REVISED

Part III

Administrative, Procedural, and Miscellaneous

26 CFR §601.201: Rulings and determination letters.

(Also §§ 61, 403(a), 403(b), 408(b), 817(h), 818(a); 1.61-1,1.403(a)-1,1.403(b)-1, 1.408-1 1.817-5,1.818-2)

Rev. Proc. 99-44

SECTION 1. PURPOSE

This revenue procedure sets forth the circumstances under which the Internal Revenue Service will treat a contract as an annuity contract described in §§ 403(a), 403(b) or 408(b) of the Internal Revenue Code ("Code") notwithstanding that contract premiums are invested at the direction of the contract holder in publicly available securities.

SECTION 2. BACKGROUND

Rev. Rul. 77-85, 1977-1 C.B. 12, concludes that if a contract holder retains control over the assets in a custodial account associated with a purported "annuity" contract, then the contract holder is the owner of those assets for federal income tax purposes. The contract holder's gross income, therefore, includes any interest, dividends, and other income generated by those assets. In the ruling, the contract holder's control over the assets in the custodial account is manifested by the ability to direct the custodian: (1) to invest amounts in the account in any of an approved list of investments, and (2) to sell, purchase, or exchange securities or other assets held in the account. Through the interaction of the custodial agreement and the annuity contract, the contract holder enjoys any increase or suffers any decrease in the value of the assets in the account as well as any income from the assets. The contract holder also has the right to vote account securities either through the custodian or personally. Rev. Rul. 77-85 generally applies to contracts entered into after March 9, 1977.

In Rev. Rul. 80-274, 1980-2 C.B. 27, an insurance company and a savings and loan association enter into a group annuity contract under which the association's depositors are issued annuity certificates. The certificate holders' premiums (net of sales and other expenses) are invested in certificates of deposit issued by the savings and loan association, with maturity dates designated by the certificate holders. When a certificate of deposit matures, the proceeds generally are invested in another certificate of deposit with the savings and loan association. Prior to the annuity starting date, a holder of an annuity certificate can withdraw part or all of his or her investment (including the investment income thereon) by partially or completely surrendering the certificate. Due to fees imposed by the insurance company, annuity certificate holders receive a lower rate of return than if they were to invest directly in the certificates of deposit. The ruling concludes, however, that, prior to the annuity starting date, the position of holders of the annuity certificates is substantially identical to what their position would have been if investments were directly maintained or established with the savings and loan association, with the insurance company acting merely as a conduit.

Rev. Rul. 81-225, 1981-2 C.B. 12, analyzes five situations involving purported variable “annuity” contracts. In four of the situations, the ruling concludes that the contracts are not annuity contracts described in §§ 403(a), 403(b), or 408(b) and that prior to the annuity starting date the contract holders are the owners of the assets held by the insurance company with regard to the contracts. In these situations, the insurance company holds shares of mutual funds that are directly or indirectly available to the public. In the fifth situation, the contract holder can invest only in a non-publicly-available mutual fund managed by the insurance company or one of its affiliates. The shares in that mutual fund are available only through the purchase of an annuity contract. In this situation, the ruling concludes that the insurance company is treated as the owner of the mutual fund shares held by the company for the contracts. Rev. Rul. 80-274 did not address the treatment of contracts described in §§ 403(a), 403(b) or 408(b). For that reason, Rev. Rul. 81-225 contains a special transition rule for such contracts. This rule provides that any contract entered into on or before September 25, 1981, is treated as an annuity contract if the arrangement would have met the requirements imposed by those sections without taking the holding or rationale of Rev. Rul. 81-225 into account, and no contributions are made on behalf of any individual who was not included under the contract on or before September 25, 1981.

In Rev. Rul. 82-54, 1982-1 C.B. 11, a variable annuity contract holder can direct that the consideration paid for the contracts be invested in any or all of three non-publicly-available mutual funds managed by the insurance company. Each of the funds has a different general investment strategy. One fund invests primarily in common stocks, another in bonds, and the third in money market instruments. A contract holder is free to allocate payments among the three funds and to reallocate account values among the three funds at any time before the annuity starting date. The ruling concludes that the contract holder's ability to choose among broad general investment strategies, either at the time of the initial purchase of the annuity contract or subsequent thereto, does not constitute sufficient control over individual investment decisions so as to cause the contract holder to be the owner of the mutual fund shares.

