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Department of the Treasury
Washington, DC 20224

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<u>Legend</u>

Taxpayer =

Parent =

State A =

Place B =

Place C =

Period D =

Period E =

System F =

Law Firm G =

Month H =

Year 1 =

Year 10 =

Year 16	=
Year 20	=
Number S	=
Number T	=
Number U	=
Number V	=
Number W	=
Number X	=
Number Y	=
Number Z	=

Dear

This responds to your letter dated September 20, 2004, in which you requested on behalf of Taxpayer, a waiver under §§ 101(f)(3)(H) and 7702(f)(8) of the Internal Revenue Code for Number W life insurance contracts (the Contracts) that inadvertently failed to meet the requirements of §101(f) or § 7702, as applicable.

Taxpayer is a stock life insurance company, as defined in § 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 A and conducts insurance business in Place B. Taxpayer joins in the filing of a consolidated federal income tax return with Parent and other eligible affiliates on an accrual accounting, calendar year basis.

The Contracts are non-participating, universal life insurance contracts issued on a number of different policy forms. Some of the Contracts were issued in Year 1. Contracts issued before January 1, 1985, were intended to comply with § 101(f) by satisfying both the "guideline premium limitation" of § 101(f)(1)(A)(i) and (f)((2) and the applicable percentage" requirements of § 101(f)(1)(ii) and (f)(3)(C). Contracts issued on or after that date were intended to comply with § 7702 by both satisfying the "guideline premium requirements" of § 7702(c) and falling within the "cash value corridor" of § 7702(d).

The Contracts provide for the payment of an initial premium and of "planned periodic premiums." The amount and the interval of the planned premiums are set forth on the policy specifications page of each policy. However, the Contracts are flexible premium policies inasmuch as a policyholder may change the frequency of the planned periodic premiums, increase or decrease the amount of the planned periodic premiums, and make unscheduled premium payments, all subject to certain limitations. For example, Taxpayer, in the role of issuer of the Contracts, reserves the right to limit the number and amount of unscheduled premium payments. That is, the Contracts provide that the issuer may refuse or refund any premium which would cause the sum of the premiums paid to exceed the “guideline premium limitation” prescribed in §§ 101(f) and 7702(c)(2), whichever is applicable.

Prior to Month H of Year 10, Taxpayer used a computed-based system (the Old System) located in its administrative offices in Place C to administer numerous aspects of its Contracts, including (but not limited to) compliance with the requirements of §§ 101(f) and 7702, whichever was applicable. For each Taxpayer Contract issued, the Old System computed a guideline premium limitation that was intended to be no greater than the “guideline premium limitation” prescribed in §§ 101(f)(2) and 7702(c)(2), whichever was applicable. Specifically, the Old System compared the premiums paid under each Taxpayer Contract with the guideline premium limitation for the Contract on every policy anniversary. In addition, Taxpayer had procedures in place that required a manual comparison of the premiums paid under each Contract with the guideline premium limitation for the Contract at the time of a change to the Contract that affected the guideline premium limitation. If the amount of a premium received for a Taxpayer Contract, together with the sum of the premiums previously paid under the Contract, exceeded the guideline premium limitation on the Contract, the Old System generated an Excess Premium Notice that identified the Contract and warned of the payment of an excess premium under the contract. More specifically, the notice stated that excess premium had been paid with respect to the Contract, which identified it by policy number, and set forth for that Contract the following information with respect to the Contract; the sum of the premiums paid, the guideline single premium, and the guideline level premium.

In Period D Taxpayer purchased a new administration system (the New System) that was designed to administer universal life insurance contracts and variable universal life insurance contracts, including their compliance with the applicable requirements of §§ 101(f) and 7702. After a period of testing the New System and training the numerous employees involved on various aspects of the system, Taxpayer began to administer newly issued life insurance contracts on the New System. However, Taxpayer continued to administer on the Old System the Taxpayer Contracts that had been issued previously while it evaluated the steps and issues involved in converting the administration of these contracts to the New System.

As part of its planning for converting the Taxpayer Contracts to the New System, Taxpayer performed “test runs” and extensively trained the staff of the Policyholder Administration Department in the Home Office regarding the operation of Taxpayer’s New System and Taxpayer’s accompanying procedures. Prior to the conversion, the policyholder service personnel in the Home Office that worked with the Old System were separate from the personnel in the Home Office that worked with the New System. At the time of conversion, Taxpayer had approximately Number T individuals devoted to servicing policies administered on the Old System and Number S individuals devoted to the New System. As part of the conversion process, Taxpayer trained all of the individuals that had been previously been devoted to the Old System regarding the operation of Taxpayer's New System. Additionally, Taxpayer integrated the two groups in order to provide the individuals that had been working with the Old System ongoing assistance with their transition working with the New System.

In Month H of Year 10, Taxpayer converted the administration of the Contracts, including compliance of the Contracts with the applicable requirements of §§ 101(f) and 7702, from the Old System to the New System. The New System compared the premiums paid under each Taxpayer Contract with the guideline premium limitation for the Contract (a) when a premium was paid, (b) when a bill was generated, (c) at the time of a change to the Contract that affected the guideline premium limitation, and (d) on each policy anniversary. The New System generated notices such as Excess Premium Worksheets if it detected Excess Premiums when it performed guideline premium testing. For example, one of the worksheets that the New System generated was an "Excess Premium Worksheet for Premium," which was generated if the premiums credited to a Taxpayer Contract exceed the guideline premium limitation for the Contract.

In addition to informing Taxpayer's policyholder service personnel that a specific Taxpayer Contract had Excess Premiums, the various Excess Premium Worksheets set forth information to enable responsible staff to determine what action needed to be taken with respect to the Contract.

In addition to generating Excess Premium Worksheets to notify employees of the existence of Taxpayer Contracts with Excess Premiums, the New System generated a report that identified all of the Taxpayer Contracts for which the New System had generated Excess Premium Worksheets. The New System also generated a daily report that provided a comprehensive listing of all Taxpayer Contracts that had errors including errors in the administration of §§ 101(f) and 7702.

Initially, the Excess Premium Worksheets generated by the New System were processed by the staff of the Policyholder Administration Department within the Home Office. These individuals were also responsible for processing other types of administrative errors (e.g., incorrect identification of a beneficiary or an incorrect address for the owner). Subsequently, Taxpayer created the Tax Administration Department to improve the handling of tax-specific policyholder issues and transitioned responsibility for processing Excess Premium Worksheets from the Home Office's Policyholder Administration Department to the Tax Administration Department. After Year 16, only the Tax Administration Department processed Excess Premium Worksheets. (Hereafter, personnel of the Home Office's Policyholder Administration

Department and the Tax Administration Department are referred to collectively as the "Policyholder Service Staff.")

Taxpayer's procedures required Excess Premium Worksheets generated by the New System to be forwarded to the Policyholder Service Staff, who, as noted above, were required to process the worksheets. In Year 20, in order to improve recordkeeping and reduce the potential for misplaced Excess Premium Worksheets, Taxpayer started using System F (the system Taxpayer uses to maintain its policy files in electronic form) to distribute the Excess Premium Worksheets electronically to the Policyholder Service Staff. Under System F procedures implemented in Year 20, after the New System generates an Excess Premium Worksheet, it is scanned to System F in a format that is similar to Adobe pdf document. System F then electronically delivers the Excess Premium Worksheet to the e-mail in-basket of the Policyholders Service Staff as a "work item" that must be completed.

Upon receipt of an Excess Premium Worksheet, either physically or electronically, Taxpayer's procedures required the Policyholder Service Staff to determine the amount of the "Excess Premium" by reference to the Excess Premium Worksheet and data available on the New System. The Policyholder Service Staff was required to compare the premiums paid set forth on the Excess Premium Worksheet with the guideline premium limitation on the New System in order to determine the amount of the Excess Premium. Taxpayer's procedures also required the Policyholder's Service Staff to "reverse" immediately that Excess Premium payment from the Taxpayer Contract. The effect of this reversal was to restore the Contract to the position it would have been in had the Excess Premium not been paid. To process a reversal on the New System, the Policyholder Service Staff were instructed to input into the New System in a particular sequence specific items of information with respect to the Contract identified on an Excess Premium Worksheet. This information included the policy number and the dollar amount of the premium reversed. The procedures required the Policyholder Service Staff, after processing a reversal, to check a certain data file on the New System that maintained information regarding the premiums paid with respect to a Taxpayer Contract and a guideline premium limitation for the Contract to verify that after the reversal the premiums paid either equaled or were less than the guideline premium limitation.

