

**COMMENTS OF THE COMMITTEE OF ANNUITY INSURERS  
ON PROPOSED AMENDMENTS TO REGULATIONS UNDER IRC SECTION 817(h)**

[REG – 163974-02]  
[68 FED. REG. 44,689 (July 30, 2003)]

October 28, 2003

**I. INTRODUCTION**

**A. The Committee of Annuity Insurers**

These comments are being submitted on behalf of the Committee of Annuity Insurers (the “Committee”). The Committee is a coalition of 30 of the nation’s largest and most prominent issuers of annuity contracts, representing more than one-half of the annuity business in the United States.<sup>1</sup> Many of the annuity contracts issued by the Committee’s member companies are variable contracts subject to the investment diversification requirements of section 817(h).<sup>2</sup>

The Committee appreciates this opportunity to comment on the proposed amendments to the regulations under section 817(h). Annuity contracts serve an important role in helping hundreds of thousands of Americans achieve a financially secure retirement. This is true both of “qualified” annuity contracts, such as those purchased in connection with individual retirement arrangements and section 403(b) arrangements, as well as “non-qualified” annuity contracts, which are purchased with after-tax dollars, often to supplement savings under tax-qualified retirement arrangements.<sup>3</sup> Non-qualified *variable* annuity contracts, in particular, play a critical part in many Americans’ retirement planning, allowing the accumulation of retirement savings at a rate that outperforms or keeps pace with inflation and guaranteeing retirement income for life – a feature unique to annuities. In this regard, as of last year Americans had over \$300 billion invested in non-qualified variable annuity contracts.<sup>4</sup>

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<sup>1</sup> The Committee was formed in 1982 to address federal legislative and regulatory issues relevant to the annuity industry and to participate in the development of federal policy regarding annuity taxation. A list of the member companies is attached as Exhibit A.

<sup>2</sup> Except as otherwise indicated, references to “sections” are to sections of the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>3</sup> Qualified annuity contracts are exempt from the investment diversification requirements of section 817(h) and, thus, are not directly affected by the proposed amendments described below. Unless indicated otherwise, references herein to annuities are to non-qualified annuities.

<sup>4</sup> See National Association for Variable Annuities, 2003 ANNUITY FACT BOOK: A GUIDE  
(continued ...)

October 28, 2003

Page 2 of 21

## B. The Proposed Amendments

Section 817(h) requires the assets of a “segregated asset account” that supports variable annuity or variable life insurance contracts to be “adequately diversified” in accordance with Treasury Department regulations. As stated by Congress, these requirements were established “to discourage the use of tax-preferred variable annuities . . . primarily as investment vehicles,”<sup>5</sup> and do so by denying “annuity . . . treatment for investments that are publicly available to investors and investments which are made, in effect, at the direction of the investor.”<sup>6</sup> The regulations under section 817(h) implement this intent by requiring the assets of a segregated asset account to be invested at all times in a certain minimum number of investments and within certain concentration limits.<sup>7</sup> In testing for adequate diversification, the regulations under section 817(h), as currently in effect, provide three different “look-through” rules for certain types of investments. If a look-through rule applies, the actual interests held in an entity by the segregated asset account are not taken into account as a single investment in testing for diversification. Instead, diversification is tested by “looking through” the entity and treating the segregated asset account as holding a *pro rata* share of the assets of that entity.

Under the first look-through rule (the “General Look-Through Rule”), look-through treatment applies only with respect to certain specified types of pooled investment entities, where all interests in the particular entity (with certain exceptions, discussed below) are held by one or more life insurance company segregated asset accounts (*i.e.*, such interests are not available to the public).<sup>8</sup> Under the second look-through rule, look-through treatment is provided

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TO INFORMATION, TRENDS AND DATA IN THE ANNUITY INDUSTRY (2d ed. 2003).

<sup>5</sup> STAFF OF THE JT. COMM. ON TAX’N, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 607 (Jt. Comm. Print 1985).

<sup>6</sup> H.R. CONF. REP. NO. 98-861, at 1055 (1984).

<sup>7</sup> The preamble to the proposed regulations under section 817(h) (which later were finalized in substantially unaltered form) states that those regulations were not intended to provide guidance “concerning the circumstances in which investor control of the investments of a segregated asset account may cause the investor, rather than the insurance company, to be treated as the owner of the assets in the account.” *See* T.D. 8101, 1986-2 C.B. 97, 98.

<sup>8</sup> The entities eligible for look-through treatment are (i) a regulated investment company (“RIC”), (ii) a real estate investment trust, (iii) a “grantor” trust, and (iv) a partnership. *See* Treas. Reg. section 1.817-5(f)(2)(i).

October 28, 2003

Page 3 of 21

with respect to any interests held in a “non-registered partnership,”<sup>9</sup> regardless of whether such interests are available to the public (the “Non-Registered Partnership Rule”). Under the third look-through rule, look-through treatment applies to a grantor trust if substantially all of the assets of the trust are represented by Treasury securities.<sup>10</sup>

On July 30, 2003, the Treasury Department and Internal Revenue Service (“IRS”) published a notice of proposed rulemaking in the Federal Register, which proposes to amend the regulations under section 817(h) (the “Proposed Amendments”).<sup>11</sup> Specifically, the Proposed Amendments would eliminate the Non-Registered Partnership Rule in Treasury Regulation section 1.817-5(f)(2)(ii). The preamble to the Proposed Amendments explains that the purpose of the proposed change is to eliminate “possible confusion” about the use of a publicly available investment to fund variable contracts in a manner contrary to the congressional intent in enacting section 817(h). In addition, the preamble states that the IRS is concerned that the Non-Registered Partnership Rule is being used as the basis for interpreting the concept of “public availability” as excluding investments available only to “qualified purchasers” or “accredited investors” within the meaning of the federal securities laws.

The preamble to the Proposed Amendments solicits comments on the Proposed Amendments generally, as well as on certain specific issues identified in the preamble.<sup>12</sup> In this regard, Part II. below sets forth the Committee’s comments on the Proposed Amendments, while Part III. provides comments on the “investor control” principles developed in IRS published guidance.<sup>13</sup>

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<sup>9</sup> A partnership is considered non-registered if it is not registered under any state or federal securities laws. *See* Treas. Reg. section 1.817-5(f)(2)(ii).

<sup>10</sup> *See* Treas. Reg. section 1.817-5(f)(2)(iii).

<sup>11</sup> *See* 68 FED. REG. 44,689 (July 30, 2003).

<sup>12</sup> The issues identified in the preamble are (1) whether the proposed revocation of the Non-Registered Partnership Rule necessitates other changes to the regulations under section 817(h), and particularly whether the list of holders permitted under Treasury Regulation section 1.817-5(f)(3) should be amended or expanded and whether a non-*pro rata* distribution of the investment returns of a segregated asset account should be permitted to take account of certain bonus or “incentive” payments to investment managers; (2) whether the regulations generally should be updated to take into account changes in variable product designs; and (3) whether regulations are needed to address investor control issues.

<sup>13</sup> *See* Rev. Rul. 2003-92, 2003-33 I.R.B. 350; Rev. Rul. 2003-91, 2003-33 I.R.B. 347; Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 13; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12.

October 28, 2003

Page 4 of 21

## **II. COMMENTS ON PROPOSED AMENDMENTS**

The Committee shares the concern that the Non-Registered Partnership Rule set forth in Treasury Regulation section 1.817-5(f)(2)(ii) creates confusion about the concept of public availability and investor control principles developed in IRS published rulings. This confusion results principally from the fact that Treasury Regulation section 1.817-5(f)(2)(ii) is not explicitly subject to limitations such as those found in Treasury Regulation section 1.817-5(f)(2)(i) regarding “public” investments. The Committee believes that elimination of the Non-Registered Partnership Rule will clarify the requirements applicable to variable contracts, including variable annuities. Accordingly, the Committee generally supports the Proposed Amendments, subject to the comments herein relating to their effective date and other specific issues.

