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Department of the Treasury

Washington, DC 2022
Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
April 10, 2003

Legend

Company A	=
Company B	=
State A	=
Jurisdiction B	=
Jurisdiction C	=
Number b	=
Number c	=
Number d	=
Number e	=
Number f	=
Number g	=
Date A	=
Date B	=
Date C	=
Date D	=

Date E =

Date F =

Group 1 =

e =

f =

g =

Contracts =

Dear :

This is in reply to your letter dated Date A in which you requested a waiver of certain errors under section 7702(f)(8) of the Internal Revenue Code such that various life insurance contracts (Contracts) will be treated as life insurance contracts for federal tax purposes.

FACTS:

Company A 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. Company A is organized and operated under the laws of State A and is licensed to engage in the insurance business in Number b states and Jurisdictions B and C. On Date B, Company A was acquired and is now an indirect subsidiary of Company B.

Company A's principal business activity consisted of issuing life insurance contracts to Group 1. Company A ceased issuing new policies as of Date C. Currently Company A's sole business activity consists of servicing previously issued policies.

The Contracts that are the subject of this ruling are nonparticipating fixed premium universal life insurance contracts that were designed to comply with section 7702 by satisfying the guideline premium requirements of section 7702(a)(2)(A) and (c) and by falling within the cash value corridor of section 7702(d).

The Contracts provide for dual cash values: the Tabular Cash Value and the Accumulation Value. During the time the premiums are paid, the Contracts' cash surrender value is the greater of (a) the minimum guaranteed amounts reflected in the Tabular Cash Value or (b) the Accumulation Value less any applicable surrender charges.

The Accumulation Value is increased by premiums and interest (including excess interest) and is reduced by withdrawals and current contract charges, such as cost of insurance. The Accumulation Value is based on guaranteed interest of e percent during the first f contract years and g percent thereafter, compounded annually and cost of insurance (COI) guarantees are based on the Date F CSO. The Accumulation Value is not expected to be sufficient to mature the contract at age 100 for the Face Amount.

The Tabular Cash Values are dictated by minimum State nonforfeiture requirements. The state nonforfeiture law generally requires the provision of a minimum cash surrender value that equals the excess of (i) the present value of future benefits over (ii) the present value of adjusted premiums due in the future. Company A calculated the Tabular Cash Value based on interest rates equal to e percent compounded annually and mortality assumptions based on 100 percent of the Commissioners' 1980 Standard Ordinary Male Mortality Table (1980 CSO).

As of Date E, Company A had Number c contracts in force issued on the same Contract Form as the Contracts. As of Date E, Number d of those Contracts did not meet the requirements of section 7702. Company A's actuaries anticipate that additional contracts issued on this Contract Form will fail in the absence of corrective action.

ERROR:

Company A represents that an error occurred causing certain of the Contracts to violate the requirements of section 7702 because of its assumption regarding the relationship between the Tabular Cash Value and the Accumulation Value.

The intention of Company A's actuaries was to design the Contracts where the Tabular Cash Value would control the determination of the Contract's guideline premiums ensuring that the gross single or level premiums for the Contracts would equal the applicable guideline premiums. Company A believed that, with respect to fixed premium universal life insurance contacts, a contract could be designed to comply with the guideline premium test by its terms similar to the cash value accumulation test. By design, the contractual guarantees underlying the Accumulation Value were insufficient to mature the Contracts. Thus, Company A looked solely at the assumptions underlying each Contract's Tabular Cash Value rather than its Accumulation Value in calculating guideline premiums. Company A's actuaries did not recognize that the Accumulation Value exceeded the Tabular Cash Value on the Contract's guarantees during some durations. Thus, Company A did not compare the Accumulation Value to the Tabular Cash Value at each duration to determine which was the appropriate value to use.

CORRECTION OF ERROR:

Company A proposes to correct the inadvertent failure of the Contracts to satisfy the requirements of section 7702 by adding a cash value accumulation (CVA) test endorsement to the Contracts so that they will comply with the CVA test of section 7702(b) retroactively to their original issue date. Company A will add the same endorsement to those contracts issued on the same contract form that have not yet failed. The Contract's death benefits will equal the greater of (a) the death benefit presently provided by a Contracts and (b) a minimum death benefit that will be defined in a manner to ensure compliance with the CVA test. Company A represents that the endorsement proposed for the Contracts to bring them into compliance with section 7702 under the terms of each Contract will not change the fixed premiums for the Contracts, nor will it result in any increase in the investment orientation of the Contracts. Company A believes that this action will not improperly discriminate against contract holders. Company A represents that the endorsement to each Contract will be effective within 90 days from the date of this letter.

