Proc. 2001-42, 2001-2 C.B. 212, and Rev. Proc. 2007-19, 2007-1 C.B. 515.
[2] Unless otherwise indicated, all references to "section" are to sections of the Internal Revenue Code of 1986, as amended.
[3] 1999-1 C.B. 1186, *superseded by* Rev. Proc. 2001-42, *superseded by* Rev. Proc. 2008-39.
[4] Hereinafter, Rev. Proc. 2001-42, as modified by Rev. Proc. 2007-19, is referred to as the "Prior Correction Procedure."
[5] *See* section 7702A(c)(2)(A).
[6] *See* section 7702A(c)(6).
[7] *See* section 7702A(c)(3)(A).
[8] *See also* H.R. REP. NO. 101-247, at 1438-39 (1989) ("a death benefit increase may be considered as attributable to the payment of premiums necessary to fund the lowest death benefit payable in the first 7 contract years or the crediting of interest or other earnings with respect to such premiums if each premium paid prior to the death benefit increase is necessary to fund the lowest death benefit payable in the first 7 contract years. Any death benefit increase that is not considered a material change under the preceding sentence, however, is to be considered a material change as of the date that a premium is paid that is not necessary to fund the lowest death benefit payable in the first 7 contract years.").
[9] *See* section 72(e)(10).
[10] *See* section 72(v).
[11] 2007-1 C.B. 503. In this Notice, the Service requested comments regarding a number of the Service's insurance related correction procedures.
[12] 2008-1 I.R.B. 1.
[13] Generally, Rev. Proc. 2008-1 sets forth the requirements taxpayers must satisfy in order to submit to the National Office of the Service a request for a ruling. Each calendar year, the Service re-evaluates those procedures, makes appropriate revisions, and re-issues this revenue procedure as the first revenue procedure issued in a calendar year. Next year, we anticipate these procedures will be set forth in Rev. Proc. 2009-1.
[14] *See* Rev. Proc. 2008-39 section 5.01(1).
[15] *See* Rev. Proc. 2007-19 section 3.05 (stating that "[t]he information required under this revenue procedure may be submitted to the Service electronically"); Rev. Proc. 2008-39 section 5.07.
[16] *See* Rev. Proc. 2008-39 section 5.01(2).
[17] *See* Rev. Proc. 2008-39 section 5.01(3).
[18] A similar change was made under all of the correction procedures discussed in this volume of *TAXING TIMES, i.e.*, Rev. Procs. 2008-38, 2008-40, 2008-41, and 2008-42.
[19] Rev. Proc. 2008-39 section 4.02(1) and (2).
[20] *See* Rev. Proc. 2008-39 section 5.06. *See also* Rev. Proc. 2008-1 section 7.01(15) (describing the requirements relating to penalties of perjury statements).
[21] *See* Rev. Proc. 2008-39 section 5.06.
[22] *See also* Rev. Proc. 2008-39 section 5.05(1). As was the case under the Prior Correction Procedure, Taxpayers must complete any corrective action required under a closing agreement within 90 calendar days of the date the Service executes that closing agreement. *Id.*
[23] *See* Rev. Proc. 2008-39 section 5.05(2).
[24] The effective date of a closing agreement is the date on which the Service executes that closing agreement. *See* Rev. Proc. 2008-39 section 6.
[25] Of course, if a premium payment thereafter caused the amount paid to increase such that the contract would fail the 7-pay test, such premium would need to be returned with interest within 60 days after the end of the contract year in which it was paid in accordance with the 60 day rule of section 7702A(e)(1)(B).
[26] *See infra* notes 30 and 32 (describing "overage earnings").
[27] The Service made the same procedural changes in Rev. Procs. 2008-38, 2008-40, and 2008-41.

[28] Rev. Proc. 2001-42 section 5.01 required the following items of information for each of the inadvertent MECs to be corrected: (1) specimen copies of the contract forms on which the inadvertent MECs were issued; (2) the policy number and original issue date for each contract; (3) the taxpayer identification number of each contract holder; (4) the "death benefit" under each contract for purposes of determining the 7-pay premium for the contract; (5) the 7-pay premium assumed by the issuer when the contract was issued; (6) the "cash surrender value" of each contract at the end of each contract year; (7) a description of the defects that caused the contracts to fail to comply with the 7-pay test, including an explanation of how and why the defects arose; (8) a description of the administrative procedures the issuer has implemented to ensure that none of its contracts will inadvertently fail the 7-pay test in the future; (9) a description of any material changes in the benefits under (or in the other terms of) any contract together with the dates on which the material changes occurred; (10) for any contract with regard to which a contract holder directly or indirectly received (or was deemed to have received) any distribution to which section 72 applies—(a) the date and amount of each distribution, (b) the amount of the distribution includible in the contract holder's gross income, (c) the amount of gross income reported to the contract holder and to the Service on a timely filed information return as a result of the distribution, (d) the date on which the contract holder attained (or will attain) age 59 ½, (e) whether the distribution is attributable to the contract holder becoming disabled, and (f) whether the distribution is part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the contract holder or the joint lives (or joint life expectancies) of the contract holder and his or her beneficiary; and (11) a template setting forth the following information for each contract: (a) the cumulative amounts paid under the contract within each contract year of the testing period, (b) the contract's cumulative 7-pay premium, (c) the overage, if any, for each contract year, (d) the earnings rate applicable for each contract year, and (e) the overage earnings for each contract year. Hereinafter, these items of information will be referred to collectively as the "Prior Information Requirements."

[29] That death benefit is used to determine the "applicable percentage" (or tax rate) for the inadvertent MEC under Rev. Proc. 2008-39 section 3.11. See Brian G. King, *History of the Use of Tax Rates in Sections 7702 and 7702A Closing Agreements, TAXING TIMES SUPPLEMENT*, February 2009, p. 24 (discussing how the applicable percentage is determined).

[30] Generally, the "overage earnings" can be thought of as the inside buildup associated with the premiums that were paid that exceeded the amounts permitted by the 7-pay test of section 7702A(b). *See infra* note 32 (describing how the overage earnings are calculated).

[31] *See* Joseph F. McKeever, III, Kirk Van Brunt, & Daniela Stoia, *Rev. Proc. 99-27: Some Relief for the Heartburn of Inadvertent MECs*, Vol. 17, No. 2, INS. TAX REV. 283, 287-291 (1999) (providing a detailed analysis of the calculation of the toll charge under Rev. Proc. 99-27, which was almost identical to the toll charge applicable under the Prior Correction Procedure).

[32] Rev. Proc. 2008-39 section 3.06 provides that the overage earnings for a contract year are determined by multiplying "(1) the sum of a contract's overage for the contract year and its cumulative overage earnings for all prior contract years," by "(2) the earnings rate set forth in section 3.07 of [Rev. Proc. 2008-39]." *See* Brian G. King, *Earnings Rates under Rev. Procs. 2008-39 and 2008-40, TAXING TIMES SUPPLEMENT*, February 2009, p. 32 (discussing the earnings rates).

[33] The income tax with regard to amounts received or deemed received under each inadvertent MEC is determined using the "applicable percentage" for the inadvertent MEC under Rev. Proc. 2008-39 section 3.11. *See* Brian G. King, *History of the Use of Tax Rates in Sections 7702 and 7702A Closing Agreements, TAXING TIMES SUPPLEMENT*, February 2009, p. 24 (discussing how the applicable percentage is determined).

[34] Rev. Proc. 2008-39 section 3.12 defines a "reported amount" as the amount that: (1) the issuer reports on a timely filed information return as includible in the contract holder's gross income, or (2) the contract holder includes in gross income on a timely filed income tax return.

[35] Rev. Proc. 2008-39 section 3.08 defines the proportionate share of overage earnings allocable to taxable distributions from an inadvertent MEC as the amount obtained by multiplying: (a) the total amount of taxable distributions under the inadvertent MEC by (b) a fraction, the numerator of which is the inadvertent MEC's cumulative overage earnings and the denominator of which is the total income on the contract of the inadvertent MEC.

[36] *See* Rev. Proc. 2008-39 section 3.10 (describing how the "distribution frequency factor" is determined for an inadvertent MEC).

[37] Rev. Proc. 2008-39 section 5.03(1)(b). Under the Prior Correction Procedure, the *de minimis* overage earnings rule only applied in the case of inadvertent MECs with $75 or less of overage earnings.

[38] *See supra* Part IV.A.3. (describing this requirement).

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History of the Use of Tax Rates in Sections 7702 and 7702A Closing Agreements

by Brian G. King

Since the enactment of section 7702, the Internal Revenue Service (the "Service") has entered into closing agreements with insurance companies to remedy section 7702 failed life insurance contracts. Closing agreements generally require an amount payable (*i.e.*, a toll charge) to the Service, based in part on the tax and deficiency interest due on the section 7702(g) "income on the contract." Prior to 1999, the Service required use of a 28 percent tax rate in determining amounts payable. The use of a 28 percent tax rate caused some insurers to argue, with limited success, for the use of a lower marginal tax rate based on the income characteristics of policyholders of failed contracts.

In 1999, the Service introduced Rev. Proc. 99-27, allowing insurers to correct inadvertent failures to comply with the modified endowment rules under section 7702A. In a departure from a past Service position, Rev. Proc. 99-27 set forth a three-tiered tax rate structure for use in determining amounts payable with tax rates varying with the underlying level of the death benefit of a particular contract. Shortly after the release of Rev. Proc. 99-27, the Service released Notice 99-48, effectively extending the use of the three-tiered tax rate structure to section 7702 closing agreements. Both Rev. Procs. 2008-39 and 2008-40 continue with this same tax rate structure.

