

INTERNAL REVENUE SERVICE

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Legend

Fund A =

Fund B =

State 1 =

Trust 1 =

Trust 2 =

a =

b =

Dear

This is in response to your letter dated a requesting rulings relating to whether the proposed transaction meets the diversification requirements of § 817(h) of the Internal Revenue Code. By FAX dated b, ruling request number 3 was withdrawn from consideration.

FACTS

Fund A is operated as a separate series of Trust 1, which is an open-ended management investment company organized as a State 1 business trust. Fund B is operated as a separate series of Trust 2, which is an open-ended management investment company organized as a State 1 business trust. Trust 1 and Trust 2 are registered under the Investment Company Act of 1940, as amended, and their shares are registered under the Securities Act of 1933, as amended,

pursuant to an effective registration statement. Fund A, a portfolio of Trust 1, and Fund B, portfolio of Trust 2, are regulated investment companies, that serve as an investment vehicles for variable life insurance policies and variable annuity contracts funded by separate accounts of various insurance companies.

Fund B seeks to make an investment in Fund A that may exceed 55% of the value of Fund B's total assets.

The following representations are made with this ruling request:

Fund A and Fund B are each treated as separate corporations for federal income tax purposes, pursuant to § 851(g) of the Code. Each Fund's annual accounting period ends on December 31, and each uses the accrual method of accounting.

Interests in Fund A and Fund B are available only to segregated asset accounts that fund variable life insurance policies and/or variable annuity contracts (the Variable Contracts). No shares of either Fund A or Fund B have ever been publicly available.

Except as may be otherwise permitted by § 1.817-5(f)(3) of the Income Tax Regulations, no interest in either Fund A or Fund B is available other than through the purchase of a Variable Contract.

LAW AND ANALYSIS

Section 817(h)(1) of the Code provides that, for purposes of subchapter L, § 72 (relating to annuities), and § 7702(a) (relating to definition of life insurance contract), a variable contract (other than a pension contract), which is otherwise described in § 817 and which is based on a segregated asset account, shall not be treated as an annuity, endowment, or life insurance contract for any period (and any subsequent period) for which the investments made by such account are not, in accordance with regulations prescribed by the Secretary, adequately diversified. Section 1.817-5(e) provides that, for purposes of § 817(h) of the Code and § 1.817-5 of the regulations, "a segregated asset account shall consist of all assets the investment return and market value of which must be allocated in an identical manner to any variable contract invested in any of such assets."

Section 1.817-5 of the regulations sets forth the diversification requirements for variable contracts. Generally, the investments of a segregated asset account will be considered to be "adequately diversified" for purposes of § 817(h) of the Code and § 1.817-5 of the regulations if no more than 55 percent of the value of the total assets of the account is represented by any one investment, no more than 70 percent by any two investments, no more than 80 percent by any three investments, and no more than 90 percent by any four investments.

Section 817(h)(4) of the Code provides, in certain situations, a "look-through"

rule for meeting the diversification requirements. If all of the beneficial interests in a regulated investment company are held by one or more (A) insurance companies (or affiliated companies) in their general account or segregated asset accounts, or (B) fund managers (or affiliated companies) in connection with the creation or management of the regulated investment company, the diversification requirements of § 817(h)(1) are applied by taking into account the assets held by such regulated investment company.

Section 1.817-5(f) of the regulations provides a “look-through” rule for the application of the diversification requirements of § 1.817-5 of the regulations. Section 1.817-5(f)(1) provides that, if the look-through rule applies, a beneficial interest in a regulated investment company will not be treated as a single investment of a segregated asset account; instead, a pro rata portion of each asset of the investment company will be treated for purposes of § 1.817-5, as an asset of the segregated asset account.

Section 1.817-5(f)(2)(i) of the regulations provides that § 1.817-5(f) shall apply to an investment company if:

- (A) All the beneficial interests in the investment company ... (other than those described in § 1.817-5(f)(3)) are held by one or more segregated asset accounts of one or more insurance companies; and
- (B) Public access to such investment company ... is available exclusively (except as otherwise permitted in § 1.817-5(f)(3)) through the purchase of a variable contract. Solely for this purpose, the status of the contract as a variable contract will be determined without regard to § 817(h) and § 1.817-5 of the regulations.

The two conditions for applying the look-through rule of § 1.817-5(f) to a segregated asset account of an insurance company that invests in the funds will be satisfied in this case. That is, all the beneficial interests in either fund (other than those described in § 1.817-5(f)(3)) will be held by one or more segregated asset accounts of one or more insurance companies; and public access to such funds will be available exclusively (except as otherwise permitted in § 1.817-5(f)(3)) through the purchase of a Variable Contract. (Solely for this purpose, the status of the contract as a variable contract is determined without regard to § 817(h) and § 1.817-5 of the regulations.) Thus, for purposes of § 1.817-5, a pro rata portion of each asset of Fund A and Fund B will be treated as an asset of the segregated asset account which directly or indirectly invested in such fund.

Based on the facts and representations made, it is held that:

- (1) The investment by Fund B in Fund A will not prevent segregated asset accounts holding shares of Fund A from looking through Fund A to the assets of Fund A for purposes of determining compliance with the § 817(h) diversification

requirements.

(2) Following Fund B's investment in Fund A, segregated asset accounts investing in Fund B will be able to look through Fund A to the individual assets of Fund A in determining compliance with the § 817(h) diversification requirements.

Except as specifically set forth above, no opinion is expressed as to the tax treatment of the proposed transaction under the provisions of any other section of the Code or regulations. Specifically, no opinion is expressed regarding the application of the investor control rules set forth in Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984); Rev. Rul. 81-225, 1981-2 C.B. 12, as modified by Rev. Proc. 99-44, 1999-48 I.R.B. 598; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12.

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

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the proposed transaction covered by this ruling letter is consummated.

Pursuant to the power of attorney on file with this office, copies of this letter are being sent to your authorized representatives.

Sincerely,
Acting Associate Chief Counsel
(Financial Institutions & Products)
By: Donald J. Drees, Jr.
Senior Technician Reviewer,
Branch 4