

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer
Parent
State A

ISSUE:

Whether short-term capital gains included within dividends paid by a regulated investment company are taken into account by a life insurance company's segregated asset account under the basis adjustment rules § 817(b) of the Internal Revenue Code, such that those short-term capital gains are excluded from the segregated asset account's gross investment income under § 812(d).

CONCLUSION:

Short-term capital gains included within dividends paid by a regulated investment company are not taken into account under the basis adjustment rules of § 817(b). Further, the short-term capital gains are taxed as ordinary income dividends and must be included in the segregated asset account's gross investment income for purposes of § 812. However, to the extent that the RIC's dividend distributions reduce the value of the segregated asset account's shares in the regulated investment company, the life insurance company has a correlative adjustment in its reserves under § 817(a).

FACTS:

Taxpayer is a life insurance company within the meaning of § 816(a) and is a wholly owned subsidiary of Parent, a financial services holding company. During the years involved, Taxpayer joined with Parent and other affiliated corporations in filing a life-nonlife consolidated return on a calendar year basis. Taxpayer has a number of separate accounts that are used to support variable life insurance contracts, variable annuities, and various group contracts under pension and other employee benefit plans. These accounts are created and regulated under the laws of State A. Under these laws, the assets in these accounts may be invested without regard to the usual restrictions that are placed on a life insurance company's investments. Where required, the separate accounts are registered as either open end diversified management investment companies or unit investment trusts under the Investment Company Act of 1940 (1940 Act).¹

Taxpayer has separate accounts that are registered under the 1940 Act as unit investment trusts and that are divided into variable subaccounts, each of which is invested exclusively in shares of underlying mutual funds. All of the mutual funds are open-end, diversified management investment companies that are registered with the SEC under the 1940 Act. All of the beneficial interests in each of these mutual funds are held by one or more of Taxpayer's separate accounts or separate accounts of other life insurance companies in connection with variable contracts. Public access to each of these mutual funds is available exclusively through the purchase of a variable contract. The mutual funds have elected to be treated as regulated investment companies (RICs) under § 851(b) and are, therefore, subject to all distribution and diversification rules of Subchapter M that apply to RICs. In addition, the assets of each of the RICs owned solely by life insurance company separate accounts have been managed to comply with the diversification standards of § 817(h) and § 1.817-5 of the Income Tax Regulations.

For clarity hereafter, a RIC that is owned solely by the separate accounts of one or more life insurance companies is referred to as a Life Insurance RIC, while a RIC owned by the general public is referred to as a Public RIC. We note, however, that although the governance and operations of a Life Insurance RIC may deviate from a RIC owned by the general public, Subchapter M does not differentiate or distinguish among different RICs when applying federal tax rules.²

Both types of separate accounts -- those that invest directly and those that invest indirectly through Life Insurance RICs held in subaccounts -- support various types of variable contracts, including pension plan, annuity and life insurance contracts, and are subject to the segregated asset account provisions of § 817. All income and all gains

¹ Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2).

² Taxpayer notes a minor excise tax exception under § 4982 that is not germane to the issue at hand.

and losses of the separate accounts are directly attributed to the annuity, life insurance, or pension accounts of persons or groups that have elected to purchase coverage from Taxpayer based on variable asset investments. Accordingly, during the accumulation phase of the variable contracts, policyholders' premiums are invested in one or more of the underlying Life Insurance RICs as selected by the policyholder. The policyholder is credited with accumulation units, based on the premiums contributed and the investment performance of the underlying Life Insurance RIC. Thus, although the life insurance company is the owner of the assets held by the segregated asset account (that is, the shares of the Life Insurance RIC held in each subaccount), the policyholder assumes the investment risk as the value of the policyholder's units varies with the investment performance of the underlying Life Insurance RIC.

