

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact: _____, ID No.

Telephone Number:

Refer Reply To:
CC:FIP:B04 – PLR-101873-04

Date:
July 13, 2004

In Re:

LEGEND:

Company =
Parent D =
Company A =
Company B =
Company C =
Employee =
Date V =
Date W =
Date X =
Date Y =
Date Z =
Year A =
Year B =
Number A =
State B =
Place C =

Dear _____ :

This is in reply to your letter dated Date X, in which you requested, on behalf of Company, a waiver under section 7702(f)(8) of the Internal Revenue Code for Number A life insurance certificates (“the Certificates”), issued under a Group Contract, that inadvertently failed to meet the requirements of section 7702 to be considered life insurance contracts, for federal income tax purposes.

Company is a stock life insurance company, and is subject to taxation under Part I of Subchapter L of the Code. Company is organized and operated under the laws of State B and is licensed to engage in the insurance business in Place C. Company joins in the filing of a consolidated life/non-life Federal income tax return with its Parent D.

DESCRIPTION OF CERTIFICATES

The Certificates that are the subject of the request were issued on Date Y to a trust established for the benefits of employees of a designated employer (“the Employer”). Through the Group Contract, the Employer makes available to certain classes of its employees a program of group universal life insurance on an elective, employee-pay-all basis. If an employee elects to participate in the program, the employee-participant (“certificateholder”) is issued a Certificate evidencing his or her rights and benefits under the Group Contract. The employee is identified on the certificate as the insured and the owner. The employee is responsible for paying all the premiums, may name the beneficiary, and surrender the certificate for the cash surrender value.

Each Certificate provides for flexible premium payments as set forth in “Premium Provisions.” The certificateholder may increase or decrease the amount of each premium payment, may make unscheduled premium payments, and may cease or resume making payments at any time, all subject to certain limitations.

Each Certificate provides for a death benefit equal to the greater of (a) the face amount set forth in the Certificate plus the Certificate’s “net cash value” at the time of death or (b) the amount determined by multiplying the Certificate’s cash value at the time of death by the appropriate percentage in a table set forth in the Certificate. The table is designed to ensure compliance with the cash value corridor of section 7702(d).

The cash value of each Certificate is equal to the premiums paid, increased by interest credits and reduced by specified charges and by partial surrender amounts. The Certificates provide for loans for certain certificateholders (as specified in the Certificates) against their cash values. Additionally, the Certificates provide that certain certificateholders, as specified in the Certificates, may purchase paid-up insurance.

The Certificates were intended to qualify as life insurance contracts under section 7702 by satisfying the “guideline premium requirements” of sections 7702(a)(2)(A) and 7702(c) and by falling within the “cash value corridor” of section 7702(d).

COMPLIANCE PROGRAM AND ERRORS

The Employer acquired the Group Contract with the assistance of a division of Company A. The division had assisted the Employer with the issuance of a prior group universal life insurance contract issued by another insurer (the “First Insurer”) covering

the same insureds. The division also provided third party administration services (the "TPA") for the First Insurer's Group Contract and the certificates thereunder for the First Insurer. As part of the administration of the First Insurer's Group Contract, TPA tested the certificates for compliance with the requirements of section 7702.

As a result of TPA's familiarity with the Employer, as well as the Company's pre-existing relationship with TPA, Company engaged TPA to administer the Group Contract and the Certificates thereunder on its behalf. TPA was also responsible for testing the Certificates to ensure that they satisfied the guideline premiums requirements of sections 7702(a)(2)(A) and 7702(c) and that they fell within the cash value corridor of section 7702(d). One of Company's actuaries periodically examined TPA's section 7702 compliance testing.

In preparation for a filing in Year A with the Internal Revenue Service under Rev. Proc. 97-27, 1991-1 C.B. 1186, one of Company's actuaries worked with the TPA to review its section 7702A compliance testing in order to identify any inadvertent modified endowment contracts (MECs) that TPA was administering. During the review, Company's actuary also inquired into TPA's section 7702 testing assumptions with respect to certificates that it administered for Company. This inquiry raised questions as to the section 7702 compliance of the Certificates. After further analysis, it became apparent that the guideline premium limitation determined by TPA for a number of the Certificates could not be reconciled with the testing results produced by Company B and Company's actuaries. In Year B, one of Company B's actuaries discovered that TPA's testing assumptions, as applied to the Certificates issued on the effective date of the Group Contract, used an issued date of Date Z, rather than the Group Contract's issue date of Date Y. As a result Number A Certificates failed to satisfy the guideline premium requirements of section 7702.

