

Internal Revenue Service

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Department of the Treasury

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Date:

May 23, 2006

Legend

Taxpayer =

Company A =

Company B =

Company C =

Date A =

Date B =

Date C =

Date D =

Date E =

Date F =

Date G =

Date H =

Number 1 =

Number 3 =

Number 4 =

State A =

X =

Z =

Dear :

This is in response to your letter of Date A and supplemented and modified by letters of Date B and C, 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).

FACTS

The information submitted indicates that Taxpayer is a life insurance company within the meaning of section 816(a). Taxpayer is a mutual life insurance company organized and operated under the laws of State A and licensed to conduct insurance business in X. Taxpayer has elected to file a life-nonlife consolidated federal income tax return with its life insurance and nonlife insurance subsidiaries. Taxpayer reports the group's income on the accrual method of accounting and files the consolidated return on a calendar year basis.

Taxpayer issues individual cash value life insurance contracts including traditional, universal and variable life insurance contracts, two of which are the subject of this request ("Failed Contracts"). The Failed Contracts, Z, are flexible premium adjustable variable life insurance contracts. Taxpayer has in force approximately Number 3 cash value life insurance contracts. Taxpayer administers these contracts on several different administrative systems (platforms). Some of these platforms are the result of Taxpayer's Date D merger with Company A, which itself had Number 4 platforms.

In Date E, prior to its merger with Taxpayer, Company A outsourced the administration of a block of variable life insurance contracts to Company B, which has since become Company C. As a result of the Date D merger of Taxpayer and Company A, Taxpayer replaced Company A as the "issuer" of that block of contracts.

The Failed Contracts are among the contracts included in the block of contracts administered by Company C. The Failed Contracts were issued in Date D and Date F by Company A prior to the merger of Taxpayer with Company A. Following the merger, the Failed Contracts became the direct obligation of Taxpayer, and an endorsement to that effect was provided to the owner of each Failed Contract.

Administration of the block of contracts that includes the Failed Contracts remained with Company C following the merger, and Company C was responsible under the administration agreement for maintaining compliance with §§ 7702 and 7702A. The failures were caused by clerical errors that inadvertently resulted in an overstated guideline premium amount for two insureds that changed from smoker to nonsmoker status or with respect to whom an "aviator" rating was removed.

The Failed Contracts were intended to qualify as life insurance contracts under § 7702 by satisfying the guideline premium requirements of § 7702(a)(2)(A) and (c) and by falling within the cash value corridor of § 7702(a)(2)(B) and (d) (collectively referred to as "Guideline Premium Test"). Neither of the Failed Contracts was designed to meet

the cash value accumulation test of §7702(b) and neither meets the test because, by the terms of each Failed Contract, its cash surrender value may exceed the net single premium which would have to be paid to fund future benefits.

Company C has administered these contracts under an administration system that is intended to insure compliance with § 7702. That system is designed to calculate the guideline premium limitation for each contract on the system, and to test each contract upon issue. Subsequent premium payments are also tested against the guideline premium limitation and against the cash value corridor applicable to each contract. Upon any change in the benefits under a contract (or a rider thereon), the guideline premium limitation is recalculated.

For one of the Failed Contracts, a risk class change was processed on Date G, changing the insured's risk class from smoker to nonsmoker. For the other Failed Contract, a risk class change was processed on Date H, removing an aviator rating that applied upon issuance. Risk classifications are reflected in the computerized compliance system on which the Failed Contracts are administered using a "Table ID," which is a numerical indicator of the insured's risk classification that directs the system which mortality table to use in calculating guideline premiums. Under Company C's administrative system and procedures, an insured's reclassification from smoker to nonsmoker status or the removal of an aviator rating requires the business associate processing the change to perform a manual update to the appropriate Table ID. This manual update involves entering or removing data on three separate computer screens within the administration system. All business associates are provided with training and instruction on the proper procedure to follow in making this manual update. The computerized contract administration system uses the date from the manual update to automatically recalculate the guideline premium limitation for the contract. In each case of Failed Contracts Z, the responsible business associate made the manual update on only two of the three required computer screens within the administration system.

This error in manual processing resulted in the Failed Contracts' guideline premium limitations not being modified in the system to reflect the change from smoker to nonsmoker status and the removal of the aviator rating. This, in turn, caused the compliance system to generate an overstated guideline premium limitation for each Failed Contract. As a result, Taxpayer inadvertently accepted a premium payment in excess of each Failed Contract's actual guideline premium limit, which caused each Failed Contract to fail to satisfy the requirements of the Guideline Premium Test. The errors were not discovered in time to correct the overpayment of premium.

In order to prevent future errors, Company C has instituted a manual review procedure for risk class changes, under which analysts specializing in actuarial functions review such changes and verify that the guideline premium limitations are properly adjusted. Taxpayer proposes to remedy the Failed Contracts to bring them into compliance with the guideline premium limitation of § 7702. Taxpayer will refund

any excess premiums, and earning thereon, to the holders within 90 days of the date on which the Service issues the requested waiver ruling.

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 (b), or both meet the guideline premiums requirements of § 7702(a)(2)(A) and § 7702(c) and fall within the “cash value corridor” of § 7702(a)(2)(B) and § 7702(d).

Section 7702(b) provides that a contract meets the cash value accumulation test if, by the terms of the contract, the cash surrender value of the contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.

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 premiums 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 changes 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.

Section 7702(c)(4) provide that the term “guideline level premium” means the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis as the guideline single premium, except that § 7702(C)(3)(B)(iii) shall be applied by substituting “4 percent” for “6 percent.” The computational rules of § 7702(e) and the definitional rules of § 7702(f) apply to both the guideline single premium and the guideline level premium.

A contract falls within the cash value corridor of § 7702(a)(2)(B) if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value. Section 7702(d)(2) provides the applicable percentage.

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).

Taxpayer proposes to remedy the Failed Contracts to bring them into compliance with the guideline premium limitation of § 7702. Specifically, Taxpayer proposes to refund any excess premiums, and earnings thereon, to the holder within 90 days of the date on which the Service issues the requested waiver ruling. In order to prevent future errors, Company C has instituted a manual review procedure for risk class changes, under which analysts specializing in actuarial functions review such changes and verify that the guideline premium limitations are properly adjusted.

After considering all the facts and circumstances, we find that failure of Number 1 contracts to satisfy the requirements 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 contracts are cured by refunding the excess premiums with interest calculated at 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 your authorized representative.

Sincerely,

/S/

Mark S. Smith
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)