Generally, Life Insurance RICs, as do Public RICs, receive income from dividends, interest, short-term capital gains and long-term capital gains. With the exception of long-term capital gains, each Life Insurance RIC reports these income items on its tax return, reduced by allowable deductions, to arrive at the taxable income of the RIC, before any deduction for dividends paid. In order to maintain their RIC status, the RICs must distribute at least 90 percent of their investment company taxable income. For purposes of this memorandum, we have been asked to assume that all dividends received by Taxpayer's separate accounts are automatically reinvested into additional shares of the distributing Life Insurance RIC. We also have been asked to assume that each Life Insurance RIC reported these dividends to Taxpayer and other life insurance company shareholders, if any, pursuant to Regulation § 270-19a-1 of the 1940 Act. Based on this information and other accounting information furnished to Taxpayer by the Life Insurance RICs, Taxpayer can determine the portion of the dividends received from each of the Life Insurance RICs that is attributable to short-term capital gain income realized by the RIC.

For federal income tax purposes, Taxpayer has applied the segregated asset account provisions of § 817 in reporting the income, deductions, assets, reserves, and company/policyholder share requirements for each of its segregated asset accounts. For these purposes, Taxpayer has relied on the definition of the term "segregated asset account" set forth in § 1.817-5(e) to decide which assets and reserves held by a separate account are subject to the segregated asset account provisions of § 817. Thus, Taxpayer has treated each subaccount of Taxpayer's separate accounts that invested in shares of an underlying Life Insurance RIC as a segregated asset account in applying the provisions of § 817. For purposes of this request, we have assumed that Taxpayer is not prohibited from making these computations at the subaccount level in applying the segregated asset account provisions of § 817.

In computing the gross income and reserve deductions attributable to its segregated asset accounts, Taxpayer excludes all capital gain dividends from the RIC, and that portion of other dividends paid by the RIC that represents short-term capital gains of the RIC. Under this approach, any dividend paid by a Life Insurance RIC that Taxpayer allocates to the RIC's capital gain income -- short-term or long-term -- is treated as allocable to adjustments already taken into account by Taxpayer under §§ 817(a) and (b) when computing the segregated asset account reserves and the

basis of the related assets -- or, as described by Taxpayer further below, as a “non-event.” For this purpose, Taxpayer treats the portion of the RIC dividends that it allocates to short-term capital gains identically to the manner in which it treats capital gain dividends under § 852(b)(3) that are distributed by the Life Insurance RICs.

The examining agent has not questioned Taxpayer’s exclusion of Life Insurance RIC capital gain dividends, but has challenged the exclusion of the portion of the RIC dividends that Taxpayer has attributed to the Life Insurance RICs’ short-term capital gains. Instead, the examining agent proposes to recompute the gross investment income and reserve deductions of those segregated asset accounts that for which Taxpayer carved out a portion of dividends that it allocated to the RIC’s short-term capital gains, adding the carved-out portion of the RIC dividends to the segregated asset accounts’ gross investment income and allowing an additional reserve deduction reflecting the reinvestment of these dividends in additional shares in the Life Insurance RICs. The effect of these adjustments is to increase the portion of a segregated asset account’s net investment income treated as allocable to policyholders under § 812, and thereby to reduce the amount of dividends received by the segregated asset account that are eligible for the DRD under §§ 243 and 805(a)(4).

LAW

Policyholders’ vs. Company’s Share

To prevent a life insurance company from obtaining a double benefit for tax preferred investment income (that is, tax-exempt interest and intercorporate dividends eligible for DRD) used to fund deductible increases in the company’s liabilities to policyholders, §§ 807 and 805 require the company to adjust certain income and deduction terms for the “policyholders’ share” of the tax-preferred income.

Sections 807(a) and (b) require the life insurance company to reduce its end-of-year reserves by the policyholders’ share of tax-exempt interest for purposes of computing the deduction or income item with respect to a net increase or net in reserves, respectively. These adjustments effectively deny the company any exclusion with respect to the policyholders’ share of tax-exempt interest.

Section 805(a)(4) permits a life insurance company to deduct only the life insurance company’s share of intercorporate dividends received (other than dividends from wholly owned subsidiaries). No DRD is allowed with respect to the policyholders’ share of intercorporate dividends.

