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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9185

RIN 1545-BB77

Diversification Requirements for Variable Annuity, Endowment, and Life Insurance Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations removing provisions of the Income Tax Regulations that apply a look-through rule to assets of a nonregistered partnership for purposes of satisfying the diversification requirements of section 817(h) of the Internal Revenue Code.

DATES: Effective Date: These regulations are effective as of March 1, 2005. However, arrangements in existence on March 1, 2005, will be considered to be adequately diversified if: (i) those arrangements were adequately diversified within the meaning of section 817(h) prior to March 1, 2005, and (ii) by December 31, 2005, the arrangements are brought into compliance with the final regulations.

Applicability Date: For dates of applicability, see §1.817-5(i).

FOR FURTHER INFORMATION CONTACT: James Polfer, (202) 622-3970 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Under section 817(h), a variable contract based on a segregated asset account is not treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified. For purposes of testing diversification, section 817(h)(4) and §1.817-5(f) of the regulations provide a look-through rule for assets held through certain investment companies, partnerships, or trusts. Section 1.817-5(f)(2)(i) provides that look-through treatment is available with respect to any investment company, partnership, or trust only if all the beneficial interests in the investment company, partnership, or trust are held by one or more segregated asset accounts of one or more insurance companies, and public access to such investment company, partnership, or trust is available exclusively (except as otherwise permitted by section 1.817-5(f)(3)) through the purchase of a variable contract. Under §1.817-5(f)(2)(ii), the look-through rule applies to a partnership interest that is not registered under a Federal or state law regulating the offering or sale of securities. Unlike §1.817-5(f)(2)(i), satisfaction of the nonregistered partnership look-through rule of §1.817-5(f)(2)(ii) is not explicitly conditioned on limiting the ownership of interests in the partnership to certain specified holders.

On July 30, 2003, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-163974-02) under section 817 in the **Federal Register** (68 FR 44689). The proposed regulations would remove the rule that applies specifically to nonregistered partnerships for purposes of testing diversification. The proposed regulations also would remove an example that illustrates that rule.

The application of §1.817-5(f)(2)(i) to interests in nonregistered partnerships will be unchanged by the removal of §1.817-5(f)(2)(ii). Thus, look-through treatment will be available for interests in a nonregistered partnership if all the beneficial interests in the partnership are held by one or more segregated asset accounts of one or more insurance companies and public access to the partnership is available exclusively (except as otherwise permitted by §1.817-5(f)(3)) through the purchase of a variable contract.

Written comments were received in response to the notice of proposed rulemaking. A public hearing on the notice of proposed rulemaking was held on April 1, 2004. After consideration of all the comments and the hearing testimony, the proposed regulations are adopted as amended by this Treasury decision.

Explanation and Summary of Comments and Public Hearing

In addition to requesting comments on the clarity of the proposed rule and how the rule could be made easier to understand, the Treasury Department and the IRS specifically requested comments on: (1) whether revocation of §1.817-5(f)(2)(ii) necessitates other changes to the look-through rules of §1.817-5(f), in particular whether the list of holders permitted by §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 payments to investment managers commonly referred to as incentive payments, (2) whether §1.817-5 should be updated to take account of changes to variable contracts since the final regulations were published in 1986, and (3) whether regulations are needed to address 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.

1. Comments on the Proposed Regulations

Two comments on the proposed regulation concerned the definition of "security" in §1.817-5(h)(6). Under §1.817-5(b)(1)(ii)(A), all securities of the same issuer are treated as one investment for the purposes of satisfying the diversification requirements. Section 1.817-5(h)(6) provides that the term security includes "a cash item and any partnership interest registered under a Federal or State law regulating the offering or sale of securities," but does not include " any other partnership interest." The commentators stated that the definition of "security" that applies to §1.817-5 should be amended to include an

interest in a non-registered partnership. The Treasury Department and the IRS agree that, in light of the revocation of former §1.817-5(f)(2)(ii), the definition of security should be modified to remove the distinction between registered and nonregistered partnership interests. The final regulations reflect this change.

A number of commentators also suggested that the regulation should be clarified by adding to or otherwise revising the examples contained in §1.817-5(g). In response to these comments, the final regulations revise §1.817-5(g) Example1 to remove the reference to partnership P as a publicly registered partnership. The Treasury Department and the IRS believe that, with this change, the examples contained in §1.817-5(g) adequately explain the application of §1.817-5 to partnership interests. Any questions concerning the application of §1.817-5 to more specific factual scenarios may be addressed by the letter ruling process or by subsequent published guidance.

