Section 817.—Treatment of Variable Contracts

26 CFR 1.817–5(f): Look-through rule for assets held through certain investment companies, partnerships, or trusts.

Segregated asset account. For purposes of determining whether a segregated asset account held by an insurance company is adequately diversified pursuant to section 817(h) of the Code, a segregated asset account that invests in a regulated investment company which in turn, holds an interest in another regulated investment company, may look through to the individual assets of both regulated investment companies.

Rev. Rul. 2005–7

ISSUE

For purposes of determining whether a segregated asset account is adequately diversified under section 817(h), how does the look-through rule of § 817(h)(4) of the Internal Revenue Code and § 1.817–5(f) of the Income Tax Regulations apply to an investment in a regulated investment company that, in turn, owns an interest in another regulated investment company?

FACTS

IC is a life insurance company subject to tax under § 801. In states where it is authorized to do so, IC offers variable life and variable annuity contracts (the "Contracts") that qualify as variable contracts under § 817(d). The assets that fund the Contracts are segregated from the assets that fund IC's traditional life insurance products. IC maintains a separate account for the assets funding the Contracts, and the income and liabilities associated with the separate account are maintained separately from IC's other accounts. The separate account is composed of several sub-accounts, one of which (the "Segregated Asset Account") is invested exclusively in Fund 1. No holder of a variable contract supported by the Segregated Asset Account possesses sufficient incidents of ownership over the assets of the account to be treated as the owner of those assets for federal income tax purposes. *See* Rev. Rul. 2003–91, 2003–2 C.B. 347.

Fund 1 is a regulated investment company within the meaning of § 851. Fund 1 owns shares in Fund 2, also a regulated investment company within the meaning of § 851, the value of which is greater than 55 percent of the value of the total assets of Fund 1. Except for Fund 1's investment in Fund 2 (and except as permitted by § 1.817–5(f)(3) of the Income Tax Regulations), all the beneficial interests in Fund 1 and Fund 2 are held by one or more segregated asset accounts of one or more insurance companies, and public access to the funds is available exclusively through the purchase of a variable contract. Pursuant to § 817(h)(1) and § 1.817–5(b) of the regulations, the investments of Fund 2 are adequately diversified. The investments of Fund 1 are likewise diversified, but only if, instead of treating its interest in Fund 2 as a single investment, Fund 1 is permitted to take into account a *pro rata* portion of each asset of Fund 2.

LAW AND ANALYSIS

Section 817(d) defines the term "variable contract" for purposes of part I of subchapter L of the Code (§§ 801–818). For a life insurance contract or an annuity contract to be a variable contract, it must provide for the allocation of all or a part of the amounts received under the contract to an account that, pursuant to state law or regulation, is segregated from the general asset accounts of the issuing insurance company. In addition, for a life insurance contract to be a variable contract, it must qualify as a life insurance contract for federal income tax purposes, and the amount of the death benefit (or the period of coverage) must be adjusted on the basis of the investment return and the market value of the segregated asset account; for an annuity contract to be a variable contract, it must provide for the payment of annuities, and the amounts paid in, or the amount paid out, must reflect the investment return and the market value of the segregated asset account.

Section 817(h)(1) of the Code provides generally that a variable contract (other than a pension plan contract) that is otherwise described in § 817 and that is based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract for any period (and for any subsequent period) for which the investments made by such account are not adequately diversified.

Section 1.817–5(e) of the regulations provides that for purposes of section 817(h) of the Code 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.

Section 1.817–5(b) of the regulations sets forth the diversification requirements for variable contracts based on segregated asset accounts. Generally, the investments of a segregated asset account are considered to be adequately diversified for purposes of § 817(h) of the Code and § 1.817–5(b) of the regulations if no more than 55 percent of the value of the total assets of the account is represented by any one investment; no more than 70 percent by any two investments; no more than 80 percent by any three investments; and no more than 90 percent by any four investments.

