

## Internal Revenue Service

## Department of the Treasury

Number: **200308032**

Release Date: 2/21/2003

Index Number: 817.06-00, 817.08-04

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

**CC:FIP:4-PLR-138655-02**

Date:

November 8, 2002

### Legend

The Company =

State X =

Date 1 =

Y Company =

Jurisdictions =

Parent =

Sub =

Annuity Separate Account 2 =

Annuity Separate Account 3 =

Annuity Separate Account 4 =

Life Separate Account 2 =

Life Separate Account 3 =

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Annuity Separate Account 6 =

Annuity Separate Account 7 =

Affiliate =

Dear :

This is in response to your submission dated July 12, 2002, and subsequent submissions, requesting rulings on behalf of the Company concerning the treatment under section 817(h) of the Internal Revenue Code of direct investments in certain institutional mutual funds (the "Non-Public Funds") that are proposed to be made in connection with Section 457(b) eligible deferred compensation plans sponsored by tax-exempt entities.

## FACTS

### A. The Company

The Company is a life insurance company organized under the laws of State X. Until Date 1, it was named Y Company. The Company is licensed to conduct an insurance business in Jurisdictions. The Company is a wholly-owned subsidiary of Parent. The Company is also registered as an investment adviser under the Investment Adviser Act of 1940 and is registered as such with the Securities and Exchange Commission. In this capacity, the Company acts as the investment adviser for certain of the Non-Public Funds discussed herein.

The Company represents that it is a life insurance company within the definition of section 816(a). It joins with its subsidiary, Sub, in the filing of a "life/life" consolidated Federal income tax return. The Company uses the accrual method of accounting for Federal income tax purposes and files its returns on a calendar year basis.

### B. The Contracts

The Company issues nonparticipating life insurance and annuity contracts (the "Contracts"), which offer both fixed and variable investment options (the "Variable Contracts"), as well as contracts offering solely fixed investment options (the "Fixed Contracts"). Some of the Contracts (the "Qualified Contracts") are issued in connection with qualified retirement plans, including: group annuity contracts issued to trustees of pension or profit sharing plans and trusts which qualify under section 401(a) ("Section 401 Contracts"); group annuity contracts issued to trustees of qualified plans established by self-employed individuals under section 401(a) and (c) ("H.R. 10 Contracts"); group annuity contracts issued to state and local governments and to tax-exempt organizations in connection with deferred compensation plans under section

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457 ("Section 457 Contracts"); group and individual annuity contracts which qualify as "individual retirement annuities" within the meaning of section 408(b) ("IRA Contracts"); and group and individual annuity contracts which satisfy the requirements of section 403(b) ("TSA Contracts").

The Company represents that the Qualified Contracts constitute "annuity contracts" for Federal income tax purposes, except to the extent that section 72(u) requires otherwise, and are "pension plan contracts" within the meaning of sections 817(h)(1) and 818(a).

Certain of the Contracts are not issued in connection with a qualified plan, but rather are purchased with "after-tax" monies (the "Non-Qualified Contracts"). The Company represents that the Non-Qualified Contracts are either (1) annuity contracts for Federal income tax purposes, except to the extent that section 72(u) requires otherwise, or (2) life insurance contracts within the meaning of section 7702(a).

The Contracts are purchased with the payment of one or more premiums ("Purchase Payments"). For the Fixed Contracts, each Purchase Payment is allocated to the Fixed Account maintained as part of the Company's general account. For Variable Contracts, each Purchase Payment is allocated as directed by the policyholder among the contract's investment options. The investment options available differ somewhat amongst the Variable Contracts, but all offer as investment options a Fixed Account option, and one or more variable options. The "Current Value" of a Variable Contract at any time generally equals the sum of the amounts in the various investment options. At any time before an annuity option is elected (for those Contracts that are annuity contracts), or before the death of an insured under a life insurance contract, all or part of the Current Value may be transferred among the investment options, subject to certain limitations on the timing, amount, and frequency of such transfers.

