Part III - Administrative, Procedural, and Miscellaneous

26 CFR § 301.7121: Closing Agreements.
(Also Part I, section 7702A)

Rev. Proc. 2007-19

SECTION 1. PURPOSE

This revenue procedure modifies the procedure by which an issuer of a life insurance contract may remedy an inadvertent non-egregious failure to comply with the modified endowment contract rules under § 7702A of the Internal Revenue Code. Rev. Proc. 2001-42, 2001-2 C.B. 212, is modified and amplified.

SECTION 2. BACKGROUND

.01 Definition of a modified endowment contract

(1) Section 7702A(a) provides that a life insurance contract is a modified endowment contract ("MEC") if the contract--

(a) is entered into on or after June 21, 1988, and fails to meet the "7-pay test" of § 7702A(b), or

(b) is received in exchange for a contract described in paragraph (a) of this section 2.01(1).

(2) A contract fails to meet the 7-pay test if the accumulated amount paid under the contract at any time during the first 7 contract years exceeds the sum of the net level

premiums which would have to be paid on or before such time if the contract were to provide for paid-up "future benefits" (as defined in §§ 7702A(c)(3) and 7702(f)(4)) after the payment of 7 level annual premiums.

.02 Tax treatment of amounts received under a MEC. Section 72(e)(10) provides that a MEC is subject to the rules of § 72(e)(2)(B), which tax non-annuity distributions on an income-out-first basis, and the rules of § 72(e)(4)(A) (as modified by §§ 72(e)(10)(A)(ii) and 72(e)(10)(B)), which generally deem loans and assignments or pledges of any portion of the value of a MEC to be non-annuity distributions. Moreover, under § 72(v), the portion of any annuity or non-annuity distribution received under a MEC that is includible in gross income is subject to a 10% additional tax unless the distribution is made on or after the date on which the taxpayer attains age 59 1/2, is attributable to the taxpayer's becoming disabled (within the meaning of § 72(m)(7)), or is part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and the taxpayer's beneficiary.

.03 Rev. Proc. 2001-42. The Internal Revenue Service ("Service") is aware of situations in which, as a result of inadvertent non-egregious failures to comply with the MEC rules, life insurance premiums are collected which exceed the 7-pay limit provided by § 7702A(b). This can produce significant unforeseen tax consequences for the contract holders. To allow issuers to remedy such situations, Rev. Proc. 2001-42 sets forth the circumstances under which the Service will enter into closing agreements which provide that contracts identified in the closing agreements will not be treated as MECs. Under Rev. Proc. 2001-42, an issuer must provide information about the contracts that are subject to the closing agreement, including a template for each contract setting forth the cumulative amounts paid under the contract, the contract's cumulative 7-pay premium, the overage, if any, for each contract year, the earnings rate applicable for each contract year, and the overage earnings for each contract year. In addition, the issuer must agree to pay under the closing agreement an amount based on the contract's overage, overage earnings, and tax and interest thereon.

.04 Need for changes to Rev. Proc. 2001-42. During the 5 years it has administered Rev. Proc. 2001-42, the Service has become aware of a number of changes that would make it easier for issuers to use that procedure to seek relief. The Service has determined that the General Account Total Return would be more accessible to taxpayers if based on Moody's Seasoned Corporate Aaa and Baa Bond Yields, rather than on the indices provided in Rev. Proc. 2001-42; similarly, the Bond Fund Total Return would be more accessible if the Merrill Lynch Corporate Bond Master Bond Index, Total Return, were instead identified as the Merrill Lynch U.S. Corporate Master Index (C0A0); the Service has the capacity to process electronic exhibits in connection with requests for closing agreements involving life insurance contracts (see, e.g., Notice 2005-35, 2005-1 C.B. 1087); and, the Service has changed the address to which payments under Rev. Proc. 2001-42 must be sent.

