Special Reports

Rev. Proc. 99-27: Some Relief for the Heartburn of Inadvertent MECs

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Introduction

Since shortly after Congress enacted IRC section 7702A and created modified endowment contracts (MECs),[1] there has been widespread recognition of the need for the Internal Revenue Service (the Service) to create a procedure to restore to non-MEC status those life insurance contracts which inadvertently become MECs. The owner of a life insurance contract that is classified as a MEC as a result of failing the 7-pay test of IRC section 7702A(a) is burdened with significantly less advantageous income tax treatment than if the contract were not a MEC. Loans from a MEC are treated as distributions and distributions from a MEC are taxed on an income first basis.[2] In addition, a contract holder who receives distributions from a MEC before reaching age 59½ generally must pay an additional 10 percent penalty tax.[3]

It is relatively easy for a life insurance contract inadvertently to become a MEC. IRC section 7702A is a complex statute requiring compliance with myriad rules, the interpretation of many of which is highly uncertain.[4] Certainly in the first few years after enactment, life insurance company administration systems were in many cases simply not able to cope with these rules. As a result, many life insurance contracts which neither the owner nor the insurer intended to be MECs nonetheless have that status. Hitherto, the only relatively certain means of ending the MEC status of a contract has been to surrender the contract and reissue it.[5] This "cure," however, is unattractive in many situations.[6]

In view of these problems, in December, 1995, the American Council of Life Insurance (ACLI) formally requested the Service to establish a procedure for restoring inadvertent MECs to non-MEC status. Issuance of this guidance has been on the IRS-Treasury Business Plan every year since 1996. During this period, the Service and the Treasury Department held numerous meetings with — and received numerous submissions from — the ACLI, individual life insurance companies, and private practitioners. Officials and industry representatives discussed a variety of issues, ranging from the appropriate "toll charge" to be paid for the relief to what contracts should be eligible for the relief. Finally, on May 18, 1999, the Service issued Rev. Proc. 99-27, 1999-23 I.R.B. 7.

Rev. Proc. 99-27 "provides the procedures by which an issuer may remedy an inadvertent non-egregious failure to comply with" IRC section 7702A.[7] More specifically, the revenue procedure describes the terms under which the Service will enter into closing agreements with life insurance companies pursuant to which the contracts identified in the closing agreement will not be treated as MECs. In general terms, the closing agreements described in the revenue procedure require the issuer —

> (1) to pay a sum of money to the Service determined by reference to
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> > (a) the amount of tax owed on distributions previously made from the MEC, and
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> > (b) a tax on the earnings on the amounts by which the 7-pay test limits were exceeded;

[1] Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, section 5012(c)(1).

[2] IRC section 72(e)(10).

[3] IRC section 72(v).

[4] *See*, *e.g.*, IRC section 7702A(c)(3)(B)(i) (the "necessary premium" rule). See generally Joseph F. McKeever, III & Kirk Van Brunt, "Life Insurance Contracts After TAMRA: More Questions than Answers," Vol. 3, No. 4 *The Insurance Tax Review*, 285 (1989).

[5] A number of life insurers have requested the Service in recent years to enter into closing agreements under which inadvertent MECs would be restored to non-MEC status, but the Service has been unwilling to do so, absent a formal revenue procedure.

[6] Among other reasons, the policyholder's underwriting status might have changed since the policy was originally issued.

[7] Section 1. (Except as otherwise indicated, all section references are to sections of Rev. Proc. 99-27.) [*Editor's note:* for the text of Rev. Proc. 99-27, see *The Insurance Tax Review, June 1999, p. 1083; Doc 1999-17876 (29 original pages)*; or *1999 TNT 96-8*.]

(2) not to increase the contract owner's investment in the contract by the amount paid to the Service; and

(3) to bring the contracts back into compliance with the 7-pay test limits.

In return, the Service agrees —

(1) to treat the contracts as satisfying IRC section 7702A from the date of issuance through the date of the closing agreement (or, if later, the date of any necessary corrective actions);

(2) to waive any civil penalties potentially applicable due to the failure of the insurer to comply with the reporting, withholding, and deposit requirements for income distributed under the contracts; and

(3) not to treat any portion of the amount paid by the insurer as income to the contract owners.[8]

This article reviews the key provisions of the long-awaited revenue procedure, focusing on the relief provided, the costs and burdens of obtaining that relief, and the circumstances in which relief will not be available under the revenue procedure.

I. Limits to the Relief: Correction Period and Eligible Contracts

A. Effective Date and Expiration Date

Rev. Proc. 99-27 is effective May 18, 1999, the date the revenue procedure was released by the Service. To the surprise of some, the relief mechanism established by the procedure is temporary. Section 8 of the revenue procedure states that it "is available only for requests for relief that are received on or before May 31, 2001." In other words, the revenue procedure by its terms is available only for about two years.

Neither the Service nor the Treasury Department has publicly explained why the revenue procedure expires in May, 2001. Certainly, there is no particular reason to expect that the phenomenon of inadvertent MECs will have disappeared by that date. To the contrary, one would expect some life contracts inadvertently will become MECs on an ongoing basis, just as life insurance contracts periodically fail the IRC section 7702 definition of life insurance and funds that support variable contracts occasionally fail the IRC section 817(h) diversification regulations. With respect to the latter two situations, the Service has provided ongoing relief through the IRC section 7702 closing agreement program first announced in Rev. Rul. 91-17[9] and the IRC section 817(h) closing agreement program established by Rev. Proc. 92-25.[10]

[8]Section 6.

[9]1991-1 C.B. 190. It is interesting to note that Rev. Rul. 91-17 stated that the Service would enter into closing agreements submitted before June 3, 1991. However, the Service has continued to enter into closing agreements pursuant to Rev. Rul. 91-17.

[10]1992-1 C.B. 741. Revision of Rev. Proc. 92-25 is on the 1999 IRS-Treasury Business Plan.

