

Legal Alert: Liberalization of Variable Insurance Product Diversification Requirements Proposed

July 31, 2007

The Internal Revenue Service (“IRS”) and Treasury published in today’s Federal Register a proposal to amend the regulations under section 817(h) of the Internal Revenue Code (“Code”), which imposes “adequate diversification” requirements on insurance company “segregated asset accounts” (*i.e.*, separate accounts and subaccounts) supporting variable life insurance and annuity contracts (“variable contracts”). Click [here](#) for a copy of the proposed regulations. The proposal would (1) expand the categories of entities allowed to hold interests in insurance-dedicated funds qualifying for look-through treatment under Treas. Reg. § 1.817-5(f); and (2) allow the IRS to change the basis for computing toll charges for diversification failures under its remediation program for diversification failures.

Permissible holders of interests in insurance-dedicated funds. Under the proposal, in addition to the categories of persons currently allowed to hold interests in insurance-dedicated funds qualifying for look-through treatment under Treas. Reg. § 1.817-5(f)(3), the following categories of entities would also become “permitted investors”:

- qualified tuition programs satisfying the requirements of Code section 529;
- trustees of pension or retirement plans established and maintained outside the United States primarily for the benefit of persons substantially all of whom are non-resident aliens; and
- segregated asset accounts of Puerto Rican insurance companies supporting contracts that otherwise qualify as variable contracts under United States Federal tax law. The notice of proposal requests comments on whether a similar rule should apply to segregated asset accounts operating under laws of United States territories.

Explanation: Under Code section 817(h) and the regulations thereunder, the investments of a segregated asset account supporting variable life insurance or annuity contracts must satisfy certain diversification requirements; otherwise, the variable contracts it supports are not treated as life insurance or annuity contracts

and are subject to current taxation on annual cash value increases. For these purposes, certain types of investment funds may be eligible for look-through treatment under Treas. Reg. § 1.817-5(f)(1), so that the compliance with the diversification requirements of a segregated asset account that invests in such a fund is tested based on the underlying investments of the fund, not the interests in the fund held by the segregated asset account. Look-through treatment is available, however, *only* if such a fund is “insurance-dedicated,” *i.e.*, only if (1) beneficial interests in the fund are held only by insurance company segregated asset accounts supporting variable contracts and certain other entities that are listed in Treas. Reg. § 1.817-5(f)(3) and (2) public access to the fund is exclusively available through the purchase of a variable contract, except for entities listed in Treas. Reg. § 1.817-5(f)(3). *See* Treas. Reg. § 1.817-5(f)(2). If a fund is offered as an investment option under a variable contract through a segregated asset account that invests exclusively in interests in the fund (such as in a typical “unit investment trust” structure) but interests in the fund are held by entities other than those permitted under Treas. Reg. § 1.817-5(f)(3), the segregated asset account will not satisfy the diversification requirements, and variable contracts allocating amounts to the segregated asset account in question will be currently taxed on cash value increases.

Change in Toll Charges for Remediation of Diversification Failures. Treas. Reg. § 1.817-5(a)(2) currently requires payment to the Government of an amount (a “toll charge”) to remediate diversification failures. That toll charge currently is “based upon the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract . . . for . . . periods” of diversification failure. The proposal would remove this constraint on the toll charge. The proposal would not actually modify the current toll charge requirements, but would allow the Service to change the toll charge subsequently through the issuance of a notice.

Explanation. Treas. Reg. § 1.817-5(a)(2) establishes a procedure for remediation, upon payment of a toll charge by a policyholder or the issuer of a variable contract, of segregated asset accounts that have “inadvertently” failed to satisfy the section 817(h) diversification requirements. The procedure is set forth in Rev. Proc. 92-25, 1992-1 C.B. 741, and currently provides for toll charges based on the “income on the contract” for each contract affected by a diversification failure for the periods of non-diversification, without regard to how much or how little of that income may have been attributable to the non-diversified segregated asset account. *See also* Notice 2000-9, 2000-1 C.B. 449. In Notice 2007-15, 2007-7 I.R.B. 503, the IRS requested public comments on its existing insurance contract remediation procedures, specifically identifying the appropriateness of basing toll charges for remediating section 817(h)

diversification failures on the “income on the contract” for the periods of non-diversification. This suggests that the IRS might at some point in the future prescribe different toll charges for section 817(h) remediation. The proposal would amend the regulation to give the IRS the flexibility to prescribe some other basis for such toll charges by a less formal procedure than an amendment of the regulation, should it eventually decide to modify the existing procedure. However, the proposal leaves the current rules in place at least for the time being.

Deadline for comments. Written or electronic comments and requests for a public hearing must be received by October 29, 2007.



If you have any questions regarding this alert, or the services we provide, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Thomas A. Gick	202.383.0191	tom.gick@sablaw.com
James V. Heffernan	202.383.0141	james.heffernan@sablaw.com
Michael R. Miles	202.383.0204	michael.miles@sablaw.com
W. Mark Smith	202.383.0221	mark.smith@sablaw.com
William J. Walderman	202.383.0243	william.walderman@sablaw.com