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Date:
May 2, 2002

Company U =

Company V =

Company W =

State X =

State Y =

Country Z =

Dear :

This is in response to the October 24, 2001 letter submitted by the representatives of company U, company V, and company W, requesting a ruling concerning the federal income tax treatment of certain assets held by a variable life insurance contract separate account. Additional information was submitted by the representatives in a letter dated March 27, 2002.

FACTS

Company U, company V, and company W are stock life insurance companies that are subject to tax under section 801 of the Internal Revenue Code and are organized and operated under the laws of state X, state Y, and country Z, respectively. Company W has made an election under section 953(d) to be taxed as a domestic

corporation. Companies U, V, and W (hereinafter collectively referred to as "Insurer") file a consolidated income tax return on a calendar year basis, and each company reports its income on an accrual method.

Insurer intends to offer variable life insurance contracts ("Contracts") in each of the 50 states, the District of Columbia, and outside the United States. The Contracts will be issued as individual contracts or as certificates under group life insurance contracts. The Contracts will qualify as life insurance contracts under section 7702. To avoid certain registration requirements, the Contracts will be sold only to "qualified purchasers"[1] or to no more than one hundred "accredited investors."[2]

The assets supporting the Contracts will be segregated from the assets that support Insurer's traditional life insurance products. Insurer will maintain a separate account (the "Separate Account") for the assets supporting the Contracts, and the income, deductions, assets, and liabilities associated with this separate account will be maintained separately from Insurer's other accounts. Insurer represents that the segregated asset account will at all times meet the asset diversification test set forth in section 1.817-5(b)(1) of the Income Tax Regulations.

The Separate Account will be divided into various unitized sub-accounts. Each sub-account will have a distinct investment objective and will account for its assets and liabilities separately from the assets of other sub-accounts. At the time of purchase, the Contract owner will specify the premium allocation among the available sub-accounts and may change this allocation for subsequent premiums at any time. Subject to certain restrictions, a Contract owner may make transfers from and to a sub-account. These restrictions include: (1) transfers must be made on specified days; (2) Insurer may limit the amount of transfer; and (3) transfers are limited to twelve per contract year, although Insurer has the right to change this limit. A Contract owner will have no voting rights with respect to any securities held by any sub-account.

Although other investment options may be available in the future, the only sub-accounts that will be available immediately are a variable money market fund and a number of Private Investment Partnerships ("PIP"), which are entities taxed as partnerships (such as private partnerships, limited liability companies, and business trusts) and sold in private placement offerings. No PIP will be a publicly traded partnership under section 7704, nor will any PIP be registered under a federal or state law regulating the offering or sale of securities. As is the case with the Contracts, PIPs will be sold only to accredited investors, and will be offered only to "qualified purchasers" or to no more than one hundred "accredited investors." Each PIP has a

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[1] As defined at 15 U.S.C. § 80a-2(a)(51).

[2] As defined in Regulation D of the Securities Act of 1933.

“general partner” or an “investment manager” that selects the PIP’s specific investments. No Contract owner may be a general partner or an investment manager of a PIP offered as an investment option under the Contract. In addition, no Contract owner may independently hold any interest in a PIP offered as an investment option under the Contract.

REQUESTED RULING

Insurer has requested the following ruling:

Insurer will be considered for federal income tax purposes as the owner of interests in Private Investment Partnerships that are held as an asset of any unitized sub-account underlying a Contract.

LAW AND ANALYSIS

Section 61(a) provides that the term "gross income" means all income from whatever source derived, including gains derived from dealings in property, interest, and dividends.

Section 817(d) defines a “variable contract” as a contract that provides for the allocation of all or part of the amounts received under the contract to an account that, pursuant to state law or regulation, is segregated from the general asset accounts of the company and that provides for the payment of annuities, or is a life insurance contract.

Section 817(h)(1) provides that, for purposes of subchapter L and section 7702(a) (relating to definition of life insurance contract), a variable contract (other than a pension contract), that is otherwise described in section 817 and that is based on a segregated asset account, shall not be treated as a life insurance contract for any period (and any subsequent period) for which the investments made by such account are not, in accordance with regulations prescribed by the Secretary, adequately diversified.

Section 1.817-5 are the regulations prescribed by the Secretary that set forth the diversification requirements for variable contracts.

Section 817(h)(4) provides, in certain situations, a "look-through" rule for meeting the diversification requirements. If all of the beneficial interests in a regulated investment company or trust are held by one or more (A) insurance companies (or affiliated companies) in their general account or in segregated asset accounts, or (B)

fund managers (or affiliated companies) in connection with the creation or management of the regulated investment company, the diversification requirements of section 817(h) are applied by taking into account the assets held by such regulated investment company.

Section 1.817-5(f)(1) provides that, if the "look-through" rule applies, a beneficial interest in an investment company, partnership, or trust will not be treated as a single investment of the segregated asset account. Instead, a pro rata portion of each asset of the investment company, partnership, or trust is treated, for purposes of section 1.817-5, as an asset of the segregated asset account.