On the other hand, Rev. Proc. 99-27 does establish a new program, the benefits and burdens of which are difficult for the Service to predict until it has had experience with actual filings. Similar programs that provide correction procedures for qualified plans have often been established on a temporary basis and then extended and modified as the Service and those using the programs have learned from their experiences.[11] In view of the continuing need for the type of relief offered by Rev. Proc. 99-27, it is reasonable to believe that the Service will extend the program. And, by the time Rev. Proc. 99-27 is set to expire in the spring of 2001, life insurance companies and the Service will have had sufficient experience with the program to identify changes that would improve the MEC correction process. Meanwhile, given the stated expiration date, insurance companies should plan on filing requests under the revenue procedure prior to May 31, 2001.[12]

B. One Bite at the Apple

A critical aspect of Rev. Proc. 99-27 is that as a general rule an "issuer" can use the revenue procedure *only* once.[13] Section 4.02(3) states that — except as provided in that section — the issuer of a contract cannot use the revenue procedure "[if] the issuer previously entered into a closing agreement to remedy a failure of any contract to comply with the requirements of section 7702A." The revenue procedure does not define the term "issuer," but presumably the term refers to the company that is contractually obligated to provide the contract's benefits to the policyholder and beneficiaries. Thus, for example, since the revenue procedure does not contain any type of affiliated company limitation, the ability of a life company in an affiliated group to use the revenue procedure generally would not be affected by whether another company in the group had already used the procedure.

> ***Given the stated expiration date, insurance companies should plan on filing requests under the revenue procedure prior to May 31, 2001.***

An exception to this "one bite at the apple" rule provides that the Service in its sole discretion may waive this limitation "[u]pon an application by the issuer setting forth un-

[11]*See, e.g.*, Rev. Proc. 92-89, 1992-2 C.B. 498 (establishing the Voluntary Compliance Resolution (VCR) program on a temporary basis through December 31, 1993); Rev. Proc. 93-36, 1993-2 C.B. 474 (expanding and extending the VCR program through December 31, 1994); Rev. Proc. 94-62, 1994-2 C.B. 778 (expanding the VCR program further and extending it indefinitely); Rev. Proc. 96-29, 1996-1 C.B. 693 (modifying eligibility standards for the VCR program); and Rev. Proc. 98-22, 1998-12 I.R.B. 11 (modifying and consolidating several correction programs, including the VCR program, into a coordinated Employee Plans Compliance Resolution System ("EPCRS").

[12]As discussed elsewhere in this article, there are a number of reasons why a company may be better served by filing near the expiration date of the procedure rather than earlier.

[13]Section 4.02(3).

usual or special facts and circumstances."[14] The revenue procedure provides illustrations of what would and would not constitute "unusual or special facts and circumstances." Thus, it states that the Service will *not* waive the limitation if a subsequent request to enter into a closing agreement involves "the same or similar failures to comply with the requirements of section 7702A that were identified in a previous closing agreement."[15]

On the other hand, the Service may waive the limitation if, after entering into a closing agreement under the revenue procedure, the issuer discovers that it inadvertently failed to identify "legal and factual assumptions not described in [the] first submission, which would cause the same and additional contracts to fail. . . ."[16] Such a situation might occur when an issuer identifies certain contracts as inadvertent MECs due to the failure of its administrative system to properly calculate the 7-pay limit, enters into a closing agreement under the revenue procedure, and then subsequently discovers that employees failed in some cases to return premiums in excess of the 7-pay limit within 60 days of the end of the contract year.[17] One can envision the possibility of metaphysical debates with the Service over whether the same factual and legal assumptions are involved. Companies and their advisors would certainly be wise to state the assumptions as precisely and narrowly as possible in their initial submissions.

The "one bite" rule also may be waived if, after entering into a closing agreement "for all of its contracts eligible for relief under [the] revenue procedure," the issuer subsequently "acquired a company" that had issued inadvertent MECs and that had not requested a closing agreement for its inadvertent MECs.[18] In this situation, the issuer is allowed to request a closing agreement under the revenue procedure for the acquired company's contracts that are otherwise eligible for relief. This exception presumably is intended to provide relief when the acquired company's contracts have been transferred through assumption reinsurance or a merger to the acquiring company. Otherwise, the acquired company — not the acquiring company — would appear to be the "issuer" of the contracts and thus not subject to the limitation on the acquiring company. Thus, for example, if issuer A which has previously used the revenue procedure purchases all the stock of issuer B which has not used the revenue procedure, issuer B should be able to file a request (without regard to the limitation). On the other hand, if issuer A merged with issuer B and after the merger wished to file a request for contracts originally issued by B, A should be able to file the request under the exception to the limitation.[19]

The "one bite" rule will create a variety of difficulties for companies. First, because companies cannot be confident that they will be able to correct inadvertent MECs discovered (or created) after entering into one closing agreement, they may wish to wait until May, 2001, to file a request for relief under the revenue procedure. Second, many companies have more than one administrative system for their life contracts and thus more than one system testing contracts for compliance with IRC section 7702A. It is not uncommon, for example, for a company to use system X to administer its variable life contracts, system Y to administer its universal life contracts, and system Z to administer its traditional contracts. Similarly, many large insurance fleets have multiple business units and divisions within one life insurance company which are separately issuing and administering a variety of life insurance contracts. In these situations, companies will have to carefully coordinate among the divisions and units before using the revenue procedure, and the result may again be to delay a filing until some time closer to the May, 2001 deadline.

Given the undesirable consequences of generally limiting issuers to one closing agreement under the revenue procedure, it is to be hoped that the Service will either modify this limitation or liberally construe the exceptions to it.

