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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:4-PLR-162330-02
Date:
April 16, 2003

Legend

Company A =

Company B =

State A =

Number A =

Date A =

Date B =

Number a =

Number b =

Number c =

Number d =

D System =

E System =

Dear :

This is in reply to your letter dated Date A in which you requested a waiver of certain errors under § 7702(f)(8) of the Internal Revenue Code and that certain life insurance contracts (the “Contracts”) will be treated as life insurance contracts for federal income tax purposes. Further, you have requested that the proposed amendment to bring the Contracts into compliance §§ 72, 264, 7702 and 7702A, not require retesting or the beginning of a new test period under §§ 264(d)(1), 7702(f)(7)(B)-(E), and 7702A(c), and not be treated as an exchange for Federal tax purposes.

FACTS

Company A is a stock life insurance company, as defined in § 816(a), and is subject to taxation under Part I of Subchapter L of the Code. Company A is organized and operated under the laws of State A an is licensed to engage in the insurance business in Number A states. Company A joins in filing a consolidated return with Company B.

The Contracts that are the subject of this ruling are flexible premium adjustable life insurance policies. The Contracts were designed to integrate traditional life insurance coverage along with the flexibility of a “universal life” policy. Thus, the Contracts have a policyholder account as well as mainstream life insurance benefits.

Policyholders had the ability to choose up to four of the following different types of insurance elements: (1) whole life insurance coverage; (2) term insurance coverage; (3) paid-up whole life insurance coverage; and (4) paid-up deferred whole life insurance coverage. Policyholder may modify, add or remove elements during the life of the insured. Supplemental benefits are available by rider, including premium waiver benefits, accidental death benefits, guaranteed insurability benefits and additional insurance coverage.

Premiums for the Contracts are generally paid in a fixed amount determined by Company A on a periodic basis: monthly, quarterly, semi-annually, or annually. Premiums are generally paid through payroll deduction. Policyholders may also pay additional premiums. The premiums flow into the policy account and interest is credited as declared by Company A from time to time and a deduction is taken for charges related to the insurance elements under the Contract. For Contracts issued prior to 1993, the policy account has a minimum interest rate guarantee of 5.5 percent and for Contracts issued after 1992, the policy account has a minimum interest rate guarantee of 4.0 percent.

Company A began issuing the Contracts on Date B. Company A represents that the Contracts were designed to comply by their terms with the guideline premium test under § 7702 of the Code. Number a Contracts are in force and Number b policies have failed to meet the requirements of § 7702.

ERRORS

Company A represents that the Number b contracts which have violated the requirements of § 7702 did so because of: 1) clerical errors made involving corrections in accordance with the 60 days rule, and 2) an incorrect adjustment methodology used by Company A.

Company A automatically refunded excess premium with interest to owners of Contracts when identified as failing to comply with the guideline premium test. Number c Contracts violated the requirements of § 7702 due to manual keying errors involving policy dates, mortality factors, and interest rates.

"Proper adjustments" must be made to the policies' guideline premiums in accordance with § 7702(f)(7)(A), when changes are made in the policy elements or charges that are made that were not previously reflected in the guideline premiums for the Contracts. Under the D system and the E System, the guideline premiums for the Contracts were adjusted when such changes were made. Under both systems, the adjustment was made to the guideline premiums using an "issue age" methodology in both benefit increases and decreases. Company A calculated a guideline premium for each element as of the date the element was issued, and then combined such guideline premiums for all of the elements to arrive at the guideline premium for the Contract. If a change occurred in the charges for the Contract, Company A assumed that the insurance element under the Contract had been issued with the new charge.

In Company A's view, the AADM (the attained age decrement method) was designed for use in connection with universal policies, not policies such as the Contracts with fixed, traditional coverage elements and fixed charges therefore. Company A determined that the AADM could not be applied to the Contract in a manner that would allow gross premiums to be paid for the Contracts in amounts that would keep them in force for the whole of life. Accordingly, Company A determined that the issue age methodology was the only means by which it could make "proper" adjustments to a Contract's guideline premium in the event of the changes to a Contract. Number d Contracts violated § 7702 with respect to the AADM.

