### **Internal Revenue Service**

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# Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

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Date:

**SEPTEMBER 27, 1999** 

## Legend

Date 1

Taxpayer =

<u>A</u> =

<u>B</u> =

<u>C</u> =

Date 2 =

Date 3 =

Date 4 =

Parent =

State 1 =

Trust =

<u>x</u> =

This is in response to your letter of Date 1 requesting rulings regarding the treatment of Taxpayer's separate account investments in the  $\underline{A}$ ,  $\underline{B}$ , and  $\underline{C}$  Funds.

### **FACTS**

Taxpayer is a stock life insurance company authorized to do business in 48

states and the District of Columbia. Taxpayer writes individual and group life insurance and annuity contracts on a nonparticipating basis. Taxpayer is an indirect wholly-owned subsidiary of Parent, a publicly-held insurance holding company.

On Date 2, Taxpayer established a separate account (the Separate Account) under State law to segregate assets dedicated to the variable portion of a combination fixed and variable annuity contract ("Contract") offered by Taxpayer. The Separate Account is registered with the Securities and Exchange Commission as a unit investment trust under the Investment Company Act of 1940. The Separate Account consists of  $\underline{x}$  subaccounts, including the  $\underline{A}$  Fund subaccount, the  $\underline{B}$  Fund subaccount, and the  $\underline{C}$  Fund subaccount, each of which is a registered asset account of the Taxpayer and each of which invests solely in shares of the corresponding portfolio of Trust.

The Trust is organized as a State 1 trust and is an open-end, diversified management investment company registered under the Investment Company Act of 1940. The Trust offers beneficial ownership ("shares") in the Funds which are separate investment portfolios. Each Fund is treated for federal income tax purposes as a separate corporation pursuant to § 851(g)(1) of the Code and has elected status as a regulated investment company under Part I of Subchapter M of the Code. The Funds issue shares that are continually offered for sale and are available exclusively as funding vehicles for the Contracts.

The  $\underline{A}$  Fund's investment objective is to realize a high long-term total rate of return consistent with prudent investment risks. All of the shares of the  $\underline{A}$  Fund are held exclusively by the  $\underline{A}$  Fund subaccount (except as otherwise permitted under Treas. Reg. § 1.817-5(f)(3)). Additionally, public access to the  $\underline{A}$  Fund is available exclusively through the purchase of a variable contract (except as otherwise permitted under Treas. Reg. § 1.817-5(f)(3)). This will continue to be true after the  $\underline{A}$  Fund begins to invest directly in the B Fund and C Fund under the arrangement described below.

The <u>B</u> Fund's investment objective is long-term capital appreciation. The <u>C</u> Fund's investment objective is to achieve a long-term total rate of return in excess of the U.S. bond market over a full market cycle. All of the shares of the <u>B</u> Fund and the <u>C</u> Fund are currently held exclusively by the <u>B</u> Fund subaccount and the <u>C</u> Fund subaccount of the Separate Account, respectively (except as otherwise permitted under Treas. Reg. § 1.817-5(f)(3)). Public access to the <u>B</u> Fund and the <u>C</u> Fund is available exclusively through the purchase of a variable contract (except as otherwise permitted under Treas. Reg. § 1.817-5(f)(3)). Furthermore, this will continue to be true after the <u>A</u> Fund begins to invest directly in the <u>B</u> Fund and the <u>C</u> Fund under the arrangement described below, except that shares of the <u>B</u> Fund and the <u>C</u> Fund will also be held indirectly by the <u>A</u> Fund subaccount through the <u>A</u> Fund.

On Date 3, the Board of Trustees of Trust approved a change in the operations

of the  $\underline{A}$  Fund so that, instead of purchasing the same individual securities purchased separately by the  $\underline{B}$  Fund and the  $\underline{C}$  Fund, the  $\underline{A}$  Fund would invest in the shares of the  $\underline{B}$  Fund and the  $\underline{C}$  Fund. Taxpayer represents that this change was undertaken for valid business reasons. This structure is commonly referred to as a "fund of funds" arrangement. The  $\underline{A}$  Fund will now be able to accomplish the same investment objectives and diversification as it historically has while avoiding the additional cost of acquiring the underlying securities held by the  $\underline{B}$  Fund and the  $\underline{C}$  Fund. Shareholders of the  $\underline{A}$  Fund on Date 4 approved the  $\underline{A}$  Fund's conversion to a fund of funds structure by approving certain changes to the  $\underline{A}$  Fund's fundamental investment restrictions. The Trust intends to seek an exemptive order from the Securities and Exchange Commission regarding the implementation of the fund of funds structure.

