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Department of the Treasury
Washington, DC 20224

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Date:
October 05, 2006

In Re:

Taxpayer =

Account 1 =

Account 2 =

Fund 1 =

Fund 2 =

Dear :

This is in response to your letter dated June 5, 2006, requesting rulings concerning annuity contracts issued by Taxpayer. Additional information was submitted on August 15, 2006 and August 23, 2006.

FACTS

According to the information provided by the Taxpayer:

Taxpayer is a life insurance company within the meaning of section 816(a) of the Internal Revenue Code ("Code") and is taxable under section 801. Taxpayer intends to make available for sale, to university endowments, private foundations and other organizations exempt from tax under 501(c) of the Code, group variable annuity contracts ("Contracts"). The Contracts will initially be funded by two segregated asset accounts, Account 1 and Account 2 (the "Accounts"), which have been established pursuant to state law. Participants in Account 1 will participate in the investment results

of the account in proportion to their units in Account 1. Participants in Account 2 will participate in the investment results of the account in proportion to their units in Account 2. Taxpayer represents that amounts received under the Contract are allocated to an Account, which is segregated from the Taxpayer's general asset account pursuant to state law.

Fund 1, a limited partnership, will invest primarily in undeveloped real estate assets in the United States. Account 1 will be invested in Fund 1. Fund 2, a regulated investment company, will be invested in short term fixed income obligations and cash equivalents. As an initial matter, all amounts allocated to Account 2 will be invested in Fund 2 (together with Fund 1, the “Funds”).

Each of the Funds will have the right in its sole discretion to invest and reinvest amounts invested in such Fund. Investment in the Funds will be restricted to insurance company segregated asset accounts. Investments in the Funds are available only through ownership of a Contract and other variable annuity contracts or variable life insurance policies issued by Taxpayer or other insurance companies. The general public cannot invest directly in the Accounts or in the underlying assets of the Accounts. The Accounts will, at all times, be adequately diversified within the meaning of section 817(h) and the regulations thereunder.

A contract owner can allocate and reallocate the distribution of amounts held under the contracts. 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 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 Accounts in general. There is no prearrangement, plan, contract, or agreement between any of the Contract owner, Fund 1, Fund 2 or the Taxpayer regarding the investments of the Funds.

Gains or losses, realized or unrealized, on assets held by an 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 Accounts. Under no circumstances will deposits, income, gains, or losses to an Account be credited or charged to Taxpayer's general account. Additionally, no amounts will be transferred from Taxpayer's general account to an Account.

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 taxpayer guarantees the annuity purchase rate set forth in the Contract. For each annuity, the total amount payable can be determined when annuity payments begin. The amounts under the Contract are not held under and agreement to pay interest thereon. Annuities are payable to the Contract owner or to persons identified by the Owner. Annuity payments options include an annuity for a fixed period, life annuities and joint survivor annuities. Annuity 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 in proportion to units credited to their policy. 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

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

Section 817(d) defines a "variable contract" as a contract:

(1) which 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;
(2) which provides for the payment of annuities or otherwise meets the requirements of section 817(d)(2); and
(3) under which, 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.

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).

The Contracts must provide for the payment of annuities. See section 817(d)(2)(A). 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).

In the case of an annuity contract, 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.

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 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.

Rev. Rul. 2003-91, 2003-2 C.B. 347 addresses whether the holder of a variable contract will be considered the owner of the assets that fund the variable contract for federal income tax purposes and whether the income earned on those assets will be included in the income of the holder in the year in which such income is earned. The ruling postulates that an insurance company issues variable life and variable annuity contracts, which are funded from a segregated asset account. The segregated asset account is divided into 12 sub-accounts. The issuing insurance company can increase or decrease the number of sub-accounts at any time, but there will never be more than 20 sub-accounts available under the contracts. Each sub-account offers a different investment strategy. Interests in the sub-accounts are available solely through the purchase of a variable contract. The investment activities of each sub-account are managed by an independent investment advisor. There is no arrangement, plan, contract, or agreement between the contract holder and the issuing insurance company or between the contract holder and the independent investment advisor regarding the availability of a particular sub-account, the investment strategy of any sub-account, or the assets to be held by a particular sub-account. Other than a contract holder's right to allocate premiums and transfer funds among the available sub-accounts, all investment decisions concerning the sub-accounts are made by the issuing insurance company or the independent investment advisor in their sole and absolute discretion. Specifically, contract holders cannot select or recommend particular investments or investment strategies. Moreover, contract holders cannot communicate directly or indirectly with any investment officer of IC or its affiliates or with Advisor regarding the selection, quality, or rate of return of any specific investment or group of investments held in a Sub-account. A contract holder has no legal, equitable, direct, or indirect interest in any of the assets held by a sub-account but has only a contractual claim against the issuing insurance company to collect cash in the form of death benefits or cash surrender values under the contract. The Service concludes that based on all the facts and

circumstances, the contract holder does not have direct or indirect control over the separate account or any sub-account asset, and therefore the contract holder does not possess sufficient incidents of ownership over the assets supporting the variable contracts to be deemed the owner of the assets for federal income tax purposes.

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.

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.

Section 817, which was enacted by Congress as part of the Deficit Reduction Act of 1984 (Pub. L. No. 98-369) (the "1984 Act"), provides rules regarding the tax treatment of variable life insurance and annuity 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. In the legislative history of the 1984 Act, Congress expressed its intent to deny life insurance treatment to any variable contract if the assets supporting the contract include funds publicly available to investors:

> 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).

Section 817(h)(1) provides that a variable contract based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified in accordance with regulations prescribed by the Secretary. If a segregated asset account is not adequately diversified, income earned by that segregated asset account is treated as ordinary income received or accrued by the policyholders.

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 32622 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.

The Contract owner does not have control over the investments that fund the Contract, the investments in the Accounts are not available for sale to the general public and the investments in the Accounts are available only through ownership of an annuity contract issued by Taxpayer. Taxpayer alone has complete control to acquire and dispose of an Account's investment assets. A Contract owner cannot select an Account's particular investments, and a Contract owner has no right to have the investment objective of the Accounts changed. There is no prearrangement, plan, contract, or agreement between a Contract owner and Taxpayer regarding the investments in the Accounts. Taxpayer does not act as a mere conduit through which a Contract owner makes investments.

CONCLUSIONS

Based on the facts and representations presented to us by the Taxpayer, we conclude that:

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

(2) For federal income tax purposes, Taxpayer, rather than Contract owner, is the owner of assets funding the 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/

DONALD J. DREES, JR.
Acting Branch Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)