

## Internal Revenue Service

Department of the Treasury

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### Legend

Fund =

Portfolio A =

Portfolio B =

Portfolio C =

Portfolio D =

Portfolio E =

Portfolio F =

Portfolio G =

Portfolio H =

Portfolio I =

Portfolio J =

Portfolio K =

Portfolio L =

Portfolio M =

Portfolio N =

Portfolio O =

Portfolio P =

Portfolio Q =

Portfolio R =

Portfolio S =

Portfolio T =

State A =

State B =

Company =

Subsidiary =

a =

b =

c =

d =

e =

This letter is in response to a letter dated July 26, 1999, submitted on behalf of the Fund which is comprised of Portfolios A through T (hereafter referred to individually as Portfolio or collectively as Portfolios), requesting rulings that:

1. The Fund's proposed Value Class Bonus Share arrangement will not result in the payment by the Portfolios of preferential dividends within the meaning of section 562(c) of the Code.
2. The Fund's proposed Value Class Bonus Share arrangement will not constitute a distribution of property to shareholders within the meaning of section 301, but will be treated for federal income tax purposes as an adjustment of an investor's purchase price of Portfolio shares, and
3. An investment in any Portfolio by an individual retirement account described in sections 408 and 408A of the Code and by any section 403(b) plan will not prevent a Separate Account from looking through to the Portfolio's underlying assets for purposes of section 817(h) of the Code.

### FACTS

Each of the Portfolios is a series of the Fund, which is an open-end management investment company organized as a business trust under the laws of State A, and is registered under the Investment Company Act of 1940 ("the 1940 Act"). Each Portfolio is treated as a separate corporation under section 851(g). Since their inception each Portfolio either has qualified and elected, or will qualify and elect treatment as a regulated investment company ("RIC") under sections 851 et. seq. of the Code. Each Portfolio is a fund that serves as an investment vehicle for variable life insurance policies and variable annuity contracts funded by segregated asset accounts ("Separate Accounts") of Company and its affiliates.

The Portfolios currently have a single class of shares, which is available only to the Separate Accounts, and to Company. Each Separate Account is a segregated asset account, the assets of which are owned by Company. Each Separate Account is subdivided into Variable Accounts each of which corresponds to a particular Portfolio. Purchasers of Variable Contracts may allocate premiums under their contracts to one or more Variable Accounts of the Separate Accounts supporting a specific Variable Contract. Income, gains and losses are credited to or charged against the assets held in the Variable Account without regard to Company's other income, gains or losses.

All of the interests in each Portfolio are held by segregated assets accounts or by a general account of Company or an affiliate. There is no public access to the Portfolios other than through the purchase of a Variable contract. Thus, the Separate Accounts look through to the assets of the Portfolios for purposes of determining whether the diversification requirements of section 817(h) are met.

Company is a life insurance company domiciled in State B, and registered as an investment adviser under the Investment Advisers Act of 1940, as amended. Company

acts as investment adviser to the Fund pursuant to an Investment Advisory Agreement . While Company directly manages the assets of Portfolios J and O, it also acts as investment adviser to other Portfolios for which Company has engaged other investment advisory firms to serve as Portfolio Managers. With respect to each Portfolio that is managed by a Portfolio Manager, the Fund, the Company and the Portfolio Manager have entered into an agreement under which the responsibilities of each Portfolio Manager are set forth. Each Portfolio Manager is paid by Company from the investment advisory fee that Company receives from each Portfolio.

Company additionally provides many of the administrative services necessary for operation of the Fund, such as registration of the Fund and the shares of the Portfolios with the Securities and Exchange Commission; maintenance of the Fund's and the Portfolios' legal existence; facilitating the preparation, printing and delivery to contract holders of reports, proxies and prospectuses; review of compliance with applicable regulatory requirements; and facilitating the conduct of the meetings of the Fund's Board of Trustees. Company also renders transfer agency services to the Fund and its Portfolios. A wholly owned subsidiary (Subsidiary) of the Company serves as distributor for the Fund pursuant to a distribution agreement. Subsidiary renders this service without any compensation from the Fund. Subsidiary, pursuant to a separate distribution agreement, also serves as distributor for the Variable Contracts and in that capacity, enters into agreements with broker-dealers for the solicitation of applications for the Variable Contracts.

