Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
September 12, 2001

Legend

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Dear

This responds to your letters dated Date1, Date 2, and Date 3, in which you requested a ruling on Taxpayer's behalf concerning Number B contracts ("Policies") that Taxpayer issued intending that they meet the definition of a life insurance contract under section 7702(a) of the Internal Revenue Code.[1] 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.

FACTS

Taxpayer is a stock life insurance company organized and operated under the laws of State A, and is treated as a life insurance company for tax purposes pursuant to section 816(a). Taxpayer is licensed to engage in the life insurance business in Number A states and in B.

Taxpayer's request pertains to three types of flexible premium universal life insurance contracts, Policy A, Policy B, and Policy C. Policy A, issued from Year 2 to Year 11, and Policy B, issued from Year 5 to Year 13, are flexible premium whole life contracts. Although Policies A and B are in form flexible premium policies, Taxpayer marketed Policies A and B as having planned periodic premiums, i.e., Taxpayer contemplated few unscheduled premiums. Policy C, issued from Year 10 to Year 14, is a traditional flexible premium life insurance contract in which Taxpayer contemplated both planned and unscheduled premium payments.

Taxpayer's ruling request pertains to Number B policies that did not meet the definition of a "life insurance contract," set forth in section 7702, due to certain errors committed by its employees.[2] Since 1984, when Congress enacted section 7702,

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended and in effect during the years in issue.

[2] 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. To be considered a life insurance contract, 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

Taxpayer has used different computer-based systems to administer its life insurance contracts, including procedures intended to assure compliance with that section's requirements. Both Policy A and Policy B contracts were designed to have few unscheduled premiums; thus, Taxpayer focused its initial section 7702 compliance efforts to assure that scheduled premiums were proper. When Taxpayer first issued Policy A, it ensured that premiums would comply with the guideline premium limitations by employing an illustration system that set forth the guideline single premium and the sum of the guideline premium levels; planned periodic premiums, therefore, would be in compliance with the guideline premium limitations if the premium was consistent with the amount set forth in the illustration. Nonetheless, if Taxpayer did receive a large, unscheduled premium with respect to a Policy A contract, Taxpayer's procedures directed that the payment be referred to its actuarial department for examination.

From Month 1, Year 5 to Month 2, Year 7, Taxpayer employed a software testing program ("System 1") to test premiums received under Policy A and B contracts. Under System 1, each calendar quarter the premiums paid would be compared with the guideline single premium and the sum of the guideline level premiums for the contract. When the system identified a policy where the premiums paid exceeded the guideline premium limit, the guideline premiums were examined manually to determine whether the policy had a qualified additional benefit or a substandard mortality rating, in which case the guideline premiums were adjusted to include the appropriate charges.

From Month 2, Year 7 to Month 2, Year 10, Taxpayer discontinued using System 1 in anticipation of a new, broader policy administration system developed by X, an unrelated party. A number of problems and delays ensued in implementing the system, and Taxpayer cancelled its contract with X and instead developed its own system ("System 2"). During the period in which Taxpayer was developing System 2, it used a another software system ("System 3") to calculate the guideline premium limitation. In similar fashion to previous years, Taxpayer required contracts under Policies A and B to be issued with planned premium payments that satisfied the guideline premium limitations, and its procedures required that large unscheduled premium payments be referred to its actuarial department for manual review.

Taxpayer completed System 2 in Month 2, Year 10, and the new system began administering Policy A, B, and C contracts. Under System 2, if an owner paid a premium that exceeded that guideline premium limitations, the system was designed to reject the excessive portion of the premium and return it before it was credited to the policy. The system generated a daily error report which required Taxpayer's customer service personnel to manually return the premiums. The system tested each policy on its monthly anniversary date, testing all premiums received during the previous month. Moreover, under System 2, when policyholders requested a change to the policy that affected the determination of guideline premium limitations, Taxpayer's actuarial

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corridor test of section 7702(c) and (d). Each of the policies considered in this ruling were issued after December 31, 1984, the effective date of section 7702.

department would calculate the new limitations, and the customer service department would report them to the policyholder.

When System 2 began functioning, it identified many Policy A contracts as being out of compliance with the guideline premium test. Taxpayer discovered that the guideline premiums for Policy A contracts that had been programmed into System 2 were lower than the correct guideline premiums. While correcting this error, Taxpayer reverted back to testing Policy A contracts under System 3.

In Year 15, Taxpayer began to replace System 2 with a new system ("System 4"). Taxpayer asserts that the System 4 has fewer section 7702 compliance deficiencies than its previous systems. Specifically, Taxpayer states that recent testing of the System 4 revealed an accurate calculation of the guideline premiums with respect to a sample group of policies. Nevertheless, under System 4, Taxpayer continues to manually monitor and administer post-issue changes to Policy A and B contracts through its actuarial department.

