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

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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.*,

continued 26

from pg. 25

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

continued 28

from pg. 27

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 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.

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.

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,

continued 30

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.

continued 32

from pg. 31

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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