

Section 7702 Closing Agreements

Notice 99-48

PURPOSE

The purpose of this notice is to specify the rates the Service will use for the purpose of computing the amount due pursuant to a closing agreement concerning failed life insurance contracts under § 7702 of the Internal Revenue Code.

BACKGROUND

Section 7702 defines the term “life insurance contract” for purposes of the Code. Section 7702(a) provides that a “life insurance contract” is any contract that is a life insurance contract under the applicable law, but only if such contract: (1) meets the cash value accumulation test of § 7702(b), or (2) meets the guideline premium requirements of § 7702(c) and falls within the cash value corridor of § 7702(d).

Section 817(h) provides that for purposes of § 7702(a), a variable contract that is otherwise described in § 817, which is based on a segregated asset account, shall not be treated as a life insurance contract for any period (and any subsequent period) for which the investments made by such account are not, in accordance with regulations prescribed by the Secretary, adequately diversified.

Section 7702(g)(1)(A) provides that if at any time a contract that is a life insurance contract under the applicable law does not meet the definition of a life insurance contract under § 7702(a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year. Further, § 7702(g)(1)(C) provides that if, during any taxable year of the policyholder, a contract that is a life insurance contract under applicable law ceases to meet the definition of a life insurance contract under § 7702(a), the income on the contract for all prior taxable years shall be treated as received or accrued during the taxable year in which such cessation occurs. Section 7702(g)(1)(B) defines the term “income on the contract” for purposes of § 7702(g)(1).

Section 7702(f)(8) provides that the Secretary may waive a taxpayer’s failure to satisfy the requirements of § 7702(a) if: (1) the requirements described in § 7702(a) for any contract year were not satisfied due to reasonable error; and, (2) reasonable steps are being taken to remedy the error. Section 7121(a) authorizes the Secretary to enter into a written agreement with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period.

In Rev. Rul. 91-17, 1991-1 C.B. 190, an insurance company issued contracts that qualified as life insurance contracts under applicable law, but failed to meet the definition of a life insurance contract under § 7702(a). The ruling concludes that the income on such a contract is a nonperiodic distribution under what is now § 3405(e)(3). Thus, the insurance company is subject to certain recordkeeping, reporting, withholding and deposit obligations under §§ 3402, 3403, 3405, 6047, 6302 and 7501. In addition, if the company’s failure to meet those obligations is not due to reasonable cause, the company could be subject to the penalties described in §§ 6651, 6652(e), 6652(h), 6656(a) and 6704.

Rev. Rul. 91-17 also provides that the Service will waive civil penalties for failure to satisfy the reporting, withholding, and deposit requirements for income deemed received under § 7702(g) and (h) in certain circumstances. For example, the Service will waive these penalties if the insurance company issuing the failed contracts, pursuant to § 7702(f)(8), requests and receives a waiver of the contracts’ failure to meet the definition of a life insurance contract. In addition, the ruling provides the Service will waive these penalties if, prior to June 3, 1991, the insurance company requests, and, in a timely manner, executes a closing agreement under which it agrees to pay an amount based on: (i) the amount of tax that would have been owed by the policyholders if they were treated as receiving the income on the contracts, and (ii) any interest with regard to such tax.

Since June 3, 1991, the Service has exercised its authority under § 7121 to enter into closing agreements that waive the

penalties described above for insurance companies that issued contracts that are “life insurance contracts” under applicable law, but which inadvertently fail to meet the definition of a life insurance contract in § 7702(a) due to errors that are not reasonable errors within the meaning of § 7702(f)(8). Until further notice, the Service will continue to enter into such closing agreements and will use the following assumed tax rates to compute the amounts of tax that would have been owed by the policyholders if they were treated as receiving the income on the contracts:

(1) 15% if the death benefit under the contract is less than \$50,000,

(2) 28% if the death benefit under the contract is equal to or exceeds \$50,000, but is less than \$180,000, and,

(3) 36% if the death benefit under the contract is equal to or exceeds \$180,000. For purposes of determining the appropriate assumed rate, the death benefit under a contract will be the death benefit (as defined in section 7702(f)(3)) as of any date within 120 days of the date of the request for closing agreement, or the last day the contract is in force.

In addition, interest on those amounts will continue to be computed under § 6621(a)(2) as if the amounts treated as received by the policyholders caused underpayments of tax in the appropriate tax years.

This notice does not apply to an issuer of a variable contract that is not treated as a life insurance contract solely because it fails to meet the diversification requirements of § 817(h). *See* Rev. Proc. 92-25, 1992-1 C.B. 741, or any successor to that procedure.

EFFECTIVE DATE

This notice is effective September 3, 1999.

DRAFTING INFORMATION

The principal author of this notice is Frank N. Panza of the Office of the Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this notice contact Mr. Panza at (202) 622-3970 (not a toll-free call).