Section 1.817-5(g) provides examples illustrating the provisions of section 1.817-5(f).

Section 7702 provides that, for a life insurance policy to be treated as a life insurance contract for federal tax purposes, the contract must be a life insurance contract under the applicable law and must satisfy either the cash value accumulation test of section 7702(b) or the guideline premium and cash value corridor test of section 7702(c) and (d).

Rev. Rul. 77-85, 1977-1 C.B. 12, concludes that if a purchaser of an "investment annuity" contract selects and controls the investment assets in the separate account of the life insurance company issuing the contract, then the purchaser is treated as the owner of those assets for federal income tax purposes. Thus, any interest, dividends, or other income derived from the investment assets are includible in the gross income of the purchasers.

In Rev. Rul. 80-274, 1980-2 C.B. 27, depositors in certain savings and loan associations could transfer cash, existing passbook accounts, or certificates of deposit to an insurance company in exchange for annuity contracts. The insurance company deducted expenses and premium taxes, and then deposited the net amounts received into a separate account at each policyholder’s savings and loan association. These amounts were then invested in the association’s certificates of deposit for a term designated by the policyholder. Except for the ability to withdraw the deposit from a failing savings and loan, the insurance company could not dispose of the deposit or convert the deposit into a different asset. The ruling concludes that if a purchaser of an annuity contract can select and control the certificates of deposit supporting the contract, then the purchaser is considered the owner of the certificate of deposit for Federal income tax purposes.

Rev. Rul. 81-225, 1981-2 C.B. 12, describes four situations in which investments in mutual funds pursuant to annuity contracts are considered to be owned by the policyholder rather than by the insurance company issuing the annuity contracts, and one situation in which the insurance company is considered the owner of the mutual

fund shares. In situation 1, the investment assets in the segregated account underlying the annuity contracts consist solely of shares in a single, publicly available mutual fund managed by an independent investment advisor. Situation 2 is similar to situation 1 except that the mutual fund is managed by the insurance company or one of its affiliates. Situation 3 also is similar to situation 1 except that the segregated asset account underlying the annuity contracts consists of five sub-accounts on which the performance of the annuity contract would depend. The policyholder retains the right to allocate or reallocate funds among the five sub-accounts during the life of the annuity contract. Situation 4 is similar to situation 2, except that the shares of the mutual fund are not sold directly to the public, but are available only through the purchase of an annuity contract or by participation in an investment plan account of the type described in Rev. Rul. 70-525, 1970-2 C.B. 144. Situation 5 also is similar to situation 2, except that the shares in the mutual fund are available only through the purchase of an annuity contract.

Rev. Rul. 81-225 concludes that the policyholders in Situations 1-4 have sufficient control and other incidents of ownership to be considered the owners of the mutual fund shares for Federal income tax purposes. The ruling reaches the opposite conclusion in situation 5, stating that the sole function of the mutual fund in situation 5 is to provide an investment vehicle to allow the insurance company to meet its obligations under its annuity contracts and that the insurance company possesses sufficient incidents of ownership to be considered the owner of the underlying portfolio of assets of the mutual fund. Rev. Rul. 81-225 concludes that in situation 5, the insurance company, not the policyholder, is treated as the owner of the mutual fund shares for federal income tax purposes.

In Rev. Rul. 82-54, 1982-1 C.B. 11, the purchasers of certain annuity contracts retained the right to direct the issuing insurance company to invest in the shares of any or all of three mutual funds that were not available to the public. One mutual fund invests primarily in common stocks, another in bonds, and a third in money market investments. Policyholders are free to allocate their premium payments among the three funds and have an unlimited right to reallocate contract values among the funds prior to the maturity date of the annuity contract. The ruling concludes that the policyholders' ability to choose among general investment strategies (for example, between stock, bonds, or money market instruments) either at the time of the initial purchase or subsequent thereto, does not constitute sufficient control so as to cause the policyholders to be treated as the owners of the mutual fund shares.

In Christoffersen v. U.S., 749 F.2d 513 (8th Cir. 1984), rev'g 578 F. Supp. 398 (N.D. Iowa 1984), the United States Court of Appeals for the Eighth Circuit upheld the investor control theory of Rev. Rul. 81-225. The taxpayers in Christoffersen purchased a variable annuity contract that reflected the investment return and market value of assets held in a separate account that was segregated from the general asset account of the issuing insurance company. The taxpayers had the right to direct that their

premium payments be invested in any one or all of six publicly traded mutual funds. Taxpayers could reallocate their investment among the funds at any time. Taxpayers also had the right upon seven days notice to make withdrawals or to surrender the contract, or to apply the accumulated value under the contract to provide annuity payments. The Court of Appeals held that the taxpayer, not the insurance company that issued the annuity contract, owned the mutual fund shares for Federal income tax purposes. Thus, the taxpayers were required to include in gross income any gains, dividends, or other income derived from the mutual fund shares.