Applicable Percentage: Section 3.11 of Rev. Proc. 2008-39 defines the applicable percentage (*i.e.*, tax rate) for a contract as follows:
- 15 percent if the death benefit in the contract is less than $50,000;
- 28 percent if the death benefit under the contract is equal to or exceeds $50,000 but less than $180,000; and
- 36 percent if the death benefit under the contract is equal to or exceeds $180,000.

Rev. Proc. 2008-40 provides for alternative toll charge calculations based in part on the amount of tax the contract owner would have owed if the contract owner were treated as receiving either the "income on the contract" or "excess earnings" as applicable. The tax rate applicable to a contract holder is equal to the applicable percentage for the contract as defined in section 3.11 of Rev. Proc. 2008-39.

Death Benefit: The determination of the applicable percentage for a contract requires the determination of the death benefit for each contract. For this purpose, the death benefit under a contract will be the death benefit—as defined in section 7702(f)(3)—as of any date within 120 days of the date of the request for closing agreement, or the last date the contract is in force. Consistent with the section 7702(f)(3) definition, death benefit would include:
1. The specified amount (or face amount of the contract);
2. Amounts contractually paid upon death in addition to the specified amount (*e.g.*, cash surrender value for contracts that define the death benefit as the specified amount plus the cash surrender value, premiums paid for a contract that define the death benefit as the specified amount plus the return of premiums paid, etc.);
3. Additional "corridor" death benefits as required by section 7702's minimum death benefit requirement; and
4. Term insurance on the primary insured that extends coverage to age 95 or later.

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New Closing Agreement Procedure for Failed Life Insurance Contracts—Rev. Proc. 2008-40

by Craig R. Springfield and Daniela Stoia

On June 30, 2008, the Internal Revenue Service (the "Service") released Rev. Proc. 2008-40, 2008-29 I.R.B. 151, which establishes a new remediation procedure for addressing life insurance contracts that fail to satisfy the requirements of section 101(f) or 7702 of the Internal Revenue Code, as applicable. Among the revenue procedures that the Service issued in 2008 providing various remediation procedures relating to insurance products, Rev. Proc. 2008-40 may prove to be one of the most significant. Under the prior correction procedures for failed life insurance contracts, innocent mistakes by an insurer, often involving what could be argued was an immaterial amount of money, in many cases led to the imposition of very high "toll charges" as a condition for remediation of contracts. The Service is to be commended for its efforts in issuing revised procedures that are fairer and ultimately more likely to encourage compliance.

In this article, we first briefly describe the statutory requirements for life insurance contracts, the consequences of failures to meet such requirements, and the history of the Service's procedure for remedying these types of failures. We then describe the new remediation procedure established by Rev. Proc. 2008-40. Finally, we discuss closing agreements for contracts that fail to satisfy the cash value accumulation test.

I. Background

Sections 101(f) and 7702 and their role under the tax law. Section 7702, which was enacted as part of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, established the first comprehensive federal tax definition of a "life insurance contract" and generally applies to contracts issued after Dec. 31, 1984. Under this provision, a contract qualifies as a life insurance contract if the contract is considered to be a life insurance contract under applicable law (generally state or foreign law of the jurisdiction where the contract was issued) and satisfies one of two alternative tests, *i.e.*, the guideline premium limitation and cash value corridor tests of section 7702(a)(2), (c) and (d) or the cash value accumulation test of section 7702(a)(1) and (b). Section 7702 largely mirrored a predecessor statute, section 101(f), which was enacted by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, and generally applies to flexible premium life insurance contracts issued prior to Jan. 1, 1985. Like section 7702, section 101(f) included two alternative tests, one imposing a guideline premium and cash value corridor requirement, and the other imposing a cash value test requirement. (The guideline premium and cash value corridor requirements under these statutes are collectively referred to herein as the "GPT," and the cash value accumulation test and cash value test requirements under these statutes are collectively referred to herein as the "CVAT.")

The principal purpose underlying the enactment of sections 101(f) and 7702 was to limit the degree of investment orientation that a contract can have and still receive the federal tax treatment normally accorded to life insurance. For life insurance that provides a cash value and in respect of which interest or other gains accrue, Congress was concerned about the investment element of the contract being disproportionately large compared with the part of a contract's death benefit that would be paid from net amounts at risk to the insurer. At the same time, there was an appreciation that funding at levels to appropriately provide for a contract's future benefits should be permitted. The two alternative tests under sections 101(f) and 7702, *i.e.*,

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the GPT and CVAT, address these purposes in different manners although with the same objective in mind: under the GPT, premiums are restricted relative to the death benefit and certain other future benefits provided under the contract, and the death benefit always must be a certain percentage of the contract's cash value; and, under the CVAT, the death benefit must always be a certain percentage of the contract's cash value, although this percentage generally is higher than that applicable under the GPT's cash value corridor test.

Consequences of failure. The GPT and CVAT, as applicable, establish actuarially-determined limits for premiums and/or cash values that are permitted under a contract that change with the passage of time. If the "line in the sand" specified by these tests is exceeded, the contract generally will fail to comply with section 101(f) or 7702, as applicable.[1] In effect, if a contract is funded so that it is near or at the applicable limit, it is accorded life insurance tax treatment. In contrast, if it is funded so that it is over the applicable limit, this tax treatment is replaced with a regime that more closely resembles the tax treatment of deposits held at interest, so that the tax deferral that applies to interest and other earnings under life insurance contracts is lost.

More specifically, for a contract that fails to satisfy the requirements of section 7702, the contract holder is treated as currently receiving the "income on the contract," as defined in section 7702(g), arising under such contract. Under this provision, the "income on the contract" for a taxable year under a failed contract generally equals the excess of (1) the sum of the increase in the contract's net surrender value during the year and the cost of life insurance protection provided under the contract during the year, over (2) the premiums paid, as defined in section 7702(f)(1), under the contract during the year. In addition, in the year a contract ceases to satisfy the requirements of section 7702, the income on the contract for all prior taxable years is treated as received or accrued during the taxable year in which such cessation occurs. Insurers have reporting and other obligations with respect to such "income on the contract" that is treated as received by a contract holder, even though the fact of failure may not be discovered until many years later.[2]

Congress implicitly recognized the complexity of both sections 101(f) and 7702 by including statutory rules permitting the Service to waive failures where the requirements of the statute were not satisfied due to reasonable error and reasonable steps are being taken to remedy the error.[3] However, the Service has construed the scope of reasonable errors somewhat narrowly, and a closing agreement with the Service is the only mechanism apart from a waiver for remedying a failed life insurance contract.

Prior closing agreement procedures. In Rev. Rul. 91-17, the Service announced that for a limited period of time it would be willing to enter into closing agreements with insurers to remedy failed life insurance contracts. Under this ruling, the Service stated that it would waive civil penalties for failures to satisfy the reporting, withholding, and deposit requirements for income treated as received or accrued under section 7702(g) if, prior to June 3, 1991, the insurance company requests and, in a timely manner, executes a closing agreement under which the company agrees to pay an amount based on (i) the amount of tax that would have been owed by the contract holders if they were treated as receiving the section 7702(g) income on the contracts, and (ii) any interest with regard to such tax.

In practice, the Service continued to enter into closing agreements after this date pursuant to its authority under section 7121, and in Notice 99-48, 1999-2 C.B. 429, the Service stated that it would continue this practice until further notice. Also, with respect to such closing agreements, Notice 99-48 states that an assumed tax rate of 15 percent would be used if the death benefit under the contract is less than $50,000, 28 percent would be used if such death benefit is equal to or exceeds $50,000 but is less than $180,000, and 36 percent would be used if such death benefit is equal to or exceeds $180,000. For this purpose, Notice 99-48 states that the death benefit under the contract is the death benefit (as defined in section 7702(f)(3)) as of any date within 120 days of the date of the request for a closing agreement, or the last day the contract is in force.

While it was helpful that the Service created a mechanism that permitted insurers to remedy failed contracts, there continued to be substantial concern regarding the appropriateness of the toll charge that was required under closing agreements as a condition to remediation. This was in part because the section 7702(g) definition of income on the contract was broader than the definition of income on the contract that applies generally under section 72(e), such as upon a withdrawal or surrender (*e.g.*, because the section 7702(g) definition includes cost of insurance charges, is increased by reductions in surrender charges, and applies with respect to all years of a contract).[4] More fundamentally, there was

concern about the appropriateness of a toll charge based on all income arising under a contract, even though the tax benefit to a contract holder attributable to the excess premiums or excess cash values causing the failure often is far less—in some cases orders of magnitude less.

In Notice 2007-15, 2007-1 C.B. 503, the Service requested comments regarding its correction procedures relating to life insurance and annuity contracts, including those for addressing failures under sections 101(f) and 7702. The Notice set forth various questions for which comments were specifically requested, including the following: "Do the amounts required to be paid under the model closing agreements strike an appropriate balance between making the government whole for the tax that otherwise would be due, and encouraging voluntary compliance with the underlying provisions once an error is discovered? If lesser amounts might be appropriate in some circumstances, what are those circumstances and how should those amounts be limited?" Rev. Proc. 2008-40 is one result of the Service's reconsideration of its closing agreement procedures for addressing failures under sections 101(f) and 7702. We commend the Service for its efforts in seeking taxpayer comments in connection with this reconsideration of procedures.

