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Contact Person:

Telephone Number:

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Legend

Taxpayer =

Country A =

State 1 =
Date 1 =
Company 1 =
B =
C =
D =
E =

F sub-system =

G =

H =

I =

J =
K =

Dear

This is in response to your letter of December 14, 1999, and to your supplemental submissions, requesting a ruling that the noncompliance of certain of Taxpayer's policies with the requirements of §§ 101 and 7702 be waived pursuant to §§ 101(f)(3)(H) and 7702(f)(8). This ruling applies to the contracts listed in Exhibit A.

Facts

General

Taxpayer is a Country A corporation operating in the U.S. exclusively through a branch. The income from Taxpayer's U.S. branch operation is taxable under § 842. That branch operation is subject to tax under § 801 as a life insurance company. As such, Taxpayer files an annual tax return in Philadelphia on Form 1120L. Taxpayer is considered domiciled in State 1 and is ultimately subject to regulation by the State 1 Insurance Commissioner. Taxpayer prepares annual statements for its U.S. business consistent with the rules prescribed for the National Association of Insurance Commissioners' life insurance company statutory blank.

In a transaction that closed on Date 1, Taxpayer effectively sold substantially all of its insurance business in Country A and other territories (other than the U.S.) to Company 1. Additionally, a portion of Taxpayer's business was ceded to Company 1 in an assumption reinsurance transaction. A pro-rata interest in Taxpayer's remaining business (i.e., business not ceded in the assumption reinsurance transaction) was also ceded to Company 1 in an indemnity reinsurance transaction. Taxpayer still maintains a U.S. life insurance business. Taxpayer's request for this ruling covers the business for which it continues to be the direct writer. Taxpayer no longer writes new policies of the type covered by this request.

Taxpayer issued its non-participating, flexible premium universal life insurance contracts from 1981 through Date 1. Taxpayer grouped its flexible premium universal life insurance contracts into product lines and has tested them for compliance with the guideline premium and cash value corridor tests of §§ 101(f) and 7702(a). Taxpayer tested the calculation of the guideline single premium, guideline level premium, and premium paid for in-force contracts, as well as for contracts for insureds who have passed away. Further, it reviewed the administration of the cash value corridor test for proper handling of the calculation of actual cost of insurance rates and the payment of death claims.

In anticipation of a conversion from the B to the C administration system that is used by Company 1, Taxpayer also compared the calculation methods used by the B and C administration systems for consistency. It found that the calculations by the two systems of the guideline single premium and guideline level premiums were not identical for each and every contract.

In recognition of the potential for errors related to manual processing, and to support its effort to ensure proper handling of its guideline premium and cash value corridor test contracts, Taxpayer has recalculated the guideline single premium and guideline level premiums for each of its flexible premium universal life contracts. To improve the reliability of the calculation, it utilized an independent program developed and run by D actuaries.

Using data specific to each contract, Taxpayer conducted the guideline premium

test for each year from the contract issue date to the current date. The testing identified not only contracts that currently fail the guideline premium test, but also identified contracts that currently meet the guideline premium test but failed that test in the past. Further, Taxpayer has contracted with D to support its effort to ensure that the guideline premium and cash value corridor tests are performed accurately.

Description of Taxpayer's § 7702 Compliance System.

Taxpayer's insurance contracts have always been administered on the B administration system, which Taxpayer developed and now runs at its E location. While Taxpayer's compliance system is largely computerized, it does rely on manual procedures and entry of data for certain activities. The following describes the components of the B system, issue date activities, premiums paid after the issue date, changes initiated by the policyholder, death claims, error reports and manual overrides.

Issue Date Activities

When an application is submitted, the contract's information is entered in the B issue system as a pending item. Once the application is in good order and approval is received, the premium is applied and the contract is posted to the B administration system. Since the original B issue and administration systems did not calculate the guideline single premium and guideline level premium for each contract, those values either were manually calculated or obtained from the contract's illustration of policy values. If the premium so calculated exceeded the guideline single premium at issue, the policyholder was contacted to determine whether she preferred an increase in death benefit or a premium refund. Once the proper adjustment to either the premium or death benefit was completed and the guideline premium requirement was met, the contract was issued and posted on the B administration system.

