Notice of Proposed Rulemaking

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

REG–163974–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document proposes 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. The Treasury Department and the IRS believe that removal of these provisions will eliminate any possible confusion regarding the prohibition on ownership of interests by the public in a nonregistered partnership funding a variable contract.

DATES: Written or electronic comments and requests for a public hearing must be received by December 3, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–163974–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:RU (REG–163974–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS internet site at *www.irs.gov/regs*.

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

SUPPLEMENTARY INFORMATION:

Background

Section 817(d) defines a variable contract as an annuity contract, a life insurance contract, or a contract that provides funding of insurance on retired lives as described in section 807(c)(6). A variable contract must provide for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset accounts (a segregated asset account) of the company under state law. In the case of an annuity contract, the amounts paid in, or the amounts paid out, must reflect the investment return and the market value of the segregated asset account. Section 817(d)(3)(A). In the case of a life insurance contract, the amount of the death benefit (or the period of coverage) must be adjusted on the basis of the investment return and the market value of the account. Section 817(d)(3)(B). In the case of a contract for funding of insurance on retired lives, the amounts paid in, or the amounts paid out, must reflect the investment return and the market value of the account. Section 817(d)(3)(C).

Section 817(h)(1) provides that a variable contract based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified in accordance with regulations prescribed by the Secretary. Under section 817(h)(1), if a segregated asset account fails to be adequately diversified for a period, then the contracts supported by that segregated asset account shall not be treated as annuity, endowment, or life insurance contracts for that period and subsequent periods, even if the segregated asset account is adequately diversified in those subsequent periods. Section 1.817–5(c)(1) defines period as a calendar quarter. If a segregated asset account is not adequately diversified, income earned by that segregated asset account is treated as ordinary income received or accrued by the policyholders.[1]

Section 817(h) was enacted by Congress in the Deficit Reduction Act of 1984 (Public Law No. 98–369). 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). In section 817(h)(1), Congress granted the Secretary broad regulatory authority to develop rules to carry out this intent. Pursuant to this authority, §1.817–5 sets forth the standards a segregated asset account must meet to be treated as adequately diversified within the meaning of section 817(h).

Section 817(h)(4) provides a look-through rule under which taxpayers do not treat the interest in a regulated investment company (RIC) or trust as a single asset of the segregated asset account but rather apply the diversification tests by taking into account the assets of the RIC or trust. Section 817(h) further provides that the look-through rule applies only if all of the beneficial interests in a RIC or trust are held by one or more general or segregated asset accounts of insurance companies (or affiliated companies), or by fund managers (or affiliated companies) in connection with the creation or management of the RIC or trust. "In authorizing Treasury to prescribe diversification standards, the conferees intend that the standards be designed to deny annuity or life insurance treatment for

[1] Section 1.817–5(a)(2) provides a mechanism for insurance companies to avoid this result if certain enumerated correction procedures are satisfied.

investments that are publicly available to investors . . .” H.R. Conf. Rep. at 1055.

Section 1.817–5(f)(1) of the regulations implements the Congressional directive to prescribe diversification standards by providing that if look-through treatment is available, a beneficial interest in a RIC, real estate investment trust, partnership, or trust that is treated under sections 671 through 679 as owned by the grantor or another person (investment company, partnership or trust) will not be treated as a single investment of a segregated asset account for purposes of testing diversification. Instead, a *pro rata* portion of each asset of the investment company, partnership, or trust will be treated as an asset of the segregated asset account.

Section 1.817–5(f)(2) provides more detailed rules for determining whether look-through treatment is available. Under §1.817–5(f)(2)(i), the look-through rule applies to any investment company, partnership, or trust if: (A) 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 (B) public access to such investment company, partnership, or trust is available exclusively through the purchase of a variable contract. Section 1.817–5(f)(iii) provides exceptions to the general ownership limitations of §1.817–5(f)(2)(i), specifically permitting life insurance company general accounts, managers of the investment company, partnership or trust, pension or retirement plan trustees, and certain individuals whose investment falls into one of two limited classes.

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 non-registered 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.

Under §1.817–5(f)(2)(iii), the look-through rule applies to a trust that is treated under sections 671 through 679 as owned by the grantor or another person if substantially all of the assets of the trust are represented by Treasury securities.

Section 1.817–5(g) provides examples of the application of the look-through rules of §1.817–5(f). Example (3) of §1.817–5(g) provides an example of the application of the §1.817–5(f)(2)(ii) non-registered partnership look-through rule.

