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In Re:

TIN:

Taxpayer =
Parent =
C1 =
C2 =
State =
Jurisdictions =

Product =
SA1 =
SA2 =
#1 =
#2 =
#3 =
SD =
LB/(SB) =
PC =
SGM =
SGM-T =
SSD =
SMV =
SIV
SMD =
STHA =
VIO =
PR =
HAB =
FIA =
A =
B =

Securities =
CMD =
PC =

Dear _____ :

This is in reply to Taxpayer's December 21, 2011 request for a ruling with respect to the ownership of assets held to support obligations under proposed non-qualified annuity contracts invested in C1 and C2 indexed-linked options ("New Investment Options").¹

FACTS

Taxpayer is a stock life insurance company, organized and operated under the laws of State, licensed to engage in the life insurance business in Jurisdictions. It represents that it qualifies as a life insurance company under § 816(a) of the Internal Revenue Code ("Code") and joins in filing consolidated Federal income tax returns with Parent on a calendar year basis using an accrual method of accounting.

Taxpayer issues Product. Product offers deferred annuity contracts with variable investment options and New Investment Options. It represents that the variable investment options meet the requirements of § 817(d) of the Code and provide returns that directly reflect the investment return and market value of the assets Taxpayer holds in related subaccounts of SA1.² New Investment Options are indexed-linked to C1 and C2 and provide a formula-based return (reflecting changes in specified indexes over a stated duration). New Investment Options give contract holders the opportunity to diversify their retirement portfolios by adding returns related to C1 and C2 but limiting risk exposure. Only Taxpayer may add, remove, or modify investment options under the contracts.³

Taxpayer will offer New Investment Options through SGMs⁴ and SGM-Ts.⁵ Each SGM will have a #1 year SD and #2 LB.⁶ Taxpayer may later offer SGMs with different SDs and LBs. It may also create new SGMs of a particular SGM-T with unique PCs.⁷

Contract owners may allocate contributions and transfers to investment options available on the date the owner enrolled or, with respect to certain exchanges, their enrollment date under a prior contract. Contributions and transfers allocated to a SGM

¹ Taxpayer already offers similar investment options for individual retirement annuity contracts under § 408(b) and Roth individual retirement annuity contracts under § 408A.

² SA1 provides for units that represent a pro rata interest in the current investment performance and current market value of the assets in the account which pass directly to the variable contract values based on the number of units allocable to each contract. SA1 is available only to pay claims of invested contract holders; they are not subject to the claims of Taxpayer's creditors.

³ Taxpayer has the right to substitute an index, end a SGM, change the SSD, SMD, change the frequency during which it offers new SGMs, stop offering SGMs, temporarily suspend offering new SGMs, and add new SGM-Ts.

⁴ SGM means an investment option established with a specific index, SD, SB, and SMD.

⁵ SGM-T means all SGMs having the same index, SD, and SB.

⁶ LB means the portion of any negative index performance absorbed by Taxpayer on the SMD. Any decline in the performance rate in excess of the LB reduces the contract holder's SMV.

⁷ PC means the highest rate of return credited on a SMD.

are first invested in the STHA⁸ until the next SSD for that SGM-T and then transferred to the SGM-T.

The contract and prospectus for New Investment Options describe two formula-based returns, the SIV and the SMV.

The SIV, calculated each business day, is the amount available under a SGM due to withdrawal or surrender, or upon death prior to the SMD. Withdrawal proceeds are taken first from contract values allocated to variable investment options, if any, and then from SGMs of New Investment Options. The SIV is based on the value of a HAB of FIAs (that match the remaining SD of the SGM) and A and B.⁹ The SIV includes a credit for the administrative and other expenses Taxpayer saves due to early withdrawal. To discourage early withdrawal from a SGM when the referenced index experiences significant gains early in the SGM's duration, the SIV calculation applies a prorated PC.¹⁰ As a result of this formula, the SIV may reflect a loss even if the referenced index experienced gain at the time of early withdrawal. The SIV is independent of the value of any assets Taxpayer actually holds.

Contract holders receive the SMV if their contract value remains in the SGM through the SMD. The SMV reflects the return on the referenced index as of the SMD, subject to the LB, PC, and, if applicable, PR.^{11, 12}

Taxpayer will notify the contract holders at least 45 days prior to a SMD. Taxpayer will follow the contract holders' SMD instructions on file to allocate the SMV to available investment options.¹³ If a contract holder has not provided Taxpayer instructions for the allocation of the SMV, it will allocate that amount to the STHA for the SGMs of the same SGM-T as the SGM that matured for transfer to the next SGM of that SGM-T. If Taxpayer terminates the contract holder's SGM-T, it will transfer the SMV to SA1.

