Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:4-PLR-132135-00
Date:
September 13, 2001

Date A
Taxpayer

Number B
Parent
Number C

Dear

This is in reply to your letter dated Date A in which your representatives requested a ruling on Taxpayer's behalf with respect to Number B contracts (the Policies) intended to meet the definition of a life insurance contract under section 7702(a) of the Internal Revenue Code. Specifically, Taxpayer asks for a waiver of a reasonable error under section 7702(f)(8) such that the Policies will be treated as life insurance contracts for federal tax purposes. The policy numbers for the Number B contracts are set forth in Exhibit 1 hereto.

Taxpayer is a stock life insurance company, as defined by section 816(a), and is subject to taxation under Part I of Subchapter L of the Code. Taxpayer primarily writes flexible premium universal life insurance, term life insurance and deferred annuity contracts. Taxpayer is wholly owned by Parent. Taxpayer joins in filing a life/nonlife Federal income tax return with Parent and its affiliates.

Taxpayer represents that all Number B Policies are life insurance contracts under the laws of the states or other jurisdictions in which they are issued. Further, if the requested ruling is granted, Taxpayer represents that the Policies will satisfy the guideline premium limitation test of section 7702(c) and the cash value corridor test of section 7702(d).

The errors causing the failures to meet the definition of a life insurance contract are of three types. In the case of three Policies, changes were made after issue that included a decrease in the death benefit of the contract. The computerized system correctly calculated the new guideline premium limitation but clerical personnel failed to follow procedures outlined in Taxpayer's procedure manual so that the correct actions could be taken to ensure continued compliance with section 7702. Specifically, the clerks in the policy change department are required to request that the actuarial

department verify whether or not the reduction would cause the policy to violate the guideline premium limitation. In two cases, Taxpayer has verified that no such request was made. In the third case, the actuarial department failed to notify the policy change department that the face reduction would cause the policy to violate guideline premium limitations. In all three instances, the computerized compliance system contained a screen that disclosed that there were now excess premiums in the contracts but clerical personnel failed the check the screen. Had proper procedure been followed, the disclosure of excess premiums would have initiated the manual process that would have verified the payment of future excess premiums so that refunds could have been timely made.

In one other case, the computerized compliance system failed properly to account for a change in death benefit option between an option B contract (cash value taken into account in the determination of death benefit) and an option A contract (level death benefit without regard to the cash value). Upon a change in death benefit option, the computerized compliance system recomputes the guideline premium limitation by taking the attained age decrement method into account. Taxpayer has learned, despite extensive testing of the compliance system, that a minor programming error has, in this one instance, produced an overstated guideline premium limitation. Instructions as to how the attained age decrement method should be incorporated into the computer software were not followed due to a programming error.

In Number C cases, guideline premiums were accepted in excess of the pertinent guideline premium limitation due to one cause only. Taxpayer computed its guideline premium limitations using section 7702(c)(3)(B)(i) to determine how to account for qualified additional benefits rather than section 7702(c)(3)(B)(ii), as mandated by section 7702(b)(2)(B). Specifically, the limitations were determined on the basis of charges (other than mortality charges) specified in the contract as opposed to the lesser charges expected to be actually paid. All Number C of these failures occurred on or after the October 21, 1988, the effective date of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) changes made to sections 7702(c)(3)(B)(i) and ((ii).

Taxpayer states that its insurance contracts were monitored carefully to ensure compliance with the guideline premium test by using an automated administration system and well managed administrative procedures. Further, as part of their overall tax compliance system, Taxpayer's management kept abreast of legislative changes, primarily through regular updates of current events in tax-related legislation provided by a tax service. For example, relevant information the TAMRA legislation was distributed to all functional areas, e.g., actuarial, legal, administration, and information technology areas. In addition to these updates, Taxpayer regularly consulted reputable actuaries. To understand viewpoints from outside the company, Taxpayer also referred to articles from sources such as the Society of Actuaries, the American Council of Life Insurers, the American Academy of Actuaries, and the National Underwriter and its representatives attended industry conferences. Taxpayer also consulted legal counsel

and other advisors.

When section 7702 was modified by TAMRA, Taxpayer made prompt modifications to its business procedures to ensure continued compliance with the standards applicable to life insurance contracts issued after the effective date of section 7702. Major changes were required in three areas: new rules relating to modified endowment contracts, new rules governing reasonable mortality charges, and the change in the type or amount of other charges that could be taken into account. As to this final change, Taxpayer noted the modifications made by TAMRA but concluded, after review, that no changes needed to be made to their compliance systems, based on their interpretation of revised section 7702(c)(3)(B)(ii).

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. More specifically, 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 section 7702(b), or (2) the guideline premium and cash value corridor test of section 7702(c) and (d). In general, section 7702 applies to contracts issued after December 31, 1984.

