

**Internal Revenue Service**

**Department of the Treasury**

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

Date: August 17, 2000

Legend

Taxpayer =

State X =

Date 1 =

Date 2 =

Amount A =

Amount B =

Amount C =

System D =

System E =

Dear :

This responds to your request of Date 1, as supplemented, for a ruling granting a waiver under §§ 101(f)(3)(H) and 7702(f)(8) of the Internal Revenue Code. You ask that certain flexible premium universal life insurance policies identified in your submissions be treated as life insurance contracts for federal tax purposes.

FACTS

The information submitted indicates that Taxpayer is a stock life insurance company subject to Subchapter L of the Code and licensed under the laws of State X and files annual

statements with the insurance department of State X.

Of more than Amount C insurance policies in force, Taxpayer has identified Amount A insurance policies that fail to qualify as life insurance contracts under the applicable provisions of §§ 101(f)(1) and 7702 of the Internal Revenue Code. Each of the failures was caused by clerical errors: either the customer service representatives made improper overrides manually to the system or the customer service representatives ignored the error report automatically generated by the system. These actions breached standard procedures that were in place and resulted in the acceptance of premiums in excess of the guideline premium limits.

The Amount A policies were initially issued by System D and administered on System E. When an application is submitted, the policyholder information is entered into System D. Once the application is in good order and an approval is received, the premium is applied and the contract is transferred to System E. Since System D does not test the premium for compliance with the guideline premium requirement, System E tests new policies immediately following the transfer to System E.

All of the Amount A failures were caused by the fact that the customer service representatives did not follow the standard method of handling the failed policies that appeared on the status report. In all cases, the customer service representatives either overrode the automatic functions alerting them that the premiums received were in excess of the guideline premium limits, or ignored the error report automatically generated by the system. Since the standard procedures were not followed, the policyholders were never contacted with the option to modify the contract or accept a return of the excess premium and the contracts failed the guideline premium limits.

In order to prevent future failures, Taxpayer has strengthened its compliance procedures with respect to overrides. Taxpayer no longer permits customer service representatives to independently perform override functions. Independent access is restricted to managers. Override functions are not permitted to be performed without prior explicit approval from management. In addition, the fact that an override function has been performed is required to be documented in the policyholder's file. This documentation makes it simpler to identify and correct any inappropriate override that would otherwise result in a failed contract. Further, if an inappropriate override is performed on the system causing a violation of the guideline premium limits, the pertinent contract is listed on the weekly error report. If the error is not immediately corrected, the contract remains on the report until appropriately handled. If, for whatever reason, the error on the error report is not corrected within fifteen days, the excess premium is automatically refunded to the policyholder.

Taxpayer has also strengthened its compliance procedures with respect to how the error list is handled. Previously, although customer service representatives were required to and trained how to address each error on the error report, if a customer service representative failed to follow administrative procedures, an error listed on the report could nonetheless result in a failed

contract. Over time the error list has been generated more frequently and now comes out on a weekly basis. Currently, if a failure shows up on the error list, the agent for that policy is contacted. If the agent does not respond within 15 days, the customer service representative will manually refund the excess premium to the policyholder. If this is not done, the excess premium is not applied to the policy or kept in suspense until the violation is appropriately handled. In addition, the violation automatically stays on the weekly error report until the violation has been corrected.

Only Amount A or less than Amount B percent of a total of over Amount C policies currently in force failed to comply with the statutory provisions in question. Taxpayer represents that it is prepared to return excess premiums with interest, or increase the death benefits on all Amount A policies.

### LAW AND ANALYSIS

Section 101(f) of the Internal Revenue Code 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 contract issued before January 1, 1985.

Section 7702 provides a statutory definition that a life insurance policy must meet to be treated as a life insurance contract for federal tax purposes. A contract must be a life insurance contract under applicable law and must also meet either of two alternative tests: (1) the cash value accumulation test of § 7702(b), or (2) the guideline premium and cash value corridor requirements of § 7702(c) and (d).

The guideline premium requirement of § 7702(c) provides 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 using the mortality and other charges specified in § 7702(c)(3)(B) and a minimum interest rate assumption of six percent. 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. The computational rules of § 7702(e) and the definitions of § 7702(f) apply to both the guideline single and guideline level premium. Policies qualifying as life insurance contracts under § 7702(a)(2) must also satisfy the cash value corridor of § 7702(d). The corridor specifies a minimum ratio of death benefits (as defined under § 7702(f)(3)) to cash surrender values.

Section 101(f)(3)(B) provides that, if, in order to comply with the requirements of § 101(f)(1)(A), any portion of any premium paid during any contract year is returned by the insurance company (with interest) within 60 days after the end of the contract year, then the

amount so returned (excluding interest) will be deemed to reduce the sum of the premiums paid under the contract during such year.

Similarly, §7702(f)(1)(B) provides that, if, in order to comply with the requirements of § 7702(a)(2)(A), any portion of any premium paid during any contract year is returned by the insurance company (with interest) within 60 days after the end of the contract year, then the amount so returned (excluding interest) will be deemed to reduce the sum of the premiums paid under the contract during such year.

Pursuant to §§ 101(f)(3)(H) and 7702(f)(8), the Secretary of the Treasury may waive a failure to satisfy the requirements of §§ 101(f) and 7702 respectively. This waiver is granted if a taxpayer establishes that the statutory requirements were not satisfied because of reasonable error and that reasonable steps are being taken to remedy the error.

Under the facts as submitted, the failure of Amount C Policies to satisfy the requirements of §§ 101(f) and 7702(a) was caused by reasonable error. Taxpayer has instituted procedures to reduce or eliminate the likelihood that such errors will recur. Taxpayer also has taken reasonable steps to remedy the failure of the Policies to satisfy the requirements of §§ 101(f) and 7702(a), as the case may be.

#### CONCLUSION

Accordingly, based on the information submitted, the failure of Amount A contracts to satisfy the requirements of §§ 101(f) and 7702(a) is waived pursuant to §§ 101(f)(3)(H) and 7702(f)(8), respectively. However, any contracts that are not cured within 90 days of the date of this letter are not covered by this waiver.

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 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.

Sincerely,  
Acting Associate Chief Counsel  
(Financial Institutions and Products)  
By: Mark S. Smith