II. Rev. Proc. 2008-40

In general. Rev. Proc. 2008-40 sets forth the Service's revised procedures for remedying failures under sections 7702 and 101(f) through a closing agreement.[5] These revised procedures are similar to those set forth in Rev. Rul. 91-17, although a number of changes have been instituted to streamline the process for entering into such closing agreements and to make the toll charge assessed as a condition to remediation more equitable.

Section 4.01 of Rev. Proc. 2008-40 sets forth specific procedures for requesting a closing agreement, and in particular requires that such a request be made pursuant to Rev. Proc. 2008-1, 2008-1 I.R.B. 1, or any successor procedure (which sets forth general procedural rules for requesting closing agreements), and that such request include: (1) the policy number of each failed contract to be covered by the closing agreement; (2) a description of the defects that caused the contracts to fail to comply with section 101(f) or 7702, as applicable; and (3) a description of the administrative procedures the issuer has implemented to prevent additional failures in the future. To further streamline the process, Rev. Proc. 2008-40 includes a model closing agreement that generally must be used by issuers.

One change instituted by Rev. Proc. 2008-40 regards the taxpayers who are eligible to enter into a closing agreement. Previously, Rev. Rul. 91-17 generally had been construed as permitting the issuer of a failed life insurance contract to seek correction, including an insurer that had assumption reinsured the contract. Rev. Proc. 2008-40 expands the scope of eligible taxpayers, stating that the revenue procedure "applies to any issuer of one or more contracts that qualified as life insurance contracts under the applicable law, but otherwise failed to meet the definition of a life insurance contract," and for purposes of the revenue procedure, "the term 'issuer' is any company that issues a contract that is intended to satisfy the definition of a life insurance contract … [and] includes a company that insures a contract holder under a contract originally issued by another company."[6] By reason of this change, coinsurers should now be eligible to correct failed life insurance contracts under the procedure.

The information that must be submitted with a request for a closing agreement under Rev. Proc. 2008-40 may be submitted electronically, in read-only format on a CD-ROM, in triplicate. The effective date of Rev. Proc. 2008-40 is July 21, 2008, and this revenue procedure supersedes, in part, Rev. Rul. 91-17, and supersedes Notice 99-48.

Determination of amount required to be paid. The amount required to be paid—*i.e.*, the toll charge—under a Rev. Proc. 2008-40 closing agreement must be calculated on a contract-by-contract basis, and the toll charge in respect of a particular contract depends on whether the "excess earnings" (described in more detail below) under the contract are equal to or less than $5,000, or whether excess earnings are greater than this amount. In particular, the toll charge with respect to the particular contract must be determined as follows:

- Where excess earnings in respect of a contract are equal to or less than $5,000, the amount required to be paid equals an excess earnings-based toll charge, including deficiency interest (the "Excess Earnings Toll Charge"), although an issuer may elect (as described in more detail below) to pay an alternative toll charge equal to 100 percent of the excess premiums for the contract (the "100 percent of the Error Toll Charge"); and
- Where excess earnings in respect of a contract exceed $5,000, the amount required to be paid

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equals the traditional section 7702(g) income-based toll charge, including deficiency interest (the "Section 7702(g) Toll Charge"), although again an issuer may elect to pay an alternative toll charge equal to the 100 percent of the Error Toll Charge.

The new Excess Earnings Toll Charge reflects comments the Service received from taxpayers that advocated a methodology for calculating the toll charge based on the tax benefit a contract holder received from being able to fund a life insurance contract at levels higher than permitted by section 101(f) or 7702, as applicable. Also, the concept of "excess earnings," discussed in detail below, is intended to reflect the earnings accruing under a contract on such higher funding. The Excess Earnings Toll Charge is narrowly tailored to "take away" the tax benefit arising from the excess funding. In addition, in limiting use of this approach to contracts with excess earnings equal to or less than $5,000, the Service appears to have made a policy judgment that larger, and thus presumably more investment-oriented, contracts should not be eligible for the new narrowly-tailored Excess Earnings Toll Charge, but rather generally should be subject to the Section 7702(g) Toll Charge, which mirrors the toll charge methodology that applied previously. For this purpose, and perhaps in the interest of simplicity, contracts with higher investment orientation were defined by reference to an absolute dollar amount of excess earnings, *i.e.*, amounts exceeding $5,000.

As noted above, however, Rev. Proc. 2008-40 permits an issuer to elect to calculate the toll charge with respect to a contract based on the 100 percent of the Error Toll Charge, regardless of the level of excess earnings under a contract. Under this alternative methodology, the calculation of the toll charge is limited to the highest amount by which premiums paid has ever exceeded the guideline premium limitation. Although the intent of this alternative methodology is not expressly stated, it leads to a much more equitable toll charge in situations where receipt of a small amount of excess premiums causes all of the gain under a contract (past and future) to be recognized under section 7702(g), even though only a small portion of the earnings under the contract may have accrued on such excess premiums.

In the following discussion, we will examine certain details of the Excess Earnings Toll Charge, the 100 percent of the Error Toll Charge, and the Section 7702(g) Toll Charge.

Concept of "excess earnings" and the Excess Earnings Toll Charge. As noted above, the Excess Earnings Toll Charge generally must be used to calculate the toll charge attributable to a contract if the "excess earnings" under the contract are equal to or less than $5,000. Where this is the case (and the issuer does not elect to use the alternative 100 percent of the Error Toll Charge), the amount required to be paid under the Rev. Proc. 2008-40 closing agreement for the contract will equal the Excess Earnings Toll Charge, which in turn equals the tax that would have been owed by the contract holder if the contract holder were treated as receiving the "excess earnings" on the contract, and the deficiency interest thereon.

Section 4.03(5)(b) of Rev. Proc. 2008-40 defines "excess earnings" as the amount obtained by multiplying: (1) "the sum of a contract's excess premiums for a contract year and its cumulative excess earnings for all prior contract years," by (2) the applicable earnings rate as set forth in section 3.07 of Rev. Proc. 2008-39, which addresses closing agreements to remediate the inadvertent modified endowment contract status of contracts. Also, the "excess premiums for a contract year" refers to the amount by which the "premiums paid," as defined in section 7702(f)(1), for a contract exceeds the contract's guideline premium limitation, as defined in section 7702(c)(2). Rev. Proc. 2008-40 does not set forth a specific methodology for identifying "excess premiums for a contract year," and thus it should be permissible, for example, to measure excess premiums on each day of a contract year and to accrue excess earnings using the applicable earnings rate based on this methodology.[7]

The applicable earnings rate that is determined under section 3.07 of Rev. Proc. 2008-39 is discussed in detail on page 32 of this issue.[8] In brief, this revenue procedure specifies rates (or a methodology to calculate rates) for each calendar year, and these rates in turn must be used as the earnings rate for the *contract year* that begins within such calendar year. Thus, for example, in the case of a failed contract that is not a variable contract and was in force throughout the contract year beginning on May 1, 1993, the applicable earnings rate would be 7.5 percent for the entire contract year beginning on that date, which would include part of the calendar year 1993 and part of the calendar year 1994. Thus, in determining the tax that the contract holder would owe for a particular calendar year in this example (*e.g.*, 1994), the excess earnings for such calendar year generally will include excess earnings accruing for parts of two contract years at different earnings rates. Once the excess earnings for a calendar year are determined, this amount then must be multiplied by the

applicable tax rate for such contract to determine the tax for such year that the contract holder would have had to pay. As discussed on page 24 of this issue, the applicable tax rate generally depends on the amount of the contract's death benefit within 120 days of the date of the submission to the Service offering to enter into a closing agreement.[9] Finally, the tax so determined for each calendar year accrues deficiency interest under section 6621(a)(2).

100 percent of the Error Toll Charge. A qualification to the above discussion is that Rev. Proc. 2008-40 permits an issuer to elect to pay an amount with respect to a contract equal to 100 percent of the excess premiums under such contract. For this purpose, section 4.03(5)(c) of Rev. Proc. 2008-40 defines "excess premiums" as the highest amount by which premiums paid exceeded the guideline premium limitation at any time under a contract. An election to use the 100 percent of the Error Toll Charge can be made regardless of whether excess earnings exceed $5,000, and, where elected, this alternative toll charge amount applies to the contract in lieu of the otherwise applicable toll charge. Thus, no deficiency interest accrues with respect to this alternative toll charge.

Section 7702(g) Toll Charge. If excess earnings under a contract exceed $5,000, an issuer must calculate the toll charge attributable to the contract using the Section 7702(g) Toll Charge (unless, as just noted, the issuer elects to calculate the toll charge for the contract using the 100 percent of the Error Toll Charge methodology). Where applicable, this toll charge equals the tax that would have had to be paid by a contract holder if each year he or she received the section 7702(g) income on the contract and deficiency interest on that tax amount. (This definition of income is discussed above under consequences of failure.) The Section 7702(g) Toll Charge generally mirrors the toll charge required with respect to failed contracts under the prior correction procedure applicable before the effective date of Rev. Proc. 2008-40. One difference appears to relate to prior reported amounts. In particular, in the past the Service often allowed an offset to tax for income amounts that were reported to contract holders due to distributions from contracts. The model closing agreement set forth in section 5 of Rev. Proc. 2008-40 does not, however, provide for any such offset.

