

Diversification Requirements for Variable Annuity, Endowment, and Life Insurance Contracts under Section 817(h)

Notice 2016-32

This notice provides guidance to taxpayers regarding the diversification requirements under section 817(h) of the Internal Revenue Code (Code) for a segregated asset account that invests in a money market fund (MMF) that is a government MMF. An MMF is a type of investment company registered under the Investment Company Act of 1940 (1940 Act) and regulated as an MMF under Rule 2a–7 under the 1940 Act (17 CFR 270.2a–7).

I. BACKGROUND

a. Money market funds

In 2014, the Securities and Exchange Commission (SEC) amended Rule 2a–7 and other rules governing MMFs. See Money Market Fund Reform; Amendments to Form PF (79 FR 47736). Rule 2a–7 as amended identifies circumstances under which an MMF is permitted or required to impose a liquidity fee or is permitted to impose a redemption gate. When an MMF has a liquidity fee in effect, the liquidity fee reduces the proceeds received by all redeeming shareholders. A redemption gate is a temporary suspension of redemptions of shares in the MMF. Liquidity fees and redemption gates may be imposed by all MMFs in certain circumstances.

Rule 2a–7 defines a government MMF as an MMF “that invests 99.5 percent or more of its total assets in cash, government securities, and/or repurchase agreements that are collateralized fully [by cash items or government securities].” 17 CFR 270.2a–7(a)(14). Section 2(a)(16) of the 1940 Act defines government security to mean “any

security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing.” 15 USC 80a–2(a)(16). As with certain other 1940 Act definitions, this definition of government security also applies for purposes of section 851(b)(3) of the Code, which generally applies to MMFs. See section 851(c)(6).

Rule 2a–7 as amended requires an MMF other than a government MMF to be prepared to impose a liquidity fee, and, in certain circumstances, to impose such a fee unless the MMF’s board of directors determines that such a fee is not in the best interests of the fund. In contrast, Rule 2a–7 permits, but does not require, government MMFs to impose liquidity fees. It is expected that some existing MMFs will convert to government MMFs.

b. Variable contracts

Section 817(d) of the Code defines the term “variable contract” to mean a contract that (1) “provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company”; (2) provides for the payment of annuities, is a life insurance contract, or provides for funding of insurance on retired lives, as described in section 807(c)(6); and (3) satisfies additional requirements in the rest of that subsection, including requirements to reflect the current investment return and market value of the segregated asset account.

Under section 817(h)(1) of the Code, “a variable contract (other than a pension plan contract [as defined in section 818(a)]) which is otherwise described in [section 817] and which is based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract for any period (and any subsequent period) for which the investments made by such account are not, in accordance with regulations prescribed by the Secretary, adequately diversified.” See also § 1.817-5(a)(1) of the Income Tax Regulations.

As defined in § 1.817-5(e), a “segregated asset account” consists of “all assets the investment return and market value of each of which must be allocated in an identical manner to any variable contract invested in any of such assets.” See also § 1.817-5(g) (providing examples illustrating the application of the segregated asset account definition).

Generally, the policyholder of a variable contract may select among various investment strategies each of which results in investment in different groups of assets. Each of these groups may be a segregated asset account within the meaning of § 1.817-5(e). See, e.g., Rev. Rul. 81-225, 1981-2 C.B. 12, modified by Rev. Proc. 99-44, 1999-2 C.B. 598, clarified and amplified by Rev. Rul. 2007-7, 2007-1 C.B. 468. Each segregated asset account must be adequately diversified within the meaning of section 817(h). In addition, the policyholder must not have investor control either as a result of the ability to select among investment strategies or for any other reason. See, e.g., Rev. Rul. 77-85, 1977-1 C.B. 12; Rev. Rul. 2003-91, 2003-2 C.B. 347.

Section 1.817-5(b)(1)(i) provides that, except as otherwise provided by exceptions in paragraphs (b) and (c) of § 1.817-5, the investments of a segregated asset account are considered adequately diversified only if:

- (A) No more than 55 percent of the value of the total assets of the account is represented by any one investment;
- (B) No more than 70 percent of the value of the total assets of the account is represented by any two investments;
- (C) No more than 80 percent of the value of the total assets of the account is represented by any three investments; and
- (D) No more than 90 percent of the value of the total assets of the account is represented by any four investments.

Under § 1.817-5(c)(1), an account is treated as adequately diversified for a calendar quarter if it satisfies the requirements of § 1.817-5(b) on the last day of the calendar quarter or within 30 days after that last day.

In applying the diversification requirement of § 1.817-5(b), a look-through rule in § 1.817-5(f) treats a segregated asset account as the owner of assets held indirectly through certain investment vehicles (certain regulated investment companies, certain real estate investment trusts, certain partnerships, or certain trusts). If one of these vehicles satisfies the criteria of § 1.817-5(f)(2) and if a segregated asset account holds an interest in the vehicle, diversification of the account is tested as if a pro rata portion of each asset of the vehicle were an asset of the account.

Section 1.817-5(h)(1) defines “government security” as “any security issued or guaranteed or insured by the United States or an instrumentality of the United States; or

any certificate of deposit for any of the foregoing.” (This definition is similar to the language used to define “government security” in section 2(a)(16) of the 1940 Act (quoted above).) For purposes of § 1.817-5(h)(1), “an instrumentality of the United States” means “any person that is treated for purposes of 15 U.S.C. 80a–2(16), as amended, as a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States.” Under section 817(h)(6), for purposes of determining whether a segregated asset account is adequately diversified, each United States Government agency or instrumentality is treated as a separate issuer. See also § 1.817-5(b)(1)(ii)(B).

Under current practice, only a limited number of United States agencies or instrumentalities issue securities that Rule 2a–7 allows MMFs to hold. Also, as was described above, some MMFs are expected to convert to government MMFs, resulting in increased demand for government securities. This increased demand may exacerbate MMFs’ difficulty in acquiring the assets necessary both to qualify as a government MMF and to satisfy the diversification requirements under section 817(h) and § 1.817-5.

II. ALTERNATIVE DIVERSIFICATION REQUIREMENTS FOR A SEGREGATED ASSET ACCOUNT THAT INVESTS IN A GOVERNMENT MMF

The Treasury Department and the Internal Revenue Service have determined that variable contracts should be able to offer government MMFs as an investment option. Therefore, the Treasury Department and the Internal Revenue Service intend to amend § 1.817-5. Pending the promulgation and effective date of future administrative or regulatory guidance, taxpayers may rely on the following alternative diversification

requirement under § 1.817-5 for a segregated asset account that invests in a government MMF:

A segregated asset account within the meaning of § 1.817-5(e) is adequately diversified for purposes of section 817(h) if—

(1) No policyholder has investor control; and

(2) Either—

(a) The account itself is a government MMF under Rule 2a-7(a)(14); or

(b) The account invests all of its assets in an “investment company, partnership, or trust” as defined in § 1.817-5(f)(1) that satisfies the criteria of

§ 1.817-5(f)(2) and qualifies as a government MMF under Rule 2a-7(a)(14).

III. DRAFTING INFORMATION

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