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

by Daniela Stoia and Craig R. Springfield

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

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

I. Accounting for QAB Charges

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

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

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

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

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

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

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

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

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

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

A. Request to the Service

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

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

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

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

B. Terms of the Model Alternative C Closing Agreement

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

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

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

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

IV. Conclusion

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

End Notes

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

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

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

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

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

[6] Rev. Rul. 2005-6.

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

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

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

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

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

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

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

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

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

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