At the CMD,¹⁴ the Taxpayer will use the contract owners' annuity account values to fund their annuity benefits.

To support its contractual liabilities under the New Investment Options, Taxpayer expects to purchase A and B to cover C1 and C2 index gains subject to the PC and

⁸ The STHA is an account that holds all contributions and transfers allocated to a SGM-T pending investment in a SGM. The STHA is a variable investment option that is currently part of the SA1.

⁹ The FIAs reflect Taxpayer's lost interest income due to early withdrawal. The A options estimate the value of possible loss; the B options estimate the value of possible gain.

¹⁰ To illustrate, if a SGM has a 10 percent PC at the SMD and the contract holder withdraws the allocated value after 146 days, the reduced PC is 4 percent -- $.10(146/365)$.

¹¹ Taxpayer expects an initial PR of #3 percent.

¹² To illustrate, if a SGM of the New C1 Investment Option has a (1) 10 percent LB, (2) 12 percent PC, and (3) 100 percent PR:

- At the SMD, if the C1 index declined by 9 percent, a contract holder in the SGM would not earn or lose any of the value allocated to it because the 10 percent LB covers the full decline in the index. However, if the index declines by 15 percent, the contract holder loses 5 percent of the value allocated to the SGM.
- At the SMD, if the C1 index increased by 10 percent, a contract holder in the SGM gets 10 percent credited to the value allocated to it because the index did not exceed the 12 percent PC. However, if the index increased by 15 percent, the contract holder receives credit to the value allocated to the SGM only up to the 12 percent PC. Taxpayer retains the remaining 3 percent.

¹³ Contract holders may change the instructions on file at any time by submitting the related form.

¹⁴ The CMD, based on the annuitant's date of birth, is the date on which the annuity payments begin.

FIAs to cover the principle amount invested and LB.¹⁵ Taxpayer represents that it assumes the economic risks of these investments.

Taxpayer will hold the A and B in its general asset account and will hold the FIAs in SA2.¹⁶ The amount of cash in SA2 will equal the cash values for New Investment Options attributable to related contracts. Therefore, Taxpayer will increase or decrease the assets held in SA2 as needed to reflect its contractual obligations with respect to the New Investment Options.

Subject to applicable state regulatory requirements, Taxpayer will use its sole discretion in determining the nature and extent of any investments it makes to support its liabilities under New Investment Options. Taxpayer has no legal obligation to invest in any specific assets to provide for its contractual liabilities with respect to New Investment Options. Contract owners will have no input with respect to these investment decisions and will not have legal, equitable, or indirect ownership interest in any particular assets Taxpayer purchases to support its contractual obligations under New Investment Options (or in any other assets Taxpayer holds for any other purpose). If a contract holder makes a withdrawal before the SMD, Taxpayer will sell whatever assets of SA2 or its general account it chooses, or use its cash reserves, to pay the withdrawal proceeds. Moreover, although Taxpayer faces the risk of loss on the assets it holds to support New Investment Options, the guaranteed return to the contract holders shields them from this risk. Therefore, losses on Taxpayer's actual investments will not affect the formula-based returns of the SIV or the SMV.

REQUESTED RULING

Taxpayer, not the contract owners, owns the assets it holds in support of its contractual obligations with respect to New Investment Options.

LAW

In general, the entity possessing legal title to property is the owner of that property for Federal income tax purposes. However, the courts attribute ownership of property for tax purposes to the person, other than the holder of legal title, who possesses the "benefits and burdens", or "incidence", of ownership. In *Corliss v. Bowers*, 281 U.S. 376, 378, 50 S.Ct. 336, 74 L.Ed. 916 (1930), the Supreme Court summarized this principle stating:

"Taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed -- the actual benefit for which the tax is paid."

Therefore, objective economic realities, not legal nicety of title, determine tax ownership. For example, in *Helvering v. Clifford*, 309 U.S. 331, 60 S.Ct. 554, 84 L.Ed.

¹⁵ It is intended that these investments will at least equal the SIV of all contracts at any point in time but they will not match the HAB. Moreover, only the SMV and SIV, as applicable, determine Taxpayer's obligations under the New Investment Contracts. If Taxpayer's investments outperform the formula-based returns, it keeps the excess; if they underperform, it must make up the difference from surplus or other investments.

¹⁶ SA2 was established pursuant to State law governing this type of account.

788 (1940), the taxpayer could not avoid tax ownership of certain securities he contributed to a trust for his wife's benefit because he declared himself trustee and the trust instrument granted him the "absolute discretion" to reinvest or pay out the income to his wife, and the ability to buy, sell, and vote the corpus.