C. Certain MECs Ineligible for Relief

Rev. Proc. 99-27 is intended to provide a remedy only for "inadvertent non-egregious failures to comply with the MEC rules."[20] As a result, not all MECs are eligible for relief under Rev. Proc. 99-27. As discussed below, section 4.02 of the revenue procedure describes three categories of contracts to which the revenue procedure does not apply: (1) certain MECs that are owned by a business; (2) MECs caused by erroneous interpretations that were part of a program to sell investment-oriented contracts; and (3) MECs caused by violating a clear rule where there is a significant increase in the investment orientation of the contract. In addition, the revenue procedure provides three "examples" of contracts that are ineligible for relief.[21] As we discuss below, however, those examples appear to identify what are arguably three additional categories of contracts that are ineligible for relief.

[14] *Id.*

[15] *Id.*

[16] Section 4.02(3)(b).

[17] *See* IRC section 7702A(e)(1)(B).

[18] Section 4.02(3)(a).

[19] It should be emphasized that this exception only applies in the case of an acquisition of "a company." In the case of an acquisition of a block of inadvertent MECs from a company that will remain in operation, if the purchaser has previously entered into a closing agreement, it is unclear in what situations the purchaser will be able to show "unusual or special facts and circumstances" with respect to the acquired MECs, particularly if the acquired MECs involve the same or similar type of IRC section 7702A failure that was involved in the purchaser's prior closing agreement. This will put somewhat of a premium on acquirers undertaking adequate MEC due diligence. Finally, it is unclear how this exception would apply in the case of insolvency situations, where the issuer's entire business is disposed of to multiple purchasers, but no one purchaser can be said to have "acquired" the issuer.

[20] Section 2.03. *See also* section 1.

[21] Section 4.03.

1. COLI MECs

Section 4.02(1) of Rev. Proc. 99-27 states that the revenue procedure is not applicable to a MEC if

> the contract insures the life of any individual (other than a "key person" as defined in section 264(e)(3)) who is or was —
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> (a) an officer, director, or employee of, or
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> (b) financially interested in,
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> any trade or business carried on by the contract holder.

Section 5.01(13)(a) of the revenue procedure requires the issuer to represent under penalties of perjury that no such contracts are included in the request for relief.

This exclusion for COLI MECs may have arisen out of the Service's concern that the revenue procedure could be used, absent the exclusion, by issuers of inadvertent MECs involved in the pending leveraged COLI litigation against the Service. Indeed, whether a contract fits the characteristics of the COLI exclusion would typically be pertinent only to a determination of whether interest expense of the taxpayer-owner of the contract was deductible despite the limitations of IRC section 264. As a result, information as to whether a contract is described in this section may not be noted in the issuer's computer files for the contracts and in some circumstances may not be available in the issuer's records at all. For example, in the case of a contract owned by a sole proprietor which insures an employee, it is not certain that the issuer would be able to distinguish such a contract from any other contract owned by an individual and insuring an individual other than the owner.

It is also noteworthy that the exclusion for COLI MECs by its terms applies to endorsement split-dollar arrangements, but not to collateral assignment split-dollar arrangements. This follows from the fact that endorsement split-dollar contracts are owned by businesses, whereas collateral assignment contracts are owned by the employees that benefit from the split-dollar arrangements.[22]

2. 'Investment Program' MECs and 'Clear Rule' MECs

Section 4.02(2) of Rev. Proc. 99-27 states that the revenue procedure is not applicable to a MEC if the contract's MEC status resulted from a failure to comply with the requirements of IRC section 7702A that

> (a) [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
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> (b) 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. . . .

By their terms, these two exclusions would appear to be aimed at MECs resulting from intentional acts and gross negligence, respectively. That is to say, the first exclusion seems to contemplate that the issuer knowingly set out to sell investment-oriented contracts and should be required to live with the consequences of such conduct by not being allowed to restore the resulting MECs to non-MEC status. The second exclusion, on the other hand, focuses on whether the error was reasonable (*i.e.*, it applies only if the violated rule was "clear") and the effect of the violation (*i.e.*, it applies only if the error caused a "significant" increase in the contract's investment orientation).

"Examples" of these exclusions are set forth in section 4.03 of the revenue procedure. Section 4.03 states that

> [p]ursuant to section 4.02(2) . . . this revenue procedure does not apply to a MEC if —
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> (1) the contract provides for paid-up future benefits after the payment of less than 7 level annual premiums,
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> (2) the amount paid under the contract in any contract year of the testing period exceeds 300 percent of the 7-pay premium for the contract year, or
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> (3) the cash surrender value of the contract (within the meaning of section 7702(f)(2)(A)) exceeded (or was illustrated or projected to exceed) the contract holder's investment in the contract (as defined in section 72(e)(6)) within 3 years after the issuance of the contract and the assumed 7-pay premium for the contract was more than 150 percent of the correct 7-pay premium for the contract.

Normally, an example applies the principles set forth in a rule to a particular set of facts so as to illustrate the manner in which a rule operates. The "examples" of MECs which are excluded from the revenue procedure do not function in this manner. The "examples" do not even indicate which of the two exclusions in section 4.02(2) are being illustrated. Thus, example 2 excludes a MEC from the revenue procedure based solely on the relationship of the amount paid for the contract in a contract year to the 7-pay premium for the contract year. This exclusion appears to apply irrespective of whether the contract's MEC status resulted from an error that was a significant feature of a program to sell investment oriented contracts or from an error involving the violation of a clear statutory rule.

As a result, rather than illustrating the application of the rules set forth in section 4.02(2), the "examples" in section

[22] *See* Rev. Rul. 64-328, 1964-2 C.B. 11.

