Internal Revenue Service

Number: **201027038**
Release Date: 7/9/2010

Index Number: 817.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:4
PLR-151475-09

Date:
March 31, 2010

Legend

Company X =

Company Y =

Parent =

Intermediate Parent =

Ultimate Parent =

Foreign Country A =

State B =

State C =

State D =

Year 1 =

Year 2 =

Dear

This is in response to your authorized representatives' submission dated November 18, 2009, requesting a ruling on the meaning of the term "State law or regulation" under § 817(d)(1) of the Internal Revenue Code of 1986.

FACTS

Company X was incorporated and licensed to conduct insurance business under Foreign Country A law. Company X's principal office is located in Foreign Country A. Company X does not maintain permanent offices in the United States. All of the stock of Company X is owned by Parent. Parent is a corporation organized under the laws of State B. All of the stock of Parent is owned by Intermediate Parent, a State C Corporation, which, in turn, is 100% owned by Ultimate Parent, a State D Corporation. Company X joins with Ultimate Parent in filing a consolidated federal income tax return.

Company Y was incorporated and licensed to conduct insurance business under Foreign Country A law. Company Y's principal office is located in Foreign Country A. Company Y does not maintain permanent offices in the United States. All of the stock of Y is owned by Company X. Company Y anticipates filing its initial federal income tax return by joining in Ultimate Parent's consolidated return for calendar Year 2.

In accordance with § 953(d), Company X has already filed its election statement and Company Y intends to file its election statement in Year 2, consistent with Rev. Proc. 2003-47, 2003-2 C.B. 55. Company X states that it qualifies as a life insurance company as defined in § 816 and subject to tax under § 801. Company Y states that it will qualify as a life insurance company as defined in § 816 and will be subject to tax under § 801 when it begins operations.

Company X issues and Company Y proposes to issue annuity contracts and life insurance contracts. Apart from the issue addressed in this request for rulings, each of the contracts otherwise meets the definition of a variable contract in § 817(d). Thus, the contracts that are annuity contracts provide for "the payment of annuities" and "the amounts paid in, or the amount paid out, reflect the investment return and the market value" of the separate accounts. Likewise, for contracts that are life insurance contracts, "the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and the market value" of the separate accounts.

Premiums paid for the contracts, less any applicable charges, are allocated to separate accounts. Company X's separate accounts are established pursuant to a private act

that it obtained in Year 1, which modifies Foreign Country A's law as it applies to Company X. As represented below, the legal effect of the private act is that assets credited to a separate account are not available to pay the amounts due to creditors whose claims do not relate to that separate account. Prior to issuing any contracts, Company Y will obtain its own private act that will have the same legal effect with respect to separate accounts it establishes.

The contracts are designed to comply with §§ 72, 817(h), 7702, and 7702A, as applicable. Company X has issued contracts since Year 1, whereas Company Y will begin issuing them in Year 2 or thereafter. The Company X and Company Y plan to issue contracts only to non-United States persons, but they may issue contracts to U.S. Persons in the future.

For purposes of this request for rulings, Company X and Company Y represent as follows:

(a) Company X has satisfied and Company Y will satisfy all requirements of § 953(d) and applicable procedures thereunder so that each company will be treated as a domestic corporation for United States tax purposes.

(b) Apart from the requirement that the separate accounts supporting the contracts be segregated from each company's general asset account "pursuant to State law or regulation," each of the contracts otherwise meets the definition of a "variable contract" in § 817(d).

(c) The legal effect of the private act pursuant to which the separate accounts are (or will be) established is that assets credited to a separate account are not available to pay the amounts due to creditors whose claims do not relate to that separate account.

(d) Generally, for purposes of Part I of subchapter L, the amount of the life insurance reserves for the contracts will be based on their net surrender values as provided in § 807(d)(1)(A), reflecting the values of the underlying separate account assets supporting the contracts.

RULING REQUESTED

For purposes of § 817(d)(1) of the Code, the separate accounts to which Company X allocated and Company Y will allocate all or part of the amounts received under the life and annuity contracts, which pursuant to Foreign Country A law, are segregated from the general asset accounts of the companies, will be treated as accounts that are segregated from the general asset accounts of the companies "pursuant to State law or regulation."

