UNDERSTANDING SECURITIES PRODUCTS OF INSURANCE COMPANIES

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Introduction

This outline summarizes the Federal income tax rules applicable to variable life insurance contracts and variable annuities. It covers only "nonqualified" uses of such contracts, i.e., the use of such contracts in connection with employer sponsored qualified plans is not addressed. The outline describes the rules that must be satisfied for such contracts to receive the favorable income tax treatment generally accorded to the products, the consequences of not adhering to those rules, and the treatment of distributions from the products.

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VARIABLE LIFE INSURANCE AND ANNUITIES: BASIC INCOME TAX RULES

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I. Scope of Discussion.

A. *Focus on Federal Income Taxation of Policyholders* – This outline addresses the Federal income taxation of variable life insurance and annuity contracts, focusing on the income tax treatment of contract owners and beneficiaries. It describes the treatment of distributions and deemed distributions from life insurance contracts, including so-called "modified endowment contracts," and from immediate and deferred annuity contracts. The outline also sets forth the various "definitional" rules applicable to such contracts, such as the definition of a life insurance contract and the "adequate diversification" requirements applicable to the separate accounts underlying such contracts, and discusses the consequences of failing to comply with those definitions. While the outline does not address state and local income taxes that may apply, many state and local income tax regimes follow the Federal rules.

B. *Employment-Related Uses Excluded* – The outline does not address the special rules governing the use of, and the treatment of distributions from, life insurance and annuity contracts in "qualified" retirement plans. In addition, the discussion does not consider the treatment of contracts used in "nonqualified" employee compensation, e.g., the imputation of income in the case of so-called "split dollar" plans. For the latter, see Adney, "Using Life Insurance in Executive Compensation," chap. 15 in M. Sirkin and L. Cagney, Executive Compensation (Law Journal Seminars-Press 1997).

C. *References* – The fundamentals of life insurance and annuity contracts are discussed in K. Black and H. Skipper, Life Insurance (13th ed. 2000), and in E. Graves (ed.), McGill's Life Insurance (American College of

Insurance 1994). Detailed information on the Federal tax definitions of life insurance and modified endowment contracts appears in C. DesRochers, J. Adney, D. Hertz, and B. King, Life Insurance & Modified Endowments (Society of Actuaries 2004). Detailed information on annuities, including the Federal tax treatment of nonqualified annuities, appears in J. Adney, J. McKeever, and B. Seymon-Hirsch, Annuities Answer Book (Panel Publishers, 4th ed. 2005).

D. *Internal Revenue Code Citations* – In the balance of this outline, all section references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

II. Life Insurance Contracts.

A. Deferral of Tax on the "Inside Buildup."

1. The Internal Revenue Service (the "Service" or "IRS") and the courts have consistently held that increments in the cash values of life insurance contracts – known as the "inside buildup" – are not constructively received until the contract's surrender or maturity. See, e.g., Theodore H. Cohen, 39 T.C. 1055 (1963), acq. 1964-1 C.B. 4; Abram Nesbitt, II, 43 T.C. 629 (1965).

2. This treatment is codified in section 7702(g), enacted in 1984, which provides for current taxation of the inside buildup of a life insurance contract *only if* the contract fails to meet the requirements of section 7702, the tax definition of "life insurance contract." (See II.E. below.)

3. Thus, the inside buildup of a life insurance contract, as defined in section 7702, is tax-deferred.

a. Moreover, if the contract terminates in the payment of a death benefit, the inside buildup is untaxed. (See II.B. below.)

b. If a contract fails to satisfy the definition of life insurance, the inside buildup is taxed currently to the contract owner according to the section 7702(g) formula. The formula provides that the owner's gross income includes the "income on the contract" for any taxable year, defined as (1) the excess of the increase in the contract's "net surrender value" during the year, plus the cost of insurance protection during the year, over the premiums paid during the year, and (2) in the case of a contract which first failed the definition during the year, the income on the contract for all prior years. This tax can be waived by the IRS in certain circumstances. (See II.E.1.d. below.)

4. Normally, the surrender or maturity of a life insurance contract terminates the period of deferral, although a contract may be exchanged for a life insurance, endowment, or annuity contract without triggering taxation. (See II.C. below.)

5. If a corporation owns a life insurance contract, then in calculating its alternative minimum tax liability, it must include the section 7702(g) "income on the contract" in determining its "adjusted current earnings," though it is allowed to deduct "that portion of any premium which is attributable to insurance coverage." See section 56(g)(4)(B)(ii).

B. Exclusion of Death Benefits.

1. The amount paid "by reason of the death of the insured" – the death benefit – under a life insurance contract, as defined in section 7702, generally is excluded from the gross income of the beneficiary under section 101(a)(1).

2. The death benefit exclusion is denied, however, in certain circumstances:

a. If the contract is transferred for value, the exclusion is denied for all amounts in excess of the consideration paid for the transfer (and any subsequent premiums). However, despite a transfer for value, the death benefit exclusion will continue to be available if the transfer is made to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is an officer or shareholder. See section 101(a)(2). A transfer partly by gift is not a transfer for value. Rev. Rul. 69-187, 1969-1 C.B. 45. To the extent the exclusion is denied following a transfer for value, the amount received is ordinary income. Rev. Rul. 2009-14, 2009-21 I.R.B. 1031 (situation 1).

b. The exclusion is denied if the owner of a contract does not possess an insurable interest in the insured, since the contract is merely a wagering contract. Atlantic Oil Co. v. Patterson, 331 F.2d 516 (5th Cir. 1964). However, it is only necessary that the insurable interest exist when the contract was issued. Ducros v. Commissioner, 272 F.2d 49 (6th Cir. 1959). Whether a business possesses an insurable interest in employees is determined by state law, although a business generally is thought to possess such an interest in its "key" employees. The law in this area is rapidly changing due to the increasing use of life insurance by corporations insuring large numbers of employees. See, e.g., Mayo v. Hartford Life Insurance Co., 193 F. Supp. 2d 927 (S.D. Tex., March 5, 2002), op. withdrawn, 2002 U.S. Dist. LEXIS 15976 (S.D. Tex., Aug. 2, 2002), and substituted op., 220 F. Supp. 2d 714 (S.D. Tex. 2002), aff'd, 354 F.3d 400 (5^{th} Cir. 2004).

c. The exclusion is denied if the benefit is paid to a creditor who is named as beneficiary under the contract "as its interest may appear," since the benefit covers a debt of the insured and is paid to the beneficiary because of the insured's indebtedness rather than death. Landfield Finance Co. v. U.S., 418 F.2d 172 (7th Cir. 1969); Rev. Rul. 70-254, 1970-1 C.B. 31 (death benefit payment may be excludable from the creditor's income as a return of capital.).

d. If the contract fails to meet the section 7702 definition, then pursuant to section 7702(g), only the excess of the death benefit over the contract's "net surrender value" at the time of death is excluded from income. Presumably, the income of the beneficiary would include the current year's "income on the contract" but (by virtue of section 102, excluding bequests from income) would not include any previously taxed "income on the contract."

e. Pursuant to section 101(j), the exclusion is limited if the contract is an employer-owned life insurance contract issued after August 17, 2006, unless the contract satisfies certain statutory requirements. Under these requirements, the insured must be an employee during the 12 months prior to death or be a (i) director or (ii) a "highly compensated employee" of the employer at the time that the contract is issued. Furthermore, certain employee notice and consent requirements must be met in order to avoid application of the section 101(j) limitation to the exclusion. <u>See</u> Notice 2009-48, 2009-24 I.R.B. 1085 (providing guidance on various aspects of section 101(j)).

C. Lifetime Distributions, Loans, and Transfers.

1. Prior to an insured's death, amounts may be paid by an insurer under a life insurance contract as (a) surrender or maturity proceeds, (b) the proceeds of a partial surrender or withdrawal, and (c) policy loans. In addition, amounts may be disbursed, by an insurer or others, consequent to a contract's (d) assignment or (e) exchange.

2. The tax treatment of such distributions, loans, and transfers may differ depending upon whether the contract is classified as a "modified endowment contract" (or "MEC") under rules enacted in 1988. As defined in greater detail in II.E.2. below, a MEC is a life insurance contract purchased with a single premium or a limited number of premiums (or possessing a comparable degree of investment orientation).

3. In the case of a life insurance contract *other than* a MEC:

   a. Complete surrender or maturity proceeds are includible in income, when they are received or made available, to the extent that they represent "gain" in the contract, i.e., the amount by which the proceeds received exceed the "investment in the contract." See section 72(e)(5)(C). The character of the income realized by the funds in which a variable life insurance contract invests is irrelevant to the taxation of the contract owner. All amounts includible in the owner's income are taxed as *ordinary* income. Thus, any capital gains realized by the funds which are received by the contract owner and includible in income are effectively converted to ordinary income.

      i. The investment in the contract consists of the premiums paid for the contract less any amounts received under the contract without taxation (such as partial withdrawals). See section 72(e)(6).

      ii. A loss upon surrender or maturity is probably not deductible to the extent the loss is attributable to the costs of providing insurance under the policy. See London Shoe Co. v. Commissioner, 80 F.2d 230 (2nd Cir. 1935); Century Wood Preserving Co. v. Commissioner, 69 F.2d 967 (3rd Cir. 1934). However, to the extent the loss is attributable to other factors, e.g., a reduction in the value of the underlying investment portfolio of a variable life insurance contract, the loss may be deductible. See PLR 200945032 (July 17, 2009) (holding that a market-driven loss in a business-owned, variable life insurance contract is deductible upon surrender by the owner-taxpayer).

iii. If the proceeds are paid out as a stream of annuitized payments under a contractual option exercised within 60 days after their payment in a lump sum first became available, the payments are taxed as an annuity, as described in III.C. below, rather than in a lump sum at the time of surrender or maturity. See section 72(h).