Since the late 1980's the B administration system's testing of the guideline premium requirement has been automated. In the event a premium payment, when submitted for posting to the B administration system, exceeds the guideline premium limit, the system accepts the submission but rejects any premium in excess of the guideline premium limit. During the nightly batch cycle, the B administration system creates a notice that the guideline premium limit is about to be exceeded. This notice lists the contract number, the premium, and the amount of any excess premium. Any premium in excess of the guideline premium limits is placed in a suspense account.

Upon receiving such a notice, a customer service representative contacts the policyholder to determine whether an increase in death benefit or refund of the excess premium is preferred. Generally the excess premium is returned; but if the policyholder chooses to comply with the guideline premium requirement by increasing the face amount of the contract, Taxpayer amends the contract to provide the necessary increase in coverage and the premium is re-applied. Once the excess premium is refunded or the death benefit increased, the contract is posted on the B administration

system and is in compliance with § 7702.

Premiums Paid after the Issue Date

During the late 1980's, the B administration system was modified to perform the guideline premium test for inforce contracts. The assumptions used to calculate the guideline single premium and guideline level premium are based on the actual contract data coded in the B administration system. As modified, the guideline premium test is performed before a premium is applied to a contract. If the premium exceeds the guideline premium limit, any excess premium is held in suspense and only the remainder is applied to the contract. The B system automatically produces a letter to the policyholder that explains the amount of and the reason for the excess premium. It offers the policyholder a choice between a returned premium and an increased death benefit. The letter also indicates the date that the policyholder might resume premium payments.

Changes Initiated by the Policyholder

The B administration system compliance process has partially automated the modifications necessitated by policy changes. When a policyholder requests a change, a customer service representative enters the requested change into the F sub-system, a component of the B administration system. The customer service representative selects the type of change activity to process on the basis of standardized procedures. Once the customer service representative has selected the appropriate processing approach, the B system then edits the request for thoroughness and reasonableness. Requests not rejected during the editing process are then processed and released. If the type of policy change causes the guideline single premium and guideline level premium to be re-calculated, the B system creates codes that automatically recalculate the guideline premiums when a premium is paid.

The guideline premium test is immediately performed by the B administration system when a policy change is processed in the F sub-system. For example, when the face amount is increased, the guideline premiums are recalculated in that sub-system, and the guideline premium test is based on these recalculated values. If the change would cause the contract to fail the guideline premium requirement, it is automatically rejected, and the rejected transaction does not occur. The customer service representative then contacts the policyholder to explain that the requested change cannot be processed as requested. If the policyholder wants to make the change, then the change is modified to comply with the guideline premium requirement. Any excess premium is refunded during the period ending 60 days after the next contract anniversary.

When a large decrease in face amount is requested, the customer service representatives are trained to test manually for compliance at the time the decrease is requested. The request is forwarded to the actuarial area to determine the maximum decrease that would not cause the contract to fail. The requested decrease is processed only if it does not cause the contract to fail the guideline premium test. Otherwise, the customer service representative contacts the policyholder to explain that the request

cannot be processed. If the policyholder wishes to make a change, the request is modified to comply with the guideline premium requirement.

If a customer service representative attempts to process a transaction that would cause the contract to fail the guideline premium requirement, then the change is rejected, and the customer service representative receives an error message. The customer service representative generally limits the change to the maximum amount that would not cause such violation. Once the request has been modified to comply with the guideline premium test, the change request can be completed.

Cash Value Corridor Test

Contract forms for contracts that use the guideline premium and cash value corridor test include appropriate applicable percentages for the cash value corridor pursuant to §§ 101(f) and 7702(d)(2).

Prior to 1990, the cash value corridor factors were not automated in B, and Taxpayer relied on manual processing to ensure its contracts complied with the rules in those statutes. Taxpayer compared the face amount of its contracts to the cash value corridor each month. If the cash value corridor exceeded the face amount, the policyholder was contacted and either the face amount was increased or the cash surrender value was decreased. If compliance necessitated that cash be withdrawn from the contract, the cash was sometimes transferred to a “side fund”, such as a premium deposit fund.

