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. 2003-92, page 350.

Variable contract holder. This ruling holds that a variable contract holder is the owner of interests in a nonregistered partnership where interests in the nonregistered partnership are not available exclusively through the purchase of a life insurance or annuity contract. Rev. Rul. 81–225 clarified and amplified.

Rev. Rul. 2003–92

ISSUES

Under the facts set forth below, will the holder of a variable annuity or life insurance contract be considered to be the owner, for federal income tax purposes, of the partnership interests that fund the variable contract if interests in the partnerships are available for purchase by the general public? What are the income tax consequences to the holder of the contract if that holder is considered to be the owner of the partnership interests that fund the variable contract?

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 deferred variable annuity contracts. *IC* has developed a variable annuity contract ("Annuity") for sale only to "qualified purchasers"[1] that are "accredited investors"[2] or to no more than one hundred accredited investors. *IC* is not required to register Annuity under the federal security laws.

Contract Holder, an individual qualifying as both a qualified purchaser and an accredited investor, purchases Annuity from *IC*. Annuity contains a number of provisions common to deferred annuity contracts, including the right of Contract Holder to surrender Annuity in part or entirely for cash (subject to a surrender charge) and the right to convert (at future dates chosen by Contract Holder) the accumulated values under Annuity into a stream of periodic payments under one of several settlement options.

The assets supporting Annuity are held in a segregated asset account that is maintained separately from *IC*'s other accounts. The segregated asset account is divided into 10 sub-accounts ("Sub-accounts"). Each Sub-account's assets and liabilities are maintained separately from the assets and liabilities of other Sub-accounts. At the time of purchase, Contract Holder specifies the premium allocation among the available Sub-accounts. Contract Holder may change the allocation of subsequent premiums at any time.

Each Sub-account available under Annuity invests in interests in a partnership ("Partnership"). None of the Partnerships are publicly traded partnerships under § 7704. All of the Partnerships are exempt from registration under federal security laws. Interests in each Partnership are sold in private placement offerings and are sold only to qualified purchasers that are accredited investors or to no more than one hundred accredited investors.

Each Partnership has an investment manager that selects the Partnership's specific investments. Contract Holder may not act as an investment manager or independently own any interest in any Partnership offered under Annuity. In addition, Contract Holder will have no voting rights with respect to any Partnership interest held by any Sub-account.

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.

Situation 2. The facts are the same as those in Situation 1, except *IC* offers, and Contract Holder purchases, a variable life insurance contract ("LIC") that qualifies as a life insurance contract under § 7702.

Situation 3. The facts are the same as those in Situation 1, except that (i) Contract Holder purchases both an Annuity and an LIC and (ii) interests in each Partnership are available for purchase only through the purchase of an Annuity,

[1] Under 15 U.S.C. § 80a–2(a)(51) a "qualified purchaser" is an individual, or other specified entity, that satisfies certain threshold financial requirements.

[2] The term "accredited investor," as defined by 15 U.S.C. § 77b(a)(15), and amplified by 17 CFR § 230.501(a), is also an investor that satisfies certain financial criteria. An accredited investor may be either an individual or certain enumerated entities. Because the criteria to be an accredited investor are similar to, but not identical to, the criteria that must be met to be a qualified purchaser it is possible for an accredited investor to also be a qualified purchaser. It is also possible for an investor to qualify only as either an accredited or qualified investor.

an LIC, or other variable contracts from insurance companies.

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.

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.

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* 51 FR 32664 (Sept. 15, 1986). The final regulations adopted, with certain revisions not relevant here, the text of the proposed regulations.

Prior to enactment of § 817, the Service issued a number of revenue rulings regarding when the owner of an annuity contract will be treated as the owner of the assets that fund the annuity. In the revenue rulings, the Service relied on long standing tax principles. *See generally*, *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Clifford*, 309 U.S. 331 (1940); *Corliss v. Bowers*, 281 U.S. 376 (1930). The revenue rulings consider whether the contract owners described in each ruling have retained sufficient incidents of ownership, as described in cases cited above, over the assets or retain sufficient control over the assets to be treated as the owners of those assets.

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 will be 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 includible in the gross income of the purchaser. Similarly, Rev. Rul. 80–274, 1980–2 C.B. 27, holds that if a purchaser of an annuity contract may select and control the certificates of deposit supporting the contract, then the purchaser is treated as the owner of the certificates of deposit for federal income tax purposes. In Rev. Rul. 80–274, the insurance company could not dispose of the deposit or convert it into a different asset. The insurance company did, however, have the power to withdraw the deposit from a failing savings and loan association.