b. Partial surrender or withdrawal proceeds generally are includible in income only to the extent that they exceed the investment in the contract — a treatment sometimes referred to as the "cost recovery" or "FIFO" rule. See section 72(e)(5)(C). However, during the first 15 contract years, an additional amount may be includible in income pursuant to the "recapture ceiling" rules of section 7702(f)(7)(B)-(E). Rev. Rul. 2003-95, 2003-2 C.B. 358, describes the application of the section 7702(f)(7) recapture rules in various situations.

c. Policy loans secured by life insurance contract cash values are treated as true loans, rather than as distributions, meaning that the amounts received are not taxed. However:

i. Loans that are liquidated upon a contract's surrender or maturity are treated as proceeds received at that time, subject to inclusion in income, although loans liquidated at death do not give rise to income due to section 101(a)(1). See Atwood v. Commissioner, T.C. Memo 1999-61 (1999).

ii. There is some question whether interest-free or "zero net cost" loans are treated as loans for these purposes.

d. The assignment of a contract, to secure a third-party loan or to effect a gratuitous transfer of the contract or an exchange of the contract (described next), is generally without income tax effect (although a gift may give rise to gift tax liability). If an assignment effects a sale of the contract, the "gain" in the contract is taxed under section 1001.

e. Upon the exchange of a contract for another life insurance contract, or for an endowment or annuity contract, the "gain" in the contract generally is not taxed, pursuant to section 1035. However:

i. If any cash or other property is received, or release of a policy loan occurs, in connection with an exchange, there is income equal to the lesser of the cash or the value of the other property received (or the amount of the loan released) and the "gain" in the contract. This is known as the "boot" rule. See sections 1031(b) and 1035(d).

ii. For an exchange to qualify as non-taxable under section 1035, the insured must be the same person before and after the exchange. An exchange involving a change in the party insured – such as in the context of a "key" employee business coverage – is a taxable exchange. See Rev. Rul. 90-109, 1990-2 C.B. 191.

iii. Pursuant to the Pension Protection Act of 2006, a life insurance contract, endowment contract, annuity contract, or qualified long-term care insurance ("QLTCI") contract can be exchanged for a QLTCI contract tax-free under section 1035(a) after December 31, 2009. In addition, tax-free exchanges among life insurance and annuity contracts after that date will not be prevented merely because the life insurance contract or annuity contract includes a QLTCI rider or feature.

f. In the event of a sale of a life insurance contract, gain is recognized under section 1001 equal to the excess of the amount realized over the adjusted basis in the contract.

i. According to guidance issued by the IRS, the seller's basis in the contract will differ depending upon whether the seller has an insurable interest in the insured or would otherwise suffer economic loss from the insured's death. If the seller has an insurable interest or would suffer a loss on the insured's death, the seller's basis consists of the premiums paid for the contract reduced for the cost of insurance under the contract. Rev. Rul. 2009-13, 2009-21 I.R.B. 1029 (situation 2). If the seller has no insurable interest or would suffer no loss on the insured's death, the seller's basis consists of the premiums paid for the contract without reduction for the cost of insurance under the contract. Rev. Rul. 2009-14, 2009-21 I.R.B. 1031 (situation 2). Not everyone agrees with the IRS position that the seller's basis in the former situation is reduced for the cost of insurance under the contract. <u>See,</u> <u>e.g.</u>, Letter to Mark Smith (Treasury) and Sheryl Flum (IRS) from the American Council of Life Insurers, July 31, 2009, <u>available</u> <u>at</u> 2009 TNT 150-11 (Tax Analysts).

ii. The gain recognized by the seller can be ordinary income or capital gain, depending on the circumstances. If the sale is of a term life insurance contract, all the gain is capital gain. Rev. Rul. 2009-13, 2009-21 I.R.B. 1029 (situation 3); Rev. Rul. 2009-14, 2009-21 I.R.B. 1031 (situation 2). If the sale is of a cash value life insurance contract, the gain is ordinary income to the extent of the gain that would have been realized under section 72 upon a surrender of the contract, and any remaining gain is capital gain. Rev. Rul. 2009-13, 2009-21 I.R.B. 1029 (situation 2).

4. In the case of a life insurance contract *which is a MEC*:

a. Pre-death distributions, and amounts treated as pre-death distributions, are (1) included in income in accordance with a "gain first" or "LIFO" rule, and (2) may be subjected to a penalty tax.

i. Under the LIFO rule, amounts are includible in income to the extent that the contract's "cash value" immediately before the distribution – unreduced by any surrender charges – exceeds the investment in the contract (as defined above), an amount referred to as the "income on the contract." See section 72(e)(3) and (10).

ii. The penalty tax equals 10 percent of the amount includible in income, though it does not apply to distributions made on or after the date on which the taxpayer (typically the owner) attains age 59-1/2, because the taxpayer became disabled, or which are part of a series of substantially equal periodic payments over the life (or life expectancy) of the taxpayer (or of the taxpayer and his or her beneficiary). See section 72(v).

b. The types of distributions subject to these rules are surrenders, partial surrenders or withdrawals, policy loans – including those used to pay premiums or to cover interest due on prior loans – and assignments for value. See section 72(e)(4) and (10).

c. The receipt or repayment of a policy loan generally does not affect the investment in the contract, except that any amount included in income increases such investment. See section 72(e)(4)(A); H.R. Rep. No. 100-1104, at 102-103 (1988).

d. While distributions made in any year prior to the year in which a contract becomes a MEC generally are not subjected to the foregoing treatment, prior distributions made "in anticipation" of MEC status (including any made within two years before a contract becomes a MEC) are subjected to it. See section 7702A(d).

e. For purposes of determining the amount includible in income in connection with pre-death distributions from a MEC, section 72(e)(12) treats all MECs issued to the same policyholder in the same calendar year by the same insurer (or its affiliates) as one contract. Rev. Rul. 2007-38, 2007-1 C.B. 1420, holds that if one or more contracts subject to such aggregation are exchanged for MECs issued by another insurer, the new MECs are not aggregated with the remaining original contracts. Question: Does the same result occur if the new MECs are issued by the same insurer as the original contracts?

f. The assignment of a contract with a death benefit of $25,000 or less for the payment of funeral expenses (as defined in section 7702(e)(2)(C)(iii)) is not treated as a distribution. See section 72(e)(10)(B).

g. Because the foregoing rules – LIFO, the treatment of loans and assignments as distributions, and the penalty tax on "premature" distributions – first applied to annuity contracts (under 1982 legislation), they are frequently referred to as the "annuity distribution rules."

D. Premiums and Borrowing to Pay Premiums.

1. Premiums paid for a life insurance contract (whether or not a MEC) generally are considered personal expenses which are not deductible in calculating taxable income, pursuant to section 262.

2. Premiums paid by a business taxpayer for a life insurance contract are not deductible, pursuant to section 264(a)(1), if the

taxpayer is directly or indirectly a beneficiary under the contract.

3. If premiums are paid by borrowing (from the insurer or a third party), the interest on the borrowing is:

   a. Generally not deductible outside of a business context (see section 163(h));

   b. Deductible in a business context only if in substance it constitutes interest under section 163;

   c. Not deductible if the borrowing is incurred or continued to purchase or carry a "single premium" contract, which is defined to include a contract the premiums for which are substantially paid-up within 4 years of issuance (see section 264(a)(2) and (c));

   d. Not deductible if the borrowing is incurred or continued to purchase or carry a contract under a plan of "systematic" borrowing – i.e., a "minimum deposit" plan – unless, among other things, four of the first seven annual premiums due under the contract are not paid by borrowing (see section 264(a)(3) and (d)); and

   e. Generally not deductible in the case of indebtedness relating to a life insurance (or annuity) contract owned by a taxpayer covering the life of any individual. However, special rules allow the deduction of interest with respect to contracts covering a "key person" to the extent the borrowing does not exceed $50,000. A key person is defined as an officer or 20-percent owner. The maximum number of persons treated as key persons is the greater of (i) 5 individuals or (ii) the lesser of 5 percent of the total officers and employees of the taxpayer or 20 individuals. For purposes of determining the number of key persons, all members of a controlled group are treated as one taxpayer. See section 264(a)(4), (d) and (e).

4. If a corporation or other entity holds a life insurance (or annuity) contract issued after June 8, 1997, a portion of the entity's interest expense deduction under section 163 may be disallowed regardless of whether the debt is connected with the contract. See section 264(f).

   a. The amount of interest disallowed is determined by multiplying the corporation's total interest expense by the ratio of:

      i. The unborrowed cash values of all such contracts issued after June 8, 1997, to

      ii. The adjusted bases of all other assets of the corporation plus the unborrowed cash values.

   b. This disallowance rule does not apply to contracts:

      i. Covering 20-percent owners, officers, directors, and employees of a business;

      ii. That are annuity contracts which are not treated as such for federal income tax purposes pursuant to section 72(u); or

      iii. Held by individuals (however, if a corporation or partnership is the direct or indirect beneficiary, the policy or contract is treated as held by the corporation or partnership).

   c. A special version of this rule applies to contracts owned by an insurance company. The application of this rule to insurers is uncertain and the IRS has issued a revenue procedure providing a safe harbor from the rule and asking for comments on how it should be applied. Rev. Proc. 2007-61, 2007-2 C.B. 747.

