Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Refer Reply To:
CC:FIP:4-PLR-102179-02
Date:
August 27, 2002

Taxpayer =

Company X =

Account 1 =

Account 2 =

Dear :

This is in response to your representatives' letter dated October 16, 2001, requesting rulings concerning annuity contracts issued by Taxpayer. Additional information was submitted in letters dated June 12, 2002 and August 9, 2002.

FACTS

Taxpayer is a life insurance company within the meaning of section 816(a) of the Internal Revenue Code and is taxable under section 801. Taxpayer intends to issue annuity contracts ("Contracts") to certain tax-exempt organizations, such as universities and private foundations. Taxpayer has established pursuant to state law a number of separate accounts, including Accounts 1 and 2 (the "Separate Accounts"), that fund the Contracts. Gains or losses, realized or unrealized, on assets held by a Separate Account will be credited or charged without regard to any other income, gains, or losses of Taxpayer. Taxpayer is not a trustee as to the amounts included in the Separate Accounts. Under no circumstances will deposits, income, gains, or losses to a Separate Account be credited or charged to Taxpayer's general account.

Additionally, no amounts will be transferred from Taxpayer's general account to a Separate Account.

The assets of Account 1 are invested solely in real estate, and the assets of Account 2 are invested in money market funds. Investments in the Separate Accounts are available only through ownership of an annuity contract issued by Taxpayer. The general public cann0ot invest directly in a Separate Account. Taxpayer represents that the Separate Accounts will be adequately diversified within the meaning of section 817(h) and the regulations thereunder.

Taxpayer has the right in its sole discretion, based on investment advice received from company X, to invest and reinvest amounts allocated to the Separate Accounts. A Contract owner cannot select or identify particular investments to be made, and a Contract owner has no right to have the investment objective of the Separate Accounts changed. A Contract owner has no right or opportunity to influence, determine, specify or otherwise control the decision to buy, sell, retain, or manage any specific investment, group of investments, or the account in general. There is no prearrangement, plan, contract, or agreement between a Contract owner and Taxpayer or company X regarding the investments in the Separate Accounts.

At any time prior to the death or change of the primary annuitant, a Contract owner may direct Taxpayer to provide a lump-sum payment or payment of annuities with respect to the amounts held under the Contract. The purchase price of each annuity will be determined from the annuity purchase rate schedule set forth in the Contract. For each annuity, the total amount payable can be determined when annuity payments begin and amounts are payable in periodic installments at regular intervals over a period of more than one full year from the date that payments begin, and the total amount payable is determinable, directly or indirectly, as of the date the payments begin.

Under the Contracts, the amounts paid out reflect the investment return and market value of the segregated accounts. Thus, Contract owners participate in the favorable and unfavorable market performance of the segregated accounts. Taxpayer will separately account for various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to the Contracts.

The Contracts provide for required distributions upon the death of the primary annuitant. In the event the primary annuitant dies before the date annuity payments are due to begin, all amounts will be liquidated and distributed within five years following the primary annuitant's death. In the event the primary annuitant dies on or after the date the payments have begun but have not yet been completed, distributions

of the remaining amounts payable must be made at least as rapidly as the rate that was being used at the date of death.

LAW AND ANALYSIS

(1) Section 817 provides special rules for variable contracts with reserves based on segregated asset accounts.

Section 817(a) provides that, for the purposes of calculating inclusions in and deductions from a life insurance company's income under sections 807(a) and (b), adjustments are made to the sum of the items described in section 807(c) taken into account with respect to variable contracts. Section 807(c) lists the reserves allowed life insurance companies. The adjustment rules of section 817(a) provide that, as of the close of the taxable year, the reserves for variable contracts are adjusted by subtracting therefrom an amount equal to the sum of the amounts added from time to time (for the taxable year) to the reserves separately accounted for in accordance with section 817(c) by reason of appreciation in value of assets (whether or not the assets have been disposed of). It further provides that the reserves for variable contracts shall be adjusted by adding thereto an amount equal to the sum of the amounts subtracted from time to time (for the taxable year) from such reserves by reason of depreciation in value of assets (whether or not the assets have been disposed of).

Acting concomitantly with the reserve adjustment rules of section 817(a) are the basis adjustment rules of section 817(b). They provide that in the case of variable contracts, the basis of each asset in a segregated asset account shall (in addition to all other adjustments to basis) be increased by the amount of any appreciation in value and decreased by the amount of any depreciation in value, to the extent such appreciation and depreciation are from time to time reflected in the increases and decreases in reserves or other items referred to in section 817(a) with respect to such contracts. The effect of these rules is to prevent gains and losses resulting from appreciation or depreciation in the value of a segregated asset account's assets (occurring while the assets were in the account) from being recognized on the assets' subsequent sale.

Section 817(c) of the Code requires life insurance companies that issue variable contracts to "separately account for various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to such variable contracts."

