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Subject: **IRS Issues Final Regs. Regarding Diversification Requirements of Variable Contracts Under Section 817(h) of the Revenue Code**

Major References: [*TD 9385, 73 Fed. Reg. 12263-12265 \(March 7, 2008\)*](#)

Prior AALU Washington Reports: 07-69; 07-10; 05-31; 03-78; 03-75; 03-74

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The Internal Revenue Service and Treasury have finalized in TD 9385 proposed regulations under Section 817(h) of the Internal Revenue Code respecting the diversification requirements applicable to variable contracts. (See our Bulletin No. 07-69.) The regulations would primarily expand the list of holders whose beneficial interests in an investment company, partnership or trust do not prevent a segregated asset account from looking through to the assets of the investment company, etc. in order to satisfy the diversification rules. The regulations also remove a sentence which had provided that the payment required to remedy an inadvertent diversification failure must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract.

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 account is adequately diversified. For purposes of testing diversification, Treasury regulations provide a “look-through” rule for assets held through certain investment companies, partnerships, or trusts. Look-through treatment is available with respect to such an entity only if (i) all of its beneficial interests are held by one or more segregated asset accounts of one or more insurance companies, and (ii) public access to the entities is available exclusively (*except as otherwise permitted by Reg. section 1.817-5(f)(3)*) through the purchase of a variable contract.

On July 23, 2003, the Treasury and Internal Revenue Service issued two important revenue rulings (Rev. Ruls. 2003-91 and 2003-92), and, on July 30, 2003, issued proposed regulations (which were finalized on March 1, 2005). In essence, these pronouncements, taken together, hold that the owner of a variable life insurance or annuity contract that is invested, via sub-accounts, in certain nonregistered partnerships that are open to investors, *other than variable contract holders*, will be treated as owning the assets in the sub-accounts directly, thus undercutting the insurance policy status of the variable contract and the favorable tax treatment that would otherwise follow for the contract holder. While ostensibly breaking new ground, the rulings collectively affirmed the Internal Revenue Service's long-standing interpretation of the "investor control" doctrine as applied to these products.

Rev. Rul. 2003-92 (and Rev. Rul. 81-225, 1981-2 C.B. 12, on which the "investor control" doctrine is presumably based) can be read restrictively to apply the doctrine negatively to all variable life insurance and annuity contracts for which the underlying investments in an investment company, partnership or trust are available to anyone other than a purchaser of a life insurance or annuity contract from an insurance company. This restrictive reading is at odds with the regulations issued under Section 817 (specifically, Reg. § 1.817-5(f)(3), cited above), which includes among "permitted investors" in a variable contract: (i) the general account of a life insurance company (if certain requirements are met); (ii) certain managers and certain corporations related to the manager of the investment company, partnership or trust; (iii) a trustee of a qualified pension or retirement plan; and (iv) investors in certain grandfathered contracts.

The Revenue Service cleared up this confusion in Rev. Rul. 2007-7 (*see* our Bulletin No. 2007-10), which affirmed that the investors in a regulated investment company that are described in § 1.817-5(f)(3) are not members of the "general public" as that term is used in Rev. Rul. 2003-92 and Rev. Rul. 81-225. Thus, the holder of a variable annuity or life insurance contract will not be treated (negatively) as the owner of an interest in a regulated investment company that funds the variable contract solely because interests in the same entity are also available to investors described in § 1.817-5(f)(3). In effect, that holder of the variable annuity or life insurance contract will not be subject to tax on the income as it accumulates in the annuity or contract.

On July 31, 2007, (in response to public comment), Treasury and IRS issued proposed regulations under Section 817(h) of the Code, in which the Service further expanded the categories of "permitted investors" under § 1.817-5(f)(3) of the diversification regulations to include:

- (i) qualified tuition programs as defined in section 529;
- (ii) trustees of foreign pension plans established and maintained outside the United States, primarily for the benefit of individuals, substantially all of whom are nonresident aliens; and
- (iii) accounts that, pursuant to Puerto Rican law or regulation, are segregated from the general asset accounts of the life insurance companies that own the accounts, provided certain other requirements are satisfied (but without regard to the requirement the accounts be segregated pursuant to "State" law or regulation).

As a result, those investment companies, partnerships and trusts, in which "permitted investors" own interests, may helpfully be "looked-through" in testing diversification.

The proposed regulation also removed from Reg. § 1.817-5(a)(2) a sentence which provided that the amount required to be paid to remedy an inadvertent failure to diversify must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract for the period or periods of nondiversification.

The final regulations, which are effective on the date of publication in the Federal Register (March 7, 2008), adopt the proposed regulations with minor changes. The government recognizes, however, the need for further study of certain aspects of the regulations in order to provide further clarity. We therefore may expect new guidance to continue to be published in this area.

Any AALU member who wishes to obtain a copy of TD 9385 may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Erik Ruselowski at ruselowski@aalu.org and include a reference to this *Washington Report*.

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