### **A. The Regulations Should Clarify the Treatment of Fund-of-Funds and Master-Feeder Arrangements.**

The preamble to the Proposed Amendments states that the Treasury Department and IRS are seeking comments on whether the regulations under section 817(h) generally should be updated to take into account changes in variable insurance product designs. As a general matter, the Committee believes that the regulations currently provide adequate flexibility for new product designs, and urges the Treasury Department and IRS to endeavor to retain such flexibility in any amendments to the regulations. Nevertheless, clarification would be useful with respect to one particular issue concerning a relatively recent development in the variable insurance product market.

Since the regulations under section 817(h) were promulgated in 1986, there has been a substantial increase in the use of so-called “fund-of-funds” and “master-feeder” arrangements in support of variable contracts. Such arrangements involve the use of multiple tiers of investment vehicles (typically RICs or, in some cases, partnerships), with the upper tier pursuing its investment objective by purchasing interests in the lower tier.

For example, a typical fund-of-funds arrangement involves a segregated asset account that invests in an upper-tier RIC, shares of which are available only to segregated asset accounts of insurance companies for the purpose of supporting variable contracts or to other investors permitted under Treasury Regulation section 1.817-5(f)(3) (“Permitted Investors”). The upper-tier RIC then invests typically in one or more lower-tier RICs, shares of which are available for direct purchase only by segregated asset accounts, Permitted Investors, and other RICs or partnerships in which only segregated asset accounts and Permitted Investors invest.<sup>14</sup>

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<sup>14</sup> An illustration of a basic fund-of-funds arrangement is attached as Exhibit B. Another  
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October 28, 2003

Page 5 of 21

Fund-of-funds arrangements typically are used to improve efficiencies in fund management, thereby lowering costs to consumers. Moreover, such arrangements simplify consumers' choices with respect to allocations of their contract values among investment options by offering a single option (*i.e.*, fund) that combines multiple investment strategies (*i.e.*, funds).

Similarly, a typical master-feeder arrangement involves multiple segregated asset accounts each of which invests in a different upper-tier RIC, shares of which are available only to segregated asset accounts of insurance companies for the purpose of supporting variable contracts or to other Permitted Investors. Each of the multiple upper-tier RICs then invests in the same lower-tier entity (a RIC or possibly a partnership), interests in which are available for direct purchase only by segregated asset accounts, Permitted Investors, and other RICs or partnerships in which only segregated asset accounts and Permitted Investors invest.<sup>15</sup> Like fund-of-funds arrangements, master-feeder arrangements typically are utilized to enhance efficiencies in fund management, as well as to allow an insurance company to offer as investment options well-performing RICs or partnerships established by other financial institutions.

The foregoing related structures present a technical issue regarding the applicability of the General Look-Through Rule to the lower-tier RIC or partnership used in these arrangements. Treasury Regulation section 1.817-5(f)(2)(i)(A) provides that the General Look-Through Rule applies in connection with a RIC or partnership only if "[a]ll the beneficial interests in the [RIC or partnership] ... are held by one or more segregated asset accounts of one or more insurance companies" or other Permitted Investors.<sup>16</sup> An entity such as an upper-tier RIC described above is not included in the list of Permitted Investors under the regulations, nor is it a segregated asset account of an insurance company. Because under the typical fund-of-funds or master-feeder arrangement an upper-tier RIC (in addition to segregated asset accounts and Permitted Investors) holds interests in a lower-tier RIC or partnership, a question arises

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common fund-of-funds structure utilizes publicly available RICs as lower-tier investments (*i.e.*, persons other than segregated asset accounts, Permitted Investors, and other RICs whose sole shareholders are segregated asset accounts and Permitted Investors can invest directly in the lower-tier funds). *See* note 17, *infra*.

<sup>15</sup> An illustration of a basic master-feeder arrangement is attached as Exhibit C.

<sup>16</sup> Of course, under the current regulations look-through treatment also applies to a non-registered partnership under the Non-Registered Partnership Rule, without regard to other investors in the partnership. Nevertheless, the General Look-Through Rule must apply in order for look-through treatment to be available to other (*i.e.*, "registered") partnerships, and will be the only rule available for look-through treatment in the case of non-registered partnerships following the proposed revocation of the Non-Registered Partnership Rule.

October 28, 2003

Page 6 of 21

whether all the beneficial interests in the lower-tier RIC or partnership are held by the appropriate persons, and, thus, whether look-through treatment applies with respect to the segregated asset account's indirect interest in the lower-tier RIC or partnership.<sup>17</sup>

The technical issue just described – whether “double” look-through treatment can apply to a fund-of-funds or master-feeder arrangement – has created confusion, prompting companies to seek private letter rulings from the IRS on this exact point. While the IRS has consistently concluded in these private rulings that double look-through treatment indeed can apply to multi-tier fund structures,<sup>18</sup> private rulings may be relied upon only by the taxpayers to whom they are issued. With a lack of formal guidance, several taxpayers have determined that a private letter ruling is their only option for obtaining comfort on this issue – as evidenced by the number of private rulings issued to date. To eliminate the need for such rulings in the future, the Committee respectfully requests that the Treasury Department and IRS amend the regulations under section 817(h) to clarify the treatment of fund-of-funds and master-feeder arrangements.

In this regard, the Committee believes that two revisions to the regulations are warranted. First, in order to clarify the treatment of the types of fund-of-funds and master-feeder arrangements utilized in the marketplace today, the list of Permitted Investors under Treasury Regulation section 1.817-5(f)(3) should be expanded to include a RIC, real estate investment trust, partnership, or trust (each, hereinafter, a “Look-Through Entity”) if such Look-Through Entity satisfies the requirements of Treasury Regulation section 1.817-5(f)(2)(i). Such a provision would ensure that the concepts underlying the General Look-Through Rule are satisfied by placing the same restrictions on upper-tier and lower-tier entities in multi-tier fund structures where double look-through treatment is desired. Second, the Committee believes that an example should be added to the regulations to illustrate the treatment of multi-tier structures

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<sup>17</sup> As described in note 14, *supra*, a fund-of-funds arrangement may be structured using publicly available RICs as the lower-tier investments. In such case, look-through treatment applies to the upper-tier RIC, but due to the public availability of the lower-tier funds the upper-tier RIC's investment therein must satisfy the diversification requirements of section 817(h) without looking through to the lower-tier funds' assets. In other words, look-through treatment is not available or necessary with respect to the lower-tier funds in such fund-of-funds arrangements. *See* PLR 9851044 (Sept. 22, 1998) (involving the application of section 817(h) to a fund-of-funds arrangement where the lower-tier funds were publicly available).

<sup>18</sup> *See, e.g.*, PLR 200115028 (April 12, 2001); PLR 200108038 (Nov. 27, 2000); PLR 200025037 (June 23, 2000); PLR 200024032 (June 16, 2000); PLR 200010020 (March 10, 2000); PLR 199951025 (Dec. 23, 1999). These rulings address the treatment of fund-of-funds arrangements, although presumably their reasoning would apply equally in the case of master-feeder arrangements.

October 28, 2003

Page 7 of 21

such as fund-of-funds and master-feeder arrangements. A draft of such an example is attached as Exhibit D.

**B. The List of Permitted Investors under Treasury Regulation section 1.817-5(f)(3) Should be Expanded to Include Qualified Tuition Programs.**

The preamble to the Proposed Amendments states that the Treasury Department and IRS also are seeking comments on whether the list of holders permitted under Treasury Regulation section 1.817-5(f)(3) (*i.e.*, Permitted Investors) should be amended or expanded. Treasury Regulation section 1.817-5(f)(3) currently provides that look-through treatment under the General Look-Through Rule is not prevented by reason of certain enumerated persons holding beneficial interests in a Look-Through Entity. The persons specifically enumerated are (1) the general account of a life insurance company or a related corporation,<sup>19</sup> (2) the manager or a corporation related to the manager of the Look-Through Entity,<sup>20</sup> (3) the trustee of a qualified pension or retirement plan,<sup>21</sup> and (4) in certain limited circumstances, the public pursuant to specified grandfathering rules.<sup>22</sup>

These rules demonstrate recognition by the Treasury Department and IRS that it is appropriate in certain circumstances for a person or entity other than a segregated asset account to hold a beneficial interest in a Look-Through Entity or otherwise have access to the Look-Through Entity without purchasing a variable contract. In some cases, such as an interest held by an insurer's general account or by the manager of the Look-Through Entity, the exception to

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<sup>19</sup> See Treas. Reg. section 1.817-5(f)(3)(i) (certain additional requirements apply, *e.g.*, the return on the holder's interest must be computed in the same manner as the return on a segregated asset account's interest in the Look-Through Entity).