The issue date error with the Certificates arose out of the fact that the First Insurer had issued coverage on Date Z of the same insureds under a similar group universal life insurance policy with the administration of the Certificates being performed by the same TPA. Effective Date Y, Company became the underwriter of this same group of insureds, at which time it issued the Group Contract and the initial set of Certificates. Several terms of the coverage issued by First Insurer were altered when the change in underwriters occurred and the Company issued the Group Contract and certificates. Specifically, the guaranteed and current COI charges and the maturity date for coverage also changed. Thus, the change in contract's terms resulted in an exchange rather than an assumption reinsurance arrangement for federal income tax purposes. Company provided TPA with copies of the new Group Contract and the new certificates it issued when it became the underwriter.

Company entered into an agreement, dated Date W and effective Date Y, with the First Insurer to facilitate the transfer of the coverage from the First Insurer to the Company, which provided, inter alia, that the "change in underwriters should be considered an exchange under section 1035." Thus, the Certificates would be treated as

newly issued on the date of the exchange and tested for purposes of section 7702 as such. Company also provided TPA with a copy of the agreement between Company and First Insurer.

Unbeknownst to the individuals at Company responsible for the section 7702 compliance of the Certificates, an Employee executed an agreement with TPA that characterized the Date Y transaction as “assumption reinsurance of the previous policy issued by First Insurer.” Company did not intend for there to be two separate agreements with respect to the change in underwriters. Company did not have any reason to suspect that Employee would enter into an agreement with TPA that characterized the transaction in a different manner than Company. Under Company’s procedures, Employee was not responsible for providing information to TPA regarding how a change in underwriters would be characterized for purposes of section 7702, nor was Employee responsible for determining the proper characterization of the transaction. Employee’s responsibilities were limited to the account management of the Group Contract and other similar group contracts. Employee did not consult with the individuals at Company responsible for the Certificates’ section 7702 compliance. Based on TPA’s past treatment of the Group Contract issued by the First Insurer and the agreement TPA entered into with Employee, TPA continued treating the transaction as assumption reinsurance. TPA was not aware that Employee did not have authority to execute such an agreement.

CORRECTIVE ACTIONS

In order to prevent a recurrence of the error incurred on this transaction, Company has informed TPA that it no longer uses assumption reinsurance as a means of becoming the underwriter for group contracts initially issued by others. Company will notify TPA whenever a change in underwriters occurs. Company and TPA will examine the facts and circumstances surrounding the transaction and determine whether it should be treated as an exchange for federal income tax purposes. Should Company and TPA conclude that the change in underwriters is properly treated as an exchange under the rules of the federal tax law; the certificates issued on the effective date of the exchange would be tested for compliance with the requirements of section 7702 using the effective date of the exchange as their issue date.

Company has also established procedures to ensure that a “compliance team” confirms that TPA performs section 7702 compliance testing in accordance with the appropriate testing methodologies for contracts subject to exchanges.

Company will remedy the compliance failure of each failed Certificate that is in force on the effective date of the requested waiver under section 7702(f)(8), and as to which the sum of the premiums paid as of that date exceeds the failed Certificate’s guideline premium limitation as of the same date, by refunding the excess to each Certificateholder with interest on such amount at the current crediting rate of the Certificate or by increasing the death benefit. With respect to Failed Certificates that have terminated by reason of the death of the insured at a time when the premiums

paid exceeded the guideline premium limitation for the Failed Certificates, Company will pay such excess to the Certificateholders, the Certificateholders' estates, or the beneficiaries of the Certificates with interest at the current crediting rate. Company will implement these corrective measures within 90 days from the effective date of this waiver.

LAW & ANALYSIS

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 contract must be treated as such under the applicable law. Pursuant to section 7702(a), the 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(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.

Section 7702(f)(1)(B) provides, in general, that if premiums paid exceed the guideline premium limitation, and the issuer refunds the excess premiums (with interest) within 60 days after the end of the policy year, then the amount returned (without interest) is deemed to reduce the sum of the premiums paid under the contract during the year.

Section 7702(f)(8) provides that if the taxpayer established to the satisfaction of the Secretary that failure to satisfy one of these tests was due to reasonable error and that reasonable steps are being taken to remedy the error, the Secretary may waive such failure.

Based on all of the facts, law, and arguments presented, we conclude that the failure of the Certificates to satisfy the requirements of section 7702 is due to reasonable error. Company's compliance system and procedures would have prevented errors if they had been properly followed. Upon the discovery that there was a possibility of errors, Company reviewed its system and procedures and discovered the cause of the failures. Company promptly requested a waiver under section 7702(f)(8). Company has instituted additional procedures to prevent future errors.

We express no opinion as to the tax treatment of the Certificates underlying the Group Contract under the provision 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 Company 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.

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 the letter is being sent to the Company.

Sincerely,

/S/

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