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Dear

This is in response to your requests for rulings dated August 4, 1999 (and to your subsequent correspondence related to those requests) regarding the treatment of sub-

accounts of certain separate accounts of insurance companies that invest in the Funds<sup>1</sup> as described below.

### Facts

#### A. Description of Interested Parties

##### 1. The Funds

Each Fund is organized as a separate series of either the A Funds or the B Series, both organized as State 1 business trusts (collectively, the "Trusts"). The A Funds were created on Date 1. The B Variable Products Series was created on Date 2. The advisers and subadvisers for the Funds include, C, D, E, F, G, and H, all of which are wholly owned subsidiaries of I (collectively the "Advisers"). The Trusts are registered as open-end management investment companies pursuant to the Investment Company Act of 1940, as amended (the "1940 Act"), and by virtue of each Trust's registration, each Fund is registered as an open-end management company under the 1940 Act. Each Fund has also registered its shares pursuant to the Securities Act of 1933, as amended (the "1933 Act").

Each Fund has elected to be operated in such a manner as to qualify as a regulated investment company ("RIC") under § 851 of the Internal Revenue Code of 1986, as amended, (the "Code") and each intends to continue to qualify as such.

Shares of each Fund are sold only to insurance company separate accounts ("Separate Accounts") to serve as the investment vehicle for both variable annuity and variable life insurance contracts. The Funds represent that (except as otherwise permitted by regulations § 1.817-5(f)(3)) all the beneficial interests in each of the Funds are held by one or more segregated asset accounts of one or more insurance companies and public access to each of the Funds is available exclusively through the purchase of a variable contract within the meaning of § 817(d) and (e). They further represent that the insurance companies that invest in the Funds are life insurance companies within the meaning of § 816(a). They also represent that each Separate Account is a Separate Account registered with the Securities and Exchange Commission (the "SEC") as a unit investment trust under the 1940 Act.

The assets of the Separate Accounts are attributable to certain contracts (the "Contracts") offered by the insurance companies and are allocated among a designated number of sub-accounts of the Separate Accounts. The sub-accounts correspond to the number of investment options available under the Contracts. The amount of net premiums which Contract holders forward to the insurance companies allocated to each investment option, and thus to each sub-account, is selected by the owners when the

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<sup>1</sup> The Funds are a through ii (not including B).

Contracts are issued, and may be changed from time to time. Each sub-account invests in the shares of a Fund that corresponds with the investment objective of the sub-account. Finally, the Funds represent that the investments of each sub-account are adequately diversified within the meaning of § 817(h) and § 1.817-5(b).

## 2. The J's

Each J is registered as an open-end management company under the 1940 Act.<sup>2</sup> Each J has registered its shares for sale pursuant to the 1933 Act. With the exception of the S series of the A Funds, such shares are available for direct investment by members of the general public. The S series of the A Funds is offered only to one or more segregated asset accounts of one or more insurance companies (or such other holders that are permitted under regulations § 1.817-(f)(3)). The J's seek current income, liquidity and capital preservation by investing exclusively in short-term money market instruments such as U.S. Government securities, bank obligations, commercial paper, municipal obligations, or repurchase agreements secured by Government securities. Such short-term debt securities are valued at their amortized cost pursuant to the requirements of Rule 2a-7 under the 1940 Act.

### B. The Proposed Transaction

Rather than have each Fund invest cash exclusively through the direct purchase of short-term investments, the Funds propose that each be permitted to invest some or all of its available cash in shares of one or more of the J's. The Advisers propose to use the J's as an additional cash management device to provide liquid investments on a short-term basis to the Funds. Depending on its needs and investment limitations, a Fund could invest up to 25% of its assets in the J's, in other cash management vehicles, or directly in short-term securities.

The Advisers of each of the Funds will make an independent analysis of the cash reserves the respective Fund needs, and will then determine into which, if any, of the J's that Adviser will invest the relevant Fund's idle cash. If the Adviser decides that a Fund will make an investment into a J, the Contract owners will have no ability to control the amount of such investment, or into which of the J's the relevant Fund will make that investment.

The Advisers state that by allowing Funds to invest in shares of the J's, the Funds may reduce their aggregate exposure to counterparties in purchase agreements and diversify the risk associated with direct purchases of short-term obligations, while providing high current rates of return, ready liquidity, and (indirectly) increased diversity

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<sup>2</sup> The J's include the K, all series of the L; the M; the N series, the O series, the P series, the Q series of R; all series of the N; and the S series of A Funds, and any other money market fund for which the Advisers may later act as investment advisor.

of holdings. Limiting the amount of uninvested cash held at custodian banks also will limit a Fund's credit exposure to such banks.

A submission has been made to the Securities and Exchange Commission which requests relevant exemptions from the requirements of the 1940 Act to permit the Funds to purchase and redeem shares of the J's, and to permit the J's to sell their shares to, and redeem their shares from each of the investing Funds, provided each investing Fund will invest its uninvested cash in and hold shares of the J's only to the extent that the investing Fund's aggregate investment of uninvested cash in all of the J's does not exceed 25% of its total assets.

