> not have any control over Insurance Fund's investments. The investment decisions of Insurance Fund are made by Insurance Fund's Adviser and Subadviser in their sole and absolute discretion and are subject to change without notice to or approval by the Variable Contract holders. The Variable Contract holders in this case do not have any more control over the assets held under their contract than was the case in Rev. Rul. 82-54 or Rev. Rul. 2003-91. Insurance Fund is not an indirect means of allowing a Variable Contract holder to invest in a publically-available fund.

Based on the foregoing, the ruling concludes that the formation and operation of the Insurance Fund, and its establishment as a separate series within the same Trust as Retail Fund, would not cause the policyholders to be treated as the owners of the Insurance Fund shares for federal income tax purposes.

***Concluding observations.*** PLR 201436005 is the latest in a series of private letter rulings evidencing a trend towards IRS acceptance of common industry practices regarding the use of so-called clone funds in support of variable insurance products. The ruling is very similar to PLR 201417007 (Dec. 19, 2013). The potential investor control question in the context of an insurance-dedicated fund that has a publicly-available clone (or vice versa) is whether the similar (or perhaps identical) holdings of the two funds will cause the insurance-dedicated fund to be treated as publicly available. Although the legislative history of section 817(h) suggests that the answer should be no,[5] the question has persisted, in part due to the uncertainty involved in applying the investor control doctrine (the fog noted above) and in part because of the disconnect between that doctrine and section 817(h). Perhaps significantly, as the basis for its conclusion, the ruling defaults to the perceived result of the IRS's prior rulings—"The Variable Contract holders in this case do not have any more control over the assets held under their contract than was the case in Rev. Rul. 82-54 or Rev. Rul. 2003-91"—and then makes a substance-over form point: "Insurance Fund is not an indirect means of allowing a Variable Contract holder to invest in a publically-available fund." Clearly, the IRS has not backed away from its fundamental ruling position on the investor control doctrine.

This latest ruling does suggest a growing acceptance by the IRS that no investor control problem will arise in clone fund situations involving retail products, as long as there is at least some possibility that differences will exist between the insurance-dedicated fund and the publicly available retail fund. Those differences may even be relatively minor, and perhaps may never materialize at all. While this may be a sign that the fog is lifting a little, it is important to remember that the ruling concerns retail mutual funds, that differences between the insurance-related fund and the public fund could emerge despite their common objectives and fees and management, and that the application of the investor control doctrine "depends on all the relevant facts and circumstances." ◂

### END NOTES

1. *See* Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 82-55, 1982-1 C.B. 12; 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; *see also* Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984), *cert. denied*, 473 U.S. 905 (1985).
2. IRC section 817(h) authorizes regulations requiring "adequate" diversification of variable contract separate account investments. The regulations issued under that provision, found in Treas. Reg. § 1.817-5, effectively preclude basing a variable contract on a single, publicly available mutual fund. The ruling mentioned is Rev. Rul. 81-225, cited in note 1 *supra*.
3. *See* Rev. Rul. 2003-91, *supra* note 1.
4. Treas. Reg. § 1.817-5(f)(3).
5. *See* H.R. Rep. No. 98-861, at 1055 (1984) (Conf. Rep.) ("The fact that a similar fund is available to the public will not cause the segregated asset fund to be treated as being publicly available.").

## SUBCHAPTER L: CAN YOU BELIEVE IT? STATUTORY RESERVES DO NOT ALWAYS HAVE TO BE SET FORTH IN THE ANNUAL STATEMENT

*By Peter H. Winslow*

Deductible federally prescribed reserves are capped by statutory reserves. To qualify as statutory reserves for this purpose, I.R.C. § 807(d)(6) provides that the reserves must be "set forth" in the annual statement. Is there ever an instance where tax reserves should not be capped even though they exceed statutory reserves that are reported in the annual statement? Yes, when statutory reserves are weakened.

