

INTERNAL REVENUE SERVICE

Index Number:

7702.02-00

Number: **199924027**

Release Date: 6/18/1999

CC:DOM:FI&P:4\PLR-115498-98

MARCH 19, 1999

Taxpayer -

State A -

State B -

Policy A -

Policy B -

Policy C -

Policy D -

Year W -

Year X -

Year Y -

Year Z -

Year ZZ -

Number 1 -

Number 2 -

Location A -

Date A -

Date B -

Date C -

Date D -

Date E -

Month A -

Month B -

Dear

This letter responds to a letter dated Date A, signed by your representative, requesting that a waiver be granted pursuant to section 7702(f)(8) of the Internal Revenue Code with respect to certain failed life insurance contracts. Supplemental information was submitted on Date B, Date C, Date D and Date E.

Taxpayer is a life insurance company that was originally organized under the laws of State A and was subsequently redomesticated in State B. Taxpayer represents that it is a life insurance company under section 816(a) and is subject to taxation under subchapter L of the Code. Taxpayer is under the audit

jurisdiction of the District Director in Location A.

Taxpayer issued Policy A, Policy B, Policy C and Policy D, flexible premium universal life insurance contracts, between Year W and Year X. A total of more than Number 1 universal life insurance contracts were issued by the Taxpayer during this period, of which Number 2 inadvertently failed section 7702. Number 2 represents less than one-tenth of one percent (0.1%) of the total number of contracts issued. Taxpayer has not retested policies that lapsed or terminated prior to Year Z. To the best of Taxpayer's knowledge, there have not been any section 7702 testing failures on any of the life insurance contracts that it has issued since Year W on other policy forms, nor have there been section 7702 testing failures on any policies issued since Year Y on its Policy A, Policy B, Policy C and Policy D policy forms.

The failures can be divided into eight groups. The first group involves failures that are the result of personnel in the administrative department using incorrect tables, either when the policy was set up or when a spousal rider was added. The second "group" involves a single failure that resulted from a manual miscalculation which, in turn, generated an insufficient refund of premiums on the contract. The third group involves failures that are the result of overstated guideline premium amounts for policyholders who changed from smoker to nonsmoker status. The fourth group involves failures that are similar to those in group three, but for changes in medical rating from sub-standard to standard. The fifth group involves failures that are the result of mathematical errors in computing new guideline premiums for contracts with face amount reductions. The sixth "group" also involves a clerical error by the person responsible for adjusting the guideline premium limitation for a contract with a reduced face amount. The seventh group involves failures that are the result of the use of incorrect gender factors. The eighth group involves TEFRA contracts for which there was a face amount change after the enactment of DEFRA. Due to an apparent miscommunication between the actuarial and administrative departments, the policies were not tested under DEFRA when the face amount was changed. Some of the failed policies have been surrendered, and others were in compliance with section 7702 as of the latest test date, according to Taxpayer. The remaining failed policies will all come into compliance immediately upon a distribution of excess premiums with interest.

In Year Z, Taxpayer discovered that its section 7702 testing procedures for its Policies A, B, C and D policy forms did not properly take into account reductions in policy face amount, changes in rating classification, or certain other ministerial changes. After it discovered the errors, Taxpayer reviewed all of the outstanding policies to identify testing failures and to

determine the cause of the testing failures. In Month A of Year Z, Taxpayer's actuaries issued compliance guidelines with respect to sections 7702 and 7702A that established the current procedures for DEFRA testing. These compliance procedures were further revised in Month B of Year ZZ. These revisions include clarifications on how to adjust for coverage changes. The change in the way Taxpayer will calculate coverage changes was the result of discussions with an outside consultant. Taxpayer states that the new method is consistent with industry practice on this issue.

The errors in groups one, two, five, six, and seven resulted from clerical errors of various sorts, ranging from mathematical errors, to use of incorrect gender factors, to failure to follow established procedures for retesting in each case. The failures were due to human error in each case; according to Taxpayer, had established procedures been followed, the contracts would not have failed.