In addition to enhancing its computer-based compliance system, Taxpayer has implemented manual procedures to assist its customer service personnel in testing post-issue changes and other service requests that may affect section 7702 compliance by requiring the actuarial department to examine manually any such changes or requests. Taxpayer has recently created procedures for its management to use in monitoring Taxpayer's ongoing section 7702 compliance efforts.

After a recent review of its policies, taxpayer identified Number B policies for which the sum of the premiums paid exceeded the policy's guideline premium limitation. Taxpayer has identified six types of errors that caused the failed policies.

Error (1) pertains to Number C Policy A contracts, Number D Policy B contracts, and Number E Policy C contracts, in which the policyholder paid a premium when the policy was issued (or within 6 months thereafter) that exceeded the guideline single premium for the policy. Taxpayer has identified two explanations for these failures: either the sales agent did not properly prepare the sales illustration developed by Taxpayer, or the customer failed to follow the correct sales illustration and company personnel failed to note the discrepancy per instructions.

Error (2) pertains to Number F Policy A contracts, and Number G Policy B contracts, in which policyholders made unscheduled premium payments. Although Taxpayer required employees processing unscheduled premium payments to refer the premium to Taxpayer's Actuarial Department to ensure compliance with the guideline premium limitations, the clerks processing the payments in some cases failed to do so. Consequently, Taxpayer accepted premiums in excess of the guideline premium limitation.

Error (3) pertains to Number H Policy A contracts, Number J Policy B contracts, and Number K Policy C contracts, in which the policyholder paid periodic payments that

exceeded the correct guideline level premium for the policy. Taxpayer offers two alternative explanations for these failures: (1) either the sales agent did not properly prepare the sales illustration developed by Taxpayer, or did not correctly check a planned periodic premium against the illustrated premium, or (2) in other instances, Taxpayer's clerical personnel, contrary to Taxpayer's procedures, failed to report policies to Taxpayer's actuarial department upon learning of a change in the policy, or failed to properly record new guideline premiums limits into Taxpayer's administration system upon occurrence of such changes in the policies.

Error (4) pertains to Number L Policy A contracts and Number M Policy B contracts, in which policyholders requested that Taxpayer increase its billed periodic premium in an amount that exceeded the correct guideline level premium. In these cases, Taxpayer's employees failed to check the requested new billed premium against the guideline premium or checked it incorrectly.

Error (5) pertains to Number N Policy B contracts issued with a "Family Term Rider." The Family Term Rider provided term life insurance coverage on the life of a member of the family of the individual insured under the Policy. Taxpayer imposes a charge for the mortality risk that it assumes pursuant to the Family Term Rider, and deducts this charge monthly from the Policy's cash value. In computing the guideline premium for these policies under section 7702(c), Taxpayer treated the Family Term Rider as a "qualified additional benefit" within the meaning of section 7702(f)(5)(A). Moreover, pursuant to section 7702(f)(5)(B), Taxpayer treated the charges for the Family Term Rider as "future benefits." In determining the amount of the charges for such future benefits that could be taken into account in calculating the guideline premiums, Taxpayer followed the "reasonable mortality charge" requirements of section 7702(c)(3)(B)(i). In accordance with Notice 88-128, 1988-2 C.B. 540, Taxpayer in calculating guideline premiums used the full charge for the Family Term Rider set forth in the 1980 Commissioners' Standard Ordinary (CSO) Mortality Table.

While reviewing its section 7702 compliance system, Taxpayer recognized that it could have calculated the guideline premiums attributable to the Family Term Rider under the "reasonable expense charge" requirements of section 7702(c)(3)(B)(ii) rather than under the "reasonable mortality charge" requirements of section 7702(c)(3)(B)(i). If section 7702(c)(3)(B)(ii) governs, Taxpayer should have reflected in the calculation of the guideline premiums only the current charges it imposed for the Family Term Rider, rather than the charges set forth in the 1980 CSO Table. Accordingly, Taxpayer has recalculated the guideline premium limitation for those policies, taking into account only the current charges that it imposed for the Family Term Rider. In the case of Number N Policy B contracts, the premiums paid do not exceed Taxpayer's original guideline premium limitation calculated on the basis of section 7702(c)(3)(B)(i), but do exceed Taxpayer's recalculated guideline premium limitation calculated on the basis of section 7702(c)(3)(B)(ii). Taxpayer requests that, in the event that we conclude that section 7702(c)(3)(B)(ii) is the applicable standard, we rule that Taxpayer's interpretation of the statute was reasonable and that Taxpayer is entitled to a waiver under section 7702(f)(8) with respect to the Number N failed contracts.