Two commentators urged that existing arrangements either should be grandfathered in some fashion or should be given additional time to be brought into compliance with the final regulations. The notice of proposed rulemaking provided that arrangements in existence on the effective date of the revocation of §1.817-5(f)(2)(ii) will be considered to be adequately diversified if: (i) those arrangements were adequately diversified within the meaning of section 817(h) prior to the revocation of §1.817-5(f)(2)(ii), and (ii) by the end of the last day of the second calendar quarter ending after the effective date of the regulation, the arrangements are brought into compliance with the final regulations. The Treasury Department and the IRS do not believe it is appropriate to

grandfather existing arrangements indefinitely. In response to these comments, however, the transition period for existing arrangements to be brought into compliance with the regulations is two calendar quarters longer than the period provided in the proposed regulations.

Finally, one commentator questioned the authority of the Treasury Department and the IRS to enact this final regulation because "the only substantive impetus for the regulation is a general statement in the legislative history." Congress enacted the diversification requirements of section 817(h) to "discourage the use of tax-preferred variable annuity and variable life insurance primarily as investment vehicles," H.R. Conf. Rep. No. 98-861, at 1055 (1984), and granted the Secretary broad regulatory authority to develop rules to carry out this intent. The Treasury Department and the IRS have determined that this final regulation and the rest of the regulations contained in §1.817-5 were prescribed within the delegation of authority provided by Congress.

2. Comments on §1.817-5 More Generally

Many comments concerned the list of permitted investors under §1.817-5(f)(3). Notwithstanding the limitations on public access to an investment company, partnership, or trust that is subject to look-through treatment under §1.817-5(f), §1.817-5(f)(3) permits look-through treatment if the beneficial interests of the investment company, partnership, or trust are held by certain other "permitted investors," including the general account of a life insurance company (if certain requirements are met), the manager or a corporation related to the manager (if certain requirements are met), or the trustee of a qualified plan.

Commentators suggested that the list of permitted investors be expanded to include, for example, qualified tuition programs described in section 529; segregated asset accounts of foreign insurance companies; foreign pension plans; persons or entities related to the manager of an investment company, partnership, or trust in a manner specified in section 707(b); certain investment professionals operating as service providers; or persons who receive interests in a partnership as a result of inadvertent transfers, such as by bankruptcy or death of the permitted investor. The sole speaker at the public hearing on the notice of proposed rulemaking testified that the list of investors permitted by §1.817-5(f)(3) should be expanded to include "floor specialists" as that term is defined in section 1236(d)(2).

Other comments suggested guidance on non-pro-rata manager compensation. In order for the manager (or a corporation related in a manner specified in section 267(b) to the manager) of an investment company, partnership, or trust, to be a permitted investor under §1.817-5(f)(3)(ii), (1) its interest must be held in connection with the creation or management of the investment company, partnership, or trust; (2) the return on such interest must be computed in the same manner as the return on an interest held by a segregated asset account is computed (determined without regard to expenses attributable to variable contracts); and (3) there must be no intent to sell such interest to the public. A number of commentators stated that the requirement that the return on a manager's interest be computed in the same manner as the return on a segregated asset account's interest -- essentially a pro-rata distribution requirement -- is inconsistent with prevailing market practices concerning manager bonuses, discourages the creation of

insurance dedicated funds, and is not necessary to prevent abuse of the look-through rules contained in §1.817-5(f).

Some comments stated there is a need to clarify the consequences to a variable contract and variable contract holder when the contract's segregated asset account contains an asset in which beneficial interests are held by investors (such as qualified plans) that qualified as permitted investors in §1.817-5(f)(2) or (3) at the time of initial investment, but subsequently lose their status. Similarly, one commentator urged that if an insurance company has a reasonable basis to believe that an investment company, partnership, or trust satisfies the requirements of §1.817-5(f)(2), a variable contract of that insurance company should be permitted to look-through that entity for purposes of testing a segregated asset account on which that contract is based, even if the investment company, partnership, or trust has investors not described in §1.817-5(f)(2) or (3). The commentator suggested that this standard would be consistent with the standard of determination often used in the Federal securities laws.

Other comments included a request for clarification of the treatment of fund-of-funds and master-feeder arrangements for purposes of testing diversification; the desirability of an updated correction procedure for failure to satisfy the diversification requirements of section 817(h) and §1.817-5; guidance concerning the use of independent investment advisors; and extension of the special diversification rules for United States Treasury securities under section 817(h)(3) and §1.817-5(b)(3) to variable annuity contracts. (The latter comment presumably would require a change to section 817(h)(3), as well as to the

regulations.)

Although the comments on §1.817-5 generally are not adopted in this Treasury decision, the Treasury Department and IRS will consider these comments in the event of future published guidance. For example, Rev. Rul. 2005-7 (2005-6 I.R.B.) (see §601.601 (d)(2)(ii)(b) of this chapter) provides guidance on the application of the diversification look-through rule to tiered investment companies.

