Internal Revenue Service

Number: **200327037**
Release Date: 7/3/2003
Index Number: 7702.20-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:4-PLR-167034-02
Date:
March 27, 2003

Legend:

Date A
Brother
State A
Place B

Sister
State C
Place D

Type E
Type F
Number G
Number H
Number I
Number J

Dear :

This is in reply to your letter dated Date A, in which you requested, on behalf of Brother and Sister, a waiver under section 7702(f)(8) of the Internal Revenue Code for various life insurance contracts (the "Contracts") that inadvertently failed to meet the requirements of section 7702. The Contracts are identified on Exhibits C1 and C2, attached to this letter.

Brother is a stock life insurance company, as defined in section 816(a), and is subject to taxation under Part I of Subchapter L of the Code. Brother is organized and operated under the laws of State A and is licensed to engage in the insurance business in Place B. Sister is also a stock life insurance company, but is organized and operated under the laws of State C and licensed to engage in the insurance business in Place D.

Brother and Sister (hereinafter Taxpayer) join in filing a consolidated life/non-life Federal income tax return with their parent company, and other includible affiliates.

DESCRIPTION OF CONTRACTS

The Contracts that are the subject of the request are either Type E universal life insurance contracts or Type F variable universal life insurance contracts. Some of the Contracts anticipate periodic planned premium payments as well as flexibly scheduled premiums. The policy forms were first used in 1984 and contracts continue to be issued on the same form now as then, subject to various endorsements. All of the Contracts permit premium payments on any date prior to a maturity date or other date specified in the Contracts.

The death benefits provided under the Contracts may be either “option 1" or “option 2.” If option 1 is elected, the death benefit equals the greater of the face amount specified in the Contract or the amount required to satisfy the cash value corridor requirements of sections 7702(a)(2)(B) and (d). An option 2 contracts provides a death benefit equal to the greater of the face amount of the Contract plus its cash value or the amount required by the cash value corridor.

As with most variable or universal contracts, the face amount and death benefit under the Contracts may be changed upon the policyholder’s request, subject to certain underwriting requirements and other limitations. Policy loans are available. If a loan is outstanding at the time of the insured’s death, Taxpayer deducts from the death benefit to be paid the outstanding loans as well as any mortality and rider charges due and unpaid through the month in which the death occurs, and Taxpayer credits interest from the date of death to the date of payment.

Finally, certain of the Contracts provide the policyholder the election to change to paid-up status after which no further premiums may be paid. If this option is elected, all amounts under the Contract are allocated to Taxpayer’s general (also called fixed) account and the death benefit from that time forward equals the level amount of coverage that the then cash value of the Contract can purchase when applied as a net single premium for the coverage at that time, determined on the basis specified in the Contract. Taxpayer ensures that each Contract for which this option is exercised continues to meet the guideline premium limitation requirements of sections 7702(a)(2)(A) and (c).

The cash value (also often referred to as the policy value) used to determine compliance with the federal tax definition of a life insurance contract and as the basis for determining the death benefit under the Contracts is defined in the Contracts. In general, for universal Contracts, the cash value consists of the premiums paid less mortality and administrative charges plus interest and any additional premiums paid since the preceding month’s calculation. If a partial withdrawal is taken or the face amount is reduced, the cash value is adjusted to reflect the amount withdrawn and any applicable surrender charges imposed.

The cash value for variable contracts is computed in a similar manner to the extent that values under the contract are allocated to Taxpayer’s general account. To the extent that amounts are allocated to one or more of Taxpayer’s separate (also called variable) accounts, the cash value in a given account, or sub-account, as of a valuation date is determined by multiplying the number of units purchased for the Contract by the then value of a unit. In that computation, premiums paid and transfers of amounts allocated to that account since the last valuation date increase the number of units, while transfer of amounts and withdrawals out of the account decrease the number of units. In addition, monthly mortality and administrative charges allocated to the account decrease the cash value in the account.

Some of the Contracts include additional benefits provided by riders, such as waiver of premium, other insured coverage, children's insurance, accidental death benefits, and guaranteed insurability. Taxpayer has represented that none of the Contracts fail to comply with section 7702 due to the presence or exercise of these additional benefits.