### Rulings Requested

1. The diversification requirements of § 817(h) and § 1.817-5(b) will be applied to a sub-account that invests in a Fund that invests in one or more J's by treating as an asset of the sub-account, a pro-rata share of each asset of the Fund, in accordance with the "look-through rule" set forth in § 1.817-5(f).
2. For purposes of § 1.817-5(f), there is look-through to the assets of the S series of the A Funds. With the exception of the shares of the S series of the A Funds, for purposes of that provision in the regulations, shares of the J's are treated as assets of the sub-account that invests in the J's and there is no look-through to the assets of the relevant J.
3. Assuming that a Contract owner does not otherwise have investment control over the sub-account's assets and does not possess sufficient other incidents of ownership within the meaning of Rev. Rul. 81-225 with respect to such assets to be considered the owner of such assets for federal income tax purposes, the Contract owner will not be treated as the owner of such assets under Rev. Rul. 81-225 because the Fund in which the sub-account invests, in turn, invests in shares of one or more J's.

### 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: (a) 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; (b) it must provide for the payment of annuities; and, (c) the amounts paid in, or the amounts paid out, must reflect the investment return and the market return of the segregated asset account. See § 817(d)(1)-(3).

Section 817(h)(1) 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.

Section 817(h)(4) 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.

Regulations § 1.817-5 contains 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) and § 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.

Regulations § 1.817-5(f) provides a "look-through" rule for the application of the diversification requirements of § 1.817-5. Regulations § 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 § 1.817-5, as an asset of the segregated asset account.

Regulations § 1.817-5(f)(2)(i) provides that § 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 § 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 § 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 § 1.817-5.

Regulations § 1.817-5(e) provides that, for purposes of § 817(h) and § 1.817-5, a "segregated asset account shall consist of all assets the investment return and market value of each of which must be allocated in an identical manner to any variable contract invested in any of such assets."

## Requested Rulings (1) and (2)

The owners of the Contracts are permitted to allocate premiums among the sub-accounts of the Separate Accounts. Thus, each sub-account of the Separate Accounts is a segregated asset account within the meaning of § 817(h) and the regulations thereunder. See § 1.817-5(g), Example 1. Hence, the diversification requirements must be met by each sub-account of the Separate Accounts that is subject to § 817(h) in order for the Contracts to be treated as annuity contracts.<sup>3</sup>

The Funds represent that all the shares of each Fund are held exclusively by segregated asset accounts of one or more insurance companies (except as otherwise permitted under § 1.817-5(f)(3)). Additionally, the Funds represent that public access to each Fund currently is available exclusively through the purchase of a variable contract (except as otherwise permitted under § 1.817-5(f)(3)). The Funds represent further that the previous two representations will continue to be true after the Funds begin to invest in the J's.

The two conditions for applying the look-through rule of § 1.817-5(f) to a sub-account that invests in the S series of the A Funds will be satisfied in this case. That is, all the beneficial interests in that series (other than those described in § 1.817-5(f)(3)) will be held by one or more segregated asset accounts of one or more insurance companies; and public access to such series will be available exclusively (except as otherwise permitted in § 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 § 1.817-5. Thus, for purposes of § 1.817-5, a pro-rata portion of each asset of the S series of the A Funds will be treated as an asset of the sub-account.

The shares of the J's (with the exception of the S series of the A Funds) are, and will continue after the proposed investment by the Funds to be, sold directly to members of the public. Therefore, all the beneficial interests in the J's (with the exception of the S series of the A Funds) will not be held solely by one or more segregated asset accounts of one or more insurance companies (or such other holders that are permitted under § 1.817-5(f)(3)). For purposes of § 1.817-5(f), the shares of the J's (with the exception of the S series of the A Funds) will be treated as assets of a Fund that invests in that J (and therefore as assets of the sub-account that invests in the Fund). Therefore, there

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<sup>3</sup>The diversification requirements under § 817(h) apply to variable contracts other than "pension plan contracts." Section 818(a) defines the term "pension plan contract" for this purpose to include a tax-sheltered annuity contract under § 403(b) and an individual retirement annuity contract under § 408(b). See §§ 818(a)(4) and (5). Hence, the diversification requirements apply to Contracts purchased with "after-tax" monies, and do not apply to Contracts which are tax-sheltered annuities or individual retirement annuities.



is no look-through to the assets of the J's (with the exception of the S series of the A Funds).

### Requested Ruling (3)

The issue presented by the third requested ruling is whether the Funds' investing in one or more J's will cause the Contract owners, rather than the respective life insurance company, to be treated, under the principles of Rev. Rul. 81-225, as the owner of the sub-accounts' assets.

Since 1977, the Service has issued a number of revenue rulings addressing when the investor in a variable annuity contract has sufficient control over the underlying investments to be treated as the owner of those investments.

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 issuing life insurance company, then the purchaser is treated as the owner of those assets for federal income tax purposes. Similarly, Rev. Rul. 80-274, 1980-2 C.B. 27 holds that where an S&L depositor transfers a certificate of deposit (C.D.) to a life insurer in exchange for an annuity contract, and the life insurer is expected to continue to hold the C.D. for the benefit of the depositor, the depositor (not the insurance company) is considered the owner of the C.D. for 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 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.<sup>4</sup> 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.

