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Rev. Proc. 2008-41—Correction of Inadvertent Diversification Failures

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I. Introduction

On June 30, 2008, the Internal Revenue Service (the "Service") released Rev. Proc. 2008-41, 2008-29 I.R.B. 155, which provides a new procedure for correcting inadvertent failures to satisfy the diversification requirements applicable to variable annuity and life insurance contracts under section 817(h) of the Internal Revenue Code (the "Code"). Like the four other new insurance product correction procedures released that day, Rev. Proc. 2008-41 is a considerable improvement on the prior correction procedure, Rev. Proc. 92-25, 1992-1 C.B. 741, and should make it easier and less costly for insurers to remediate the adverse consequences of inadvertent diversification failures.

To obtain relief under the new diversification correction procedure, insurers will still need to file a request for a closing agreement with the Service's National Office in Washington, D.C., *i.e.*, there is still no "self help" available. Such a filing will require the use of legal, accounting and actuarial resources. Also, depending on the facts and circumstances, insurers will need to pay a toll charge to the government that can equal as much as $5 million for each nondiversified segregated asset account. As a result, insurers will continue to have a strong interest in establishing and following effective procedures to assure compliance with the diversification rules. To paraphrase the proverb, "An ounce of prevention is still worth a pound of cure," at least when it comes to maintaining adequately diversified segregated asset accounts.

II. Background

Section 817(d) of the Code defines a variable contract as a contract that (1) provides for the allocation of premiums to an account that, pursuant to State law or regulation, is segregated from the insurer's general asset accounts; and (2) provides for the payment of annuities, is a life insurance contract, or provides for the funding of insurance on retired lives. In addition, in the case of an annuity contract or a contract that funds insurance on retired lives, the amounts paid in or the amounts paid out must reflect the investment return and market value of the segregated asset account, while in the case of a life insurance contract, the death benefit (or the period of coverage) must be adjusted on the basis of the investment return and the market value of the segregated asset account. A variable contract (other

than a pension plan contract)[1] is subject to the requirements of Code section 817(h)(1), which provides in sweeping terms that a variable contract will not be treated as an annuity or life insurance contract "for any period (and any subsequent period) for which the investments made by [the segregated asset] account are not … adequately diversified" in accordance with applicable regulations.

The regulations provide that a segregated asset account will be considered adequately diversified only if (1) no more than 55 percent of the value of the total assets of the account is represented by any one investment; (2) no more than 70 percent is represented by any two investments; (3) no more than 80 percent is represented by any three investments; and (4) no more than 90 percent is represented by any four investments.[2] For this purpose, all securities of the same issuer are treated as a single investment, and each government agency or instrumentality that issues a government security is treated as a separate issuer.[3] In addition, if certain requirements are met, a segregated asset account's interest in a regulated investment company, partnership, real estate investment trust or grantor trust (each, a "Look-Through Entity") is not treated as a single investment, and instead the account is treated as directly holding the assets of the Look-Through Entity. For this look-through treatment to apply, all beneficial interests in the Look-Through Entity must be held by life insurance company segregated asset accounts and certain other investors permitted under the regulations, and public access to the Look-Through Entity must be available exclusively through the purchase of a variable contract.[4] Finally, variable life insurance contracts (but not variable annuities) are permitted to be based on a segregated asset account that is more heavily invested in Treasury securities than otherwise permitted under the percentage limitations summarized above.[5]

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Treas. Reg. § 1.817-5(c)(1) specifies that the investments of a segregated asset account must be adequately diversified at the end of each calendar quarter or within 30 days thereafter.[6] The same regulation (reflecting section 817(h)(i) of the Code) expressly provides that once a diversification error causes a variable contract to lose its status as an annuity or life insurance contract, that condition is permanent even if the investments of the nondiversified segregated asset account are adequately diversified in a subsequent calendar quarter. In addition, the regulations provide that a variable contract will be treated as based on a segregated asset account for a calendar quarter if any amounts under the contract are allocated to that account at any time during the quarter. If a contract is not treated as an annuity or a life insurance contract under these rules, the "income on the contract" is currently includible in the policyholder's income, *i.e.*, tax-deferral on the inside buildup is lost.[7]

The consequences of these rules are illustrated by the following example. Policyholder X allocates his variable annuity's cash value of $100,000 among 15 different segregated asset accounts. Fourteen of those segregated asset accounts are adequately diversified in accordance with the regulations, but one (SAA #1) is not adequately diversified during the third calendar quarter of 2008. Even if X allocated only $1 to SAA #1 and on only one day of the third quarter (perhaps X is an active trader), X's contract loses its status as an annuity contract. As a result, he is currently taxable on the income generated by the entire $100,000 cash value for all periods beginning with the third quarter of 2008.

Recognizing the potentially harsh consequences of these rules, the regulations have offered—from the time they were finalized in 1989—a way to restore the tax-deferred status of a contract affected by a diversification error. Specifically, they provide that such status can be restored if:

(1) the issuer (or holder) of the contract shows that the error was inadvertent;

(2) the investments of the nondiversified account satisfied the diversification requirements "within a reasonable time" after the error was discovered; and

(3) the issuer (or holder) agrees to "make such adjustments or pay such amounts as may be required by the [Service] with respect to the period or periods" of nondiversification.[8]

Until they were recently amended as part of the government's efforts to update the various insurance product correction procedures, the section 817(h) regulations also provided that the amount payable to the Service "shall be an amount based upon the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract (as defined in section 7702(g)(1)(B), without regard to section 7702(g)(1)(C)) for such period or periods."[9]

Prior to the release of Rev. Proc. 2008-41, the correction mechanism contemplated by the regulations was governed by Rev. Proc. 92-25, which closely tracked the regulatory provisions described above. Its key elements were as follows:

(1) The issuer needed to file a ruling request and pay the associated IRS user fee.

(2) The ruling request had to (a) identify the period(s) of nondiversification; (b) show that the failure was inadvertent; (c) show that the investments were restored to diversified status within a reasonable time after the error was discovered; (d) describe the method used to compute the toll charge; and (e) identify the amount of the toll charge. (Items (d) and (e) were determined without regard to contracts that the owners completely surrendered for cash during the nondiversified period.)

(3) The issuer was required to submit an unexecuted closing agreement using a prescribed model and showing the amount owed to the Service (hereinafter, the "Rev. Proc. 92-25 Toll Charge"). The Rev. Proc. 92-25 Toll Charge was equal to all the untaxed income within each affected contract during the period of nondiversification multiplied by a proxy tax rate, plus deficiency interest.[10] Deficiency interest was computed as if the described amounts were underpayments of tax by the policyholders for the tax years containing the periods of nondiversification.

(4) The issuer was required to agree not to deduct the Rev. Proc. 92-25 Toll Charge and not to increase the policyholders' investment in the contract by any portion of (a) the income attributable to the contracts or (b) the Rev. Proc. 92-25 Toll Charge.

(5) The issuer was required to pay the Rev. Proc. 92-25 Toll Charge to the Service within 30

days of the date the Service executed the closing agreement.

(6) In consideration of the issuer paying the Rev. Proc. 92-25 Toll Charge, the investments of the segregated asset accounts were treated as adequately diversified during the period(s) of nondiversification, and no part of the Rev. Proc. 92-25 Toll Charge was treated as income to the policyholders.

The Service has never released any statistics on the number of closing agreements entered into under Rev. Proc. 92-25, the nature of the errors requiring closing agreements, or the amounts that insurers paid as Rev. Proc. 92-25 Toll Charges. However, the authors understand from anecdotal information that over the last 15 years, there have been a number of such closing agreements and payments have been made involving tens of millions of dollars. The types of errors involved in those cases are not publicly known, except that some clearly involved companies allowing variable annuities to be based on segregated asset accounts that were heavily invested in Treasury securities in erroneous reliance on the special rule that allows such higher concentration only with respect to variable life insurance contracts.[11] The Service addressed this specific type of error in Notice 2000-9, 2000-1 C.B. 449, apparently after taxpayers approached the Service and requested special relief. The Notice established a closing agreement program under which the toll charge required for relief was based on significantly lower proxy tax rates than otherwise applied under Rev. Proc. 92-25.[12] The program was only available to correct variable annuity contracts that inadvertently failed the diversification requirements but would have satisfied those requirements if the contracts had been variable life insurance contracts instead of annuities. Although the program was an improvement upon Rev. Proc. 92-25, it addressed only one type of diversification failure and was limited to closing agreement offers filed before Aug. 2, 2000.

In January 2007, the Service published Notice 2007-15, 2007-7 I.R.B. 503, in which it requested public comments on how to permanently improve the procedures for correcting diversification and other insurance product compliance errors. At least one commentator noted that the Rev. Proc. 92-25 Toll Charge and the provisions of the regulations on which it was based had the unfortunate effect of discouraging taxpayers from approaching the Service to remedy diversification failures.[13] Indeed, the stakes were such that the prior procedures arguably created incentives for taxpayers to adopt aggressive interpretations of the law to support the position that a diversification failure had not in fact occurred.