COMPLIANCE PROGRAM

The Contracts were intended to qualify as life insurance contracts under section 7702 by satisfying the guideline premium requirements of section 7702(a)(2)(A) and (c) and by falling within the cash value corridor of section 7702(a)(2)(B) and (d), and Taxpayer has so administered them since they were issued. Specifically, Taxpayer has used software designed to calculate the guideline premium limitation for each Contract, and to test each Contract upon issuance. Subsequent premiums paid were also tested against the guideline premium limitations. In addition, upon any change in the benefits under a Contract or rider, the guideline premium limitation was recalculated.

When the section 7702 compliance system, or an employee of Taxpayer responsible for ensuring compliance, identified premiums paid for any Contract as in excess of the guideline premium limitation, employees were to follow detailed written procedures established to provide a proper result. Pursuant to these procedures, relevant parties with Taxpayer (including sales agents) would be notified of the problem, and the Contract owner would be contacted to determine whether the excess premium should be refunded (with any interest due) or whether, alternatively, a change should be made in the Contract that would permit the excess amount to be retained in the Contract (again taking into account any interest due).

For those Contracts anticipating periodic payment of premiums, Taxpayer's administrative systems sends each Contract owner an annual reminder of planned or scheduled premiums 21 days prior to the Contract anniversary date. This period of time prior to the anniversary date was selected to permit the owner sufficient time to respond prior to a Contract entering its grace period. If a premium was received prior to the anniversary date, Taxpayer's systems and procedures required that the premium be tested against the then guideline premium limitation and any excess returned to the policyholder. Taxpayer regularly refunded excess premiums to the policyholder/owner even though paid only a few days prior to the date upon which the guideline premium limitation would increase.

Discovery of one Contract that violated section 7702 resulted in a timely exhaustive review of not only that violation but of the system being used to calculate the guideline premiums and to ensure compliance of all of Taxpayer's contracts with federal tax law. Taxpayer identified Number G contracts that failed section 7702 due to one of four errors described below.

ERRORS

The first problem causing the failure of Number H Contracts was the inadvertent removal of an alert system by a Taxpayer employee working on a system enhancement. Specifically, the compliance system automatically recalculated the guideline premiums upon changes in the Contracts such as smoker/nonsmoker reclassification or a reduction in face amount and further issued an alert notification to appropriate personnel in the event that the change would cause a violation of the guideline premium limitation. The employee's removal of the alert trigger caused Taxpayer to be unable to make timely refunds or Contract changes to avoid exceeding the limitation.

A second group of Number I failures was caused by the manner in which employees handled premiums received immediately prior to a Contract anniversary date. As noted above, Taxpayer systems and procedures required testing of the premium against the limitation then in effect. If the premium exceeded the limitation, the excess was routinely refunded. In Number I instances, however, Taxpayer employees (in contravention of established written procedure) incorrectly credited the premiums to the Contracts when received without testing the premium against the limitation then in effect, thus causing the Contract to fail the definition of a life insurance contract under section 7702.

A third error occurred during the contract review process undertaken prior to the filing of the waiver request. All contracts that might be in error were segregated for further examination. A Taxpayer employee incorrectly included within that group Number J contracts that had not yet passed through the 60-day refund period permitted by section 7702(f)(1)(B). Because these Number J contracts were pulled aside from the regular procedure, refunds were not timely made and the Contracts failed.

A fourth group of two contracts failed. One contract each failed due to a temporary manual override of a properly functioning system, and a data entry error.

TIMELY CURES

Taxpayer has corrected the first error by reinstating the alert notifying Taxpayer's employees in time to take preventive measures. Any Contracts undergoing changes that would otherwise result in violation of the revised guideline premium limitation are now corrected before the violation occurs.

Early application of premiums to Taxpayer contracts should no longer occur. Taxpayer has adjusted its procedures to highlight the issue of premature receipt of scheduled premiums that would exceed the guideline premium limitation if applied to a contract upon receipt. Further, to the extent permitted under SEC rules (where applicable), Taxpayer now holds the excess premium in a premium deposit fund until the anniversary date. If the premium is received five or more days prior to the anniversary date, Taxpayer attempts to obtain the contract owner's instruction as to whether to hold or refund the excess premium. In the absence of such instructions, the excess premium is refunded with any interest due.

