

**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-152260-10

Date:  
June 14, 2011

**Legend:**

Company: =

Parent Company: =

State =

Dear :

This responds to your request dated December 13, 2010, as supplemented on March 15, 2011, April 15, 2011, and May 3, 2011, that your authorized representative submitted on Company's behalf. Company requests that the Service rule that expense charges are taken into account when determining the deemed cash surrender value for purposes of the necessary premium test under section 7702A(c)(3)(B)(i).

**Facts:**

Company is a stock life insurance company organized and operated under the laws of State. Company qualifies as a life insurance company under section 816(a). Company is a subsidiary of Parent Company and joins in the filing of a consolidated federal income tax return with Parent Company on a calendar year basis, using an accrual method of accounting.

One of the life insurance policies the Company issues (Contract) is a universal life insurance policy. Contract will be considered a life insurance contract under the laws of

the jurisdictions in which it will be issued. It will satisfy the requirements of the “cash value accumulation test” of section 7702(a)(1) and (b) (CVAT) by providing a minimum death benefit that equals the product of the Contract’s cash surrender value, within the meaning of section 7702(f)(2)(A), and a corridor factor that varies with the age and certain other characteristics of the insured. As is typical of universal life insurance, the Contract provides for flexible premium payments, planned periodic premiums that may be paid, and an adjustable death benefit.

The Contract may be sold as either a “modified endowment contract” as defined in section 7702A (a “MEC”) or as a life insurance contract that is not a MEC (a “non-MEC”). In circumstances where an Owner wishes that the Contract not become a MEC, the Company will identify and the Owner will pay premiums that are intended to comply with the 7-pay test under section 7702A. The Company needs to apply the “necessary premium test” described in section 7702A(c)(3)(B)(i) to determine if a Contract fails the 7-pay test.

In this connection, the Company needs to know if reasonable expense charges may be deducted in computing the “deemed cash surrender value” of a Contract for purposes of satisfying the necessary premium test. The Company has represented that the expenses it proposes to reflect in computing the deemed cash surrender value satisfy the reasonable expense charge rule of section 7702(c)(3)(B)(ii).

#### Law and Analysis:

Section 7702A(a)(1) states that any contract that is entered into on or after June 21, 1988 and meets the requirements of section 7702, but fails to meet the 7-pay test of section 7702A(b) is a modified endowment contract for purposes of section 72.

Section 7702A(b) states that a contract fails to meet the 7-pay test if the accumulated amount paid under the contract at any time during the first 7 contract years exceeds the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of 7 level annual premiums.

Section 7702A(c)(3)(A) states that if there is a material change in the benefits under (or in other terms of) the contract that was not reflected in any previous determination under section 7702A, the contract will be treated as a new contract entered into on the day the material change takes effect and appropriate adjustments shall be made in determining whether such contract meets the 7-pay test of subsection 7702A(b) to take into account the cash surrender value under the contract.

Section 7702A(c)(3)(B) states that the term “material change” includes any increase in the death benefit under the contract or any increase in, or addition of, a qualified additional benefit under the contract.

Section 7702A(c)(3)(B)(i) provides an exception by which any increase in the death benefit that is attributable to the payment of premiums necessary to fund the lowest level of the death benefit and qualified additional benefits payable in the first 7 contract

years (determined after taking into account death benefit increases described in subparagraph (A) or (B) of section 7702(e)(2)) or to crediting of interest or other earnings (including policyholder dividends) in respect of such premiums will not be considered a material change.

The rule under 7702A(c)(3)(B)(i) is known as the “necessary premium test.” The statute provides no further explanation as to what constitutes a “necessary premium.” Therefore, we look to the legislative history for guidance. The necessary premium test was added to the statute in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).

H.R. Rep. No. 100-1104 (Conf. Rep.), at 104-105 (The TAMRA Conference Report), provides a means for calculating a necessary premium. For contracts intended to satisfy the CVAT under section 7702(b):

A premium is necessary to fund the lowest death benefit payable during the first 7 contract years to the extent that the net amount of the premium (i.e., the amount of the premium reduced by any expense charge) does not exceed the excess, if any, of

(1) the attained age net single premium for the contract immediately before the premium payment, over

(2) the deemed cash surrender value of the contract immediately before the premium payment.

Section 7702A(c)(3)(B)(i) and the TAMRA Conference Report imply that the purpose of the necessary premium test is to allow for the payment of premiums “necessary to fund” future benefits under the contract if those premiums must be paid to keep the contract in force.

H.R. Rep. No. 100-795, at 481 (1988) (The TAMRA House Report), describes the deemed cash surrender value as follows:

The deemed cash surrender value of any contract equals the cash surrender value (determined without regard to any surrender charge or policy loan) that would result if the premiums paid under the contract had been credited with interest at the policy rate and had been reduced by the applicable mortality and expense charges. For this purpose, in the case of a contract that satisfies the cash value accumulation test, the policy rate equals the greater of 4 percent or the rate or rates guaranteed on the issuance of the contract....The applicable mortality and expense charges for any contract are those charges that were taken into account for prior periods under the [CVAT] or the guideline premium requirement, whichever is applicable.

These statements from the TAMRA House Report demonstrate that the deemed cash surrender value is properly computed by taking into account the expense charges imposed under the contract. In describing the deemed cash surrender value, the

legislative history statements speak to the calculation of a cash surrender value. The deemed cash surrender value of a contract is an amount that, as of any point in time, is intended to reflect the cash surrender value that is assured to be available under the contract to fund future benefits. Therefore, this deemed cash surrender value is calculated by accumulating the premiums actually paid for the contract, net of expense charges specifically imposed against those premiums, at the minimum interest rate or rates assumed to be credited (the contractually guaranteed rate(s) or, if greater, the statutory minimum rate of 4 percent) less the mortality and expense charges that would be assessed against that cash surrender value.

As set forth in the TAMRA House Report, if expense charges are taken into account in determining the cash surrender value of a CVAT contract, it is appropriate to reflect them in the deemed cash surrender value calculation. In the case of the Contract, the expense charges are assessed against the premiums that enter into the determination of the cash value. Thus, it is appropriate to reflect the expense charges in the deemed cash surrender value for purposes of the necessary premium test. Also, the TAMRA House Report is not addressing the net single premium computation, but rather the calculation of a cash value, which necessarily is reduced by expense charges.

The TAMRA Conference Report provides that the actual cash surrender value of a contract at any time may, if it is less than the deemed cash surrender value, be substituted for the latter in determining the amount of the necessary premium. This actual cash surrender value would consist of net premium payments. It is not logical to allow as substitute for the deemed cash surrender value an amount calculated by taking expense charges into account if it were not the intent of Congress to allow such charges to be recognized in the calculation of the deemed cash surrender value itself.

**Ruling:**

For purposes of the necessary premium test under section 7702A(c)(3)(B)(i), reasonable expense charges are taken into account when determining the deemed cash surrender value of a policy intended to satisfy the Cash Value Accumulation Test under section 7702(b).

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 who requested it, and is limited to the facts as represented by the taxpayer. Section 6110(k)(3) provides that this letter may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

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Donald J. Drees, Jr.  
Senior Technician Reviewer, Branch 4  
Office of Associate Chief Counsel  
(Financial Institutions and Products)