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-101004-03
Date:
May 6, 2003

Legend:

Taxpayer:

Parent:

Date A:
Date B:
Year A:
State A:
X:
Policy Form A:
Number 1:
Number 2:
Number 3:
Number 4:
Number 5:
Number 6:
Number 7:
Number 8:
System A:
System B:
Department A:
Department B:

Dear :

This is in response to your letter of Date A, requesting a waiver pursuant to § 7702(f)(8) of the Internal Revenue Code for Number 1 insurance contracts issued by Taxpayer that failed to meet the requirements of § 7702(a).

FACTS

The information submitted indicates that Taxpayer is a stock life insurance company organized and operated under the laws of State A. Taxpayer is licensed to do business in X. Taxpayer represents that it qualifies as a life insurance company under § 816(a). Taxpayer is a wholly-owned subsidiary of Parent and files a consolidated return with Parent, on an accrual accounting, calendar year basis.

All of the life insurance contracts (hereinafter referred to as policies) that are the subject of this request are flexible premium universal life insurance contracts issued by Taxpayer on Policy Form A. All of the policies were issued after Date B and were intended to comply with § 7702 by both satisfying the guideline premium requirements of § 7702(a)(2)(A) and (c) and falling within the cash value corridor of § 7702(a)(2)(B) and (d). Taxpayer issued over Number 2 policies and has Number 3 policies in-force.

The policy provides for the payment of an initial premium and of planned premiums. The amount and interval of the planned premium are set forth in a schedule attached to the policy. Although the policy form allows the policyholder to change the frequency, as well as increase or decrease the amount, of the planned premiums, policyholders generally only pay the premium set forth on the schedule. The policies allow Taxpayer to limit any increase in the planned premium and to limit the number and amount of any additional payments to maintain the compliance of the policies with the requirements of § 7702.

The policies provide for the payment of a death benefit prior to maturity. The death benefit provided by the policy varies depending on the death benefit option selected by the policyholder and in effect at the death of the insured. The policy provides two death benefit options. The first option is that the death benefit is the greater of (1) the specified amount or (2) the applicable percentage (as set forth in § 7702(d)(2)) of the policy's cash value. The second option is that the death benefit is the greater of (1) the specified amount plus the policy's cash value or (2) the applicable percentage (as set forth in § 7702(d)(2)) of the policy's cash value.

Taxpayer's compliance procedures for the policies include the use of System A and System B, and the accompanying manual procedures. As part of the policy application process, Taxpayer's procedures require policyholders to identify the amount of the planned premium they will pay for the policy. Employees in Department A use System A to calculate the guideline premium limitation within the meaning of § 7702(c)(2) for the policy and to determine whether the sum of the planned premiums will always be less than the guideline premium limitation for the policy.

Taxpayer also uses System B to generate billing statements for the planned premiums. When each policy is issued, Taxpayer's procedures require employees in Department A to determine the date as of which the planned premiums for the policy (and the bill for the planned premium) will be modified or terminated (the policy change date). A policy change date may be needed for a variety of reasons, such as the expiration of a benefit or the termination of a temporary substandard extra. Employees in Department A calculate the policy change date for a policy using a specific formula. Different formulas are used for the various types of life insurance policies. Employees in Department A are provided with a procedure manual that contain directions regarding the manner in which the policy change date should be calculated. Additionally, supervisors in Department A train employees in their department to enter the policy change date into the policy change date field in System B.

If the planned premium will need to be reduced or terminated by a certain date to continue a policy's compliance with the guideline premium limitation, the policy change date would be that date, rather than the date produced by the applicable formula for the policy. Once the policy change date is determined, senior employees in Department A are required to enter it into the policy change date field of Taxpayer's System B with a code indicating the reason for the policy change. If the planned premium will need to be modified or terminated to continue the policy's compliance with the guideline premium limitation, the current procedure is to use code G.