Section 812 provides the mechanism to calculate the life insurance company’s and the policyholders’ share of the tax-preferred income items. Section 812(a)(1) defines the company’s share as the percentage obtained by dividing (i) the company’s share of net investment income for the taxable year, by (ii) the net investment income for the taxable year. The policyholders’ share is derived by subtracting the company’s share from 100%.

Pursuant to § 812(b)(1), the company’s share of net investment income equals the excess, if any, of net investment income for the taxable year over the sum of (i)

policy interest, and (ii) gross investment income's proportionate share of policyholder dividends for the taxable year. Section 812(d) defines gross investment income to include interest, dividends, rents, royalties and short-term capital gains in excess of long-term capital losses. Section 812(c), in turn, defines net investment income as 90 percent of gross investment income or, in the case of gross investment income attributable to assets held in segregated asset accounts under variable contracts, 95 percent of gross investment income.

Rules Applicable to Segregated Asset Account Reserves and Basis

Section 817 prescribes special rules with respect to segregated asset accounts used by life insurance companies to fund variable life insurance, variable annuities, and various group contracts under pension or other employee benefit plans.

Section 817(a) provides that for purposes of determining a life insurance company's deduction for net increases in reserves with respect to variable contracts under §§ 805(a)(2) and 807(b), or the income item resulting from a net decrease in such reserves under §§ 803(a)(2) or 807(a), those amounts that from time to time are either added to, or subtracted from the company's reserves based on the appreciation or depreciation in value of the assets held the segregated asset account (whether or not realized) are to be disregarded. The amount of appreciation or depreciation that is disregarded in computing the net increase or decrease in reserves for the taxable year is included in the life insurance company's beginning of the year reserves for purposes of computing the net increase or decrease in such reserves for the succeeding taxable year. See § 1.801-8(f)(2), Example.

Section 817(b) provides that the basis of each asset in a segregated asset account is increased or decreased by the amount of appreciation or depreciation in value of that asset (whether or not realized), to the extent that the life insurance company's reserves for the variable contracts must be adjusted to remove such appreciation or depreciation in applying § 817(a). Accordingly, on disposition of the asset held in the segregated asset account, the life insurance company will not be taxable on any realized appreciation (and cannot reduce its tax with respect to other capital gains by virtue of any realized depreciation).

Section 817(c) requires a life insurance company that issues variable contracts to account separately for various income, exclusion, asset, reserve, and other liability items properly attributable to the segregated asset accounts supporting those contracts. Thus, for example, the company's share of dividends received, and the policyholders' share of tax-exempt interest (which reduces the end-of-year reserves), is determined with reference to the income and deduction items of the segregated asset account.

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), that is described in § 817 and that 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) in

which the investments made by such account are not, in accordance with Treasury regulations, adequately diversified.

Section 1.817-5 contains the diversification requirements for variable contracts. Section 1.817-5(f) provides a look-through rule for the application of these requirements. If the look-through rule of this regulation applies, a beneficial interest in a RIC is not treated as a single investment of the segregated asset account; instead, a pro rata portion of each asset of the investment company is treated, for diversification determination purposes as an asset of the segregated asset account.

Section 1.817-5(e) states 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. According to the examples in the regulations that illustrate this definition, to the extent that the policyholder may specify how the premiums are allocated among the asset groupings held by the life insurance company's separate account, each such asset grouping constitutes a segregated asset account for purposes of § 817(h) and § 1.817-5. See § 1.817-5(g), Examples (1) and (4).

Regulated Investment Company Rules

Section 851(a) defines a RIC, in part, as a domestic corporation registered under the 1940 Act as a management company or unit investment trust. Further, § 851(b)(2) applies the rules of Subchapter M only to a corporation meeting certain election, gross income, and diversification requirements.

Section 852(b)(1) imposes a tax, computed at the normal corporate rates under § 11, on a RIC's investment company taxable income, as computed in accordance § 852(b)(2) and § 1.852-3, for each taxable year of a RIC.

Section 852(b)(2)(D) allows a RIC a deduction for dividends paid (as defined in § 561 with certain modifications). Section 561 defines the deduction for dividends paid and applies the rules of § 562 to determine which dividends are eligible for the deduction for dividends paid. Under § 1.852-4(a)(1), a shareholder receiving dividends from a RIC is generally required to include those dividends in gross income for the taxable year in which they are received. See also §§ 301(a) and (c), and § 316(a), which provide for the taxability and definition of the term "dividend."

All RICs are subject to the same information reporting requirements under § 6042, and are not required to report s from investment company taxable income to those shareholder(s) that are exempt recipients as defined in §1.6049-4(c)(1)(ii). Thus, because all shareholders of Life Insurance RICs are exempt from reporting under that provision as separate accounts of life insurance companies, Life Insurance RICs need not issue Form 1099's to its shareholder(s). Shareholders of Life Insurance RICs do receive the details necessary for them to file federal income tax returns pursuant to the 1940 Act.

Under § 852(b)(3)(B), any shareholder of a RIC who receives capital gain dividends from a RIC that is taxed under Subchapter M treats those capital gain dividends as gains from the sale of exchange of assets held for more than 1 year. Accordingly, dividends designated by the RIC as capital gain dividends retain their character as long-term capital gains when distributed to the shareholders. Similarly, depending on the types of gross income received by the RIC, appropriate portions of any dividends paid may be designated by the RIC -- and consequently taxed to the shareholders -- as exempt-interest dividends and dividends qualifying for the DRD. Sections 852(b)(5) and 854.

A dividend received from a RIC is subject to the limitations in § 854. Section 243(d)(2). A capital gain dividend received from a RIC is not considered a dividend for purposes of § 243. Section 854(a). Under § 854(b), a RIC shareholder may take into account in computing any deduction under § 243 only that portion of the dividend (other than a capital gain dividend) received from the RIC that is designated by the RIC as a dividend for purposes of § 243. The portion so designated is treated as received from a corporation that is not a 20-percent owned corporation.

ANALYSIS

This memorandum addresses the interaction of the segregated asset account provisions of § 817 and the federal income tax treatment of Life Insurance RICs held as investments within those segregated asset accounts. The specific issue is the treatment of the portion of RIC dividends paid to the life insurance company's segregated account that Taxpayer allocates to short-term capital gains, and whether Taxpayer may treat the adjustments made under §§ 817(a) and (b) for realized and unrealized appreciation with respect to assets held in the segregated asset account as allocable to that portion of dividends paid by the RIC(s), thereby excluding that portion of the dividends from the segregated asset account's gross investment income under § 812(d).

Agent's Position

The examining agent points out that the Life Insurance RICs are separate legal entities from Taxpayer's segregated asset accounts. Accordingly, while the segregated asset accounts are taxed as part of the life insurance company, the Life Insurance RICs are separate entities that have elected to be taxed under Subchapter M. The revenue agent further maintains that, under the provisions of Subchapter M, all dividends distributed by a Life Insurance RIC, other than capital gain dividends, are included in a RIC's deduction for dividends paid under § 852(b)(3)(B), and are taxed to the shareholders of the RIC as ordinary income dividends. Thus, unlike capital gain dividends, Life Insurance RIC dividends that Taxpayer would like to attribute to the RIC's short-term capital gains are treated as ordinary dividends when received by the RIC shareholders. The examining agent's ultimate position is that where a life insurance company's segregated asset account holds interests in a RIC (including a Life insurance RIC), the company must account for dividends received from the RIC (other than capital gain dividends) as ordinary dividends in the year received, even

though a portion of these dividends could be attributable to short-term capital gains realized by the RIC.