Special considerations for accruing excess earnings and section 7702(g) income on the contract in the year the closing agreement is filed with the Service. Based on our prior experience with submissions under both Rev. Rul. 91-17 and Rev. Proc. 2008-40 and statements made by representatives of the Service, we expect that the Service will require the toll charge paid under a Rev. Proc. 2008-40 closing agreement to be current as of the date the Service executes the closing agreement. Effectively, this means that taxpayers must calculate the toll charge through a date that is beyond the date on which the taxpayer submits the executed closing agreement to the Service with the request for the closing agreement, *e.g.*, perhaps to a date that is 60 to 90 days beyond the date the request is submitted to the Service. This requirement is only material for taxpayers using the Excess Earnings Toll Charge and the Section 7702(g) Toll Charge because these toll charges have elements that must be calculated through a future date, *e.g.*, earnings and deficiency interest. Since the issuer will have actual data relating to the contract only through a current date (that usually must be close in time to the date of the submission of the executed closing agreement), the issuer will need to adopt certain assumptions (and disclose them to the Service) in order to calculate the income

The Section 7702(g) Toll Charge generally mirrors the toll charge required with respect to failed contracts under the prior correction procedure applicable before the effective date of Rev. Proc. 2008-40.

accruing from this current date through the future date, *i.e.*, for the estimation period. For example, it generally should be reasonable to assume no premium payments and no withdrawals after that current date.

Correction of failed contracts. Section 4.05 of Rev. Proc. 2008-40 requires that, for each contract that is in force on the effective date of the closing agreement, the issuer take certain corrective action to the extent necessary to bring each contract into compliance with section 101(f) or 7702, as applicable. Such corrective action must be made not later than 90 days after the date of execution of the closing agreement by the Service.

The corrective action must be either (1) to increase the death benefit to not less than an amount that will ensure compliance with section 101(f) or 7702, as applicable,

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or (2) to refund to the contract holder the excess of the sum of the premiums paid as of the effective date of the closing agreement over the guideline premium limitation as of that date, with interest at the contract's interest crediting rate. If the sum of the premiums paid does not exceed the guideline premium limitation, no corrective action is necessary for the contract. Also, in the case of a contract which terminated by reason of the death of the insured prior to the date of execution of the closing agreement by the Service and at a time when premiums paid exceeded the guideline premium limitation for the contract, the issuer must pay the contract holder[10] (or the contract holder's estate) the amount of such excess premiums with interest thereon. The revenue procedure does not specify in this last regard how interest should be determined, although it seems appropriate to use the contract's current interest crediting rate for this purpose (for instance, the rate as of the date of termination, or perhaps the rate(s) applicable since that date).

Required representations. Section 4.06 of Rev. Proc. 2008-40 provides that submissions to the Service offering to enter into a Rev. Proc. 2008-40 closing agreement must include the following representations to the effect that: (1) the issuer is within the scope of section 3 of the revenue procedure (*i.e.*, the taxpayer is the issuer of one or more contracts that qualified as life insurance contracts under applicable law, but otherwise failed to meet the definition of a life insurance contract under section 7702(a) or to meet the requirements of section 101(f)); (2) the issuer properly computed the amount required to be paid with regard to the contracts in accordance with section 4.03 of the revenue procedure (*i.e.*, using the Excess Earnings Toll Charge, the Section 7702(g) Toll Charge, as applicable, or the alternative 100 percent of the Error Toll Charge, as described above); and (3) the issuer has brought the contracts into compliance with the requirements of section 101(f) or 7702, as applicable, or will do so within the time period specified in the model closing agreement set forth in section 5 of the revenue procedure.

The representations must be made under penalties of perjury, and the issuer must retain documentation available for audit to support the representations. The revenue procedure does not specify for how long such documentation must be retained. Given the long-term nature of contracts and the fact that a failure (or inadequate correction) can only be remediated through a proceeding or filing with the Service, it would be prudent to retain documentation for as long as the contract in question is in force, and for some reasonable period of time thereafter (perhaps reflecting the three year statute of limitations that typically would apply to contract holders and the issuer's otherwise applicable document retention policies).

III. Model Closing Agreement

Section 4.02 of Rev. Proc. 2008-40 states that "[i]n the case of a failure to meet the guideline premium requirements of § 7702(c), the issuer must submit a proposed closing agreement, in triplicate, executed by the issuer, in the same form as the model closing agreement in section 5 of this revenue procedure." This model closing agreement generally follows the principal terms of closing agreements entered into under the prior correction procedure. In particular, in return for the issuer's agreement to pay the toll charge and take corrective action as described above, the contracts are retroactively treated as complying with section 101(f) or 7702, as applicable (so that, for example, no income is deemed to arise under section 7702(g) and death benefits paid prior to the effective date of the closing agreement are treated as paid by reason of the death of the insured under a life insurance contract for purposes of the exclusion from income under section 101(a)(1)).

Under the terms of the model closing agreement, the issuer also must agree not to deduct or seek refund of the toll charge paid, or to increase the contract holder's investment in the contract under section 72 or premiums paid by any portion of such amount (or by any portion of the income on the contract). Further, the Service agrees to waive civil penalties for failures of the issuer to satisfy reporting, withholding, and deposit requirements with respect to deemed income arising due to contract failures, and to treat no portion of the toll charge paid as income to the contract holders.

IV. Contracts that Fail to Satisfy the CVAT

The provisions of Rev. Proc. 2008-40, including the model closing agreement set forth therein, are intended to address failures under the GPT. In this regard, section 4.02 of Rev. Proc. 2008-40 states that "[i]n the case of a failure to meet the guideline premium requirements of § 7702(c), the issuer must submit a proposed closing agreement, in triplicate, executed by the issuer, in the same form as the model closing agreement in section 5 of this revenue procedure." This provision goes on, however, to state that "[i]n the case of *any other failure*, the issuer may propose amendments to the proposed closing agreement set forth in section 5 of this revenue proce-

dure, including the amount required to be paid, as appropriate on a case-by-case basis." (Emphasis added.)

This last sentence shows that the Service is willing to enter into closing agreements to address CVAT contract failures and that it anticipated that appropriate modifications to the model closing agreement would be needed. The Service does not amplify on what modifications to the toll charge might, or might not, be appropriate. However, the considerations that led the Service to modify the toll charge for GPT contract failures are equally applicable to CVAT contract failures. Thus, it seems that a toll charge based on the gains arising from cash values exceeding those permitted under the CVAT would be appropriate, *i.e.*, an excess cash value toll charge for CVAT contracts as a substitute for the Excess Earnings Toll Charge that applies to GPT contracts.

Because the CVAT must be satisfied by the terms of a contract, failures under this test often involve an error under a contract's terms. As a result, corrective action for CVAT contract failures often may require that a modification to such terms be made, such as through the addition of an endorsement to increase a contract's death benefit. Of course, if the error affects values only during an initial time period under a contract (*e.g.*, during the first year), and the contract is now past that time period, it seemingly should not be necessary to amend the contract since any such amendment would be inconsequential.

In some instances, a contract may fail to comply with the CVAT, but by happenstance complies with the GPT (or, perhaps more often, the issuer may not know whether contracts comply with the GPT since they are not monitored for compliance with section 7702 under that test, but the issuer cannot rule out the possibility that they comply). Where a contract is intended to satisfy the requirements of the CVAT, *i.e.*, the requirements of section 7702(a)(1), there should be no obligation placed on an issuer to verify whether the contract inadvertently complies with the GPT, and the Service's closing agreement procedure should allow for corrections under the CVAT. At the same time, if the issuer is aware that certain failed CVAT contracts inadvertently comply with the GPT, this should be an important consideration in determining the toll charge, if any, that should apply for correction of that contract under the CVAT. In such instances, there has not been to that date any harm to the government, *i.e.*, no section 7702(g) income has ever accrued, and in fact it would be permissible for an issuer and contract holder to exchange the failed CVAT contract (that complies with the GPT) for a new complying CVAT contract in a section 1035 exchange.

As a result, corrective action for CVAT contract failures often may require that a modification to such terms be made, such as through the addition of an endorsement to increase a contract's death benefit.

Similarly, if an issuer of failed CVAT contracts is able to test them under the GPT and can identify the toll charge that would apply to such contracts under Rev. Proc. 2008-40 (*i.e.*, using the methodology described above that applies in calculating the toll charge for GPT failures), it seemingly should be permissible to use this GPT toll charge as the applicable toll charge, but to allow such correction under the CVAT. (In such instances, it would seem that only minor adjustments to the model closing agreement would be needed.)

V. Concluding Thoughts

The new Service correction procedure for failed life insurance contracts streamlines the process for addressing failed life insurance contracts, and in our view involves a more equitable toll charge structure that will materially promote greater compliance.

See End Notes on page 32.

