Office of Chief Counsel
Internal Revenue Service
Memorandum

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Program Manager
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LMSB:FS

from: Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)
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subject: Notification of Withdrawn Letter Ruling Request

LEGEND

Taxpayer =

Country 1 =

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 Proc. 2007-1, 2007-1 I.R.B. 1, 27, this is to notify you that Taxpayer has withdrawn a letter ruling request regarding the "investor control doctrine" and §§ 61 and 817 of the Internal revenue Code (the "Code") after we reached a conclusion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 (1) the Taxpayer and not the holder of a variable contract is the tax owner of assets held in a segregated asset account where the segregated asset account directly invests in assets available to the general public and

(2) the contemplated contracts meet the definition of variable contract within the meaning of 817(d) of the Code.

CONCLUSION

Where a segregated asset account directly invests in assets available to the general public, the policyholder and not the taxpayer is the owner of the assets in the segregated asset account. When the Taxpayer received notice of our adverse determination regarding the first ruling request, the taxpayer withdrew their letter ruling, which made it unnecessary to address the second issue.

FACTS

Taxpayer is a life insurance company incorporated in Country 1 using the accrual method of accounting. Taxpayer meets the definition of a life insurance company as defined in § 816(a) of the internal Revenue Code (the "Code"). Taxpayer has filed an election to be treated as a United States corporation for all purposes under § 953(d). Taxpayer proposes to create a segregated asset account for each policy it issues. The Taxpayer represents that all such contracts will be designed to comply with §§ 72, 817, 817A, 7702 and 7702A of the Code and the applicable regulations thereunder.

Each segregated asset account would be managed by an investment advisor retained by the Taxpayer. The holder of the policy linked to the segregated asset account would be able to nominate the investment advisor for the segregated asset account link to their policy (the nominated investment advisor cannot be related or subordinate to such policyholder) and the Taxpayer would generally accept such nomination. The investment decisions within the segregated asset account would be made by such investment advisor at their sole and unfettered discretion, however, the policyholder would be permitted to submit a questionnaire regarding investment horizons, investment goals, risk tolerance, risk profile, comfort with investments in different regions (i.e. Latin America, Eastern Europe, Far East; Western Europe, Australia), and comfort level with different types of investment vehicles (e.g. real estate, ADR's, partnerships, etc.). There would be no agreements, understandings or communications between the policy holder and the Taxpayer or the investment advisor regarding the investments in the segregated asset account other than the guidance provided in the questionnaire.

It is anticipated that the segregated asset accounts will directly invest in assets available to the general public.

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.

A long standing doctrine of taxation provides that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed--the actual benefit for which the tax is paid." *Corliss v. Bowers,* 281 U.S. 376 (1930). The incidence of taxation attributable to ownership of property is not shifted if the transferor continues to retain significant control over the property transferred, *Frank Lyon Company v. United States,* 435 U.S. 561 (1978); *Commissioner v. Sunnen,* 333 U.S. 591 (1948); *Helvering v. Clifford,* 309 U.S. 331 (1940), without regard to whether such control is exercised through specific retention of legal title, the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency. *Christoffersen v. United States,* 749 F.2d 513 (8th Cir. 1984), rev'g 578 F. Supp. 398 (N.D. Iowa 1984).

Rev. Rul. 77-85, 1977-1 C.B. 12, considers a situation in which the individual purchaser of a variable annuity contract retained the right to direct the custodian of the account supporting that variable annuity to sell, purchase, and exchange securities or other assets held in the custodial account. The purchaser also was able to exercise an owner's right to vote account securities either through the custodian or individually. The Service concluded that the purchaser possessed "significant incidents of ownership" over the assets held in the custodial account. The Service reasoned that if a purchaser of an "investment annuity" contract may select and control 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 included in the purchaser's gross income.

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 contract holder's savings and loan association. These amounts were then invested in the association's certificates of deposit for a term designated by the contract holder. 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. In the event of a withdrawal from a failing savings and loan association, the insurance company was required to deposit the withdrawn amounts in another federally insured savings and loan association. When the certificate of deposit expired, the insurance company was required to reinvest the proceeds in a certificate of deposit for the same duration if the duration would not extend beyond the annuity starting date. If reinvestment for the same duration would extend beyond the annuity starting date, then the insurance company was required to purchase a certificate of deposit with a duration not extending beyond the annuity starting date. If no such certificate of deposit was available, the insurance company was required to reinvest the proceeds in a passbook savings account. 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 certificates 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 contract holder 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 asset 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 contract holder 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. The ruling concludes that the contract holders 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.

