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Subject: **IRS Clarifies Meaning of "General Public" As Used in Certain Variable Contract "Investor Control" Rulings**

Major References: ***Rev. Rul. 2007-7, 2007-7 I.R.B. 1***

Prior AALU Washington Reports: *05-31; 03-78; 03-75; 03-74*

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The Internal Revenue Service, in a published ruling (Rev. Rul. 2007-7), has clarified and amplified Rev. Ruls. 2003-92 and 81-225, each of which elaborate on the circumstances in which, under the "investor control" doctrine, the investments underlying a variable contract will be considered to be available only to purchasers of such contracts, and not to the general public. The clarification was necessary because existing regulations under Section 817 of the Revenue Code set forth a broader category of "permitted investors" for this purpose to include, not just purchasers of variable contracts, but also certain other investors, such as qualified retirement plans. (See specifically Treas. Regs. sections 1.817-5(f)(3).)

Under section 817(h), a variable contract based on a segregated asset account is not treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified. For purposes of testing diversification, applicable Treasury regulations provide a "look-through" rule for assets held through certain investment companies, partnerships, or trusts. Look-through treatment is available with respect to any investment company, partnership, or trust only if (i) all the beneficial interests in the investment company, partnership, or trust are held by one or more segregated asset accounts of one or more insurance companies, and (ii) public access to such investment company, partnership, or trust is available exclusively (*except as otherwise permitted by section 1.817-5(f)(3)*) through the purchase of a variable contract.

On July 23, 2003, the Treasury and Internal Revenue Service issued two revenue rulings (Rev. Ruls. 2003-91 and 2003-92), designed, in the words of the Treasury press release accompanying the rulings, "to curtail the abusive use of life insurance and annuity contracts to avoid current taxation on investment earnings." (*See* our Bulletins Nos. 03-74 and 03-75.) The rulings were followed, on July 30, 2003, by proposed regulations issued under the authority of Section 817 of the Revenue which were intended to conform the regulations to the position adopted in the rulings. (*See* our Bulletin No. 03-78.) These regulations were, in turn, finalized with little change on March 1, 2005 (*See* T.D. 9185, discussed in our Bulletin No. 05-31.)

In essence, these pronouncements, taken together, hold that the owner of a variable life insurance or annuity contract that is invested, via sub-accounts, in certain nonregistered partnerships (commonly referred to as "hedge funds") that are open to investors *other than variable contract holders* will be treated as owning the assets in the sub-accounts directly. Thus the hedge fund income (much of which is in the form of short-term capital gains) earned on the investment will be subject to taxation in the hands of the contract's holder. While ostensibly breaking new ground, the rulings collectively affirm the Internal Revenue Service's long-standing interpretation of the "investor control" doctrine as applied to these products. *See, e.g.,* Rev. Rul. 81-225, 1981-2 C.B. 12, which held that the insurance company in Situation 5 of the ruling would be considered to be the owner of mutual fund shares in a situation in which the investments in the mutual fund shares are controlled by the insurance company and the mutual fund shares *only are available through the purchase of an annuity from the insurance company.* The net result is an absence of taxable income recognition by the annuity's holder.

Both Rev. Rul. 2003-92 and Rev. Rul. 81-225 can be read restrictively to apply the investor control doctrine negatively to all variable life insurance and annuity contracts in which the underlying investments in an investment company, partnership or trust are available to anyone other than a purchaser of a life insurance or annuity contract from an insurance company. This restrictive reading is at odds with the regulations issued under Section 817 (specifically, Reg. § 1.817-5(f)(3), cited above), which includes among "permitted investors" in a variable contract: (i) the general account of a life insurance company (if certain requirements are met); (ii) certain managers and certain corporations related to the manager of the investment company, partnership or trust; (iii) a trustee of a qualified pension or retirement plan; and (iv) investors in certain grandfathered contracts.

At the time that the final regulations (T.D. 9185) were issued, the Revenue Service noted that several commentators had suggested that regulations under section 817 should clarify that the permitted investors under § 1.817-5(f)(3) do not constitute the "general public" as that term is used in Rev. Rul. 2003-92 and Rev. Rul. 81-225. According to these commentators, "it would be anomalous for ownership by a permitted investor under § 1.817-5(f)(3) to result in a variable contract holder being treated as the owner of an investment company, partnership, or trust, when the look-through rule itself appears to endorse ownership by that same investor for purposes of testing diversification."

While the Service did not provide a remedy to these commentators when issuing the final regulations, it noted that these and other comments on investor control "will receive careful attention in the event of further guidance on investor control."

Now, in Rev. Rul. 2007-7, the IRS has issued that guidance, ruling (favorably to taxpayers) that the investors in a regulated investment company that are described in § 1.817-5(f)(3) are not members of the "general public" as that term is used in Rev. Rul. 2003-92 and Rev. Rul. 81-225, and, thus, the holder of a variable annuity or life insurance contract will not be treated (negatively) as the owner of an interest in a regulated investment company that funds the variable contract solely because interests in the same

regulated investment company are also available to investors described in § 1.817-5(f)(3). In effect, that holder of the variable annuity or life insurance contract will not be subject to tax on the income accumulating in that annuity or contract.

Rev. Rul. 81-225, 1981-2 C.B. 12 and Rev. Rul. 2003-92, 2003-2 C.B. 350 are clarified and amplified in accordance with Rev. Rul. 2007-7.

Any AALU member who wishes to obtain a copy of any of Rev. Rul. 2007-7 may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your social security number and select *Current Washington Report* for linkage to source material or (3) email James Larsen at larsen@aalu.org and include a reference to this *Washington Report*.

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