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

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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

continued 16

from pg. 15

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

continued 18

from pg. 17

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

continued 20

from pg. 19

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.

continued 22

from pg. 21

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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