E. Definitions.

1. "Life Insurance Contract."

a. In general, a life insurance contract is defined in section 7702, for all purposes of the Internal Revenue Code, as a contract of life insurance under "the applicable law" – generally meaning the law of the state in which the contract is delivered – and that meets either of two tests:

i. A "cash value accumulation test," which is met if, by the contract's terms, its cash value (before surrender charges) at any time cannot exceed the "net single premium" for its "future benefits" – the death and endowment benefits – at that time. See section 7702(b).

ii. "Guideline premium" and "cash value corridor" requirements, which essentially limit the premiums that may be paid for a contract (the "guideline premium limitation") and mandate that the contract's death benefit be at least a statutorily prescribed multiple of its cash value. See section 7702(c).

b. In applying the section 7702 tests:

i. The "net single premium" is computed using the contract's guaranteed interest rate or rates (including any initial guarantees), but at least an annual effective rate of 4 percent, and "reasonable" mortality charges as limited by the statute and regulations. See section 7702(b).

(a) In the case of a variable life insurance contract that does not have any guaranteed interest rate, the 4-percent rate is used. See Staff of the Jt. Comm. on Taxation, General Explanation of the

Revenue Provisions of the Deficit Reduction Act of 1984, p. 648 (the "1984 Blue Book"). If a variable life insurance contract has a fixed or general account investment option with a guaranteed interest rate in excess of 4 percent, that higher guaranteed rate should be used.

(b) In general, pursuant to section 7702(c)(3)(B)(i) as revised in 1988, the mortality charges must meet requirements set forth in regulations and cannot, except as provided in regulations, exceed the charges in the "prevailing commissioners' standard tables" defined in section 807(d)(5) for computing a company's tax reserves.

(c) Regulations defining reasonable mortality charges, mandated by 1988 law, have not yet been issued, but "safe harbor" rules are provided by two interim notices issued by the Service and by the statute.

Notice 88-128, 1988-2 C.B. 540, permits the assumption that 100 percent of 1980 CSO-based charges (sex-distinct and aggregate) are reasonable mortality charges.

Notice 2006-95, 2006-2 C.B. 848, creates three safe harbors, including safe harbors relating to the 2001 CSO tables. Notice 2006-95 also provides that for contracts issued after 2008, 2001 CSO tables will be mandatory. Notice 2006-95 supersedes Notice

2004-61, 2004-2 C.B. 596, which had limited somewhat Notice 88-128.

The statute provides that charges higher than those based on the prevailing commissioners' standard tables, if they do not differ materially from those that are reasonably expected to be actually imposed (based on underwriting), are reasonable mortality charges. This rule is relied upon, pending the issuance of further guidance, in the case of contracts covering substandard risks. See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 5011(c) (1988).

(d) The reasonable mortality charge requirement applies to contracts entered into on or after October 21, 1988. Caution: if a contract issued before that date is changed in some significant way, it may become subject to this requirement (and, perhaps, thereby fail the section 7702 tests).

ii. The "guideline premium limitation" is the greater of the "guideline single premium" for the contract or the sum of its "guideline level premiums" as of any date. A contract satisfies this limitation if, in fact, the sum of the premiums paid for it as of any time (less any untaxed withdrawals or dividends) does not exceed the guideline premium limitation at that time. See section 7702(c).

(a) The guideline single premium is the premium needed to fund the contract's future benefits, assuming guaranteed interest (not less than 6 percent), reasonable mortality charges, and "reasonable" expense charges specified in the contract which are "reasonably expected to be actually paid."

(b) The guideline level premium is the level annual premium counterpart of the guideline single premium, payable at least to age 95, with a 4 percent minimum interest assumption.

iii. A contract falls within the "cash value corridor" if, in fact, its death benefit is at least a percentage multiple of its (pre-surrender charge) cash value: 250% up to the insured's attained age 40, declining to 100% by age 95. See section 7702(d).

iv. To limit the possible investment orientation of contracts, certain "computational rules" must be followed in the net single premium and guideline premium calculations: a non-increasing death benefit generally must be assumed, the contract's maturity date is assumed to be not earlier than the insured's age 95 and not later than age 100, the death benefit is deemed to be provided until the maturity date, and the guaranteed endowment benefit may not be projected to exceed the lowest death benefit provided over the life of the contract. See section 7702(e)(1). Exceptions to the no-increase rule are allowed in the case of, e.g., guideline level premiums and certain funeral expense contracts. See section 7702(e)(2). For life insurance contracts maturing after the insured reaches age 100, the Service has prescribed a safe harbor for satisfying the computational rule that requires an assumed maturity date falling between the ages 95 and 100. Rev. Proc. 2010-28, 2010-34 I.R.B. 270

(the safe harbor may be met by satisfying certain “Age 100 Safe Harbor Testing Methodologies” set forth in the Revenue Procedure.)

v. “Qualified additional benefits” provided under a contract – defined as guaranteed insurability benefits, accidental death or disability benefits, “family” term coverage, disability waiver benefits, and any other benefits specified in regulations – may be reflected in the net single premium and guideline premium calculations. Their reflection (technically, the inclusion of the present value of their costs) in the section 7702 premiums permits them to be prefunded. See section 7702(f)(5).

Revenue Ruling 2005-6, 2005-1 C.B. 471, provides that charges for QABs are subject to the “expense charge rule” of section 7702(c)(3)(B)(ii) for purposes of determining whether a contract qualifies as a life insurance contract under section 7702 and as a modified endowment contract under section 7702A. Rev. Proc. 2008-38, 2008-29 I.R.B. 139, describes the means by which taxpayers may obtain relief from the IRS if they have not accounted for charges for QABs properly.

vi. “Adjustments” of the section 7702 calculations are required when certain future benefits (or other contract terms) change. See section 7702(f)(7)(A).

c. The section 7702 rules are quite complex and have raised a myriad of questions, many still unanswered. For example, in the case of many contracts, the ascertainment of the “guaranteed” interest rate is difficult, and some of the calculation techniques for adjustments and for contracts involving significant qualified additional benefits may be debated.

d. Failure to comply with the requirements of section 7702 due to "reasonable error" may be waived by the Service, pursuant to section 7702(f)(8), if "reasonable" steps are taken to correct the error. Provision of additional death benefits or return of excessive premiums with interest typically are conditions to the granting of a waiver. Rev. Proc. 2008-42, 2008-29 I.R.B. 160, provides a procedure for obtaining an automatic waiver, and is limited to certain enumerated forms of errors. If an error is not covered by the revenue procedure, an insurer can request a waiver through the private letter ruling process. If an error is not eligible for a waiver (automatic or otherwise), the only way to restore the tax-favored status of the contract is to enter into a "closing agreement" with the IRS and pay a "toll charge." The toll charge required to be paid in connection with a closing agreement may be calculated by using either the method described in Rev. Rul. 91-17, 1991-1 C.B. 190, or one of two additional methods provided in Rev. Proc. 2008-40, 2008-29 I.R.B. 151.

e. Additional definitional requirements apply in the case of variable life insurance contracts:

    i. Such contracts must comply with the section 7702 tests only when the amount of the death benefit changes, although not less frequently than once a year. <u>See</u> section 7702(f)(9).

    ii. To preclude the use of the variable funds underlying the contracts as merely tax-deferred investment vehicles, such funds must meet minimum investment diversification requirements prescribed by section 817(h) and regulations issued thereunder. (See IV. below.)

iii. As an extension of the above, the contracts also must be structured in a manner that does not permit excessive "control" of the underlying investments by the policyholders. (See IV. below.)

2. "Modified Endowment Contract."

a. Section 7702A(a) defines a "modified endowment contract" for all purposes of the Internal Revenue Code (although the term is used only under section 72) as a life insurance contract for which the accumulated premiums paid at any time during the first seven contract years exceed the sum of the seven level annual premiums (the "7-pay premiums") needed on or before that time to pay up the benefits under the contract.

i. A MEC is thus said to be a contract that fails the "7-pay test."

ii. A contract received in exchange for a MEC is automatically considered a MEC.

b. The 7-pay premiums are computed using the rules of the cash value accumulation test of section 7702, with some modifications. <u>See</u> section 7702A(b) and (c).

i. As a result, the 7-pay premiums cannot reflect contractual expense charges. This means that, being computed net of premium loads, they generally will fall below the level annual gross premiums needed to pay up the contract in seven years.

ii. To ameliorate the effect of this no-load requirement on smaller contracts, $75 may be added to each of the 7-pay premiums in the case of a contract providing a death benefit of $10,000 or less and that meets certain other requirements. Also, the statute provides that regulations may allow expenses attributable solely to the collection of modal premiums to be taken into account. However, no such regulations have been issued.

iii. A specific rule in section 7702A requires that the 7-pay premiums be computed assuming that the initial death benefit is provided until the contract's maturity date, despite scheduled decreases after the seventh year.

c. The 7-pay premiums are required to be recomputed if:

i. Benefits are decreased during the first seven years of a contract. See section 7702A(c)(2).

(a) In such a case, the 7-pay premiums are recomputed as if the new, decreased benefit had been in effect from the inception of the contract, and the test is re-applied from inception (the "look-back" rule).

(b) Such retroactive testing may well result in MEC status.

(c) Such re-testing is undertaken *at any time* a joint and last survivor contract's benefits are decreased.

ii. The contract undergoes a "material change." See section 7702A(c)(3).

(a) A material change occurs whenever there is a change in benefits (or other terms) of a contract not reflected in a prior 7-pay premium calculation. A material change includes any exchange and any term conversion.

(b) Excluded from material change treatment is any decrease in benefits (which is addressed, if at all, by the "look-back" rule). Also excluded is any increase, such as a dividend addition or a section 7702(d) corridor increase, due to "necessary premiums" (generally those needed to mature the contract for a level, initial face amount) and interest, earnings, or dividends credited thereon.

(c) Upon a material change, the 7-pay premiums are recalculated for the new, changed benefit, and the 7-pay test is re-applied from the time of the change. Each of the new 7-pay premiums is reduced, to account for any pre-existing cash value in the contract, by an amount equal to that cash value multiplied by a fraction: the new 7-pay premium divided by the new net single premium.

