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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
November 10,1999

Date A
Company A
Company B

State B
Number B
Location B
Company C

State C
Number C
Location C
Date D
Date E
Number F
Number G
Number H
Company I
Person J

Dear

This is in reply to your letter dated Date A in which you requested a waiver of certain errors under section 7702(f)(8) of the Internal Revenue Code such that various life insurance contracts (the “Contracts”) will be treated as life insurance contracts for federal tax purposes. These Contracts were originally issued by Company B’s predecessor, Company A, but are now the responsibility of Company C by reason of an assumption reinsurance agreement. In a few cases, pending policyholder consent to the assumption, those Contracts are still the responsibility of Company B.

Facts

Company C is a State C 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 is licensed to engage in the life insurance business in Number C states and the District of Columbia. Company C is a member of an affiliated group that files its Federal income tax returns on a consolidated basis. Company C is subject to the audit jurisdiction of the District Director in Location C. Company C uses the accrual method of accounting for income tax purposes and files its returns on a calendar year basis.

Company B is a State B stock life insurance company, as defined by section 816(a), and is subject to taxation under Part I of Subchapter L of the Code. Company B is licensed to engage in the life insurance business in Number B states. Company B is a member of an affiliated group that files its Federal income tax returns on a consolidated basis. Company B is subject to the audit jurisdiction of the District Director in Location B. Company B uses the accrual method of accounting for income tax purposes and files its returns on a calendar year basis.

Company B was acquired by its current parent on Date D essentially as a shell corporation whose principal assets consisted of licenses to conduct the business of life insurance. Prior to that acquisition, Company B was known as Company A and was a wholly owned subsidiary of Company C from Date E until its acquisition on Date D. During the period of ownership of Company B by Company C, Company C assumed all of Company B's business pursuant to an assumption reinsurance transaction, including approximately Number F Contracts. A small number of Contracts remain with Company B, however, pending receipt of consent to the assumption reinsurance transaction by the owners of the contracts. All of the Contracts are currently being administered by Company C. Companies B and C have entered into an indemnity reinsurance agreement regarding these contracts.

As both companies have responsibilities for liabilities arising from any failure of the Contracts to comply with the requirements of sections 7702, the Contracts are considered in the aggregate for this ruling request, without regard to their current holder.

Companies B and C represent that the Contracts are life insurance contracts under applicable state law and, apart from contracts issued before 1985, were intended to qualify as life insurance contracts within the meaning of section 7702 by satisfying the guideline premium limitation of section 7702(c) and the cash value corridor of section 7702(d). Similarly, flexible premium Contracts issued before 1985 were intended to satisfy the guideline premium limitation of section 101(f)(2) and the cash value corridor described in sections 101(f)(1)(A)(ii) and 101(f)(3)(C). These requirements parallel the correlative provisions of section 7702 insofar as relevant to this ruling request and thus are not discussed in detail below.

Company B maintained procedures that were designed to ensure compliance with the guideline premium limitations. Those procedures included both the extensive use of mainframe computers and manual review in the case of situations identified by the computer as having potential for failure. If such a situation arose, company personnel were required to manually enter the data relevant to the contract in a secondary personal computer-based system that produced illustrations of the appropriate guideline single and level premiums for the product both for use in marketing and to verify compliance. The process required was iterative and required extensive manual input until the late 1980's when this portion of the process began to be performed automatically.

If the compliance procedures identified a contract as having premiums received that were in excess of the contract's guideline premium limitation, compliance personnel sent a notice to the policyholder offering a variety of options. The default option was an actual refund, by check, of the excess premium with interest at the contract crediting rate. Alternatively, excess premiums plus interest could be retained by the company, at the policyholder's option, to purchase a deferred annuity contract or be applied to policy loans, if any were outstanding. A further option, subject to underwriting approval, was an increase in the contract's death benefit to an amount sufficient to ensure compliance with section 101(f) or section 7702, as applicable. In all events, Company B was required to issue a Form 1099-INT for the amount of interest paid on the excess premium even if that excess premium plus interest was subsequently used to acquire an additional benefit – a deferred annuity contract, reduction of a policy loan, or an increase in the contract's face amount.