The Contracts that are annuity contracts provide for payments under the applicable annuity options. Some of the Variable Contracts provide annuity payments which are fixed, variable, or a combination of fixed and variable, as the policyholder specifies, and some of the Contracts, including all Fixed Contracts, provide only fixed annuity payments. The Contracts that are annuities may also provide a death benefit payable to the beneficiary upon the death of the Annuitant.

### C. The Separate Accounts

Amounts allocated to the variable options under the Variable Contracts currently are invested in one of the following separate accounts of the Company:

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- (1) amounts allocated to the variable options under some TSA Contracts, some IRA Contracts, certain Section 457 Contracts, and under the Non-Qualified Contracts that are annuities, are held in Annuity Separate Account 2.
- (2) amounts allocated to the variable options under some TSA Contracts, some Section 401 Contracts, some IRA Contracts and most Section 457 Contracts are held in Annuity Separate Account 3;
- (3) amounts allocated to the variable options under most Section 401 Contracts, and certain Section 457 Contracts, are held in Annuity Separate Account 4;
- (4) amounts allocated to the variable options under most of the Company's Non-Qualified Contracts that are life insurance contracts are held in Life Separate Account 2;
- (5) amounts allocated to the variable options under one of the Company's Non-Qualified Contracts that is a life insurance contract issued to a state retirement system are held in Life Separate Account 3;
- (6) amounts allocated to the variable options under certain Section 401 Contracts and Section 457(b) Contracts that invest in shares of certain publicly available mutual funds are held in Annuity Separate Account 6; and
- (7) amounts allocated to the variable options under a closed block of Qualified Contracts and Non-Qualified Contracts that are annuities and that were assumed by the Company pursuant to an assumption reinsurance agreement are held in Annuity Separate Account 7.

The aforementioned separate accounts were established pursuant to the insurance laws of State X for the purpose of segregating assets attributable to the variable portions of the Contracts from other assets of the Company. Annuity Separate Account 2, Annuity Separate Account 3, Annuity Separate Account 7, Life Separate Account 2 and Life Separate Account 3 are registered under the Investment Company Act of 1940 (the "1940 Act") with the Securities and Exchange Commission as unit investment trusts. Pursuant to section 3(a)2 of the Securities Act of 1933 and section 3(c)11 of the 1940 Act, Annuity Separate Account 4 and Annuity Separate Account 6 are not registered with the Securities and Exchange Commission.

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D. The Funds

The assets of Annuity Separate Accounts 2, 3, 4 and 7, and Life Separate Accounts 2 and 3, currently may be invested in shares of several investment companies that are not available to the general public (the "Non-Public Funds"). Each of the Non-Public Funds is registered under the 1940 Act with the Securities and Exchange Commission as an open-end investment company, i.e., each is a mutual fund. Certain of the Non-Public funds are managed by the Company or one of its affiliates, while others are managed by unaffiliated entities. The Company represents that each of the Non-Public Funds managed by the Company or one of its affiliates qualifies as a regulated investment company within the meaning of section 851 and is considered a "segregated asset account" within the meaning of Treas. Reg. § 1.817-5(e). The Company further represents, to the best of its knowledge and belief, that each of the Non-Public Funds not managed by the Company or one of its affiliates qualifies as a regulated investment company within the meaning of section 851 and is considered a "segregated asset account" within the meaning of Treas. Reg. § 1.817-5(e). Pursuant to Treas. Reg. § 1.817-5(f)(2), all of the shares of the Non-Public Funds are held either by segregated asset accounts of insurance companies or by interests otherwise allowed by Treas. Reg. § 1.817-5(f)(3). With the exception of those interests permitted under Treas. Reg. § 1.817-5(f)(3), public access to the Non-Public Funds is available exclusively through the purchase of a variable contract within the meaning of sections 817(d) and (e). Also, the Company represents that the investments of the Non-Public Funds managed by the Company or one of its affiliates in which the Non-Qualified Contracts can invest satisfy, and will continue to satisfy, the diversification requirements of section 817(h) and the regulations thereunder. Further, the Company represents, to the best of its knowledge and belief, the investments in the Non-Public Funds not managed by the Company or one of its affiliates in which the Non-Qualified Contracts can invest satisfy, and will continue to satisfy, the diversification requirements of section 817(h) and the regulations thereunder.