The third error was due to a misunderstanding of instructions with respect to the review process. The team member understood the rule with respect to the need to refund within 60 days, but misunderstood an instruction during the review process. Although this situation is not expected to recur, Taxpayer has reminded the employee of the rule in section 7702(f)(1)(B). To prevent any similar situation from occurring in the future, monthly reports are now generated to alert actuarial and supervisory staff to required refunds.

The fourth type group of errors, together with the failures described above, have caused Taxpayer to undertake four measures. First, Taxpayer has required additional training for all employees and instituted other procedures that will reduce the likelihood of future clerical and data entry problems. Second, new procedures now mandate that certain complex transactions be processed by experienced, senior-level employees who are then subject to an additional level of review. Third, additional quality controls are in place for any transaction that affects the calculation of the guideline premium limitation. Finally, monthly reports now are generated to alert actuarial and supervisory staff to potential violations of section 7702, thereby enabling corrections to be implemented within the allotted 60 days.

PROPOSED CORRECTION

Taxpayer proposes to remedy the compliance failure of each failed Contract that is in force on the date that the requested ruling is issued and under which the sum of the premiums paid as of that date exceeds the Contract’s guideline premium limitation on that date. Taxpayer proposes, within 90 days of receipt of this ruling, either (1) to refund any excess premium with interest equal to or greater than the Contract crediting rate to the Contract holders, or (2) to increase the death benefit payable under the failed Contract to the level needed to ensure compliance with section 7702. If the guideline premium limitation is not exceeded by the premiums paid as of the date of issuance of this letter, Taxpayer will not make a correction.

LAW & ANALYSIS

In general, for contracts issued after 1984, section 7702 provides a definition of the term "life insurance contract" for all purposes of the Code. To satisfy this definition, a life insurance or endowment contract must be treated as such under the applicable law. Pursuant to section 7702(a), contract must also either (1) meet the cash value accumulation test of subsection 7702(b) or (2) satisfy the guideline premiums requirements of subsection 7702(c) and fall within the cash value corridor test of section 7702(d).

Section 7702(b) provides that a contract meets the cash value accumulation test if, by the terms of the contract, the cash surrender value of the contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.

Section 7702(c)(1) provides that a contract meets the guideline premium requirements if the sum of the premiums paid under such contract does not at any time exceed the guideline premium limitation as of such time.

Section 7702(c)(2) provides that the term "guideline premium limitation" means, as of any date, the greater of (A) the guideline single premium, or (B) the sum of the guideline level premiums to such date.

The guideline single premium is the single premium at issue that is needed to fund the future benefits under the contract using the mortality and other charges specified in section 7702(c)(3)(B). Section 7702(c)(3)(B) specifically provides the guideline single premium is based on (i) reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in the 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 actually be 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, with interest at the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on issuance of the contract. Section 7702(c)(4). The computational rules of section 7702(e) and the definitions of section 7702(f) apply for purposes of determining both the guideline single and guideline level premium.

If premiums paid exceed the guideline premium limitation, section 7702(f)(1)(B) allows the issuer 60 days after the end of the policy year in which to refund the excess premiums as may be necessary to cure a failure.

Pursuant to section 7702(f)(8), the Secretary of Treasury may waive a failure to satisfy the requirements of section 7702. This waiver is granted if a taxpayer establishes that the statutory requirements were not satisfied due to reasonable error and that reasonable steps are being taken to remedy the error.

Based on all of the facts, law, and arguments presented, we conclude that the failure of the Contracts to satisfy the requirements of section 7702 is due to reasonable error. Taxpayer’s compliance system and procedures would, if properly followed, have prevented the errors described. Upon discovery of possible errors, Taxpayer timely reviewed its procedures, discovered failures, and requested a waiver of error. Further, Taxpayer has instituted additional methods by which to avoid future errors. Finally, Taxpayer’s proposed method of correcting the errors is reasonable

We express no opinion as to the tax treatment of the Contracts under the provisions of any other sections of the Code and Income Tax Regulations that may also be applicable thereto.

This ruling letter is directed only to the Taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the next federal income tax return to be filed by Taxpayer.

Sincerely yours,

Associate Chief Counsel
(Financial Institutions and Products)

Mark Smith
Chief, Branch 4