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(d)(1) and (2). 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. Section 817(d)(3)(A). If a contract ceases to reflect current investment return and current market value, it will not be considered a variable contract after such cessation. Section 817(d).

Amounts received under the Contract are allocated to a Separate Account, which is segregated from the Taxpayer's general asset account pursuant to state law. Therefore, the Contracts meet the requirements set forth in section 817(d)(1).

Because the Contracts are not life insurance contracts, they must provide for the payment of annuities. See section 817(d)(2)(A). As section 817 does not define the phrase "provides for the payment of annuities," it is necessary to look to section 1.72-2(b)(1) and (2) of the Income Tax Regulations, which relate to the amounts received under an annuity contract as "amounts received as an annuity." Section 1.72-2(b)(2) provides that amounts are considered to be "amounts received as an annuity" only if they are received on or after the "annuity starting date" as that term is defined in section 1.72-4(b); they are payable in periodic installments at regular intervals over a period of more than one full year from the annuity starting date; and with an exception not here relevant, the total amount payable is determinable as of the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both. See also section 72(j) (interest payments received under an agreement to pay interest on any amount will be included in gross income, and thus will not be subject to the exclusion ratio applicable to amounts received as an annuity).

The facts, as stated above, indicate that the amounts under the Contracts are not held under an agreement to pay interest thereon and are payable in periodic installments at regular intervals over a period of more than one full year from the date that payments begin and that the total amount payable is determinable, directly or indirectly, as of the date the payments begin. Therefore, the Contracts meet the requirement of section 817(d)(2)(A) that it provide for the payment of annuities.

Section 72(u)(1)(A) provides that an annuity contract that is held by a person who is not a natural person will not be treated as an annuity contract for purposes of subtitle A of the Code (other than for purposes of subchapter L). Although the Contracts are held by persons who are not natural persons, the Contracts are annuity contracts for purposes of subchapter L of the Code, which includes section 817(d). See section 72(u)(1)(A). In view of the Contracts' status as annuity contracts under subchapter L, the tax treatment of a Contract-holder under section 72(u)(1)(A) does not preclude the Contract from satisfying the requirements of section 817(d)(2)(A) for purposes of determining Taxpayer's income.

In order to be a variable contract, a Contract must also satisfy the requirements of section 817(d)(3). In the case of an annuity contract, including a contract described in section 72 (u)(1), section 817(d)(3) requires that amounts paid in or the amounts paid out reflect the investment return and the market value of the segregated asset account. Under the Contracts, the amounts paid out reflect the investment return and market value of the segregated account.

Accordingly, based on the facts and representations set forth above, the Contracts satisfy the requirements of section 817(d)(1)-(3), and are thus “variable contracts,” as that term is defined in section 817(d).

(2) 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(d)(1) and (2). 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. Section 817(d)(3)(A).

If a policy otherwise satisfies the definition of a variable contract under section 817 and the regulations thereunder, that policy will be a variable contract under section 817 irrespective of whether a variable contract funded by the same separate accounts is issued to tax exempt organizations.

Thus, we conclude that issuance of the Contracts to tax-exempt organizations will not prevent other contracts funded by the Separate Accounts from constituting variable contracts under section 817 if such other contracts otherwise satisfy the definition of variable contracts under the Internal Revenue Code and Income Tax Regulations.

(3) 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.

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 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 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 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 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 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 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 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 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 considered the issue of who owns the assets underlying 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 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 which 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.

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:

> 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.

Taxpayer owns the assets held in the Separate Accounts because the Contract owner does not have control over the investments that fund the Contract and because the investments in the Separate Accounts are available only through ownership of an annuity contract issued by Taxpayer. Taxpayer alone (with advice from company X) has complete control to acquire and dispose of a Separate Account's investment assets. A Contract owner cannot select a Separate Account's particular investments, and a Contract owner has no right to have the investment objective of the Separate Accounts changed. There is no prearrangement, plan, contract, or agreement between a Contract owner and Taxpayer or company X regarding the investments in the Separate Accounts. Taxpayer does not act as a mere conduit through which a Contract owner makes investments.

Accordingly, we conclude that Taxpayer rather than the Contract owner is the owner of assets held in the Separate Accounts, and income, gain, or loss with regard to those assets is includible in the computation of Taxpayer's life insurance company taxable income.

CONCLUSIONS

(1) The Contracts issued by Taxpayer are variable contracts within the meaning of section 817(d).

(2) Issuance of the Contracts to tax-exempt organizations will not prevent other contracts funded by the Separate Accounts from constituting variable contracts under section 817 if such other contracts otherwise satisfy the definition of variable contracts under section 817 and the regulations thereunder.

(3) For federal income tax purposes, Taxpayer, rather than Contract owner, is the owner of assets funding the Separate Accounts.

No opinion is expressed as to the tax treatment of the transaction under the provisions of any other section of the Code or regulations, such as section 72, or to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above ruling.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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 yours,

/S/

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