Error (6) pertains to Number M Policy A contracts that were issued with a "Spousal Term Rider." The Spousal Term Rider provides term life insurance coverage on the life of the spouse of the individual insured under Policy A. The policy also set forth maximum premiums for the rider, although Taxpayer often imposed a charge for the rider that was less than the maximum premium. In computing the guideline premiums for a policy to which the Spousal Term Rider was attached, Taxpayer treated the rider in similar fashion to the manner in which it treated the Family Term Rider discussed with respect to Error (5). Particularly, Taxpayer treated the Spousal Term Rider as a "qualified additional benefit" within the meaning of section 7702(f)(5)(A), and treated the maximum premiums for the rider as a "future benefit" pursuant to section 7702(f)(5)(B).

Taxpayer, however, first issued the rider prior to enactment of the Technical Miscellaneous Revenue Act of 1988 (TAMRA)[3], the pertinent portions of which apply to contracts issued on or after October 21, 1988. Prior to that date, Taxpayer followed the "specified charges" rule in former section 7702(c)(3)(B) to determine the amount of charges for the rider that could be taken into account in calculating the guideline premiums. TAMRA amended section 7702(c)(3)(B) and replaced the "specified charges" rule with the "reasonable charges" rule.[4] Upon enactment of TAMRA, Taxpayer reviewed its contracts and modified the guideline premiums to reflect the new reasonable mortality charge standard. During Taxpayer's review of its section 7702 compliance system, Taxpayer realized that for contracts with Spousal Term Riders issued after October 21, 1988, the premiums for the rider should have been treated as future benefits only to the extent of 100 percent of the 1980 CSO Mortality Table, as allowed by amended section 7702(c)(3)(B)(i) and Notice 88-128. Taxpayer's employees who were assigned to review the contracts for compliance with TAMRA mistakenly failed to identify instances where the maximum premium for the Spousal Term Rider exceeded the charges set forth in the 1980 CSO.

Taxpayer has recalculated the guideline premium limitation for Policy A contracts containing the rider to reflect the lower mortality charges allowed under section 7702(c)(3)(B)(i) and Notice 88-128. Error (6) pertains to Number M Policy A contracts where the premiums paid exceed the correct guideline premium limitation, assuming that section 7702(c)(3)(B)(i) was the proper standard. Thus, in the event that we conclude that section 7702(c)(3)(B)(ii) is the appropriate standard, Taxpayer requests that we grant waivers for both its employees' failure to compare premiums received to the 1980 CSO Mortality Table and for its misinterpretation of the statute.

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[3] Pub. L. No. 100-647, 102 Stat. 3342 (1988).

[4] Prior to TAMRA, section 7702(c)(3)(B)(i) and (ii) provided that the amount of charges to be taken into account in determining the guideline premium were the "charges specified in the contract." Incorporating the changes enacted by TAMRA, section 7702(c)(3)(B)(i) and (ii) presently provides that the amount of charges taken into account in determining the guideline premium are the "reasonable" charges.

In addition to the contracts that failed due to a particular error, Taxpayer has identified Number K Policy A contracts and Number M Policy B contracts that failed to comply with section 7702 due to a combination of the types of errors described above. Particularly, Number K Policy A contracts failed due to a combination of Errors (2) and (3); Number K Policy B contracts failed due to a combination of Errors (1) and (3); and Number K Policy B contracts failed due to a combination of errors (3) and (4).

RULING REQUESTED

The Service waive, pursuant to section 7702(f)(8), the failure of certain policies to comply with the general requirements of section 7702. Taxpayer further proposes to address these compliance failures by either (1) increasing the death benefits available under each failed policy or (2) refunding to the policyholder the excess premiums and interest. Taxpayer proposes to implement these changes within 90 days from the effective date of the requested waiver.

LAW AND ANALYSIS

As previously explained, in order to qualify as a life insurance contract for Federal income tax purposes, section 7702(a) requires that a contract must satisfy the "cash value accumulation test" set forth in section 7702(b), or both meet the "guideline premium requirements" of section 7702(c), and fall within the "cash value corridor" defined in section 7702(d).

With respect to the guideline premium requirements, section 7702(c) requires 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 determined on the basis of the following three elements enumerated in section 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 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, 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, using a minimum interest rate of four percent, rather than six 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 section 7702(e) and the definitions of section 7702(f) apply to both the guideline single and guideline level premium.

Section 7702(f)(4) defines the term “future benefits” to mean death benefits and endowment benefits. Section 7702(f)(5)(A)(iii) characterizes family term riders as “qualified additional benefits,” and section 7702(f)(5)(B) provides further that 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.