Insurer argues that the availability of the same investment both "inside" and "outside" a variable contract is not a sufficient reason to treat the contract holder as the owner of the investment. Insurer claims that, to treat a variable contract holder as the owner of assets held by the insurance company under the variable contract, the non-tax economic rights and benefits that accrue to the contract holder must be substantially identical to the non-tax economic rights and benefits that would accrue to the contract holder as direct owner of the assets. Accordingly, Rev. Rul. 81-225 does not apply to Insurer's Contracts. The underlying assets of the segregated asset account are not available to the general public because the PIPs are limited to purchase by only certain investors. In addition, the death benefit provisions (and mortality charges) create material economic differences between the direct ownership of any asset and the ownership of that asset through a variable life insurance contract.

In addition, Insurer argues that section 7702 established a uniform definition of the term "life insurance contract" and that the specificity of section 7702 precludes the application of the investor control theory to assets held by a life insurance company under a life insurance contract that satisfies the requirements of section 7702.

Finally, Insurer argues that sections 1.817-5(f) and (g) evidence that a variable life insurance contract holding an investment in a nonregistered partnership may qualify for favorable tax treatment even though persons other than insurance company separate accounts hold interests in that nonregistered partnership, and that the drafters of section 1.817-5 could not have intended a policyholder of such a contract, absent any additional circumstances, to be considered the owner of the investment under the investor control rules.

In the legislative history of the Deficit Reduction Act of 1984 (Pub. L. No. 98-369), which contained both section 817 and section 7702, Congress expressed its intent to deny life insurance treatment to any variable contract containing segregated accounts backed by publicly available funds:

> The conference agreement allows any diversified fund to be used as the basis of variable contracts so long as all shares of the funds are owned by one or more segregated asset accounts of insurance companies, but only if access to the fund is available exclusively through the purchase of a

> variable contract from an insurance company. . . . In authorizing Treasury to prescribe diversification standards, the conferees intend that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors . . .

H.R. Conf. Rep. No. 98-861, at 1055 (1984).

Approximately two years after the enactment of section 817, the Treasury Department issued proposed and temporary regulations under section 817(h) relating to the minimum level of diversification applicable to the investments underlying variable annuity and life insurance contracts. The preamble to the regulations stated as follows:

> The temporary regulations . . . do not provide guidance concerning the circumstances in which investor control of the investments of a segregated asset account may cause the investor, rather than the insurance company, to be treated as the owner of the assets in the account. For example, the temporary regulations provide that in appropriate cases a segregated asset account may include multiple sub-accounts, but do not specify the extent to which policyholders may direct their investments to particular sub-accounts without being treated as owners of the underlying assets. Guidance on this and other issues will be provided in regulations or revenue rulings under section 817(d), relating to the definition of variable contracts.

51 FR 32633.

The text of the temporary regulations served as the text of proposed regulations in the notice of proposed rulemaking. See 51 FR 32664 (Sept. 15, 1986). The final regulations adopted, with certain revisions not relevant here, the text of the proposed regulations. Thus, the final regulations do not provide guidance concerning the extent to which policyholders may direct the investments of a segregated asset account without being treated as the owners of the underlying assets.

Based on these authorities, we conclude that Rev. Rul. 81-225 was not preempted by either section 817(h) or section 7702. We also conclude that section 1.817-5 of the regulations is consistent with Rev. Rul. 81-225.

Under Rev. Rul. 81-225, the Contract holders in the present case own, for federal income tax purposes, interests in PIPs that support the Contracts' sub-accounts because these interests are available for purchase not only by a prospective purchaser of the Contract, but also by other members of the general public. Under Rev. Rul. 81-225 (Situation 3), a variable contract holders' right to allocate or reallocate premium payments and contract values among five publicly available mutual funds is sufficient to treat the contract holders as the owners of the mutual fund shares because

> [T]he mutual fund shares are available for purchase not only by the prospective purchaser of the deferred variable annuity, but also by other members of the general public . . . The policyholder's position . . . is substantially identical to what his or her position would have been had the mutual fund shares been purchased directly . . .

Like the mutual fund shares in Rev. Rul. 81-225 (Situation 3), the interests in PIPs that support the Contracts' sub-accounts are available for purchase not only by a prospective purchaser of the Contract, but also by other members of the general public. Treating the Contract holders as the owners of interests in PIPs that support the Contracts' sub-accounts is consistent with Congress' intent to deny annuity or life insurance treatment for investments that are publicly available to investors.

Accordingly, we conclude that a Contract holder, rather than Insurer, is the owner of any interest in a Private Investment Partnership that is held as an asset of any unitized sub-account underlying a Contract. Thus, the earnings and/or gains from the interest in a Private Investment Partnership that is held as an asset of any unitized sub-account underlying a Contract is includible in the Contract holder's gross income under section 61(a).

Except as expressly provided herein, no opinion is expressed concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based upon information and representations submitted by Insurer 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 who requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

/S/
DONALD J. DREES, JR.
Senior Technician Reviewer
Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)