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End Notes

1. In the case of the GPT, there is a limited ability to return premiums that exceed the guideline premium limitation with interest within 60 days of the end of a contract year, so that such excess premiums are disregarded. Also, if a contract is intended to comply with the CVAT but does not, it may inadvertently comply with the GPT; the converse generally would not be the case because the CVAT must be satisfied at all times by the terms of the contract.
2. *See* Rev. Rul. 91-17, 1991-1 C.B. 190, wherein the Service discussed various obligations that arise with respect to failed life insurance contracts.
3. *See* sections 101(f)(3)(H) and 7702(f)(8).
4. As noted above, the section 7702(g) income on the contract for all years prior to the year of failure is deemed received by a contract holder in the year of failure. *See* section 7702(g)(1)(C). The Service's closing agreement procedures for correcting failures under sections 101(f) and 7702, both past and present, do not permit reflection of statute of limitations defenses.
5. *See also* Rev. Proc. 2008-38, 2008-29 I.R.B. 139, addressing contracts that fail to comply with section 7702 due to failures to account properly for charges for qualified additional benefits.
6. Rev. Proc. 2008-40 section 3.
7. Section 4.03(5)(c) of Rev. Proc. 2008-40 sets forth a definition of "excess premiums" that looks to the highest amount by which premiums paid exceeded the guideline premium limitation at any time under a contract. This definition, however, appears to be applicable only for purposes of the 100 percent of the Error Toll Charge calculation (which is discussed on page 29 of this issue) and not for purposes of the calculation of excess earnings.
8. *See* Brian G. King, *Earnings Rates under Rev. Procs. 2008-39 and 2008-40, TAXING TIMES SUPPLEMENT*, February 2009, p. 32.
9. *See* Brian G. King, *History of the Use of Tax Rates in Sections 7702 and 7702A Closing Agreements, TAXING TIMES SUPPLEMENT*, February 2009, p. 24.
10. If all rights under a contract have vested with the beneficiary of the death benefit, it would seem appropriate to treat such person as the contract holder for this purpose.

Earnings Rates Under Rev. Procs. 2008-39 and 2008-40

by Brian G. King

Rev. Procs. 2008-39 and 2008-40 both provide for alternative toll charge calculations that are based in whole or in part on the "earnings" that accrue on amounts in excess of the respective premium limitation. As was the case under Rev. Procs. 99-27[1] and 2001-42,[2] Rev. Proc. 2008-39 continues to provide a toll charge calculation based on "overage earnings" (*i.e.*, the earnings that accrue on a contract's "overage") while Rev. Proc. 2008-40 provides a new toll charge alternative based on "excess earnings" (*i.e.*, the earnings that accrue on "excess premiums").

While both revenue procedures define "earnings" using different terminology (overage earnings vs. excess earnings), both are determined based on the same set of earnings rates. In defining the earnings that underlie the development of the toll charge, the revenue procedures do not look to the actual earnings accruing inside the life insurance contract, but instead base the earnings calculation on proxy earnings rates. These earnings rates are defined in section 3.07 of Rev. Proc. 2008-39 and vary based on whether the contract qualifies as a variable contract under section 817(d) and apply on a contract year basis according to the calendar year in which the contract year begins.

Methodology for Computing Earnings Rates: For contract years beginning in calendar years 1988 through 2007, the earnings rates are specified in section 3.07(2)(a) and (3)(a) of Rev. Proc. 2008-39. Section 3.07(2)(b) and (3)(b) of Rev. Proc. 2008-39 provides the formulas to be used to determine the earnings rates for contract years after 2007.[3] The **general account total return** rate defines the earnings rate applicable to contracts other than variable life insurance contracts, while the **variable contract earnings rate** defines the rates applicable to variable life insurance contracts.

The general account total return equals:

(i) 50 percent of the Moody's Seasoned Corporate Aaa Bond Yield,[4] frequency annual, or any successor thereto; plus

TABLE 1: EARNINGS RATES TO BE USED TO CALCULATE EITHER "EXCESS EARNINGS" OR "OVERAGE EARNINGS"			
YEAR	CONTRACTS OTHER THAN VARIABLE CONTRACTS	VARIABLE CONTRACTS	SOURCE
1982	15.0%	21.8%	Application of Rev. Proc. 2008-39 Section 3.07 Formulas
1983	12.8%	16.4%	Application of Rev. Proc. 2008-39 Section 3.07 Formulas
1984	13.5%	7.0%	Application of Rev. Proc. 2008-39 Section 3.07 Formulas
1985	12.0%	26.1%	Application of Rev. Proc. 2008-39 Section 3.07 Formulas
1986	9.7%	15.0%	Application of Rev. Proc. 2008-39 Section 3.07 Formulas
1987	10.0%	2.7%	Application of Rev. Proc. 2008-39 Section 3.07 Formulas
1988	10.2%	13.5%	Rev. Proc. 2008-39
1989	9.7%	17.4%	Rev. Proc. 2008-39
1990	9.8%	1.4%	Rev. Proc. 2008-39
1991	9.2%	25.4%	Rev. Proc. 2008-39
1992	8.6%	5.9%	Rev. Proc. 2008-39
1993	7.5%	13.9%	Rev. Proc. 2008-39
1994	8.3%	-1.0%	Rev. Proc. 2008-39
1995	7.8%	23.0%	Rev. Proc. 2008-39
1996	7.7%	14.3%	Rev. Proc. 2008-39
1997	7.6%	17.8%	Rev. Proc. 2008-39
1998	6.9%	19.7%	Rev. Proc. 2008-39
1999	7.4%	12.8%	Rev. Proc. 2008-39
2000	8.0%	-5.5%	Rev. Proc. 2008-39
2001	7.5%	-7.1%	Rev. Proc. 2008-39
2002	7.2%	-14.1%	Rev. Proc. 2008-39
2003	6.2%	19.6%	Rev. Proc. 2008-39
2004	6.1%	6.9%	Rev. Proc. 2008-39
2005	5.6%	2.1%	Rev. Proc. 2008-39
2006	6.0%	10.0%	Rev. Proc. 2008-39
2007	6.0%	3.6%	Rev. Proc. 2008-39
2008	5.9%	5.2%	Average of Prior Three Years

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(ii) 50 percent of the Moody's Seasoned Corporate Baa Bond Yield, frequency annual, or any successor thereto.

The **variable contract earnings rate** is equal to the sum of:

(i) 10 percent of the **general account total return**, and

(ii) 90 percent of the **separate account total return** for the calendar year in which the contract year begins.

Separate account total return. The separate account total return equals:

(a) 75 percent of the **equity fund total return**, plus

(b) 25 percent of the **bond fund total return**, less

(c) 1.1 percentage point.

Equity fund total return. The equity fund total return equals:

(a) the calendar year percentage return[5] represented by the end-of-year values of the Standard and Poor's (S&P) 500 Total Return Index, with daily dividend reinvestment, or any successor thereto, less

(b) 1.5 percentage point.

Bond fund total return. The bond fund total return equals:

(a) the calendar year percentage return represented by the end-of-year values of the Merrill Lynch U.S. Corporate Master Index (C0A0)[6], or any successor thereto, less

(b) 1.0 percentage point.

Incomplete calendar year: In order to compute the earnings rate for calendar year 2008 and later, the calendar year-end values for the various indices must be available. If the general account total return or the separate account total return for a calendar year cannot be determined because the calendar year in which the contract year begins has not ended, the earnings rate for the contract year (or portion thereof) is determined by taking the average of the rates (general account total return or variable contract earnings rates) for the prior three years. For example, the general account total return for 2008 (assuming the year-end indices are not available) would be based on the average of the general account total return rates for 2005, 2006, and 2007 ((5.6% + 6.0% + 6.0%) / 3 = 5.8666% or 5.9%).

Table 1 on page 33 contains the earnings rates for years 1982 to 2008. The earnings rates for years 1982 through 1987 are based on the application of the formulas contained in section 3.07(2)(b) and (3)(b) of Rev. Proc. 2008-39. The rates for 1988 through 2007 are provided in Rev. Proc. 2008-39, while the earnings rates for 2008 are based on the arithmetic average of the earnings rates for 2005, 2006 and 2007.

It is important to note that the 2008 rates will change once the published indices are available. At that point, the 2009 rates will be based on the arithmetic average of the 2006, 2007 and 2008 rates until the 2009 indices are available.

End Notes

1 1999-1 C.B. 1186, *superseded by* Rev. Proc. 2001-42.

2 2001-2 C.B. 212, *modified and amplified by* Rev. Proc. 2007-19, 2007-7 I.R.B. 515.

3 Section 3.07(2)(a) and (3)(a) of Rev. Proc. 2008-39 only provides earnings rates back to 1988 because section 7702A was enacted in that year. However, sections 101(f) and 7702 were enacted earlier, and, as a result, earnings rates prior to 1988 will be needed to calculate excess earnings for contracts failing to comply with those sections prior to 1988. In this regard, section 4.03(5)(b)(ii) of Rev. Proc. 2008-40 provides that the applicable earnings rate for contract years beginning prior to 1988 is determined using the formulas set forth in section 3.07 of Rev. Proc. 2008-39 for contract years after 2007.

4 Moody's Seasoned Corporate Aaa and Baa Bond Yields are publicly available at *www.federalreserve.gov*.

5 The calendar year percentage return is calculated by:

(a) dividing the end-of-year value of the index for the calendar year by the end-of-year value of the index for the immediately preceding calendar year, and

(b) subtracting 1 from the result.

6 The Merrill Lynch U.S. Corporate Master Index (C0A0) is publicly available at *www.mlindex.ml.com*.

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Rev. Proc. 2008-41—Correction of Inadvertent Diversification Failures

by Joseph F. McKeever, III and Bryan W. Keene

I. Introduction

On June 30, 2008, the Internal Revenue Service (the "Service") released Rev. Proc. 2008-41, 2008-29 I.R.B. 155, which provides a new procedure for correcting inadvertent failures to satisfy the diversification requirements applicable to variable annuity and life insurance contracts under section 817(h) of the Internal Revenue Code (the "Code"). Like the four other new insurance product correction procedures released that day, Rev. Proc. 2008-41 is a considerable improvement on the prior correction procedure, Rev. Proc. 92-25, 1992-1 C.B. 741, and should make it easier and less costly for insurers to remediate the adverse consequences of inadvertent diversification failures.