4.03 may be better thought of as setting forth three additional and specific exclusions from the revenue procedure. Indeed, it is possible that the three examples in section 4.03 will have greater practical importance than the general exclusionary rules set forth in section 4.02(2). In the case of the examples, issuers will be required to make a representation that none of the MECs for which relief is requested match the facts of any of the three examples.[23] Thus, the "examples" could operate as an absolute bar to relief for MECs with those characteristics.[24] In contrast, identifying contracts that fit within the general exclusionary rules of section 4.02(2)(a) and (b) will be difficult in many instances; but the burden will largely fall on the Service, rather than the issuer, as no representations are required from the issuer with respect to the general exclusionary rules. For example, even though issuers will provide information about the reasons for a MEC's noncompliance,[25] if the Service wishes to judge the applicability of the general exclusionary rules to a MEC, it will have to somehow assess whether the error(s) were "a significant feature of a program to sell investment oriented contracts" or resulted "in a significant increase in the investment orientation of a contract."

> ***The 'examples' in section 4.03 may be better thought of as setting forth three additional and specific exclusions from the revenue procedure. Indeed, it is possible that the three examples in section 4.03 will have greater practical importance than the general exclusionary rules set forth in section 4.02(2).***

To summarize, at this time there appear to be four "bright line" tests and two "facts and circumstances" tests that will foreclose relief:

Bright Line Bar

1. Contracts that insure the life of an individual (other than a key person) who is or was an officer, director, or employee of, or financially interested in, a trade or business of the owner.

2. Contracts that provide for paid-up future benefits after the payment of less than 7 level annual premiums.

3. Contracts where the amount paid in a contract year was more than three times greater than the 7-pay premium for the year.

4. Contracts where (a) the assumed 7-pay premium exceeded 150 percent of the correct 7-pay premium, *and* (b) the cash surrender value exceeded (or was illustrated to exceed) the investment in the contract within three years of issuance.

Facts and Circumstances Bar

1. MECs caused by one or more erroneous interpretations or positions that were a significant feature of a program to sell investment-oriented contracts.

2. MECs caused by noncompliance with a provision that is clear on its face and the failure resulted in a significant increase in the investment orientation of the contract.

One final comment about the scope of Rev. Proc. 99-27 should be made. The guidance does not state that it is the *exclusive* means by which the Service will restore an inadvertent MEC to non-MEC status. To the contrary, as discussed above, the revenue procedure states that it provides procedures for those situations which the Service views as "inadvertent non-egregious failures."[26] As a result, the Service may (and in our view should) be willing to enter into closing agreements restoring to non-MEC status contracts that are excluded from the relief provided by Rev. Proc. 99-27, albeit on terms which may differ from those of the revenue procedure.

II. Computing the Toll Charge

A. Overview

Under Rev. Proc. 99-27, an "amount required to be paid" must be separately calculated for each contract included in the closing agreement.[27] As described in section 5.04, this toll charge generally consists of the sum of three amounts:

(1) the income tax (and any applicable IRC section 72(v) penalty tax) on amounts previously received or deemed to be received from the MEC;[28]

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[23]Section 5.01(13)(b)-(d).

[24]This would be an unfortunate result, because it is not difficult to envision circumstances in which MECs would fit the characteristics of the examples but would not have resulted from either the intent of the issuer to sell such contracts or from gross negligence. For example, an employee responsible for returning "excess" premiums within 60 days of the end of the contract year may have inadvertently failed to return a premium that exceeded 300 percent of the 7-pay premium for the year. Such errors in the administration of IRC section 7702 are routinely waived by the Service. *See, e.g.,* LTR 9834020 (May 22, 1998) and LTR 199911010 (Dec. 8, 1998). [*Editor's note:* For the text of LTR 9834020, see *The Insurance Tax Review,* Oct. 1998, p. 561; *Doc 98-26240 (4 pages)*; or *98 TNT 163-46.* For the text of LTR 199911010, see *The Insurance Tax Review,* May 1999, p. 975; *Doc 1999-10590 (6 original pages)*; or *1999 TNT 54-58.*]

[25]This is required by section 5.01(8).

[26]Section 1.

[27]Section 3.13 states —

> *Aggregation of contracts.* All MECs issued by the same issuer to the same contract holder during any calendar year are treated as one MEC.

This rule is not amplified or discussed in the revenue procedure and its scope is uncertain. It may, for example, require the "toll charge" for contracts to be computed on a combined basis which would affect, among other things, the "applicable percentage," *i.e.*, the tax rate, to be used.

[28]Section 5.04(1)(a).

(2) deficiency interest on the amounts determined under (1);[29] and

(3) an amount determined by reference to the deemed earnings on the premiums paid under the MEC in excess of the 7-pay limit, adjusted for the likelihood of distributions under the contract.[30]

In the case of certain contracts with *de minimis* earnings on the premiums paid in excess of the 7-pay limit, the toll charge for the contract is determined without regard to the first two amounts, *i.e.*, excluding the income tax and deficiency interest that would be owed on prior distributions under the contract. Specifically, if the "overage earnings" (discussed below) of a contract issued before January 1, 1999, do not exceed $75, then the toll charge is measured solely by reference to the overage earnings.[31]

Each component of the total toll charge is discussed in detail below.

B. Tax on Prior Distributions

Some MECs for which relief is requested under Rev. Proc. 99-27 may have had actual or deemed distributions that the issuer did not properly report to the owner and with respect to which the owner therefore did not pay the appropriate amount of income tax.[32] The first part of the toll charge appears to be designed to enable the Service to recover these amounts. It requires the issuer first to identify all amounts received or deemed received (other than "reported amounts") under the MEC during the period beginning on the date two years before the contract first became a MEC and ending on the date of the closing agreement.[33]

The "reported amount" for a contract is defined as (1) the amount that the issuer reported (on a timely filed information return) as includible in the contract owner's gross income, or (2) the amount the contract holder included in gross income on a timely filed tax return.[34]

In the case of information returns that were not filed in a timely manner but were filed prior to April 15 of the year following the year in which the distribution occurred and reported the correct amount of income, insurers might still be able to treat the amounts as "reported amounts" on the basis that contract holders would have likely included the reported amounts on a timely filed tax return. The request for a closing agreement must include a variety of information with respect to these distributions, including the amount of gross income reported to the policyholder and the Service on a timely filed information return.[35] Interestingly, the requested information does not include amounts that the contract owner actually included in gross income, only amounts that were reported on a timely filed return. Presumably an issuer that wished to treat amounts that were not timely reported as "reported amounts" would need to furnish data in support of its position.