System B generates, three times a month, a list of all the policies with policy change dates in the following month (the policy change date notice). The policy change date notice also sets forth a code for each policy change date that explains the nature of the modification required. After the policy change date notice is generated, it is sent to Department B for processing. Department B reviews the policy change notice in order to determine whether a specific code is identified for each policy. If a specific code is identified, for example, code G-- change needed to maintain compliance with the guideline premium limitation, Department B modifies the planned premium to maintain the policy's compliance. However, if the code is identified on the policy change date notice is miscellaneous code, the file for the policy must be reviewed by Department B in order to determine the nature of the modification required.

Department A can enter only one policy change date into System B for each policy. If a policy will require more than one change date in its planned premium or other aspects of its coverage (since use of the policy change date field is not restricted only to premium changes), the date of the first policy change is coded with the appropriate code for that change or if there is no specific code, a "miscellaneous" code is used. With respect to certain policies, multiple policy change dates are required. For example, in the case of a policy issued with a temporary substandard extra that expires after a certain number of years, the policy change date would be coded with a miscellaneous code. This would inform Department B that the policy file must be reviewed in order to determine the nature of the modification required and whether a subsequent policy change date is required.

Approximately one year ago, Taxpayer discovered that certain of the policies it issued failed to meet the requirements of § 7702. These policies are referred to hereafter as failed policies. Described below are the nature of the errors and the steps that Taxpayer is taking or will take to correct these errors and to prevent them from reoccurring.

Clerical processing errors resulted in the noncompliance of Number 1 failed policies. These clerical processing errors stemmed from the inadvertent failure of employees to follow Taxpayer's established procedures. There are four types of clerical processing errors.

The first type of error stemmed from the failure of employees in Department A to follow Taxpayer's procedures from for determining the policy change date and entering the date into System B. Taxpayer's procedures require employees in Department A to determine the policy change date using one of the formulas provided. Once a policy change date is determined, senior employees in Department A are required to enter it into System B. Employees in Department A inadvertently used an incorrect formula, in certain instances, to determine the policy change date. In other instances, employees in Department A , after correctly determining the policy change date, did not enter the date into System B. As a result, the policy change date notices generated by System B did not correctly reflect the policy change date for these policies. Since the employees in Department B were not provided the correct policy change date, they did not correctly modify the planned premium for these policies with the result that premiums in excess of the guideline premium limitation (excess premiums) were paid. This resulted in the noncompliance of Number 4 policies.

The second error resulted from the failure of employees in Departments A and B to follow Taxpayer's procedures for entering the policy change date into System B. When each policy is issued, Taxpayer's procedures require senior employees in Department A to enter the policy change date into the System B. Contrary to Taxpayer's procedures, employees in Department A did not enter the policy change date into System B in certain instances. As a result, the policy change date notices generated by System B did not contain the policy change date for these policies. Consequently, employees in Department B were not aware that the planned premium had to be modified in order to prevent excess premiums from being paid. The error resulted in the noncompliance of Number 5 policies.

After a policy change notice is generated, Taxpayer's procedures require employees in Department B to review the policy file of all the policies on the policy change date notice that are identified with a miscellaneous code. For these policies, Taxpayer's procedures also require employees in Department B to determine, based on the policy file , (1) the nature of the planned policy change required and (2) whether a subsequent policy change date should be entered into System B for the policies. In certain instances, when a subsequent policy change date needed to be entered into System B, employees in Department B did not do so. As a result, any policy change date notice generated by System B did not contain the subsequent policy change date for these policies, and employees in department B were not aware that the planned premium had to be modified a second time in order to prevent excess premiums from being paid. This error resulted in the noncompliance of Number 6 policies.

The third clerical processing error stemmed fro the failure of employees in Department B to follow Taxpayer's procedures with respect to policy change date notices. As described above, Taxpayer's procedures require employees in Department B to review the policy change date notices and modify the planned premium accordingly. In certain instances, employees in Department B did not follow Taxpayer's procedures and did not change the planned premium as indicated on the policy change date notices. Consequently, policyholders paid excess premiums, which were not refunded within 60 days of the end of the contract year in which they were paid. This error resulted in the noncompliance of Number 7 policies.

