

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:
July 17, 2001

Date A
Taxpayer B

Taxpayer C

Date D
Parent E
Parent F
Number G
Number H
Number I
Number J
Number K
Number L
Number M
Number N
Number O
Number P
Date Q
Number R
Number S

Dear _____ :

This is in reply to your letter dated Date A in which you requested a ruling on behalf of Taxpayers B and C with respect to Number R 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.

Taxpayer B 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. Prior to Date D, the

predecessors to Taxpayers B and C were members of a controlled group that filed a consolidated tax return with Parent E. At that time, Taxpayer B's predecessor owned all of the stock of the predecessor to Taxpayer C, also a stock life insurance company. On Date D, Taxpayer B's predecessor was merged into a subsidiary of Parent F. From Date D until Date Q when both were merged into pre-existing Parent F subsidiaries, the predecessors to both Taxpayers B and C were members of the consolidated group of which Parent F is the parent corporation. On Date Q, the predecessors to Taxpayers B and C were each merged into subsidiaries of Parent F. Taxpayers B and C are hereafter jointly referred to as Taxpayer without reference to their changing ownership structure.

After the initial merger of Taxpayer into Parent F's subsidiary, Parent F began converting all Taxpayer policy data to its own computerized compliance testing system. The conversion process disclosed that some of Taxpayer Policies are not in compliance with the requirements of section 7702(a). Of the Number R policies proposed for waiver of errors, one was issued by Taxpayer C while the remaining Policies were issued by Taxpayer B.

Taxpayer represents that all Number R 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 all occurred during the period that Taxpayer was a subsidiary of Parent E prior Taxpayer's acquisition by Parent F. In the case of Number G Policies, data was incorrectly entered into the computerized testing system. Specifically, despite instructions to the contrary and oversight procedures to implement the testing system, individuals used the higher guideline premium limitation as of the date of a policy modification rather than using the original guideline premium limitation from the date of issue to the date of change. Had the data been properly inputted, the testing system would have reported the payment of future excess premiums so that refunds could have been timely made.

In another Number H cases, the policy calculations required the use of one loading charge if the premium was below a target level, and a different, lower rate if the premium paid was a higher amount. Because of this complexity, compliance was performed manually. Using the incorrect higher loads produced a higher guideline premium limitation and therefore did not result in the compliance system identifying excess premiums when paid. In Number H instances, incorrect data relating to this loading feature was used for the manual computation and was then entered into the computerized compliance system. Taxpayer had in place instructions and oversight procedures to require that the correct loads be input. But for the failures of Taxpayer personnel to perform their duties as required by company procedure, the testing system

would have reported the payment of future excess premiums so that refunds could have been timely made.

Number I Policies were issued prior to the effective date of section 7702. When changes occurred that required that a policy be treated as having been issued under section 7702, Taxpayer personnel had to collect the initial calculations manually before the data was input into the computerized system. In Number I instances, incorrect data was used in that manual system resulting in errors in the computerized system once the manual data was input. In an additional Number J instances, Taxpayer personnel failed to input data according to the rules applicable under section 7702 as instructed, but rather continued to input data according to the rules applicable prior to the effective date of section 7702. Had Taxpayer personnel input the data as instructed into the manual system, the computerized system would have reported the payment of future excess premiums so that refunds could have been timely made.

A separate group of Number K Policies involved data input errors that resulted in an improper calculation.

(1) In Number L instances, personnel incorrectly used the premium due date rather than the date of receipt of the premiums to test the policies. In cases where the policies were at or near the guideline premium limitation, this error resulted in excess premiums that were not detected.

(2) In Number M instances, the wrong codes for the policy features were entered into the computerized compliance system producing erroneous results so that the failures of the contract to comply with section 7702 was not timely detected.

(3) In Number N instances, personnel failed to take action upon a computer warning as should have been done under Taxpayer's normal procedures.

Had it not been for these errors, Taxpayer's instructions and oversight procedures under its compliance system would have ensured compliance.

With another Number O Policies, Taxpayer's compliance system did report the payment of excess premiums. Furthermore, Taxpayer had in place procedures requiring either refund of excess premiums within 60 days of receipt or an increase in policy face value within the same period. Nonetheless, personnel responsible for implementing these procedures by performing manual tasks failed to do so in Number P instances. But for the failure of personnel to perform these tasks, the excess premiums would have been refunded or death benefit increased in a timely manner.

Finally, with respect to Number P of the Policies, a difference in the rounding conventions used by Taxpayer's prior compliance system while in the consolidated group with Parent E and that used for the insurance subsidiaries of Parent F resulted in

a determination that the Number P policies failed section 7702. The errors produced necessary refund amounts of less than a dollar for each policy. Without the different rounding conventions used by Taxpayer's two parents, these Number P Policies would not have failed.

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(a)(i), or (2) the guideline premium and cash value corridor test of section 7702(a)(2)(A) and (B). Section 7702 applies to contracts issued after December 31, 1984.

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.

The legislative history for the Deficit Reduction Act of 1984, Pub. Law 98-369, in its discussion of the computational rules under section 7702(e), includes the following with respect to permissible rounding differences:

"Finally, it was understood that in computing actual cash surrender values that rounding differences or other computational variations could produce minor variations in results. For example, it has been standard practice for most companies to round all cash values up to the next whole dollar per thousand of face amounts. This simplifies displays and assures compliance with minimum nonforfeiture standards under State law. Thus, it is expected that, in addition to the application of the above described computational rules, reasonable approximations (e.g., \$1.00 per \$1,000 of face amount) in the calculation of the net single premium or the guideline premiums will be permitted."

Joint Committee on Taxation Staff, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 653 (1985).

Under the facts submitted and representations made, in the absence of regulations and in light of the legislative history, the rounding errors related to Number P of the Policies are deemed to satisfy the requirements of section 7702(a). Further, the conversion to Taxpayer's new parent's software programs have been completed and no further discrepancies should occur.

Under the facts submitted and representations made, the failure of Number S Policies to satisfy the requirements of section 7702(a) is due to reasonable error as the excess premiums paid were the result of clerical error in the manual computation of the guideline premium limitations of section 7702(c) or were the result of data input errors.

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 the excess premium with interest 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.

Accordingly, based on the information submitted, it is held that the failure of the 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)