<sup>20</sup> See Treas. Reg. section 1.817-5(f)(3)(ii) (again, certain additional requirements apply, including the requirement – discussed further below – that the return on the holder's interest be computed in the same manner as the return on a segregated asset account's interest in the Look-Through Entity).

<sup>21</sup> See Treas. Reg. section 1.817-5(f)(3)(iii); Rev. Rul. 94-62, 1994-2 C.B. 164 (providing guidance on the meaning of "qualified pension or retirement plan," as discussed in note 28, *infra*).

<sup>22</sup> See Treas. Reg. section 1.817-5(f)(3)(iv). This provision preserves the grandfathering that the IRS granted with respect to Revenue Ruling 81-225. See Rev. Rul. 82-55, 1982-1 C.B. 12.

October 28, 2003

Page 8 of 21

the General Look-Through Rule is necessitated by certain business realities.<sup>23</sup> In other cases, such as an interest held by the trustee of a qualified pension or retirement plan, the exception simply is good tax policy – it encourages retirement savings and facilitates economies of scale that can reduce costs for variable contract owners and qualified plan participants alike. And in all cases, the exceptions provided for Permitted Investors are appropriate because they do not give rise to the concerns Congress expressed in enacting section 817(h) in the first instance.

The Committee believes that the list of Permitted Investors should be expanded to include interests in a Look-Through Entity that are held by qualified tuition programs described in section 529. As a general matter, a qualified tuition program is a program established and maintained by a state (or agency or instrumentality thereof) or certain educational institutions for the purpose of funding – on a tax-preferred basis – the costs of higher education. Qualified tuition programs are subject to requirements similar to those applicable to qualified pension and retirement plans, such as requirements limiting the amount and type of contributions and prohibiting the use of program funds as security for a loan. Thus, in many respects qualified tuition programs are similar to qualified pension and retirement plans – they serve a public policy goal that Congress has determined is important and they are subject to some of the same types of limitations and restrictions that Congress placed on other tax-preferred savings programs.

Like the exception to the General Look-Through Rule provided for qualified pension and retirement plans, a similar exception for qualified tuition programs would be consistent with sound tax policy. Creation of such an exception would allow qualified tuition programs to invest directly in the many funds that have been created to support variable contracts. In this regard, such funds are particularly well suited for supporting qualified tuition programs. For example, the investments of Look-Through Entities supporting variable contracts are broadly diversified, and generally designed for the same long-term investment horizon that is ideal for a portion of the funds invested in qualified tuition programs. In addition, such Look-Through Entities – consistent with investor control principles – are designed so that individuals purchasing variable contracts supported by the Entities cannot control the investment decisions of the Entities or their managers. Similar restrictions on investment direction apply to qualified tuition programs under section 529.<sup>24</sup> Moreover, like all exceptions currently provided for

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<sup>23</sup> For example, a life insurer may need to provide initial funding, or “seed money,” for a Look-Through Entity prior to its use in connection with variable contracts. In addition, a life insurer may charge “mortality and expense” risk charges under a variable annuity on a daily basis, but collect the fee only monthly. In such case, the insurer’s general account typically will hold an ongoing interest in the Look-Through Entity in the amount of the charges, and the Look-Through Entity will redeem a sufficient number of its shares at month-end to pay those charges.

<sup>24</sup> See section 529(b)(5) (prohibiting a contributor to or beneficiary of a qualified tuition  
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October 28, 2003

Page 9 of 21

Permitted Investors, a similar exception for qualified tuition programs would not give rise to the concerns Congress expressed in enacting section 817(h) because it would not enable an investor to choose between investing in the same Look-Through Entity on a taxable or tax-deferred basis. Furthermore, such an exception would encourage insurance companies to be more active in the qualified tuition program market, increasing advertising and awareness of such programs and bringing those companies' substantial distribution networks to the market. This, in turn, would promote the broad participation in qualified tuition programs and the increased college savings that Congress envisioned when such programs were created.<sup>25</sup> Finally, costs could be reduced by increasing competition and facilitating economies of scale.

Accordingly, the Committee respectfully requests that the Treasury Department and IRS update the list of Permitted Investors under Treasury Regulation section 1.817-5(f)(3) to include qualified tuition programs described in section 529.

**C. The Regulations Should be Amended to Allow Non-Pro Rata Manager Compensation.**

The preamble to the Proposed Amendments states that the Treasury Department and IRS are seeking comments on whether the list of Permitted Investors under Treasury Regulation section 1.817-5(f)(3) should be amended to allow for a non-*pro rata* distribution of the investment returns of a segregated asset account to an investment manager that holds a beneficial interest therein. Under Treasury Regulation section 1.817-5(f)(3)(ii), if certain conditions are met, the manager (or a corporation related to the manager) of a Look-Through Entity can hold a beneficial interest in the entity in connection with its creation or management without affecting the applicability of the General Look-Through Rule. One condition that must be met is that the return on the manager's interest must be computed in the same manner as the return on a segregated asset account's interest.

Due to applicable securities law requirements, the foregoing condition generally is satisfied with respect to Look-Through Entities supporting variable annuities that are registered under the Securities Act of 1933<sup>26</sup> and the Investment Company Act of 1940.<sup>27</sup>

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program from directing the investment of any contributions to the program or any earnings thereon).

<sup>25</sup> See STAFF OF THE JT. COMM. ON TAX'N, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 104<sup>TH</sup> CONGRESS, at 197 (Jt. Comm. Print 1996) (stating that in enacting section 529 Congress intended to "encourage persons to save to meet secondary educational expenses").

<sup>26</sup> 15 U.S.C. § 77a *et seq.* (2003), as amended (the "1933 Act").

October 28, 2003

Page 10 of 21

However, it is less clear whether this requirement is always satisfied in connection with variable products sold in the private placement market. For example, in the case of a partnership entity supporting a private placement variable product, the investment manager may hold an interest in the profits of the partnership that is sometimes referred to as a “carried interest” or “incentive payment” interest. Such interests often are structured as a special allocation of partnership profits, and are intended to motivate the investment manager to achieve higher investment returns and to reward the manager for having done so. In the case of such a carried interest or incentive payment, the return on the investment manager’s interest in the partnership seemingly is not computed in the same manner as the return on the other interests in the partnership that are held by a segregated asset account, thus precluding the availability of the General Look-Through Rule. Under current law, this issue is irrelevant due to the availability of the Non-Registered Partnership Rule, which, as discussed above, does not contain a restriction on the nature of the return a manager may earn. The Committee believes that this issue also should be irrelevant under the General Look-Through Rule.

In this regard, the fact that the return an investment manager earns on its interest in a Look-Through Entity is seemingly calculated differently from other interests in that entity does not result in “public availability” within the meaning of the legislative history of section 817(h) or the regulations under that section. Rather, the additional returns an investment manager may earn are analogous to fees paid by a mutual fund to its investment manager for the performance of services, or insurance fees paid by variable contract holders (from the cash values of their variable contracts) for administrative services performed and insurance risks assumed by the issuing life insurance company. In fact, the requirements of Treasury Regulation section 1.817-5(f)(3)(ii) mandate that any interest in a Look-Through Entity held by an investment manager be in furtherance of the “creation or management” of the entity – *i.e.*, in connection with the performance of services. Thus, under this requirement the manager’s interest must relate to the start-up services it performed for the Look-Through Entity or its ongoing management services, and any type of interest that does not relate to such services would violate the requirement. Moreover, Treasury Regulation section 1.817-5(f)(3)(ii) requires the investment manager to lack any intent to sell to the public any interests it holds in the Look-Through Entity. Thus, under this requirement only the investment manager, and not members of the general public (including “qualified purchasers” and “accredited investors”), can hold or benefit from a carried or similar interest in a Look-Through Entity. In other words, a carried or similar interest in a non-registered partnership held by the manager of that partnership does not present the potential for the types of abuses that the Treasury Department and IRS identified as the impetus for the proposed revocation of the Non-Registered Partnership Rule.