After the net amount received (amounts received or deemed received net of reported amounts) is determined for a contract during the relevant period, it is multiplied by the "applicable percentage" for the contract (discussed below in section D 3).[36] Added to this amount, if applicable, is the 10 percent penalty tax under IRC section 72(v).[37]

C. Deficiency Interest on Tax on Prior Distributions

The second element of the toll charge consists of any deficiency interest owed on the amount of tax determined to be due on the prior distributions. The interest rate used is that of IRC section 6621(a)(2) (the federal short term rate plus 3 percentage points).[38] This is the rate applicable to the underpayments of individual taxpayers, as opposed to large corporate underpayments. Interest is computed as if the amounts of tax due on the prior distributions were underpayments by the contract holder for the tax year or years in which the distributions occurred. Thus, interest runs from April 15 of the year following the year in which the distribution occurred. Rev. Proc. 99-27 does not specify through what date the deficiency interest must be computed.[39]

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[29]Section 5.04(1)(b).

[30]Section 5.04(1)(c).

[31]Section 5.04(2).

[32]In some cases, no distribution may have been reported, *e.g.*, a loan under a contract which the issuer did not realize was a MEC, while in other cases an incorrect amount may have been reported, *e.g.*, a partial surrender under such a contract which was reported on a cost-recovery rather than an income-first basis.

[33]This period follows the rule in IRC section 7702A(d) which identifies the distributions affected by a contract's MEC status.

[34]Section 3.12.

[35]*See* section 5.01(11).

[36]Section 5.04(1)(a).

[37]As mentioned previously, section 5.01(11) requires that a variety of information with respect to distributions be set out in the closing agreement request. Included in this information are (1) the date on which the contract holder attained age 59½, (2) whether the distribution is attributable to the contract holder becoming disabled, and (3) whether the distribution is part of a series of substantially equally periodic payments made for the life or life expectancy of the contract holder. See section 5.01(11)(d)-(f). Presumably, all this information is intended to allow the Service to determine whether any distributions were subject to the penalty tax. Given that all submissions will be accompanied by a declaration under penalties of perjury, one would have thought that it would have been sufficient simply to require the issuer to state whether it believed any exception to the penalty tax was applicable.

[38]Section 5.04(1)(b).

[39]In the case of closing agreements involving life insurance contracts which fail the IRC section 7702 definition of a life insurance contract, the Service has required deficiency interest on the tax due on the "income on the contracts" to be calculated through a date which is within approximately 30 days of the date the closing agreement is executed by the Associate Chief Counsel (Domestic). Since taxpayers have no means of knowing what that date will be at the time the closing agreement offer is filed, it is common practice not to make the interest calculations until the offer has been evaluated by the Insurance Branch and the docket attorney has informed the taxpayer that the Branch will recommend to the Associate Chief Counsel (Domestic) that the offer be accepted. (Some taxpayers include the interest calculation in their initial offer, but in that event they routinely need to recalculate the interest at the time the Branch recommends acceptance.)

D. Tax on Overage Earnings

The third — and most complex — element of the toll charge calculated under section 5.04 of Rev. Proc. 99-27 can be characterized as a tax on those portions of the contract earnings that (a) are attributable to premiums in excess of the 7-pay limit, and (b) might have been distributed to the policyholder had the relief provided by the revenue procedure not been used. In broad terms, this part of the toll charge can be viewed as an effort to identify the tax the Service might have obtained in the future from the owner of the MEC. Under the terms of the revenue procedure, this tax (which cannot be less than $0) is calculated by multiplying —

> (i) the excess, if any, of the contract's "cumulative overage earnings" over the "proportionate share of overage earnings allocable to taxable distributions under the contract," by
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> (ii) the "applicable percentage for the contract," and
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> (iii) the "distribution frequency factor for the contract."[40]

1. Calculation of 'Cumulative Overage Earnings'

Rev. Proc. 99-27 does not directly define the term "cumulative overage earnings." However, example 1 of section 5.04(3), which provides an illustration of the calculation of the toll charge for a contract, indicates that the cumulative overage earnings for a contract is equal to the sum of the "overage earnings" for each contract year in which there is an "overage."

a. Overage

The "overage" for a contract is calculated for each contract year of the contract's "testing period."[41] In substance, the "overage" for each contract year is simply the amount by which the cumulative premiums paid through that year exceed the cumulative 7-pay premium for the contract through that year. More specifically, section 3.05 of Rev. Proc. 99-27 defines the overage for a contract year as equal to the excess, if any, of —

> (1) the sum of the amounts paid[42] under the contract during the testing period for the contract year and all prior contract years, over
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> (2) the sum of the 7-pay premiums[43] for the contract year and all prior contract years of the testing period.[44]

b. Overage Earnings

A contract's "overage earnings" for a contract year are, in simple terms, the earnings (calculated using rates specified in the revenue procedure) in that contract year on both the contract's overage for that year and any earnings on prior contract year overages. (The overage earnings are considered to compound over time.) More specifically, section 3.06 defines the "overage earnings" for a contract year as the amount 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. . . .

In order to identify the earnings attributable to premiums paid in excess of the 7-pay limit, the Service could have required calculations based on the facts of each particular MEC. For example, the revenue procedure could have taken into account the actual expense charges, mortality charges, and interest (or other earnings) credited for each contract. Instead, the revenue procedure takes what presumably is intended to be a simpler approach of using proxy earnings rates. The applicable proxy rate varies by the calendar year in which the contract year begins. In addition, the applicable proxy rate depends on whether the contract is a variable contract under IRC section 817(d).[45] As is the case with any proxy, the simplicity that is gained must be balanced against

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[40]Section 5.04(1)(c).