To obtain relief under the new diversification correction procedure, insurers will still need to file a request for a closing agreement with the Service's National Office in Washington, D.C., *i.e.*, there is still no "self help" available. Such a filing will require the use of legal, accounting and actuarial resources. Also, depending on the facts and circumstances, insurers will need to pay a toll charge to the government that can equal as much as $5 million for each nondiversified segregated asset account. As a result, insurers will continue to have a strong interest in establishing and following effective procedures to assure compliance with the diversification rules. To paraphrase the proverb, "An ounce of prevention is still worth a pound of cure," at least when it comes to maintaining adequately diversified segregated asset accounts.

II. Background

Section 817(d) of the Code defines a variable contract as a contract that (1) provides for the allocation of premiums to an account that, pursuant to State law or regulation, is segregated from the insurer's general asset accounts; and (2) provides for the payment of annuities, is a life insurance contract, or provides for the funding of insurance on retired lives. In addition, in the case of an annuity contract or a contract that funds insurance on retired lives, the amounts paid in or the amounts paid out must reflect the investment return and market value of the segregated asset account, while in the case of a life insurance contract, the death benefit (or the period of coverage) must be adjusted on the basis of the investment return and the market value of the segregated asset account. A variable contract (other

than a pension plan contract)[1] is subject to the requirements of Code section 817(h)(1), which provides in sweeping terms that a variable contract will not be treated as an annuity or life insurance contract "for any period (and any subsequent period) for which the investments made by [the segregated asset] account are not … adequately diversified" in accordance with applicable regulations.

The regulations provide that a segregated asset account will be considered adequately diversified only if (1) no more than 55 percent of the value of the total assets of the account is represented by any one investment; (2) no more than 70 percent is represented by any two investments; (3) no more than 80 percent is represented by any three investments; and (4) no more than 90 percent is represented by any four investments.[2] For this purpose, all securities of the same issuer are treated as a single investment, and each government agency or instrumentality that issues a government security is treated as a separate issuer.[3] In addition, if certain requirements are met, a segregated asset account's interest in a regulated investment company, partnership, real estate investment trust or grantor trust (each, a "Look-Through Entity") is not treated as a single investment, and instead the account is treated as directly holding the assets of the Look-Through Entity. For this look-through treatment to apply, all beneficial interests in the Look-Through Entity must be held by life insurance company segregated asset accounts and certain other investors permitted under the regulations, and public access to the Look-Through Entity must be available exclusively through the purchase of a variable contract.[4] Finally, variable life insurance contracts (but not variable annuities) are permitted to be based on a segregated asset account that is more heavily invested in Treasury securities than otherwise permitted under the percentage limitations summarized above.[5]

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Treas. Reg. § 1.817-5(c)(1) specifies that the investments of a segregated asset account must be adequately diversified at the end of each calendar quarter or within 30 days thereafter.[6] The same regulation (reflecting section 817(h)(i) of the Code) expressly provides that once a diversification error causes a variable contract to lose its status as an annuity or life insurance contract, that condition is permanent even if the investments of the nondiversified segregated asset account are adequately diversified in a subsequent calendar quarter. In addition, the regulations provide that a variable contract will be treated as based on a segregated asset account for a calendar quarter if any amounts under the contract are allocated to that account at any time during the quarter. If a contract is not treated as an annuity or a life insurance contract under these rules, the "income on the contract" is currently includible in the policyholder's income, *i.e.*, tax-deferral on the inside buildup is lost.[7]

The consequences of these rules are illustrated by the following example. Policyholder X allocates his variable annuity's cash value of $100,000 among 15 different segregated asset accounts. Fourteen of those segregated asset accounts are adequately diversified in accordance with the regulations, but one (SAA #1) is not adequately diversified during the third calendar quarter of 2008. Even if X allocated only $1 to SAA #1 and on only one day of the third quarter (perhaps X is an active trader), X's contract loses its status as an annuity contract. As a result, he is currently taxable on the income generated by the entire $100,000 cash value for all periods beginning with the third quarter of 2008.

Recognizing the potentially harsh consequences of these rules, the regulations have offered—from the time they were finalized in 1989—a way to restore the tax-deferred status of a contract affected by a diversification error. Specifically, they provide that such status can be restored if:

(1) the issuer (or holder) of the contract shows that the error was inadvertent;

(2) the investments of the nondiversified account satisfied the diversification requirements "within a reasonable time" after the error was discovered; and

(3) the issuer (or holder) agrees to "make such adjustments or pay such amounts as may be required by the [Service] with respect to the period or periods" of nondiversification.[8]

Until they were recently amended as part of the government's efforts to update the various insurance product correction procedures, the section 817(h) regulations also provided that the amount payable to the Service "shall be an amount based upon the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract (as defined in section 7702(g)(1)(B), without regard to section 7702(g)(1)(C)) for such period or periods."[9]

Prior to the release of Rev. Proc. 2008-41, the correction mechanism contemplated by the regulations was governed by Rev. Proc. 92-25, which closely tracked the regulatory provisions described above. Its key elements were as follows:

(1) The issuer needed to file a ruling request and pay the associated IRS user fee.

(2) The ruling request had to (a) identify the period(s) of nondiversification; (b) show that the failure was inadvertent; (c) show that the investments were restored to diversified status within a reasonable time after the error was discovered; (d) describe the method used to compute the toll charge; and (e) identify the amount of the toll charge. (Items (d) and (e) were determined without regard to contracts that the owners completely surrendered for cash during the nondiversified period.)

(3) The issuer was required to submit an unexecuted closing agreement using a prescribed model and showing the amount owed to the Service (hereinafter, the "Rev. Proc. 92-25 Toll Charge"). The Rev. Proc. 92-25 Toll Charge was equal to all the untaxed income within each affected contract during the period of nondiversification multiplied by a proxy tax rate, plus deficiency interest.[10] Deficiency interest was computed as if the described amounts were underpayments of tax by the policyholders for the tax years containing the periods of nondiversification.

(4) The issuer was required to agree not to deduct the Rev. Proc. 92-25 Toll Charge and not to increase the policyholders' investment in the contract by any portion of (a) the income attributable to the contracts or (b) the Rev. Proc. 92-25 Toll Charge.

(5) The issuer was required to pay the Rev. Proc. 92-25 Toll Charge to the Service within 30

days of the date the Service executed the closing agreement.

(6) In consideration of the issuer paying the Rev. Proc. 92-25 Toll Charge, the investments of the segregated asset accounts were treated as adequately diversified during the period(s) of nondiversification, and no part of the Rev. Proc. 92-25 Toll Charge was treated as income to the policyholders.

The Service has never released any statistics on the number of closing agreements entered into under Rev. Proc. 92-25, the nature of the errors requiring closing agreements, or the amounts that insurers paid as Rev. Proc. 92-25 Toll Charges. However, the authors understand from anecdotal information that over the last 15 years, there have been a number of such closing agreements and payments have been made involving tens of millions of dollars. The types of errors involved in those cases are not publicly known, except that some clearly involved companies allowing variable annuities to be based on segregated asset accounts that were heavily invested in Treasury securities in erroneous reliance on the special rule that allows such higher concentration only with respect to variable life insurance contracts.[11] The Service addressed this specific type of error in Notice 2000-9, 2000-1 C.B. 449, apparently after taxpayers approached the Service and requested special relief. The Notice established a closing agreement program under which the toll charge required for relief was based on significantly lower proxy tax rates than otherwise applied under Rev. Proc. 92-25.[12] The program was only available to correct variable annuity contracts that inadvertently failed the diversification requirements but would have satisfied those requirements if the contracts had been variable life insurance contracts instead of annuities. Although the program was an improvement upon Rev. Proc. 92-25, it addressed only one type of diversification failure and was limited to closing agreement offers filed before Aug. 2, 2000.

In January 2007, the Service published Notice 2007-15, 2007-7 I.R.B. 503, in which it requested public comments on how to permanently improve the procedures for correcting diversification and other insurance product compliance errors. At least one commentator noted that the Rev. Proc. 92-25 Toll Charge and the provisions of the regulations on which it was based had the unfortunate effect of discouraging taxpayers from approaching the Service to remedy diversification failures.[13] Indeed, the stakes were such that the prior procedures arguably created incentives for taxpayers to adopt aggressive interpretations of the law to support the position that a diversification failure had not in fact occurred.

As noted above, the Rev. Proc. 92-25 Toll Charge was clearly derived from the statement in the regulations that the toll charge was to be based on the amount of tax that the policyholders would owe if treated as having received all the income on the affected contracts during the period(s) of nondiversification. This provision was a significant barrier to any changes to the Rev. Proc. 92-25 Toll Charge. Not surprisingly, then, in July 2007 the Treasury Department and the Service proposed deleting this sentence from the regulations.[14] The preamble to the proposed change explained that it responded to public comments on Notice 2007-15 and that the targeted sentence had "caused confusion about the scope of the IRS's authority to provide for amounts that depart from the plain language of the regulation."[15] On March 6, 2008, the government finalized the proposed change, which set the table for alternatives to the Rev. Proc. 92-25 Toll Charge.[16]

III. Scope, Procedural Requirements, and Relief Provided under Rev. Proc. 2008-41

Clearly, the most significant changes brought about by Rev. Proc. 2008-41 are those involving the determination of the toll charge that issuers must pay to obtain relief. Those changes are discussed in detail in the next section, but initially it is worthwhile to make note of some other aspects of Rev. Proc. 2008-41.

