Internal Revenue Service Department of the Treasury

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Person to Contact:

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Legend

Taxpayer   =

Company B   =

Company C   =

Parent 1   =

State U   =

State V   =

State W   =

Country XX   =

Country YY   =

Year 1   =

Year 2   =

Year 3   =

Date 1   =

Date 2   =

Date 3   =

Date 4   =

Date 5   =

Date 6   =

Date 7   =

Date 8   =

Amount D   =

Amount E   =

Amount F   =

Amount G   =

System AA   =

Module AA   =

System BB   =

Module BB   =

Code 1   =

Code 2   =

Code 3   =

Firm A   =

Product Z   =

Dear

This is in response to your letter of Date 1, as supplemented, requesting a ruling that the noncompliance of certain of Taxpayer's policies with the requirements of § 7702 of the Internal Revenue Code be waived pursuant to § 7702(f)(8).

FACTS

The information submitted indicates that Taxpayer is a stock life insurance company subject to Subchapter L of the Code, incorporated under the laws of State U, and is licensed to do business in Amount D states, State V, Country XX and Country YY, and is an authorized reinsurer in State W.

Taxpayer is the successor to Company B, a ____ life insurance company. Effective Date 2, Company B reorganized by forming a ____ company named Company C. Company B continued its corporate existence following conversion as Taxpayer. All of the shares of the voting stock of Taxpayer are owned by Parent 1, a ____ company. Parent 1 in turn is a ____ subsidiary of Company C.

Taxpayer continues to serve as the primary insurer on all of the outstanding contracts issued by its predecessor, Company B, including the contracts that are the subject of this request for waiver. Taxpayer files its returns on a calendar-year basis and files its Federal income tax returns on a consolidated basis with its parent, Company C.

Prior to Year 1, all of the life insurance products that Taxpayer offered were designed to comply with the cash value accumulation test (CVAT) of § 7702(b). In Date 3, Taxpayer decided to offer a new ____ life insurance product know as) Product Z and to offer a version of Product Z designed to comply with the guideline premium limitation of § 7702(c) and the cash value corridor of § 7702(d), as well as a version designed to comply with the CVAT.

In conjunction with the development of a guideline premium limitation/cash value corridor product, Taxpayer embarked on a project to develop a new administrative system for its ____ life insurance products, to be known as System AA. System AA had to have the capability to test premiums against death benefits in order to ensure that the proper relationship between the two would be maintained. This capability had been unnecessary as long as Taxpayer offered only CVAT products. Taxpayer decided to develop the new system in-house, rather than contract with an outside vendor. As the project progressed, it became apparent that the in-house staff was not able to develop the new system without assistance from outside sources. In the fourth quarter of Year 2, Taxpayer engaged a temporary contract programmer (System AA Contract Programmer) to join the System AA team.

By Date 4, most of System AA was ready. However, the module that calculated the minimum face amount necessary for a given premium payment to keep a contract in compliance with the guideline premium/cash value corridor requirements (Module AA) remained to be completed. The System AA contract programmer had primary responsibility for programming Module AA and, upon completion of it, documented the specifications for Module AA in a memorandum dated Date 5.

Taxpayer's ____ life insurance division recognized that Taxpayer would need an

illustration system capable of generating illustrations coordinating death benefit levels with premiums in accordance with the guideline premium limitation. Taxpayer's existing illustration system, known as System BB, had been developed exclusively for CVAT products, and had to be modified by developing additional modules capable of handling guideline premium limitation/cash value corridor products. The   life insurance division engaged another contract programmer, the System BB Contract Programmer, to program a module similar to that of Module AA that could handle guideline premium limitation/cash value corridor products. The   life insurance division engaged another contractor (the Module BB Contract Programmer) who developed Module BB in the last quarter of Year 1. In developing Module BB, the System BB Contract Programmer relied on the specifications of Module AA set forth in the Date 5 memorandum.

Systems AA and BB were implemented in Date 6. A flaw was buried in Module AA. Module AA was designed so that each transaction involving a contract was recorded in event logs. The event log entry for a transaction consisted of the dollar amount of the transaction and a code for the type of transaction. The routine that computed the premiums paid, designated Code 1, accessed System AA's event logs for transactions that entered into the premiums paid computations. By error, however, that routine was not programmed to access the system's event logs for external and internal nontaxable § 1035 exchange transactions (Code 2 and Code 3), so that the cash value transferred from another contract in a § 1035 exchange was not included in the premiums paid for a contract.

Module BB was based on Module AA and contained the same error.