3. Comments on Investor Control

Finally, some comments concerned the need for additional guidance addressing circumstances under which the holder of a variable contract will be treated as the owner of assets held by a segregated asset account by virtue of the control the contract holder has over those assets. Under Rev. Rul. 81-225, 1981-2 C.B. 12 (see §601.601 (d)(2)(ii)(b) of this chapter), the owner of a variable annuity contract funded by publicly available mutual fund shares is treated as the owner of those shares. Rev. Rul. 2003-92, 2003-33 I.R.B. 350 (see §601.601 (d)(2)(ii)(b) of this chapter), clarified and amplified Rev. Rul. 81-225 by applying the same rule to variable life insurance contracts, and by treating as publicly available a nonregistered partnership, interests in which are sold only to qualified purchasers that are accredited investors or to no more than one hundred accredited investors. See also Rev. Rul. 2003-91, 2003-33 I.R.B. 347; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12.; Christoffersen v. U.S., 749 F.2d 513 (8th Cir. 1984), rev'g 578 F. Supp. 398 (N.D. Iowa 1984). See §601.601(d)(2)(ii)(b) of this chapter.

One commentator urged that Rev. Rul. 2003-92 should not be applied retroactively to treat certain investors as the "general public" as that term is used in Rev. Rul. 81-225. Specifically, the commentator requested relief for investments in real estate partnerships, interests in which are held directly by (1) organizations described in section 501(c)(3), and (2) such partnerships' investment managers, if those managers are not described in §1.817-5(f)(3)(ii) because of bonus payment arrangements. The commentator believed such relief is warranted because of uncertainty concerning the meaning of "general public" as that term is used in Rev. Rul. 81-225. Several other commentators suggested that regulations under section 817 should clarify that the permitted investors under §1.817-5(f)(3) do not constitute the "general" public as that term is used in Rev. Rul. 2003-92 and Rev. Rul. 81-225. According to these commentators, it would be anomalous for ownership by a permitted investor under §1.817-5(f)(3) to result in a variable contract holder being treated as the owner of an investment company, partnership, or trust, when the look-through rule itself appears to endorse ownership by that same investor for purposes of testing diversification. Still another commentator noted that when determining whether a contract holder is treated as the owner of segregated account assets, communications between investment advisors or officers and variable contract holders should be permitted if the communications are consistent with Federal securities and commodities laws.

One commentator suggested that the preamble to this Treasury decision should confirm the intended scope of Rev. Proc. 99-44, 1999-2 C.B. 598. Under Rev. Proc. 99-44, a contract is treated as an annuity contract described in sections 403(a), 403(b), or

408(b), notwithstanding that contract premiums are invested at the direction of the contract holder in publicly available securities, so long as certain requirements are met. Those requirements include a limitation that no additional Federal tax liability would have been incurred if the employer of the contract holder had instead paid amounts into a custodial account in an arrangement that satisfied the requirements of section 403(b)(7)(A) or no additional Federal tax liability would have been incurred if the consideration for the contract had instead been held as part of a trust that would satisfy the requirements of section 408(a), as applicable. The commentator urged that the preamble to this Treasury decision clarify that the "no additional Federal tax liability" limitation was intended to apply only to tax on unrelated business income. Finally, one commentator noted that, given the inherent factual nature of the determination whether a contract holder is treated as the owner of segregated account assets, the issue is better addressed by letter ruling or revenue ruling, rather than by regulations.

Although the comments on investor control are not adopted in this Treasury decision, they are responsive to the request for comments in the July 30, 2003, notice of proposed rulemaking and will receive careful attention in the event of further guidance on investor control.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure

Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is James Polfer, Office of the Associate Chief Counsel (Financial Institutions and Products), Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

Adoption of Amendment to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAX

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.817-5 also issued under 26 U.S.C. 817(h). * * *

Par. 2. Section 1.817-5 is amended as follows:

1. Paragraphs (f)(2)(ii) and (g) Example 3 are removed.

2. Paragraph (f)(2)(iii) is redesignated as paragraph (f)(2)(ii).

3. The first sentence of paragraph (g) Example 1 is revised.

4. Paragraph (g) Example 4 is redesignated as paragraph (g) Example 3.

5. Paragraph (h)(6) is revised.

6. New paragraph (i)(2)(v) is added.

The revisions read as follows:

§ 1.817-5 Diversification requirements for variable annuity, endowment, and life insurance contracts.

* * * * *

(g) * * *

Example 1. (i) The assets underlying variable contracts issued by a life insurance company consist of two groups of assets: (a) a diversified portfolio of debt securities and (b) interests in P, a partnership. * * *

(h) * * *

(6) Security. The term security shall include a cash item and any partnership interest, whether or not registered under a Federal or State law regulating the offering or sale of securities. The term shall not include any interest in real property, or any interest in a commodity.

* * * * *

(i) * * *

(2) * * *

(v) A segregated asset account in existence before March 1, 2005, will be considered to be adequately diversified if—

(A) As of March 1, 2005, the account was adequately diversified within the meaning of section 817(h) and this regulation as in effect prior to that date; and

(B) By December 31, 2005, the account is adequately diversified within the meaning of section 817(h) and this regulation.

/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement

Approved: February 15, 2005

/s/ Eric Solomon

Acting Deputy Assistant Secretary of the Treasury