Assets held in Annuity Separate Accounts 3 and 4 on behalf of certain Section 401 Contracts, TSA Contracts and Section 457 Contracts, as well as the assets of Annuity Separate Account 6, may be invested in shares of investment companies that are available to the general public. Each of these funds is registered under the 1940 Act with the Securities and Exchange Commission as open-ended investment companies, each qualifies as a regulated investment company, and each is considered a "segregated asset account" under Treas. Reg. § 1.817-5(e).

#### E. Proposed Arrangement for Section 457(b) Non-governmental Plans

As a result of expanded deferral limits allowed by provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001, there has been increased interest in top hat deferred compensation plans for tax-exempt organizations described in section 457(e)(1)(B). In response to this interest, the Company has developed an arrangement (the "Arrangement") that combines administrative services in connection with such top hat plans, along with a facility providing a variety of participant-directed investment options.

The Arrangement consists of several agreements. Initially, there is a Plan Services Agreement. Under this agreement between the Company and the plan sponsor, the Company agrees to provide required participant record keeping and related services in connection with the administration of the Section 457(b) plan. As outlined in the Plan Services Agreement, these services may include plan installation services, maintenance of individual account records for each participant, balancing and allocation of plan contributions to individual participant accounts, monitoring contribution limits, provision of quarterly statements for the plan sponsor and participants, processing of distributions and in-service withdrawals, tax withholding and reporting, providing toll-free phone and internet access to plan participants, minimum required distribution processing, and the calculating, processing and distribution of lump sum and installment payments to participants.

Consistent with the rules of section 457, a variety of participant-directed fixed and variable investment options are offered under the Arrangement. A guaranteed, fixed income investment option is offered to plan participants through a fixed deferred annuity contract (the "Annuity Contract"). The Annuity Contract is a group contract issued by the Company to the plan sponsor or to the trustee of a Rabbi trust, discussed below. Separate record keeping accounts are maintained by the Company with respect to amounts directed to the contract on behalf of each plan participant. Contributions to, and distributions from, the Annuity Contract will be made at the direction of the plan sponsor on behalf of plan participants.

In addition to the guaranteed investment option offered through the Annuity Contract, the Arrangement offers direct investments in a variety of mutual funds. Administrative costs to plan sponsors may be lower through the direct investment in these funds rather than through indirect investment by the purchase of a variable annuity contract. Investments on behalf of plan participants to these mutual fund options will be made, at the direction of the plan sponsor, by the trustee of a Rabbi Trust, established pursuant to a trust agreement entered into between the plan sponsor and a trust institution (the "Trustee"). The Trustee will be the registered owner of the shares of the mutual funds. Generally, Affiliate, an affiliate of the Company, will be the

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trustee under the Arrangement, although in some instances an unrelated trust institution may be utilized by the plan sponsor. Where an alternate trustee is involved, Affiliate's role will be that of a custodian to the trustee. The Trust has been established in order to provide a centralized facility for making direct mutual fund investments with respect to the Section 457(b) plan, and to offer additional security for plan participants. The Company represents to the best of its knowledge and belief that Trust is a grantor trust, subject to the provisions of sections 671-679 of the Code, and the trust assets will remain subject to the claims of the plan sponsor's general creditors in the event of insolvency.