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<sup>27</sup> 15 U.S.C. §80a-1 *et seq.* (2003), as amended (the “1940 Act”). The Investment Advisers Act of 1940, as amended, generally prohibits the charging of performance fees, with certain narrow exceptions. *See* 15 U.S.C. § 80b-5(a)(1) (2003).

October 28, 2003

Page 11 of 21

Based on the foregoing, the Committee believes that the requirements of Treasury Regulation section 1.817-5(f)(3)(ii) described in the preceding paragraph already effectively preclude any potential for abuse of the General Look-Through Rule, without the need for the current rule requiring that the return on an investment manager's interest be determined on an equal, *pro rata* basis with the return on a segregated asset account's interest. Accordingly, the Committee respectfully requests that the Treasury Department and IRS amend the list of Permitted Investors under Treasury Regulation section 1.817-5(f)(3) to allow for a non-*pro rata* distribution of the investment returns of a Look-Through Entity to an investment manager that holds a beneficial interest therein where such a distribution relates to the creation or management of such entity.

**D. The Regulations Should Provide Safe Harbors for Look-Through Treatment for Variable Contracts when a Qualified Pension or Retirement Plan or Look-Through Entity Loses its Tax Status.**

The General Look-Through Rule applies to a Look-Through Entity only if all beneficial interests in the Look-Through Entity are held by segregated asset accounts and public access to the Look-Through Entity is available exclusively through the purchase of a variable contract. As described above, the regulations under section 817(h) provide an exception to these requirements, under which a beneficial interest in a Look-Through Entity that is held by the trustee of a qualified pension or retirement plan (*i.e.*, a Permitted Investor) will not affect the applicability of the General Look-Through Rule.<sup>28</sup> While investments in a Look-Through Entity by qualified pension or retirement plans are expressly permitted by the current regulations, and clearly do not result in the Look-Through Entity becoming "publicly available" for purposes of the investor control doctrine, many insurers nonetheless are hesitant to allow such investments because of the highly uncertain consequences to the Look-Through Entity and the variable contract owners invested in such Look-Through Entity in the event that a plan loses its qualified

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<sup>28</sup> See Treas. Reg. section 1.817-5(f)(3)(iii). Although the regulations do not define the term "qualified pension or retirement plan," Revenue Ruling 94-62 provides that for purposes of Treasury Regulation section 1.817-5(f)(3)(iii), the term includes certain arrangements established and maintained under sections 401(a); 403(a) and (b); 408(a), (b), and (k); 414(d); 457(b); 501(c)(18); and "[a]ny other trust, plan account, contract, or annuity that the Internal Revenue Service has determined in a letter ruling to be within the scope of [Treasury Regulation section] 1.817-5(f)(3)(iii)." See also PLR 200122013 (Feb. 21, 2001) (concluding that a trustee of a section 457(f) plan that was sponsored by a section 501(c)(3) tax exempt organization or that was a "governmental plan" within the meaning of section 414(d) was the trustee of a "qualified pension or retirement plan" within the meaning of Treasury Regulation section 1.817-5(f)(3)(iii)).

October 28, 2003

Page 12 of 21

status. In this connection, a literal reading of the regulations suggests that the disqualified plan ceases to be a Permitted Investor at that time. That, in turn, would cause a loss of look-through treatment with respect to the Look-Through Entity, because beneficial interests in the Look-Through Entity then would be held by persons who are not Permitted Investors. Because many segregated asset accounts consist entirely of an interest in a single Look-Through Entity, or otherwise rely on the General Look-Through Rule to comply with the requirements of section 817(h), such a loss of look-through treatment with respect to the Look-Through Entity in which the disqualified plan invests generally would cause any non-qualified variable contract supported directly or indirectly by an interest in that Look-Through Entity to fail to be adequately diversified. Under current IRS procedures, the only option available to the Look-Through Entity and/or the insurer in such case would be to enter into a closing agreement with the IRS and pay a toll charge to the IRS approximately equal to the tax that would be owed by all of the contract owners.<sup>29</sup>

A similar issue can arise in connection with a fund-of-funds or master-feeder arrangement supporting a variable annuity. As described above, under such arrangements one or more upper-tier RICs holds beneficial interests in one or more lower-tier RICs. For example, in a typical master-feeder structure, a number of upper-tier RICs are established by unaffiliated insurance companies to fund the variable contracts they issue. Each of these unaffiliated upper-tier RICs is managed by a different investment manager, each of whom makes an independent decision to invest in the same lower-tier RIC, which itself is established and managed by an entity unaffiliated with any of the upper-tier RICs. Based on reasoning similar to that used by the IRS in private letter rulings addressing fund-of-funds arrangements, look-through treatment can apply with respect to lower-tier RICs in such master-feeder structures if all beneficial interests in the upper-tier RICs are held by segregated asset accounts for the purpose of funding variable contracts or by other Permitted Investors.<sup>30</sup> Presumably, if an upper-tier RIC loses its status as a Look-Through Entity (for example, by failing to qualify as a RIC under section 851), the result would be the same as that described in the preceding paragraph – namely, the General Look-Through Rule would not apply to any lower-tier RIC in which the upper-tier RIC holds an interest. As described above, if a Look-Through Entity such as a RIC loses its ability to rely on the General Look-Through Rule, then typically any non-qualified variable contract supported in whole or in part by interests in that Look-Through Entity will fail to be adequately diversified within the meaning of the regulations under section 817(h). Thus, in the case of a master-feeder structure, this means that any variable contract supported by the lower-tier RIC directly (without an intervening upper-tier RIC) or indirectly (through *any* upper-tier RIC) would fail to satisfy the diversification requirements.

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<sup>29</sup> See section 4 of Rev. Proc. 92-25, 1992-1 C.B. 741. See also Treas. Reg. section 1.817-5(a)(1).

<sup>30</sup> See *supra* note 18.

October 28, 2003

Page 13 of 21

As in the case of a qualified pension or retirement plan that loses its Permitted Investor status as a result of its disqualification, the loss of an upper-tier RIC's status as a Look-Through Entity can occur through no fault of the lower-tier RIC in which that Look-Through Entity invests or other upper-tier RICs that invest in such lower-tier RIC. This is particularly true in a master-feeder arrangement, where the various RICs under the arrangement share no affiliation. In such common circumstances, the lower-tier RIC will have no control over actions that the unaffiliated upper-tier RICs might take to disqualify themselves as Look-Through Entities. Thus, the actions of company or manager "A" can have severe consequences for the owners of variable contracts issued by company "B," even though such contract owners and company B itself acted in accordance with applicable law at all times.

The Committee believes that it would be appropriate for the Treasury Department and the IRS to amend the regulations under section 817(h) to include a safe harbor that could be relied upon to avoid the harsh results outlined above. For example, in the case of a qualified pension or retirement plan, the safe harbor could provide that if a plan administrator represents to a Look-Through Entity that the plan satisfies all requirements necessary for qualified status at the time of the initial investment in the Look-Through Entity, then, absent any knowledge by the Look-Through Entity to the contrary, any disqualification of the plan would have no effect on the availability of look-through treatment with respect to non-qualified variable contracts invested in the same Look-Through Entity. As a condition to this safe harbor, the rule could provide that if the Look-Through Entity subsequently learns that the plan was or became disqualified, the Look-Through Entity must require the plan to restore its qualified status or terminate its investment in the Look-Through Entity within a reasonable time.