In the case of Number G Contracts, compliance personnel failed to refund the excess premiums with interest due to clerical errors that were contrary to established procedures. Specifically, in some instances, the personnel failed to effect the correction within 60 days after the end of the contract year due to inaction or failure to note the notation on the computer reports of excess premiums. In other instances, the amount of the excess premium was incorrectly calculated, due to errors in the manual entry portion of the compliance process. Had proper procedures been followed and clerical errors had not occurred, the Contracts would not have failed to satisfy the guideline premium limitation.

In the case of Number H Contracts, the failure to comply had a very different cause, that of a misinterpretation of the adjustment rules of sections 101(f)(2)(E) and 7702(f)(7)(A). Company B's mainframe compliance system reflected adjustments by determining a guideline single premium for the existing death benefit by determining a guideline single premium for the existing death benefit using the issue age of the insured. In addition, the personal computer-based illustration system made adjustments upon a change in the contract's benefits by taking into account the overall benefit structure (from issue to maturity) as known at the time of the change. Specifically this second system determined the guideline premium limitation that would apply if the contract had been issued with the expectation that the benefits would increase or decrease on the date of the adjustment. Company B's method generally resulted in lower guideline premium limitations upon an increase in benefits and a higher guideline premium limitation upon a decrease in benefits than the results that would be obtained by use of the "attained age decrement" method more commonly used in the industry, as more fully described below.

Company B received advice in a June 5, 1987 letter from the actuarial consulting firm of Company I regarding the proper adjustment method to use. In particular, Company I referred Company B to the 1982 colloquy between Senators Dole and Bentsen in connection with the adjustment rule of section 101(f)(2)(E), which is generally viewed as the road map for the section 7702(f)(7)(A) adjustment rule. The letter noted, however, that no regulations had yet been published under section 7702. Company B's personnel charged with maintaining compliance with sections 101(f) and 7702 understood the letter in its totality to mean that no change would be required in Company B's procedures pending the issuance of such regulations.

In its more recent examination of the issue of whether "proper" adjustments upon changes in benefits or terms were performed using Company B's method, the two Companies have consulted with Person J, a reputable actuary. Specifically, Companies B and C asked whether Company B's adjustment method was reasonable from an actuarial perspective and were told yes.

Law and Analysis

Section 101(f) was added to the Code by section 221 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), 1982-2 C.B. 462. Under section 101(f), any amount paid by reason of the death of the insured under a life insurance contract described as a flexible premium contract is excluded from gross income only if the contract satisfies either (1) the guideline premium limitation and the applicable percentage of cash value test of section 101(f)(1)(A)(i) and (ii), respectively, or (2) the cash value test of section 101(f)(1)(B). The limitations of section 101(f) are applicable generally only to contracts issued before January 1, 1985.

Section 101(f)(2)(E) provides that a flexible premium life insurance contract's guideline premiums are adjusted in the event of a change in the contract's future benefits or any qualified additional benefit if the change was not reflected in any guideline single premium previously determined. The legislative history of section 101(f) explains:

> At the start of the contract the guideline premiums are based on the future benefits specified in the contract as of such date. If future contract benefits are changed at a subsequent date, the guideline premiums will be adjusted (upward or downward) to reflect the change.

S. Rep. No. 494 (Vol. 1), 97th Cong., 2d Sess 354 (1982). See also H.R. Rep. 760, 98th Cong., 2d Sess. 648 (1982) (conference agreement generally follows the Senate amendment).

