

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, §§ 817; 1.817-5)

Rev. Proc. 2018-54

SECTION 1. PURPOSE

This revenue procedure provides guidance and procedural rules for taxpayers that hold investments in one or more segregated asset accounts on which variable contracts are based. The guidance and rules allow these taxpayers to elect to treat certain mortgage-backed securities as having deemed issuers for purposes of the diversification requirements of § 817(h) of the Internal Revenue Code.

SECTION 2. BACKGROUND

.01 Under the direction of the Federal Housing Finance Agency (FHFA), the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae, and together with Freddie Mac, the GSEs) will develop a common mortgage-backed security (the Single Security Initiative). As part of the Single Security Initiative, key features and terms of Freddie Mac's securities will be aligned with those of Fannie Mae's securities to create new Uniform Mortgage Backed Securities (UMBS). UMBS will be issued by both GSEs with substantially similar terms. UMBS would trade primarily in the "To-Be-Announced" (TBA) market.

.02 Freddie Mac currently issues mortgage-backed securities, called Participation Certificates (PC), to the market. Fannie Mae currently issues similar securities, called Mortgage-Backed Securities (MBS), to the market. PC and MBS are issued under trust agreements and represent undivided beneficial ownership interests in pools of mortgages and related assets held by those trusts (Mortgage Pools). Mortgage servicers perform certain servicing functions for each Mortgage Pool on behalf of the GSE issuer for a fee. Each GSE acts as master servicer and guarantor of the mortgages for a periodic fee.

.03 Today, PC and MBS differ in their respective remittance cycles. Although the remittance cycle for PC is 45 days, the remittance cycle for MBS is 55 days, meaning that an MBS holder receives payments 10 days later than a PC holder.

.04 As part of the Single Security Initiative, the GSEs will combine their fixed-rate PC and MBS programs into a new single mortgage-backed security program in which both GSEs will issue UMBS having substantially similar features and terms, including identical remittance cycles.

.05 Most trading of PC and MBS occurs in the TBA market, which is a forward market in mortgage-backed securities. Today, when counterparties enter into an “unstipulated” TBA trade, they enter into a forward contract that specifies six criteria that the security delivered must satisfy. These six criteria are the coupon, maturity, settlement date, face value, price, and issuer (that is, Freddie Mac or Fannie Mae). Investors may enter into “stipulated” TBA trades to require additional attributes of the security delivered, such as the geographical location of the underlying mortgages. Once UMBS begin trading in the TBA market, the parameters for unstipulated TBA

trades in UMBS will exclude specification of the issuer. As a result, investors that acquire UMBS in unstipulated TBA trades will not know the issuer until the security to be delivered is identified 48 hours prior to settlement.

.06 Section 817(h) provides that for purposes of subchapter L (§§ 801 through 848), § 72 (relating to annuities), and § 7702(a) (relating to the definition of life insurance contract), a variable contract (other than a pension plan contract, as defined in § 818(a)) that is otherwise described in § 817 and that is based on a segregated asset account is not treated as an annuity, endowment, or life insurance contract for any period (and any subsequent period) for which the investments made by the account are not adequately diversified (in accordance with regulations prescribed by the Secretary). See also § 1.817-5(a)(1) of the Income Tax Regulations.

.07 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).

.08 In current commercial practice, the policyholder of a variable contract may usually select among various investment strategies, each of which results in investment in different portfolios of assets. Each of these portfolios 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 § 817(h).

.09 (1) Section 1.817-5(b)(1)(i) provides that the investments of a segregated asset account are considered adequately diversified for purposes of § 1.817-5 and § 817(h) only if no more than—

(A) 55 percent of the value of the total assets of the account is represented by any one investment;

(B) 70 percent of the value of the total assets of the account is represented by any two investments;

(C) 80 percent of the value of the total assets of the account is represented by any three investments; and

(D) 90 percent of the value of the total assets of the account is represented by any four investments.

