

Internal Revenue Service

Department of the Treasury

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Date:

February 21, 2002

Date A
Taxpayer

Location B
Location C
Number D
State E
Number F

Dear _____ :

This is in reply to the Date A letter, filed on your behalf by your representative. The letter requests that we rule that the holding of beneficial interests in a regulated investment company (a RIC), within the meaning of section 851(a) of the Internal Revenue Code, by a segregated asset account of Taxpayer supporting variable life insurance and/or variable annuity contracts will not cause the RIC to be ineligible for application of the look-through rule set forth in section 817(h)(4) and Treas. Reg. § 1.817-5(f)(1). For the reasons discussed below, we conclude that the look-through rule applies to the RIC even though Taxpayer is a fraternal beneficiary society exempt from tax under section 501(c)(8).

FACTS

Taxpayer is a fraternal beneficiary society that operates under the lodge system and that provides for the payment of life, sick, accident, and other benefits to its members and their dependents. Taxpayer is exempt from tax under section 501(c)(8) and is, therefore, not subject to tax as an insurance company under Subchapter L of the Internal Revenue Code. Taxpayer files its Federal information returns with the IRS Service Center in Location B and is subject to the audit jurisdiction of the District Director in Location C.

Taxpayer is engaged in numerous charitable and fraternal activities and also, consistent with its purpose, issues life insurance and annuity contracts to its members. Taxpayer is licensed to issue insurance contracts in Number D states and the District of

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Columbia. Taxpayer represents that more than half of its activities consist of the issuing of insurance or annuity contracts. Taxpayer further represents that more than 50 percent of Taxpayer's total reserves, within the meaning of section 816(c), consist of life insurance reserves within the meaning of section 816(b).

Taxpayer's issuance of life insurance and annuity contracts is regulated under the laws of its domiciliary state (State E) as well as under the insurance laws of all other jurisdictions where Taxpayer is licensed to issue contracts. State E and Number F of the states in which Taxpayer issues life insurance and annuity contracts have adopted the Model Fraternal Code and the remaining jurisdictions have similar laws. These laws governing issuance of insurance contracts by fraternal beneficiary societies are comparable to the laws governing life insurance and annuity contracts issued by stock and mutual life insurance companies. Among other things, Taxpayer is subject to nonforfeiture and reserve requirements.

The provisions governing fraternal beneficiary societies also permit those entities, in a manner parallel to the rules applicable to stock and mutual life insurance companies, to establish separate accounts and to issue variable life insurance and annuity contracts supported by those accounts. The requirements applicable to these separate accounts once established are the same requirements applicable to separate accounts established by insurance companies.

Until now, Taxpayer has offered only life insurance and annuity contracts based on its general account. Taxpayer is, however, currently in the process of developing variable life insurance and annuity contracts and making the necessary financial and legal arrangements for distributing those types of contracts to its members. Among other steps, Taxpayer has obtained the necessary authority in its domiciliary state and is in the process of obtaining authority to issue variable contracts in all other relevant jurisdictions.

Taxpayer intends to offer holders of its variable contracts a choice of broadly defined investment options, allowing them to allocate the assets underlying their contracts among these options. To support these investment options, Taxpayer has established two separate accounts: one for variable annuity contracts and one for variable life insurance contracts. Each separate account will be divided into subaccounts, each of which will pursue a specified, broadly defined investment strategy. Rather than directly managing a portfolio of investments in the subaccounts or retaining an independent investment advisor to do so, Taxpayer will take advantage of the economies of scale afforded by using RICs that are managed by recognized investment management firms unaffiliated with Taxpayer and that are offered through variable contracts issued by one or more other insurers. Each of the subaccounts of Taxpayer's two separate accounts will invest exclusively in shares of a particular RIC that pursues the same investment strategy as established for the subaccount. This is known as a "unit investment trust" structure and is widely used throughout the insurance industry.

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Taxpayer intends that the subaccounts supporting its variable contracts invest only in “insurance-dedicated” RICs, *i.e.*, RICs that satisfy the requirements set forth in Treas. Reg. § 1.817-5(f)(2)(i) for look-through treatment under section 817(h)(4) and Treas. Reg. § 1.817-5(f)(1). Specifically, Treas. Reg. § 1.817-5(f)(2)(i) provides that, in order for owners of interests in the RIC to be able to look through the RIC to its underlying assets, two requirements must be satisfied. First, except as otherwise permitted under Treas. Reg. § 1.817-5(f)(3), all of the beneficial interests in the RIC must be held solely by one or more segregated asset accounts of one or more insurance companies. Second, public access to the RIC must be available exclusively through the purchase of a variable contract within the meaning of section 817(d).

In the course of negotiating participation agreements with various insurance-dedicated RICs, the RICs have questioned whether the holding by Taxpayer’s separate accounts of beneficial interests in the RICs will render the RICs ineligible for look-through treatment. This issue arises because, as noted above, Taxpayer is not subject to tax as an insurance company under Subchapter L of the Code, but rather is a fraternal beneficiary society exempt from tax under section 501(c)(8). If look-through treatment of a RIC is not available due to Taxpayer’s tax-exempt status, the shares of the RIC will be treated as a single investment for purposes of applying the diversification requirements of section 817(h).

Taxpayer requests that the Service rule that a RIC will not be ineligible for look-through treatment merely because one of the subaccounts underlying Taxpayer’s variable contracts holds shares of such RIC. Because public access to the RICs offered through Taxpayer’s variable contracts is available exclusively through the purchase of a variable contract, the focus of this ruling request is whether Taxpayer’s status as a fraternal beneficiary society exempt from tax under section 501(c)(8) will prevent the RICs from meeting the restriction of section 817(h)(4)(A) and Treas. Reg. § 1.817-5(f)(2)(i)(A), *i.e.*, the requirement that all of the beneficial interests in a RIC eligible for look-through treatment be held by one or more insurance company segregated asset accounts.