LAW AND ANALYSIS

Section 817(a) of the Code provides that with respect to variable contracts, increases and decreases in § 807(c) reserves attributable to the appreciation and deprecation in the value of the assets in the segregated asset account are disregarded for purposes of § 807(a) and (b).

Under § 817(b), the basis of each asset in a segregated asset account is increased or decreased by the amount of appreciation or deprecation, to the extent the reserves or other items referred to in § 817(a) are adjusted.

Section 817(c) provides that, for purposes of Part I of subchapter L, a life insurance company which issues variable contracts shall separately account for the various income, exclusion, deduction, asset, reserve, and other liability items attributable to such variable contracts.

Section 817(d) defines the term "variable contract," for purposes of Part I of subchapter L, as a contract that: (1) "… provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general assets of the company," (2) provides for the payment of annuities, is a life insurance contract, or provides for funding of insurance on retired lives, as described in § 807(c)(6), and (3) in the case of an annuity contract, the amounts paid in, or the amounts paid out, reflect the investment return and market value of the segregated asset account, or in the case of a life insurance contract, the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and market value of the segregate asset account, or in the case of funds held under a contract described in § 817(d)(2)(C), the amounts paid in, or the amounts paid out, reflect the investment return and the market value of the segregated asset account.

Section 817(h)(1) of the Code provides that, for purposes of subchapter L, § 72 (relating to annuities), and § 7702(a) (relating to the definition of a life insurance contract), a variable contract (other than a pension contract) which is otherwise described in § 817 and which is based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract for any period (and any subsequent period) for which investments made by such account are not, in accordance with regulations prescribed by the Secretary, adequately diversified.

Section 7701 of the Code provides:

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof - …

(9) United States. The term "United States" when used in a geographic sense includes only the States and the District of Columbia.

(10) State. The term “State” shall be construed to include the District of Columbia, where such construction is needed to carry out the provisions of this title.

Section 953(d) provides:

1) In general. If –

> (A) a foreign corporation is a controlled foreign corporation (as defined in § 957(a) by substituting “25 percent or more” for “more than 50 percent” and by using the definition of United States shareholder under § 953(c)(1)(A)),
>
> (B) such foreign corporation would qualify under Part I or Part II of subchapter L for the taxable year as if it were a domestic corporation,
>
> (C) such foreign corporation meets such requirements as the Secretary shall prescribe to ensure that the taxes imposed imposed on it by Chapter 1 of the Code are paid, and
>
> (D) such foreign corporation makes an election to have this paragraph apply and waives all benefits to such corporation granted by the United States under any treaty,

for purposes of this title, such corporation shall be treated as a domestic corporation.[1]

Section 953(e)(5) provides that for purposes of § 953 and § 954, the determination of whether a contract issued by a controlled foreign corporation or a qualified business unit (within the meaning of § 989(a)) is a life insurance contract or an annuity contract shall be made without regard to §§ 72(s), 101(f), 817(h) and 7702 if –

> (A) such contract is regulated as a life insurance or annuity contract by the corporation’s or unit’s home country, and
>
> (B) no policyholder, insured, annuitant, or beneficiary with respect to the contract is a United States person.

The issue presented in this case is whether the Company X’s and Company Y’s (Companies’) separate account products are “variable contracts,” as defined in § 817(d)(1) of the Code. The difficulty in this case lies in § 817(d)(1) which requires a

[1] Section 953(d)(3) provides an exception to the electing corporation’s treatment as a domestic corporation. It provides that, if any corporation treated as a domestic corporation under § 953(d) is treated as a member of an affiliated group for purposes of chapter 6 (relating to consolidated returns), any loss of such corporation shall be treated as a dual consolidated loss for purposes of § 1503(d) without regard to paragraph (2)(B) thereof.

variable contract to provide "for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general assets of the companies. (Emphasis added.)" The term "State" is defined in § 7701(a)(9)[2] and (10) which are set forth above. The implication from these paragraphs of § 7701(a) is that the term "State" means that one of the 50 states or the District of Columbia.

