Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:4-PLR-166502-01
Date:
April 9, 2002

Legend

Taxpayer A =

Taxpayer B =

Parent =
State U =
State V =
State W =
Year 1 =
Year 2 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Policy A =
Policy B =
Policy C =
Policy D =
Policy E =
Policy F =
Policy G =
Policy H =

Amount 1	=
Amount 2	=
Amount 3	=
Amount 4	=
Amount 5	=
Amount 6	=
Amount 7	=
Amount 8	=
Amount 9	=
Amount 10	=
Amount 11	=
Amount 12	=
Amount 13	=
Amount 14	=
Amount 15	=
Amount 16	=
Amount 17	=
Amount 18	=
Amount 19	=
Amount 20	=
Amount 21	=
Amount 22	=
Amount 23	=
Amount 24	=
Amount 25	=
Amount 26	=
Amount 27	=
Amount 28	=
Amount 29	=
Amount 30	=
Program I	=

Dear :

This is in response to your letter of Date 1, as supplemented, requesting a waiver pursuant to §§ 101(f)(3)(H) and 7702(f)(8) of the Internal Revenue Code (Code) for certain insurance contracts issued by Taxpayer A and Taxpayer B (hereinafter sometimes referred to as “Taxpayers”) that failed to meet the requirements of §§ 101(f) and 7702(a).

The information submitted indicates that Taxpayer A is a stock life insurance company subject to Subchapter L of the Code, incorporated under the laws of State U, and is licensed to do business in Amount 1 states, including State V. Taxpayer B, a wholly-owned subsidiary of Taxpayer A, is a stock life insurance company subject to Subchapter L of the Code, incorporated under the laws of State W, and is licensed to do business in Amount 2 states, including State V. Taxpayers A and B and other affiliates join in the filing of a consolidated federal income tax return with Parent.

All of the life insurance contracts ("policies") that Taxpayers A and B issued on or before December 31, 1984, were designed to comply with § 101(f) by satisfying the guideline premium limitations and the applicable percentage requirements of that section. Policies issued after that date were designed to comply with § 7702 by satisfying both the guideline premium requirements and the cash value corridor of that section. All policies were designed to qualify as life insurance contracts for tax purposes.

This request relates to eight types of nonparticipating, flexible premium universal life insurance contracts issued by Taxpayers, as follows: Policy A, Policy B, Policy C, Policy D, Policy E, Policy F, Policy G and Policy H. As of Date 2, Taxpayers had Amount 3 policies in force including the following: Amount 4 Policy A contracts; Amount 5 Policy B contracts; Amount 6 Policy C contracts; Amount 7 Policy D Contracts; Amount 8 Policy E Contracts; Amount 9 Policy F Contracts; Amount 10 Policy G Contracts; and Amount 11 Policy H Contracts. Approximately in Date 3, Taxpayers discovered that Amount 12 policies ("failed policies") failed to meet the requirements of §§ 101(f) and 7702, whichever was applicable, for a variety of reasons.

Errors (1) through (3) were clerical processing errors which resulted in the noncompliance of Amount 13 policies issued by Taxpayer A and Amount 14 policies issued by Taxpayer B. Error (1) stemmed from the failure by personnel to follow the Taxpayers' established procedures for processing the monthly report that listed policies with excess premiums and for returning to policyholders excess premiums with interest within 60 days of the end of the contract year in which they were paid. The monthly report was sorted by policy number and did not include the policy anniversary date of each of the policies identified as potentially having excess premiums. Personnel did not always process those policies on the monthly report that were closest to the 60-day deadline ahead of those which were further from the deadline. This error resulted in the noncompliance of Amount 15 Policy A contracts, Amount 16 Policy B contracts, Amount 17 Policy C contracts, Amount 18 Policy D contracts, Amount 19 Policy E contracts, Amount 18 Policy F contracts, and Amount 18 Policy G contracts.

With regard to Error (2), Amount 18 Policy H contracts failed because the report generated for that Policy was not processed in a timely manner in accordance with the Taxpayers' procedures. The report generated for this Policy was one of the first such reports generated and the employee responsible for processing the report did not realize that this report needed to be processed in the same manner as the premium limitation violation notice. Hence, the excess premiums paid under the Policies were not refunded within 60 days of the end of the contract year in which they were received. Taxpayers had procedures existing at that time that, if properly followed, would have resulted in the contracts complying with the statute. Further, Taxpayers have represented that, in order to prevent a recurrence of such an error, the Taxpayers held a training session on Date 4 for the personnel responsible for processing the reports. During this session, supervisors reviewed (1) the content of the report and (2) the actions that must be taken by the personnel upon receiving such a report. Supervisors also stressed the importance of personnel following Taxpayers' procedures for processing the reports in a timely manner.