CORRECTION OF ERRORS

Company A has added a cash value accumulation test (CVAT Endorsement) to all in-force Contracts (including failed Contracts) effective retroactively to the original issue date of the Contracts. The CVAT test factors, determined using the1980 CSO mortality, are set forth in the endorsement. The CVAT test factors were also determined in a manner consistent with sound and accepted actuarial practice and in accordance with the requirements of § 7702. For Contracts where the current death benefit is less that the minimum death benefit with the endorsement, the Company A will increase the death benefit provided by the Contract to the level determined using the percentage factors of the CVAT Endorsement. In cases where the death benefit increase required as a result of the CVAT Endorsement is substantial, Company A will distribute appropriate amounts from the Contract to or for the benefit of the policyholder. The distribution will occur concurrently with the addition of the CVAT Endorsement. In the case of failed Contracts terminated by reason of death of the insured at a time when the premiums paid exceeded the guideline premium limitations for the Contracts, Company A will refund such excess to the policyholders, the policyholders' estates or the beneficiaries, with interest at the Contract's interest crediting rate.

LAW & ANALYSIS

In general, for contracts issued after 1984, § 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 state law. A contract must also satisfy one of two alternative tests: (1) the cash value accumulation test of § 7702(a)(1), or (2) the guideline premiums requirement and the cash value corridor test of § 7702(a)(2)(A) and (B).

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(f)(7)(A) requires, in general, that if there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under § 7702, there shall be proper adjustments in future determinations made under the section. The statute itself provides no guidance on what constitutes "proper adjustments".

The legislative history concerning what constitutes "proper adjustments" is ambiguous. There is no legislative history contemporaneous with the inclusion of the term in § 7702(f)(7)(A) in 1984. The Tax Reform Act of 1986 included technical corrections to the 1984 legislation, including amendments of § 7702(f)(7). The explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee contains the following description of an attained age decrement method to be used in making "proper adjustments" after a reduction in benefits:

> Under [the attained age decrement method], when benefits under the contract are reduced, the guideline level and single premium limitations are each adjusted and redetermined by subtracting from the original guideline premium limitation a "negative guideline premium limitation" which is determined as of the date of the reduction in benefits and at the attained age of the insured on such date. The negative guideline premium limitation is the guideline premium limitation for an insurance contract that, when combined with the original insurance contract after the reduction in benefits," produces an insurance contract with the same benefit as the original contract before such reduction.

Joint Committee on Taxation, 99th Cong., 2d Sess., Explanation of Technical

Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation, 108 (Comm. Print 1987).

Section 7702(f)(1)(A) defines the term “premiums paid” as the premiums paid under the contract less § 72(e) amounts and less any excess premiums with respect to which there is a distribution relating to certain changes during the first 15 years and distributions made in anticipation of benefit reductions.

Section 7702(f)(1)(B) provides that if an insurance company, in order to comply with the guideline premium test, returns (with interest) any portion of any premium paid during any contract year within 60 days after the end of the contract year, then the amount returned (without interest) reduces the sum of the premiums paid under the contract during that year.

Pursuant to § 7702(f)(8), the Secretary of the Treasury may waive a failure to satisfy the requirements of § 7702. This waiver is granted if a taxpayer established 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 Number b contracts to satisfy the requirements of § 7702 is due to reasonable error. Company A’s errors are reasonable within the meaning of §7702(f)(8). The legislative history is not clear as to the use of the attained age increment-decrement method, nor is there a specific requirement for its use in section 7702(f)(7)(A). Company A has taken reasonable steps to remedy the error. Company A will add a CVAT Endorsement within 90 days from the date of this ruling to all in-force Contracts (including all in-force failed Contracts) that will be effective retroactively to the original issue date of each Contract. The clerical errors that were made with respect to the requirements of the 60 day rule were keying errors. Taxpayer has automated procedures in place to prevent such errors in the future.

Accordingly, based on the information submitted, it is held that the failure of the Contracts to satisfy the requirements of § 7702(a) is waived pursuant to section 7702(f)(8).

We further hold that the remedy will have no effect on the issue dates or on the dates on which they are considered to be “entered into” of the Contracts and will not be considered a material change. Thus, the addition of the proposed CVAT Endorsement, will not result in a loss of “grandfathered” status for purposes of §§ 72, 264, 7702, and 7702A, will not require retesting or the beginning of a new test period under §§ 264(d)(1), 7702(f)(7)(B)-(E), and § 7702A(c), and will not be treated as an exchange for Federal tax purposes.

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 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 should be attached to the next federal income tax return to be filed by Taxpayer.

Sincerely yours,

DONALD J. DREES, JR.
Senior Technician Reviewer, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)

Attachment: Exhibit A