Section 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. Specifically, it states that the determination shall be made on the basis of the rules of subparagraph (B)(i) (and, in the case of qualified additional benefits, subparagraph (B)(ii) of subsection (c)(3)). This language was included in section 7702 as originally enacted and has not been modified. Although this requirement nominally refers only to the determination required for the cash value accumulation test, this provision is the only direction provided by the statute as to how charges for qualified additional benefits are to considered from a computational standpoint. Section 7702(c) dealing with the guideline premium limitation requirements does not have a specific computational rule for qualified additional benefits. None of the legislative history explicitly discusses the rules in section 7702(b)(2).[1] The Legislative history, however, is absent of any

[1] The legislative history provides additional support for concluding that section 7702(c)(2)(B)(ii) is the operative rule for qualified additional benefits. See H. Rep. No. 98-432, Pt. 2, 98th Cong., 2d. Sess. (March 5, 1984), p. 1445, footnote 25, (distinguishing “mortality charges” from “charges” for “additional benefits”); 1 Senate Committee on Finance, 98th Cong., 2d. Sess. Deficit Reduction Act of 1984: Explanation of Provisions Approved By The Committee On March 21, 1984, at 575, footnote 24 (S. Prt. 98-169, 1984) (same). See also Staff of Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 648, footnote 51 (1984) (stating that the discussions therein relating to “mortality and other charges” are generally applicable to both the cash value accumulation and guideline premium tests).

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. Furthermore, there is no indication in TAMRA that Congress intended to change the existing rules dealing with qualified additional benefits.

The rules specifically applicable to the guideline premium limitation appear in section 7702(c), which 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 section 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 section 7702(e) and the definitions of section 7702(f) apply to both the guideline single and guideline level premium. Contracts qualifying as life insurance under section 7702(a)(2) must also satisfy the cash value corridor of section 7702(d). The corridor specifies a minimum ratio of death benefits (as defined under section 7702(f)(3)) to cash surrender values.

Qualified additional benefits that may be taken into account in the determination of the guideline premium limitations are described in section 7702(f)(5)(A) as

(i) guaranteed insurability
(ii) accidental death or disability benefit,
(iii) family term coverage,
(iv) disability waiver benefit, or
(v) other benefit prescribed under regulations.

Section 7702(f)(5)(B) states that, for purposes of section 7702, 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. “Future benefits” is, in turn, defined under section 7702(f)(4) to mean death benefits and endowment benefits.

The basis upon which the determination of the guideline single premium is to be made for purposes of the guideline premium limitation is set forth in section 7702(c)(3)(B). Prior to the TAMRA amendment, sections 7702(c)(3)(B)(i) and (c)(3)(B)(ii) read:

(i) the mortality charges specified in the contract (or, if none is specified, the mortality charges used in determining the statutory reserves for such contract),

(ii) any charges (not take into account under clause (i) specified in the

> contract (the amount of any charge not so specified shall be treated as zero), and"

TAMRA changed section 7702(c)(3)(B)(ii) by removing the reference to "charges . . . specified in the contract" and inserting "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" but also changed the language of section 7702(c)(3)(B)(i). After the amendment, neither clause contained a reference to the charges specified in the contract although the practical effect was that section 7702(c)(3)(B)(i) was now both a cap and a floor on the mortality charges to be taken into account[2] while section 7702(c)(3)(B)(ii) served only as a ceiling. The new language reads:

> (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. . . .

Taxpayer divided qualified additional benefits between those that provide family term riders and those that provide other qualified additional benefits (Other Benefits). Family term riders are provided in one of two different forms: (1) an Additional Insured Rider (coverage for a family member not to extend beyond the base insured's attainment of age 70) and (2) a Child's Rider (all designated children but not to extend beyond the earlier of the child's attainment of age 22 or the base insured's attainment of age 65). The tables of cost of insurance charges for the Additional Insured Rider are based on the same 1980 Commissioners Standard Ordinary (CSO) table as used for the base coverage.

The bulk, or Number C, of the Policies at issue involve Other Benefits, namely: accidental death, disability waiver and monthly disability, and payer death and disability benefits (Other Benefits). The contract for each benefit specifies a cost of insurance charge, but the cost of insurance charges for each of these benefits is less than the maximum rate specified in the contract.

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[2] The effect of the modification of this clause is not at issue in this ruling but has been discussed in the Section 5011(c)(2) of TAMRA; TAMRA's legislative history (see H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. 108 (1988)); Notice 88-128, 1988-2 C.B. 540, proposed regulations under section 7702, and numerous articles. See also Rev. Rul. 92-19, 1992-1 C.B. 227 and updates thereto.