Error (3) was due to the failure of personnel to input correctly the pertinent policy information necessary to calculate the correct amount of refund to ensure the policies' compliance with § 101(f) or § 7702, as applicable. As a result, an incorrect amount of premium was refunded, lower than the correct amount that needed to be refunded. This error resulted in the noncompliance of Amount 20 Policy A contracts, Amount 21 Policy B contracts, Amount 22 Policy C contracts, Amount 18 Policy D contracts, Amount 23 Policy E contracts, Amount 22 Policy F contracts, Amount 18 Policy G contracts and Amount 18 Policy H contracts.

When the audit program was developed, the few policies that were listed could be processed within 60 days after the end of the contract year in which the excess premiums were paid. As Taxpayers expanded the audit program, the number of policies identified on the audit reports increased to Amount 24 to Amount 25 policies on each audit report. Over 80 percent of these policies do satisfy the requirements of §§ 101(f) and 7702, as applicable. To remedy the above clerical errors and to ensure the audit reports would continue to be processed in a timely manner, the Taxpayers increased the number of employees whose primary job responsibility was to process the audit reports, and added the policy anniversary date to the audit reports in Date 6.

These changes enable personnel to process the potentially failed policies in a timely manner. In addition, the audit report is now consistently received by the processing personnel between the third and fifth business day of the month. As a result, processing personnel can begin their review of the potentially failed policies listed on the monthly audit report several days earlier than previously.

Taxpayers are also in the process of modifying the audit program so that it will correctly compare premiums paid to the greater of the guideline single premium and the sum of the guideline level premiums for certain policy forms developed more recently. Once this modification to the audit program is complete, the audit report will no longer incorrectly identify a large number of policies issued on more recently developed policy forms as having excess premiums. This will greatly reduce the policies that were incorrectly listed on the audit report as having excess premiums and will significantly shorten the report.

In order to reduce the likelihood that the data input clerical error will recur, Taxpayers are in the process of streamlining the spreadsheet used to generate the audit report so that less information will have to be inputted manually and therefore the potential for data input errors will be reduced. Taxpayers represent that certain revisions to the spreadsheet containing the information have already been made and Taxpayers expect to complete the revisions by Date 5. These revisions will reduce the possibility of incorrect information being inputted by clarifying what information needs to be inputted, and, in some situations, providing specific options from which the personnel can choose. In addition, an adjunct program to calculate the insured's age will be made available to the personnel using the spreadsheet.

With regard to Error (4), in late Year 1, Taxpayers learned that a maintenance error had occurred in their audit program and that the audit program had not been comparing the correct amount of premiums paid with the premium limitation for certain policies. When Taxpayers' audit program compared premiums paid against the premium limitation, it retrieved premium payment information it stored in order to correctly determine the amount of premiums paid. Taxpayers learned that the audit program had stopped accessing this stored data after routine maintenance was performed by third party consultants (consultants) who inadvertently deactivated, for a period of about 18 months, the audit program's ability to access the premium payment it stores. As a result, premiums were retained in excess of the premium limitation and not refunded within 60 days of the end of the contract year in which they were applied to the policy. After discovering this error, Taxpayers promptly enabled the audit program to once again access both current premium payments and stored premium payments in order to identify all of the policies that do not satisfy the applicable requirements of §§ 101(f) and 7702. This error resulted in the noncompliance of: Amount 26 Policy A contracts; Amount 27 Policy B contracts; Amount 18 Policy C contracts, Amount 22 Policy D contracts, Amount 28 Policy E contracts, Amount 29 Policy F contracts, and Amount 18 Policy G contracts.

With regard to Error (5), early in Year 2, Taxpayers identified certain policies on the audit report as failed policies. Upon further investigation, Taxpayers determined excess premiums with respect to these failed policies had been paid in an earlier year. Taxpayers learned that their audit program contained a programming error in connection with counting the correct number of days in a leap year. Specifically, in leap years the program treated the date immediately preceding a policy anniversary date as the policy anniversary date in the case of policies with policy anniversaries occurring on the first of the month in the months of March through December. As a result of Error (5), because of the extra day in February in leap years, policies with an anniversary date on the first of each subsequent month were not properly selected or audited. This programming error resulted in the failure of Amount 30 Policy A contracts, Amount 18 Policy B contracts, Amount 22 Policy C contracts and Amount 17 Policy E contracts.