A safe harbor such as the one proposed above would be consistent with the Code's treatment of "pension plan contracts" under sections 817(h) and 818(a). In this regard, section 817(h) does not apply to pension plan contracts, which are defined under section 818(a) to include contracts entered into under various types of retirement plans that "*as of the time the contracts were entered into*" were qualified under their respective Code sections. Thus, any subsequent change in the tax status of the plan does not affect the status of the contract as a pension plan contract – much like the effect under the proposed safe harbor. The proposed safe harbor also would be consistent with another safe harbor provided under current law in connection with direct rollovers among qualified plans. In this regard, a qualified plan that accepts invalid direct rollovers can be faced with disqualification – a harsh consequence that affects all plan participants, even those not involved with the invalid rollovers. However, for purposes of maintaining qualified plan status, a direct rollover is treated as valid if the receiving plan obtains a representation from the distributing plan that the latter satisfies the requirements of section 401 (*i.e.*, it is a qualified plan) and the receiving plan distributes any direct rollovers that

October 28, 2003

Page 14 of 21

it later learns were not valid.<sup>31</sup> This situation is analogous to the potential diversification failure resulting from the loss of a qualified pension or retirement plan's status discussed above, and the Committee therefore believes that a similar safe harbor is appropriate.

Likewise, the Committee believes that a similar safe harbor is warranted in the case of an upper-tier RIC in a multi-tier structure such as a master-feeder structure that loses its status as a Look-Through Entity through no fault of the lower-tier RIC(s) in which the upper-tier RIC invests. For example, the safe harbor could provide that if an upper-tier RIC represents to a lower-tier RIC that the upper-tier RIC qualified as a Look-Through Entity under Treasury Regulation 1.817-5(f)(2)(i) at the time of the initial investment in the Look-Through Entity, then any disqualification of the upper-tier RIC as a Look-Through Entity would have no effect on the availability of look-through treatment with respect to variable contracts supported directly or indirectly by investments in the same lower-tier RIC in which the upper-tier RIC invests. Like the safe harbor proposed above in connection with qualified pension or retirement plans, a condition could be placed on the safe harbor requiring the lower-tier RIC to terminate the upper-tier RIC's investment within a reasonable time of learning that the upper-tier RIC does not qualify as a Look-Through Entity if the upper-tier RIC does not seek a closing agreement with the IRS to restore its Look-Through Entity status. Such a safe harbor would prevent an inappropriate "domino" effect that penalizes innocent taxpayers for the actions of other taxpayers, while still resulting in loss of look-through treatment to any variable contract supported in whole or in part by the offending upper-tier RIC.

**E. Clarifications Needed as a Result of the Revocation of the Non-Registered Partnership Rule**

The preamble to the Proposed Amendments states that the Treasury Department and IRS also are seeking comments on whether the proposed revocation of the Non-Registered Partnership Rule necessitates other changes to the regulations under section 817(h). In this regard, the Committee believes that the two changes described below are necessary.

**1. *The definition of "security" should be amended to include an interest in a non-registered partnership.***

For purposes of applying the diversification requirements of section 817(h), Treasury Regulation section 1.817-5(b)(1)(ii)(A) provides that "[a]ll securities of the same issuer ... are ... treated as a single investment." Thus, in applying the diversification requirements, all securities of the same issuer must be aggregated and treated as one investment. Treasury Regulation section 1.817-5(h)(6), in turn, provides that the term "security" includes "any

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<sup>31</sup> See Treas. Reg. section 1.401(a)(31)-1, Q&A-14.

October 28, 2003

Page 15 of 21

partnership interest registered under a Federal or State law regulating the offering or sale of securities,” but that such term does not include “any other partnership interest ....” Although it is not entirely clear why non-registered partnerships are excluded from the definition of security, one plausible reason is that such partnerships automatically are Look-Through Entities under the Non-Registered Partnership Rule, and, as such, there is no need to aggregate interests therein with other assets of the same “issuer.” However, if the Non-Registered Partnership Rule is revoked, any interest in such a partnership will be treated as a single investment of the segregated asset account, and taxpayers will need to know how to characterize the interest so they can properly apply the aggregation rule of Treasury Regulation section 1.817-5(b)(1)(ii)(A). Accordingly, the Committee believes that Treasury Regulation section 1.817-5(h)(6) should be amended to provide, in relevant part, that the term “security” includes “any partnership interest, whether or not registered under a Federal or State law regulating the offering or sale of securities.” Of course, partnerships, whether registered or non-registered, would continue to be treated as Look-Through Entities, rather than securities, in circumstances where the General Look-Through Rule applies.

**2. *The regulations should be amended to clarify existing examples and provide a new example regarding partnership interests.***

The regulations under section 817(h) include several examples of the application of the rules imposed by those regulations. If the Non-Registered Partnership Rule is revoked, the Committee believes that certain of those examples should be clarified, and a new example should be added illustrating the application of the diversification requirements in the case of non-registered partnerships. Specifically, the Committee believes that Example (1) in Treasury Regulation 1.817-5(g) should be amended by removing the reference therein to a “registered” partnership. Rather, Example (1) should refer only to a partnership, with no reference to whether or not interests in the partnership are registered under securities laws. Thus, following the proposed amendment Example (1) would illustrate the application of the General Look-Through Rule to a partnership, whether registered or non-registered, where all beneficial interests in the partnership are held by segregated asset accounts and Permitted Investors. Example (2), by referencing the facts of amended Example (1), would illustrate the inapplicability of the General Look-Through Rule to a partnership, whether registered or non-registered, where beneficial interests are held by persons other than segregated asset accounts and Permitted Investors.

The Committee also believes that Example (3) should be deleted as unnecessary, and that in its place a new example should be added illustrating the application of the diversification requirements in a situation involving non-registered partnerships. This example could clarify that the diversification requirements can be satisfied even if beneficial interests in a non-registered partnership are held by persons other than segregated asset accounts and Permitted Investors, as long as the investments of the segregated asset account (including the non-registered partnership interests) collectively satisfy the percentage limitations of Treasury Regulation section 1.817(b)(1)(i). A draft of such an example is attached as Exhibit E.

October 28, 2003

Page 16 of 21

**F. The Effective Date of the Proposed Amendments Should be Modified.**

The elimination of the Non-Registered Partnership Rule under the Proposed Amendments is proposed to be effective on the date final regulations are published. This would apply to all investments in non-registered partnerships, including investments made prior to the effective date that hitherto have relied on the Non-Registered Partnership Rule in order to satisfy the diversification requirements and that do not meet the requirements of the General Look-Through Rule. However, the Proposed Amendments would provide limited transitional relief. A segregated asset account that is adequately diversified by virtue of reliance on the Non-Registered Partnership Rule would continue to be treated as adequately diversified after the effective date, provided that it is brought into compliance with the final regulations by the end of the second calendar quarter ending after the effective date thereof. Thus, a brief “cure period” (as few as 91 days or as many as 184 days) would be provided for segregated asset accounts that currently are relying on the Non-Registered Partnership Rule.

As indicated in the preamble to the Proposed Regulations, the existence of the Non-Registered Partnership Rule may have led to “confusion [by taxpayers] regarding the prohibition on ownership of interests by the public in a non-registered partnership funding a variable contract.” As part of such confusion, some taxpayers may have interpreted the Non-Registered Partnership Rule to permit arrangements that are inconsistent with congressional intent and the investor control principles developed by the IRS. However, some taxpayers declined to interpret the Rule in this manner. For example, some variable contracts only utilized non-registered partnerships that were fully “closed” to the public (including closed to accredited investors and qualified purchasers), *i.e.*, the only investors in the partnerships were segregated asset accounts supporting variable contracts. This use of, and reliance on, the Non-Registered Partnership Rule does not implicate any investor control issues, including those identified in Revenue Ruling 2003-92. For taxpayers in this situation, the Committee believes that the elimination of the Non-Registered Partnership Rule should be fully prospective. These taxpayers should not be forced, at considerable cost and disruption to the partnerships, to “un-wind” legitimate arrangements that were structured in reliance on the Non-Registered Partnership Rule and that do not involve any of the concerns that are prompting the elimination of that Rule.<sup>32</sup> Alternatively, the Committee believes that, if full prospectivity is not granted, existing

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<sup>32</sup> This hardship would be ameliorated if Treasury Regulation section 1.817-5(f)(3)(ii) (regarding investment managers’ interests in Look-Through Entities) is amended as requested in Part II.C. above (see pages 9-11). Such an amendment would enable many legitimate arrangements to begin relying on the General Look-Through Rule going forward and thus avoid having to restructure their operations as a result of the revocation of the Non-Registered Partnership Rule.