SECTION 3. CHANGES TO EXISTING PROCEDURE

.01 General Account Total Return. Rev. Proc. 2001-42, section 3.07(2), is modified to provide that the General Account Total Return is the arithmetic average (weighted on a 50-50 basis) of the following two rates: (1) Moody's Seasoned Corporate Aaa Bond Yield, frequency annual; and (2) Moody's Seasoned Corporate Baa Bond

Yield, frequency annual. Both rates are published by Moody's Investors Service, Inc., or any successor thereto, and are publicly available at www.federalreserve.gov. Under this methodology, the General Account Total Return for 2005 would be (5.23 + 6.06)/2 = 5.645. Section 3.07(2) is further modified to include the following tables setting forth the General Account Total Return as so determined for the years 1988 through 2005:

Year	General Account Total Return	Year	General Account Total Return
1988	10.2%	1997	7.6%
1989	9.7%	1998	6.9%
1990	9.8%	1999	7.4%
1991	9.2%	2000	8.0%
1992	8.6%	2001	7.5%
1993	7.5%	2002	7.2%
1994	8.3%	2003	6.2%
1995	7.8%	2004	6.1%
1996	7.7%	2005	5.6%

.02 Variable Contracts Earnings Rate Table. Rev. Proc. 2001-42, section 3.07(3), is modified by substituting the following earnings rate table for that which appears in section 3.07. This table supplements the existing table by providing earnings rates for the years 2001 through 2005:

Year	Variable contracts Earnings rate	Year	Variable contracts Earnings rate
1988	13.5%	1997	17.8%
1989	17.4%	1998	19.7%
1990	1.4%	1999	12.8%
1991	25.4%	2000	-5.5%
1992	5.9%	2001	-7.1%
1993	13.9%	2002	-14.1%
1994	-1.0%	2003	19.6%
1995	23.0%	2004	6.9%
1996	14.3%	2005	2.1%

.03 Bond Fund Total Return. Rev. Proc. 2001-42, section 3.07(6), is modified to provide that the Bond Fund Total Return is (a) the "calendar year percentage return" (as defined in section 3.07(7) of Rev. Proc. 2001-42) represented by the end-of-year values of the Merrill Lynch U.S. Corporate Master Index (C0A0), as published by Merrill Lynch & Company, Inc., or any successor thereto, less (b) 1.0 percentage point. The Merrill Lynch U.S. Corporate Master Index (C0A0) is publicly available at www.mlindex.ml.com. Under this methodology, the Bond Fund Total Return for 2005 would be ((1546.511-1516.602)/1516.602) - .01 = 0.9721 percent.

.04 Address for Payment. The address set forth in Rev. Proc. 2001-42, section 5.04, for payment of the amount required under a closing agreement concerning inadvertent MECs is modified to read as follows: Internal Revenue Service, Receipt & Control Stop 31, 201 W. Rivercenter Blvd., Covington, KY 41011.

.05 Electronic Submissions. A new section 5.06 is added to Rev. Proc. 2001-42 to read as follows:

> ".06 Electronic submissions. The information required under this revenue procedure may be submitted to the Service electronically, in read-only format, on a CD-ROM. Adobe Portable Document format is a suitable format. Other formats may be arranged on a case-by-case basis. The issuer must provide a total of 3 CD-ROMs, one for each of the three (3) copies of the closing agreement."

.06 Additional changes to Rev. Proc. 2001-42. The Service is aware that additional changes to Rev. Proc. 2001-42 may be warranted. Notice 2007-15, page ____, this Bulletin, requests comments on a variety of issues affecting closing agreements for life insurance products, including inadvertent MECs. The Service will continue to process closing agreements under the provisions of Rev. Proc. 2001-42, as modified by this revenue procedure, until Rev. Proc. 2001-42 is replaced or further modified by publication in the Internal Revenue Bulletin.

SECTION 4. PAPERWORK REDUCTION ACT

The collections of information in Rev. Proc. 2001-42 have been previously reviewed and approve by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1752. This revenue procedure does not make substantive changes to those collections of information.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for submissions received after January 26, 2007, the date this revenue procedure was made available to the public.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2001-42 is modified and amplified.

DRAFTING INFORMATION

The principal author of this revenue procedure is Katherine A. Hossofsky of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, please contact Ms. Hossofsky at (202) 622-8435 (not a toll free call).