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Date:
October 25, 2013

Company	=	
Company A	=	
Parent	=	
Foreign Country	=	
Year 1	=	

Dear :

This ruling is in response to your authorized representatives' submission dated April 24, 2013, requesting a ruling on the meaning of the term "State law or regulation" under § 817(d)(1) of the Internal Revenue Code.

FACTS

Company is a life insurance company organized under the laws of Foreign Country. Company's principal office is located in Foreign Country. Company does not maintain a permanent office in the United States. Company is wholly owned by Company A, which, in turn, is a controlled foreign corporation of Parent, a U.S. corporation.

Company files a U.S. tax return on a calendar year basis pursuant to the election it filed under § 953(d) to be treated as a domestic corporation for U.S. tax purposes. Company represents that it is treated as a domestic corporation for U.S. tax purposes pursuant to § 953(d).

Company represents that it qualifies as a life insurance company as defined in § 816 and, as such, is subject to tax under § 801.

Company issues annuity contracts and life insurance contracts ("Contracts") that provide benefits based on the value of assets Company holds in separate accounts it establishes under Foreign Country laws (the "Separate Accounts"). Company has issued Contracts since Year 1. Company issues the Contracts exclusively to U.S. persons, but may issue them to non-U.S. persons in the future.

Company represents that, apart from the issue addressed in this request for a ruling, 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. *See* § 817(d)(2)(A), (3)(A). 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. *See* § 817(d)(2)(B), (3)(B).

Premiums paid for the Contracts, less any applicable charges, are allocated to the Separate Accounts. Company's Separate Accounts are established pursuant to a "Private Act" which modifies Foreign Country law as it applies to Company. Company represents that 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.

The Contracts are designed to comply with §§ 72, 817(h), 7702, and 7702A, as applicable. Company represents that generally, for purposes of part I of subchapter L of chapter 1, subtitle A of the Code, 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), the Separate Accounts to which Company allocates all or part of the amounts received under the Contracts and that, pursuant to Foreign Country law, are segregated from the general asset accounts of Company, will be treated as accounts that are segregated from the general asset accounts of Company "pursuant to State law or regulation."

LAW

Variable Contracts in General

Section 817(d) defines the term "variable contract," for purposes of part I of subchapter L, as a contract:

(1) that 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 asset accounts of the company,

(2) that provides for the payment of annuities, is a life insurance contract, or provides for funding of insurance on retired lives as described in section 807(c)(6), and

(3) under which –

(A) in the case of an annuity contract, the amounts paid in, or the amount paid out, reflect the investment return and the market value of the segregated asset account,

(B) 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 the market value of the segregated asset account, or

(C) in the case of funds held under a contract funding insurance on retired lives, the amounts paid in, or the amounts paid out, reflect the investment return and the market value of the segregated asset account.

In addition, § 817(h)(1) of the Code provides that a variable contract (other than a pension contract) based on a segregated asset account is not treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified.

Definition of "State"

Section 7701(a) sets forth various definitions for terms and phrases used in the Code that apply "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof." Of particular relevance here, § 7701(a)(9) states that "[t]he term 'United States' when used in a geographical sense includes only the States and the District of Columbia." Section 7701(a)(10), in turn, provides that "[t]he term 'State' shall be construed to include the District of Columbia, where such construction is needed to carry out provisions of this title."

Life Insurance Companies that Issue Variable Contracts

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

Section 817(a) provides that, with respect to variable contracts, increases and decreases in § 807(c) reserves attributable to the appreciation and depreciation 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 depreciation, respectively, to the extent the reserves or other items referred to in § 817(a) are adjusted.

Foreign Insurance Company Election to be Treated as a Domestic Corporation

In general, § 953(d) permits a foreign insurance company to make an election to be treated as a domestic corporation for U.S. income tax purposes. Such treatment is permitted if the following conditions are met:

(1) the foreign corporation must be a controlled foreign corporation as defined in section 957(a) by substituting "25 percent or more" for "more than 50 percent" and by using the definition of United States shareholder under section 953(c)(1)(A),

(2) the foreign corporation would qualify under part I or II of subchapter L of the Code for the taxable year if it were a domestic corporation,

(3) the foreign corporation must meet such requirements as the Secretary shall prescribe to ensure that the taxes imposed on it by chapter 1 of the Code are paid, and

(4) the foreign corporation must make an election to have section 953(d)(1) apply and waive all benefits to such corporation granted by the United States under any treaty.[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 –

(1) such contract is regulated as a life insurance or annuity contract by the corporation's or unit's home country, and

(2) no policyholder, insured, annuitant, or beneficiary with respect to the contract is a United States person.

ANALYSIS

[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 of subtitle A of the Code (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.

The ultimate issue in this ruling is whether the Contracts are "variable contracts" within the meaning of § 817(d). Company has represented that the Contracts meet the requirements to qualify as variable contracts, other than the requirement that they provide for the allocation of amounts to an account which, "pursuant to State law or regulation," is segregated from the general asset accounts of Company. A question exists whether the "pursuant to State law or regulation" requirement is met because the Separate Accounts are established pursuant to Foreign Country law, not the law of a domestic State.

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 one of the 50 states or the District of Columbia. This implication, however, is subject to the flush language appearing at the beginning of § 7701(a). Pursuant to that language, the prescribed definition of "State" applies only "where not otherwise directly expressed or manifestly incompatible with the intent" of the Code provision in which the term is used.

Section 817(d)(1) does not contain a directly 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, it must be determined 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 § 817(d)(1) in the context of a foreign taxpayer that has elected to come within the provisions of § 953(d).[3]

In this case, Company filed an election under § 953(d) to be treated for purposes of the federal tax law as a domestic corporation. As a domestic corporation, Company also qualifies for treatment as a life insurance company under subchapter L. If, however, the Contracts are not treated as variable contracts because "State" is given a restrictive meaning, then Company and any of its U.S. policyholders will in the following respects be treated differently from a situation involving a domestic life insurance company.

