

Internal Revenue Service

Department of the Treasury

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Date:

MARCH 19, 1999

In re:

Legend

Taxpayer =

Parent =

Date RR =

Date 1 =

e =

f =

g =

j =

k =

m =

n =

p =

q =

r =

x =

z =

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Policy A =
Policy B =

Policy C =

years s =

years t =

years u =

year v =

year w =

c =

State =

Dear

This is in response to your letter dated Date RR, and supplemental submissions, requesting a ruling that waivers be granted pursuant to §§ 101(f)(3)(H) and 7702(f)(8) of the Internal Revenue Code, as applicable, with regard to the failure of certain contracts to satisfy the "guideline premium limitation" under §§ 101(f)(2) and 7702(c)(2), as applicable. This ruling letter applies to the x contracts listed in Exhibit A.

FACTS

Taxpayer represents that it is a stock life insurance company organized and operated under the laws of State, and that it is a life insurance company within the meaning of § 816(a) of the Code.

Taxpayer further represents that it is a wholly-owned subsidiary of Parent. Taxpayer represents that Parent is a life insurance company within the meaning of § 816(a) of the Code, and that Taxpayer joins in the filing of a consolidated federal income tax return with Parent.

This request for waivers relates to three types of flexible premium universal life insurance contracts issued by Taxpayer (the "Policies"). Taxpayer issued Policy A contracts in years s, Policy B contracts in years t, and Policy C contracts in years u. Policies issued on or before December 31, 1984, were intended to comply with § 101(f) of the Code by satisfying both the "guideline premium limitation" of

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§ 101(f)(1)(A)(i) and (f)(2) and the "applicable percentage" requirements of § 101(f)(1)(A)(ii) and (f)(3)(C). Policies issued after December 31, 1984, were intended to comply with § 7702 by both satisfying the "guideline premium requirements" of § 7702(a)(2)(A) and (c) and falling within the "cash value corridor" of § 7702(a)(2)(B) and (d). As of Date 1, Taxpayer had approximately m Policies in force, including n Policy A contracts, p Policy B contracts, and q Policy C contracts.

Taxpayer uses the Z automated computer system (the "current system") supplemented by specified manual procedures to calculate and monitor the compliance of each Policy with the "Premium Limitation" for the Policy. The Premium Limitation is intended to equal the "guideline premium limitation" for the Policy prescribed in §§ 101(f)(2) and 7702(c)(2) of the Code, whichever is applicable. Taxpayer purchased the current system in year v, and has updated and modified the system (and accompanying manual procedures) over the years for various reasons, including changes in the tax law.

The current system compares the premiums paid under each Policy with the Premium Limitation for the Policy at the time the Policy is issued, each time a premium payment is made, on each policy anniversary date, and, except as described below, at the time of a change in coverage under the Policy which affects the Premium Limitation. If a policyholder attempts to pay a premium for a Policy which will result in the sum of the premiums paid under the Policy exceeding the Premium Limitation for the Policy (an "excess premium"), the current system indicates that the Premium Limitation will be exceeded if the payment is processed. Beginning with the c time period,¹ Taxpayer's manual procedures have required that an excess premium payment not be accepted; instead, personnel of Taxpayer are required to return the excess premium (with interest) immediately to the policyholder. Prior to the c time period, Taxpayer's manual procedures provided that if a policyholder attempted to pay an excess premium, Taxpayer's employees would refund the excess premium (with interest) to the policyholder. Taxpayer's manual procedures further provided that, in connection with the refund, Taxpayer's employees were to notify the policyholder of the policyholder's ability to have the excess premium applied to the contract with the contract's death benefits being increased to the extent necessary to accommodate the excess premium. Additionally, Taxpayer's procedures permitted the policyholder, if the policyholder so requested, to have the excess premium applied to the contract

¹The text refers to a time period, rather than an exact date, because Taxpayer has been unable to determine the exact date on which its manual procedures were changed.

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without increasing the contract's death benefits. In this event, Taxpayer's manual procedures provided that Taxpayer's employees would process the excess premium, treating the policyholder's contract as failing to comply with the requirements of §§ 101(f) or 7702, as applicable, and accordingly, subject to the reporting, withholding, and deposit requirements applicable to noncomplying contracts. Taxpayer's manual procedures further provided that, in the case of a policyholder's request to have the excess premium applied to the contract without increasing the contract's death benefits, Taxpayer's employees were to input a "bypass code" into the current system with respect to the contract. As long as the bypass code was in place, the current system would not compare the premiums paid under the contract with the Premium Limitation for the contract, and thus would not indicate the presence of an excess premium under the contract. Beginning with time period c, the bypass code no longer served any purpose, because Taxpayer's manual procedures no longer allowed for the processing of excess premiums under any circumstances. Nevertheless, the bypass code was not eliminated. Even after the beginning of time period c, entry of the bypass code by one of Taxpayer's employees would prevent the current system from comparing premiums paid under the contract with the contract's Premium Limitation.