Currently, all of the funds offered under the Arrangement are available for purchase by the general public. However, subject to the receipt of a favorable ruling, the Arrangement would also allow plan investments in institutional mutual funds that are not publicly available. These options would include certain of the Non-Public Funds that presently are available solely through the purchase of a Variable Contract or through direct purchase by qualified pension or retirement plans described in Treas. Reg. § 1.817-5(f)(3)(iii) and Rev. Rul. 94-62, 1994-2 C.B. 164. It is the proposed investment in the Non-Public Funds under the Arrangement that is the subject of this ruling request.

Subject to certain limitations, participants will be able to transfer investments between the fixed options under the Annuity Contract and the mutual fund investments made through the Trust, as well as among the various mutual fund options. At the time a participant retires, or otherwise reaches a distributable event under the Section 457(b) plan, amounts invested on behalf of the individual under the Arrangement will be payable to the participant in a lump sum, in installments, or in the form of an annuity.

#### LAW AND ANALYSIS

For purposes of section 457 of the Code, the term "eligible deferred compensation plan" is defined in section 457(b) as a plan established and maintained by an eligible employer meeting certain requirements.

For purposes of section 457, the term "eligible employer" is defined in section 457(e)(1) as:

(A) a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State, and

(B) any other organization (other than a governmental unit) exempt from tax under this subtitle.

Section 817(h)(1) of the Code provides that, for purposes of subchapter L, section 72 (relating to annuities), and section 7702(a) (relating to the definition of life

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insurance contract), a variable contract (other than a pension plan contract), which is otherwise described in section 817 and which is based on a segregated asset account, shall not be treated as an annuity, endowment, or life insurance contract for any period (and any subsequent period) for which the investments made by such account are not, in accordance with regulations prescribed by the Secretary, adequately diversified.

Treas. Reg. § 1.817-5 contains the diversification requirements for variable contracts based on segregated asset accounts. Treas. Reg. § 1.817-5(f) provides a look-through rule for the application of the diversification requirements of § 1.817-5. Treas. Reg. § 1.817-5(f)(1) provides that, if the look-through rule applies, a beneficial interest in a regulated investment company will not be treated as a single investment of a segregated asset account; instead, a pro rata portion of each asset of the investment company will be treated, for purposes of § 1.817-5, as an asset of the segregated asset account.

Treas. Reg. § 1.817-5(f)(2)(i) 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. Solely for this purpose, the status of the contract as a variable contract will be determined without regard to section 817(h) of the Code and § 1.817-5 of the regulations.

Treas. Reg. § 1.817-5(f)(3) provides that satisfaction of the requirements of Treas. Reg. § 1.817-5(f)(2)(i) shall not be prevented by reason of beneficial interests in the investment company that are “(iii) Held by the trustee of a qualified pension or retirement plan.”

Rev. Rul. 94-62, 1994-2 C.B. 164, lists nine arrangements that qualify as a “qualified pension or retirement plan” for purposes of Treas. Reg. § 1.817-5(f)(3)(iii). Specifically, the list under Rev. Rul. 94-62, includes: “6. A governmental plan within the meaning of § 414(d) or an eligible deferred compensation plan within the meaning of § 457(b) . . .”

The Company has represented that the retirement plans underlying the Arrangement are nongovernmental “eligible deferred compensation plans” within the meaning of section 457(b).



### CONCLUSION

Based on the facts presented and the representations made we hold:

Satisfaction of the look-through rule of Treas. Reg. § 1.817-5(f)(2)(i) by Taxpayer shall not be prevented by reason of beneficial interests in the Non-Public Funds being held by an eligible deferred compensation plan within the meaning of section 457(b) under the Arrangement offered 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(s) requesting it. Section 6110(k)(3) of the Code 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 the taxpayer.

The rulings contained in this letter are based upon information and 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,

/S/

DONALD J. DREES, JR.  
Senior Technician Reviewer, Branch 4  
Office of Associate Chief Counsel  
(Financial Institutions & Products)