Taxpayer's Argument

Taxpayer's basic argument is that the portion of the RIC dividends that are attributable to short-term capital gains are not included in the segregated asset account's gross investment income because these gains have already been taken into account under § 817(a) and (b).³ Taxpayer asserts that reliance upon the general rules in Subchapter M characterizing a RIC's dividends to shareholders ignores the special relationship between a Life Insurance RIC and the segregated asset account, as well as the manner in which the segregated asset account provisions of § 817 operate to allow a life insurance company to avoid tax on capital gains attributable to assets held in a segregated asset account. Taxpayer argues further that the segregated asset account reserve and basis adjustment provisions of §§ 817(a) and (b) allow it to look through the Life Insurance RIC entity not only to determine the diversification of the assets supporting the variable contracts, but also to exclude any appreciation income on a Life Insurance RIC's assets from recognition at the life insurance company level. Taxpayer concludes that the dividends distributed by the Life Insurance RIC (some portion of which it would like to attribute to the Life Insurance RIC's short-term capital gains) should be a non-event because the portion of the dividend that Taxpayer would allocate to short-term capital gain represents the realization of appreciation in value of a separate account's assets that has already been reflected in the separate account asset bases and reserves under the rules of §§ 817(a) and (b).

Discussion of Allocation of Basis under § 817

We agree with the examining agent that Taxpayer is not permitted to characterize any portion of the dividends distributed by the Life Insurance RIC to its segregated asset accounts as short-term capital gains, as such an allocation disregards Subchapter M. We further find that the treatment of the dividends as ordinary income dividends is consistent with both Subchapters L and M and does not result in double reporting of income in conjunction with the reserve and basis adjustments made by segregated asset account under §§ 817(a) and (b).

Section 817 prescribes special rules for increasing or decreasing segregated asset account reserves under §§ 807(a) and (b), to the extent that reserve changes are attributable to appreciation or depreciation in value of the assets held in the segregated

³ Taxpayer's approach prevents this allocable portion of the dividends from being taken into account in calculating the company and policyholder shares of the segregated asset account's gross investment income under § 812(d). Effectively, Taxpayer argues that the segregated asset account never realizes gain if it is short-term in nature but instead modifies reserves and basis under § 817. This exclusion of part of the RICs' dividends from gross investment income increases the Taxpayer's DRD.

asset account. Under § 817(a), neither appreciation nor depreciation in the value of the assets held by the segregated asset account (whether or not realized) is counted in computing the life insurance company's deduction or income item resulting from a net increase or decrease in reserves, respectively. This offset of reserves and basis is accomplished, under § 817(b), by increasing or decreasing the basis of each asset in the segregated asset account by any change in the value of that asset, to the extent that this appreciation or depreciation in value has been removed from the segregated asset account reserves. Accordingly, although § 817(a) denies issuers of variable contracts any reserve deduction for increases in required reserves reflecting appreciation in value of the segregated asset account assets, the life insurance company is not taxed on any gain or loss upon disposition of those assets (and cannot reduce its tax with respect to other capital gains by virtue of any realized losses (which would have occurred but for the depreciation or reduction in basis under § 817(b))).

If a life insurance company's segregated asset account invests in a Life Insurance RIC, the reserves for the variable contracts will reflect the investment performance of the Life Insurance RIC through the daily valuation of the RIC shares held by the segregated asset account. Accordingly, if the Life Insurance RIC earns income, whether capital or ordinary in nature, but is not required to distribute that income, the shares of the Life Insurance RIC held by the segregated asset account will appreciate in value, so that there will be corresponding increases in the reserves for those variable contracts. Conversely, if the Life Insurance RIC's holdings depreciate in value, the value of each share of that RIC held by the segregated asset account will also depreciate, leading to a decrease in the life insurance company's reserves for variable contracts.

Under § 817(a), any increase or decrease in the life insurance company's reserves for the variable contracts reflecting the net appreciation or depreciation in the value of the segregated asset account's interest in the Life Insurance RIC is not counted in determining the deduction or income item for a net increase or decrease in reserves, respectively. Correspondingly, the segregated asset account's basis in the the Life Insurance RIC's shares are continuously adjusted to reflect any appreciation or depreciation of the assets held within the RIC, so that the life insurance company will not be subject to tax on those redemption of those shares. The value of the RIC shares can change due to appreciation or depreciation of the RIC's assets and can also change if a portion of the income of the RIC is distributed to its shareholders.

Thus, if the segregated asset account directly holds, and subsequently sells, shares of stock (including shares in a Life Insurance RIC), or any other capital asset, no capital gain is recognized on such sale due to the adjustments to basis, made from time to time, reflecting appreciation or depreciation required by §§ 817(a) and (b). However, if the RIC distributes ordinary income to its separate account owner(s), the dividend income is taxable as ordinary income without regard to the funding source within the owned entity, even if that income was short-term capital gain in the hands of the Life Insurance RIC. Similarly, a dividend distribution (other than a capital gain dividend) made to the life insurance company's segregated asset account with respect to its interest in a Life Insurance RIC also does not represent "appreciation in the value of

assets,” as referred to in §§ 817(a) and (b). The Life Insurance RIC does not distribute short-term capital gains as such. Further, the distribution of an ordinary dividend does not directly reduce the basis of the segregated asset account’s shares in the Life Insurance RIC.

However, the net asset value per share of a Life Insurance RIC is ordinarily reduced by the payment of an ordinary dividend, so that immediately following the dividend distribution, there is a depreciation in the value of the Life Insurance RIC shares held by the segregated asset account. Pursuant to § 817(a), the life insurance company may adjust (that is, increase) the deduction item for increases in reserves for the variable contracts by this depreciation in value of the assets held by the segregated asset account, so that the inclusion of the ordinary income dividend in the gross investment income of the segregated asset account is offset by a reserve deduction attributable to the depreciation in value of the Life Insurance RIC shares with respect to which the dividend distribution was paid.

If, as is usually the case, the segregated asset account applies this dividend to the purchase of additional shares in the Life Insurance RIC, the segregated asset account acquires a basis in these additional shares equal to the amount of the dividend that has been included in gross investment income. As a result, the segregated asset account’s basis in each of its Life Insurance RIC shares reflects the current net asset value attributable to each of the RIC’s outstanding shares, so that no gain or loss would be recognized by the life insurance company on the sale or redemption of any of those shares.

Taxpayer’s Alternative Arguments

Taxpayer has made several alternative arguments for excluding the portion of Life Insurance RIC dividends that it believes are derived from short-term capital gains. Several of these arguments are based on the erroneous assumption that ownership of assets through a RIC must be taxed identically to owning the assets directly. For instance, Taxpayer argues that § 817 is designed to exclude all corporate-level capital gains and losses, and the tax effect thereof, from insurance company income. See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (the 1984 Blue Book), 98th Cong. 2d Sess. 546 (Dec. 31, 1984). That statement is true but only applies where the income realized at the segregated asset account level meets the definition of capital gains. Short-term capital gains earned by a Life Insurance RIC are distributed by the RIC as ordinary income dividends, as noted above, and not as capital gains.

Similarly, Taxpayer interprets situation 5 of Rev. Rul. 81-225, 1981-2 C.B. 12, to imply that a life insurance company is the owner not of the RIC, but of its underlying assets. That ruling, which dealt with the tax treatment of a so-called “wrap-around” variable annuity, discussed five fact patterns under which the policyholder would or would not be considered the direct owner of assets nominally held by the insurance company. In situation 5, a Life Insurance RIC was described as an alter ego of the insurance company and further holds that the company is the “owner of these

underlying assets.” The ruling further states that the company “is the owner of the shares [of the RIC] for federal income tax purposes.” The ruling also indicates that this beneficial interest is reflected in the Life insurance RIC’s shares, and that the segregated asset account is treated as the owner of these shares for federal income tax purposes. The focus of the ruling is on whether the insurance company or the policyholder will be treated as the owner of the assets of a Life Insurance RIC from the standpoint of investor control. Both the excerpts quoted by Taxpayer and the remainder of the ruling indicate that, under situation 5, the life insurance company’s segregated asset account -- rather than the policyholder -- is the owner of the Life Insurance RIC used as the investment vehicle to support its variable contracts. Any inference that the insurance company is thereby also the owner of the assets of the RIC is misplaced. The insurance company is the owner of the RIC assets only to the extent that it is also the owner of the assets of any other corporate entity in which it holds shares.