October 28, 2003

Page 17 of 21

arrangements should be permitted to continue but without new premium payments – *i.e.*, existing arrangements would be “closed” to further investment.

In all events, the Committee believes that any “cure period” under which taxpayers may unwind their arrangements should be extended beyond the period described in the Proposed Amendments. Many investments in non-registered partnerships are highly illiquid and difficult to dispose of within a short period of time without incurring a loss. For example, it is not uncommon for there to be “lock-up” periods (under which redemptions or liquidation of the investor’s interest in the partnership are not permitted for certain periods of time) and other, substantial restrictions on redemptions from the partnership. For this reason, at a minimum, the cure period should be extended. One possibility would be to extend it to the end of the fourth calendar quarter ending after the date final regulations are published in the Federal Register (*i.e.*, a cure period as short as 274 days or as long as 366 days).

### III. INVESTOR CONTROL

#### A. In General

The preamble to the Proposed Amendments states that the Treasury Department and IRS also are seeking comments on whether regulations are needed to address investor control issues – *i.e.*, the circumstances when a holder of a variable contract will be treated as the owner of assets held in a segregated asset account and, therefore, required to include earnings on those assets in income. As indicated in the original preamble to the regulations under section 817(h), those regulations were not intended to provide guidance concerning investor control, and instead the Treasury Department and IRS intended to provide guidance on this “and other issues” through regulations or revenue rulings under section 817(d) (relating to the definition of variable contracts).<sup>33</sup> Such guidance was not issued until just prior to the publication of the Proposed Amendments, when the IRS released Revenue Rulings 2003-91 and 2003-92. In the meantime, the variable annuity marketplace continued to evolve within the parameters established by the series of revenue rulings the IRS issued prior to the promulgation of final regulations under section 817(h). In addition, since the time those earlier rulings were issued, Congress has significantly modified the federal tax rules applicable to annuities by imposing an early withdrawal penalty tax,<sup>34</sup> taxing non-periodic withdrawals on an income-first basis,<sup>35</sup> requiring an

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<sup>33</sup> See T.D. 8101 (setting forth the temporary and proposed regulations under section 817(h), which later were adopted as final regulations in substantially the same form).

<sup>34</sup> See section 72(q) (added to the Code by section 265(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 (“TEFRA”)).

<sup>35</sup> See section 72(e)(1) and (2) (as amended by TEFRA section 265(a)).

October 28, 2003

Page 18 of 21

owner's interest in a deferred annuity to be distributed on his or her death,<sup>36</sup> and taxing on a current basis earnings under an annuity held by a non-natural person.<sup>37</sup> These changes were directed at assuring the use of annuities as retirement vehicles, and they have achieved that purpose.<sup>38</sup> However, the Committee understands that the principles underlying the IRS' investor control rulings have continued importance in the federal tax treatment of annuities.

As the revenue rulings addressing investor control all indicate (particularly, Revenue Rulings 2003-91 and 2003-92), the investor control analysis necessarily involves a consideration of all the facts and circumstances surrounding a particular arrangement. This facts and circumstances analysis becomes particularly challenging upon a review of relevant case law.<sup>39</sup> In this regard, although the investor control doctrine originally was described as evolving from the *Clifford* and *Griffiths* cases and their progeny, this line of authority encompasses a substantial body of case law that, using economic substance principles and basic "benefits and burdens" analysis, determines who is the ultimate owner of an asset for federal income tax purposes. The interaction of these authorities with the investor control doctrine developed through IRS rulings is not always clear. In light of this lack of clarity and the inherent factual nature of the investor control analysis, it is probably impossible to codify in regulations any bright lines or firm rules regarding the application of the doctrine, especially in the context of evolving variable products and consumer needs. At best, any regulations regarding investor control could only identify (*e.g.*, by virtue of examples) extreme circumstances on opposing ends of the spectrum of the investor control analysis, which would not necessarily prove useful to

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<sup>36</sup> See section 72(s) (added to the Code by section 222(b) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369).

<sup>37</sup> See section 72(u) (added to the Code by section 1123(a) of the Tax Reform Act of 1986, Pub. L. No. 99-541).

<sup>38</sup> In a 2001 Gallup Poll surveying owners of non-qualified annuity contracts, such owners were asked whether they intended to use their annuity savings in one of five specified ways. Approximately eight out of ten owners surveyed stated that they intend to use their annuity savings for retirement purposes in the following manners: (1) to use as a financial cushion if they or their spouse live beyond their life expectancy (83%), (2) to avert being a burden on their children financially (82%), and (3) to use as retirement income (81%). The Gallup Organization, *2001 Survey of Owners of Non-Qualified Annuity Contracts for Committee of Annuity Insurers*, October 2001, at 21 (hereinafter, "2001 Gallup Survey"). (The complete 2001 Gallup Survey is available on the Internet at [www.annuity-insurers.org](http://www.annuity-insurers.org).)

<sup>39</sup> See, *e.g.*, *Helvering v. Clifford*, 309 U.S. 331 (1940); *Griffiths v. Commissioner*, 308 U.S. 355 (1939).

October 28, 2003

Page 19 of 21

taxpayers. Accordingly, the Committee believes that the most appropriate form for providing guidance on investor control is the form already utilized effectively by the IRS – that is, revenue rulings reaching conclusions based on specific fact situations and private letter rulings addressing new factual circumstances as they arise. However, the Committee also believes that it is important that any new guidance on investor control generally account for industry practices that have developed in the absence of guidance, and that any guidance imposing new restrictions be given prospective applicability.

Moreover, the Committee believes that it is important for the Treasury Department and IRS to appreciate that virtually all, if not all, variable annuity products sold in the marketplace today are structured and administered in accordance with section 817(h) as well as the investor control principles described in IRS rulings. The typical variable annuity contract is sold to middle and upper-middle income individuals<sup>40</sup> saving for their retirement. Such contracts offer the policyholder a selection of broad investment strategies developed by companies and the companies' investment advisors, without prior negotiation with the policyholders. These strategies parallel investment strategies commonly used by individuals saving for retirement, whether through qualified plans, taxable investment accounts, or variable annuities.

In this regard, the number of investment strategies available to retirement investors has increased dramatically in recent years. In part, this is attributable to the fact that more and more individuals need to accumulate their retirement savings in defined contribution plans and after-tax investments such as mutual funds and deferred annuity contracts rather than in defined benefit plans. Unlike defined benefit plans, where employers promise a fixed monthly income on retirement and thus make all investment decisions, defined contribution plans in many cases require individuals to choose among a variety of investment strategies. Offering multiple investment options allows individuals to select strategies that best suit their particular risk tolerances and retirement goals. Thus, investment management firms have developed an increasing number of fund styles and strategies, which are available to retirement investors. For example, Morningstar tracks and reports on over 40 categories of mutual funds, while the *Wall Street Journal* tracks and reports on over 50 categories (excluding in both cases municipal bond funds).

Life insurance companies typically have sought to assure that their variable annuity customers are able to maximize their retirement saving returns by making these strategies available in annuities. Thus, for example, the variable annuities that represented 85% of sales of registered individual variable annuity contracts in 2003 (as of the second quarter) had

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<sup>40</sup> See 2001 Gallup Survey, *supra* note 38, at 11 (reporting that 62% of owners of non-qualified annuity contracts have annual household incomes under \$75,000).