[41]The "testing period" is defined as the first seven contact years or any additional period required as a result of a material change. Section 3.01.

[42]"Amount paid" is a defined term under the revenue procedure. *See* section 3.02. The definition largely restates the statutory definition of the term, as set forth in IRC section 7702A(e)(1), taking into account the "roll over" rule applicable to contract exchanges.

[43]Section 3.03(1) generally defines the 7-pay premium for a contract as —

> the net level premium (computed in accordance with the rules of section 7702A(c)) that would have to be paid for a contract if the contract were to provide for paid up future benefits after the payment of 7 level annual premiums.

This definition is essentially a restatement of the 7-pay test set forth in IRC section 7702A(b).

The revenue procedure excludes from the general definition of the 7-pay premium discussed above the "7-pay premium for a contract that undergoes a material change." Section 3.03(2) defines the "7-pay premium for a contract that undergoes a material change" as —

> an amount equal to the excess, if any, of — (a) the net level premium (computed in accordance with the rules in section 7702A(c)) that would have to be paid for the changed contract if the contract were to provide for paid up future benefits after the payment of 7 level annual premiums, over (b) a "proportionate share of the cash surrender value" ... under the contract.

Section 3.04 in turn defines the "proportionate share of the cash surrender value" as follows:

> the amount obtained by multiplying — (1) the "cash surrender value" (as defined in section 7702(f)(2)(A)) of the contract, by (2) a fraction, the numerator of which is the net level premium (computed in accordance with the rules in section 7702A(c)) that would have to be paid for the changed or new contract if such contract were to provide for paid up future benefits after the payment of 7 level annual premiums, and the denominator of which is the net single premium (determined using the rules in section 7702) for such contract at that time.

This definition of the 7-pay premium for a contract that has undergone a material change is largely a restatement of the "rollover" rule set forth in the legislative history of IRC section 7702A. *See* H.R. Rep. No. 100-1104, vol. II, 100th Cong., 2d Sess. 105 (1988). *See also* McKeever, III & Van Brunt, *supra* note 4, at 307-308 (1989).

[44]Section 3.05.

[45]*See* sections 3.07(1) and (3).

the accuracy that is lost. The earnings rate proxies used by the revenue procedure will overstate the earnings of some contracts and understate the earnings of others.

In the case of non-variable contracts, the earnings rate for a contract year is the "general account total return" for the calendar year in which the contract year begins.[46] The "general account total return" for a calendar year is the average of the monthly interest rates of "Moody's Corporate Bond Yield Average - Monthly Average Corporates."[47]

> ***The guidance does do not directly address how an issuer should calculate the overage earnings in the common circumstance where the overage exists for only part of a contract year.***

In the case of variable contracts, the earnings rates for the calendar years 1988-1998 are set forth in section 3.07(3)(a) and range from a low of -1.0 percent for 1994 to a high of 25.4 percent for 1991. The earnings rate for a variable contract for a post-1998 calendar year consists of 10 percent of the general account total return and 90 percent of the "separate account total return" and is calculated according to a formula set forth in section 3.07(3)(b). The "separate account total return" is also defined by a formula which takes into account equity returns based upon the S&P 500 (75 percent) and bond returns based on the Merrill Lynch Corporate Bond Master Bond Index, Total Return (25 percent).[48]

Under section 5.01(12) of the revenue procedure, the calculation of the overage earnings must be presented in a specified format (or "template"). An example of the required format is set forth in section 5.04(3). Interestingly, the sample template provided and the example on which it is based do not directly address how an issuer should calculate the overage earnings in the common circumstance where the overage exists for only part of a contract year. The example (and thus the template) involve a contract where all the premiums are paid on the first day of the policy year which coincides with the calendar year. As a consequence, the excess premium is present in the contract for the entire policy year and the overage earnings calculation presented in the template appropriately reflects that fact.

Many inadvertent MECs, however, have resulted from premiums being received and credited under a contract only a few days before the beginning of a new contract year.[49] Thus, the overage in many contracts exists for only a very small part of the contract year. Computing overage earnings by reference to the time that premiums were actually paid will accurately reflect the "excess earnings" occurring under the MEC. It will also avoid the inappropriate result of issuers paying a toll charge based on "overage earnings" that vastly exceed actual earnings under the MEC. There are several techniques that could be used to reflect the actual time at which premiums were paid, but we hope that the Service will soon clarify how it believes this should be done.

2. Proportionate Share of Overage Earnings Allocable to Taxable Distributions Under the Contract

Before the tax on the overage earnings is determined, the overage earnings are reduced to reflect the tax that has already been paid by the owner (or will be paid by the issuer) on the earnings attributable to distributions made under the contract. If this were not done, the Service would collect tax twice on the same earnings. The "proportionate share of overage earnings allocable to taxable distributions under the contract" is determined by multiplying the total amount of taxable distributions under the contract by the following fraction:

$$\frac{\text{contract's cumulative overage earnings}}{\text{total income on the contract}}$$[50]

The "total income on the contract" is equal to the excess of the cash surrender value of the contract (determined without regard to any surrender charge or policy loan) over the premiums paid.[51] Premiums paid are reduced by prior distributions which were excludible from the policyholder's gross income.[52] This amount should be readily available to issuers as it will equal the "amount paid" which is tracked for 7-pay testing.[53]

3. Applicable Percentage

The next step in calculating the tax on the overage earnings is to multiply the amount by which the overage earnings exceed the proportionate share of overage earnings allocable to taxable distributions under the contract by the "applicable percentage for the contract." The applicable percentage functions as a tax rate and varies with the amount of the death benefit under the contract as follows:

Death Benefit	Percentage[54]
Less than $50,000	15
$50,000 - $179,999	28
$180,000 or more	36

[46] Section 3.07(1).

