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Automatic Waivers and Other Waivers Under New IRC § 7702 and § 101(f) Correction Procedures

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On June 30, 2008 the Internal Revenue Service (the “Service”) and the Treasury Department (the “Treasury”) issued Rev. Proc. 2008-42 to allow insurers to obtain automatic waivers for certain types of life insurance policy disqualifications under IRC § 7702(f)(8) or § 101(f)(3)(H), without having to file a request to the Service for such a waiver. As indicated below, Rev. Proc. 2008-42 basically provides a definitional description of eligible errors for such automatic waivers, and merely requires that the insurer file an “Automatic Waiver Request” for such a waiver with both its federal income tax return and the IRS National Office Insurance Branch (Insurance Branch). The pre-existing waiver procedures continue to be available as an alternative for an insurer, and they allow it to request a private letter ruling (PLR) from the Service to formally approve a waiver under IRC § 7702(f)(8) or § 101(f)(3)(H), *e.g.*, where the insurer’s reasons for failure are ineligible for an automatic waiver under Rev. Proc. 2008-42, or where the insurer is uncertain whether the failure is eligible for any automatic (or nonautomatic) waiver.

Pre-existing Waiver Procedures

Prior to the issuance of Rev. Proc. 2008-42, an insurer always had to request a PLR from the Service, in order to obtain a waiver under either IRC § 7702(f)(8) or § 101(f)(3)(H). Such a PLR request could be both expensive and time-consuming, and insurers and the Insurance Branch often had doubts whether these waiver procedures were worth it.

The advantage to an insurer of obtaining such a waiver was generally that it would allow the insurer to correct a failed life policy retroactively to its date of failure, without having to pay the Service any “toll charge” for a closing agreement to make such a retroactive correction. Generally, the Insurance Branch required that such a toll charge be roughly equal to the federal income tax that the policyholder would have had to pay to the Service for such a failed policy under IRC § 7702(g) (*i.e.*, a proxy tax). Under IRC § 7702(f)(8) and § 101(f)(3)(H), the Service had broad discretion to waive any policy’s disqualification under IRC § 7702 or § 101(f) due to reasonable error. The Insurance Branch generally exercised this discretion by determining when it would be appropriate to waive such a toll charge for



the insurer, in order for it to obtain the retroactive correction of the failed policies.

However, in exercising this discretion, the Insurance Branch not only required an insurer to file a PLR request and pay the full filing fee for such a request (currently \$11,500), but also frequently required the insurer to submit detailed factual descriptions and representations concerning the reasons for failure. The Insurance Branch then carefully reviewed such submissions, and frequently asked follow-up questions, requiring further detailed answers and submissions. In the end, the Insurance Branch often found grounds to refuse such a waiver, and this would leave the insurer with no recourse but to seek a closing agreement—and pay the full toll charge anyway—to obtain the necessary retroactive corrections of the failed policies.

In addition, over time the waivers actually granted by the Insurance Branch tended to fall into certain broad categories, *e.g.*, human errors where the insurer’s personnel failed to follow appropriate (and verified) testing or other compliance procedures, or where they made certain types of computer programming errors. On the other hand, any failures due to any flaw in the insurer’s computer monitoring system (even if it were attributable to an outside vendor), or in any of the insurer’s other monitoring or correction procedures, were generally ineligible for any waiver.

As a result, the industry began clamoring for less expensive and time-consuming procedures for such waivers,

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and the Insurance Branch, in turn, began considering how it could make such procedures simpler and more efficient for its own personnel. This led to the automatic waiver procedures for certain eligible categories of failures in Rev. Proc. 2008-42.

Automatic Waiver Procedures under Rev. Proc. 2008-42

Rev. Proc. 2008-42 not only simplified the waiver procedures for certain specified categories of “eligible reasonable errors” (described below), but it also expanded their availability beyond the current insurer to include any reinsurer, by defining the term “issuer” to cover any company that insures a contract holder under a contract originally issued by another company.

Eligible Reasonable Errors

Rev. Proc. 2008-42 expressly provides for an automatic waiver for any failure to satisfy IRC § 7702 or § 101(f) due to an eligible reasonable error, provided that reasonable steps are taken to remedy such error. An eligible reasonable error is defined to exist if (1) the insurer has compliance procedures with specific, clearly articulated provisions that, if followed, would have prevented the contract from failing to satisfy the requirements of IRC § 7702 or § 101(f); (2) an employee or independent contractor of the insurer acted, or failed to act, in accordance with these compliance procedures; and (3) such act or failure to act was inadvertent, and was the sole reason that the contract failed to satisfy these requirements. Specific examples of these eligible errors included an employee’s incorrect recording of the age or gender of the insured, or of the incorrect amount or time of payment of a premium payment.

Rev. Proc. 2008-42 also specified certain “noneligible errors” that could not qualify for an automatic waiver, such as a defective legal interpretation or a computer programming error. Nevertheless, Rev. Proc. 2008-42 pointed out that any such noneligible error might qualify for a waiver through the pre-existing PLR request procedures, or for the new simplified closing agreement procedures for IRC § 7702 or § 101(f) corrections, which were provided in the companion Rev. Proc. 2008-40.

Procedural Requirements for Automatic Waivers

As indicated above, to obtain the automatic waiver for an eligible reasonable error under Rev. Proc. 2008-42, the insurer need only (1) take reasonable steps to remedy such error, and (2) file a statement with its federal income tax return and with the Insurance Branch

entitled “Automatic Waiver Request under Rev. Proc. 2008-42” (Waiver Statement).

For the reasonable steps to remedy, Rev. Proc. 2008-42 provides that this requirement is satisfied if the insurer refunds excess premium with interest and/or increases the death benefit on the contract, no later than the date on which the insurer files its federal income tax return to which the Waiver Statement is attached. The Revenue Procedure makes clear that such a remedy does not include changes to the insurer’s compliance procedures, because the definition of an eligible reasonable error requires that the insurer already have specific, clearly articulated procedures that, if followed, would have prevented such error.

For the Waiver Statement, the insurer must (1) provide a brief description of the error and the steps taken to remedy the error; (2) list the policy numbers of the contracts for which it seeks an automatic waiver; and (3) provide representations to the effect that the insurer is within the scope of Rev. Proc. 2008-42 (Section 3) and is otherwise entitled to the automatic waiver. Such representations must be executed under penalties of perjury by an appropriate party described in Section 4.04 of the Revenue Procedure, and the insurer must retain documentation available for audit to support these representations.

The insurer must attach this Waiver Statement to a timely-filed federal income tax return for the taxable year during which the insurer relies upon Rev. Proc. 2008-42 for such waiver. This return also must contain an additional statement that refers to this Waiver Statement and that is spelled out in Section 4.03 of the Revenue Procedure. In addition, this Waiver Statement must be signed and dated and filed with the IRS National Office, at the address specified in Rev. Proc. 2008-42, no later than the date such tax return is filed. Acceptable electronic filings of this Waiver Statement are also provided by Rev. Proc. 2008-42 in Sections 4.03 and 4.05.

While questions undoubtedly will arise as to the scope of the eligible errors for automatic waivers, the Service and the Treasury are to be commended greatly for simplifying their waiver procedures, and for providing cost-efficient automatic waivers for these eligible errors. ◀

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