(2) Section 1.817-5(b)(1)(ii)(A) provides that all securities of the same issuer are treated as a single investment.

(3) 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.

.10 Section 1.817-5(f)(1) provides a look-through rule for assets held through certain investment companies, partnerships, or trusts. For this purpose, the term “investment company, partnership, or trust” refers to a regulated investment company, a real estate investment trust, a partnership, or a trust that is treated under §§ 671 through 679 as owned by the grantor or another person.

(1) The look-through rule applies to an investment company, partnership, or trust that meets the requirements described in § 1.817-5(f)(2). Section 1.817-5(f)(2)

generally requires that all the beneficial interests in such an entity be held by one or more segregated accounts and that public access to such an entity be available exclusively through the purchase of a variable contract.

(2) Section 1.817-5(f)(3) provides limited exceptions to § 1.817-5(f)(2).

.11 If the look-through rule applies, a beneficial interest in an investment company, partnership, or trust is not treated as a single investment of a segregated asset account. Instead, a pro rata portion of each asset of the investment company, partnership, or trust is treated as an asset of the segregated asset account. For purposes of that treatment, the ratable interest of a partner in a partnership's assets is determined in accordance with the partner's capital interest in the partnership.

.12 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 § 2(a)(16) of the Investment Company Act of 1940.) 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 § 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).

.13 When a market participant enters into an unstipulated TBA trade to acquire UMBS, it will not know the issuer (Fannie Mae or Freddie Mac) until 48 hours prior to

delivery. Thus, suppose that an insurance company enters into unstipulated TBA trades to acquire GSE securities for inclusion in a segregated asset account on which one or more contracts issued by the company are based. Once the Single Security Initiative is effective, such a company will not know until 48 hours before settlement the issuers of the UMBS to be delivered to it under the contract. If the account is already heavily invested in securities issued by one of the GSEs, the TBA contract may require acceptance of additional securities of that issuer—an acceptance that may jeopardize the segregated asset account’s satisfaction of the diversification requirements of § 817(h) and the regulations thereunder.

SECTION 3. DEFINITIONS

Solely for purposes of this revenue procedure—

.01 The term “taxpayer” means—

(1) An insurance company that issues variable contracts within the meaning of § 817(d); and

(2) An investment company, partnership, or trust, as defined in section 2.10 of this revenue procedure, that qualifies for “look-through” treatment under § 1.817–5(f).

.02 The term “electing taxpayer” means a taxpayer subject to a deemed-issuance-ratio election as described in this revenue procedure.

.03 The term “generic GSE security” means a TBA-eligible GSE security that a buyer acquires by taking delivery pursuant to a TBA trade in which, at the time that the buyer entered into the TBA contract, the buyer had no way of knowing the actual issuer(s) of the securities to be delivered under the contract.

.04 For purposes of determining whether a security is a generic GSE security, the term “buyer” includes a taxpayer that is either of the following:

(1) An assignee of a buyer (taking into account this section 3.04), provided that—

- a. There is a legal transfer to the assignee of rights and obligations under the assignor’s TBA contract for the acquisition of a generic GSE security; and
- b. This transfer occurs at a time when neither the assignor nor the assignee has any way of knowing the actual issuer(s) of the securities to be delivered under the contract.

(2) A successor entity to a buyer (taking into account this section 3.04), provided that—

- a. The successor entity succeeds to attributes of the buyer in a transaction to which § 381(a) applies;
- b. The buyer to which the successor entity succeeds is an electing taxpayer; and
- c. The successor entity either already is an electing taxpayer or makes a deemed-issuance-ratio election for the first taxable year in which that entity becomes a successor to the buyer.

.05 For purposes of the operation of these definitions, the following rules apply:

(1) The term “generic GSE security” applies to those securities only with respect to a buyer who acquired them in the manner described in section 3.03 or section 3.04 of this revenue procedure. That is, they are not generic GSE securities with respect to any other person.