Section 817(h)(4) and § 1.817–5(f) of the regulations provide a look-through rule for purposes of testing the diversification of a segregated asset account that invests in a regulated investment company, partnership, or trust. Section 1.817–5(f)(1) provides, in part, that if the look-through rule applies, a beneficial interest in an investment company shall not be treated as a single investment of a segregated asset account; instead, a *pro rata* portion of each asset of the investment company shall be treated, for purposes of § 1.817–5, as an asset of the segregated asset account.

Section 817–5(f)(2)(i) of the regulations provides that the look-through rule of § 1.817–5(f) shall apply to an investment company if (A) all the beneficial interests in the investment company (other than those described in § 1.817–5(f)(3)) are held by one or more segregated asset accounts of one or more insurance companies; and (B) public access to such investment company is available exclusively (except as otherwise permitted under § 1.817–5(f)(3)) through the purchase of a variable contract.

The beneficial interests described in § 1.817–5(f)(3) are interests that are held by (i) the general account of a life insurance company or a corporation related in a manner specified in § 267(b) of the Code to a life insurance company, but only if the return on those interests is computed in the same manner as the return on an interest held by a segregated asset account, there is no intent to sell the interests to the public, and a segregated asset account of the life insurance company also holds or will hold a beneficial interest in the investment company; (ii) the manager or a corporation related in a manner specified in § 267(b) to the manager of the investment company, provided similar requirements are met concerning the computation of return on the interests and intent to sell the interests to the public; (iii) the trustee of a qualified pension or retirement plan; or (iv) the public or policyholders that are treated as owners of beneficial interests in the investment company under Rev. Rul. 81–225, 1981–2 C.B. 12, but only if (A) the investment company was closed to the public in accordance with Rev. Rul. 82–55, 1982–1 C.B. 12; or (B) all the assets of the segregated asset account are attributable to premium payments made by policyholders prior to September 26, 1981, to premium payments made in connection with a qualified pension or retirement plan, or to any combination of such premium payments.

Under the look-through rule of § 817(h)(4) and § 1.817–5(f), a *pro rata* portion of each asset of Fund 1 is treated as an asset of the Segregated Asset Account

for purposes of determining whether the Segregated Asset Account is adequately diversified. Because the value of Fund 1's investment in Fund 2 is greater than 55 percent of the value of the total assets of Fund 1, however, the Segregated Asset Account is not adequately diversified unless its investment in Fund 1 is treated as including an investment in a *pro rata* portion of each of the assets of Fund 2.

In order for the look-through rule to apply to a beneficial interest in a regulated investment company, all the beneficial interests in the investment company must be held by one or more segregated asset accounts of one or more insurance companies (except as otherwise permitted pursuant to § 1.817–5(f)(3) of the regulations), and public access to the investment company must be available solely through the purchase of a variable contract. These two requirements are met with respect to both Fund 1 and Fund 2. Except as otherwise permitted under § 1.817–5(f)(3), all the beneficial interests in Fund 1 are held by segregated asset accounts that invested directly in Fund 1; all the beneficial interests in Fund 2 are held either by segregated asset accounts that invested directly in Fund 2, or by segregated asset accounts that invested directly in Fund 1 (and thus indirectly in Fund 2). Likewise, except as otherwise permitted under § 1.817–5(f)(3), public access to both Fund 1 and Fund 2 is available exclusively through the purchase of a variable contract funded by a segregated asset account that invests in Fund 1 or Fund 2. Accordingly, under the look-through rule of § 817(h), the Segregated Asset Account is treated as owning a *pro rata* portion of each asset of Fund 1, including a *pro rata* portion of each asset of Fund 2.

HOLDING

Under the facts set forth above, the look-through rule of § 817(h)(4) and § 1.817–5(f) of the regulations requires that the Segregated Asset Account be treated as owning a *pro rata* portion of each asset of Fund 1 and Fund 2 for purposes of satisfying the diversification requirements of § 817(h).

DRAFTING INFORMATION

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