First, as required by the regulations and reflected in Rev. Proc. 92-25, the relief available under Rev. Proc. 2008-41 is limited to inadvertent diversification errors.[17] In the authors' experience, establishing inadvertence under Rev. Proc. 92-25 was usually a simple matter because errors resulted from simple human oversights or misunderstandings. There seems to be little reason to expect this to change in the future, but it is worth keeping in mind that this constraint on the ability to obtain relief for diversification failures does exist.

Second, Rev. Proc. 92-25, by its terms, allowed only the "issuers" of variable contracts to obtain relief for nondiversified segregated asset accounts. Rev. Proc. 2008-41 defines "issuer" (as do the other new remediation revenue procedures) to include not only the company that issues a contract, but also "a company that insures a contract

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holder under a contract originally issued by another company."[18] While there is not a great deal of coinsurance (or assumption reinsurance) of variable contracts, allowing a reinsurer to seek a closing agreement in its own name, rather than in the name of the company that originally issued the contracts, should simplify the closing agreement process in such cases.

Third, as was the case under Rev. Proc. 92-25, an issuer seeking relief for a diversification failure must file a request for a private letter ruling with the Service's National Office and pay the Service user fee for such a request (currently $11,500). Similar to the prior procedure, the ruling request must (a) identify the period(s) of nondiversification; (b) show that the error was inadvertent; (c) show that the investments were restored to diversified status within a reasonable time after the error was discovered; and (d) describe which of the methods allowed by Rev. Proc. 2008-41 to determine the toll charge was used.[19] In addition, the issuer must make the following representations and retain adequate documentation to support them:

(1) the issuer is within the scope of the revenue procedure, *i.e.*, it issued or reinsured the contracts and the failure was inadvertent;

(2) the issuer properly computed the toll charge; and

(3) the issuer has brought the contracts into compliance with Code section 817(h) and Treas. Reg. § 1.817-5(b).[20]

Fourth, the issuer must submit a proposed closing agreement, in triplicate, executed by the issuer using the model closing agreement in section 6 of Rev. Proc. 2008-41. (This differs from Rev. Proc. 92-25, which required an unexecuted closing agreement be submitted for Service review.) Representatives of the Service and the Treasury Department have made it clear that they anticipate allowing taxpayers to deviate from the model closing agreement only in rare and unusual circumstances.

Fifth, the issuer is required to pay the toll charge determined under section 4.04 of the revenue procedure to the Service within 60 days of the date the Service executes the closing agreement (Rev. Proc. 92-25 allowed only 30 days).

Sixth, as was the case under Rev. Proc. 92-25, the issuer must agree not to deduct the toll charge and not to increase the policyholders' investment in the contract (or premiums paid for purposes of section 7702) by (a) any portion of the toll charge, or (b) any portion of the amount of the aggregate income on the contracts.

Finally, in consideration of the issuer's undertakings, the Service will agree as follows:

(1) to treat the investments of the segregated asset account as adequately diversified during the period(s) of nondiversification;

(2) not to treat any portion of the toll charge paid as income to the policyholders;

(3) to treat the failures and any corrective actions as having no effect on the date the contracts were issued, entered into, or purchased for any tax purposes (*i.e.*, the correction will not upset grandfathers); and

(4) to waive civil penalties for failure of the issuer to satisfy reporting, withholding, or deposit requirements for income deemed received by the policyholders as a result of the error.

IV. Determination of Toll Charge

As indicated above, perhaps the most significant aspects of Rev. Proc. 2008-41 are the modifications it makes to the toll charge required to correct diversification failures. Like the other four insurance product correction procedures released in conjunction with Rev. Proc. 2008-41, the new diversification procedure retains the prior toll charge methodology (*i.e.*, the Rev. Proc. 92-25 Toll Charge). However, it also offers an alternative toll charge method, which in many cases will prove to be more attractive, and also establishes a dollar cap that limits the amount of the toll charge regardless of whether the traditional or alternative toll charge methodology is used.

The alternative toll charge is based on the degree of nondiversification and has been referred to colloquially as the "100% of the error" toll charge. This reference derives from the fact that the alternative toll charge equals "100 percent of the amount by which the [segregated asset] account's interest in a single investment exceeded the applicable limitation" of the diversification regulations.[21] For example, assume that the total value of a segregated asset account is $100. It could invest up to $55 in a single asset without exceeding the

55 percent limit of Treas. Reg. § 1.817-5(b)(1)(i)(A). Under these facts, if the diversification error resulted from a $56 investment in a single asset, the alternative toll charge would equal $1, *i.e.*, the excess of the actual investment over the permitted investment. Likewise, if the error resulted from a $56 investment in asset #1 and a $16 investment in asset #2, so that the combination of the two investments exceeded the 70 percent limit of Treas. Reg. § 1.817-5(b)(1)(i)(B) by $2, the toll charge would equal such $2 excess.

The alternative toll charge is determined as of the 30th day after the end of the calendar quarter of nondiversification. In response to public comments on an earlier draft of Rev. Proc. 2008-41, the procedure clarifies that if the nondiversification spans multiple calendar quarters the alternative toll charge is based on the quarter that produces the highest amount. This avoids a duplicative calculation that counts the same error more than once. In another departure from Rev. Proc. 92-25, deficiency interest is not required under the alternative toll charge, presumably because it is not a proxy for the tax the policyholders would owe if treated as having received the income on the affected contracts.

Both the traditional Rev. Proc. 92-25 Toll Charge and the new alternative toll charge are subject to a dollar cap under Rev. Proc. 2008-41. Specifically, the amount that an issuer is required to pay to correct a diversification failure is capped at the lesser of $5 million or 5 percent of the total value of the nondiversified segregated asset account.[22] Like the alternative toll charge, the dollar cap is determined as of the 30th day following the end of the calendar quarter and is based on the calendar quarter that produces the highest amount if the failure spans multiple quarters. The cap is not increased by deficiency interest, but if the error affects multiple segregated asset accounts the cap is determined separately for each account.

The dollar cap is a positive development in that it addresses one of the main criticisms of Rev. Proc. 92-25, namely, that the prior procedure could produce extremely large toll charges even for relatively minor diversification failures. Placing an upper limit on the toll charge, even at a $5 million level, is an improvement, especially when combined with the alternative toll charge methodology summarized above. However, the alternative toll charge does little to provide relief for inadvertent diversification failures that are caused by a loss of a Look-Through Entity's status as such.

As described above, the diversification regulations provide that a segregated asset account is treated as directly holding a Look-Through Entity's assets rather than holding shares of the Look-Through Entity. Most retail variable contracts are structured so that a segregated asset account invests exclusively in shares of a single Look-Through Entity, making this look-through treatment critical to a contract's compliance with the diversification rules. If the Look-Through Entity inadvertently loses its status as such (*e.g.*, by offering shares to a person who is not permitted to hold them),[23] the segregated asset account is treated as holding only a single investment (shares of the Look-Through Entity). In such case, the alternative toll charge seemingly would equal 45 percent of the total value of the Look-Through Entity's assets. The alternative toll charge would always exceed the "lesser of 5 percent or $5 million" cap, making the alternative toll charge meaningless in these cases. The insurance industry has asked the Service and the Treasury Department for published guidance that would prevent diversification failures in such circumstances if the issuer followed appropriate procedures to ensure that only permitted investors hold interests in a Look-Through Entity.[24] While they have not issued such guidance to date, the Service and Treasury Department recently indicated that they might consider doing so in the future.[25]

The cap is not increased by deficiency interest, but if the error affects multiple segregated asset accounts the cap is determined separately for each account.

V. Conclusion

Like the other insurance product remediation procedures issued in 2008, Rev. Proc. 2008-41 is a considerable improvement on the prior correction procedure. Most importantly, the alternative toll charge and dollar cap should make it easier and less costly for insurers to remediate the adverse consequences of inadvertent diversification failures.

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End Notes

1 A pension plan contract is defined in Code section 818(a).

2 Treas. Reg. § 1.817-5(b)(1)(i).

3 Treas. Reg. § 1.817-5(b)(1)(ii). Treas. Reg. § 1.817-5(b)(1)(ii) also provides that all interests in the same real property project and all interests in the same commodity are each treated as a single investment. Treas. Reg. § 1.817-5(h)(1) defines the term government security as "any security issued or guaranteed or insured by the United States or an instrumentality of the United States; or any certificate of deposit for any of the foregoing."

4 Treas. Reg. § 1.817-5(f). The other investors that are permitted to hold interests in a Look-Through Entity include life insurance company general accounts, investment managers, and trustees of qualified pension or retirement plans. Such interests are subject to certain requirements. *See* Treas. Reg. § 1.817-5(f)(3).

5 Code section 817(h)(3); Treas. Reg. § 1.817-5(b)(3). For purposes of this special rule for variable life insurance contracts. the term Treasury security is defined as "a security the direct obligor of which is the United States Treasury," which excludes instruments such as options on Treasury securities. Treas. Reg. § 1.817-5(h)(2).

6 A segregated asset account is defined in Treas. Reg. § 1.817-5(e) in somewhat oblique terms. As a practical matter, under the typical variable contract each investment option will constitute a segregated asset account within the meaning of this definition.