The facts and circumstances of each case determine ownership of the property for tax purposes.¹⁷ In *Grodts & McKay Realty, Inc., v. Commissioner*, 77 T.C. 1221 (1981), the Tax Court considered whether the benefits and burdens of ownership passed from the selling cattle company to the taxpayers stating:

Some of the factors which have been considered by courts in making this determination are: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property. (*Citations omitted.*)

Other indicia of ownership for Federal income tax purposes include use of property to satisfy creditors' claims¹⁸ and treatment for accounting purposes.¹⁹

The Service applied these general tax ownership principles in a series of "investor control" rulings.²⁰ The rulings stand for the proposition that contract holders possessing control over the investment of the separate account assets (in addition to the other benefits and burdens of contract ownership) are the owners of separate account assets for Federal income tax purposes even if the insurance company retains possession of and legal title to those assets.^{21, 22} The Service found investor control when (1) the

¹⁷ See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561, 572-73 (1978); *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939); *Helvering v. Clifford*, 309 U.S. 331, 335 (1940); *Sun Oil Co. v. Comm'r*, 562 F.2d 258, 263, 269 (3d Cir. 1977); *Bailey v. Commissioner*, 912 F.2d 44, (1990).

¹⁸ *Pommier v. Commissioner*, T.C. Memo 1986-506 (1986), taxpayer is the sole beneficiary of a land trust when he has not parted permanently with his rights upon contract of sale of the property (through the trustee) and has a continuing interest in the installment payments made by the purchasers which are applied for his benefit in the discharge of his obligations to his creditor. So much is especially clear when that power to procure payment is used to apply the money he is entitled to collect to an obligation owed by him. *But see*, *Miami National Bank v. Commissioner* 67 T.C. 793 (1977), taxpayer treated as owner of stock in which it retained the right to dividends, to vote the stock, to reacquire the stock by substituting cash or readily marketable securities of equivalent value, and to file a claim against the broker for the proceeds of any shares sold out of the subordination account even though it transferred legal title to a broker who could sell the stock to satisfy the claims of its creditors.

¹⁹ See Notice 94-47, 1994-1 C.B. 357 (listing factors for distinguishing between debt and equity). *But see* *Unocal Corp. v. Kaabipour*, 177 F.3d 755, in which the purported leasee in a synthetic lease arrangement "for practical purposes has the attributes of ownership" even though, as the court noted, it was not the owner for tax purposes. "Indeed, general law treats synthetic lease arrangements as transparent for tax and other purposes. The entire point of a synthetic lease is that it is treated as an operating lease for accounting purposes, but is otherwise regarded by virtually all concerned, including the government, as a secured loan." *Cf.* Andrew Ratner, *Synthetic Leasing: Too Good to be Ignored; Real Estate Financing*, National Real Estate Investor, August 1996, at 104. "While the arrangement is treated as an operating lease for accounting purposes under Generally Accepted Accounting Principles, a synthetic lease is viewed as a secured loan by the IRS for tax purposes."

²⁰ Rev. Rul. 77-85, 1977-1 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 81-225, 1981-2 C.B. 12; and Rev. Rul. 82-55, 1982-1 C.B. 12. See also Rev. Proc. 99-44, 1999-2 C.B. 598.

²¹ Rev. Rul. 2003-91, 2003-2 C.B. 347, citing *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), *Comm'r v. Sunnen*, 333 U.S. 591 (1948), *Helvering v. Clifford*, 309 U.S. 331 (1940), and *Christoffersen v. United States*, 749 F.2d 513 (8th Cir. 1984) (variable contract under which the policyholder did not possess sufficient control over the separate account assets to be treated as owning them for tax purposes.) Rev. Rul. 2003-92, 2003-2 C.B. 350, (for Federal income tax purposes, the contract holder owns the interests in the partnerships held by the sub-accounts when the interests in the partnerships are available for purchase by investors other than purchasers of annuity or variable contracts; when interests in the partnerships are available for purchase only by purchasing an annuity, life insurance contract, or other variable contracts from an insurance company, for Federal income tax purposes, the insurance company owns the interests in the partnerships held by the sub-accounts) cites the same cases as Rev. Rul. 2003-91.

holder exercises sufficient control over the assets to be deemed the owner; or (2) the assets are not available exclusively through the purchase of a life insurance or annuity contract.²³

In *Christoffersen v. United States*, 749 F.2d 513 (8th Cir. 1984), the U.S. Court of Appeals for the Eighth Circuit addressed the tax ownership issue in the context of a variable annuity contract. The contract permitted the taxpayer to allocate premiums among sub-accounts of the issuing insurance company's separate account. The premiums allocated to a particular sub-account were invested in a specified mutual fund the shares of which were also available for purchase (directly or indirectly) by the general public. The court ruled that the contract was not an annuity under § 72. Relying on general tax principles, the court concluded that the taxpayer had (1) "surrendered few of the rights of ownership or control over the assets of the sub-account", (2) bore the entire investment risk, (3) could withdraw any or all of the investment upon seven days notice, and (4) might never annuitize the contract. Further, the only difference between this "variable annuity" arrangement and that of a traditional brokerage account was the fact that the investor was limited to withdrawing cash.²⁴

ANALYSIS

The courts have identified the factors to consider and the facts and circumstances of each case determine the ownership of property for Federal income tax purposes.