(d) Thus, upon a material change – which includes an exchange – the "old" cash value is not counted as a lump sum premium. So, if a non-MEC is exchanged for a new, single premium contract (without the payment of any additional premium), the new contract generally will not be a MEC.

d. The MEC rules are effective for contracts issued on or after June 21, 1988. Previously issued contracts which are changed in certain ways – e.g., benefits are added which the policyholders did not have unilateral rights to obtain – may become subject to the MEC rules.

e. In 1999, the IRS published a temporary revenue procedure, Rev. Proc. 99-27, 1999-1 C.B. 1186, allowing life insurers to restore contracts which inadvertently had become MECs to "non-MEC" status by paying a monetary sanction and taking certain corrective action. The 1999 corrective procedure was subsequently modified, and the current procedure is Rev. Proc. 2008-39, 2008-29 I.R.B. 143, which generally provides relief on more favorable terms than did the prior procedures.

III. Annuity Contracts.

A. Premiums Payments and Tax Deferral.

1. Premiums paid for an annuity contract generally are not deductible in calculating taxable income.

a. Premiums paid by an individual taxpayer for an annuity contract are considered personal expenses which are not deductible in calculating taxable income. See section 262.

b. Premiums paid by a business taxpayer for an annuity contract are not deductible, pursuant to section 264(a)(1), if the taxpayer is directly or indirectly a beneficiary under the contract. However, this disallowance does not apply to premiums paid to purchase an annuity contract used in connection with certain qualified retirement plans or an annuity contract which is issued to an entity and thus not treated as an annuity contract for federal income tax purposes. See section 264(b).

2. In general, annuity contracts owned by "natural persons," or held by "non-natural" persons as agents for natural persons, are accorded tax deferral of their inside buildup just as in the case of life insurance contracts. Such annuity contracts, however, must meet the definitional requirements noted in III.E. below.

3. Annuity contracts owned by non-natural persons are *currently taxed* on their inside buildup, pursuant to section 72(u), with some exceptions.

   a. Included in income for any taxable year is the "income on the contract" for the year, which is defined as the excess of (1) the contract's net surrender value at year-end plus all distributions under the contract to date, over (2) the premiums paid for the contract (net of dividends) plus all distributions includible in income to date.

   b. The inside buildup taxation applies with respect to contributions to annuity contracts after February 28, 1986.

   c. Exceptions from this treatment are made for:

      i. An immediate annuity, defined in section 72(u)(4) as an annuity purchased with a single premium and providing for a payout of substantially equal periodic amounts beginning no later than one year from purchase and continuing over the annuity period. See Rev. Rul. 92-95, 1992-2 C.B. 43 (considering whether an annuity received in an exchange qualifies as an "immediate annuity").

      ii. A contract acquired by a decedent's estate by reason of the decedent's death.

      iii. A structured settlement annuity.

      iv. A contract held in one of specified qualified plan arrangements.

B. Distributions, Loans, and Transfers Before Annuitization.

1. Prior to annuitization, a surrender, partial surrender, loan, or assignment is governed by the rules described in II.C.4. above. These rules are provided in section 72(e) and (q) (penalty tax).

2. For purposes of determining the "gain" or "income on the contract," section 72(e)(12) requires the "aggregation" of all annuity contracts sold to the same policyholder within the same calendar year by the same insurer (or its affiliates). <u>See</u>, <u>e.g.</u>, PLR 200243047 (July 30, 2002). Excluded from this aggregation rule are immediate annuities and annuities used in qualified plan arrangements. Also excluded are so-called "split-funded" annuities (though these may be subject to other aggregation treatment).

3. The section 72(q) 10 percent penalty tax on annuity distributions provides for exceptions that extend beyond those applicable to MEC distributions under section 72(v). Specifically, also excepted from the penalty tax are distributions made from immediate annuities (again, as defined by section 72(u)(4)), made on or after the death of the "holder" of the contract, made from a structured settlement annuity or a qualified plan arrangement, made from a "grandfathered" annuity (<u>i.e.</u>, allocable to investment in the contract before August 14, 1982), or made as part of a series of substantially equal periodic payments for the life (or life expectancy) of the taxpayer or the lives (or joint life expectancies) of the taxpayer and his designated beneficiary. The exception also applies for distributions from a contract owned by a grantor trust if the grantor has attained age 59½. <u>See</u> Information Letter 2001-0121 (Apr. 19, 2001).

   In Notice 2004-15, 2004-1 C.B. 526, the IRS concluded that taxpayers may use one of the methods set forth in Notice 89-25, 1989-1 C.B. 662, as modified by Rev. Rul. 2002-62, 2002-2 C.B. 710, to determine whether a distribution from a non-qualified annuity contract is part of a "series of substantially equal periodic payments" under section 72(q)(2)(D) and, thus, exempt from the 10 percent penalty tax of section 72(q)(1).

(Notice 89-25 as modified by Rev. Rul. 2002-62 applies to qualified annuity contracts and describes how to determine whether a payment from a qualified annuity contract is a part of series of substantially equal period payments under section 72(t)(2)(A)(iv) and, thus, exempt from the 10 percent penalty tax of section 72(t)(1).) Although the IRS concluded that substantially equal periodic payments should be calculated in the same manner for qualified and nonqualified annuity contracts, IRS guidance published with respect to Code provisions applicable to qualified annuity contracts does not always apply to similar (or identical) Code sections applicable to nonqualified annuity contracts.

4. The rules governing the disallowance of deductions for interest on borrowing in connection with life insurance contracts described in II.D.3. and 4. above apply to annuity contracts as well.

5. The gratuitous transfer of an annuity contract is effectively treated as a surrender of the contract, pursuant to section 72(e)(4)(C), unless the transfer is to a spouse or to a former spouse incident to a divorce.

6. Until recently, combinations of annuity contracts with QLTCI contracts were not possible for tax purposes because features of the annuity (e.g., its cash value) ran afoul of certain qualification requirements applicable to QLTCI contracts. To address this, the Pension Protection Act of 2006 amended section 7702B(e) to provide that the portion of a contract providing long-term care insurance coverage is treated as a separate contract from the annuity. Thus, the annuity contract's features do not infect the long-term care insurance portion of the contract and accordingly such portion may qualify as a QLTCI contract (assuming the applicable requirements under section 7702B are met). In addition, any charges against the annuity cash value to pay for the QLTCI coverage are excludable from income, although they reduce the investment in the contract. See, e.g., PLR 200919011 (Feb. 2, 2009). This rule applies to contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009.

7. An annuity contract may be exchanged for another annuity contract without triggering taxation, under section 1035, if the "obligee" is not changed. It is unclear whether the "insured" under the two contracts must be the same. See Treas. Reg. sec. 1.1035-1(c). If the contract owner receives a check from the first insurer and transfers it to the second insurer, the event is not a tax-free exchange. Rev. Rul. 2007-24, 2007-1 C.B. 1282. An existing deferred annuity contract may be merged into another existing deferred annuity in a tax-free "exchange." See Rev. Rul. 2002-75, 2002-2 C.B. 812. If "boot" is involved, it is taxed as previously described.

An annuity contract may also be exchanged tax-free for a QLTCI contract. See II.C.3.e.iii. above.

The direct transfer of a portion of the cash value of an existing annuity contract issued by one insurance company for a new annuity contract issued by a second insurance company can qualify as a tax-free exchange under section 1035. Conway v. Commissioner, 111 T.C. 350 (1998), acq. 1999-2 C.B. xvi. Rev. Proc. 2008-24, 2008-1 C.B. 684, provides that a partial exchange of an annuity contract will be tax-free if there is no surrender of, or distribution from, either the original annuity contract or the new annuity contract within 12 months of the partial exchange or if one of several enumerated events occurs between the date of transfer and the date of surrender or distribution. (In PLR 201038012 (June 22, 2010), the IRS clarified that if the taxpayer is 59½ or older at the date of surrender or distribution, the above 12-month restriction does not apply.) In addition, if the exchange satisfies the terms of the Revenue Procedure, the IRS will not require aggregation under section 72(e)(12) (or otherwise) of the existing and the new contracts, even if the two contracts are issued by the same insurer. However, if the exchange fails to satisfy the Revenue Procedure, although aggregation under 72(e)(12) still will not apply, the exchange will be treated as a taxable distribution, followed by payment for a new contract. The basis and investment in the contract of the existing annuity contract is allocated ratably between the existing annuity contract and the new annuity contract, based on the percentage of the cash value retained in the existing contract and the percentage of the cash value transferred to purchase the new contract. See Rev. Rul. 2003-76, 2003-2 C.B. 355; PLR 200342003 (July 9, 2003).

8. A loss incurred upon the surrender of an annuity contract is deductible as an ordinary loss, assuming that the contract was entered into for profit. See Rev. Rul. 61-201, 1961-2 C.B. 46; George M. Cohan, 39 F.2d 540 (2nd Cir. 1930). The deduction likely is subject to the 2 percent of adjusted gross income "floor" imposed with respect to miscellaneous deductions. See section 67.

C. Annuitized Payments.

1. If the entire value of an annuity contract is applied to provide a stream of periodic payments satisfying certain requirements set forth in Treasury regulations, each of those payments (technically, "amounts received as an annuity") will be partly includible in income and (because of nondeductible premium payments) partly excludable as a return of capital, pursuant to an "exclusion ratio." (This is often referred to as the contract being "annuitized.") See section 72(b)(1) and Treas. Reg. sec. 1.72-2(b)(2).

2. Specifically, each payment is included in income to the extent it exceeds an excluded amount.

   a. In the case of fixed annuity payments, the excluded amount is determined by multiplying the payment by a fraction (known as the "exclusion ratio"): the investment in the contract divided by the "expected return" under the contract. The expected return is determined under tables of life expectancies prescribed in regulations, and an adjustment is made for any refund feature. See section 72(c); Treas. Reg. secs. 1.72-4 through 1.72-7.

   b. In the case of variable annuity payments, the excluded amount is determined by dividing the investment in the contract by the expected number of payments. See Treas. Reg. sec. 1.72-2(b)(3).