7 *See* Treas. Reg. § 1.817-5(a)(1). "Income on the contract" is computed using the rules of Code section 7702(g) and (h), appli cable to life insurance contracts that do not comply with the Code section 7702 definition of a life insurance contract. *Id.*

8 Treas. Reg. § 1.817-5(a)(2).

9 *See* Treas. Reg. § 1.817-5(a)(2)(iii) prior to amendment by T.D. 9385, 2008-15 I.R.B. 735.

10 The proxy tax rates were 20% for annuity contracts "from which payments have not been made as of the end of the period," 15% for annuity contracts "from which payments have been made as of the end of the period," and 28% for life insurance contracts.

11 *See supra* note 5 and accompanying text.

12 The proxy tax rates were 3.5%, 2.5%, or 1.5%, depending on the degree of over-investment in Treasury securities. Thus, the rates were significantly lower than the 20% and 15% proxy tax rates for annuities under Rev. Proc. 92-25.

13 Letter from Joseph F. McKeever, III, and Bryan W. Keene, on behalf of the Committee of Annuity Insurers, to the Internal Revenue Service (June 12, 2007).

14 Diversification Requirements for Variable Annuity, Endowment, and Life Insurance Contracts, 72 Fed. Reg. 41,651 (July 31, 2007).

15 *Id.* at 41,652.

16 T.D. 9385, 2008-15 I.R.B. 735.

17 Treas. Reg. § 1.817-5(a)(2)(i) and Rev. Proc. 2008-41, §§ 3, 4.01(2).

18 Rev. Proc. 2008-41, § 3.

19 Rev. Proc. 2008-41, § 4.01.

20 Rev. Proc. 2008-41, § 4.06. The representations must be executed under penalties of perjury by an appropriate party. *Id.* It is unclear whether the Service contemplates a separate, signed document making the representations, or whether incorporation of the representations into the request for ruling, which must under standard procedures be accompanied by an executed penalties of perjury statement, will suffice.

21 Rev. Proc. 2008-41, § 4.03(3).

22 Rev. Proc. 2008-41, § 4.03(4).

23 *See supra* note 4.

24 The Service has issued private guidance to this effect. *See, e.g.*, PLR 200730005 (April 27, 2007).

25 *See* T.D. 9385, 2008-15 I.R.B. 735, 737.

Automatic Waivers and Other Waivers Under New IRC § 7702 and § 101(f) Correction Procedures

by Stephen P. Dicke

On June 30, 2008 the Internal Revenue Service (the "Service") and the Treasury Department (the "Treasury") issued Rev. Proc. 2008-42 to allow insurers to obtain automatic waivers for certain types of life insurance policy disqualifications under IRC § 7702(f)(8) or § 101(f)(3)(H), without having to file a request to the Service for such a waiver. As indicated below, Rev. Proc. 2008-42 basically provides a definitional description of eligible errors for such automatic waivers, and merely requires that the insurer file an "Automatic Waiver Request" for such a waiver with both its federal income tax return and the IRS National Office Insurance Branch (Insurance Branch). The pre-existing waiver procedures continue to be available as an alternative for an insurer, and they allow it to request a private letter ruling (PLR) from the Service to formally approve a waiver under IRC § 7702(f)(8) or § 101(f)(3)(H), *e.g.*, where the insurer's reasons for failure are ineligible for an automatic waiver under Rev. Proc. 2008-42, or where the insurer is uncertain whether the failure is eligible for any automatic (or nonautomatic) waiver.

Pre-existing Waiver Procedures

Prior to the issuance of Rev. Proc. 2008-42, an insurer always had to request a PLR from the Service, in order to obtain a waiver under either IRC § 7702(f)(8) or § 101(f)(3)(H). Such a PLR request could be both expensive and time-consuming, and insurers and the Insurance Branch often had doubts whether these waiver procedures were worth it.

The advantage to an insurer of obtaining such a waiver was generally that it would allow the insurer to correct a failed life policy retroactively to its date of failure, without having to pay the Service any "toll charge" for a closing agreement to make such a retroactive correction. Generally, the Insurance Branch required that such a toll charge be roughly equal to the federal income tax that the policyholder would have had to pay to the Service for such a failed policy under IRC § 7702(g) (*i.e.*, a proxy tax). Under IRC § 7702(f)(8) and § 101(f)(3)(H), the Service had broad discretion to waive any policy's disqualification under IRC § 7702 or § 101(f) due to reasonable error. The Insurance Branch generally exercised this discretion by determining when it would be appropriate to waive such a toll charge for

the insurer, in order for it to obtain the retroactive correction of the failed policies.

However, in exercising this discretion, the Insurance Branch not only required an insurer to file a PLR request and pay the full filing fee for such a request (currently $11,500), but also frequently required the insurer to submit detailed factual descriptions and representations concerning the reasons for failure. The Insurance Branch then carefully reviewed such submissions, and frequently asked follow-up questions, requiring further detailed answers and submissions. In the end, the Insurance Branch often found grounds to refuse such a waiver, and this would leave the insurer with no recourse but to seek a closing agreement—and pay the full toll charge anyway—to obtain the necessary retroactive corrections of the failed policies.

In addition, over time the waivers actually granted by the Insurance Branch tended to fall into certain broad categories, *e.g.*, human errors where the insurer's personnel failed to follow appropriate (and verified) testing or other compliance procedures, or where they made certain types of computer programming errors. On the other hand, any failures due to any flaw in the insurer's computer monitoring system (even if it were attributable to an outside vendor), or in any of the insurer's other monitoring or correction procedures, were generally ineligible for any waiver.

As a result, the industry began clamoring for less expensive and time-consuming procedures for such waivers,

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and the Insurance Branch, in turn, began considering how it could make such procedures simpler and more efficient for its own personnel. This led to the automatic waiver procedures for certain eligible categories of failures in Rev. Proc. 2008-42.

Automatic Waiver Procedures under Rev. Proc. 2008-42

Rev. Proc. 2008-42 not only simplified the waiver procedures for certain specified categories of "eligible reasonable errors" (described below), but it also expanded their availability beyond the current insurer to include any reinsurer, by defining the term "issuer" to cover any company that insures a contract holder under a contract originally issued by another company.

Eligible Reasonable Errors

Rev. Proc. 2008-42 expressly provides for an automatic waiver for any failure to satisfy IRC § 7702 or § 101(f) due to an eligible reasonable error, provided that reasonable steps are taken to remedy such error. An eligible reasonable error is defined to exist if (1) the insurer has compliance procedures with specific, clearly articulated provisions that, if followed, would have prevented the contract from failing to satisfy the requirements of IRC § 7702 or § 101(f); (2) an employee or independent contractor of the insurer acted, or failed to act, in accordance with these compliance procedures; and (3) such act or failure to act was inadvertent, and was the sole reason that the contract failed to satisfy these requirements. Specific examples of these eligible errors included an employee's incorrect recording of the age or gender of the insured, or of the incorrect amount or time of payment of a premium payment.

Rev. Proc. 2008-42 also specified certain "noneligible errors" that could not qualify for an automatic waiver, such as a defective legal interpretation or a computer programming error. Nevertheless, Rev. Proc. 2008-42 pointed out that any such noneligible error might qualify for a waiver through the pre-existing PLR request procedures, or for the new simplified closing agreement procedures for IRC § 7702 or § 101(f) corrections, which were provided in the companion Rev. Proc. 2008-40.

Procedural Requirements for Automatic Waivers

As indicated above, to obtain the automatic waiver for an eligible reasonable error under Rev. Proc. 2008-42, the insurer need only (1) take reasonable steps to remedy such error, and (2) file a statement with its federal income tax return and with the Insurance Branch entitled "Automatic Waiver Request under Rev. Proc. 2008-42" (Waiver Statement).

For the reasonable steps to remedy, Rev. Proc. 2008-42 provides that this requirement is satisfied if the insurer refunds excess premium with interest and/or increases the death benefit on the contract, no later than the date on which the insurer files its federal income tax return to which the Waiver Statement is attached. The Revenue Procedure makes clear that such a remedy does not include changes to the insurer's compliance procedures, because the definition of an eligible reasonable error requires that the insurer already have specific, clearly articulated procedures that, if followed, would have prevented such error.

For the Waiver Statement, the insurer must (1) provide a brief description of the error and the steps taken to remedy the error; (2) list the policy numbers of the contracts for which it seeks an automatic waiver; and (3) provide representations to the effect that the insurer is within the scope of Rev. Proc. 2008-42 (Section 3) and is otherwise entitled to the automatic waiver. Such representations must be executed under penalties of perjury by an appropriate party described in Section 4.04 of the Revenue Procedure, and the insurer must retain documentation available for audit to support these representations.

The insurer must attach this Waiver Statement to a timely-filed federal income tax return for the taxable year during which the insurer relies upon Rev. Proc. 2008-42 for such waiver. This return also must contain an additional statement that refers to this Waiver Statement and that is spelled out in Section 4.03 of the Revenue Procedure. In addition, this Waiver Statement must be signed and dated and filed with the IRS National Office, at the address specified in Rev. Proc. 2008-42, no later than the date such tax return is filed. Acceptable electronic filings of this Waiver Statement are also provided by Rev. Proc. 2008-42 in Sections 4.03 and 4.05.

While questions undoubtedly will arise as to the scope of the eligible errors for automatic waivers, the Service and the Treasury are to be commended greatly for simplifying their waiver procedures, and for providing cost-efficient automatic waivers for these eligible errors.

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