Rev. Rul. 81–225, 1981–2 C.B. 12, describes four situations in which investments in mutual fund shares to fund annuity contracts are treated as owned by the policyholder rather than by the issuing insurance company, and one situation in which the issuing insurance company is treated as the owner of the mutual fund shares. In Situation 1, the investment assets in the segregated account supporting the annuity contracts consisted 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 publicly available mutual fund was managed by the issuing insurance company or one of its affiliates. Situation 3 also is similar to Situation 1, except that the segregated asset account supporting the annuity contracts consisted of five sub-accounts. Each sub-account was invested in the shares of a different mutual fund. Shares of the mutual funds were offered for sale to the general public. The policyholder retained 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 mutual fund did not sell shares directly to the public. The shares of the mutual fund were 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 was similar to Situation 2, except that the shares in the mutual fund were available only through the purchase of an annuity contract.

Rev. Rul. 81–225 concludes that the policyholders in Situations 1 through 4 had sufficient control and other incidents of ownership to be treated as the owners of the mutual fund shares for federal income tax purposes. The ruling reaches the opposite conclusion in Situation 5, because the sole function of the mutual fund in Situation 5 was to provide an investment vehicle that allows the issuing insurance company to meet its obligations under its annuity contracts and the insurance company possessed sufficient incidents of ownership to be treated as the owner of the underlying portfolio of assets of the mutual fund for federal income tax purposes.

In Rev. Rul. 82–54, 1982–1 C.B. 11, the purchasers of certain annuity contracts could direct the issuing insurance company to invest in the shares of any one or any combination of three mutual funds that were not available to the public. One mutual fund invested primarily in common stocks, another in bonds, and the third in money market investments. Policyholders could allocate their premium payments among the three funds and had 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 stock, bonds, or money market funds) either at the time of the initial purchase or subsequent thereto, did not constitute control sufficient to cause the policyholders to be treated as the owners of the mutual fund shares.

In *Christoffersen v. United States*, 749 F.2d 513 (8th Cir.), *rev'g* 578 F. Supp. 398 (N.D. Iowa 1984), the Eighth Circuit considered the federal income tax 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 or a combination 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 "surrender 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 the 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.

ANALYSIS

In Situation 1, Sub-accounts hold interests in Partnerships available for purchase other than by purchasers of Annuity or other variable contracts from insurance companies. Therefore, for federal income tax purposes, Contract Holder is the owner of the interests in Partnerships held by Sub-accounts. As a result, pursuant to § 61(a), Contract Holder must include in its gross income any interest, dividends, or other income derived from the interests in the Partnerships in the year in which the interest, dividends, or other income is earned.

In Situation 2, Sub-accounts hold interests in Partnerships available for purchase other than by purchasers of LIC or other variable contracts from insurance companies. Therefore, for federal income tax purposes, Contract Holder is the owner of the interests in Partnerships held by Sub-accounts. As a result, pursuant to § 61(a), Contract Holder must include any interest, dividends, or other income derived from the Partnerships in gross income in the year in which the interest, dividends, or other income is earned.

In Situation 3, Sub-accounts hold interests in Partnerships available for purchase only by a purchaser of an Annuity, a LIC, or other variable contracts from insurance companies. Therefore, for federal income tax purposes, *IC* owns the interests in Partnerships that fund the Sub-accounts. As a result, pursuant to § 61(a), any interest, dividends, or other income derived from the Partnerships is not included in Contract Holder's gross income in the year in which the interest, dividends, or other income is earned.

HOLDINGS

Under the facts set forth above, the holder of a variable annuity or life insurance contract will be considered to be the owner, for federal income tax purposes, of the partnership interests that fund the variable contract if interests in the partnerships are available for purchase by the general public. If the holder of a variable annuity or life insurance contract is considered to be the owner of the partnership interests that fund the variable contract, pursuant to § 61(a), the contract holder must include any interest, dividends, or other income derived from the partnership interests in gross income in the year in which the interest, dividends, or other income is earned.

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 81–225, 1981–2 C.B. 12 is hereby clarified and amplified.

DRAFTING INFORMATION

The principal author of this revenue ruling is James Polfer of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Mr. Polfer at (202) 622–3970 (not a toll-free call).