3. Once the investment in the contract is fully recovered, the entirety of each succeeding annuity payment is includible in income. Conversely, if the death of the annuitant causes payments to cease without full recovery of the investment, the unrecovered portion is deductible by the annuitant in his or her final tax return. See section 72(b)(2)-(4).

4. The Small Business Jobs Act of 2010, Pub. L. No. 111-240, amends section 72(a) to allow an annuity (and a life insurance or endowment) contract to be partially annuitized, i.e., an exclusion ratio will be available even though only a portion of a contract's cash value is applied to create a series of periodic payments. The periodic payments must be for a period of 10 years or more or for life. See section 72(a)(2). The annuitized portion of the contract is treated as a separate contract and the investment in the contract is allocated pro rata between the annuitized portion and the remaining deferred portion. See section 72(a)(2)(B) and (C). The new rule is applicable to amounts received after December 31, 2010.

5. In certain circumstances, a series of systematic partial withdrawals under a deferred annuity may be treated as annuity payments, that is, as "amounts received as an annuity" for purposes of section 72. See PLR 200313016 (Dec. 20, 2003) (concluding that each payment received *via* a systematic partial withdrawal option under a deferred annuity is "an amount received as an annuity" to the extent it does not exceed the amount computed by dividing the investment in the contract by the number of expected payments). In such case, a portion of the payment will be excludable from gross income.

6. Payments made under an annuity contract's guaranteed minimum withdrawal benefit for life (GMWBL) typically will not qualify as "amounts received as an annuity" while the contract still has a cash value, but may so qualify after the cash value is exhausted and the insurer's funds are the source of the payments.

D. Death Benefits — Amounts payable under an annuity contract (whether or not it has been annuitized) to a beneficiary after the death of the contract owner or annuitant are taxable to the beneficiary, when received, under the normal section 72 rules.

1. There is no section 101 exclusion or section 1014 "step-up" in basis. See Rev. Rul. 55-313, 1955-1 C.B. 219; Rev. Rul. 79-335, 1979-2 C.B. 292, modified and superseded by Rev. Rul. 2005-30, 2005-1 C.B. 1015 (variable annuities).

2. A variable annuity contract may provide an "enhanced" death benefit, i.e., an amount that exceeds the greater of the premiums paid or the cash surrender value of a contract, and for which a separate charge usually is imposed. Typically, such a benefit would not be treated as a life insurance contract under state law and, thus, would not be a life insurance benefit for federal income tax purposes, nor would the charge for the benefit be treated as a distribution from the annuity. See sections 72(e) and 7702(a). However, if the annuity contract provides a benefit which is treated as life insurance under state law, the charge for such benefit will be deemed distributed from the annuity and includible in the owner's income, while the death benefit may be treated as an excludable from the gross income of the beneficiary. See PLR 200022003 (Dec. 9, 1999) involving a deferred annuity with a term life insurance rider.

E. Medicare Hospital Insurance Tax.

1. The recent health care legislation adopted a 3.8% tax on the "net investment income" of certain high income taxpayers, effective January 1, 2013. See Health Care and Education Reconciliation Act, Pub. L. No. 111-152, § 1402 (2010). "Net investment income" includes, among other things, gross income from interest, dividends, annuities, royalties, and rents. Gross income from annuities likely covers both "amounts received as an annuity" (i.e., annuity payments) and "amounts not received as an annuity" (i.e., withdrawals), but there is some uncertainty about the scope of the provision.

2. The new tax only applies to the extent a taxpayer's modified adjusted gross income exceeds a specified income threshold. The thresholds are $250,000 for married couples filing jointly, $125,000 for married couples filing separately, and $200,000 for everyone else.

F. Definition of an Annuity.

1. The earnings credited under a deferred annuity contract will be tax deferred and any annuity payments will qualify for pro rata exclusion ratio treatment only if the contract is treated as an annuity for tax purposes. While there is no comprehensive statutory definition of an annuity contract for tax purposes, the characteristics of such a contract may be identified from regulations, case law, and certain statutory provisions.

2. An annuity contract, according to regulations, includes a contract that is recognizable as an annuity under "customary" insurance industry practices. <u>See</u> Treas. Reg. sec. 1.72-2(a)(1). Under the regulations and cases, the contract must provide for (at least annual) periodic payments. Further, such payments must liquidate principal and interest or earnings; if, in substance, the payments provide only interest, with the principal left intact for payment upon a commutation or to a death beneficiary, the entirety of the interest payments will be includible in income. <u>See</u> section 72(j); Treas. Reg. sec. 1.72-14(a); <u>Igleheart v. Comm'r.</u>, 174 F. 2d 605, 606-07 (7th Cir. 1949), aff'g 10 T.C. 766 (1948); <u>Meyer v. Comm'r.</u>, 139 F. 2d 256, 258-59 (6th Cir. 1943).

   a. *Maximum annuity starting date*. Until about 10-15 years ago, most deferred annuity contracts provided for annuity payments to commence around age 85. Now, many contracts defer the commencement of payments to age 95 (or later). Is there a maximum age for the annuity starting date, past which a contract might no longer be viewed as an annuity contract? <u>See</u>, <u>e.g.</u>, GCM 38934 (July 9, 1982) (questioning whether a contract with an annuity commencement date of age 95 would be an annuity). Or, is it sufficient that the owner (or annuitant) has the option exercisable before death to convert the cash value to a stream of fixed and determinable periodic payments that will liquidate the cash value over some period? See, e.g., GCM 38378 (May 16, 1980).

b. *Immediate annuities with surrender values*. The IRS has issued private letter rulings holding that an immediate annuity with a cash surrender value will be treated as an annuity for federal tax purposes. See PLR 200305018 (Oct. 24, 2002); PLR 200036021 (Sept. 8, 2000); PLR 9237030 (Jun. 16, 1992). However, the existence of such a surrender value presents the possibility that the principal and interest (or other earnings) under the annuity are not being amortized. What standard is appropriate for determining whether payments are sufficient to liquidate a contract?

c. *Deferred annuities without surrender values.* In the early years of the 20th century, it was not unusual for a deferred annuity contract to be issued without a surrender value or a death benefit. Such contracts paid a life annuity if the annuitant survived to a stated age, e.g., 70, but otherwise paid no benefits. Sometimes called "pure deferred annuities," these contracts had largely disappeared until recently, but are now being marketed as "longevity insurance." After these products reappeared, questions occasionally were raised by IRS officials as to whether the contracts are annuity contracts for federal income tax purposes. However, a recent private letter ruling involving a contract which provided no cash value or death benefit for a number of years, but upon maturity provided a life annuity, held that the contract was an annuity subject to the rules of section 72. See PLR 200939018 (June 18, 2009).

Another form of annuity contract without a cash value, sometimes referred to as a contingent annuity, or a stand-alone withdrawal benefit, has also begun to be offered by a few insurers. These contracts promise to provide an annual payment based on the value of an account referenced by the contract for as long as the annuitant lives, even if the account value is reduced to zero, provided annual withdrawals are not made from the account in amounts exceeding a stated percentage (e.g., 5%) of the amounts deposited in the account. The assets in the account are owned not by the insurer but by the person who purchases the contract. The IRS has ruled that this form of a contract is an annuity contract subject to the rules of section 72. These rulings also concluded that the assets in the account referenced by the contract are subject to capital gains treatment, and ownership of the contract does not cause a loss of capital gains treatment under the straddle rules. See PLR 201001016 (Sept. 14, 2009); PLR 200949036 (July 30, 2009); PLR 200949007 (July 30, 2009).

3. An annuity contract issued after January 18, 1985, whether deferred or immediate, must satisfy *by its terms* the minimum distribution-at-death requirements of section 72(s):

   a. If the "holder" of the contract dies *before* the "annuity starting date," the contract's entire value must be required to be distributed within five years of the death. See section 72(s)(1)(B). There are exceptions:

      i. Any portion of the contract's value distributable over the life or life expectancy of a designated beneficiary, distribution of which begins to be made no later than one year from the date of death, is treated as distributed on the day that the distribution commences.

      ii. If the designated beneficiary is the spouse of the holder, the spouse may "step into the shoes" of the decedent and continue the contract.

         In an increasing number of states, individuals of the same sex are now treated as spouses either because the state recognizes same sex marriages or because spousal status is extended to same sex individuals who enter into a domestic partnership or civil union. However, under the Defense of Marriage Act, Pub. L. No. 104-199 (1996), for federal tax purposes, a spouse must be an individual of the opposite sex. As a result, there is sometimes a conflict between spousal status for federal tax purposes and for local law purposes. This conflict creates the potential for annuity contracts to violate the section 72(s) rules if the contract may be continued after the owner's death by an individual who is a spouse under local law but not Federal law. These issues have been the subject of extensive discussion with state insurance authorities.

See also PLR 200323012 (Feb. 20, 2003) (where the designated beneficiary of a deferred variable annuity contract is a grantor trust, the beneficiary of the grantor trust is considered the "designated beneficiary" of the contract within the meaning of section 72(s)(4)); PLR 200313016 (Dec. 20, 2002) and PLR 200151038 (Sept. 25, 2001) (both involving the use of systematic withdrawals to make post-death distributions).

b. If the holder dies on or *after* the annuity starting date, any remaining payments must be required to be made at least as rapidly as they would have been made under the distribution method in effect prior to the holder's death. See section 72(s)(1)(A).

c. If the holder is not a natural person (and section 72(u) does not apply), the "primary annuitant" under the contract – the individual whose life, age, etc., primarily affects the timing and amount of the payout under the contract – is treated as the holder. If such primary annuitant is changed, the contract must provide for its liquidation as if the holder had died. See section 72(s)(6)-(7).

d. If there is more than one holder (as in the case of joint owners), the death of *any* holder must trigger the above-described liquidation of the contract.

e. Structured settlement annuities and contracts used in qualified retirement plans are exempted from the section 72(s) requirements. <u>See</u> section 72(s)(5).

