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

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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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