Several years ago, Taxpayer considered converting the monitoring process for its life insurance contracts from the current system to a newer computer-based system. In connection with this undertaking, Taxpayer conducted an extensive review of the current system (and accompanying procedures) and a comprehensive internal audit of Taxpayer's life insurance contracts to evaluate the performance of the current system. After considering the results of the review and internal audit, Taxpayer decided to convert from the current system to a different computer system that it determined will be better able to monitor life insurance policies for compliance with §§ 101(f) and 7702 of the Code. Taxpayer currently is in the process of making this conversion and expects that the conversion will be completed in the first half of year w. The new computer system will not contain a manual override, such as a bypass code, that prevents the system from comparing premiums paid against the Premium Limitation and flagging contracts for which the Premium Limitation has been exceeded.

Taxpayer's internal audit revealed that, due to certain errors, discussed in this ruling letter, premiums paid with respect to the x Policies that are the subject of this ruling letter were accepted by Taxpayer in excess of the Policies' respective Premium Limitations, and that such excess premiums were not refunded (with interest) within 60 days of the end of the policy year in which they were accepted in accordance with

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§§ 101(f)(3)(B) and 7702(f)(1)(B) of the Code, whichever was applicable. Taxpayer further represents that the x Policies would have been in compliance with § 101(f) or 7702, as applicable, but for the errors discussed in this ruling letter.

The first type of error, encompassing r Policies,² consisted of the failure of Taxpayer's personnel to follow Taxpayer's manual procedures when the current system properly indicated that the Premium Limitations for the contracts would be exceeded if the excess premium payments were processed. In most cases in which a policyholder attempted to pay an excess premium, the excess premium was returned (with interest) to the policyholder, and prior to the c time period, the policyholder was also notified of the possibility of applying the excess premium to the contract and having the death benefit increased to the extent necessary to accommodate the excess premium. Additionally, Taxpayer represents that there were k instances in which policyholders requested that an excess premium be applied under the contract without increasing the contract's death benefits.³ Taxpayer represents that in each of these k instances it treated the contracts as failed contracts under § 101(f) or § 7702, as applicable, and fulfilled the reporting, withholding, and deposit requirements under these provisions.⁴

Taxpayer has provided us with a more specific description of the instances in which the failure to follow its manual procedures resulted in premiums being accepted when the current system indicated the Premium Limitation was exceeded.

With respect to j Policies, prior to the c time period, the current system properly indicated that the Premium Limitation for the contracts would be exceeded if the excess premium payments were processed. However, Taxpayer's employees failed to provide the policyholders with a refund of the excess premium (with interest) and with the required notification which was to accompany the refund. Taxpayer's employees

²Taxpayer represents that, with respect to some of the x Policies, more than one of the errors discussed in the text cannot be ruled out as contributing to the contract's failure. Thus, the sum of the Policies affected by each type of error discussed in the text exceeds x.

³The k contracts referred to in the text are not included in the Policies that are the subject of this ruling request.

⁴Thus, entry of the "bypass code," in accordance with Taxpayer's manual procedures, did not lead to Taxpayer not meeting the reporting, withholding, and deposit requirements for failed contracts.

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improperly processed the excess premiums and the contracts were not treated as failed contracts by Taxpayer's employees.

With respect to e Policies, after the current system properly indicated that the Premium Limitation for the contracts would be exceeded if the excess premium payments were processed, Taxpayer's employees entered the bypass code in contravention of Taxpayer's manual procedures, blocking the current system from making any further comparisons of premiums paid against the Premium Limitation. No excess premiums were returned to policyholders with respect to these contracts. No notifications were sent to policyholders regarding the possibility of increasing death benefits for these contracts. Neither were any requests received from policyholders to treat these contracts as failed contracts, and they were not so treated by Taxpayer.⁵

The second type of error stems from mechanical computer programming errors. This type of error resulted from the failure of certain of Taxpayer's computer technicians to correctly implement programming instructions in connection with updates and modifications made to the current system. The programming instructions to the technicians were based on a proper interpretation of §§ 101(f) and 7702 of the Code, and the technicians did not misunderstand the instructions. Hence, if the current system had been programmed in accordance with the instructions, the mechanical programming errors would not have occurred. However, the technicians made certain inadvertent errors in programming into the current system the computer commands necessary to implement properly all of the instructions. As a result, the current system determined the Premium Limitations for the Policies affected by these programming errors to be higher than they should have been.

Two types of mechanical programming errors were made. The first type involved the failure to reflect the correct amount of the monthly expense charge⁶ in the Premium Limitation for the Policies. The current system was inadvertently

⁵Taxpayer represents that f of the errors involving the use of the bypass code occurred prior to the c time period when the its first set of manual procedures was in effect, while g of these errors occurred beginning in the c time period when its new set of manual procedures took effect. Taxpayer represents that j of these errors occurred during the period when it was changing its manual procedures, and therefore it is unable to determine which set of manual procedures were in effect.

⁶The monthly expense charge does not include the mortality charge.

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programmed to compute the Premium Limitation for the Policies using a monthly expense charge equal to the annual amount of the expense charge. Hence, the Premium Limitations under these Policies reflected an amount allocable to expenses which was twelve times greater than it should have been. This error is present with respect to all x of the Policies that are the subject of this ruling letter.