[47] Section 3.07(2). The revenue procedure does not enumerate what those averages are for past years, and it would be useful for the Service to publish those averages to avoid questions and disputes.

[48] Section 3.07(4).

[49] This problem was discussed with Service representatives during the development of the revenue procedure.

[50] Section 3.08.

[51] Section 3.09.

[52] *Id.*

[53] *See* IRC section 7702A(e)(1)(A).

[54] These percentages correlate fairly closely with our understanding of the marginal tax rates of the owners of cash value life insurance, which vary with the face amount purchased.

Under section 5.01 of the revenue procedure, one of the many items of information that must be furnished by the issuer in its request for relief is the "death benefit" for each contract "as defined in IRC section 7702(f)(3)."[55] Interestingly, the revenue procedure does not state as of what date the death benefit is to be identified.

4. Distribution Frequency Factor

The final step in calculating the tax on the overage earnings is to reduce the tentative tax by applying the "distribution frequency factor." This step of the calculation apparently is included to reflect the probability of the overage earnings being distributed to the contract owner and tax paid thereon. If the owner of a MEC does not take a loan or other distribution, the contract's status as a MEC is irrelevant, as the death benefit will still be excludible from the beneficiary's income and the Service would collect no more tax than if the contract were not a MEC. Given that the appatent premise of Rev. Proc. 99-27 is to require the issuer to pay the tax that the Service would have collected from the contract owner by virtue of the contract's status as a MEC, it is appropriate to reduce the earnings subject to tax to take account of the fact that the MEC status of some contracts will not result in additional tax collections.

Section 3.10(2) of Rev. Proc. 99-27 provides that the distribution factor is .5 for all contracts except those described in section 3.10(1), in which case the distribution factor is .8. As a practical matter, however, it appears that most inadvertent MECs will be subject to a distribution factor of .8, which will, of course, yield a higher tax on the overage earnings. Section 3.10(1) identifies two categories of contracts subject to the .8 distribution frequency factor:

> (1) Contracts with a guaranteed spread of 1 percent or less between the interest rate charged on a loan and the interest rate credited to the portion of the contract cash value securing the loan;[56] and
>
> (2) Contracts that allow withdrawals that reduce the death benefit by a smaller proportion than the proportion by which the cash value is reduced.[57]

The Service presumably views the presence of either of these features as indicative of a greater likelihood that distributions will occur.

An example of a contract that falls into the first category would be one that provides that at some time during the contract's life (*e.g.*, after the tenth contract year) the owner may borrow amounts at an interest rate that is guaranteed not to exceed the rate at which earnings are credited to the contract's cash value plus 1 percentage point. A number of life contracts issued in recent years contain such a provision.

Even more MECs are likely to be swept into the second category of contracts subject to the .8 distribution factor by the proportionality test articulated in the revenue procedure. Under this proportionality test, a contract is subjected to the higher distribution factor if the owner "has an option" to make a partial withdrawal that reduces the death benefit by less than the amount determined by the following formula:

$$\text{Death benefit}^{58}\text{ (before withdrawal)} \times \frac{\text{Amount withdrawn}}{\text{Cash value (before withdrawal)}}$$

Most universal life insurance contracts provide that the death benefit is reduced by the same dollar amount as a partial withdrawal.[59] Since the death benefit of a universal life insurance contract will always be greater than the cash value of the contract, the death benefit reduction resulting from a partial withdrawal will be proportionately smaller than the cash value reduction. As a result, most universal life insurance contracts will be subject to the .8 distribution frequency factor.

The typical participating whole life contract is also likely to be subjected to the .8 distribution frequency factor because of the policyholder's ability to surrender a paid-up addition. Such a surrender would typically result in the death benefit being reduced by a smaller proportion than the cash value. Consider, for example, a whole life contract with a base death benefit of $100,000, a base cash value of $20,000 and paid-up additions with a death benefit of $10,000 and cash value of $5,000. If the policyholder surrenders the paid-up additions, the contract's death benefit will be reduced from $110,000 to $100,000 and its cash value will be reduced from $25,000 to $20,000. The cash value would be reduced by 20 percent ($5,000); the contract's death benefit, on the other hand, would be reduced by only 9 percent ($10,000) — substantially less than the $20,000 required to satisfy the proportionality test under the revenue procedure.

5. Payment of the Toll Charge

The toll charge calculated must be paid by check to the Service within 30 days after the date the closing agreement is executed by the Service.[60] Payment is made to the IRS Service Center in Philadelphia, the same Service Center which processes payments under IRC section 7702 closing agreements.

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[55] Section 5.01(5).

[56] Section 3.10(1)(a).

[57] Section 3.10(1)(b).

[58] Here too, the death benefit is determined using the definition under IRC section 7702(f)(3).

[59] Kenneth Black, Jr. and Harold D. Skipper, Jr., *Life Insurance* 138 (12th ed. 1994).

[60] Section 5.05.

III. Correcting the MECs

In addition to paying a toll charge for each of the inadvertent MECs, the issuer must also agree to bring each of the contacts into compliance with the requirements of IRC section 7702A.[61] The revenue procedure offers little specific guidance on the required corrections. Rather, it simply states that the correction can be accomplished by either (1) "an increase in death benefit[s]," or (2) "the return of excess premiums and earnings thereon."[62] The revenue procedure also requires that these actions be taken within 90 days of the date the Service executes the closing agreement.[63] Based on our experience with similar corrections under IRC section 7702, it may be impossible to comply with a 90-day limit in some situations.

The revenue procedure does not define the term "excess premiums," nor does it define the "earnings" on the excess premiums. Presumably, the Service's position on these issues will become known in the ensuing months. However, it would seem reasonable and appropriate to view as "excess premiums" only those premiums, if any, that exceed the 7-pay limit for the contract at the time the corrective action is taken. Thus, in the case of a contract that was no longer within the testing period, (*e.g.*, a contract which was in its ninth policy year and had not undergone a material change) there would be no "excess premiums" to be returned, and thus no corrective action would be necessary. This approach would be consistent with the purpose of requiring the return of excess premiums — namely, that the contract be brought into compliance with IRC section 7702A.