Taxpayer possesses the following ownership attributes in the assets it holds to support the New Investment Options:

- (1) Legal Title - Taxpayer will hold legal title to all of the assets in its general account and SA2. The contract holders will have no legal, equitable, or indirect ownership interest in any particular assets Taxpayer purchases to support its contractual obligations under New Investment Options or in any other assets Taxpayer holds for any purpose.
- (2) Rights of Possession – Only Taxpayer has the right to receive income (such as dividends or interest) generated by the assets it holds. Subject to state regulatory requirements, only Taxpayer determines the nature and extent of any investments it makes in support of its contractual liabilities under New Investment Options and has no legal obligation to invest in any specific assets to provide for its contractual liabilities with respect to New Investment Options. Also, if a contract holder makes a withdrawal before the SMD, Taxpayer will choose which assets of SA2 or its general account it sells, or will use its cash reserves, to pay the withdrawal proceeds.

²² Contract holders treated as the owners of the separate account assets lose the tax benefits of the insurance or annuity contract and are currently taxed on income generated by the separate account assets. They may also be taxed at capital gains, rather than ordinary income, rates.

²³ See, e.g., Rev. Rul. 77-85; Rev. Rul. 80-274; Rev. Rul. 81-225; *Christoffersen v. United States*, 749 F.2d 513 (8th Cir. 1984).

²⁴ *Id.* at 515.

- (3) Taxes and Other Costs -- Assets in the Taxpayer's general account and the SA2 may generate taxes or incur commissions or other costs. Taxpayer bears the full burden of such taxes and other costs. The formulas to calculate contract values based on New Investment Options do not reflect taxes and other costs.
- (4) Risk of Loss – The formulas set forth in the contract and prospectus determine Taxpayer's contractual liabilities under New Investment Options. Taxpayer chooses the assets it purchases to support its liabilities and bears the full burden of any losses on these assets. Taxpayer must pay the contract holders the guaranteed formula-based return under the New Investment Options. Therefore, if Taxpayer's investments perform worse than the guarantee under the Contract, it will fund the difference from its surplus or other investments. The contract owners' only risk with respect to assets Taxpayer holds is the general risk that the Taxpayer will become insolvent and unable to perform under the terms of the contract.
- (5) Profits – For the same reasons Taxpayer is subject to risk of loss, it enjoys all the opportunity for gain on its investments. If its investments perform better than the formula-based return guaranteed under New Investment Options, it keeps the excess.
- (6) Accounting -- Taxpayer accounts for the assets and liabilities as its own.

The Taxpayer, not the contract owner, enjoys the benefits and bears the burdens of owning the assets purchased to fund payments under New Investment Options and therefore should be treated as the owner for Federal income tax purposes.

Conversely, in the investor control rulings, the Service considered the rights of the contract holders, not the insurance company, and treated those with sufficient control over the company's investments as the owner those assets for Federal income tax purposes. Contract holders have this control if they can purchase or dispose of the assets directly or through an annuity contract.

The contract owners purchasing New Investment Options will not have any control over the purchase or disposition of the investments Taxpayer buys to support its obligations under their contracts. The contract holders are not investing directly in C1 or C2 and the C1 and C2 indexed returns they receive are available only by purchasing New Investment Options, and not outside the contract. Also, the contract holders receive a formula-based return, as described in the contract and the prospectus, which is completely independent of Taxpayer's investment returns.

The contract holders have no investor control over the investments supporting New Investment Options and therefore would not be treated as the owners of those assets for Federal income tax purposes.

RULING

Taxpayer, not the contract owners, owns the assets it holds in support of its contractual obligations with respect to the New Investment Options.

CAVEATS

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. No ruling was requested, and no opinion is expressed, with respect to whether New Investment Options are fixed or variable annuity contracts (see § 817(d)) or whether SA2 is an account "segregated from the general asset accounts" of Taxpayer under §817(d)(1). Also, no ruling was requested, and no opinion is expressed with respect to the treatment of New Investment Options under any other provisions of subchapter L of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. 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 on facts and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process.

Sincerely,

SHERYL B. FLUM
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: