Section 817.—Treatment of Variable Contracts

A revenue ruling describes the tax treatment of the assets in a variable contract's segregated asset account. See Rev. Rul. 2003-91, page 347.

Section 61.—Gross Income Defined

26 CFR 1.61–1: Gross income.
(Also §§ 801, 817; 1.817–5.)

Investor control doctrine. This ruling presents guidance on the investor control doctrine by presenting a factual scenario in which a variable contract holder does not have control over segregated account assets sufficient to be deemed the owner of the assets. In this manner, this ruling presents a "safe harbor" from which taxpayers may operate.

Rev. Rul. 2003–91

ISSUE

Under the facts set forth below, will the holder of a variable contract be considered to be the owner, for federal income tax purposes, of the assets that fund the variable contract? Will income earned on those assets be included in the income of the holder in the year in which it is earned?

FACTS

Situation 1: *IC* is a life insurance company subject to tax under § 801 of the Internal Revenue Code. In states where it is authorized to do so, *IC* offers variable life and variable annuity contracts that qualify as variable contracts under § 817(d) ("Contracts").

The assets that fund the Contracts are segregated from the assets that fund *IC*'s traditional life insurance products. *IC* maintains a separate account ("Separate Account") for the assets funding the Contracts, and the income and liabilities associated with the Separate Account are maintained separately from *IC*'s other accounts.

The Separate Account is divided into various sub-accounts ("Sub-accounts"). Each Sub-account's assets and liabilities

are maintained separately from the assets and liabilities of other Sub-accounts. Interests in the Sub-accounts are not available for sale to the public. Rather, interests in the Sub-accounts are available solely through the purchase of a Contract. *IC* engages an independent investment advisor ("Advisor") to manage the investment activities of each Sub-account.[1] Each Sub-account will at all times meet the asset diversification test set forth in § 1.817–5(b)(1) of the Income Tax Regulations.

Twelve sub-accounts are currently available under the Contracts, but *IC* may increase or decrease this number at any time. However, there will never be more than 20 Sub-accounts available under the Contracts. Each Sub-account offers a different investment strategy. The currently available Sub-accounts include a bond fund, a large company stock fund, an international stock fund, a small company stock fund, a mortgage backed securities fund, a health care industry fund, an emerging markets fund, a money market fund, a telecommunication fund, a financial services industry fund, a South American stock fund, an energy fund and an Asian markets fund.

An individual ("Holder") purchases a life insurance Contract ("LIC"). At the time of purchase, Holder specifies the allocation of premium paid among the then available Sub-accounts. Holder may change the allocation of premiums at any time, and Holder may transfer funds from one Sub-account to another. Holder is permitted one transfer between Sub-accounts without charge per thirty-day period. Any additional transfers during this period are subject to a fee assessed against the cash value of LIC.

There is no arrangement, plan, contract, or agreement between Holder and *IC* or between Holder and Advisor regarding the availability of a particular Sub-account, the investment strategy of any Sub-account, or the assets to be held by a particular sub-account. Other than Holder's right to allocate premiums and transfer funds among the available Sub-accounts as described above, all investment decisions concerning the Sub-accounts are made by *IC* or Advisor in their sole and absolute discretion. Specifically, Holder cannot select or recommend particular investments or investment strategies. Moreover, Holder cannot communicate directly or indirectly with any investment officer of *IC* or its affiliates or with Advisor regarding the selection, quality, or rate of return of any specific investment or group of investments held in a Sub-account. Holder has no legal, equitable, direct, or indirect interest in any of the assets held by a Sub-account. Rather, Holder has only a contractual claim against *IC* to collect cash from *IC* in the form of death benefits, or cash surrender values under the Contract.

All decisions concerning the choice of Advisor or the choice of any of *IC*'s investment officers that are involved in the investment activities of Separate Account or any of the Sub-accounts, and any subsequent changes thereof, are made by *IC* in its sole and absolute discretion. Holder may not communicate directly or indirectly with *IC* concerning the selection or substitution of Advisor or the choice of any *IC*'s investment officers that are involved in the investment activities of Separate Account or any of the Sub-accounts.

Situation 2: The facts are the same as Situation 1 except that Holder purchases an annuity Contract ("Annuity").

LAW

Section 61(a) provides that the term "gross income" means all income from whatever source derived, including gains derived from dealings in property, interest and dividends.

A long standing doctrine of taxation provides that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss v. Bowers*, 281 U.S. 376 (1930). The incidence of taxation attributable to ownership of property is not shifted if the transferor continues to retain significant control over the property transferred, *Frank Lyon Company v. United States*, 435 U.S. 561 (1978); *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Clifford*, 309 U.S. 331 (1940), without regard to whether such control is exercised through specific retention of legal title, the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency. *Christoffersen v. U.S.*, 749 F.2d 513 (8th Cir.), *rev'g* 578 F. Supp. 398 (N.D. Iowa 1984).

Rev. Rul. 77–85, 1977–1 C.B. 12, considers a situation in which the individual purchaser of a variable annuity contract retained the right to direct the custodian of the account supporting that variable annuity to sell, purchase, and exchange securities or other assets held in the custodial account. The purchaser also was able to exercise an owner's right to vote account securities either through the custodian or individually. The Service concluded that the purchaser possessed "significant incidents of ownership" over the assets held in the custodial account. The Service reasoned that if a purchaser of an "investment annuity" contract may select and control the investment assets in the separate account of the life insurance company issuing the contract, then the purchaser is treated as the owner of those assets for federal income tax purposes. Thus, any interest, dividends, or other income derived from the investment assets are included in the purchaser's gross income.

In Rev. Rul. 80–274, 1980–2 C.B. 27, the Service, applying Rev. Rul. 77–85, concludes that, if a purchaser of an annuity contract may select and control the certificates of deposit supporting the contract, then the purchaser is considered the owner of the certificates of deposit for federal income tax purposes. Similarly, Rev. Rul. 81–225, 1981–2 C.B. 12, concludes that investments in mutual fund shares to fund annuity contracts are considered to be owned by the purchaser of the annuity if the mutual fund shares are available for purchase by the general public. Rev. Rul. 81–225 also concludes that, if the mutual fund shares are available only through the purchase of an annuity contract, then the sole function of the fund is to provide an investment vehicle that allows the issuing insurance company to meet its obligations under its annuity contracts and the mutual fund shares are considered to be owned by the insurance company. Finally, in Rev.

[1] For these purposes, the term investment officer refers to anyone whose responsibilities include giving investment advice or making investment decisions relating to assets held in a Sub-account and to any person who directly or indirectly supervises the work performed by such individual.

Rul. 82–54, 1982–1 C.B. 11, the purchaser of certain annuity contracts could allocate premium payments among three funds and had an unlimited right to reallocate contract value among the funds prior to the maturity date of the annuity contract. Interests in the funds were not available for purchase by the general public, but were instead only available through purchase of an annuity contract. The Service concludes that the purchaser's ability to choose among general investment strategies (for example, between stock, bonds, or money market instruments) either at the time of the initial purchase or subsequent thereto, does not constitute control sufficient to cause the contract holders to be treated as the owners of the mutual fund shares.

In *Christoffersen v. U.S.*, the Eighth Circuit considered the federal income tax consequences of the ownership of the assets supporting a segregated asset account. The taxpayers in *Christoffersen* purchased a variable annuity contract that reflected the investment return and market value of assets held in an account that was segregated from the general asset account of the issuing insurance company. The taxpayers had the right to direct that their premium payments be invested in any one of six publicly traded mutual funds. The taxpayers could reallocate their investment among the funds at any time. The taxpayers also had the right upon seven days notice to withdraw funds, surrender the contract, or apply the accumulated value under the contract to provide annuity payments.

The Eighth Circuit held that, for federal income tax purposes, the taxpayers, not the issuing insurance company, owned the mutual fund shares that funded the variable annuity. The court concluded that the taxpayers "surrendered few of the rights of ownership or control over the assets of the sub-account," that supported the annuity contract. *Christoffersen*, 749 F.2d at 515. According to the court, "the payment of annuity premiums, management fees and the limitation of withdrawals to cash [did] not reflect a lack of ownership or control as the same requirements could be placed on traditional brokerage or management accounts." *Id*. at 515–16. Thus, the taxpayers were required to include in gross income any gains, dividends, or other income derived from the mutual fund shares.

Section 817, which was enacted by Congress as part of the Deficit Reduction Act of 1984 (Pub. L. No. 98–369) (the "1984 Act"), provides rules regarding the tax treatment of variable life insurance and annuity contracts. Section 817(d) defines a "variable contract" as a contract that provides for the allocation of all or part of the amounts received under the contract to an account that, pursuant to State law or regulation, is segregated from the general asset accounts of the company and that provides for the payment of annuities, or is a life insurance contract. In the legislative history of the 1984 Act, Congress expressed its intent to deny life insurance treatment to any variable contract if the assets supporting the contract include funds publicly available to investors:

> The conference agreement allows any diversified fund to be used as the basis of variable contracts so long as all shares of the funds are owned by one or more segregated asset accounts of insurance companies, but only if access to the fund is available exclusively through the purchase of a variable contract from an insurance company. . . . In authorizing Treasury to prescribe diversification standards, the conferees intend that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors . . .

H. R. Conf. Rep. No. 98–861, at 1055 (1984).

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

Approximately two years after enactment of § 817(h), the Treasury Department issued proposed and temporary regulations prescribing the minimum level of diversification that must be met for an annuity or life insurance contract to be treated as a variable contract within the meaning of § 817(d). The preamble to the regulations stated as follows:

> The temporary regulations . . . do not provide guidance concerning the circumstances in which investor control of the investments of a segregated asset account may cause the investor, rather than the insurance company, to be treated as the owner of the assets in the account. For example, the temporary regulations provide that in appropriate cases a segregated asset account may include multiple sub-accounts, but do not specify the extent to which policyholders may direct their investments to particular sub-accounts without being treated as owners of the underlying assets. Guidance on this and other issues will be provided in regulations or revenue rulings under section 817(d), relating to the definition of variable contracts.

T.D. 8101, 1986–2 C.B. 97 [51 FR 32633] (Sept. 15, 1986). The text of the temporary regulations served as the text of proposed regulations in the notice of proposed rulemaking. *See* LR–295–84, 1986–2 C.B. 801 [51 FR 32664] (Sept. 15, 1986). The final regulations adopted, with certain revisions not relevant here, the text of the proposed regulations.

ANALYSIS

The determination of whether Holder possesses sufficient incidents of ownership over Sub-account assets to be deemed the owner of the assets supporting LIC and Annuity depends on all of the relevant facts and circumstances.

Holder may not select or direct a particular investment to be made by either the Separate Account or the Sub-accounts. Holder may not sell, purchase, or exchange assets held in the Separate Account or the Sub-accounts. All investment decisions concerning the Separate Account and the Sub-accounts are made by *IC* or Advisor in their sole and absolute discretion.

The investment strategies of the Sub-accounts currently available are sufficiently broad to prevent Holder from making particular investment decisions through investment in a Sub-account. Only *IC* may add or substitute Sub-accounts or investment strategies in the future. No arrangement, plan, contract, or agreement exists between Holder and *IC* or between Holder and Advisor regarding the specific investments or investment objective of the

Sub-accounts. In addition, Holder may not communicate directly or indirectly with Advisor or any of *IC*'s investment officers concerning the selection, quality, or rate of return of any specific investment or group of investments held by Separate Account or in a Sub-account.

Investment in the Sub-accounts is available solely through the purchase of a Contract, thus, Sub-accounts are not publicly available. The ability to allocate premiums and transfer funds among Sub-accounts alone does not indicate that Holder has control over either Separate Account or Sub-account assets sufficient to be treated as the owner of those assets for federal income tax purposes.

Based on all the facts and circumstances, Holder does not have direct or indirect control over the Separate Account or any Sub-account asset. Therefore, Holder does not possess sufficient incidents of ownership over the assets supporting either LIC or Annuity to be deemed the owner of the assets for federal income tax purposes. So long as LIC and Annuity continue to satisfy the diversification requirements of § 817(h) and *IC*'s and Holder's future conduct is consistent with the facts of this ruling, Holder will not be required to include the earnings on the assets held in Separate Account or any of the Sub-accounts in income under § 61(a).

HOLDING

Under the facts set forth above, the holder of a variable contract will not be considered to be the owner, for federal income tax purposes, of the assets that fund the variable contract. Therefore, any interest, dividends, or other income derived from the assets that fund the variable contract is not included in the holder's gross income in the year in which the interest, dividends, or other income is earned.

DRAFTING INFORMATION

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