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In Re:

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Dear :

This is in reply to your letter of November 18, 2004, submitted by your authorized representative, requesting a ruling concerning the treatment under section 7702 of the Internal Revenue Code of certain life insurance policies issued by Company X.

#### FACTS

Company X is a stock life insurance company organized under the laws of State Z and is subject to tax under § 801. Company X joins in the filing of a consolidated life/non-life federal income tax return with Parent and other includible affiliates on a calendar year basis.

Company X issued certain individual, non-participating, flexible premium life insurance policies (the "Contracts"). All Contracts were issued after December 31, 1984.

Each Contract provides for the payment of certain premiums, the amount or frequency of which may be changed by the owner, subject to certain restrictions. Certain charges ("Charges") are assessed against the premiums paid for each Contract. Charges are expressed as a percentage of premiums paid for the Contract and are assessed to cover applicable state and local taxes, the federal tax associated with deferred acquisition costs, and sales and related acquisition expenses.

The Contracts are designed to satisfy the cash value accumulation test of § 7702(b) (the "CVA test"). Each Contract provides for a minimum death benefit (the "Minimum Death Benefit") that is intended to equal the amount required by the CVA test.

Each contract provides for an account value ("Account Value"), which equals premiums paid for the Contract, less Charges, cost of insurance, and other applicable fees, plus interest or earnings (or less losses), and less any partial withdrawals.

A Contract owner may borrow any amount up to the Contract's Net Account Value, which is an amount equal to the Account Value less any policy indebtedness, less all monthly deductions to the next policy anniversary. Interest is charged on policy loans.

If the owner of a Contract surrenders the Contract in full, Company X will pay the owner on the date of surrender an amount equal to the Account Value, less any outstanding policy indebtedness, and less any surrender charge. In circumstances involving the early surrender of a Contract, certain amounts (the "Remittance") in addition to the above amounts are paid to a Contract owner upon the full surrender of the Contract.

The Remittance guaranteed under the Contracts equal l percent of the premiums paid for the Contract if the Contract is surrendered during the first m months after issuance and n percent of the premiums paid during the o policy year of the Contract if the Contract is surrendered during the p through q month after issuance. In addition to these guaranteed amounts, for certain Contracts Company X has followed a practice of paying certain non-guaranteed Remittance if these Contracts are surrendered during the first r months after issuance. For these Contracts, Company X has paid Remittance equal to (i) s percent of the premiums paid for the Contract up to a target premium identified in the Contract and t percent of the premiums paid in excess of the target premium if the Contract is surrendered during the first u months after issuance, (ii) v percent of the premiums paid during the o policy year of the Contract up to the target premium and w percent of the premiums paid during the o policy year in excess of the target premium if the Contract is surrendered during the p to q months after issuance, and (iii) x percent of the premiums paid during the o policy year up to the target premium if the Contract is surrendered during the y to z months after issuance.

## LAW AND ANALYSIS

The first issue is whether the Remittance that could be payable under a Contract is part of the Contract's cash surrender value within the meaning of § 7702(f)(2)(A).

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 contract must be treated as such under the applicable law. Under § 7702(a), the contract must also either (1) meet the cash value accumulation test of § 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) 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(d) provides that a contract falls within the cash value corridor if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value.

Section 7702(f)(2)(A) provides that, for purposes of § 7702, the cash surrender value of any contract shall be its cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends.

The common definition of cash surrender value is “the amount made available, contractually, to a withdrawing policyowner who is terminating his or her protection.” Kenneth Black, Jr. & Harold D. Skipper, Jr., *LIFE & HEALTH INSURANCE* 46 (13<sup>th</sup> ed. 2000); see also John H. Magee, *LIFE INSURANCE* 599 (3<sup>rd</sup> ed. 1958) (“The cash value represents the amount available to the policyholder upon the surrender of the life insurance contract.”).

The legislative history of §7702 defines cash surrender value as the “cash value of any contract (i.e., any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend.” S. PRT. NO. 98-169, at 573 (1984); H.R. REP. NO. 98-432, at 1444 (1984).

Section 1.7702-2(b)(1) of the proposed Income Tax Regulations provides that, for purposes of § 7702, the cash value of a contract generally equals the greater of (i) the maximum amount payable under the contract (determined without regard to any surrender charge or policy loan), or (ii) the maximum amount that the policyholder can borrow under the contract. 57 Fed. Reg. 59319 (Dec. 15, 1992).

Section 1.7702-2(h)(2) of the proposed regulations provides that the cash surrender value of a contract generally equals its cash value, as defined in section 1.7702-2(b)(1) of the proposed regulations.

In Notice 93-37, 1993-2 C.B. 331, the Service announced that the effective dates of the proposed regulations under § 7702 would be no earlier than the date of publication of final regulations in the Federal Register. The Notice also stated that it is anticipated that insurance companies generally will be allowed a period of time after final regulations are published to bring their policy forms into compliance with any new rules.

We conclude that the Remittance that could be payable under a Contract is part of the Contract’s cash surrender value within the meaning of § 7702(f)(2)(A).

The second issue is whether Company X's error in not treating the Remittance that could be payable under a Contract as part of the Contract's cash surrender value within the meaning of § 7702(f)(2)(A) is an error that can be waived pursuant to § 7702(f)(8).

Section 7702(f)(8) provides that the Secretary may waive the failure to satisfy the statutory requirements under § 7702(a) for a life insurance contract for any contract year if such failure was due to reasonable error and reasonable steps are taken to remedy the error.

Because Notice 93-37 stated that the effective dates of the proposed regulations under § 7702 would be no earlier than the date of publication of final regulations and because the proposed regulations do not contain language identical to the definition of cash surrender value in the legislative history of §7702, we conclude that the failure of the Contracts to satisfy the requirements of § 7702 because the Remittance that could be payable under a Contract was not treated as part of the Contract's cash surrender value within the meaning of § 7702(f)(2)(A) is due to reasonable error.

The remedial actions proposed by Company X are (i) for each in-force Contract under which a Remittance could become payable after the 90th day from the date this ruling is issued, Company X will amend the terms of the Contract so the amount of the Remittance is included as part of the value that is used to determine such Contract's Minimum Death Benefit during the period that the Remittance could become payable, and (ii) for each Contract under which the insured dies or has died at a time a Remittance is or was payable upon a full surrender of the Contract, Company X will calculate the death benefit under the Contract by taking the Remittance into account as part of the value that is used to determine the Minimum Death Benefit. If a death benefit already has been paid with respect to such a Contract, Company X will pay the beneficiary the difference between the required death benefit and the death benefit actually paid.

Company X represents that if they issue any insurance contract in the future with features identical to or similar to the Remittance features that exist in the Contracts, Company X will include the Remittance that could be payable under the contract as part of the contract's cash surrender value within the meaning of § 7702(f)(2)(A).

We conclude that Taxpayer's proposed method of remedying 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 Income Tax Regulations that may also be applicable thereto.

The rulings contained in this letter are based upon information and representations submitted by Company X 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) provides that it may not be used or cited as precedent.

Sincerely,

/S/

Donald J. Drees, Jr.  
Acting Branch Chief, Branch 4  
Office of Associate Chief Counsel  
(Financial Institutions & Products)