In computing the guideline premiums for a policy to which the Family Term Rider or Spousal Term Rider was attached, Taxpayer treated the charges for the rider as a future benefit, and, accordingly, increased the guideline premium for each policy by that amount. Taxpayer, however, treated those charges under the “reasonable mortality charge” standard set forth in section 7702(c)(3)(B)(i), rather than under the “reasonable expense charge” standard set forth in section 7702(c)(3)(B)(ii). Charges contemplated by section 7702(c)(3)(B)(i) are deemed reasonable if they do not exceed the charges set forth in the 1980 CSO Mortality Table, regardless of whether the charges actually set forth in the contract are less than the 1980 CSO amount. In contrast, charges contemplated by section 7702(c)(3)(B)(ii) are deemed reasonable only if they reflect the amount expected to be actually paid, which will typically correlate to a company’s actual charges. Consequently, in many instances the guideline premiums attributable to certain benefits will be higher if treated under section 7702(c)(3)(B)(i) rather than section 7702(c)(3)(B)(ii).

In treating the charges for the Family Term Rider and Spousal Term Rider under section 7702(c)(3)(B)(i), Taxpayer reasoned that the risks insured by the rider were mortality risks, and that (c)(3)(B)(i) specifically applies to mortality charges. In this regard, section 7702(c)(3)(B)(ii) expressly excludes mortality charges from its scope. Taxpayer further reasoned that there is no express provision in the Code that requires a family term rider to be treated under section 7702(c)(3)(B)(ii) in calculating the guideline premium.

We disagree with Taxpayer’s legal analysis in this respect. Although the Code in setting forth the guideline premium limitations does not specifically direct taxpayers to treat family term riders under section 7702(c)(3)(B)(ii), rather than (c)(3)(B)(i), the rules applicable to the cash value accumulation test are controlling in this regard.[5]

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[5] Section 7702(b)(1) provides that a contract meets the cash value accumulation test if the cash surrender value of the contract does not at any time exceed the “net single premium” which would have to be paid to fund the contract’s “future benefits.”

Particularly, 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. Section 7702(b)(2)(B) states that such computation, in the case of qualified additional benefits, shall be made on the basis of section 7702(c)(3)(B)(ii). Thus, for the purpose of the cash value accumulation test, family term riders, as qualified additional benefits, are treated under section 7702(c)(3)(B)(ii). Although the requirement set forth in section 7702(b)(2)(B) refers only to the determination required for the cash value accumulation test, and does not expressly apply to the guideline premium limitations, this provision is the only direction provided by Congress as to how charges for qualified additional benefits are to considered from a computational standpoint. The legislative history, moreover, is absent of any 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. Given Congress' indication that family term riders should be treated under section 7702(c)(3)(B)(ii) for the purpose of the cash value accumulation test, and absent any indication to the contrary, we conclude that section 7702(b)(2)(B) implicitly requires family term rider benefits to be treated under (c)(3)(B)(ii) for the purpose of the guideline premium limitations as well.[6]

After considering all of the facts and circumstances, we find that the failure of the Number B policies to satisfy the requirements of section 7702 was due to reasonable error, and that Taxpayer is taking reasonable steps to remedy the error. In so doing, we note that although Errors (5) and (6) were due to Taxpayer's incorrect application of section 7702(c)(3)(B)(i) rather than (c)(3)(B)(ii), Taxpayer's error in this regard was reasonable. To remedy the compliance failure of the Number B policies, Taxpayer will, within 90 days of receipt of this ruling, either increase the death benefits payable under any failed policy, or refund any excess premium with interest at the contract crediting rate. To further cure the errors attributable to Taxpayer's incorrect application of section 7702(c)(3)(B)(i), Taxpayer will within 90 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).

Accordingly, Taxpayer is granted a waiver under section 7702(f)(8) for the failure of the Policies listed in Exhibit 1 to satisfy the requirements of section 7702(a).

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[6] The legislative history provides additional support for our conclusion. See H.R. Rep. No. 98-432, Pt. 2, at 1445 n.25 (1984) (distinguishing "mortality charges" from "charges" for "additional benefits"); 1 Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984: Explanation of Provisions Approved by the Committee on March 21, 1984, 575 n.24 (S. Prt. No. 98-169, Comm. Print 1984) (same); Staff of Joint Comm. on Taxation, 98th Cong. 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 648 n.51 (Comm. Print 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).

The rulings in this letter are based on the information and representations Taxpayer submitted under penalties of perjury. While this office has not verified any of the material submitted in support of the request for the ruling, it is subject to verification on examination.

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.

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

Attachment:
Exhibit 1

cc: