

## Internal Revenue Service

## Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:FIP:4- PLR-157427-02

Date:

February 6, 2003

In Re:

Legend:

Taxpayer:

Year A:

Date A:

Date B:

Date C:

Date D:

State A:

Number 1:

Number 2:

Number 3:

Number 4:

Form A:

Form B:

Form C:

Form D:

Form E:

Rider A:

Rider B:

Dear \_\_\_\_\_ :

This is in response to your letter of Date A, requesting a waiver pursuant to § 7702(f)(8) of the Internal Revenue Code for Number 1 insurance contracts issued by Taxpayer that failed to meet the requirements of § 7702(a).

The information submitted indicates that Taxpayer, founded in Year A, \_\_\_\_\_ is organized and operated under the laws of State A. Taxpayer is licensed to issue life insurance and annuity contracts in Number \_\_\_\_\_.

2 states

All of the life insurance (hereinafter referred to as policies) that are the subject of this request are participating, flexible premium universal life insurance contracts. All of the policies were issued after Date B and 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 C, Taxpayer had Number 3 policies in force. Taxpayer has determined that Number 4 of its policies failed to qualify as life insurance contracts under § 7702. Number 1 of the policies failed to satisfy the guideline premium requirements for the reasons set forth below. The remaining policies are the subject of a separate request for a closing agreement. The policies at issue in this letter used Forms A, B, C, D, and E.

The contract values of these policies on is the initial premium less the monthly deduction for the first policy month. The contract value on any monthly anniversary of is: (1) the contract value on the preceding monthly anniversary with interest credits received to that date; plus (2) any premium received since the preceding monthly anniversary date with interest credits from the day received to that date; plus (3) any dividend added on that date; less (4) any withdrawal since the preceding monthly anniversary with interest credits from the day of withdrawal to that date; less (5) the monthly deduction for the month that begins on that date. The monthly deduction consists of an expense charge, charges for the cost of insurance, and charges for the costs of any riders.

The policies could be issued with one or both of the following riders, Rider A or Rider B. The Riders A and B provide for the waiver of monthly deductions under certain circumstances. Both of these riders are “qualified additional benefits” (“QABs”) within the meaning of § 7702(f)(5)(A).

Riders A and B are funded with charges that are assessed against the contract value of a policy. These charges are guaranteed not to exceed certain specified amounts. In practice, Taxpayer has imposed charges for the Riders that are less than the guaranteed amounts. The current Rider charges imposed vary directly with the current cost of insurance imposed under a Policy. Taxpayer has reflected, however, the guaranteed amount of charges in the guideline premium calculations for policies under § 7702.

In connection with a prior submission that the Taxpayer made to the Service on Date D pursuant to Rev. Proc. 99-27, 1997-1 C.B. 1186, Taxpayer discovered certain errors affecting the compliance of the policies with § 7702. In reaction to this discovery, Taxpayer, with the assistance of an outside consulting firm, undertook an extensive review and analysis of the manner in which its life insurance policies are administered, including the manner in which Taxpayer seeks to assure compliance with § 7702. As a result of this review, Taxpayer realized its treatment of Riders A and B was incorrect. Taxpayer has recalculated the guideline premium limitation for policies with the Riders taking into account only reasonable charges that it reasonably expects to impose in accordance with § 7702(c)(3)(B)(ii). As a result of this recalculation, Taxpayer discovered that Number 1 of its policies failed to comply with the guideline premium requirements of § 7702(c) due to treatment of QABs (hereinafter referred to as the "QAB error").

Taxpayer has modified its § 7702 compliance administrative system to eliminate the QAB error. Under its modified system, and any successor system, Taxpayer's calculation of guideline premiums will reflect only reasonable charges for the Riders that Taxpayer actually expects to impose, consistent with the requirements of § 7702(c)(3)(B)(ii). Taxpayer believes that the administrative procedures that it maintains relating to the compliance of policies under § 7702 are now adequate.

Taxpayer proposes to remedy the noncompliance of each of the failed policies that is in force on the effective date of the requested waiver, as appropriate, and under which the sum of the premiums paid as of that date exceeds the guideline premium limitation as of that date by refunding to the policyholder the amount of such excess with interest (using rates at least as high as those applied for purposes of crediting interest to the policies' contract values). Taxpayer has already or will implement these corrective measures within 90 days of the date of this letter.

## LAW AND ANALYSIS

Section 7702 defines the term "life insurance contract" for all purposes of the Code.

Under § 7702(a), a life insurance contract must qualify as such under the applicable law and must satisfy either the cash value accumulation test of § 7702(a)(1) and § 7702(b), or both the “guideline premium requirements” of § 7702(a)(2)(A) and § 7702(c) and the “cash value corridor” of § 7702(a)(2)(B) and § 7702(d).