4. A variable annuity contract, to be treated as an annuity for tax purposes, also must comply with the investment diversification requirements of section 817(h) (and the regulations thereunder) and must not provide the policyholder with excessive "control" of the investments underlying the contract. (See IV. next below.)

IV. Investor Control and Diversification Requirements

A. The Doctrine of "Investor Control" and Events Leading to the Enactment of Section 817(h).

1. *Ownership of assets*. Under the "traditional" variable life insurance or annuity contract, the insurance company (and not the policyholder) is considered the owner of the underlying separate account assets. Consistently with this, the policyholder is not taxed on any income generated by those assets unless and until he withdraws amounts from the contract (in which case the rules of section 72 are applied).

2. *The "wraparound" issue*. In the mid-1970s, the Service began to question the tax-deferred status of variable annuities which permitted varying degrees of policyholder control over the investment of the underlying assets.

a. Subsequently, a series of rulings were issued indicating that, in certain circumstances, the policyholder would be deemed to "own" the assets for Federal income tax purposes, with the annuity contract being characterized as a mere "wrapper."

b. As a result, the policyholder would be currently taxable on earnings from those assets, e.g., realized capital gains, dividends, and interest.

c. These “wraparound” or “investor control” rulings apparently are based on a general principal of tax law: that the substance of an arrangement, not merely its form, controls the taxation of the arrangement.

3. *Revenue Ruling 77-85.* In Rev. Rul. 77-85, 1977-1 C.B. 12, the Service held that the bundle of rights given the policyholder in an “investment annuity” contract amounted to a direct investment in the underlying account assets. Thus, the policyholder would be treated as the owner of the assets and currently taxed on their earnings.

a. The “bundle of rights” included substantial control over the selection of the underlying assets and the possession of voting rights with respect to the underlying securities.

b. The ruling was a reversal of earlier private letter rulings which had granted annuity tax treatment to policyholders under investment annuities. See, e.g., PLR 7747111 (Aug. 29, 1977); PLR 7208091300A (Aug. 9, 1972); PLR 7204041250A (Apr. 4, 1972).

c. In Investment Annuity, Inc. v. Blumenthal, 442 F. Supp. 681 (D.D.C. 1977), the court sustained the issuing company's action to void Rev. Rul. 77-85 and enjoin IRS enforcement. The case was reversed on procedural grounds, 609 F.2d 1 (D.C. Cir. 1979), cert. denied, 446 U.S. 981 (1980).

4. *Revenue Ruling 80-274.* In the “savings and loan annuity” contract, a policyholder's premiums were invested in certificates of deposit having a duration and rate selected by the policyholder and issued by a bank or savings and loan association of the policyholder's choice. In Rev. Rul. 80-274, 1980-2 C.B. 27, the Service ruled that “the policyholder's

position is substantially identical to what his position would have been" had the investment been made directly with the savings institution, so that the policyholder (and not the insurer) would be considered the owner of the assets underlying the contract.

5. *Revenue Ruling 81-225.* Rev. Rul. 81-225, 1981-2 C.B. 12, pertained to annuity contracts funded by insurance company unit investment trust separate account arrangements, where the insurance company purchased and sold shares of mutual funds which were also offered for sale directly to the public. The ruling held that the policyholders of those variable annuity contracts whose purchase payments were invested in publicly available mutual fund shares would be treated as the owners of the mutual fund shares.

6. *Revenue Ruling 82-54.* In Rev. Rul. 82-54, 1982-1 C.B. 11, the Service held that a policyholder's ability to choose among three broad, general investment strategies (stocks, bonds and money market instruments) would not constitute sufficient control over individual investment decisions so as to cause ownership of mutual fund shares not offered directly to the public to be attributable to the policyholder.

7. *Revenue Ruling 82-55.* In Rev. Rul. 82-55, 1982-1 C.B. 12, the Service attempted to clarify various issues which had been left open under Rev. Rul. 81-225. In particular, the ruling stated that purchasers of annuity contracts whose funds were invested in a "closed" mutual fund (i.e., its shares were no longer available for purchase by the general public) would not be treated as the owners of those mutual fund shares.

8. *The "representations."* In 1982, the Service began to issue private letter rulings detailing certain "representations" that would be required from an issuer of a variable annuity contract (and subsequently a variable life insurance contract) in order to receive a favorable ruling. Changes to these "representations," which related to the nature and control of the assets in variable contract separate accounts, were made almost continuously after the initial letter ruling was issued.

9. *Christoffersen v. United States*.

a. On October 15, 1981, taxpayers purchased a variable annuity contract which permitted them as policyholders to allocate premiums among sub-accounts of the issuing insurance company's separate account. The premiums allocated to a particular sub-account were invested in a specified mutual fund, the shares of which were also available for purchase (directly or indirectly) by the general public.

b. Pursuant to Rev. Rul. 81-225, the taxpayers included in their taxable income for 1981 income received by the insurance company on the mutual fund shares allocated to the contract at issue. The taxpayers then sued for a refund, challenging the validity of Rev. Rul. 81-225.

c. The U.S. District Court for the Northern District of Iowa decided in favor of the taxpayers, holding that the "contract is an annuity pursuant to 26 U.S.C. 801(g) qualifying for deferred taxation under 26 U.S.C. 72." See 578 F. Supp. 398 (N.D. Ia. 1984).

d. On appeal by the Government, the U.S. Court of Appeals for the 8th Circuit overturned the district court's ruling and held that the taxpayers' variable annuity contract did not qualify for deferred tax treatment under section 72, and thus that the policyholders were currently taxable on income from the contract. See 749 F.2d 513 (8th Cir. 1984)

i. The Court of Appeals characterized the contract as "an investment program which includes a contract for the purchase of an annuity."

ii. The court observed, with respect to the contract, that the "investors" bore the entire investment risk, could withdraw any or all of the investment upon 7 days notice, and might never annuitize the contract. Further, the only difference between this "variable annuity" arrangement and that of a traditional brokerage account was the fact that the investor was limited to withdrawing cash.

iii. The court held that the taxpayers were in constructive receipt of the income generated by the account assets.

iv. The court did not analyze (or mention) the specific issue involved in the case and the essence of Rev. Rul. 81-225 — the public availability of the mutual funds upon which the contract was based. However, after describing the doctrine of constructive receipt, the court noted that "[t]his is the essence of Rev. Rul. 81-225, which we find persuasive."

e. The rationale of the Court of Appeals conceivably could be applied to alter the tax treatment of all variable annuity contracts (and variable life insurance contracts). However, the provisions of the Internal Revenue Code at issue were substantially revised in 1982 and again in 1984 so as to place significant restrictions on nonqualified annuity contracts. In this connection, the court specifically noted that, because the case involved the 1981 tax year, it dealt only with the statute as it existed in 1981.

B. Diversification Requirements Under Section 817(h).

1. Section 817(h).

a. Section 817(h), containing the variable contract "investment diversification" rules, was enacted by section 211(a) of the Deficit Reduction Act of 1984 (Pub. L. 98-369) "in order to discourage the use of tax-preferred variable annuities and variable life insurance primarily as investment vehicles." S. Rep. No. 98-169, vol. 1, 98th Cong., 2nd Sess. 546 (1984).

b. General rule of section 817(h)(1): a variable contract is not treated as an annuity, endowment, or life insurance contract for life insurance company tax purposes or for purposes of sections 72 and 7702 unless the investments made by the segregated asset account on which such contract is based are "adequately diversified" in accordance with regulations prescribed by the Secretary of the Treasury.

c. Section 817(h) does not apply to pension plan contracts described in section 818(a). Thus, variable annuities used as section 403(b) "tax-sheltered annuities" and section 408(b) individual retirement annuities do not need to be based on diversified accounts (although they often are). See section 817(h)(1).

d. "Safe harbor" rules.

   i. Any fund will be deemed to be adequately diversified if it meets the diversification requirements of section 851(b)(4) (relating to regulated investment companies) *and* not more than 55 percent of its total assets consist of cash, cash items, Government securities, and securities of "other regulated investment companies." See section 817(h)(2).

   ii. Funds underlying *variable life insurance contracts* are deemed adequately diversified even if such funds invest totally in U.S. Treasury securities. The statute does not provide a similar exception for variable annuity contracts. See section 817(h)(3).

   iii. An insurance company may use an independent investment advisor to manage the assets underlying its variable contracts. See section 817(h)(5).

e. "Look-through rule": the insurer is allowed to look through to the assets of the underlying investment vehicle in determining compliance with investment diversification requirements in certain circumstances. See section 817(h)(4).

f. "Clone funds": according to the Conference Report on the 1984 law, the fact that a "similar fund" is available to the general public will not, in itself, cause a fund underlying a segregated asset account to be treated as publicly available. See H.R. Rep. 98-861, 98th Cong., 2nd Sess. 1055 (1984).

2. Temporary and proposed regulations under section 817(h)(1).

a. Temporary and proposed regulations implementing section 817(h) were issued in September 1986.

b. The preamble to the temporary and proposed regulations provided background information and a summary of the regulatory provisions. The preamble noted, in particular, that the temporary and proposed regulations did not provide guidance relating to the circumstances in which "investor control" of variable account investments may cause the investor, rather than the insurance company, to be treated as the owner of assets of such account. Rather, the preamble stated such guidance "will be provided in regulations or revenue rulings under section 817(d), relating to the definition of a variable contract."

c. Numerous comments were filed by the life insurance industry on the proposed regulations, and a number of changes were made in the final regulations, issued in March 1989.