This implication is, however, subject to the flush language appearing at the beginning of § 7701(a): "When used in this title, where not otherwise directly expressed or manifestly incompatible with the intent thereof." Section 817(d)(1) does not contain a distinctly expressed meaning for "State," other than one of the 50 states or the District of Columbia. Neither does the legislative history underlying this Code provision. Thus, our task is to determine whether the § 7701(a)(10) meaning of "State – one of the 50 states or the District of Columbia - is "manifestly incompatible with the intent of [federal tax law]" in the context of § 817(d)(1) and a foreign taxpayer that has elected to come within the provisions of § 953(d).

In this case, the Companies have elected or will elect under § 953(d) to be treated for purposes of the federal tax law as a domestic corporation. If the Companies' separate account contracts are not treated as variable contracts because "State" is given a restrictive meaning, Companies and any of their U.S. policyholders will in the following respects be treated differently from a situation involving a domestic life insurance company.

Section 817(c) requires that a life insurance company that issues variable contracts separately account from the "various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to such variable contracts." If the Companies' contracts are not variable contracts, even though they have separate accounts protected from the Companies' general creditors, the policyholders and the Companies will not receive separate account treatment. This would be a major difference between the treatment of a domestic life insurance company and § 953(d) electing company issuing a similar product.

This disparity of treatment is readily seen if we focus on the treatment of the reserves for the Companies and a domestic company's separate account products. First, assume that the Companies' reserves for its separate accounts do not receive the treatment mandated by § 817(a)-(c) for variable contracts. The reserves estabished by the Companies for their life insurance contracts should qualify as life insurance reserves under § 807. The Companies will be allowed a deduction for increases in the reserve under §§ 805(a)(2) and 807(b) and will be required to include deceases in reserves in gross income under §§ 803(a)(3) and 807(a). The amount of the reserves will be

---

[2] Section 7701(a)(9) is actually a definition of the term "United States." Section 7701(a)(9)'s definition of "United States" helps place § 7701(a)(10)'s definition of "State" in context.

established under § 807(d)(1) as the greater of the net surrender value of the contract or the reserve established under § 807(d)(2).

If the value of the underlying assets held in the separate account increases, the cash surrender value of the contract will increase. The Companies will be entitled to a deduction for the increase in the reserve. No adjustment will be made to the basis of the assets to reflect the increase in market value. When the assets are sold, the Companies will recognize a capital gain. Accordingly, the Companies will recognize a current deduction when the value of the assets increases and a future capital gain when the assets are disposed. In contrast, life insurance companies that are subject to § 817(a) would not recognize a current deduction for the increase in reserve attributable to the increase in the value of the assets and, due to the basis adjustment provisions of § 817(d), would not recognize any gain on the disposition of the assets.

Conversely, if the value of the assets held in the separate account decreases, the cash surrender value of the contract will decrease. If § 817(a) does not apply to the Companies, the Companies unlike domestic life insurance companies subject to the provisions of § 817(a), will be required to include the decrease in reserves in gross income. No adjustment will be made to the basis of the assets to reflect the decrease in market value. When the assets are sold, the companies will recognize capital losses. Accordingly, the Companies will recognize current ordinary income when the value of the assets decreases and a future capital loss when the assets are disposed.

If the Companies' separate account products are not treated as variable contracts, its contracts will receive different treatment from domestic contracts under § 817(h) and the regulations thereunder prescribing diversification rules. The diversification rules under § 817(h) only apply to variable contracts (other than pension plan contracts). Thus, if the Companies' separate account products are not variable contracts, the diversification rules would be inapplicable to them.

The Code's sanction for not meeting the diversification requirements is severe. Section 817(h) provides that, for purposes of subchapter L, § 72, and § 7702(a), a variable contract that does not meet the diversification requirements shall not be treated as an annuity, endowment, or life insurance contract for any period (and any subsequent period) for which the investments made by the segregate asset account are not adequately diversified under regulations prescribed by the Secretary.