Currently, the cash value corridor test is currently automated on the B administration system. During monthly anniversary processing for contracts using death benefit option A (the death benefit equals the relevant policy’s face amount), the calculation of the cost of insurance rate is based on the greater of the face amount or cash value corridor. For contracts with death benefit option B (the death benefit equals a specified amount plus the policy’s cash value), the death benefit is the greater of the face amount plus the cash surrender value, or cash value corridor.

Error Reports and Manual Overrides

The B administration system provides the ability to override the system’s tax fields; however, customer service representative’s training does not cover this type of contract record modification. Override or “force” transactions are handled only at the manager level and appropriate controls are in place.

Description of the Failed Contracts and of the Reasons for the Failures

1 - Issue Age Calculation (9 contracts)

Benefits were changed for 6 contracts prior to 1994. Where such benefits were increased or decreased Taxpayer recomputed the guideline single or level premiums on

those contracts using a method that it believed was reasonable based on information its actuaries had received at that time. In 1993 Taxpayer began to compute the adjustments to premiums on contracts whose benefits were changed utilizing an attained age decrement method.

Customer service representatives had been instructed to forward contracts whose face amounts were reduced to the actuarial department in order for that department to recompute the relevant guideline premiums. In spite of those instructions, from 1989 to 1991, the customer service representatives failed to forward 3 contracts whose face amounts were reduced to the actuarial department, and thus the relevant contracts were not tested with the reduced guideline premiums. For these three contracts, the system did not reflect a corrected guideline premium until another premium had been paid.

2 - 1993 Programming Error (6 contracts)

The face amounts of 6 of Taxpayer's contracts were decreased during the period from late 1993 to 1997, and the corresponding reduction in the guideline premiums after the policy change caused the policy to fail. A programming error unrelated to the tax calculations made with respect to the relevant contracts caused the error message for the failed contracts to be suppressed. Without an error message, the customer service representative could not know that the premiums were in excess of the guideline premium limit causing the policy to fail.

3 - Interest Rate Coding Error (52 contracts)

The initial programming for the guideline premium test was based directly on the Code. The interest rate to be used in the calculation of the guideline single premium is defined in § 7702(c)(3)(B)(ii) as interest at the greater of an annual effective rate of 6 percent or the rate or rates guaranteed on the issuance of the contract. Pursuant to § 7702(c)(4) the guideline level premium is calculated similarly to the guideline single premium except that the interest rate is the greater of 4 percent or the rate or rates guaranteed on the issuance of the contract. Taxpayer's marketing and administration areas communicated the tax law changes to the relevant programming personnel utilizing several methods, including simple descriptions in understandable language.
The coding for the guideline level premiums for Taxpayer's first universal life policies was calculated correctly. However, the calculation of the guideline single premium was based on an inappropriate, i.e., a 4% instead of a 6%, interest rate. That error was the sole cause of the failure of 52 contracts in three of Taxpayers Plans, the I, J, and K Plans.

4 - Mortality Table Coding Errors (28 contracts)

Pursuant to § 7702(c)(3)(i), as in effect when the relevant contracts were issued, tax calculations were to be based on the mortality tables specified in the contract or, if none was specified, the mortality tables used in determining the statutory reserves for the relevant contract. Clerical personnel responsible for inputting policy coding information for policies issued under the G Plan mistakenly coded the G Plan as a 1958 CSO plan. This

occurred even though the policy form described the 1980 CSO table and internal procedures required the personnel to use the table specified in the policy form. This error caused the guideline single and level premiums to be overstated, and the administration system was not able to detect the resulting premium overpayments responsible for the failures of 20 policies.

Another mortality coding error occurred when a programmer accidentally overlooked the 4-year setback for female lives on certain policies issued under Taxpayer's H plans. The guaranteed cost of insurance rates under the H plans were based on the 1958 CSO table. When that mortality table was initially developed, all mortality rates were based on male mortality and explicit female rates were not available. To provide suitable rates for females, Taxpayer followed industry practice of using a setback rate for females. It reflected the mortality costs under that 4-year setback on the relevant policy forms. Between February 1, 1985 and December 15, 1986 Taxpayer issued 8 contracts under various H plans upon which it ignored that 4-year set back in calculating the guideline premiums on those contracts.

As a result of the error described in the preceding paragraph, the mortality rates used to determine the guideline single premium and guideline level premiums on the relevant 8 contracts exceeded the rates guaranteed in the contract. This coding error resulted in 8 failed contracts.