Taxpayers have represented that, by Date 7, they will have corrected the programming error, Error (5), in the audit program. As an additional corrective measure, Taxpayers have begun using Program I, a program that measures performance data and causal data to systematically ascertain how to eliminate the root causes of defects with the goal of zero defects. This approach uses controls that include quality verification of refund amounts, timeliness measurements to ensure that the entire audit report is worked prior to the end of the month and additional report controls to identify any unusual situations as soon as possible. Other control measures include a documented spot check process to verify the accuracy of premium refunds and a check for accuracy of each data input. In addition, each employee in the processing area will be reviewed using specific performance standards. Using Program I, Taxpayers expect to eliminate untimely processing of premium violation notices and audit reports. These improvements will be monitored on a monthly basis.

In addition, a task force will be created consisting of representatives from the administration and compliance departments that will be responsible for addressing and resolving unusual situations immediately. The task force will also meet periodically to review the maintenance of the process controls.

By letters dated Date 8 and Date 9, Taxpayers identified Error (6) in Amount 30 contracts, all of which had been included in the waiver request of Date 1. The contracts all were issued with a rider that provides term life insurance coverage on the life of a family member of the individual insured under the policy. In computing the guideline premium limitation for these contracts, Taxpayers treated the rider as a "qualified additional benefit" within the meaning of § 7702(f)(5)(A). In addition, pursuant to § 7702(f)(5)(B), Taxpayers treated the charges for the rider as a future benefit. In determining the amount of the charges for such future benefits which could be taken into account in the guideline premium limitation, Taxpayers followed the "reasonable mortality charge" requirements of § 7702(c)(3)(B)(i). Taxpayers contend that approach was reasonable because the charge for the rider is a mortality charge and § 7702(c)(3)(B)(i) specifically applies to mortality charges. Pursuant to those requirements and the safe harbor of Notice 88-128, 1988-2 C.B. 540, Taxpayers reflected the full 1980 CSO Mortality Charge for the rider in the guideline premium.

Taxpayers propose to remedy policies with Errors (1) through (5) by refunding the excess premiums, with interest equal to or greater than the contract crediting rate, to the contract holders. Taxpayers represent this cure will be implemented within 90 days of the effective date of the requested waiver.

To remedy Error (6), Taxpayers have recalculated the guideline premium limitation for the Amount 30 contracts with the rider following the reasonable expense charge rule of § 7702(c)(3)(B)(ii) and thus taking into account only the current charges imposed for the rider. Taxpayers will increase the death benefits under each of the Amount 30 policies so that the premiums paid for such policies will not exceed the guideline premium limitation as so redetermined.

LAW AND ANALYSIS

Section 101(f) excludes from gross income any amount paid by reason of the death of the insured under a life insurance contract known as a flexible premium contract only if the contract satisfies either (1) the guideline premium limitation and the applicable percentage limitation of §§ 101(f)(1)(A)(i) and (ii), or (2) the cash value test of § 101(f)(1)(B). Section 101(f) applies to contracts issued before January 1, 1985.

Section 7702 defines the term "life insurance contract" for all purposes of the Code. Under § 7702(a), in order to be a life insurance contract for federal income tax purposes, a contract must qualify as such under the applicable law and must satisfy either the cash value accumulation test of §§ 7702(a)(1) and 7702(c), or both the “guideline premium requirements” of §§ 7702(a)(2)(A) and 7702(c) and the “cash value corridor” of §§ 7702(a)(2)(B) and 7702(d).

With respect to the guideline premium requirements, § 7702(c) requires that the premiums paid under the contract at any time must not exceed the greater of the guideline single premium or the sum of the guideline level premiums to that date. The guideline single premium is the single premium at issue that is needed to fund the "future benefits" under the contract determined on the basis of the following three elements enumerated in § 7702(c)(3)(B)(i)-(iii):

i. reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) 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,

ii. 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, and

iii. interest at the greater of an annual effective rate of 6 percent or the rate or rates guaranteed on issuance of the contract.

The guideline level premium is the level annual equivalent of the guideline single premium payable until a deemed maturity date between the insured's attained ages 95 and 100, using a minimum interest rate of four percent, rather than six percent. Accordingly, the amount of both the guideline single premium and guideline level premium is proportional to the amount of future benefits under the contract. The computational rules of § 7702(e) and the definitions of § 7702(f) apply to both the guideline single and guideline level premium.