October 28, 2003

Page 20 of 21

on average 56 investment options available to the owner,<sup>41</sup> including fixed accounts and such widely accepted and utilized strategies as stock index funds. Offering this range of choices in investment strategies allows variable annuity holders saving for their retirement to assemble an overall portfolio within their annuity that matches their retirement savings needs. And, because the funds to which contract owners can allocate premiums and cash values are available only to segregated asset accounts and other Permitted Investors, owners are precluded from “wrapping” publicly available investments. In short, when one takes into account the various limitations and restrictions placed on variable contract owners by the Code, and the market evidence available, it is impossible to escape the conclusion that variable annuities are being used exactly as Congress intended – for retirement savings and income purposes.

**B. Confirmation is Warranted with Respect to Revenue Procedure 99-44.**

Although, as described above, the Committee believes the regulations under section 817(h) should not be amended to include provisions addressing the investor control doctrine, the Committee does believe that it would be beneficial to the public, life insurance companies, and the government if the preamble to the regulations were to confirm the intended scope of Revenue Procedure 99-44. Revenue Procedure 99-44 was issued in response to requests by representatives of the insurance industry to confirm that the “public availability” concept of Revenue Ruling 81-225 does not apply to annuity contracts described in sections 403(a) and 403(b) (“section 403 annuities”) and individual retirement annuities described in section 408(b) (“IRA annuities”) after the enactment of section 817(h). The Treasury Department and the Internal Revenue Service generally agreed with the industry, and thus, Revenue Procedure 99-44 currently provides that section 403 annuities and IRA annuities will be treated as annuity contracts for federal income tax purposes (and as section 403 annuities or IRA annuities if the contracts otherwise qualify as such) notwithstanding the fact that premiums are invested at the contract holder’s direction in publicly available securities, provided certain conditions are satisfied.

Although generally in agreement with the industry, during the formulation of Revenue Procedure 99-44 the Treasury Department did express one concern about the scope of the proposed guidance. Specifically, the concern was expressed that, absent some limitation on its scope, such guidance could enable a section 403 annuity or IRA annuity to avoid unrelated business income tax (“UBIT”).<sup>42</sup> To address this concern, Revenue Procedure 99-44 allows

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<sup>41</sup> This figure is based on data from AnnuityNet/VARDS. The variable annuities tracked by AnnuityNet/VARDS represent approximately 98% of the variable annuities in force in the United States.

<sup>42</sup> More specifically, the Treasury Department was concerned about the possibility of a policyholder utilizing a section 403 annuity or IRA annuity to avoid UBIT that would otherwise

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October 28, 2003

Page 21 of 21

investment in publicly available securities only if “no additional federal tax liability would be incurred” if “an amount” had instead been paid into a trust or custodial account rather than an annuity. Although Revenue Procedure 99-44 refers to “federal tax liability” generally, rather than referring specifically to UBIT, at the time Revenue Procedure 99-44 was issued all parties recognized and understood that the clear intent was to limit the scope of Revenue Procedure 99-44 only with respect to those situations involving UBIT. However, as time passes, questions are likely to arise whether the limitation on the scope of Revenue Procedure 99-44 actually was meant to refer only to situations involving UBIT.

For the foregoing reasons, the Committee believes that it would be beneficial if the Treasury Department were to include a statement in the preamble to the new regulations confirming that the limitation on the scope of Revenue Procedure 99-44 was intended to refer only to those situations that involve UBIT.

#### IV. CONCLUSION

The Committee appreciates this opportunity to comment on the Proposed Amendments and looks forward to working with the Treasury Department and the IRS regarding the points raised in these comments. If you have any questions or desire further information, please contact Joseph F. McKeever, Kirk Van Brunt, or Bryan W. Keene by phone at 202-347-2230, or by electronic mail at [jfmckeever@davis-harman.com](mailto:jfmckeever@davis-harman.com), [kvbrunt@davis-harman.com](mailto:kvbrunt@davis-harman.com), or [bwkeene@davis-harman.com](mailto:bwkeene@davis-harman.com) (respectively).

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Attachments

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arise from a direct investment in certain types of public securities. While such a situation may be theoretically possible for some types of investments, it is not a concern with respect to publicly available RICs (RICs do not generate income that could be UBIT), and, as a practical matter, publicly available RICs are the only type of public investment that is of concern to the industry in this context.