Taxpayer in connection with another matter related to tax administration began to investigate whether any of Contracts failed to satisfy the applicable requirements of §§ 101(f) and 7702. Taxpayer assembled an internal group of actuaries, programmers, the Policyholder Service Staff, and attorneys to participate in this investigation. Taxpayer also engaged Law Firm G to assist in this process.

Taxpayer began its investigation by reviewing the manner in which the guideline premium limitations for Taxpayer Contracts were computed. As part of this review, Taxpayer also verified the accuracy of the guideline premium limitations on the New System with respect to the Taxpayer Contracts. In addition, Taxpayer reviewed the procedures it had in place for the Policyholder Service Staff to process Excess Premium Worksheets. A number of Contracts were identified that might not comply with the applicable requirements of §§ 101(f) and 7702.

Following a conversion from the Old System to the New System, the investigative team requested the Consultant for assistance. The Consultant was a computer programmer who had been previously engaged by Taxpayer on a full time basis on a matter not directly related to the present waiver requests under §§ 101 and 7702. Specifically, the Consultant was asked to review the manner in which the New System generally (1) compared the premiums paid with the guideline premium limitations for the Contracts, and (2) generated Excess Premium Worksheets when Excess Premiums were paid for such Contracts. As a result of the Consultant’s review of the New System, the investigative team identified Contracts that potentially did not comply with the applicable requirements of §§ 101(f) and 7702.

Further research and review of the New System by the Consultant found, in fact, that a number of the potential failed contracts in fact did not comply with the applicable requirements of §§ 101(f) and 7702. Since Taxpayer continued to be uncertain regarding whether the remaining Contracts identified as potentially failing to satisfy the applicable requirements of §§ 101(f) and 7702 did, in fact, fail to satisfy those requirements, Taxpayer engaged additional employees for the specific task of reviewing the policy files of all such Contracts.

Historically, Taxpayer maintained policy files in paper form. In the Period E Taxpayer started using System F to maintain such files electronically. For Contracts issued prior to that time, Taxpayer retained the existing paper files, but new additions to policy records were stored under System F. Thus, for Contracts issued prior to the date Taxpayer began using System F, policyholder files consisted of both paper and electronic policy files. In order to review the policy files for the Contracts, it was necessary to review the paper policy files, the electronic policy files, and various items of data and information stored on the New System and on the Old System.

With the assistance of the Policyholder Service Staff, one of Taxpayer’s actuaries, and the Consultant, the employees reviewed the policy files of Number Y Contracts that have been identified as potentially failing to satisfy the applicable requirements of §§ 101(f) and 7702. As a result of the policy file review, Taxpayer determined that there were Number X contracts that did not satisfy the applicable requirements of §§ 101(f) and 7702 out of the Number Z in-force universal life insurance contracts Taxpayer administers.

The result of the review and the additional analysis by the investigative team, Taxpayer has concluded that the non-compliance certain of the Contracts with the applicable requirements of §§ 101(f) and 7702 resulted from the following errors.

Error 1

As described above, Taxpayer's procedures required the Policyholder Service Staff to reverse immediately the Excess Premium payments identified by Excess Premium Worksheets generated by the New System. To execute such a reversal, the Policyholder Service Staff input into the New System in a particular sequence specific items of information with respect to a Taxpayer Contract identified on an Excess Premium Worksheet. As described, such reversal restores a Contract to a position it would have been in had the Excess Premiums not been paid.

The Consultant has reviewed the computer records documenting the reversals performed by the Policyholder Service Staff with respect to the Contracts in this error category. He determined that all reversals correctly reduced the premiums paid for the Contracts to an amount no greater than the guideline premium limitation for the Contracts. However, the Consultant also has determined that the manner in which the Policyholder Service Staff were instructed to input the reversals into the New System had an unintended consequence; if an Excess Premium was paid after the reversal, an Excess Premium Worksheet was not generated. The Policyholder Service Staff were not aware of this unintended consequence of the manner in which they input the reversal into the New System.