Taxpayer makes the following representations in connection with this ruling request:

- 1. Each of the Funds is treated for federal income tax purposes as a separate corporation under § 851(g)(1) of the Code and each has elected status as a regulated investment company under Part I of Subchapter M of the Code.
- 2. The only shareholder of each Fund is the corresponding subaccount of the Separate Account (except for other shareholders permitted by Treas. Reg. § 1.817-5(f)(3)). All shares of the A Fund will continue to be held by the A Fund subaccount after the creation of the fund of funds structure and thus, this will continue to be true except that the B Fund and the C Fund will also have the A Fund subaccount as a shareholder indirectly by virtue of the A Fund investment in the B Fund and the C Fund. Therefore, all the beneficial interests in the Funds will continue to be held by one or more segregated asset accounts of one or more insurance companies (or such other holders that are permitted under Treas. Reg. § 1.817-5(f)(3)).
- 3. Public access to each Fund is available exclusively through the purchase of a variable contract (except as otherwise permitted under Treas. Reg. § 1.817-5(f)(3)). Taxpayer represents that this will continue to be true after the <u>A</u> Fund begins to invest directly in the B Fund and C Fund under the fund of funds structure.

#### LAW AND ANALYSIS

For purposes of part I of subchapter L of chapter 1 of the Code (§§ 801 - 818), the term "variable contract" is defined in § 817(d). In order for an annuity contract to be a variable contract, (1) it must provide for the allocation of all or a 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 issuing insurance company; (2) it must provide for the payment of annuities; and (3) the amounts paid in, or the amounts paid out, must reflect the investment return and the market return of the segregated asset account. I.R.C. § 817(d)(1)-(3).

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 life insurance contract), a variable contract (other than a pension plan 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 the investments made by such account are not, in accordance with regulations prescribed by the Secretary, adequately diversified. A segregated asset account consists of all of the assets for which the investment return and market value is allocated in an identical manner to any variable contract invested in any of such assets. Treas. Reg. § 1.817-5(e). Where the owner of the variable contract is permitted to allocate premiums among the subaccounts of a separate account, each subaccount of the separate account is a segregated asset account within the meaning of section 817(h) and the regulations thereunder. See Treas. Reg. § 1.817-5(g), Example 1.

Treas. Reg. § 1.817-5 sets forth the diversification requirements for variable contracts. Generally, the investments of a segregated asset account will be considered to be "adequately diversified" for purposes of § 817(h) of the Code and Treas. Reg. § 1.817-5 if no more than 55 percent of the value of the total assets of the account is represented by any one investment, no more than 70 percent by any two investments, no more than 80 percent by any three investments, and no more than 90 percent by any four investments.

Section 817(h)(4) of the Code provides, in certain situations, a "look-through" rule for meeting the diversification requirements. If all of the beneficial interests in a regulated investment company are held by one or more (A) insurance companies (or affiliated companies) in their general account or in segregated asset accounts, or (B) fund managers (or affiliated companies) in connection with the creation or management of the regulated investment company, the diversification requirements of § 817(h)(1) are applied by taking into account the assets held by such regulated investment company.

Treas. Reg. § 1.817-5(f) further describes the "look-through" rule. Treas. Reg. § 1.817-5(f)(2)(i) provides that Treas. Reg. § 1.817-5(f) shall apply to an investment company if:

- (A) all the beneficial interests in the investment company (other than those described in Treas. Reg. § 1.817-5(f)(3)) are held by one or more segregated asset accounts of one or more insurance companies; and
- (B) public access to such investment company is available exclusively (except as otherwise permitted in Treas. Reg. § 1.817-5(f)(3)) through the purchase of a variable contract. Solely for this purpose, the status of the contract as a variable contract will be determined without regard to § 817(h) and Treas. Reg. § 1.817-5.

Treas. Reg. § 1.817-5(f)(1) provides that, if the look-through rule applies, a beneficial interest in a regulated investment company will not be treated as a single investment of a segregated asset account; instead, a pro rata portion of each asset of the investment company will be treated for purposes of Treas. Reg. § 1.817-5, as an asset of the segregated asset account. Thus, under the fund of funds arrangement described herein, applying the look-through rule to the  $\underline{A}$  Fund, the shares of the  $\underline{B}$  Fund and the  $\underline{C}$  Fund held by the  $\underline{A}$  Fund will be treated, for purposes of Treas. Reg. § 1.817-5, as assets of the  $\underline{A}$  Fund subaccount of the Separate Account. Further, since the  $\underline{B}$  Fund and the  $\underline{C}$  Fund satisfy the look-through requirements, a pro rata portion of the assets of the  $\underline{B}$  Fund and the  $\underline{C}$  Fund will be treated as assets of the  $\underline{A}$  Fund subaccount.