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<sup>4</sup> Rev. Rul. 81-225 was clarified by Rev. Rul. 82-55, 1982-1 C.B. 12, and modified by Rev. Proc. 99-44, 1999-48 I.R.B.\_ (November 29, 1999).

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 assets of the mutual fund. Rev. Rul. 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.

In Christoffersen v. United States, 749 F.2d 513 (8<sup>th</sup> Cir. 1984). cert. denied, 473 U.S. 905 (1985), the Court of Appeals for the Eighth Circuit upheld the investor control theory of Rev. Rul. 81-225. 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 assets 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. The taxpayers could reallocate their investment among the funds at any time, and had the right to make withdrawals, to surrender the contract, and to apply the accumulated value under the contract to provide annuity payments. The court held that the taxpayers, and not the issuing insurance company, owned the mutual funds for federal income tax purposes.

For purposes of Requested Ruling (3) the Funds ask the Service to assume the Contract owners do not otherwise have investment control and do not possess sufficient other incidents of ownership over the relevant assets to be considered the owner of those assets for federal income tax purposes under the principles of Rev. Rul. 81-225. The issue presented by Requested Ruling (3) is whether allowing the Funds to invest in the J (other than the S series of the A Funds) will cause the Contract owners, rather than the issuing insurance company, to be treated as the owner of the sub-accounts' assets.

After the Funds' proposed investment in the J's, just as in situation 5 of Rev. Rul. 81-225, the shares of the Funds will continue to be unavailable to members of the

general public; they will be available exclusively through the purchase of a variable contract (with the exception of those investors listed in § 1.817-5(f)(3)).

In Rev. Rul. 82-54, the amounts held in a segregated asset account under a variable contract were invested, as the policyholder directed, in shares of one or more of three open-end diversified management investment companies (Mutual Funds). Each Mutual Fund represented a different broad, general investment strategy, and the Mutual Fund shares were available only to insurance company segregated asset accounts. In Rev. Rul. 82-54, the Mutual Funds held common stocks, bonds, and money market instruments; assets that were available for purchase directly by members of the general public. The public availability of the assets of the Mutual Funds in Rev. Rul. 82-54 did not lead to the conclusion that the issuing insurance company was simply a conduit between the policyholders and their Mutual Funds. Instead, Rev. Rul. 82-54, citing Rev. Rul. 81-225 and its companion revenue rulings, held that the insurance company, not the policyholder, was the owner of the Mutual Fund shares for tax purposes.

The Funds' purchase of the shares in the J's does not give the Contract owners greater investment control than was the case in Rev. Rul. 82-54. It is true that the Contract owners could have purchased the J shares separately from the purchase of their annuity contracts. However, the same could be said of a person who purchases a variable annuity contract and allocates his premiums to a non-publicly available Fund, that in the discretion of its investment managers, invests in a publicly available investment, (such as common stock). Like the contract owner in Rev. Rul. 82-54, that person would have no control over the Fund's decision to invest in the publicly available investment.

Consequently, assuming that the Contract owners do not otherwise have investment control over the sub-accounts' assets and do not possess sufficient other incidents of ownership within the meaning of Rev. Rul. 81-225 with respect to such assets to be considered their owner for federal income tax purposes, the Contract owners in this case will not be treated as the owner of such assets under Rev. Rul. 81-225 simply because the Fund in which the relevant sub-account invests, in turn, invests in shares of one or more J's.

## Rulings

Accordingly, based solely on the information submitted and representations made, we hold:

1. The diversification requirements of § 817(h) and § 1.817-5(b) will be applied to a sub-account that invests in a Fund that invests in one or more J's by treating as an asset of the sub-account, a pro-rata share of each asset of the Fund, in accordance with the "look-through rule" set forth in § 1.817-5(f).

2. For purposes of § 1.817-5(f), a pro-rata portion of each asset of the S series

of the A Funds will be treated as an asset of a sub-account that purchases shares of that series. The shares of all other J's (and not their underlying assets) will be treated as assets of the sub-account that invests in the relevant J.

3. Assuming that a Contract owner does not otherwise have investment control over the sub-account's assets and does not possess sufficient other incidents of ownership within the meaning of Rev. Rul. 81-225 with respect to such assets to be considered the owner of such assets for federal income tax purposes, the Contract owner will not be treated as the owner of such assets under Rev. Rul. 81-225 because the Fund in which the sub-account invests, in turn, invests in shares of one or more J's.

Except as specifically set forth above, no opinion is expressed as to the tax treatment of the Contracts under the provisions of any other sections of the Code or regulations. Specifically, no opinion is expressed, except to the extent set forth above, as to the application of the investment control rules as set forth in Christofferson v. United States, supra; Rev. Rul. 82-54; Rev. Rul. 81-225; Rev. Rul. 80-274; and, Rev. Rul. 77-85.

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

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

Sincerely,

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Mark Smith  
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