For all Number B Policies, Taxpayer took into account, for purposes of determining the guideline premium limitation, the full charge specified in the contract for each of these types of qualified additional benefits. Taxpayer did not reduce the amount taken into account even where the amounts reasonably expected to be actually paid were known to be less than the maximum charges. Taxpayer's methodology was to apply section 7702(c)(3)(B)(i) which does not take into account actual charges but rather reasonable charges.

Taxpayer argues that its position was consistent with the approach taken in the off-the-shelf computerized compliance system supplied to it and warranted as being compliant with the new rules added by TAMRA. The system was programmed to use the maximum rate specified in the contract for all qualified additional benefits and did not include the ability to use a lower rate if expected to be actually paid.

Taxpayer believed that neither the Code nor legislative history clearly tied qualified additional benefits to being governed by section 7702(c)(3)(B)(i) or (ii). After consideration, the actuaries erroneously reached two conclusions: (1) the "reasonable charges other than mortality charges" described in section 7702(c)(3)(B)(ii) referred only to expense loads,[3] and (2) cost of insurance charges for family term riders and other qualified additional benefits were considered mortality charges to be taken into account under section 7702(c)(3)(B)(i). Accordingly, the actuaries directed that the compliance system continue to treat the charges for qualified additional benefits as being governed by the maximum rates specified in the contract despite the legislative change to section 7702(c)(3)(B)(ii).

Taxpayer argues that, because the riders were qualified additional benefits under section 7702(f)(5)(A)(iii), then, under section 7702(f)(5)(B) the benefits themselves were not to be treated as future benefits under the contract but, rather, that the charges for the benefits were to be treated as future benefits. Taxpayer then concluded that "future benefits" under section (f)(4) included "death benefits" and that the "death benefit" (i.e., the charge for the rider) under the rider was a mortality charge. Accordingly, they looked at section 7702(c)(3)(B)(i), found nothing in its language or supporting legislative history related directly to the guideline premium limitation to contradict their conclusions, and decided that the charges for this rider should be governed by section 7702(c)(3)(B)(i).

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[3] As the maximum charges specified in the contract and the rate actually being charged for expense charges such as monthly administration charges and percentage of premium loads were identical, no change in the guideline premium limitation was deemed necessary for these charges due to the legislative change. None of the Number C Policies included in Taxpayer's submissions involve errors related to expense charges.

Taxpayer's actuaries concluded that the charges for Other Benefits were to be treated as death benefits and thence as mortality charges. Because charges for death benefits are commonly known as mortality charges, the actuaries concluded that charges for Other Benefits should be governed by section 7702(c)(3)(B)(i).

Section 7702(f)(8) provides that if a taxpayer establishes to the satisfaction of the Secretary of the Treasury that the requirements of section 7702 were not satisfied due to reasonable error, and reasonable steps are being taken to remedy the error, the Secretary may waive the failure to satisfy such requirements.

Under the facts submitted and representations made, the failure of the first four of the Policies to satisfy the requirements of section 7702(a) is due to reasonable error as the failure to recognize that excess premiums had been paid was due to clerical error. Taxpayer had procedures existing at that time that, if properly followed, would have resulted in the Policies complying with the statute. Further Taxpayer will, within 30 days of receipt of this ruling, refund any excess premium with interest at the contract crediting rate as of the date of refund, which is a reasonable step to remedy the failure of the Policies to satisfy the requirements of section 7702(a). Also, Taxpayer has in place automated procedures designed to prevent future noncompliance.

As to the remaining Number C contracts, we do not agree with Taxpayer's conclusions as to the legal analysis of section 7702. The Code and legislative history referring to the treatment of qualified additional benefits under section 7702 provide a sound basis for the conclusion that charges for qualified additional benefits are controlled by section 7702(c)(3)(B)(ii). This treatment is the same for both the cash value accumulation test and the guideline premium limitation requirements. After considering Taxpayer's arguments,[4] we find that its error was reasonable. Taxpayer will also, within 30 days of receipt of this ruling, conform its compliance system to take the charges for all qualified additional benefits into account under section 7702(c)(3)(B)(ii). If, as a result of the adjustment, any Policy contains excess premiums, Taxpayer will, also within 30 days of receipt of this ruling, either refund the excess premium together with interest at the contract crediting rate or raise the death benefit sufficiently to ensure compliance with section 7702. Together these are reasonable steps to cure the error made.

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[4] Among other grounds for its error being reasonable, Taxpayer argues that it should have been able to rely on the accuracy and correct analysis contained in the programming for off-the-shelf compliance software marketed to the insurance industry. We do not find this argument either persuasive or determinative. Taxpayers are required to independently analyze, test, and verify all assumptions and methodology contained in such software and may not avoid culpability for any errors therein. The obligation to comply with the requirements of section 7702 belongs to Taxpayer and responsibility for failures to comply may not be delegated. However, as with internally developed software, there can be errors that are reasonable and thus waivable.

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

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.

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

Attachment:
Exhibit 1