In support of this ruling request, Taxpayer represents, assuming that the RICs in which it intends to hold interests otherwise qualify for look-through treatment under section 817(h)(4) and Treas. Reg. § 1.817-5(f), that:

- (1) The variable life insurance contracts that Taxpayer intends to offer will qualify as life insurance contracts within the meaning of section 7702;
- (2) The variable annuity contracts it intends to offer will be considered to be annuity contracts in accordance with the customary practice of life insurance companies, will contain the language required by section 72(s), and will be treated as annuity contracts, not as debt instruments, under section 1275(a)(1)(B)(ii); and
- (3) The variable contracts Taxpayer will offer will qualify as variable contracts under section 817(d), *i.e.*, the variable contracts will provide for the allocation of all or

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part of the amounts received under the contract to an account which, pursuant to State law or regulations, will be segregated from Taxpayer's general asset accounts; the variable contracts will provide for the payment of annuities or qualify as life insurance contracts; under the variable annuity contracts, the amounts paid out will reflect the investment return and the market value of a Taxpayer segregated asset account; and under the variable life insurance contracts, the amount of the death benefit (or the period of coverage) will be adjusted on the basis of the investment return and the market value of a Taxpayer segregated asset account.

LAW

Under section 817(h), a non-qualified variable life insurance or annuity contract is not treated for Federal tax purposes as a life insurance or annuity contract, as the case may be, unless the investments made by the segregated asset account on which the contract is based are adequately diversified in accordance with Treas. Reg. § 1.817-5. Section 817(h)(4) and Treas. Reg. § 1.817-5(f)(1) generally provide that, if a RIC satisfies certain conditions, the diversification requirements are applied by looking through the RIC, *i.e.*, by taking into account the assets held by the RIC rather than treating the RIC shares as a single investment. Under Treas. Reg. § 1.817-5(f)(2)(i), a RIC can be looked through by the holders if (A) all the beneficial interests in the RIC are held by one or more insurance company segregated asset accounts, and (B) public access to the RIC is available exclusively through the purchase of a variable contract.

Taxpayer's variable contracts (and other variable contracts investing in RICs in which Taxpayer's variable contracts have invested) are able to use the look-through rule for those RICs only if Taxpayer itself is an insurance company for purposes of Treas. Reg. § 1.817-5(f)(2)(i)(A) such that access to the RIC through Taxpayer's variable contracts will not violate the public access requirement. In the present case, Taxpayer is not taxed as an insurance company for Federal tax purposes but, rather, is a fraternal benefit society exempt from tax under section 501(c)(8). The issue, therefore, is whether Taxpayer's tax-exempt status affects its status as an insurance company for purposes of Treas. Reg. § 1.817-5(f)(2)(i)(A). The issue is whether Taxpayer is an insurance company for this purpose or whether this regulation requires that the entity be taxed under Subchapter L.

Treas. Reg. § 1.801-3(a) defines an insurance company as -

a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

This definition applies for purposes of part I, subchapter L, chapter I of the Code, which includes section 817(h). A more stringent definition is provided for a life insurance company under section 816(a), which specifies that the taxpayer must be an insurance company more than half of the business of which is the issuing of insurance or annuity

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contracts or the reinsuring of risks underwritten by insurance companies. Taxpayer has represented that it factually satisfies both of these Federal tax requirements for treatment as an insurance company. Taxpayer therefore meets the available definitions of an insurance company for purposes of section 817(h) and the regulations thereunder, and nothing in the definitions precludes that status simply because Taxpayer is not taxed as an insurance company by virtue of its fraternal activities and lodge system of organization.

Moreover, there are a variety of contexts outside of Subchapter L in which fraternal beneficiary societies that also qualify as insurance companies have been treated identically for Federal tax purposes. For example, the IRS has recognized that a fraternal beneficiary society may, consistent with its tax-exempt status under section 501(c)(8), issue whole life insurance contracts with cash surrender and loan values. Rev. Rul. 86-75, 1986-1 C.B. 245. Proceeds of life insurance contracts issued by fraternal beneficiary societies are treated as the proceeds of life insurance contracts for purposes of determining the value of a taxpayer's gross estate under section 2042. Treas. Reg. § 20.2042-1(a)(1).

For purposes of testing diversification under section 817(h), there is no material difference between Taxpayer and an insurance company subject to tax under Subchapter L of the Code, other than that Taxpayer qualifies for exemption from Federal tax as a fraternal beneficiary society under section 501(c)(8). We do not believe that exemption from tax at the entity level should preclude application of the look-through rule whose requirements are based on participation solely by insurance companies and through products sold by insurance companies.

CONCLUSION

Accordingly, based upon the facts submitted and the representations made by Taxpayer, a regulated investment company within the meaning of section 851(a) will not be ineligible for application of the look-through rule set forth in section 817(h)(4) and Treas. Reg. § 1.817-5(f) merely because beneficial interests in the RIC are held by one or more of Taxpayer's segregated asset accounts (i.e., a subaccount of Taxpayer's separate accounts) supporting variable life insurance or annuity contracts issued by Taxpayer.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and

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representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,
GARY E. GEISLER
Assistant to the Branch Chief, Branch 4
Associate Chief Counsel
(Financial Institutions & Products)