The second mechanical programming error involved the failure to recompute the Premium Limitation for certain Policy A and Policy C contracts after death benefits were reduced. See §§ 101(f)(2)(E) and 7702(f)(7)(A), which require such recomputation. The current system was programmed to properly recompute a Policy's Premium Limitation after a death benefit reduction under the Policy. However, with respect to certain Policy A and Policy C contracts, the current system was inadvertently modified to circumvent this recomputation function. As a result, in the case of a death benefit reduction under these Policy A or Policy C contracts, the current system failed to recompute the Premium Limitation based on the reduced death benefit. Accordingly, the Premium Limitation for these contracts was based on the unreduced death benefit, and thus was greater than it should have been. This error is present in j Policy A contracts and k Policy C contracts.

Taxpayer proposes to remedy the failure of the Policies that are in force⁷ by (1) increasing the death benefits payable under a Policy in an amount sufficient to ensure compliance with §§ 101(f) or 7702(a) of the Code, as applicable, or (2) refunding excess premiums under a Policy with interest⁸ to the policyholder. These actions will be taken within 60 days of the date of this letter ruling.

In addition, in order to reduce the likelihood that clerical processing errors will occur in the future, Taxpayer has both revised its procedures and improved the training of its personnel regarding the rejection and immediate return of excess premiums. Taxpayer has also modified the current system to correct the mechanical programming errors. Moreover, as stated above, Taxpayer currently is in the process of converting to a different computer system for the purpose of

⁷All x of the Policies that are the subject of this ruling letter are either in force, or have terminated by surrender or lapse.

⁸Taxpayer represents that such interest will be paid at rates at least as high as the rates applied for purposes of crediting interest to the Policy's cash values.

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improving compliance with §§ 101(f) and 7702 of the Code. The new system will not contain a manual override code, such as the bypass code in the current system.

LAW

Section 101(f) of the Code requires a "flexible premium life insurance contract" to satisfy either of two tests in order for the death benefit thereunder to be excludable under § 101(a) as the proceeds of a life insurance contract: (1) a "guideline premium limitation" (coupled with an "applicable percentage" requirement) set forth in § 101(f)(1)(A) or (2) a "cash value test" set forth in § 101(f)(1)(B). Section 101(f) applies only to flexible premium life insurance contracts issued before January 1, 1985.

Section 7702 of the Code contains a definition of 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 which is a life insurance contract under applicable law must either satisfy the "cash value accumulation test" set forth in § 7702(a)(1) and (b), or both meet the "guideline premium requirements" set forth in § 7702(a)(2)(A) and (c) and fall within the "cash value corridor" pursuant to § 7702(a)(2)(B) and (d). In general, § 7702 applies to all life insurance contracts issued after December 31, 1984.

Section 101(f)(3)(B) of the Code provides that, if, in order to comply with the requirements of § 101(f)(1)(A), any portion of any premium paid during any contract year is returned by the insurance company (with interest) within 60 days after 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.

Similarly, § 7702(f)(1)(B) of the Code provides that, if, in order to comply with the requirements of § 7702(a)(2)(A), any portion of any premium paid during any contract year is returned by the insurance company (with interest) within 60 days after 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.

Sections 101(f)(3)(H) and 7702(f)(8) of the Code provide that the Secretary of the Treasury may waive a failure to satisfy the requirements of §§ 101(f) and 7702, respectively, 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."

Both prior to the c time period, and thereafter, Taxpayer had in place manual procedures that would have resulted in

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compliance with the requirements §§ 101(f) and 7702 of the Code. The failure of Taxpayer's personnel to follow these manual procedures after the current system flagged premiums in excess of the Premium Limitation was attributable to human clerical errors. Similarly, the mechanical programming errors made by Taxpayer's personnel in implementing a set of computer programming instructions that would have, but for these errors, properly reflected the tests of §§ 101(f) and 7702, were also attributable to human errors that were clerical in nature.

Further, Taxpayer has represented that it is taking measures to improve the monitoring of its contracts for compliance with §§ 101(f) and 7702 of the Code. Taxpayer has also, as stated above, represented that it will promptly take curative actions with respect to Policies in force.

After consideration of all the facts and circumstances, we find that the failure of the x Policies to satisfy the requirements of §§ 101(f) and 7702(a) of the Code, as set forth in this ruling, was due to reasonable error, and that Taxpayer is taking reasonable steps to remedy the error.

CONCLUSION

Taxpayer is granted a waiver under §§ 101(f)(3)(H) and 7702(f)(8) of the Code for the failure of the x Policies listed in Exhibit A to satisfy the requirements of §§ 101(f) and 7702, respectively.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

No opinion is expressed as to whether the x Policies comply with the requirements of §§ 101(f) or 7702, as applicable, that were not the subject of this letter ruling or other sections of the Code and income tax regulations.

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.

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

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modified retroactively except in rare or unusual circumstances.

A copy of this letter 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 the taxpayer.

Sincerely,

Assistant Chief Counsel
(Financial Institutions &
Products)

By: SIGNED BY DONALD J. DREES

Donald J. Drees, Jr.
Senior Technician Reviewer
Branch 4

Attachment
Exhibit A

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Exhibit A