A colloquy between Senator Dole and Senator Bentsen provides the following explanation regarding the circumstances under which guideline premiums are to be adjusted:

> Mr. Bentsen. Paragraph (2)(E)...states that if the death benefits or rider benefits are changed after issue of these policies, adjustments will need to be made....I understand that such adjustments are only to be made in two situations: First, if the change represents a previously scheduled benefit increase that was not reflected in the guideline premiums because of the so-called computational rules; or second, if the change is initiated by the policyholder to alter the amount or pattern of the benefits. Is this correct?
>
> Mr. Dole. That is my understanding.

128 Cong. Rec. S10943, August 19, 1982.

In general, for contracts issued after 1984, section 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 section 7702(a)(1), or (2) the guideline premium requirements and the cash value corridor test of section 7702(a)(2)(A) and (B).

The guideline premium limitation of section 7702(c) 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 interest at the greater of an annual effective rate of six 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, with interest at the greater of an annual effective rate of four percent or the rate or rates guaranteed on issuance of 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 premiums.

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 section 7702, there shall be proper adjustments in future determinations made under the section. The statute itself provides no guidance on what constitute "proper adjustments."

The legislative history concerning what constitute "proper adjustments" is at best ambiguous. There is no legislative history contemporaneous with the inclusion of that term in section 7702(f)(7)(A) in 1984. The Tax Reform Act of 1986 included technical corrections to the 1984 legislation, including amendments to section 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, at 108 (Comm. Print 1987); see also H. R. Rep. No. 426, 99th Cong., 1st Sess. 967-968 (1985), 1986-3 C.B. Vol. 2, 967-968 (the language above is taken from this report verbatim. The terms "guideline level and single premium limitations" are not in the Code and do not appear to be "determinations."

Pursuant to section 7702(f)(8), the Secretary of the Treasury may waive a failure to satisfy the requirements of section 7702. This waiver is granted if a taxpayer establishes 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 G Contracts to satisfy the requirements of section 101(f) or section 7702, as applicable, is due to reasonable error. In those instances, the excess premiums were either paid or retained as the result of human error in the operation of the compliance system for monitoring compliance with the guideline premium limitations of sections 101(f) and 7702(c), as applicable. Company B had procedures existing at that time that, if properly followed, would have resulted in the Contracts complying with the statute.

We also conclude that the failure of Number H Contracts to satisfy the requirements of section 101(f) or section 7702, as applicable, is due to reasonable error. Company B concedes that its method is an erroneous construction of the adjustment rule and differs from the more widely applied interpretation of the method required upon adjustments governed by sections 101(f)(2)(E) and 7702(f)(7)(A). Company B's error, however, is reasonable within the meaning of section 7702(f)(8). The requirement to use the attained age decrement method does not appear in section 7702(f)(7)(A) itself. Considerable confusion has occurred in the application of the mechanics of the attained age decrement method and the interpretation of the unclear legislative history and Blue Book language, reflecting the ambiguity of the statutory provision. Company B's method took attained age into account, albeit incorrectly, in making the adjustments required by section 7702(f)(7), and was in our view a reasonable error. Company C has taken reasonable steps to remedy the error by following a more proper methodology.

Finally, we conclude that premiums paid on a Contract in excess of the guideline premium limitation during a policy year ("excess premiums") and interest thereon, calculated at the Contract crediting rate, are treated as distributed to the policyholder, with interest to be reported to the policyholder on a Form 1099-INT, even if the excess premiums and interest are not actually returned to the policyholder by check. In such a situation, the excess premiums plus interest that are treated as distributed and then returned to the life insurance company as new and additional premiums paid for the Contract that are used to increase the Contract's death benefit within 60 days of the close of a policy year, will satisfy the requirements for distributions of excess premiums plus interest mandated by section 101(f)(3)(B) and section 7702(f)(1)(B) and (C), as appropriate.

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. No opinion is expressed as to the compliance of these Contracts with other requirements of section 101(f) or section 7702.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) 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 the consolidated groups including both Company B and Company C.

Sincerely yours,
Assistant Chief Counsel
(Financial Institutions and Products)
By: Mark S. Smith
Chief, Branch 4