> In Situations 1, 2, 3 and 4 the policyholder has investment control over the mutual fund shares and possesses sufficient other incidents of ownership to be considered the owner of the mutual fund shares for federal income tax purposes. In each of these situations, the 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 either directly (as in *Situations 1, 2, and 3*) or indirectly (as in *Situation 4*). The policyholder's position in each of these situations is substantially identical to what his or her position would have been had the mutual fund shares been purchased directly (or indirectly, as in *Situation 4*). Although a mutual fund's diversified portfolio of securities is controlled by the manager of the mutual fund and not by the policyholder, this does not distinguish these situations from Rev. Ruls. 77-85 and 80-274 because the mutual fund themselves are securities the incidents of ownership of which may be attributed to the policyholder in these situations. Prior to the annuity starting date *IC* is, in such circumstances, little more than a conduit between the policyholders and their mutual fund shares. Rev. Rul. 81-225.

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. Contract holders are free to allocate their purchase payments among the three funds and allocations made with respect to previous purchase payments may be changed by a policyholder at any time prior to the maturity date of the annuity contract. The ruling concludes that the contract holders' 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 contract holders to be treated as the owners of the mutual fund shares.

In Rev. Rul. 2003-92, 2003-2 C.B. 350, a life insurance company issues variable life insurance and annuity contracts that are funded by a segregated asset account. The segregated asset account is divided into 10 sub-accounts. Each sub-account invests in a partnership, none of which are publicly traded partnerships (as defined under section 7704). Each partnership has an investment manager that selects such partnership's specific investments. In addition, contract holders will not have any voting rights with respect to any partnership interests held by any of the sub-accounts. Each sub-account will meet the asset diversification test of section 1.817-5(b)(1) of the Income Tax Regulations at all times. In example 1, variable annuity contracts are funded by sub-accounts that invest in partnerships that are available to qualified purchasers and accredited investors in private placement offerings. In example 2, life insurance contracts are funded by sub-accounts that invest in partnerships that are available to qualified purchasers and accredited investors in private placement offerings. In example 3, both life insurance contracts and an annuity contracts are funded by sub-accounts that invest in partnerships that are only available through the purchase of an annuity contract, life insurance contract or other variable contracts from insurance companies. The ruling holds that the holder of a variable annuity or life insurance contract will be considered the owner, for federal income tax purposes, of the partnership interests that fund the variable contracts if interests in the partnerships are available for purchase by the general public. The ruling further holds that if the holder of a variable annuity is considered to be the owner of the partnership interests that fund the variable contracts, the contract holder must include interest, dividend or other income derived from the partnership interests in gross income in the year in which the income is earned. Rev. Rul. 81-225 is amplified and clarified.

In *Christoffersen*, the United States Court of Appeals for the Eighth Circuit considered the federal income tax consequences of the ownership of the assets supporting a segregated asset account. 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 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 Eighth Circuit held that, for federal income tax purposes, the taxpayers, not the issuing insurance company, owned the mutual fund shares that funded the variable annuity. The court concluded that the taxpayers "surrendered few of the rights of ownership or control over the assets of the sub-account," that supported the annuity contract. *Christoffersen,* 749 F.2d at 515. According to the court, "the payment of annuity premiums, management fees and the limitation of withdrawals to cash [did] not reflect a lack of ownership or control as the same requirements could be placed on traditional brokerage or management accounts." *Id.* At 515-516. Thus, the taxpayers were required to include in gross income any gains, dividends, or other income derived from the mutual fund shares.

Under Rev. Rul. 81-225, assets held directly by a segregated asset account that are available to the general public are owned by the policyholder for federal tax purposes. For this reason, we believe that the policyholder in the ruling request and not the Taxpayer would own the assets in the proposed segregated asset accounts for federal tax purposes.

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 (202) 622-3970 if you have any further questions.

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By: ______________________________

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