LAW & ANALYSIS:

In general, for contracts issued after 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 premium 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.

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 that 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 to both the guideline single and guideline level premium.

The Joint Committee on Taxation's General Explanation of The Revenue Provisions of the Deficit Reduction Act of 1984 describes the manner in which the net single premium or the guideline single premium limitation are to be determined:

> Also, if the contract's nonforfeiture values for any duration are determined by a formula that uses the highest value produced by alternative combinations of guaranteed interest rate or rates and specified mortality (and other) charges, the combination of such factors used, on a guaranteed basis, in the highest cash surrender value for such duration should be used for such duration in determining either the net single premium or the guideline premium limitation.

Footnote 53 in this passage illustrates this provision with respect to a fixed premium universal life insurance contract as follows:

> . . . [U]nder a so-called fixed premium universal life contract, if the cash surrender value on a guaranteed basis (ignoring nonguaranteed factors such as excess interest) is not determined by the guaranteed interest rate and the specified mortality and expense charges used to determine the policy value for some duration, but is instead determined by a secondary guarantee using the guaranteed interest rate and specified mortality and expense charges associated with an alternate State law minimum nonforfeiture value for such duration, the guaranteed interest rate and the mortality and expense charges for the secondary guarantee are to be used with respect to such duration in determining either the net single premium or the guideline single premium limitation.

Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 649 (Comm. Print 1984).

Footnote 53 is an illustration of the general rule provided in the legislative history regarding the determination of the guideline premium. The legislative history states that the guarantees that provide the highest cash surrender values should be used in a duration in determining the net single premium or the guideline single premium. Company A misinterpreted Footnote 53 in assuming that the Tabular Cash Value, which represented the "alternate State law minimum nonforfeiture guarantee," would always exceed the Accumulation Value. Actuaries misapplied Footnote 53 because the actuaries focused on the fact that the Accumulation Value could not mature a policy rather than focusing on the factors required to be considered in determining the guideline premium limitation on a universal life policy.

Company A has determined that the Accumulation Value prevails over the Tabular Cash Value at the time the contract is issued and for some period thereafter. After that period, the Tabular Cash Value prevails for the remaining life of the Contract. The length of the period during which the Accumulation Value prevails depends on the characteristics of the Contract involved, such as the age and sex of the insured at issue, the premiums paid, and the size of the death benefit provided. The length of the period also depends on the version of the Contract used.

Pursuant to section 7702(f)(8), the Secretary of Treasury may waive a failure to satisfy the requirements of section 7702. This waiver is granted if a taxpayer establishes that the statutory requirements were not satisfied due to reasonable error and that the 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 Number d and g contracts to satisfy the requirements of section 7702 is due to reasonable error. Company A's errors are reasonable within the meaning of section 7702(f)(8). Although Company A erred in its application of Footnote 53 in determining its guideline premiums, the errors are a possible misinterpretation of the mechanics of section 7702 with respect to these types of Contracts. The design of the Contracts was that the gross level premium of a Contract would equal the guideline level premium and therefore comply with section 7702. Company A believed this design would eliminate compliance concerns. Company A made assumptions that the Tabular Cash Value would always exceed the Accumulation Value.

We further hold that the correction of the errors described above will have no effect on the issue dates of the Contracts or on the dates on which they are considered to be "entered into" and will not be considered a change in benefits under section 7702(f)(7) or a material change under section 7702A. Thus, the addition of the endorsement to both the failed contracts and those contracts not yet failed but issued on the same contract form, will not result in a loss of the "grandfathered" status for purposes of sections 72, 264, 7702, 7702A, will not require retesting or the beginning of a new test period under sections 264(d), 7702(f)(7)(B)-(E), and section 7702A(c), and will not be treated as an exchange for Federal tax purposes.

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.

This ruling letter is directed only to the Taxpayer who requested it. Section 6110(k)(3) 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,

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