A simple example illustrates how reserve weakening results in this tax reserve anomaly. Suppose a life insurer issues contracts that include a disability waiver-of-premium benefit

for an additional charge. Tax reserves for this type of benefit are equal to the reserves taken into account on the annual statement because they are held for qualified supplemental benefits under I.R.C. § 807(e)(3). Now suppose the company changes its basis of computing its statutory reserves for this benefit and the result is lower statutory (and therefore tax) reserves. In such case I.R.C. § 807(f) comes into play. I.R.C. § 807(f) defers until the succeeding taxable year the tax recognition of the decreased reserves resulting from the reserve weakening for contracts issued before the taxable year. For those contracts, tax reserves are computed on the old method for the year of change, and reserves computed on the new method are used for the years thereafter. The difference between the closing reserves computed on the old basis and the closing reserves computed on the new basis for the year of change is spread over ten years beginning in the year following the year the change in basis of computing reserves occurs. Going back to the qualified supplemental benefits example, the effect of I.R.C. § 807(f) is that the year-of-change tax reserves are computed for previously-issued contracts as if no change in statutory reserves occurred. But wait. Should we cap tax reserves for the year of change by the lower amount of statutory reserves actually "set forth" for that year in the annual statement? The answer is "no."

The technical statutory language under current law that leads to this result is found in I.R.C. § 807(f) itself. The requirement to compute reserves using the "old basis" for the year of change refers to the entire reserve "item" described in I.R.C. § 807(c), which by its terms includes application of the statutory reserves cap.

I.R.C. § 807(f) is carried over almost word-for-word (with minor conforming amendments) from former I.R.C. § 810(d) in effect before the Tax Reform Act of 1984. Also, in general, except where an election was made with respect to preliminary term reserves, tax reserves under pre-1984 Act law were equal to reserves set forth in the annual statement.[1] Therefore, the concepts of both statutory reserves and of reserve strengthening or weakening of statutory (and tax) reserves under current law are generally the same as under pre-1984 Act law. The legislative history of the 1984 Act states that "where provisions of prior law are incorporated in the [1984] Act, the Congress expects that, in the absence of contrary guidance in the committee reports and conference agreement, the regulations, rulings, and case law under prior law will serve as interpretative guides to the new provisions."[2] This legislative history confirms that we should look for guidance as to how reserve weakening works under current law by examining how former I.R.C. § 810(d) operated when statutory (and tax) reserves were weakened.

There is no doubt that under former I.R.C. § 810(d) deductible tax reserves for contracts issued in prior years were not reduced by the reserve weakening in the year of change.[3] This was so even though life insurance reserves were required to be "set aside" and "required by law" under former I.R.C. § 801(b), as well as required to be "held" under Treas. Reg. § 1.801-4(d). The same result should apply to reserve weakening under current law where statutory reserves similarly are required to be "set forth." That is, the statutory reserve cap should not come into play to limit tax reserves required to be computed on the old basis in the year of change. Thus, as under prior law, the reserve weakening rules of I.R.C. § 807(f) should trump the "set forth" requirement for statutory reserves in I.R.C. § 807(d)(6).

The same analysis also should apply in the more complicated scenario when federally prescribed reserves computed under I.R.C. § 807(d) and statutory reserves are both weakened. Just as in the case of statutory reserves for qualified supplemental benefits subject to the statutory reserves cap, the requirement of I.R.C. § 807(f) to remain on the old tax reserve method for the year of change should override the "set forth" requirement in the definition of statutory reserves in I.R.C. § 807(d)(6). So, in the case of reserve weakening, statutory reserves need not be "set forth" statutory reserves in the year of change. *Can you believe it?* ◂

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**END NOTES**

1. Former I.R.C. § 810; *Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148 (1977).
2. Jt. Comm. on Tax'n, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 581 (Comm. Print 1984).
3. See examples in Treas. Reg. § 1.810-3(b) which provide that reserves at the end of the year of change for contracts issued before the year of change are determined on the "old" basis.