The fourth clerical error involved a mistake in inputting certain information into Systems A and B. Specifically, for Number 8 policies with respect to which the insured was a female, the planned premium and the guideline premiums were calculated for a male of the same age. As a result, premiums were paid in excess of the correct guideline premium limitation.

As a short term solution to correct its procedures, Taxpayer is comparing the premiums paid for a policy, which are not equal to the billed premium and/or are received prior to the due date, to the policy's guideline premium limitation on a monthly basis to determine whether the premium can be accepted. A report is also generated on a monthly basis indicating all policies that had excess premiums paid in the preceding month. Employees of Taxpayer review each policy on the report in order to determine whether in fact premiums have been paid in excess of the guideline premium limitation for the policy. If excess premiums have been paid, such premiums are returned to policyholders (with interest) within 60 days after the end of the contract year in which they are received pursuant to § 7702(f)(1)(B).

Taxpayer also has implemented some additional procedures designed to prevent noncompliance. Specifically, employees in Department A use in conjunction with System A a detailed spreadsheet to calculate the guideline premium limitation for a policy to determine whether the sum of the planned premiums will always be less than the guideline premium limitation of the policy. Taxpayer's procedures also require a supervisor in Department A to review the determination of the guideline premium limitation for a policy before it is sent to the policyholder.

In order to reduce the likelihood that the errors described above will recur, Taxpayer is in the process of converting the policies to a new administrative system. Taxpayer expects the conversion to be completed by the end of Year A. The new administrative system will compare premiums paid under the policy with the guideline premium limitation applicable to the policy each time a premium payment is received. Additionally, the new administrative system will not allow premiums in excess of the guideline premium limitation to be applied to a policy. Such excess premiums will be returned (with interest) to policyholders within 60 days after the end of the contract year in which they were paid, pursuant to § 7702(f)(1)(B). These actions will reduce the likelihood that the errors described above will recur.

LAW AND ANALYSIS

Section 7702 defines the term "life insurance contract" for all purposes of the Code.Under § 7702(a), a life insurance contract must qualify as such under the applicable law and must satisfy either the cash value accumulation test of § 7702(a)(1) and § 7702(b), 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 premium 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 § 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 means the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis as the guideline single premium, except § 7702(C)(3)(B)(iii) shall be applied by substituting "4 percent" for "6 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 premium and the guideline level premium.

Under § 7702(f)(8) , the Secretary of the Treasury may waive the failure to satisfy the requirements of § 7702 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).

Taxpayer proposes to remedy the compliance failure of each failed policy that is in-forced on the effective date of the waiver and under which the sum of the premiums paid as of that date exceeds the guideline premium limitation for the failed policies as of that date. Specifically, Taxpayer proposes to refund to the policyholders the amount by which the sum of the premiums paid exceed the guideline premium limitation for the policy as of the effective date of the waiver with interest on such amount at the contract crediting rate. With respect to failed policies that terminate by reason of the death of the insured at the time when the premiums paid exceed the guideline premium limitation for the failed policies, Taxpayer will pay the policyholders, the policyholders' estates, or the beneficiaries such excess, with interest at the contract crediting rate. Taxpayer is prepared to implement these corrective measures within 90 days from the effective date of the requested waiver.

After considering all the facts and circumstances, we find that failure of Number 1 policies to satisfy the requirement of § 7702 was due to reasonable errors, and Taxpayer is taking reasonable steps to remedy the errors.

CONCLUSION

Accordingly, based on the information submitted, the failure of Number 1 contracts to satisfy the requirements of § 7702(a) is waived pursuant to § 7702(f)(8), provided that the excess premiums are refunded with interest calculated equal to the contract crediting rate, 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 on information submitted by the Taxpayer 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 a ruling, it is subject to verification on examination.

Except as 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) 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 Taxpayer.

Sincerely yours,
MARK S. SMITH
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions and Products)