As described, Taxpayer's procedures required the Policyholder Service Staff who reversed a premium to then review the data files in the New System that stored information with respect to the premiums paid and the guideline premium limitation for Taxpayer's Contracts. Thus, when the Policyholder Service Staff reviewed those files for these Contracts, they correctly concluded that the action they had taken reduced the premiums paid to an amount no greater than the guideline premium limitation. However, they did not realize that due to the manner in which they input the reversal into the New System, the system would not generate an Excess Premium Worksheet if an Excess Premium was subsequently paid. As a result of this error, when subsequent Excess Premium payments were made, the New System did not generate Excess Premium Worksheets identifying the Excess Premium payments and, as a consequence, the Policyholder Service Staff were not aware that Excess Premiums had been paid. This error resulted in Number U of the Contracts that failed.

Error 2

As described, the New System generated an Excess Premium Worksheet when an Excess Premium was credited to a Taxpayer Contract. Pursuant to Taxpayer's procedures, such Worksheets were delivered to the Policyholder Service Staff. Taxpayer's procedures required the Policyholder Service Staff to reverse the Excess Premium payment identified by the New System. Pursuant to Taxpayer's procedures, such Excess Premiums were then to be refunded to policyholders. In reviewing the policy files of the Contracts which failed, Taxpayer has discovered that the Policyholder Service Staff in some instances failed to follow Taxpayer's procedures for processing

Excess Premium Worksheets. Taxpayer has discovered that in a few instances the Policyholder Service Staff reversed an amount that was less than the Excess Premium. Taxpayer also has discovered that, in all other instances, the Policyholder Service Staff failed to reverse the Excess Premiums altogether. Such errors by the Policyholder Service Staff in following Taxpayer's procedures resulted in Number V Contracts which failed.

Taxpayer has already modified the manner in which the New System administers the compliance of the Contracts with the applicable requirements of §§ 101(f) and 7702. If a policyholder attempts to pay an Excess Premium under a Contract, other than a Contract which has failed, as described above, the New System will automatically (1) reject the payment, (2) credit it to a suspense account for the benefit of the policyholder, and (3) generate a message identifying the Contract and stating that the policyholder has attempted to pay an Excess Premium. Taxpayer's procedures require that when such a message is produced, the amount in the suspense account be returned immediately to the policyholder. Hence, under the New System as modified, no Excess Premium can be accepted and credited under a Contract, other than a contract which has failed.

Taxpayer proposes to remedy the non-compliance of each Contract, which has failed, that is in force on the effective date of the requested waiver, and under which the sum of the premiums paid as of that date exceeds the guideline premium limitation as of that date, by (1) increasing the death benefit payable under a Contract which has failed or, (2) refunding to policyholders the amount of such excess with interest (using rates at least as high as those applied for purposes of crediting interest to each Contract's cash value), or a combination of (1) or (2).

In general, for flexible premium life insurance contracts entered into before January 1, 1985, § 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 § 101(a): a guideline premium limitation set forth in § 101(f)(1)(A), or a cash value test set forth in § 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, § 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 § 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 § 7702(c) and fall within the cash value corridor test of § 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 § 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 commissioners' standard tables (as defined in § 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% 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% or the rate or rates guaranteed on issuance of the contract. Section 7702(c)(4). The computational rules of § 7702(e) and the definitions of § 7702(f) apply for purposes of determining both the guideline single and guideline level premium.

If premiums paid exceed the guideline premium limitation, § 101(f)(3)(B) and § 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 §§ 101(f)(3)(H) and 7702(f)(8), the Secretary of Treasury may waive a failure to satisfy the requirements of § 101(f) or § 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 (Number W) Contracts to satisfy the requirements of § 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. 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 the Income Tax Regulations that may be applicable thereto.

The rulings contained in this letter are based upon information and representations submitted by 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 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 the 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 11.04 of Rev. Proc. 2005-1, 2005-1 I.R.B. 1, 47-48. However, when the criteria in section 11.06 of Rev. Proc. 2005-1 are satisfied, a ruling is not revoked 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.

Pursuant to 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 Chief, Branch 4
(Financial Institutions & Products)