Rev. Rul. 82-55, 1982-1 C.B. 12, clarifies that, if an annuity contract holder's premiums are invested in a separate account that holds mutual fund shares and the mutual fund's shares were originally available to the public but are unavailable to the public when the contract holder's premiums are invested, then the contract holder is not treated as the owner of the mutual fund shares.

In Christofferson v. United States, 749 F.2d 513 (8^{th} Cir. 1984), an individual purchased a purported deferred "annuity" contract that permitted the contract holder to allocate the consideration paid for the contract among various mutual funds. The contract holder could reallocate funds among the mutual funds at any time, and could withdraw part or all of the funds with seven days notice. The contract also gave the contract holder an option to purchase an immediate life annuity at guaranteed rates. The contract holder did not have to exercise the option. The court found that the contract holder had surrendered few of the rights of ownership or control over the assets, and therefore concluded that the contract holder was the owner of the mutual fund shares for tax purposes. As the contract holder could surrender the contract for cash prior to annuitization, the possibility that the mutual fund shares could be converted into an immediate annuity at rates guaranteed in the contract did not cause the contract holder to lack ownership or control.

Section 817(h) of the Internal Revenue Code was added by §211(a) of the Tax Reform Act of 1984, 1984-3 (Vol. 1) C.B. 259-60, effective for taxable years beginning after December 31, 1983. Section 817(h) provides that a variable contract (other than a pension plan contract described in § 818(a)) is not treated as a life insurance, endowment, or annuity contract if the investments of a segregated asset account upon which the contract is based are not adequately diversified in accordance with regulations prescribed by the Secretary. Pension plan contracts described in § 818(a) are subject to a variety of statutory limits, including limits on annual contributions, that do not apply to other variable contracts.

The legislative history explains the purpose underlying the § 817(h) diversification requirement as follows:

> In authorizing Treasury to prescribe diversification standards, the conferees intend that standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors and investments that are made, in effect, at the direction of the investor.

H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1055, 1984-3 (Vol. 2) C.B. 309.

Section 1.817-5 of the Income Tax Regulations provides guidance related to the minimum level of diversification applicable to the investments underlying variable annuity and life insurance contracts. Satisfying the diversification requirements, however, does not prevent a contract holder's control of the investments of a segregated asset account from causing the contract holder, rather than the insurance company, to be treated as the owner of the assets in the account.

SECTION 3. SCOPE

This revenue procedure applies to a contract that otherwise would qualify as an annuity contract for purposes of §§ 403(a) or 403(b), or as an individual retirement annuity for purposes of § 408(b), but for the fact that contract premiums are invested at the direction of the contract holder in publicly available securities.

SECTION 4. APPLICATION

Notwithstanding that contract premiums are invested at the contract holder's direction in publicly available securities, the Service will treat a contract described in section 3 of this revenue procedure as an annuity contract and will not treat the contract holder as owning the assets associated with the contract, provided the following conditions are met:

1. For a contract that is intended to qualify as an annuity contract for purposes of §§ 403(a) or 403(b), no additional federal tax liability would have been incurred if the employer of the contract holder had instead paid an amount into a trust or a custodial account in an arrangement that satisfied the requirements of §§ 401(a) or 403(b)(7)(A), respectively; or

2. For a contract that is intended to qualify as an individual retirement annuity for purposes of § 408(b), no additional federal tax liability would have been incurred if consideration for the contract had instead been held as part of a trust that would satisfy the requirements of § 408(a), except that the general account of an insurance company shall be treated as a common investment fund for purposes of satisfying § 408(a)(5).

EFFECTIVE DATE

This revenue procedure is effective on November 16,1999, with respect to all taxable years.

Under the authority of § 7805(b) of the Code, this revenue procedure will not be applied adversely to an issuer or holder of a contract issued before November 16,1999.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 81-225 is modified.

DRAFTING INFORMATION

The principal author of this revenue procedure is Katherine Hossofsky of the Office of Assistant Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contract Ms. Hossofsky on (202) 622-3477 (not toll-free call).