Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: August 17, 2007

to: Stuart Mann
Program Manager
(Financial Institutions & Products)
LMSB:FS

from: Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)
CC:FIP:4

subject: Notification of Withdrawn Letter Ruling Request

LEGEND

Taxpayer =

Year 1 =

Year 2 =

Date 3 =

ISSUES

Pursuant to § 7.07(2)(a) of Rev. Proc. 2007-1, 2007-1 I.R.B. 1,27, this is to notify you that Taxpayer has withdrawn a letter ruling request regarding §§ 101 and 7702 of the Internal Revenue Code after we reached a conclusion adverse to that requested and to provide you our view on issues raised in the request.

Taxpayer requested a ruling that a change in death benefits and the addition of qualified additional benefit riders (the “QAB Riders”) to contracts originally issued before January 1, 1985 (the “Pre-DEFRA Contracts”) would not cause the Pre-DEFRA Contracts to become subject to § 7702 as it existed on January 1, 1985.

Taxpayer also requested a ruling that a change in death benefits and the addition of QAB Riders to contracts originally issued before October 20, 1988 (the “Pre-TAMRA Contracts” and together with the Pre-DEFRA Contracts, the “Grandfathered Contracts”)) would not cause the Pre-TAMRA Contracts to become subject to the 1988 amendments to § 7702(c)(3)(B)(i) or § 7702(c)(3)(B)(ii) (the “Reasonable Mortality Rule”).

CONCLUSIONS

Section 7702 will apply as it exists on the date on which death benefits are changed or QAB Riders are added.

FACTS

Taxpayer issued life insurance contracts between Year 1 and Year 2. The Pre-TAMRA Contracts were intended to comply with then § 101(f) by satisfying (1) the “guideline premium limitation” of §§ 101(f)(1)(A)(i) and 101(f)(2), and (2) the “applicable percentage” requirements of §§ 101(f)(1)(A)(ii) and 101(f)(3)(C). Contracts issued after December 31, 1984, were intended to comply with § 7702 by satisfying both the “guideline premium requirements” of §§ 7702(a)(2)(A) and 7702(c) and by falling within the “cash value corridor” of § 7702(a)(2)(B) and 7702(d). The Pre-TAMRA Contracts were not designed to comply with the Reasonable Mortality Rule. Contracts issued after October 19, 1988 were intended to comply with the Reasonable Mortality Rule.

The Taxpayer now wants to permit holders of Grandfathered Contracts to add one or more QAB Riders to the Grandfathered Contracts. The additions of the QAB Riders are subject to Taxpayer’s receipt of evidence of insurability. The express terms of the Grandfathered Contracts do not address the QAB Riders. The QAB Riders include (1) two types of riders that waive cost of insurance (“COI”) charges in the event of total and permanent disability; (2) a rider that provides life insurance coverage on an additional insured under the contract (who must be a family member of the primary insured) sometimes coupled with a waiver of COI charges for the rider in the event of total and permanent disability; and (3) a rider that provides life insurance coverage for the children of the individual insured under the contract. Each of the QAB Riders qualifies as a “qualified additional benefit” within the meaning of §7702(f)(5)(A). The Taxpayer has a practice of allowing contract holders to add QAB Riders.

Under contracts issued before Date 3, the only death benefit offered to contract holders was an “Increasing Death Benefit” (where the amount at risk remained level for the duration of the contract). The Taxpayer now wants to permit holders of Grandfathered Contracts to elect to have their death benefits become level (so that the amount at risk decreases as the cash value increases). The terms of the Grandfathered Contracts do not expressly provide the holders of Grandfathered Contracts with the option of electing a different death benefit. At the time of issuance, the Taxpayer was not technologically able to offer level death benefits.