The diversification rule of § 817(h) was added to the Code in the Tax Reform Act of 1984. The Senate Finance Committee in 1 S. Prt. 98-169, 98th Cong., 2d Sess. 546 (1984), explained the purposes of new § 817(h) as follows:

> The bill adopts a provision that grants the Secretary of the Treasury regulatory authority to prescribe diversification standards for investments of segregated assets accounts underlying variable contracts. The diversification

> requirement is provided in order to discourage the use of tax-preferred variable annuities and variable life insurance primarily as investment vehicles. The committee believes that, by limiting a customer's ability to select specific investments underlying a variable contract, the bill will help ensure that a customer's primary motivation in purchasing the contract is more likely to be the traditional economic protections provided by annuities and life insurance.

If the Companies' separate account products are denied variable account status, then, as stated above, the diversification rules of § 817(h) and the regulations thereunder will not apply to the Companies' separate account products. The result will be that the Companies' separate account products will be recognized as life insurance contracts without meeting the diversification rules of the Code and regulations. Further, Congress' stated purpose in enacting the diversification requirements, to discourage the use of tax-preferred variable annuity and variable life insurance primarily as investment vehicles, would be subverted.[3]

Thus, another anomaly will exist if the Companies' separate account products are denied variable account status. A foreign insurance company that elected to be treated as a domestic insurance company under § 953(d) would be able to issue separate account products that do not meet the diversification rules, but nevertheless qualify as life, endowment, or annuity contracts. The inside buildup on the electing foreign company's nondiversified contracts would not be subject to current taxation, while the inside buildup on nondiversified contracts issued by domestic companies would be subject to current taxation. This is a dubious result, which does not treat the electing § 953(d) company the same as a domestic company. The electing foreign company is given better treatment and their policyholders given less protection against what Congress saw as an abusive use of separate account products.

The anomalies that we have discussed above with respect to reserves for separate account products and with respect to the diversification standards exist because § 953(d) was added to the Code later than § 817, which was added to the Code in 1984.[4] We conclude, in light of the anomalies whose existence we have demonstrated, the statutory scheme of § 953(d), permitting an electing foreign insurance company to be treated as a domestic insurance company for all purposes (except with respect to dual consolidated losses) is manifestly incompatible with giving "State" a restrictive meaning in § 817(d)(1), and denying variable contract status to Companies' separate account products. We conclude that, in the context of electing § 953(d) companies, "State," in § 817(d)(1) should be interpreted broadly enough to include the jurisdiction

[3] Cf. United States v. Bardina, 365 F. Supp. 459 (S.D. N.Y. 1973), dealing with the six year statute of limitations, in which the court found reasons, including legislative history, not to use § 7701(a)(9)'s definition of "United States," and instead used a broader definition.
[4] Section 953(d) was added to the Code by section 6135(a) of the Technical and Miscellaneous Revenue Act of 1988, effective for tax years beginning after December 31, 1987.

exercising statutory or regulatory authority over the companies' separate accounts. In this case, that is Foreign Country A.

Another provision that further supports our conclusion is § 953(e)(5), set forth above. Section 953(e) was added to the Code in 1998 by section 1005(b)(1)(B) of the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277. If the foreign controlled corporation's separate account products are regulated as life insurance or annuity contracts by the home country and no policyholder, insured annuitant, or beneficiary with respect to the contract is a United States person, the reference to § 817(h) is given a restrictive meaning.

CONCLUSION

For purposes of § 817(d)(1) of the Code, the separate accounts to which Company X allocated and Company Y will allocate all or part of the amounts received under life insurance and annuity contracts issued by the Companies, which pursuant to Foreign Country A law, are segregated from the general asset accounts of the Companies, will be treated as accounts that are segregated from the general asset accounts of the Companies, "pursuant to State law or regulation."

CAVEATS

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 reference in this ruling letter.

No opinion is expressed or implied concerning any foreign insurance company that has not made an election to be treated as a domestic company under § 953(d)

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the authorization on file with this office, copies of this letter are being sent to your authorized representatives.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer 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.

Sincerely,

/S/

DONALD J. DREES, JR.
Senior Technician Reviewer
(Financial Institutions & Products)