Internal Revenue Service

Number: **200503021**
Release Date: 01/21/2005
Index Number: 7702.20-00, 101.05-00

Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:B04 – PLR-148434-04
Date: October 6, 2004

In Re:

Taxpayer

Date Y

Number X

Number A1

Number A2

Number A3

State B

Place C

Date D

Dear :

This is in reply to your letter dated Date Y, in which you requested, on behalf of Taxpayer, a waiver under sections 101(f)(3)(H) and 7702(f)(8) of the Internal Revenue Code for Number X life insurance contracts (the "Contracts") that inadvertently failed to meet the requirements of section 101(f) or section 7702, as applicable. This letter substitutes for and replaces a letter previously issued to Taxpayer with case number PLR-100280-03 (previously released as PLR 200350001, published December 12, 2003). The Contracts are identified on Exhibit A1, A2, and A3, attached to this letter.

Taxpayer is a stock life insurance company, as defined in section 816(a), and is subject to taxation under Part I of Subchapter L of the Code. Taxpayer is organized and operated under the laws of State B and is licensed to engage in the insurance business in Place C. Although Taxpayer is a wholly owned subsidiary, Taxpayer does not join in the filing of a consolidated return.

DESCRIPTION OF CONTRACTS

The Contracts that are the subject of the request are flexible premium life insurance contracts. The Contracts permit, but do not require, the payment of both scheduled (planned) and unscheduled premiums.

The death benefits provided under the Contracts may be either “option 1" or “option 2.” If option 1 is elected, the death benefit equals the greater of the face amount specified in the Contract or the amount required to satisfy the cash value corridor requirements of sections 7702(a)(2)(B) and (d). An option 2 contract provides a death benefit equal to the greater of the face amount of the Contract plus its cash value or the amount required by the cash value corridor.

In addition, subject to certain restrictions, the policyholder may make changes under the Contracts that constitute adjustment events within the meaning of section 101(f)(2)(E) and section 7702(f)(7), e.g., increases and decreases in the face amount, changes in death benefit options, and additions or deletions of certain qualified additional benefits within the meaning of section 101(f)(3)(E) and 7702(f)(5)(A) (QABs).

As is typical of universal life insurance policies, the cash value of each of the Contracts is equal to the premiums paid, increased by interest credits, and decreased by various contract charges and withdrawals. The Contracts also permit loans against their cash values. Additionally, certain of the Contracts permit policyholders to apply policy values as a net single premium to purchase paid-up whole life insurance.

The contracts were intended to comply with the guideline premium limitation tests and cash value corridors of section 101(f) or section 7702, as applicable.

COMPLIANCE PROGRAM AND ERRORS

Taxpayer was one of the first insurance companies to develop a universal life insurance policy and has worked with a series of combinations or manual systems and

computerized compliance programs. Those systems should have been sufficient, if followed accurately, to ensure compliance of the Contracts with the applicable provisions of the Code.

However, in Number A1 instances, clerical staff failed to make timely corrections within the 60-day period described by section 7702(f)(1)(B) as they were under the erroneous impression that refunds of excess premiums were not permitted if the funds were received as part of a tax-free exchange under section 1035. Taxpayer's compliance system expressly provided for excess premiums to be refunded within the 60-day period. Taxpayer's procedures did not include any special rules that directed staff not to refund excess premiums with respect to section 1035 exchanges. Excess premiums were received under section 1035 exchanges when the initial calculation of the death benefit to be applied under the new insurance contract failed to take into account interest that would be applied to the old contract's cash value before the amounts were transferred to Taxpayer from the previous issuer. As noted, when that occurred, certain clerical staff were under the erroneous belief that they could neither increase the death benefit nor refund the excess premiums received. Accordingly, upon failure of the staff to undertake either of these corrections, these Contracts failed section 101(f) or section 7702, as applicable.

In an additional Number A2 instances, clerical staff simply failed to refund excess premiums during the 60-day period despite having received directions to do so.

Finally, in Number A3 cases, data with respect to certain Contracts was incorrectly input in the process of manually transferring from one compliance system to another. These errors were not discovered in time to correct subsequent overpayments of premiums.

TIMELY CURES AND CORRECTION

As of Date D, Taxpayer has corrected the failed Number X Contracts by refunding excess premiums with interest at a rate at least equal to the contract crediting rate. Further, Taxpayer has implemented a compliance system that requires far less clerical or manual input and represents that these errors should not recur.