3. Final regulations (Treas. Reg. sec. 1.817-5).

   a. Basic rule (Treas. Reg. sec. 1.817-5(b)(1)): the assets of a “segregated asset account” will be treated as adequately diversified only if —

      i. No more than 55% of the value of the assets of the account is represented by any one investment;

      ii. No more than 70% of the value of the assets of the account is represented by any two investments;

      iii. No more than 80% of the value of the assets of the account is represented by any three investments; and

      iv. No more than 90% of the value of the assets of the account is represented by any four investments.

   b. Safe harbor (Treas. Reg. sec. 1.817-5(b)(2)): see IV.B.1.d.i. above.

   c. Special rule for variable life contracts (Treas. Reg. sec. 1.817-5(b)(3)): under a formula set forth in the regulations, a segregated asset account supporting variable life insurance contracts is effectively allowed to invest entirely in Treasury securities — see IV.B.1.d.ii. above.

   d. Aggregation of securities (Treas. Reg. sec. 1.817-5(b)(1)(ii)): all securities of the same issuer generally are treated as a single investment. However, in the case of Government securities, each Government agency or instrumentality is treated as a separate issuer.

   e. Period for which account must be adequately diversified (Treas. Reg. sec. 1.817-5(c)):

i. An account must be adequately diversified each calendar quarter. It is treated as adequately diversified for the quarter if it is diversified on the last day of a calendar quarter (i.e., March 31, June 30, Sept. 30, and Dec. 31) or within 30 days thereafter.

ii. There are special, more liberal rules for new and for liquidating accounts. See Treas. Reg. sec. 1.817-5(c)(2) and (3).

iii. There is also a special rule to prevent market value fluctuations of assets from causing the percentage limitations to be violated. See Treas. Reg. sec. 1.817-5(d).

f. Definition of a "segregated asset account" (Treas. Reg. sec. 1.817-5(e)): for purposes of the diversification regulations —

i. "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."

ii. In the case of the typical variable contract, each sub-account or investment division is treated as a segregated asset account for diversification testing. However, this treatment presupposes that the owner of the contract has the right to allocate funds among the sub-accounts or investment options. See Treas. Reg. sec. 1.817-5(g).

g. Look-through rule (Treas. Reg. sec. 1.817-5(f)):

i. If certain conditions are satisfied, a segregated asset account is treated as owning a pro-rata portion of each asset of the entity in which the account invests, rather than an interest in the entity itself. The rule applies only to certain entities: regulated investment companies, real estate investment trusts, partnerships, and grantor trusts.

ii. General conditions to be satisfied: in general, the look-through is available only if all the beneficial interests in the entity are held by one or more segregated asset accounts of one or more insurance companies, and public access to such entity is available exclusively through the purchase of a variable contract. (This has the effect of enforcing the holding of Rev. Rul. 81-225.) See also PLR 201038008 (June 24, 2010), PLR 201027038 (Mar. 31, 2010), PLR 200919025 (Jan. 29, 2009), and PLR 200246022 (Aug. 13, 2002) (each involving whether life insurance and annuity contracts issued by a foreign insurance company that has made a section 953(d) election meet the definition of variable contracts under section 817(d)).

iii. Exceptions: application of the look-through rule is not prevented if beneficial interests in the entity are held –

(a) by the general account of the life company or certain related corporations, if certain conditions are satisfied;

(b) by the manager, or certain related corporations, of the entity, but only if the holding of the interest is in connection with the creation of the entity and certain other conditions are satisfied;

(c) by the trustee of a qualified pension or retirement plan (See Rev. Rul. 94-62, 1994-2 C.B. 164; Rev. Rul. 2007-58, 2007-2 C.B. 562; PLR 200308032 (Nov. 8, 2002); PLR 200244016 (Aug. 1, 2002); PLR 200221036 (Feb. 21, 2002); PLR 200122013 (Feb. 21, 2002); PLR 200607011 (Feb. 17, 2006); and PLR 200613028 (Apr. 3, 2006));

(d) by a qualified tuition program as defined in section 529;

(e) by Puerto Rican segregated asset accounts; or

(f) in connection with certain grandfathered "wraparound" annuity contracts.

iv. Non-registered partnerships. Until 2005, the regulations also allowed look-through treatment with respect to a segregated asset account's interest in a partnership that was not registered under any federal or state law regulating the offering or sale of securities (a "non-registered partnership"). See former Treas. Reg. sec. 1.817-5(f)(2)(ii).

(a) Thus, look-through treatment applied to non-registered partnerships without regard to whether the "beneficial interest" and "public access" requirements were satisfied.

(b) This special rule was repealed in 2005.

v. An issue that sometimes arises is whether a "double" look through is available in circumstances where one fund invests in another fund. The general answer is "yes," providing that the requirements of the look-through rule are satisfied by both funds. See Rev. Rul. 2005-7, 2005-1 C.B. 464. See also, e.g., PLR 200016008 (Jan. 18, 2000).

h. Definitions of terms (Treas. Reg. sec. 1.817-5(h)): the regulations define a number of the terms that they use, including "government security" and "Treasury security." Terms that are undefined are to be given the same meaning as when used in section 851.

i. Consequences of nondiversification (Treas. Reg. sec. 1.817-5(a)(1)):

i. The regulations provide that for purposes of subchapter L, section 72, and section 7702(a), a variable contract which is based on one or more segregated asset accounts shall not be treated as an annuity or life insurance contract for (1) any calendar quarter for which the investments of *any* such account are not "adequately diversified," and (2) any subsequent period even if the investments are adequately diversified for such subsequent period.

ii. A contract is treated as based on a segregated asset account for a calendar quarter if *any* amounts under the contract are allocated to the account at *any* time during the quarter.

iii. If a contract is not treated as an annuity or life insurance contract as a result of the foregoing rule, the "income on the contract" within the meaning of section 7702(g) is treated as ordinary income received by the policyholder during the year.

j. Inadvertent failures to diversify (Treas. Reg. sec. 1.817-5(a)(2)): the investments of a nondiversified segregated asset account will be treated as adequately diversified if certain conditions are satisfied —

   i. The nondiversification must have been "inadvertent."

   ii. The nondiversification must be cured within a "reasonable time after the discovery" of the nondiversification.

   iii. Either the issuer of the contract or the holder must "agree to make such adjustments or pay such amounts as may be required by the Commissioner with respect to the period or periods during which the investments of the account [were not diversified.]"

   iv. Rev. Proc. 2008-41, 2008-29 I.R.B. 155, sets forth the procedure to be followed and the computation of the sanction, or "toll charge," to be paid to obtain this relief.

k. Notice 2008-92, 2008-43 I.R.B. 1001, addresses the consequences under section 817(h) of participation in a Treasury Department Temporary Guarantee Program for Money Market Funds (the "Program") by an insurance-dedicated money market fund. Under the Program, which has ended, the Treasury Department guaranteed the share price of any eligible money market fund that applied for and paid a fee to participate in the Program. The Notice states that participation in the Program would not result in a failure of the section 817(h) diversification requirements (nor an investor control problem).

C. Status of Investor Control Doctrine Today.

1. The investor control doctrine was not specifically addressed in the final regulations under section 817(h), although some have viewed the doctrine as being preempted by section 817(h) and the regulations thereunder. In this regard, in July 2003, the IRS released two revenue rulings addressing the investor control doctrine. These rulings represent the first formal guidance on the investor control doctrine since 1982.

2. Revenue Ruling 2003-91, 2003-2 C.B. 347.

a. Facts.

i. Revenue Ruling 2003-91 describes two situations involving the purchase of a variable contract within the meaning of section 817(d) from a life insurance company subject to tax under section 801 ("IC"). Under the first situation, an individual ("Holder") purchases a life insurance contract from IC, and under the second situation the Holder purchases an annuity contract from IC (collectively, the variable life and annuity contracts are called the "Contracts"). Otherwise, the situations are identical.

ii. Assets supporting the Contracts are maintained by IC in a separate account ("Separate Account") that is divided into various sub-accounts ("Sub-Accounts").

(a) Interests in the Sub-Accounts are available solely through the purchase of a Contract, i.e., they are not otherwise available for sale to the public.

(b) IC engages an independent investment advisor ("Advisor") to manage the investments of each Sub-Account.

(c) Each Sub-Account at all times will meet the diversification requirements of section 817(h).

iii. Twelve Sub-Accounts currently are available under the Contracts, according to the ruling, and IC may increase or decrease this number at any time, although there will never be more than 20 Sub-Accounts available under the Contracts. The Sub-Accounts (which, as identified in the ruling, actually numbered 13) consist of:

(a) a bond fund,
(b) a large company stock fund,
(c) an international stock fund,
(d) a small company stock fund,
(e) a mortgage backed securities fund,
(f) a health care industry fund,
(g) an emerging markets fund,
(h) a money market fund,
(i) a telecommunication fund,
(j) a financial services industry fund,
(k) a South American stock fund,
(l) an energy fund, and
(m) an Asian markets fund.

iv. Holder specifies the allocation of premiums paid among the Sub-Accounts at issuance and thereafter may transfer amounts among the Sub-Accounts without limitation, subject to incurring fees for more than one transfer per 30 days.

v. There is no prearrangement, 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.

vi. All investment decisions are made by IC or Advisor in their sole and absolute discretion. Holder cannot select or recommend particular investments or investment strategies, and 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 on any specific investment or group of investments held in a Sub-Account.

vii. Holder has only a contractual claim against IC to collect cash under the Contract in the form of death benefits or surrenders, and has no legal, equitable, direct, or indirect interest in any of the assets held by a Sub-Account.

viii. All decisions regarding the choice of Advisor or the choice of any of IC's investment officers that are involved in the investment activities of the Separate Account or any Sub-Account are made by IC in its sole and absolute discretion. Holder cannot communicate directly or indirectly with IC regarding these matters.