- (2) The term does not include securities acquired in specified pool trades, stipulated trades in which the issuer is stipulated, or any other trade in which the issuer of the security can be known when the TBA contract is initiated.

SECTION 4. SCOPE

This revenue procedure applies to—

.01 Any taxpayer as defined in section 3.01 of this revenue procedure; and

.02 Any generic GSE security, as defined in section 3.03 of this revenue procedure,

with respect to which such a taxpayer is a buyer.

SECTION 5. APPLICATION—ABILITY TO MAKE A DEEMED-ISSUANCE-RATIO ELECTION

A taxpayer may make a deemed-issuance-ratio election with respect to its generic GSE securities. The consequences of a deemed-issuance-ratio election are described in section 6 of this revenue procedure. The required time and manner for making a deemed-issuance-ratio election are described in section 7 of this revenue procedure.

SECTION 6. APPLICATION—CONSEQUENCES OF A DEEMED-ISSUANCE-RATIO ELECTION

.01 For purposes of applying § 817(h) and the regulations thereunder, the consequences described in sections 6.02 through 6.05 of this revenue procedure apply to the extent that an electing taxpayer's generic GSE securities either—

(1) Are held in a segregated asset account on which a variable contract issued by the taxpayer is based; or

(2) Are treated under § 1.817-5(f) as being held in a segregated asset account on which a variable contract issued by some other person is based.

.02 (1) If an electing taxpayer holds a generic GSE security, that security is deemed to be issued in part by Fannie Mae and in part by Freddie Mac. Except to the extent provided in section 6.02(2) of this revenue procedure, the portions deemed issued by each are determined by the deemed-issuance ratio that was applicable to the year in which the taxpayer entered into the TBA contract under which the generic GSE security was to be delivered. See section 6.05 of this revenue procedure. It is irrelevant which GSE is the actual issuer of the generic GSE securities that are delivered under the TBA contract.

(2) In the case of a taxpayer that is a buyer by virtue of section 3.04(2) of this revenue procedure (concerning successor entities), if such a taxpayer acquired a generic GSE security in the succession transaction, then the security retains the same deemed-issuance ratio in that taxpayer's hands that it had in the hands of the predecessor.

(3) Example. Assume that an electing taxpayer entered into a TBA contract to acquire \$100x in generic GSE securities to be held in a segregated asset account on which a variable contract issued by the electing taxpayer is based. On the date when the contract was entered, the applicable deemed-issuance ratio (as described in section 6.05 of this revenue procedure) was 60-to-40, Fannie Mae to Freddie Mac. Accordingly, for purposes of applying § 817(h) and the regulations thereunder, any generic GSE security that was delivered under the contract is deemed to have been issued 60 percent by Fannie Mae and 40 percent by Freddie Mac. In the aggregate, therefore, when those generic GSE securities are first acquired, they are treated as \$60x Fannie Mae securities and

\$40x Freddie Mac securities, regardless of which GSE is the actual issuer of the generic GSE securities that are delivered under the TBA contract.

.03 As long as the electing taxpayer continues to hold a generic GSE security, the security's deemed-issuance ratio remains constant. Thus—

- (1) As an electing taxpayer's generic GSE securities pay down, the remaining balance of each retains its deemed-issuance ratio, regardless of any pre-payments or foreclosures made on the generic GSE securities and the actual issuers of remaining generic GSE securities.
- (2) If the electing taxpayer disposes of some of its generic GSE securities, the deemed-issuance ratio of each remaining generic GSE security does not vary.

.04 If a generic GSE security held by an electing taxpayer is aggregated into a pool of mortgage-backed securities as part of a GSE resecuritization program and new securities are issued, then the issuer of the new security is the known GSE that issued the resecuritization security, and the deemed-issuance ratio no longer applies to the old security in its role as a component of the resecuritization pool. To the extent a new resecuritization security is delivered into a generic TBA trade (with the issuer unknown by the taxpayer at the trade date), a taxpayer that has made a deemed-issuance-ratio election treats the resecuritization security consistent with the deemed-issuance rule.