After the  $\underline{A}$  Fund acquires shares of the  $\underline{B}$  Fund and the  $\underline{C}$  Fund, all of the beneficial interests in the  $\underline{B}$  Fund will be held by the  $\underline{B}$  Fund subaccount and indirectly by the  $\underline{A}$  Fund subaccount, by virtue its ownership of all of the shares of the  $\underline{A}$  Fund. All of the beneficial interests in the  $\underline{C}$  Fund will be held by the  $\underline{C}$  Fund subaccount and indirectly by the  $\underline{A}$  Fund subaccount, by virtue its ownership of all of the shares of the  $\underline{A}$  Fund. Thus, all of the beneficial interests in these Funds will continue to be held exclusively by one or more segregated asset accounts of one or more insurance companies (except as otherwise permitted under Treas. Reg. § 1.817-5(f)(3)).

After Taxpayer adopts the fund of funds structure described above, public access to the  $\underline{B}$  Fund and the  $\underline{C}$  Fund will continue to be available exclusively through the purchase of a variable contract (except as otherwise permitted under Treas. Reg. § 1.817-5(f)(3)). Therefore, the look-through rule applies to the  $\underline{B}$  Fund and the  $\underline{C}$  Fund as assets of the  $\underline{B}$  Fund subaccount and  $\underline{C}$  Fund subaccount, respectively.

Revenue Ruling 81-225, 1981-2 C.B. 12, clarified by Rev. Rul. 82-55, 1982-1 C.B. 12, describes four situations in which investments in mutual funds made pursuant to annuity contracts are considered to be owned by the policyholder, 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 policyholder 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 policyholders 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. The ruling reaches the opposite conclusion in situation 5, stating that the sole function of the mutual fund in situation 5 is to provide an investment vehicle to allow the insurance company to meet its obligations under its annuity contracts and that the insurance company possesses sufficient incidents of ownership to be considered the owner of the underlying portfolio of assets of the mutual fund. Revenue Ruling 81-225 concludes that in situation 5, the insurance company, not the policyholder, is treated as the owner 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 have the right to direct the issuing insurance company to invest in the shares of any or all of three mutual funds that are not available to the public. One mutual fund invests primarily in common stocks, another in bonds, and a third in money market investments. Policyholders 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 policyholders' ability to choose among general investment strategies (for example, between stocks, 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 policyholders to be treated as the owners of the mutual fund shares.

The use of the fund of funds structure to facilitate the investment objectives of the  $\underline{A}$  Fund does not convey any additional control or other incidents of ownership to the policyholders of the Contracts invested in the A Fund.

#### **HOLDING**

Based solely upon the information provided and the representations made, we conclude:

- 1. The look-through rule of Treas. Reg. § 1.817-5(f) will apply to both the  $\underline{A}$  Fund subaccount's (i) direct investment in the  $\underline{A}$  Fund such that the assets of the  $\underline{A}$  Fund will be treated as assets of the  $\underline{A}$  Fund subaccount for purposes of applying the diversification test of § 817(h) of the Code, and (ii) indirect investment, through the  $\underline{A}$  Fund, in the  $\underline{B}$  Fund and the  $\underline{C}$  Fund such that the assets of those funds will be treated as assets of the  $\underline{A}$  Fund subaccount for purposes of applying the diversification test of § 817(h) of the Code.
- 2. The look-through rule of Treas. Reg. § 1.817-5(f) will continue to apply to the <u>B</u> Fund subaccount's investment in the <u>B</u> Fund and the <u>C</u> Fund subaccount's

investment in the <u>C</u> Fund after the <u>A</u> Fund acquires shares of these Funds.

3. A variable annuity contract that invests in a Fund and otherwise satisfies the investor control requirements of Rev. Rul. 81-225 and Rev. Rul. 82-54 will not fail those investor control requirements merely because the  $\underline{A}$  Fund has invested in the  $\underline{B}$  Fund and the  $\underline{C}$  Fund.

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.

Except as specifically set forth above, no opinion is expressed as to the tax treatment of the Funds under the provisions of any other section of the Code or regulations. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

Assistant Chief Counsel Financial Institutions & Products

By: \( \s\ \)

Mark S. Smith Chief, Branch 4