

**MEMO# 16345**

July 24, 2003

## **IRS ISSUES TWO REVENUE RULINGS ON FUNDS OFFERED THROUGH VARIABLE CONTRACTS**

[16345] July 24, 2003 TO: TAX MEMBERS No. 37-03 VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 4-03 RE: IRS ISSUES TWO REVENUE RULINGS ON FUNDS OFFERED THROUGH VARIABLE CONTRACTS The Internal Revenue Service has issued two revenue rulings on investment funds offered through variable annuities and variable life insurance contracts. These revenue rulings provide the first industry-wide guidance from the Service since the enactment of Section 817(h) on the question of when the owner of a variable contract exerts sufficient control over investment decisions to be deemed for tax purposes to be the owner of the assets underlying the contract. If a contract owner is deemed to own the underlying assets, then the owner will lose the tax-deferral benefits ordinarily associated with variable contracts. Revenue Ruling 2003-91 describes a set of circumstances under which the contract owner will not be deemed to be the owner of the assets underlying the contract. The contract described in the ruling allows contract holders to allocate premiums among up to 20 subaccounts.<sup>1</sup> Each subaccount represents an investment fund available only through the purchase of an insurance contract. The available subaccounts currently include funds with a range of investment strategies, including a bond fund, a large company fund, an international stock fund, a small company stock fund, a mortgage-backed securities fund, a health care industry fund, an emerging markets fund, a money market fund, a telecommunications fund, a financial services industry fund, a South American stock fund, an energy fund, and an Asian markets fund. The contract owner may change the allocation of premiums among subaccounts at any time and may transfer funds between subaccounts, although more than one transfer between funds in a thirty-day period will incur a fee.<sup>2</sup> Revenue Ruling 2003-92 describes a set of circumstances under which the owner of a variable contract will be treated as the owner of the assets underlying the contract, and will owe 1 Prior guidance, Rev. Rul. 82-54, indicated that contract owners could allocate premiums among three subaccounts – a stock fund, a bond fund, and a money market fund. 2 Additional facts identified in the ruling include satisfaction of the diversification requirements of Treas. Reg. 1.817-5(b), the absence of any agreement between the contract owner and the issuer of the contract regarding investment strategies, and the absence of any communication by the contract holder with any investment officer regarding the selection or rate of return of any specific investment or group of investments. 2 tax on any income derived from those assets.<sup>3</sup> The contract described in this ruling is offered for sale only in private placements to accredited investors and qualified purchasers. The contract owner may allocate premiums among ten subaccounts, each of which invests in an unregistered investment partnership.<sup>4</sup> Interests in the underlying investment partnerships may also be purchased directly, through private

placements, by qualified purchasers and accredited investors. The ruling holds that, because taxpayers may purchase interests in the underlying investment partnerships without purchasing a variable contract, the owner of a variable contract with assets allocated to such an investment partnership will be treated as owning an interest in the investment partnership, and will owe tax on any income earned by the partnership. If, however, the investment partnerships are not available to investors except by purchase of a variable contract, then the contract holder will not be treated as owning an interest in the underlying investment partnership. David Orlin Assistant Counsel Note: Not all recipients receive the attachments. To obtain copies of the attachments, please visit our members website (<http://members.ici.org>) and search for memo 16345, or call the ICI Library at (202) 326-8304 and request the attachments for memo 16345. Attachment no. 1 (in .pdf format) Attachment no. 2 (in .pdf format) 3 This ruling tracks closely the facts, and holding, of PLR 200244001 (Aug. 9, 2002). 4 Each subaccount will satisfy the diversification regulations of Treas. Reg. 1.817-5(b).

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