Explanation of Provisions

This document contains proposed amendments to 26 CFR part 1 under section 817(h). These proposed amendments would remove §1.817–5(f)(2)(ii), which requires taxpayers to look through an interest in a nonregistered partnership, as defined in §1.817–5(f)(2)(ii), to determine whether a segregated asset account supporting a variable contract is adequately diversified within the meaning of section 817(h) and §1.817–5. In addition, the proposed regulations would conform the other provisions of §1.817–5 to the removal of §1.817–5(f)(2)(ii), and would remove Example (3) of §1.817–5(g).

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: (A) all the beneficial interests in the nonregistered partnership (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 nonregistered partnership is available exclusively (except as otherwise permitted in §1.817–5(f)(3)) through the purchase of a variable contract.

Reasons for Change

The Treasury Department and the IRS are concerned that §1.817–5(f)(2)(ii) is not consistent with Congressional intent because it is not explicitly subject to the public availability limitation of section 817(h). The Treasury Department and the IRS believe that removal of §1.817–5(f)(2)(ii) will eliminate any possible confusion regarding the prohibition on ownership of interests by the public in a non-registered partnership funding a variable contract.

In addition, the Treasury Department and the IRS understand that certain taxpayers are purchasing contracts invested in partnerships that rely on the nonregistered partnership rule of §1.817–5(f)(2)(ii) to satisfy the diversification requirements of section 817(h). The Treasury Department and the IRS are concerned that these contracts are funded by interests in partnerships that are also available to certain limited classes of investors, specifically individuals that are “qualified purchasers” within the meaning of 15 U.S.C. § 80a–2(a)(51) or “accredited investors” as defined in Regulation D of the Securities Act of 1933.[2] The Treasury Department and the IRS believe that Congress intended to treat qualified purchasers and accredited investors as part of the general public when determining whether an investment is available for the purchase by the general public. Elimination of §1.817–5(f)(2)(ii) will limit access to interests in non-registered partnerships to the same holders that are permitted under §1.817–5(f)(2)(i), which does not include either qualified investors or accredited investors.

Proposed Effective Date

The Treasury Department and the IRS intend revocation of §1.817–5(f)(2)(ii) and Example (3) of §1.817–5(g) to be effective on the date the final regulations are published in the Federal Register. The revocation will be effective for all investments in nonregistered partnerships, including investments made prior to the effective date of the revocation that relied on the look-through rule of §1.817–5(f)(2)(ii) to satisfy the diversification requirements of section 817(h) and the regulations and do not meet the requirements of §1.817–5(f)(2)(i). However, arrangements

[2] The Treasury Department and the IRS understand that many of the partnership interests that are available under these arrangements are interests in partnerships that operate as hedge funds, often established and operated in foreign jurisdictions. In many cases, interests in these partnerships are available for purchase directly by the general public as well as through the purchase of a variable contract. Taxpayers that purchase a variable annuity or life insurance contract are indirectly investing in partnership interests that are available for direct investment by the general public. By indirectly investing in these partnership interests through the purchase of a variable contract, taxpayers defer tax on partnership earnings that might otherwise be currently taxable. The Treasury Department and the IRS believe that these arrangements (often marketed as “insurance wrappers”) are the type of overly investment oriented insurance and annuity arrangements that Congress sought to prevent when it enacted the diversification rules of section 817(h).

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.

Special Analyses

It has been determined that this notice of proposed rulemaking 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 will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Request for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are timely submitted to the IRS. The Treasury Department and the IRS specifically request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

The Treasury Department and the IRS specifically request 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.[3]

Drafting Information

The principal author of these proposed 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.

* * * * *

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAX

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read 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. Paragraph (g) *Example 4* is redesignated as paragraph (g) *Example 3*.

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on July 29, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 30, 2003, 68 F.R. 44689)

---

[3] The Treasury Department and the IRS have issued a number of revenue rulings that provide guidance for determining whether 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. *See* Rev. Rul. 2003–92, 2003–33 I.R.B. 350 (August 18, 2003); Rev. Rul. 2003–91, 2003–33 I.R.B. 347 (August 18, 2003); Rev. Rul. 82–54, 1982–1 C.B. 11; Rev. Rul. 81–225, 1981–2 C.B. 12; Rev. Rul. 80–274, 1980–2 C.B. 27; Rev. Rul. 77–85, 1977–1 C.B. 12. *See also Christoffersen v. U.S.*, 749 F.2d 513 (8th Cir. 1984), *rev'g* 578 F. Supp. 398 (N.D. Iowa 1984). These rulings apply general concepts of ownership that have developed in case law to conclude that a contract holder was the owner of assets held in the account that supported the contract holder's annuity contract, and was therefore subject to current taxation on the earnings on those assets.