This manual processing error resulted from the failure of certain of Taxpayer's computer technicians to implement correctly the instructions of Taxpayer's actuaries. Taxpayer's actuaries had correctly interpreted the requirements of §§ 7702 and 1035 and had instructed the technicians as to the proper implementation of those sections. However, the technicians made certain inadvertent errors in manually programming the compliance programs into the computer systems, causing certain contracts to fail.

On Date 9, Taxpayer instituted a comprehensive review of its outstanding life insurance contracts to determine (1) whether they were in compliance with § 7702, and (2) whether life insurance contracts that were not intended to be modified endowment contracts within the meaning of § 7702A had inadvertently become modified endowment contracts. To that end, Firm A, an actuarial consulting firm, was engaged. Firm A's review of Taxpayer's systems uncovered the flaw described above in System AA, as well as the parallel flaw in System BB, and also uncovered Amount E failed coverages.

In Year 3, Taxpayer consummated Amount G Product Z transactions involving § 1035 exchanges. As a result of the flaws in Modules AA and BB, System BB failed to take into account cash values transferred in these transactions as "premiums paid". The guideline premium limitation calculations by the system were based on premiums paid since the exchange

and did not include the cash surrender values that were transferred. Therefore, when premium payments were made that would have exceeded the guideline premium limitations for those contracts, System AA failed to flag those policies (the Failed coverages) as failing to satisfy the guideline premium limitation.

Taxpayer represents that it has taken steps to correct System AA and System BB to ensure that similar errors do not occur in the future. Taxpayer has corrected the flaw in System AA, as well as the parallel flaw in System BB, so that both systems now take into account funds received in both external and internal § 1035 exchanges as premiums in calculating the minimum death benefit necessary for coverage under a Product Z contract to comply with the guideline premium limitation. Taxpayer represents that Firm A has determined that System AA and System BB will now properly monitor compliance with the guideline premium limitation.

Firm A has also determined that no contracts issued by Taxpayer other than the Amount E failed coverages under the Contract require relief from the Service because of the flaw in System AA. Taxpayer proposes to bring the Amount E failed coverages into compliance with § 7702 either by increasing the death benefits to levels adequate to satisfy the guideline premium limitation based on the total premiums paid for those coverages, including amounts transferred from the Original Contracts, or by refunding excess premium, with interest.

LAW AND ANALYSIS

Section 7702 defines the term "life insurance contract" for all purposes of the Code. Under § 7702(a), in order to be considered a life insurance contract for federal tax purposes, a contract must qualify as such under applicable law and must satisfy either the "cash value accumulation test" set out in § 7702(a)(1) and (b), or meet the § 7702(a)(2)(A) and (c) "guideline premium requirements", and fall within the § 7702(a)(2)(B) and (d) "cash value corridor".

The guideline premium requirement of § 7702(c) provides that the premiums 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 using the mortality and other charges specified in § 7702(c)(3)(B) and a minimum interest rate assumption of six percent. 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, using a minimum interest rate of four percent. The computational rules of § 7702(e) and the definitions of § 7702(f) apply to both the guideline single and guideline level premium. Policies qualifying as life insurance contracts under § 7702(a)(2) must also satisfy the cash value corridor of § 7702(d). The corridor specifies a minimum ratio of death benefits (as defined under § 7702(f)(3)) to cash surrender values.

Pursuant to § 7702(f)(8), the Secretary of the Treasury may waive a failure to satisfy the

requirements of § 7702. This waiver is granted if a taxpayer establishes that the statutory requirements were not satisfied because of reasonable error and that reasonable steps are being taken to remedy the error.

After considering all of the facts and circumstances, we find that the failure of Amount E life insurance contracts to satisfy the requirement of § 7702 (a) was due to reasonable error, and Taxpayer is taking reasonable steps to remedy the error.

CONCLUSION

Accordingly, based on the information submitted, the failure of Amount E contracts to satisfy the requirements of § 7702(a) is waived pursuant to
§ 7702(f)(8), provided that: 1) the failed contracts are cured within 60 days of the date of this letter; and 2) the excess premiums are refunded with interest calculated as of the date of the cure, and/or the revised death benefits are calculated as of the date of the cure. Any contracts that are not cured within 60 days of the date this letter are not covered by this waiver.

Except as expressly 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 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 this letter is being sent to the Taxpayer.

> Sincerely,
> Acting Associate Chief Counsel
> (Financial Institutions and Products)
>
> By: Donald J. Drees, Jr.
> Senior Technician Reviewer,
> Branch 4