## **EXHIBIT A**

### **The Committee of Annuity Insurers**

The Willard Office Building

Suite 1200

1455 Pennsylvania Ave., NW

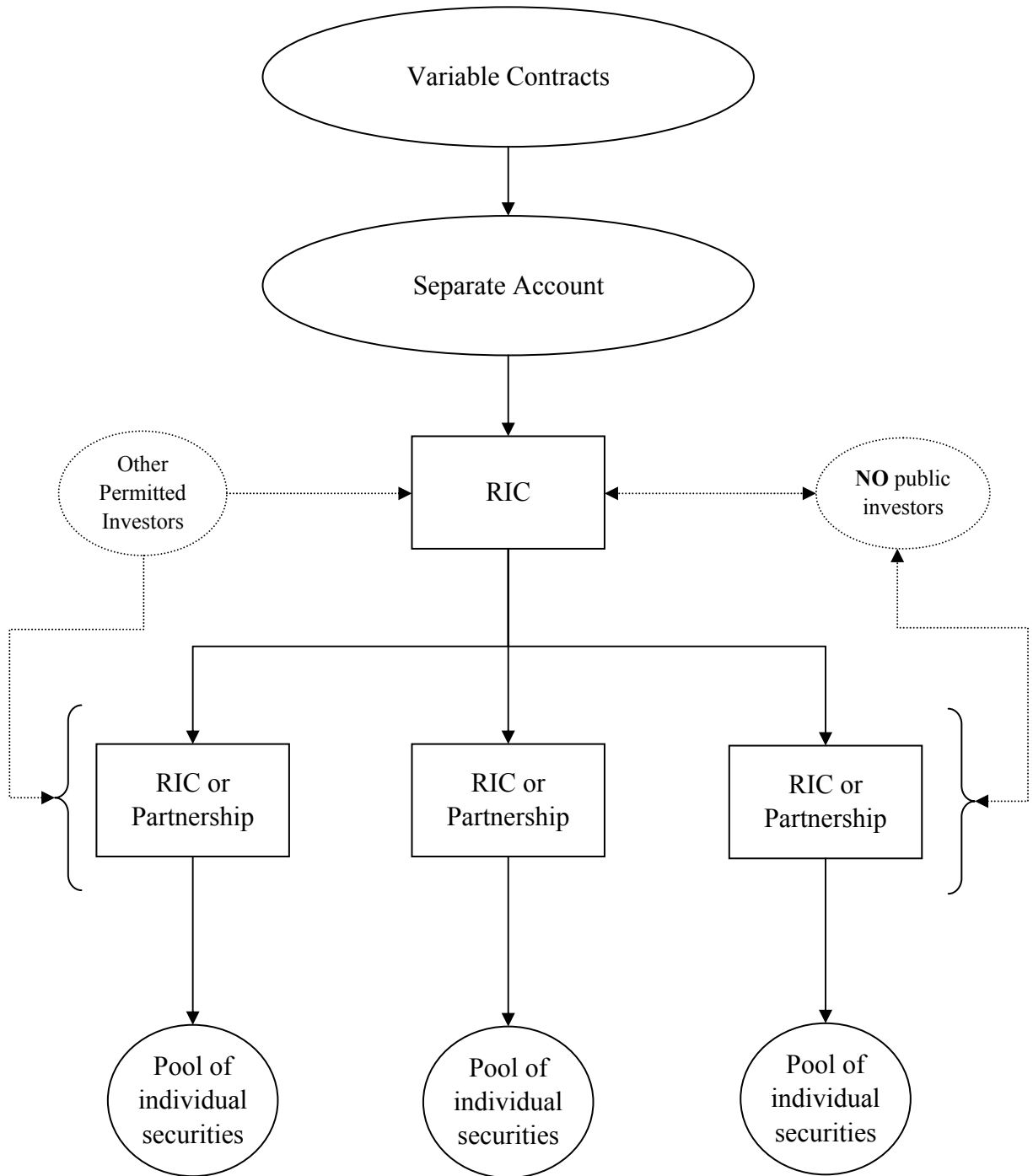
Washington, D.C. 20004

Allmerica Financial Company, Worcester, MA  
Allstate Financial, Northbrook, IL  
American International Group, Inc., Wilmington, DE  
AmerUs Annuity Group Co., Topeka, KS  
Equitable Life Assurance Society of the United States, New York, NY  
F & G Life Insurance, Baltimore, MD  
Fidelity Investments Life Insurance Company, Boston, MA  
GE Financial Assurance, Richmond, VA  
Great American Life Insurance Co., Cincinnati, OH  
Hartford Life Insurance Company, Hartford, CT  
ING North America Insurance Corporation, Atlanta, GA  
Jackson National Life Insurance Company, Lansing, MI  
Life Insurance Company of the Southwest, Dallas, TX  
Lincoln Financial Group, Fort Wayne, IN  
ManuLife Financial, Boston, MA  
Merrill Lynch Life Insurance Company, Princeton, NJ  
Metropolitan Life Insurance Company, New York, NY  
Mutual of Omaha Companies, Omaha, NE  
Nationwide Life Insurance Companies, Columbus, OH  
New York Life Insurance Company, New York, NY  
Northwestern Mutual Life Insurance Company, Milwaukee, WI  
Ohio National Financial Services, Cincinnati, OH  
Pacific Life Insurance Company, Newport Beach, CA  
The Phoenix Life Insurance Company, Hartford, CT  
Protective Life Insurance Company, Birmingham, AL  
Prudential Insurance Company of America, Newark, NJ  
Sun Life of Canada, Wellesley Hills, MA  
Travelers Insurance Companies, Hartford, CT  
USAA Life Insurance Company, San Antonio, TX  
Zurich Kemper Life Insurance Companies, Chicago, IL

The Committee of Annuity Insurers was formed in 1982 to participate in the development of federal tax policy with respect to annuities. The member companies of the Committee represent over half of the annuity business in the United States.

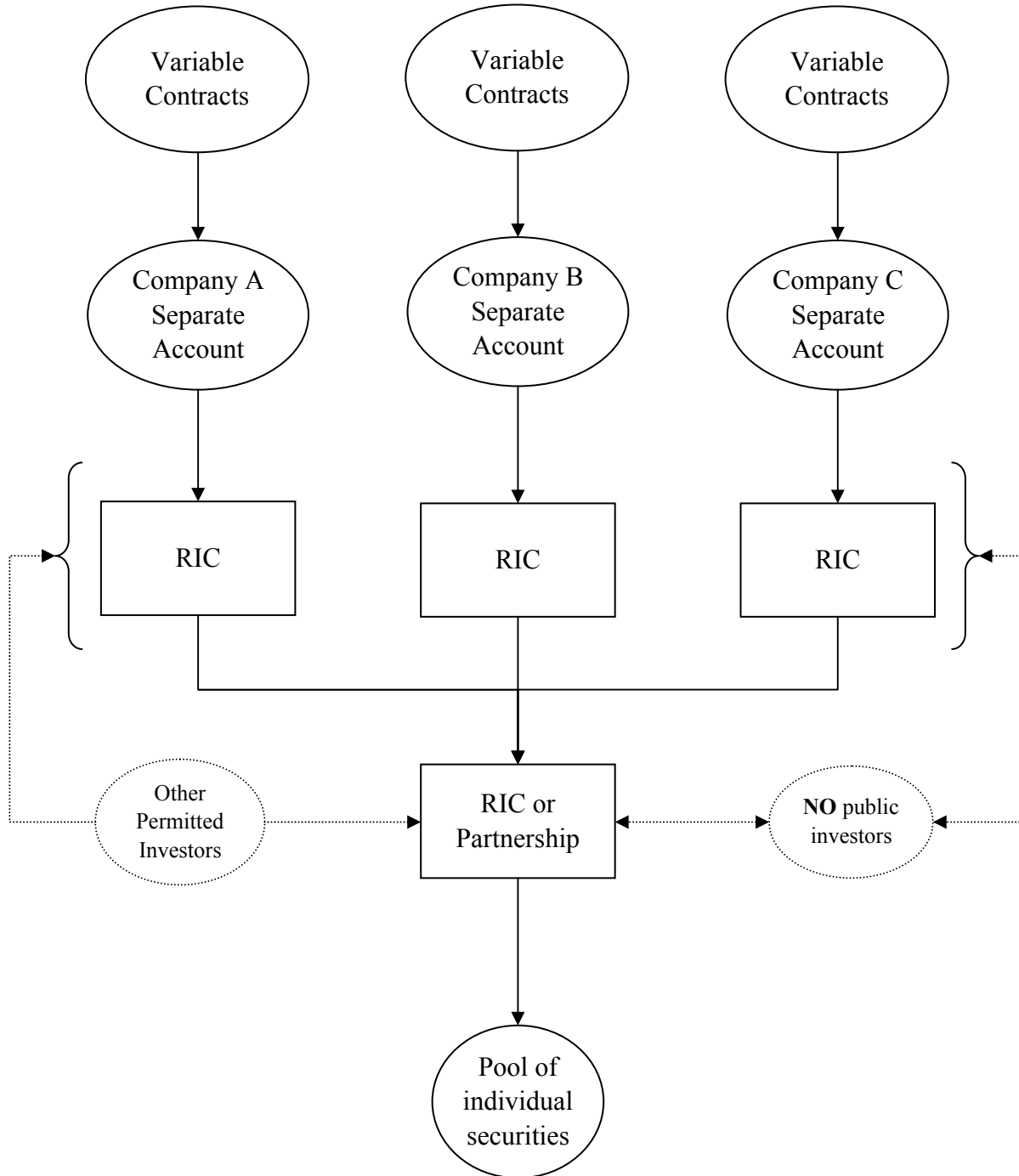
**EXHIBIT B**

**Basic Fund-of-Funds Arrangement**



**EXHIBIT C**

**Basic Master-Feeder Arrangement**



## **EXHIBIT D**

*Example (5).* (i) The facts are the same as in example (1), except that P is a regulated investment company the shares of which are sold only to insurance company segregated asset accounts or to persons described in (f)(3) of this section. P, in turn, purchases shares of L, another regulated investment company. Shares of L are sold only to insurance company segregated asset accounts, persons described in paragraph (f)(3) of this section, and regulated investment companies (such as P) the shares of which are sold only to insurance company segregated asset accounts or persons described in paragraph (f)(3) of this section. Public access to L is available exclusively through the purchase of a variable contract, except as otherwise permitted by paragraph (f)(3) of this section.

(ii) Because P is described in paragraph (f)(2)(i) of this section, interests in P will not be treated as a single investment of Account 1. Rather, Account 1 is treated as owning a pro rata portion of the assets of P. In addition, because P is described in paragraph (f)(2)(i) of this section, P will not be treated as holding a beneficial interest in L. Rather, Account 1 will be treated as holding a beneficial interest in L to the extent P holds shares of L. Based on this treatment, and because L is described in paragraph (f)(2)(i) of this section, interests in L will not be treated as a single investment of Account 1. Rather, Account 1 is treated as owning a pro rata portion of the assets of L.

## **EXHIBIT E**

*Example (3).* The facts are the same as example (1), except that P invests 55% of its assets in partnership A, 15% of its assets in bonds of corporation B, 10% of its assets in limited partnership C, 10% of its assets in stock of corporation D, and 10% of its assets in limited liability company E, which is treated as a partnership for federal income tax purposes. Some of the beneficial interests in A, C, and E are held by persons not described in paragraph (f)(3) of this section. Since A, C, and E are not described in paragraph (f)(2) of this section, P will not be treated as owning a pro rata portion of the assets of A, C, and E. Rather, A, C, and E each will be treated as a single, separate investment of P. Because P is described in paragraph (f)(2) of this section, and because the investments of P satisfy the requirements of paragraph (b)(1)(i) of this section, Account 1 is adequately diversified. Accordingly, variable contracts that are based on Account 1 are treated as annuity, endowment, or life insurance contracts.