Taxpayer also asks us to rely upon the rationale it sees in Rev. Rul. 71-197, 1971-1 C.B. 207, that held that capital gain dividends received from a RIC held in a segregated asset account to fund qualified pension contracts were not taxed to the life insurance company. Rev. Rul. 71-197 dealt with the application of a provision of the 1959 Act⁴ (former § 801(g)(7)) which permitted issuers of variable annuities used in connection with pension plans to adjust the basis of the segregated asset account assets to reflect appreciation or depreciation of those assets.⁵ Taxpayer argues that Rev. Rul. 71-197 indicates Service recognition that the reserve and basis adjustments made by the segregated asset account to reflect appreciation in the assets held by the account are allocable against dividends that could be allocable to a RIC’s short-term capital gains

We believe that Taxpayer’s reliance on this ruling in the present context is misplaced. Rev. Rul. 71-197 dealt with capital gain dividends from a RIC, not dividends attributable to the RIC’s short-term capital gains. Under § 852(b)(3)(B), a capital gain dividend is treated by the shareholders as a gain from the sale or exchange of a capital asset held for more than 1 year. This treatment is not available with respect to a RIC’s dividends, even if sourced from the RIC’s short-term capital gain, that are taxed as ordinary income dividends to the RIC shareholders. Moreover, the regulations under the segregated asset account provisions of the 1959 Act make clear that the adjustments made by a life insurance company to the segregated asset account reserves based on realized and unrealized appreciation in the assets held in the segregated asset account are not allocable against ordinary dividends. See § 1.801-8(f)(2), Example.

⁴ Life Insurance Company Tax Act of 1959, Public Law 86-69.

⁵ In the Tax Reform Act of 1984 (included within the Deficit Reduction Act of 1984, Public Law 98-369), Congress amended the segregated asset account provisions to extend the forbearance of tax on capital gains to segregated asset accounts supporting all variable contracts, not only those held by pension plans.

Finally, Taxpayer suggests that there is a difference in reporting standards between Public and Life Insurance RICs that produces a substantive difference in characterization of the RIC dividend. As noted above, no RIC is required to report dividends on a Form 1099 to exempt recipients, including life insurance companies. The alternative information given the shareholders of a Life Insurance RIC under the 1940 Act includes the amount of short-term capital gain. (We note that this information is also generally given by Public RICs with their Form 1099's.) In effect, Taxpayer asks that we conclude that the categories of dividend used in Subchapter M do not apply if the amount of short-term gain is known to an exempt recipient. We find no support in the law for this distinction.

Subchapter M Governs Character of Dividends

The RIC structure used in segregated asset accounts has a number of advantages from an operational and administrative standpoint that make the use of sub-accounts a preferred approach for the support of variable contracts. The use of RICs invokes Subchapter M, however, which clearly delineates the types of dividends that can and must be made. Taxpayer cannot ignore Subchapter M simply because it would be to its benefit in computing DRD. Section 817 operates properly to remove gains attributable to appreciation in the value of assets held in a segregated asset account supporting variable contracts. The inclusion of what would, with direct ownership, be short-term capital gain in gross investment income is a simple and direct consequence of Taxpayer's chosen structure.

Accordingly, we conclude that Taxpayer cannot rely on the reserve and basis adjustment rules of §§ 817(a) and (b) to exclude short-term capital gains included in dividends paid to its separate accounts by a Life Insurance RIC. Taxpayer must include these ordinary dividends in each segregated asset account's gross investment income under § 812(d).

We note that the reduction in DRD under the proration formula of § 812 is the only adverse impact of the inability of Taxpayer to exclude short-term capital gains earned by the RIC from its separate accounts' gross investment income, as the income is otherwise attributable to the policyholders. Specifically, to the extent that distribution of these dividends by the Life Insurance RICs reduces the value of the RICs held by Taxpayer's segregated asset accounts, Taxpayer will have a correlative adjustment in its end of year segregated asset account reserves by this depreciation in value when computing the deduction or income item under §§ 805(a)(2) and 803(a)(2) with respect to a net increase or net decrease in reserves, respectively.

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.