5 - Manual Override (109 contracts)

Prior to putting into place automated procedures in the early 1990's, Taxpayer processed manually recalculations of the guideline single and guideline level premiums necessitated by policy changes. To initiate the recalculation of the guideline level premiums on this system, a policy service representative would hand code a key-punch form that included data for the recalculation of those premiums. After two separate entries over two nightly cycles, the guideline level premiums were recalculated and the system records updated with those manual entries.

Customer Service Representatives were trained to take corrective action when an error message was sent. For at least 59 contracts, an error message was sent to a customer service representative. Those representatives had been trained to refund premiums or increase the face amount of the relevant contracts within the 30 day period following the anniversary of the relevant contracts. For the relevant contracts, those representatives neglected to do so.

The administration system tested at least 24 guideline single premium contracts and identified them as having failed the guideline single premium test. An error message was sent to the relevant customer service representative. Despite their training, the customer service representatives replaced the guideline single premium with an amount slightly higher than the premium paid. After that replacement, the error message disappeared.

In the case of 26 contracts, despite their training, customer service personnel either ignored an error message, or inappropriately increased the guideline premium as described in the preceding paragraph.

The training for the customer service representatives has since been reinforced by restricting the override transactions to use by managers, and these types of human errors should not recur in the future. As described above, Taxpayer's current compliance system automatically tests each premium for compliance with the guideline premium test in lieu of the former manual procedures. Based on this automation and the recalculation of the guideline premiums by the D guideline premium program, Taxpayer believes the types of errors described in this ruling request could not recur.

Corrective Action

Taxpayer is prepared to return excess premiums paid with interest or to increase the death benefits on all outstanding contracts that are in violation of the guideline premium limits. Taxpayer will also make reasonable efforts to locate the beneficiaries of the policies relating to insureds who passed away, and to refund to them, the excess premiums on those policies as of the dates of death, with interest thereon.

Law

Section 7702 of the Code defines the term "life insurance contract" for all purposes of the Code. Under § 7702(a), in order to be considered a life insurance contract for federal tax purposes, a contract must qualify as such under applicable law and must satisfy either the "cash value accumulation test" set out in § 7702(a)(1) and (b), or meet the § 7702(a)(2)(A) and (c) "guideline premium requirements", and fall within the § 7702(a)(2)(B) and (d) "cash value corridor".

Section 7702(f)(1)(B) provides that if in order to comply with the guideline premium requirements, any portion of the premium paid during any contract year is returned by the insurance company (with interest) within 60 days of 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.

For contracts issued before October 21, 1988, the guideline level and guideline single premiums are determined on the basis of mortality charges specified in the contract (or if none are specified, the mortality charges used in determining the statutory reserves for such contract). See former § 7701(c)(1)(B)(i) as that subsection read prior to its amendment by § 5011 of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Public Law 100-647 (1988). The 8 contracts Taxpayer issued to females under the various H plans between February 1, 1985 and December 15, 1986 pursuant to which it was required to calculate the guideline premiums on the basis of the 1958 CSO table with a 4 year set back would have qualified as life insurance contracts under the rules in § 7702 had it done so.

Section 7702(f)(8) provides that the Secretary of the Treasury may waive a failure to satisfy the requirements of § 7702 if the taxpayer establishes to the satisfaction of the Secretary that the failure was due to "reasonable error" and that "reasonable steps are being taken to remedy the error."

After considering all of the facts and circumstances, we find that the failure of the contracts listed in Exhibit A to satisfy the requirements of § 7702(a) was due to reasonable error, and Taxpayer is taking reasonable steps to remedy the error.

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.

No opinion is expressed as to whether Taxpayer's policies comply with those requirements of § 7702 (or of any other sections of the Code and of the income tax regulations) that were not the subject of this letter ruling.

This ruling is directed only to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore this ruling will be modified or revoked by the adoption of temporary or final regulations to the extent that the regulations are inconsistent with any conclusion in the ruling. See section 12.04 of Rev. Proc. 99-1, 1999-1 I.R.B. 6, 47. However, when the criteria in section 12.05 of Rev. Proc. 99-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

A copy of this ruling 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,
Assistant Chief Counsel
(Financial Institutions & Products)
By: Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4