b. Holdings and analysis.

i. When regulations were first proposed under section 817(h) in 1986, the IRS indicated that the particular facts relating to a variable contract owner's ability to allocate premiums and contract values among sub-accounts could give rise to an investor control issue. However, prior to Revenue Ruling 2003-91, the IRS had never published further guidance on these points.

ii. Based on the facts summarized above, the IRS concludes in Revenue Ruling 2003-91 that in both situations described in the ruling Holder will not be considered the owner, for federal income tax purposes, of the assets funding the

Contracts. In so concluding, the IRS states that the determination of whether Holder possesses sufficient incidents of ownership over Sub-Account assets to be deemed the owner of those assets for tax purposes depends upon all the relevant facts and circumstances.

iii. In this regard, the IRS notes that Holder may not select or direct particular investments to be made by either the Separate Account or the Sub-Accounts, that Holder may not sell, purchase, or exchange assets in the Separate Account or Sub-Accounts, and that investment in the Sub-Accounts is available solely through the purchase of a Contract.

iv. The IRS also notes that Holder's ability to transfer Contract values among Sub-Accounts does not, in itself, indicate that Holder has control over those assets for tax purposes. In so stating, however, the IRS observes that the investment strategies of the Sub-Accounts (i.e., the funds listed above) are "sufficiently broad" to prevent Holder from making particular investment decisions through investment in a Sub-Account.

c. *Point of interest regarding the ruling.* Prior to Revenue Ruling 2003-91, the only published guidance from the IRS addressing the number of investment options available under a variable contract in the context of the investor control doctrine was Revenue Ruling 82-54. As described above, in that ruling the IRS concluded a variable contract owner's "ability to choose among broad, general investment strategies such as stocks, bonds or money market instruments" did not cause an investor control problem. Revenue Ruling 2003-91 suggests that investment strategies that are more specific than the fundamental "stock, bond, and money market" asset classes (such as the 13 strategies listed in the ruling) can be viewed as "broad, general investment strategies" for purposes of the investor control doctrine.

3. Revenue Ruling 2003-92, 2003-2 C.B. 350.

a. Facts.

i. Revenue Ruling 2003-92 describes three situations involving the purchase of a variable annuity contract and/or variable life insurance contract from a life insurance company ("IC"). In each situation, the variable contract is not registered under federal securities laws, and is sold only to "qualified purchasers" that are "accredited investors" or to no more than 100 accredited investors (i.e., the variable contract is sold only through "private placement" offerings).

ii. In the first situation, an individual who is a qualified purchaser and accredited investor ("Holder") purchases an annuity. The assets supporting the annuity are held in a segregated asset account that is divided into 10 sub-accounts ("Sub-Accounts").

(a) Each Sub-Account at all times will meet the asset diversification requirements of section 817(h).

(b) Holder specifies how premiums are to be allocated among the Sub-Accounts at issuance of the annuity, and may change the allocation of subsequent premiums at any time.

iii. Also in the first situation, each Sub-Account invests in interests in a partnership ("Partnership").

(a) No Partnership is a publicly traded partnership within the meaning of section 7704, and each Partnership is exempt from registration under federal securities laws.

(b) Interests in the Partnerships are available to qualified purchasers and accredited investors without purchasing an annuity.

(c) Each Partnership has an investment manager that selects the Partnership's investments.

(d) Holder may not act as investment manager or independently own any interest in any Partnership offered under the annuity.

(e) Holder will have no voting rights with respect to any Partnership.

iv. The second situation described in the ruling is identical to the first, except that Holder purchases a life insurance contract rather than an annuity.

v. In the third situation, Holder purchases both an annuity and a life insurance contract, but interests in the Partnerships are available for purchase only through the purchase of a variable contract.

b. Holdings and analysis.

i. Based on the foregoing facts, the IRS concludes that "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," i.e., other than through the purchase of a variable contract.

ii. Thus, the IRS states that because in the first two situations the Partnership interests are available other than by purchasers of a variable contract from an insurance company, Holder is the owner of the interests in the Partnerships for tax purposes. However, because in the third situation the Partnership interests are available for purchase only by a purchaser of a variable contract, IC is the owner of the Partnership interests for federal income tax purposes.

c. *Point of interest regarding ruling.* Revenue Ruling 2003-92 marks the first time that the IRS has published guidance on investor control issues in the context of a private placement life insurance or annuity contract. Likewise, it is noteworthy that the guidance reaches a favorable conclusion under the third situation described in the ruling.

i. With regard to the unfavorable conclusion reached in the first two situations, the holding of Revenue Ruling 2003-92 is essentially the same as the conclusion the IRS reached in a private letter ruling issued in 2002 (PLR 200244001 (May 2, 2002)).

ii. Significantly, Revenue Ruling 2003-92 did not refer to the non-registered partnership look-through rule in Treas. Reg. sec. 1.817-5(f)(2)(ii), which the taxpayer in PLR 200244001 argued was inconsistent with the IRS's holding in that ruling (and now, the holding in Revenue Ruling 2003-92).

4. Other guidance on investor control.

a. "Dedicated" or "private" separate accounts are accounts used for one or a small number of similarly situated policyholders. In PLR 9433030, the IRS concluded that a single policyholder's separate account did not run afoul of the investor control doctrine. The IRS based its conclusion on Rev. Rul. 77-85, Rev. Rul. 80-274, Rev. Rul. 81-225, and the Christoffersen case. The status of this private letter ruling has been questioned in light of Rev. Rul. 2003-91 and Rev. Rul. 2003-92.

"Private separate account" reporting – in order to help the IRS enforce the investor control doctrine, the Obama Administration's Fiscal Year 2011 Revenue Proposals contains a measure that would impose on life insurance companies certain informational reporting requirements regarding each life insurance and annuity contract that is partially or completely invested in a "private separate account" (defined as a separate account in which a group of related persons owns a 10% interest). This item was also on the Administration's Fiscal Year 2010 Revenue Proposals. Recommendations have been made to the Treasury Department regarding specific aspects of this proposal. See Letter to Mark Smith on behalf of the Committee of Annuity Insurers, Aug. 20, 2009, available at 2009 TNT 168-8 (Tax Analysts).

b. Indirect funding with public mutual funds:

The IRS has issued a number of rulings on investor control in recent years where insurance-dedicated funds could invest their assets completely (PLR 201014001 (Dec. 8, 2009), PLR 200952009 (Sept. 16, 2009), PLR 200938018 (June 29, 2009), PLR 200938006 (June 17, 2009), PLR 200915006 (Dec. 23, 2008), PLR 200420017 (May 14, 2004), PLR 9839034 (June 30, 1998), and PLR 9851044 (Sept. 22, 1998)) or partially

(PLR 200025037 (Mar. 24, 2000) and PLR 200601006 (Sept. 30, 2005)) in publicly available funds.

c. Direct funding with public mutual funds:

i. In Rev. Rul. 81-225, the Service held that contracts based on public mutual funds were "not annuity contracts described in section 403(a) or (b) or section 408(b) of the Code."

ii. In 1984, when Congress enacted section 817(h), Congress expressly excepted from the diversification requirements all qualified retirement plan contracts, including those just listed.

iii. As a result, some taxpayers requested the IRS to rule that variable contracts used to fund qualified retirement plans can be based on publicly available mutual funds. The IRS has issued such a ruling in the case of variable annuity plan contracts issued to section 401(a) plans. See PLR 9723032 (Mar. 10, 1997).

iv. The IRS issued Rev. Proc. 99-44, 1999-2 C.B. 598, in response to this request. Under Rev. Proc. 99-44, a section 403(b) annuity, a section 408(b) IRA annuity, and a section 403(a) annuity can invest in public mutual funds and still be treated as annuities if certain conditions are satisfied.

v. Rev. Proc. 99-44 reaffirmed the Service's position that the investor control doctrine retains vitality independent from the diversification requirements of section 817(h) and the regulations thereunder.

d. Rev. Rul. 2007-7, 2007-1 C.B. 468, clarifies that investors in dedicated insurance funds that are described in Treas. Reg. sec. 1-817-5(f)(3) are not "public" investors that cause the owners of variable contracts to be treated as owning the assets underlying their contracts.

e. In CCA 200840043 (Oct. 3, 2008), the IRS addressed the investor control doctrine in the context of variable contracts issued by a foreign insurer that made an election to be treated as a domestic insurer pursuant to section 953(d). The CCA Memo states the broad conclusion that a segregated asset account's investment in publicly available individual securities violates the investor control doctrine. This conclusion seems highly questionable based on the administrative, Congressional, and judicial precedents involving investor control.

5. Open issues.

a. Permissible number of fund options — is there a limit? Rev. Rul. 2003-91, supra, states that the contract will provide up to 20 investment options, but the IRS' analysis makes no reference to that figure as a limitation on the permissible number of investment options. Instead, the IRS concludes that the investment strategies identified in the facts are "sufficiently broad" to avoid an investor control problem.

b. Permissible number of transfer/exchanges among funding options — are there any limits? Rev. Rul. 2003-91, supra, states that the contract allows unlimited transfers among investment options, subject to fees for more than one transfer per 30 days.

c. Clone funds – in PLR 9437027, the IRS modified an earlier set of private rulings to delete references in the earlier rulings that could have been viewed as "blessing" clone funds. It is unclear whether there are limits on the extent to which an insurance dedicated fund's investments and strategy can replicate those of a public fund without creating an investor control issue.

d. Narrowly focused funds – how broad must the focus or permitted investments of a fund be? Rev. Rul. 2003-91, supra, suggests that investment strategies that are more specific than the fundamental "stock, bond, and money market" asset classes (such as the 13 strategies listed in that ruling) can be viewed as "broad, general investment strategies" for purposes of the investor control doctrine.