Taxpayer's past practice was to immediately apply all premiums received to the Contracts without regard to whether those amounts exceeded the then applicable guideline premium limitation.[1] Taxpayer then relied upon the 60-day rule as its primary method of avoiding retention of these excess premiums. Early application of premiums to Taxpayer Contracts should no longer occur under Taxpayer's principal administration system. Taxpayer has adjusted its procedures to address the issue of premature receipt of scheduled premiums that would exceed the Contract's guideline premium limitation if applied to the Contract upon receipt. To the extent permitted under SEC rules (where applicable), Taxpayer, under this system, now either returns the excess premiums or holds it outside the policy (at interest) until the anniversary date. For certain Contracts, Taxpayer has adopted other procedures to timely remedy the error.

LAW & ANALYSIS

In general, for flexible premium life insurance contracts entered into before January 1, 1985, section 101(f) requires the contract to satisfy either of two tests in order for the death benefit to be excludable as the proceeds of a life insurance contract under section 101(a): a guideline premium limitation set forth in section 101(f)(1)(A), or a cash value test set forth in section 101(f)(1)(B). These requirements differ slightly from those applicable to contracts issued after that date, but not in a manner material to this letter.

In general, for contracts issued after December 31, 1984, section 7702 provides a definition of the term "life insurance contract" for all purposes of the Code. To satisfy this definition, a life insurance or endowment contract must be treated as such under the applicable law. Pursuant to section 7702(a), contract must also either (1) meet the cash value accumulation test of subsection 7702(b) or (2) satisfy the guideline premiums requirements of subsection 7702(c) and fall within the cash value corridor test of section 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.

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[1] Premiums received must be compared to the then applicable guideline premium limitation, not the guideline premium limitation as of the upcoming policy anniversary, even if the premium is received only a few days before that anniversary. If the premiums are in excess of the guideline premium limitation when applied to the contract, that excess is not voided simply through the passage of time and its concurrent increase in the guideline premium limitation. If the error is not corrected through the return of excess premiums (with interest) within the 60-day period, an error caused by a procedure that routinely applies premium when they exceed the guideline premium limitation is not waivable and can be cured only through execution of a closing agreement with the Service. This error can be avoided through establishing a procedure of either refunding the excess premium or retaining the excess premium in a separate fund (with interest) outside of the insurance policy until the guideline premium limitation increases.

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.

The guideline single premium is the single premium at issue that is needed to fund the future benefits under the contract using the mortality and other charges specified in section 7702(c)(3)(B). Section 7702(c)(3)(B) specifically provides the guideline single premium is based on (i) reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in the regulations) do not exceed the mortality charges specified in the prevailing commissioners' 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 actually be 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, with interest at the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on issuance of the contract. Section 7702(c)(4). The computational rules of section 7702(e) and the definitions of section 7702(f) apply for purposes of determining both the guideline single and guideline level premium.

If premiums paid exceed the guideline premium limitation, section 101(f)(3)(B) and section 7702(f)(1)(B) allows the issuer 60 days after the end of the policy year in which to refund the excess premiums as may be necessary to cure a failure.

Pursuant to sections 101(f)(3)(H) and 7702(f)(8), the Secretary of Treasury may waive a failure to satisfy the requirements of section 101(f) or section 7702, as applicable. These waivers are granted if a taxpayer establishes that the statutory requirements were not satisfied due to reasonable error and that reasonable steps are being taken to remedy the error.

Based on all of the facts, law, and arguments presented, we conclude that the failure of the Contracts to satisfy the requirements of section 101(f) or 7702, as applicable, is due to reasonable error. Taxpayer's compliance system and procedures would, if properly followed, have prevented the errors described. Upon discovery of possible errors, Taxpayer timely reviewed its procedures, discovered failures, and requested a waiver of its errors. Further, Taxpayer has instituted additional methods by which to avoid future errors. Finally, Taxpayer's proposed method of correcting the errors is reasonable.

We express no opinion as to the tax treatment of the Contracts under the provisions of any other sections of the Code and Income Tax Regulations that may also be applicable thereto.

The rulings contained in this letter are based upon information and representations 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 rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer(s) 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 the regulations are inconsistent with any conclusion in the letter ruling. See section 12.04 of Rev. Proc. 2003-1, 2003-1 I.R.B.1, 44. However, when the criteria in section 12.06 of Rev. Proc. 2003-1 are satisfied, a ruling is not revoked or 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 Taxpayer.

Sincerely,

/S/

Donald J. Drees, Jr.
Acting Branch Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)