INTERNAL REVENUE SERVICE

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February 8, 2001

LEGEND

Insurer 1 =

Insurer 2 =

First Tier Parent =

Second Tier Parent =

Parent =

Sister Corp. =

Broker Affiliate =

State A =

State B =

a =

b =

c =

d	=
Date A	=
Date B	=
Date C	=
Date D	=
Separate Account 1	=
Separate Account 2	=
AB Contracts	=
ABC Program	=
ABC Agreement	=
***	=

Dear Sirs:

This refers to your letter dated June 9, 2000, filed on behalf of Taxpayer, relating to certain flexible premium deferred variable annuity contracts (the "AB Contracts") whose owners are enrolled in an asset allocation program (the "ABC Program"). Sister Corp., an affiliate of Taxpayer, administers the ABC Program. You have requested a ruling that, for purposes of determining whether the investments supporting the AB Contracts whose owners are enrolled in the ABC Program are adequately diversified for purposes of § 817(h) of the Internal Revenue Code, the group of assets selected by Sister Corp. for each "investment profile" within the ABC Program qualifies as the "segregated asset account" (as defined in § 1.817-5(e) of the Income Tax Regulations) for the AB Contracts assigned to that "investment profile." Additional information and representations relating to this ruling request were submitted by letters dated August 16, 2000, October 12, 2000, and January 22, 2001.

FACTS

Insurer 1 and Insurer 2 are wholly owned stock subsidiaries of Second Tier Parent, which is a wholly owned stock subsidiary of First Tier Parent, and are life insurance companies subject

to tax under § 801 of the Code. Both Sister Corp. and First Tier Parent are wholly owned stock subsidiaries of Parent; Broker Affiliate is a wholly owned stock subsidiary of Sister Corp. Insurer 1 is organized under the laws of State A and Insurer 2 is organized under the laws of State B. Each of the foregoing corporations join with Parent, as the common parent of the affiliated group, in the filing of a consolidated federal income tax return. Because the underlying facts relevant to this ruling request are identical for both Insurer 1 and Insurer 2, the term "Taxpayer" will be used hereinafter to apply to both life insurance companies.

In Date C, Taxpayer began offering the AB Contracts.

[1]

At present, Taxpayer has approximately b AB Contracts outstanding.

The AB Contracts provide for an initial premium payment and generally permit the policy owner to make additional premiums at any time prior to the annuity date. Although Taxpayer owns the assets supporting the AB Contracts, State law requires these assets be segregated from Taxpayer's other assets. Taxpayer holds the assets supporting the AB Contracts in Separate Account 1 or Separate Account 2. Assets held in these separate accounts cannot be charged with liabilities arising out of any other business that Taxpayer conducts. Additionally, a Separate Account cannot be charged with any liabilities of any other Separate Account of Taxpayer.[2] The Separate Accounts are each registered as a unit investment trust under the Investment Company Act of 1940 (the "1940 Act"). Taxpayer has organized Separate Account 1 into various divisions that it refers to as "subaccounts."

If not enrolled in the ABC Program, the owner of an AB Contract may direct the investment of his or her premiums among a number of investment options, each of which is represented by a subaccount of Separate Account 1. Each subaccount is represented by shares of a regulated investment company (hereinafter referred to collectively as the "Funds"). The policy owner is permitted to reallocate contract values among the Funds supporting the AB Contract whenever he or she chooses, but Fund transfers in excess of per year are subject to a transfer change and Taxpayer reserves the right to limit the number of additional transfers permitted.

Each Fund is registered (or is a "series" of a mutual fund that is registered) under the 1940 Act as an open-end management investment company. Each of the Funds has a stated investment objective and professional fund manager or managers who make all decisions

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[2] In the case of Insurer 1, Separate Account 1 and Separate Account 2 are separate investment accounts established on Date A, under the laws of State A. In the case of Insurer 2, Separate Account 1 and Separate Account 2 are separate investment accounts established on Date B, under the laws of State B. Each Separate Account 2 holds shares in a fund and is not relevant for purposes of this ruling.

regarding how the Fund's assets will be invested. Each Fund is treated as a separate regulated investment company under § 851 and meets the diversification requirements of § 1.851-2(c) of the Income Tax Regulations. Additionally, each Fund is required by its investment policies to manage its investment assets in a manner that will assure that those assets will always be adequately diversified within the meaning of § 817(h) and § 1.817-5(b). Shares in the Funds are offered solely to pension plans and to life insurance company separate accounts to support variable annuity and life insurance contracts.