## PROPOSED TRANSACTION

The Fund proposes to expand the universe of available investors in the Variable Contracts to include section 403(b) retirement plans and individual retirement accounts ("Qualified Plans") that would be able to purchase shares of the Fund's Portfolios directly, rather than through a Variable Contract. The Fund proposes to institute a multi-class structure for each Portfolio that would consist of three additional classes of shares. Each new class of shares will have shareholder services and distribution arrangements that are different from the existing class of Fund shares to reflect the different nature of shareholder accounts held through Variable Contracts and through Qualified Plans.

Class I shares, which will include all currently existing shares, will be available only to Separate Accounts and possibly to other separate accounts of the Company. All servicing and distribution arrangements currently in place regarding existing shares will be applicable to Class I shares.

A new class of shares known as Value Class shares will be established and will be available only to the types of Qualified Plans listed in Rev. Rul. 94-62, 1994-2 C.B. 164. These shares will be subject to a seven-year contingent deferred sales charge on redemptions of Value Class shares, and a distribution and services plan under section

12b-1 of the 1940 Act. Pursuant to the 12b-1 plan, the Fund will pay the Subsidiary a fee at an annual rate of a of the average daily net asset value of Value Class shares. Because the Qualified Plans will require different services, a separate servicing agent will be engaged by the Fund to provide shareholder services pursuant to an Administration Agreement under which the Fund will pay a fee to the servicing agent of up to b of the average daily net asset value of Value Class shares. The Subsidiary will serve as the distributor for the Value Class shares and will enter into agreements with brokers or other financial intermediaries to sell Value Class shares to Qualified Plans under the Distribution Agreement. The Subsidiary would receive 12b-1 plan fees from the Portfolios with respect to the Value Class shares as well as amounts from contingent deferred sales charges.

Additionally, for each purchase of Value Class shares, the Subsidiary will pay to the Fund, for the benefit of the Qualified Plan making an investment, an amount equal to c of the purchase price, to be used to purchase additional Value Class shares ("Bonus Shares") for the Qualified Plan's account. The purpose of this Bonus Share arrangement and the expenditure by Subsidiary would be to enhance the distribution of the Value Class shares. Value Class shares purchased by the reinvestment of dividends or capital gains distributions would not be eligible for Bonus Shares. However, Qualified Plans holding Value Class shares may make additional purchases of Value Class shares with their own funds, and these additional purchases would be eligible for Bonus Shares. Value Class shares will be subject to a conversion feature whereby such shares will convert to Class A shares nine years after the time of purchase.

A new Class B of shares will be established and also will be available only to the types of Qualified Plans listed in Rev. Rul. 94-62. Class B shares will be subject to the same service and distribution arrangements as the Value Class shares, but will be subject to a five-year contingent deferred sales charge on redemption. Class B shares will also be subject to a conversion feature whereby they would convert to Class A shares seven years after the time of purchase. Purchasers of Class B shares will not be eligible to receive Bonus Shares.

Finally, a new Class A of shares will be established and also will be available only to the types of Qualified Plans listed in Rev. Rul. 94-62. Class A shares will have the same service arrangements as Value Class and Class B shares, but will have a different distribution arrangement than those classes of shares. Class A shares will be subject to front-end sales load of up to a maximum of d of the purchase price, except that Class A shares arising from the conversion of Value Class or Class B shares, will not be subject to the front-end sales load. Additionally, a 12b-1 plan will be adopted under which the fund will pay to Subsidiary a fee at an annual rate of e of the average daily net asset value of Class A shares. Class A shares will not be subject to a contingent deferred sales charge. The shareholder servicing arrangement for Class A shares will be identical of that for Value Class and Class B shares. Purchasers of Class

A shares will not be eligible to receive Bonus Shares.

## LAW AND ANALYSIS

Section 851(a) defines a RIC, in part, as a domestic corporation, which at all times during the taxable year, is registered under the 1940 Act as a management company.

Section 851(b) limits the definition of a RIC to a corporation meeting certain election, gross income, and diversification requirements. In particular, one such requirement is that a RIC's deduction for dividends paid during the taxable year pursuant to section 561(a)(1) of the Code, must equal or exceed 90% of its taxable income for the taxable year. Under section 562(c) a RIC may not deduct the amount of any distributions that are non pro rata with a preference to any shares of stock as compared with other shares of the same class or with a preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference..