With respect to the guideline premium requirements, § 7702(c) requires that the premium paid under the contract at any time must not exceed the greater of the guideline single premium or the sum of the guideline level premium to that date. The guideline single premium is the single premium at issue that is needed to fund the “future benefits” under the contract determined on the basis of the following three elements enumerated in § 7702(c)(3)(B)(i)-(iii):

- (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 prevailing commissioners’ standard tables (as defined in § 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.

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, using a minimum interest rate of 4 percent, rather than 6 percent. Accordingly, the amount of both the guideline single premium and guideline level premium is proportional to the amount of future benefits under the contract. The computational rules of § 7702(e) and the definitions of § 7702(f) apply to both the guideline single premium and the guideline level premium.

Section 7702(f)(4) defines the term “future benefits” to mean death benefits and endowment benefits. Section 7702(f)(5)(A)(i)-(v) provides that the term “qualified additional benefits” means any-- (i) guaranteed insurability, (ii) accidental death or disability benefit, (iii) family term coverage, (iv) disability waiver benefit, or (v) other benefit prescribed under regulations. Section 7702(f)(5)(B) provides that qualified additional benefits shall not be treated as future benefits under the contract, but that charges for such benefits shall be treated as future benefits.

In computing the guideline premium for a policy to which Rider A or Rider B was attached, Taxpayer treated the charges for the rider as a future benefit, and

accordingly, increased the guideline premium for each policy by that amount. Taxpayer, however treated those charges under the “reasonable mortality charge” standard set forth in § 7702(c)(3)(B)(i), rather than the “reasonable expense charge” standard set forth in § 7702(c)(3)(B)(ii). Charges contemplated by § 7702(c)(3)(B)(i) are deemed reasonable if they do not exceed the charges set forth in the 1980 CSO Mortality Table, regardless of whether the charges actually set forth in the contract are less than the 1980 CSO amount. In contrast, charges contemplated by § 7702(c)(3)(B)(ii) are deemed reasonable only if they reflect the amount expected to be actually paid, which typically correlates to a company’s actual charges. Consequently, in many instances the guideline premium attributable to certain benefits will be higher if treated under § 7702(c)(3)(B)(i) rather than § 7702(c)(3)(B)(ii).

Although the Code in setting forth the guideline premium limitations does not specifically direct taxpayers to treat Riders A and B under § 7702(c)(3)(B)(ii), rather than (c)(3)(B)(i), the rules applicable to the cash value accumulation test are controlling in this regard. Particularly, § 7702(c)(3)(B) provides one of the computational rules for determining the net single premium used to ascertain compliance with the cash value accumulation test. Section 7702(b)(2)(B) states that such computation, in the case of qualified additional benefits, shall be made on the basis of § 7702(c)(3)(B)(ii). Thus, for purposes of the cash value accumulation test, Riders A and B are treated under § 7702(c)(3)(B)(ii). Although the requirement set forth in § 7702(b)(2)(B) refers only to the determination required for the cash value accumulation test, and does not expressly apply to the guideline premium limitations, this provision is the only direction provided by Congress as to how charges for qualified additional benefits are to be considered from a computational standpoint. The legislative history, moreover, is absent of any indication that there be two separate standards for inclusion of such charges: one for the cash value accumulation test and one for the guideline premium limitation. Given Congress’ indication that QABs should be treated under § 7702(c)(3)(B)(ii) for purposes of the cash value accumulation test, and absent any indication to the contrary, we conclude that § 7702 (b)(2)(B) implicitly requires Riders A and B benefits to be treated under § 7702 (c)(3)(B)(ii) for purposes of the guideline premium limitations as well.

Under § 7702(f)(8) , the Secretary of the Treasury may waive the failure to satisfy the requirements of § 7702 if the taxpayer establishes that the requirements were not satisfied due to reasonable error(s) and that reasonable steps are being taken to remedy the error(s).

After considering all the facts and circumstances, we find that failure of Number 1 policies to satisfy the requirement of § 7702 was due to reasonable errors, and Taxpayer is taking reasonable steps to remedy the errors.

## CONCLUSION

Accordingly, based on the information submitted, the failure of Number 1 contracts to satisfy the requirements of § 7702(a) is waived pursuant to § 7702(f)(8), provided that the excess premiums are refunded with interest calculated equal to or greater than the contract crediting rate, as of the date of the cure. Any contracts that are not cured within 90 days of the date of this letter are not covered by this waiver.

The rulings contained in this letter are based on information submitted by the 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 a ruling, it is subject to verification on examination.

Except as provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. 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 Taxpayer.

Sincerely yours,

/S/

MARK S. SMITH  
Chief, Branch 4  
Office of Associate Chief Counsel  
(Financial Institutions and Products)