The failures in groups three and four involved the computation of the guideline premium after an adjustment event (changes from smoker to non-smoker, or sub-standard to standard medical rating). Neither the Code nor the legislative history of section 7702 provides guidance as to the acceptable methodology to be used in such situations. Taxpayer recomputed the guideline premium using a methodology that did not completely take into account the additional cash value that accumulated for the years before the adjustment, based on the prior status. A subsequent review of this methodology resulted in a second recomputation of the guideline premium. Taxpayer attempted to comply with the requirements of section 7702 when Taxpayer made its initial recomputation. Taxpayer's initial recomputation, although not correct, was based on a reasonable interpretation of section 7702(f)(7).

Finally, the eighth group of failures involved adjustments to the face amount of policies that did not result in full recomputation of the guideline premium limitation. Most of the policies in this group were TEFRA policies, for which changes were made after the enactment of DEFRA. In these situations, as explained above, the administrative department either failed to make any adjustment or failed to make the proper adjustment, due to an apparent miscommunication between the actuarial and administrative department.

Section 7702 statutorily defines the requirements that a life insurance policy must meet to be treated as a life insurance contract for federal income tax purposes. A contract must be a life insurance contract under applicable law and must meet either of two alternative tests: (1) the cash value accumulation test of section 7702(a)(1) or (2) the guideline premium and cash value

corridor test of section 7702(a)(2)(A) and (B).

Section 7702(c)(1) provides that a contract meets the guideline premium requirements if the sum of the premiums paid under such contract does not at any time exceed the guideline premium limitation as of such time.

Section 7702(c)(2) provides that the term "guideline premium limitation" means, as of any date, the greater of (A) the guideline single premium, or (B) the sum of the guideline level premiums to such date.

Section 7702(c)(3)(A) provides that the term "guideline single premium" means the premium at issue with respect to future benefits under the contract. Section 7702(c)(3)(B) provides that the determination of the guideline single premium amount shall be based on (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 commissioner's 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.

Section 7702(f)(8) provides that the Secretary may waive the failure to satisfy the statutory requirements under section 7702(a) for a life insurance contract for any year if such failure was due to reasonable error and reasonable steps are taken to remedy the error.

Taxpayer submits that the noncompliance with the applicable guideline limitations in section 7702 resulting in the inadvertent monitoring errors was due to "reasonable error" within the meaning of section 7702(f)(8). The Policies are not by design inconsistent with the applicable requirements of section 7702. Flexible premium universal life insurance contracts, such as the failed Policies, by their nature do not contractually require a fixed amount of premium payments. Rather, they permit payments that are flexible and are largely at the discretion of the policyholder. The only means of control over the Policies' compliance that is available to Taxpayer is to monitor such premium payments as they are made to ensure that they do not exceed the applicable guideline limitation under section 7702.

Taxpayer calculated a premium limitation for each Policy in accordance with the requirements of section 7702 and monitored

premium payments in an effort to prevent any policy from exceeding its premium limitation. However, inadvertent human errors were made in accepting excess premiums despite Taxpayer's efforts to prevent this from occurring. Human mistakes of the type resulting in errors are inevitable when administering the large number of policies that the Taxpayer has outstanding.

Taxpayer monitored premium payments through a compliance system in an effort to prevent any Policy from exceeding its premium limitation. Taxpayer has changed its compliance guidelines for section 7702 testing purposes in order to prevent inadvertent Policy failures.

Based on the facts submitted, the errors that caused a number of Policies A, B, C and D to exceed the guideline premium limitation were reasonable errors. Taxpayer had attempted to systematically monitor the Policies. Taxpayer is taking reasonable steps to correct the errors within 30 days by refunding the excess premiums with interest, or increasing death benefits for each affected policyholder.

Accordingly, based on the information submitted, it is held that failure of Number 2 Policies (described in detail in the Taxpayer's submission) to satisfy the requirements of section 7702(a) is waived pursuant to section 7702(f)(8).

We express no opinion as to the tax treatment of the Policies under the provisions of other sections of the Code and Income Tax Regulations that may be applicable thereto. No opinion is expressed as to the compliance of these Policies with other provisions of section 7702.

This ruling is addressed 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 taxpayer.

Sincerely yours,
Assistant Chief Counsel
(Financial Institutions & Products)

By: SIGNED BY MARK S. SMITH
Mark S. Smith
Chief, Branch 4