Section 851(g)(1) provides that each fund of a RIC shall be treated as a separate corporation for federal income tax purposes. Section 851(g)(2) defines the term "fund" for this purpose, as a segregated portfolio of assets, the beneficial interest in which are owned by the holders of a class or series of stock of the RIC that is preferred over all other classes or series in respect of such portfolio of assets.

Upon the purchase of Value Class shares by a Qualified Plan investor, the Subsidiary will pay to the Fund, for the benefit of the Qualified Plan, an amount equal to c of the purchase price to be used to purchase additional Bonus Shares for the Qualified Plan's account. This arrangement is similar to situations in which mutual fund investors receive points upon purchasing shares that can be redeemed for airline tickets. The proposed award of Bonus Shares to investors in the Fund solely upon the purchase of Fund shares is integrally related to that purchase. It is well established that if, as part of a transaction involving a purchase of property, the purchaser receives other consideration, either from the seller of the property or from a third party, as an inducement to the purchase, the fair market value of the other consideration received is treated as a rebate that adjusts the purchase price of the property. Accordingly, a downward adjustment to the basis in the newly purchased shares is required under section 1016. Rev. Rul. 76-96, 1976-1 C.B. 23 (rebate paid by automobile manufacturer to customer who purchased automobile from dealer).

Section 817(d), in pertinent part, defines the term variable contract as a contract which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company, which provides for the payment of annuities, under which the amounts paid in, or the amount paid out, reflect the

investment return and the market value of the segregated asset account. Moreover, section 817(h) provides that a variable contract based on a segregated asset account shall not be treated as an annuity contract unless, in accordance with regulations prescribed by the Secretary, it is adequately diversified.

Section 1.817-5(b) of the regulations, in general, prescribes the diversification requirements of variable contracts as (a) no more than 55% of the value of the total assets of the account represented by one investment; (b) no more than 70% of the value of the total assets of the account represented by any two investments; (c) no more than 80% of the value of the total assets of the account represented by any three investments; and (d) no more than 90% of the value of the total assets of the account represented by any four investments.

Section 1.817-5(f) provides look-through rules for assets of a separate account held through certain investment companies, partnerships or trusts. Under these rules a separate account may look through to the assets of a RIC in determining whether it has met the diversification requirements listed above. This look through is not permitted unless all of the interests in the RIC are held by segregated asset accounts. In general, under section 1.817-5(f)(3), shares of a RIC will be treated as held by a segregated asset account if (1) they are only available through the purchase of variable contracts; (2) they are held (under certain circumstances) by life company general accounts or by the RIC's manager or its affiliates; or (3) they are held by the trustee of a qualified pension or retirement plan.

Rev. Rul. 94-62, supra, lists the types of arrangements that are considered qualified plans for purposes of section 1.817-5(f)(3)(iii) of the regulations. Rev. Rul. 94-62 lists, inter alia, (a) an annuity contract described in section 403(b), including a custodial account described in section 403(b)(7); and (b) an individual retirement account described in section 408(a) or an individual retirement annuity described in section 408(b).

## HOLDINGS

Based on the facts as represented by Fund, we rule as follows:

1. The award of Bonus Shares upon the purchase of Value Class shares will be treated for federal income tax purposes as an adjustment of the investor's purchase price in its shares, and will result in an adjustment to its basis in those shares.
2. The award of Bonus Shares upon the purchase of Value Class shares will not result in the distribution of property or the payment of preferential dividends by Fund within the meaning of section 562(c) of the Code.

3. An investment in any Portfolio by an individual retirement account described in sections 408 and 408(a) of the Code or by any section 403(b) plan will not prevent a Separate Account from looking through to the Portfolio's underlying assets for purposes of section 817(h) of the Code.

No opinion is expressed, nor was a ruling requested, as to whether the transfer of amounts by Subsidiary to investors for the acquisition of Bonus Shares in general constitutes dividends required to be reported under the provisions of section 6042. Further, no opinion is expressed about whether each of the Funds qualifies as a RIC that is taxable under subchapter M, part I of the Code.

This ruling is directed only to Fund and its Portfolios. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax return of each Portfolio for each taxable year in which the Portfolio has outstanding Value Class shares described above.

Sincerely yours,  
Assistant Chief Counsel  
(Financial Institutions & Products)

By: William E. Coppersmith  
William E. Coppersmith  
Chief, Branch 2