Section 7702(f)(4) defines the term "future benefits" to mean death benefits and endowment benefits. Section 7702(f)(5)(A)(iii) characterizes family term riders as "qualified additional benefits," and § 7702(f)(5)(B) provides further that qualified additional benefits shall not be treated as future benefits under the contract, but the charges for such benefits shall be treated as future benefits.

In computing the guideline premiums for a policy to which the Family Term Rider or Spousal Term Rider was attached, Taxpayer treated the charges for the rider as a future benefit, and, accordingly, increased the guideline premium for each policy by that amount. Taxpayer, however, treated those charges under the "reasonable mortality charge" standard set forth in § 7702(c)(3)(B)(i), rather than under the "reasonable expense charge" standard set forth in § 7702(c)(3)(B)(ii). Charges contemplated by § 7702(c)(3)(B)(i) are deemed reasonable if they do not exceed the charges set forth in the 1980 CSO Mortality Table, regardless of whether the charges actually set forth in the contract are less than the 1980 CSO amount. In contrast, charges contemplated by § 7702(c)(3)(B)(ii) are deemed reasonable only if they reflect the amount expected to be actually paid, which will typically correlate to a company's actual charges. Consequently, in many instances the guideline premiums attributable to certain benefits will be higher if treated under § 7702(c)(3)(B)(i) rather than § 7702(c)(3)(B)(ii).

Although the Code in setting forth the guideline premium limitations does not specifically direct taxpayers to treat family term riders under § 7702(c)(3)(B)(ii), rather than (c)(3)(B)(i), the rules applicable to the cash value accumulation test are controlling in this regard. Particularly, § 7702(b)(2)(B) provides one of the computational rules for determining the net single premium used to ascertain compliance with the cash value accumulation test. Section 7702(b)(2)(B) states that such computation, in the case of qualified additional benefits, shall be made on the basis of § 7702(c)(3)(B)(ii). Thus, for the purpose of the cash value accumulation test, family term riders, as qualified additional benefits, are treated under § 7702(c)(3)(B)(ii). Although the requirement set forth in § 7702(b)(2)(B) refers only to the determination required for the cash value accumulation test, and does not expressly apply to the guideline premium limitations, this provision is the only direction provided by Congress as to how charges for qualified additional benefits are to be considered from a computational standpoint. The legislative history, moreover, is absent of any indication that there be two separate standards for inclusion of such charges: one for the cash value accumulation test and one for the guideline premium limitation. Given Congress' indication that family term riders should be treated under § 7702(c)(3)(B)(ii) for the purpose of the cash value accumulation test, and absent any indication to the contrary, we conclude that § 7702(b)(2)(B) implicitly requires family term rider benefits to be treated under (c)(3)(B)(ii) for the purpose of the guideline premium limitations as well.

Under §§ 101(f)(3)(H) and 7702(f)(8), the Secretary of the Treasury may waive the failure to satisfy the requirements of §§ 101(f) and 7702 respectively if the taxpayer establishes that the requirements were not satisfied due to reasonable error(s) and that reasonable steps are being taken to remedy the error(s).

After considering all of the facts and circumstances, we find that the failure of the Amount 12 policies to satisfy the requirements of §§ 101(f) and 7702 was due to reasonable errors, and that Taxpayers are taking reasonable steps to remedy the errors. In so doing, we note that, although Error 6 was due to Taxpayers' incorrect application of § 7702(c)(3)(B)(i) rather than (c)(3)(B)(ii), Taxpayers' error in this regard was reasonable. To remedy the compliance failure of the Amount 12 policies with regard to Errors (1) through (5), Taxpayer will, within 90 days of receipt of this ruling, refund any excess premium with interest equal to or greater than the contract crediting rate to the contract holders. To cure Error (6) attributable to Taxpayers' incorrect application of § 7702(c)(3)(B)(i), Taxpayers will, within 90 days of receipt of this ruling, increase the death benefits under each of the Amount 30 policies so that the premiums paid for such policies will not exceed the guideline premium limitation as so redetermined.

CONCLUSION

Accordingly, based on the information submitted, the failure of the Amount 12 contracts to satisfy the requirements of §§ 101(f) or 7702(a) is waived pursuant to §§ 101(f)(3)(H) and 7702(f)(8), provided that the excess premiums are refunded with interest calculated equal to or greater than the contract crediting rate, as of the date of the cure, and/or, the revised death benefits are calculated as of the date of the cure. Any contracts that are not cured within 90 days of the date of this letter are not covered by this waiver.

The rulings contained in this letter are based upon information and representations submitted by the Taxpayers and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the Taxpayers.

Sincerely yours,

/S/

Mark Smith
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)