LAW AND ANALYSIS

The Pre-DEFRA Contracts

The Pre-DEFRA Contracts were intended to comply with then § 101(f) by satisfying (1) the “guideline premium limitation” of §§101(f)(1)(A)(i) and 101(f)(2), and (2) the “applicable percentage” requirements of §§ 101(f)(1)(A)(ii) and 101(f)(3)(C). The Deficit Reduction Act of 1984 required contracts issued after December 31, 1984 to comply with § 7702 (earlier effective dates and alternative transitional rules apply in the case of certain contracts).

DEFRA PL 98-369, 1984 HR 4170 states in pertinent part:

> In General.—Except as otherwise provided in this subsection, the amendments made by this section shall apply in contracts issued after December 31, 1984, in taxable years ending after such date.

The Staff of Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 656 (Comm. Print 1984) states in pertinent part:

> Contracts issued in exchange for existing contracts after December 31, 1984, are to be considered new contracts issued after that date. The exercise of an option or right granted under the contract as originally issued does not result in an exchange and does not constitute the issuance of a new contract for purposes of new section 7702 and any applicable transition rules if the option guaranteed terms that might not have otherwise been available when the option is exercised . . . . In addition, a change in an existing contract will not be considered to result in an exchange, if the terms of the resulting contract (that is, the amount or pattern of death benefits, the premium pattern, the rate or rates guaranteed on the issuance of the contract, or mortality and expense charges) are the same as the terms of the contract prior to the change.

The negative implication of the language in the JCT Bluebook is that the addition of QAB Riders and the change in the death benefit to a level death benefit would result in an exchange. A contract that is exchanged for an existing contract after the effective date is to be considered a new contract issued after that date. Therefore, the DEFRA provisions will apply to all Contracts that undergo the modifications presented above.

The Pre-TAMRA Contracts

The Pre-TAMRA Contracts were not designed to comply with the Reasonable Mortality Rule. The Technical and Miscellaneous Revenue Act of 1988 required contracts entered into on or after October 21, 1988 to comply with the Reasonable Mortality Rule.

TAMRA PL 100-647, 1988 HR 4333 states in pertinent part:

> Effective Date.—The amendments made by this section "26 USC 7702 note" shall apply to contracts entered into on or after October 21, 1988.

H.R. Report 100-795 states in pertinent part:

> Reason for Change:
>
> Concerns have been raised that some insurance companies are taking aggressive positions with respect to mortality and expense charges . . . contrary to the intent of Congress when the definition of life insurance was enacted. The committee believes that it is appropriate to clarify that such practices with respect to mortality and expense charges are not reasonable.
>
> Effective Date
>
> The provision generally is effective for all life insurance contracts issued on or after July 13, 1988 and for all life insurance contracts that are materially changed on or after July 13, 1988. A material change for this purpose has the same meaning as a material change under the provisions relating to modified endowment contracts (see III.B.3, above).

H.R. Conf. Rep. 100-1104 states in pertinent part:

House Bill: The [Reasonable Mortality Rule] applies to contracts entered into or materially changed on or after July 13, 1988.

Senate Amendment: [The Senate Amendment did not contain a provision on unreasonable mortality and expense charges for the purposes of the definition of life insurance.]

Conference Agreement: No inference is intended by this provision that present law does not require mortality and expense charges specified in a life insurance contract to be reasonable.
The conference agreement follows the House Bill, with modifications.
The provision is effective with respect to contracts entered into on or after October 21, 1988.

Therefore the “material change” language that is referenced by the House version of the effective date provisions for the unreasonable mortality charge rules of § 7702 will cause a life insurance contract to be entered into anew (for purposes of §7702(c)(3)(B)) if there is an increase in future benefits.

We read the intent expressed in the House Report together with the acquiescence of the Conference Agreement to follow the House Bill, with modifications, to trigger the loss of grandfathering on the facts presented by the Taxpayer. To do otherwise would virtually eliminate the ability to lose grandfathered status except in the clearest of circumstances (new contracts actually issued after the effective date or tax avoidance) and does not follow the intent of Congress. Therefore, the Reasonable Mortality Rule will apply to all Pre-TAMRA Contracts that undergo the modifications presented above.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call if you have any further questions.

By: _______________________________
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