.05 At least three weeks prior to the start of each calendar year, FHFA will determine and publicize the deemed-issuance ratio that electing taxpayers are to use for TBA contracts entered into during that calendar year.

- (1) FHFA will determine this ratio based on the ratio of TBA-eligible securities issued by Fannie Mae and Freddie Mac during a 24-month period ending not

earlier than October 31 immediately preceding the year to which the new ratio will apply. The ratio must be two whole numbers. FHFA may round the observed ratio in the data to whatever extent FHFA considers appropriate, provided that the rounded ratio to be used is further from 50-50 than the actual observed data.

(2) Example. At least three weeks prior to the start of 2019, FHFA will determine and publicize the deemed-issuance ratio that electing taxpayers are to use for TBA contracts to acquire generic GSE securities entered into during 2019. FHFA will determine this ratio based on the ratio of TBA-eligible securities issued by Fannie Mae and Freddie Mac during the 24-month period ending not earlier than October 31, 2018. If the percent of aggregate TBA-eligible securities issued by Fannie Mae and Freddie Mac during the 24-month period ending on October 31, 2018, was 59 percent and 41 percent respectively, then FHFA might determine a deemed-issuance ratio of 60-to-40, Fannie Mae-to-Freddie Mac. If it did so, then solely for purposes of determining whether electing taxpayers' segregated asset accounts meet the diversification requirements of § 817(h), that deemed-issuance ratio would apply to any generic GSE security delivered under a TBA contract that is entered into during 2019, regardless of the actual issuers of the delivered securities.

SECTION 7. PROCEDURE—MAKING THE ELECTION

.01 A deemed-issuance-ratio election must be made in a statement attached to the taxpayer's income tax return for the first taxable year for which the taxpayer wants the election to apply. The statement must be titled "Section 817(h) Deemed-Issuance-Ratio

Election.” The statement must indicate that the taxpayer elects the deemed-issuance-ratio election (as described in this revenue procedure) and must include the taxpayer’s name, address, and TIN. If the common parent (or agent within the meaning of § 1.1502-77) of a group of corporations filing a consolidated return is making the election on behalf of one or more members of the consolidated group, the parent must indicate the name, address, and taxpayer identification number of each consolidated group member for which the election is being made.

.02 A deemed-issuance-ratio election is applicable to all of the electing taxpayer’s generic GSE securities acquired under TBA contracts that were entered into for quarters ending in the year specified in the election and for quarters ending in all subsequent taxable years for which the election is effective.

.03 A deemed-issuance-ratio election is revocable only with the prior written consent of the Commissioner of Internal Revenue. To request the Commissioner’s consent, the electing taxpayer (or successor) must submit a request for a private letter ruling in accordance with the provisions of Rev. Proc. 2018-1, 2018-1 I.R.B. 1 (or its then-applicable successor).

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective for elections with respect to quarters ending on or after the date on which investors can first enter into TBA contracts that do not specify the issuer of the GSE securities that may be delivered under it.

SECTION 9. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been submitted to the Office of Management and Budget (OMB) in accordance with the

Paperwork Reduction Act (44 U.S.C. 3507) and OMB approval is pending. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

This revenue procedure contains a collection of information requirement in section 7. The purpose of the collection of information is to verify the taxpayer's deemed-issuance-ratio election. The collection of information is required to obtain the benefit of using the election. The likely respondents are taxpayers (as defined in section 3.01 of this revenue procedure) that hold investments in one or more segregated asset accounts on which variable contracts are based.

The estimated total annual reporting and/or recordkeeping burden is: 5 hours.

The estimated annual burden per respondent and/or recordkeeper: 15 minutes.

The estimated number of respondents and/or recordkeepers: 20.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

SECTION 10. DRAFTING INFORMATION

The principal author of this revenue procedure is Katherine A. Hossofsky of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure, please contact Katherine A. Hossofsky at (202) 317-6995 (not a toll-free call).