In the case of a contract that was in the testing period, the excess premiums would seem to be equal to the "overage" (at the time of the calculation of the overage) as defined in section 3.05 of the revenue procedure and the "earnings" on the excess premiums might be viewed as the "overage earnings" as defined in section 3.06. Both of these amounts will have been computed by the issuer in order to determine the toll charge for the contract. However, it is unclear whether the Service will equate these amounts.

The revenue procedure does not state that the "earnings" on excess premiums are treated as income to the policyholder. This is the correct result. Under the revenue procedure, these returned amounts will consist of premiums and earnings on the premiums. The premiums would be clearly excludible from income as a return of the policyholder's investment in the contract.[64] Given that the issuer will have paid tax on the overage earnings and that the owner's investment in the contract is not increased by such tax, it would be clearly inappropriate to subject those amounts to tax again when they are distributed to the policyholder.

Finally, it is worth noting that the revenue procedure also requires a company to describe what changes it has made to prevent future inadvertent failures of the 7-pay test. Section 5.01(9) includes in the list of information to be furnished to the Service in a request for relief "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."

IV. Procedure

A. Submissions in the Form of Ruling Requests

A life insurance company that desires to obtain relief under Rev. Proc. 99-27 must file a request for a ruling. The request must conform to the various procedural requirements applicable to other requests for rulings from the Office of Associate Chief Counsel (Domestic) as detailed in Rev. Proc. 99-1, 1999-1 I.R.B. 6.[65] These requirements include the payment of a user fee (typically $5,000 for a life insurance company),[66] and the submission of a statement by an officer of the company certifying under penalties of perjury to the accuracy and completeness of the facts set forth in the ruling request.

B. Information Required

In addition to the usual information associated with a ruling request, Rev. Proc. 99-27 expressly requires a great deal of other information. The required information, which is set forth in section 5.01 of the revenue procedure, includes such items as the policy number for each contract for which relief is requested,[67] the 7-pay premium assumed by the life insurance company when the contract was issued,[68] a variety of details about prior distributions from the contract,[69] and a description of the defect(s) that caused the contract(s) to fail to comply with the 7-pay test.[70]

Some of the requested information is needed to process requests and provide insurers with the relief they desire, *e.g.*, the policy number of each of the contracts for which relief is requested. On the other hand, some of the requested information is *not* needed by the Service, *e.g.*, the taxpayer identification number of each contract holder[71] and the cash surren-

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[61]Section 5.06.

[62]*Id.*

[63]*Id.*

[64]By virtue of the closing agreement, the amounts returned will be distributions from a non-MEC and thus follow the cost-recovery rule of IRC section 72(e)(5), rather than the income-first rule of IRC section 72(e)(10) which applies to MECs.

[65]Section 5.01.

[66]*See* section 15.02 of Rev. Proc. 99-1 and section (A)(3)(d) of Appendix A thereto.

[67]Section 5.01(2).

[68]Section 5.01(6).

[69]Section 5.01(11).

[70]Section 5.01(8).

[71]Section 5.01(3).

der value of each contract at the end of each contract year.[72] In addition, some of the required information will not be readily available to an insurer, *e.g.*, whether past distributions were attributable to the contract holder being disabled.[73] As the Service and life companies gain experience with the revenue procedure, it is to be hoped that the information requirements will be applied in a flexible manner that will reduce the burden on both insurers and the Service. For example, allowing companies to provide at least certain of the required information in electronic rather than paper form would benefit the Service and life insurance companies.

C. Submission of a Proposed Closing Agreement

As part of the submission requesting relief the life insurance company is required to submit a closing agreement "in substantially the same form as the model closing agreement"[74] included in Rev. Proc. 99-27. The model closing agreement is set forth in section 6 of the revenue procedure and is very similar to the closing agreements that have been used under IRC section 7702. Although section 5.03 states that the closing agreement submitted with the ruling request should be executed by the life insurance company, the feasibility of this is questionable.[75] It is likely the Service will need several months to process submissions, and one would expect that certain information submitted will need to be updated and amended during that period.

[72]Section 5.01(7).

[73]Section 5.01(11)(e).

[74]Section 5.03.

[75]*Id.*

Conclusion

Rev. Proc. 99-27 is complex and in some respects its requirements are burdensome and its provisions severe. It will take the numerous life insurers who wish to obtain the relief provided by the revenue procedure many months to gather the information required. Insurers will discover, in some instances, that they simply cannot obtain all the information requested and, in other instances, that the information can only be obtained at significant expense or through intrusive communications with their policyholders. Moreover, insurers will inevitably identify contracts that inadvertently became MECs but are excluded from the relief offered by the revenue procedure.

While Rev. Proc. 99-27 is not exactly what the industry desired, it is an important and positive development.

However, as the Service begins to field the questions that will arise under the revenue procedure and as it reviews the initial submissions made by companies, it can be expected that at least some of these problems will be resolved. It is not unrealistic to expect that over the next two years some of Rev. Proc. 99-27's sharper edges will be dulled and that if it is extended, as it should be by the spring of 2001, it will be improved. In the interim, it is important to keep in mind that the life insurance industry requested a procedure to address a substantial problem for life insurers and their policyholders and the Service has responded affirmatively. While Rev. Proc. 99-27 is not exactly what the industry desired, it is an important and positive development. Indeed, it is to be hoped that Rev. Proc. 99-27 is only the first step in improving the current process for correcting contracts that fail one of the many "qualification" requirements of the Internal Revenue Code — IRC section 7702 for life insurance contracts, IRC section 817(h) for variable contracts, and IRC section 72(s) for annuities.

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