Shares in the Funds fluctuate in value based on the investment experience of the underlying regulated investment company. The amount paid as an annuity under the AB Contract reflects the investment return and market value of the assets represented by the shares of the Funds to which the policy owner has allocated the premiums and contract values.

Since Date C, Taxpayer has offered an asset allocation program (the "ABC Program") to owners of AB Contracts who are interested in obtaining the expertise of the investment professionals employed by Sister Corp. in managing the portfolio of assets supporting their AB Contracts. Generally, the owner of an AB Contract will enroll in the ABC Program at the same time he or she purchases the AB Contract.

To enroll in the ABC Program, the owner of an AB Contract executes an agreement which provides that any allocation of the premiums and contract values among the subaccounts of Separate Account 1 shall be at the direction of Sister Corp. so long as the contract owner continues to be enrolled in the ABC Program. The fundamental premise of the ABC Program is that, in exchange for obtaining the investment expertise of Sister Corp.'s investment professionals, the policy owner gives up the right to select the Funds that support his or her contract. Rather, the Funds are selected by investment professionals of Sister Corp.[3] The policy owner pays Sister Corp. an annual advisory fee for the services provided by Sister Corp. in managing the portfolio of investments underlying his or her AB Contract. At present, approximately c of Taxpayer' AB contract owners have elected to participate in the ABC Program.

Prior to enrolling in the ABC Program, the policy owner must complete an ABC Profiling Questionnaire, which elicits information about the extent and nature of the policy owner's financial holdings, tolerance for risk, and time horizon. The questionnaire is initially evaluated by Taxpayer for a preliminary determination of the policy owner's eligibility for the ABC Program and to ensure proper completion of all documentation. Next, the completed

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[3] In order to assist Sister Corp. in implementing its investment strategies, Taxpayer has modified a number of the provisions of the AB Contracts as regards those owners who participate in the ABC Program. For example, owners of AB Contracts who are enrolled in the ABC Program may not choose Dollar Cost Averaging, they are not subject to subaccount transfer fees, and they not subject to any limit that may be imposed on the maximum number of Fund transfers per year.

questionnaire is evaluated by personnel of Sister Corp. in accordance with an algorithm which determines whether the policy owner is suitable for one of the "investment profiles" designed by Sister Corp. for the ABC Program.

While a contract owner's responses to the questionnaire may affect the application of the algorithm and the investment profile assigned to the contract owner by Sister Corp.'s investment professionals, the contract owner cannot select specific subaccounts or specific securities for investment. Each investment profile consists of a particular selection of Funds and a plan of allocation among those Funds that are appropriate for contract owners fitting that profile. At any given time, several thousand contract owners may be assigned to a particular investment profile. If a contract owner requests that a particular Fund or Funds be included in the portfolio of Funds that support his or her contract, this request will be denied. Sister Corp., in its sole discretion, determines the group of Funds that are associated with each investment profile and the proportion of premiums and contract values allocated to each Fund. The group of Funds selected for an investment profile and the allocation of premiums and contract values among the Funds in that group may be changed by the personnel of Sister Corp. at any time. A policy owner is not advised of the existence of the investment profiles or of the composition of the Funds for each investment profile prior to the investment of any premium or contract value by Sister Corp.'s investment professionals. However, quarterly statements and investment confirmation statements inform a contract owner after Fund shares have been purchased by the subaccounts to which premiums and contract values have been allocated on behalf of the policy owner.

The ABC Profiling Questionnaire does advise the policy owner that he or she "may have the ability to restrict certain funds" from the portfolio of investments that support his or her AB Contract. In actual practice, however, very few of the participants in the ABC Program have requested that a specific fund be restricted from the portfolio of investments supporting their AB Contracts. Moreover, a restriction request is evaluated to determine whether the restriction request may be accommodated without compromising Sister Corp.'s responsibility for determining how the premiums and contract values are invested. Requests for specific investment allocations are not honored. If the contract owner requests that multiple Funds be excluded from the portfolio supporting his or her AB Contract, or if the requested restriction would prevent Sister Corp.'s investment professionals from making sound investment decisions on the policyholder's behalf, this contract owner would be reminded that the ABC Program is intended for the contract owner who wants Sister Corp.'s investment professionals to make all investment decisions regarding the allocations of premiums and contract values. The contract owner would be offered the opportunity to modify or withdraw the restriction request and enroll (or remain) in the ABC Program. Contract owners who decide to take control over the investment of premiums and/contract values in specific Funds will terminate their participation in the ABC Program.

The operative effect of the ABC Program, therefore, is that the premiums and contrct values of every AB Contract assigned to a particular investment profile are allocated to each of

the Funds in that profile in the same fashion. Every policy owner assigned to a particular investment profile will have the same relative portion of his or her total contract value allocated to a Fund as every other policy owner assigned to that investment profile. Each AB Contract assigned to a particular investment profile, therefore, will share in the market value and investment return of the particular mix of assets allocated to that investment profile in an identical manner with every AB Contract assigned to that investment profile.

Based on the foregoing, Taxpayer has requested a ruling that, in determining whether the investments supporting the AB Contracts issued by Taxpayer to policyholders who enroll in the ABC Program are "adequately diversified" within the meaning of § 817(h), Taxpayer should consider the assets of all of the Funds assigned to a particular investment profile as comprising the "segregated asset account" within the meaning of § 1.817-5(e) for AB contracts assigned to that investment profile.

LAW AND ANALYSIS

Section 817(d) defines the term "variable contract" for purposes of Part I of subchapter L of the Code (§§ 801-818). In order for an annuity contract to be a variable contract, (1) it must provide 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 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 market value of the segregated asset account." Section 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 a 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 Treasury, adequately diversified.

Section 1.817-5 contains the diversification requirements for variable contracts based on segregated asset accounts. 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 per cent by any four investments. See § 1.817-5(b)(1).

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 or trust are held by one or more (A) insurance companies (or affiliated companies) in their general account or in segregated asset accounts, or (B) fund manages (or affiliated companies) in connection with the creation or management of the regulated investment company, the

diversification requirements of § 817(h) are applied by taking into account the assets held by such regulated investment company.

Section 1.817-5(f)(1) provides that, if the "look-through" rule applies, a beneficial interest in an investment company, partnership, or trust will not be treated as a single investment of the segregated asset account. Instead, a pro rata portion of each asset of the investment company, partnership, or trust is treated, for purposes of § 1.817-5, as an asset of the segregated asset account.

Section 1.817-5(f)(2)(i) provides, in relevant part, that the "look-through" rule will apply to an investment company only if- (i) 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 (ii) 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.

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

Section 1.817-5(g) contains examples that illustrate the provisions of §§ 1.817-5(e) and (f). In Example 1, a life insurance company's variable contracts are supported by two groups of assets: (a) a diversified portfolio of debt securities, and (b) interests in P, a partnership that is publicly registered. All of the beneficial interests in P are held by one or more segregated asset accounts of one or more insurance companies and public access to P is available through the purchase of a variable contract. The variable contracts provide that policyholders may specify which portion of each premium is to be invested in the debt securities and which portion is to be invested in P interests. The portfolio of debt securities and the assets of P, considered separately, each satisfy the diversification requirements of § 1.817-5(b).

According to Example 1, as a result of the ability of policyholders to allocate premiums among the two groups of assets, the investment return and market value of the interests in P and the debt securities may be allocated to different variable contracts in a non-identical manner. Accordingly, the interests in P are treated as part of one segregated asset account ("Account 1") and the debt securities are treated as part of a different segregated asset account ("Account 2"). Because P is a partnership described in § 1.817-5(f)(2)(i), interests in P will not be treated as a single investment of Account 1. Rather, Account 1 is treated as owning a pro rata portion of the assets of P. Because Account 1 and Account 2 each satisfy the requirements of § 1.817-5(b), variable contracts that are based on either or both accounts will be treated as annuity, endowment, or life insurance contracts.

The facts in Example 2 are the same as in Example 1, except some of the interests in P are held by persons not described in § 1.817-5(f)(3). As a result, the "look-through" rule does not apply, and interests in P will be treated as a single investment of Account 1. Thus, Account 1 does not satisfy the diversification requirements of § 1.817-5(b), and variable contracts based on whole or in part on Account 1 will not be treated as annuity, endowment, or life insurance contracts.

The facts in Example 4 are the same as in Example 2, except that the variable contracts do not permit policyholders to allocate premiums between or among the portfolio of debit securities and interests in P. As a result, the investment return and market value of the interests in P and the debt securities must be allocated to the same variable contracts and in an identical manner. Thus, under § 1.817-5(e), the interests in P and the debt securities are treated as part of a single segregated asset account. If the interests in P (which by itself does not meet the diversification requirements of § 1.817-5(b)) and the debt securities, considered together, satisfy the diversification requirements of §1.817-5(b), contracts based on this segregated asset account will be treated as annuity, endowment, or life insurance contracts.

Section 1.817-5(e) defines a "segregated asset account" as consisting 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." This definition focuses on whether the investment return and market value of each asset in a group of assets must be allocated in identical proportions to all policyholders whose contract values are supported by that group of assets. The examples of § 1.817-5(g) illustrate this definition by combining assets into one segregated asset account, or dividing assets into multiple segregated asset accounts, depending on whether policyholders have the ability under their contracts to allocate their premiums within the group of assets. In other words, if policyholders have the ability to allocate their premiums or contract values between or among various assets, the assets cannot be treated as a single segregated asset account.

Taxpayer represents that owners of AB Contracts who are enrolled in the ABC Program may neither direct the allocation of their premiums or policy values among the various subaccounts nor choose among the Funds available to support their contracts. Rather, the particular Funds that support the AB Contracts of policyholders who have enrolled in the ABC Program are selected solely by investment professionals employed by Sister Corp. As noted, the investment professionals employed by Sister Corp. combine Funds into "investment profiles" and assign owners of AB Contracts to various profiles depending upon their personal financial information and tolerance for risk. At any given time, several thousand contract owners may be assigned to a particular investment profile. If the owner of an AB Contract who is enrolled in the ABC Program requests the investment professionals employed by Sister Corp. to include a particular Fund or Funds in the portfolio of Funds that supports his or her AB Contract, this request would be denied. In addition, no owner of an AB Contract whose contract values are administered under the ABC Program may request that particular types of securities (for example, stocks of communications companies) be excluded from the investment portfolio

supporting his or her AB Contract. Accordingly, the operation of the ABC Program results in the investment return and market value of the assets from the Funds selected for an investment profile being allocated in an identical manner to all AB Contracts assigned to that investment profile. The assets from the Funds selected for each investment profile, therefore, may be properly characterized as the "segregated asset account" within the meaning of § 1.817-5(e) which supports the AB Contracts assigned to that investment profile.

Accordingly, based solely on the information submitted and the representations made in connection with Taxpayer' ruling request, we conclude as follows:

For purposes of determining whether the investments supporting the AB Contracts whose policy owners have enrolled in the ABC Program are "adequately diversified" within the meaning of § 817(h) and § 1.817-5(b), the group of assets corresponding to the combination of Funds selected by Sister Corp.'s investment professionals for each investment profile comprises the "segregated asset account" within the meaning of § 1.817-5(e) for the AB Contracts assigned to that particular investment profile.

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 referenced in this letter.

This ruling 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 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,

Acting Associate Chief Counsel
(Financial Institutions and Products)
By: /S/
Donald J. Drees, Jr.
Senior Technician Reviewer
Branch 4