[2] Section 7701(a)(9) is a definition of the term "United States." Section 7701(a)(9)'s definition of "United States" helps place section 7701(a)(10)'s definition of "State" in context.
[3] *See 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 section 7701(a)(9)'s definition of "United States," and instead used a broader definition.

Section 817(c) requires that a life insurance company that issues variable contracts separately account for the “various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to such variable contracts.” If the Contracts are not variable contracts, even though they are based on Separate Accounts protected from Company’s general creditors, Company will not receive separate accounting treatment. This would be a major difference between the treatment of a domestic life insurance company issuing a similar product and Company, a § 953(d) electing company.

The disparity in treatment is readily seen if one focuses on the treatment of the reserves for Company’s and a domestic company’s separate account products. First, assume that Company’s reserves for its Separate Accounts do not receive the treatment mandated by § 817(a)-(c) for variable contracts. The reserves that Company establishes for the Contracts should qualify as life insurance reserves under § 807. Company will be allowed a deduction for increases in the reserves under §§ 805(a)(2) and 807(b) and will be required to include decreases in reserves in gross income under §§ 803(a)(3) and 807(a). The amount of the reserves will be established under § 807(d)(1) as the greater of the net surrender value of the Contract or the reserve established under § 807(d)(2). Company has represented that, generally, for purposes of part I of subchapter L of the Code, 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.

If the value of assets held in the Separate Accounts increases, the cash surrender value of the Contracts will increase. Company will be entitled to a deduction against ordinary income 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, Company will recognize a capital gain. Accordingly, absent variable contract treatment under § 817(d), Company generally would recognize a current deduction against ordinary income when the value of the assets increases and a future capital gain when it disposes of the assets. In contrast, life insurance companies that issue variable contracts and that are subject to § 817(a)-(c) would not recognize a current deduction for the increase in the reserve attributable to the increase in value of the separate account assets and, due to the basis adjustment provisions of § 817(b), would not recognize any gain on the disposition of the assets.

Conversely, if the value of assets held in the Separate Account decreases, the cash surrender value of the Contracts will decrease. If § 817(a)-(c) does not apply to Company, then it, unlike a domestic life insurance company subject to § 817(a)-(c), will be required to include the decrease in reserves in gross income as ordinary income. No adjustment will be made to the basis of the assets to reflect the decrease in market value. When the assets are sold, Company will recognize a capital loss. Accordingly, Company will recognize current ordinary income when the value of the assets decreases and a future capital loss when it disposes of the assets.

In addition, if the Contracts are not treated as variable contracts, the owners of the Contracts will receive different treatment from owners of domestic contracts under § 817(h) and the regulations thereunder prescribing diversification rules. The diversification rules under § 817(h) apply only to variable contracts (other than pension plan contracts). Thus, if the Contracts are not variable contracts, the diversification rules will not apply to them.

The Code's sanction for not meeting the diversification requirements is severe. Section 817(h)(1) provides that, for purposes of subchapter L of the Code, § 72, and § 7702(a), a variable contract that does not meet the diversification requirements is not treated as an annuity, endowment, or life insurance contract for any period (and any subsequent period) for which the investments made by the segregated asset account are not adequately diversified under regulations prescribed by the Secretary.

The diversification rule of § 817(h) was added to the Code by the Tax Reform Act of 1984. The Senate Finance Committee explained the purpose 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 asset 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.

S. PRT. NO. 98-169 at 546 (1984). If the Contracts are not treated as variable contracts, then, as stated above, the diversification rules of § 817(h) and the regulations thereunder will not apply to them. The result would be that, absent any other defect (such as a violation of the "investor control" principles of Rev. Rul. 2003-91, 2003-1 C.B. 347, and related rulings), the Contracts would be recognized as life insurance or annuity contracts without having to meet the diversification rules of the Code and regulations. Further, the stated purpose of Congress in enacting the diversification requirements, that is, to discourage the use of tax-preferred variable annuities and variable life insurance contracts as primarily investment vehicles, would be subverted.

In addition to the reserve anomaly described above, another anomaly will exist if the Contracts are not treated as variable contracts: 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 insurance, 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 against what Congress viewed as an abusive use of separate account products.

The statutory structure also supports a broad interpretation of "State." Section 953(d) was added to the Code in 1988, after §§ 817(d) and (h) were added in 1984. This suggests that, in 1984, when Congress used the term "State" in § 817(d), it did not anticipate the potential anomalies, discussed above, that § 953(d) might create with respect to reserves for separate account products and with respect to the diversification standards if the term "State" in § 817(d) was given a restrictive meaning.

In light of these anomalies and the statutory scheme of § 953(d), we conclude that interpreting "State" in § 817(d)(1) as meaning one of the 50 states or the District of Columbia is "manifestly incompatible with the intent" of § 817(d)(1) in the context of electing § 953(d) companies like Company involved here. Accordingly, in the context of electing § 953(d) companies, "State" in § 817(d)(1) should be interpreted broadly enough to include the jurisdiction exercising statutory or regulatory authority over the company's separate accounts. In this case, it is Foreign Country.

CONCLUSION

For purposes of § 817(d)(1), the Separate Accounts to which Company allocates all or part of the amounts received under Contracts and that, pursuant to Foreign Country law, are segregated from the general asset accounts of Company, will be treated as accounts that are segregated from the general asset accounts of Company "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,

SARAH E. LASHLEY
Assistant to the Branch Chief
Branch 4
Office of the Associate Chief Counsel
(Financial Institutions & Products)

cc: