INTERNAL REVENUE SERVICE

UIL Nos. 101.00-00, 101.05-00,
7702.00-00 and 7702.20-00
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December 8, 1998

LEGEND

Company =

Taxpayer =

Date 1 =

Date 2 =

State A =

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Dear

This replies to your letter of Date 1, as supplemented, on behalf of Company and Taxpayer requesting a ruling granting a waiver under sections 101(f)(3)(H) and 7702(f)(8) of the Internal Revenue Code. You ask that certain flexible premium universal life insurance contracts and certain fixed premium current assumption whole life contracts (the "Contracts") identified on Exhibit A attached to this letter be treated as life insurance contracts for federal tax purposes.

FACTS

Company is a life insurance company engaged in the business of issuing various forms of life insurance. Company owns 100% of the shares of Taxpayer, a stock life insurance company, which also is engaged in the business of issuing various forms of life insurance and annuities. Taxpayer is organized under the laws of State A, which is its domicile for insurance regulatory purposes.

Company and Taxpayer (together, the "Insurance Companies") file separate U.S. federal income tax returns (Form 1120L). Taxpayer's return is filed as part of a consolidated group.

The Insurance Companies have in force approximately A life insurance contracts. Of those A contracts, the Insurance Companies have identified B contracts that fail to qualify as life insurance contracts under the applicable provisions of section 101(f)(1) or 7702(a) (the "Failed Contracts").

In each case, the Failed Contract was designed to satisfy the guideline premium requirements of the applicable provision. As described below, where the contract structure was sufficiently flexible to permit the policyholder to take actions that could result in violation of the applicable guideline premium test, monitoring procedures were devised to ensure continued compliance. In other cases, the contracts were designed and structured in a non-flexible manner intended to automatically preclude the policyholder from taking any action that could violate the applicable guideline premium test. Nevertheless, amounts in excess of the guideline premium were accepted under each of the Failed Contracts.

All of the Failed Contracts are of a type of generic insurance plan that provides for the use of a current interest rate to credit interest on the policies' account values. Within this broad classification of interest sensitive insurance plans, there are two subcategories of plans: i) Universal Life; and ii) Current Assumption Whole Life. C of the Failed Contracts are Universal Life Policies, which have a variable premium structure that allows the policyholder to select and vary the amount of premium paid. The remaining D Failed Contracts are Current Assumption Whole Life Policies, which have a fixed premium structure that requires the regular payment of a predetermined premium.

Because the Universal Life plans allow for variable payments, the Insurance Companies instituted monitoring procedures to ensure that each Universal Life Policy complied with the guideline premium rules. Whenever an amount paid into the contract caused the total premiums paid to exceed the guideline premium, the Insurance Companies' computer system produced a coded message called a "Highlight." Because both the legal requirements and the computer system were relatively new, the Insurance Companies instituted manual confirmation procedures intended to ensure that the system operated properly. Once the computer system produced a Highlight, customer service personnel manually reviewed the appropriate calculations.

Occasionally, personnel's manual recalculations did not agree with the calculations of the computer system. The Highlight system correctly identified C policies which required a refund to the policyholder of excess premium payments. With respect to E of these policies, personnel's manual recalculations indicated that the amount to be refunded to the policyholder was smaller than the amount calculated by the computer system. Checks were sent to the policyholders of these E policies refunding the excess premium in the manually recalculated amounts. However, the original computer generated amounts were correct and the manually recalculated amounts were incorrect. Thus, the amounts of the checks were insufficient to prevent these E policies from violating the guideline premium requirements of section 7702.

With respect to F of these policies, personnel's manual recalculations were incorrect in that they indicated that the guideline premium had not been exceeded. Again, the original computer generated amounts were correct and the manually recalculated amounts were incorrect. Although checks were issued to the policyholders of these F policies, personnel cancelled the checks in the mistaken belief that the guideline premium had not been exceeded for these F policies.

In the case of the Current Assumption Whole Life plans, the Insurance Companies instructed their product actuary to design a fixed-premium policy which precluded the policyholders from taking any actions that could cause the policies to violate the guideline premium requirements of section 7702. Policyholders either paid an initial lump sum premium to produce a paid up policy or paid the scheduled premium. Although the lump sum amounts were appropriately limited to the then-current maximums allowed under the guideline premium tests, subsequent scheduled premium payments caused the sum of premiums paid into the contract to exceed the permitted amounts due to a product design error by the product actuary. The terms of the Current Assumption Whole Life insurance contract did not permit decreases in the face amount of the policy.

Due to the fact that the product design purportedly did not permit the policyholder to take actions that could cause the policies to violate the guideline premium requirements, the

Insurance Companies did not implement a computer program or administrative procedure to monitor compliance. In the course of servicing the Current Assumption Whole Life product, policyholders were permitted to execute G types of transactions that resulted in D Failed Contracts.

In the case of H of these Failed Contracts, policyholders were allowed to make lump sum payments into the policies. The subsequent excess premium payments were not detected by the Insurance Companies because, as noted above, no ongoing compliance system was believed to be necessary with respect to the Current Assumption Whole Life product.

In the case of the remaining I Failed Current Assumption Whole Life Contracts, personnel permitted extracontractual decreases in the face amount. Upon processing these decreases, personnel reduced the contractual fixed premium in proportion to the amount of the face reduction, rather than in accordance with the attained-age decrement method mandated by the legislative history to the Tax Reform Act of 1986, P.L. 99-514 (October 22, 1986). Because the proportionate reduction method resulted in higher fixed premiums than would have been permitted under the attained-age decrement method, policyholders made premium payments in excess of the guideline premium limitation. The actions by personnel in these cases was entirely outside of the terms of the insurance contract and the Insurance Companies customary procedures. Had policyholders not been permitted to take such extracontractual actions, the policies would not and could not have violated the guideline premium requirements.

The Insurance Companies did not become aware of the existence of the Failed Contracts until Date 2, when the Insurance Companies began to convert the records for their entire portfolio of products to a new computer system. As the Insurance Companies began to convert the interest sensitive block of business, the new computer system indicated that amounts in excess of the guideline premium limitation had been paid into the Failed Contracts. When this discovery was brought to its attention, management ordered a more detailed investigation.

As a result of the discovery of the Failed Contracts, the Insurance Companies undertook measures to ensure that the errors resulting in premium payments in excess of the guideline premium limitation would not recur. The new computer system includes a fully automated compliance procedure which will not accept premium payments in excess of the guideline premium limitation. When the system determines that all or part of a premium payment causes total premiums paid to exceed the guideline premium limitation, the system automatically creates a refund check in all cases. These checks are mailed to the policyholder along with a cover letter. Personnel cannot override the system by cancelling the check because the system will continue to reject such excess premium payments. This new computer system is currently operational with respect to the interest sensitive portfolio.

The Insurance Companies also took measures to ensure compliance during the conversion process. In the case of the Universal Life policies, the Insurance Companies relied on manual intervention procedures in the event that the old computer system generated an overpayment Highlight. The previous manual recalculation procedures were changed to require automatic refund of excess premium. In addition, customer service personnel were required to provide daily written confirmation to the responsible manager as to the disposition of each Highlight. The customer service manager then correlated the written confirmations against the list of daily Highlights and followed up with responsible personnel in the event that any Highlight remained unconfirmed.

With respect to Current Assumption Whole Life Policies, the Insurance Companies created a separate computer program to test the policies every month for guideline premium compliance. Where amounts were paid in excess of the guideline premium limitation, customer service personnel followed the same revised automatic refund procedure applicable to Universal Life products.

LAW AND ANALYSIS

Section 101(f) of the Code excludes from gross income any amount paid by reason of the death of the insured under a life insurance contract known as a flexible premium contract only if the contract satisfies either (1) the guideline premium limitation and the applicable percentage limitation of section 101(f)(1)(A)(i) and (ii), or (2) the cash value test of section 101(f)(1)(B). The mandate of section 101(f) applies to contracts issued before January 1, 1985.

Section 7702 of the Code provides a statutory definition that a life insurance policy must meet to be treated as a life insurance contract for federal tax purposes. A contract must be a life insurance contract under applicable laws and must also 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 applies generally to contracts issued after December 31, 1984.

Pursuant to sections 101(f)(3)(H) and 7702(f)(8) of the Code, the Secretary of the Treasury may waive a failure to satisfy the requirements of sections 101(f) and 7702. This waiver is 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.

Under the facts as submitted, the failure of the B life insurance contracts to satisfy the requirements of section 101(f) or section 7702(a) of the Code, as applicable, is due to reasonable error. The errors were a result of inadvertent human error in the implementation and/or execution of the compliance procedures. Taxpayer has instituted procedures to reduce the likelihood that such errors will recur. Taxpayer has also proposed steps to cure the failure, which steps are reasonable actions to remedy the failure of such contracts to satisfy the requirements of section 101(f) and section 7702(a), as the case may be.

HOLDING

Accordingly, based on the information submitted, the failure of the contracts listed in Exhibit A to satisfy the requirements of section 101(f) or section 7702(a) of the Code, is waived pursuant to section 101(f)(3)(H) and section 7702(f)(8), respectively. However, any contracts that are not cured within 90 days of the date of this letter are not covered by this waiver.

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. No opinion is expressed as to the compliance of these contracts with other provisions of section 7702.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) of the Code 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 Taxpayer.

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions & Products)

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Branch 4