As noted above, the Rev. Proc. 92-25 Toll Charge was clearly derived from the statement in the regulations that the toll charge was to be based on the amount of tax that the policyholders would owe if treated as having received all the income on the affected contracts during the period(s) of nondiversification. This provision was a significant barrier to any changes to the Rev. Proc. 92-25 Toll Charge. Not surprisingly, then, in July 2007 the Treasury Department and the Service proposed deleting this sentence from the regulations.[14] The preamble to the proposed change explained that it responded to public comments on Notice 2007-15 and that the targeted sentence had "caused confusion about the scope of the IRS's authority to provide for amounts that depart from the plain language of the regulation."[15] On March 6, 2008, the government finalized the proposed change, which set the table for alternatives to the Rev. Proc. 92-25 Toll Charge.[16]

III. Scope, Procedural Requirements, and Relief Provided under Rev. Proc. 2008-41

Clearly, the most significant changes brought about by Rev. Proc. 2008-41 are those involving the determination of the toll charge that issuers must pay to obtain relief. Those changes are discussed in detail in the next section, but initially it is worthwhile to make note of some other aspects of Rev. Proc. 2008-41.

First, as required by the regulations and reflected in Rev. Proc. 92-25, the relief available under Rev. Proc. 2008-41 is limited to inadvertent diversification errors.[17] In the authors' experience, establishing inadvertence under Rev. Proc. 92-25 was usually a simple matter because errors resulted from simple human oversights or misunderstandings. There seems to be little reason to expect this to change in the future, but it is worth keeping in mind that this constraint on the ability to obtain relief for diversification failures does exist.

Second, Rev. Proc. 92-25, by its terms, allowed only the "issuers" of variable contracts to obtain relief for nondiversified segregated asset accounts. Rev. Proc. 2008-41 defines "issuer" (as do the other new remediation revenue procedures) to include not only the company that issues a contract, but also "a company that insures a contract

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holder under a contract originally issued by another company."[18] While there is not a great deal of coinsurance (or assumption reinsurance) of variable contracts, allowing a reinsurer to seek a closing agreement in its own name, rather than in the name of the company that originally issued the contracts, should simplify the closing agreement process in such cases.

Third, as was the case under Rev. Proc. 92-25, an issuer seeking relief for a diversification failure must file a request for a private letter ruling with the Service's National Office and pay the Service user fee for such a request (currently $11,500). Similar to the prior procedure, the ruling request must (a) identify the period(s) of nondiversification; (b) show that the error was inadvertent; (c) show that the investments were restored to diversified status within a reasonable time after the error was discovered; and (d) describe which of the methods allowed by Rev. Proc. 2008-41 to determine the toll charge was used.[19] In addition, the issuer must make the following representations and retain adequate documentation to support them:

(1) the issuer is within the scope of the revenue procedure, *i.e.*, it issued or reinsured the contracts and the failure was inadvertent;

(2) the issuer properly computed the toll charge; and

(3) the issuer has brought the contracts into compliance with Code section 817(h) and Treas. Reg. § 1.817-5(b).[20]

Fourth, the issuer must submit a proposed closing agreement, in triplicate, executed by the issuer using the model closing agreement in section 6 of Rev. Proc. 2008-41. (This differs from Rev. Proc. 92-25, which required an unexecuted closing agreement be submitted for Service review.) Representatives of the Service and the Treasury Department have made it clear that they anticipate allowing taxpayers to deviate from the model closing agreement only in rare and unusual circumstances.

Fifth, the issuer is required to pay the toll charge determined under section 4.04 of the revenue procedure to the Service within 60 days of the date the Service executes the closing agreement (Rev. Proc. 92-25 allowed only 30 days).

Sixth, as was the case under Rev. Proc. 92-25, the issuer must agree not to deduct the toll charge and not to increase the policyholders' investment in the contract (or premiums paid for purposes of section 7702) by (a) any portion of the toll charge, or (b) any portion of the amount of the aggregate income on the contracts.

Finally, in consideration of the issuer's undertakings, the Service will agree as follows:

(1) to treat the investments of the segregated asset account as adequately diversified during the period(s) of nondiversification;

(2) not to treat any portion of the toll charge paid as income to the policyholders;

(3) to treat the failures and any corrective actions as having no effect on the date the contracts were issued, entered into, or purchased for any tax purposes (*i.e.*, the correction will not upset grandfathers); and

(4) to waive civil penalties for failure of the issuer to satisfy reporting, withholding, or deposit requirements for income deemed received by the policyholders as a result of the error.

IV. Determination of Toll Charge

As indicated above, perhaps the most significant aspects of Rev. Proc. 2008-41 are the modifications it makes to the toll charge required to correct diversification failures. Like the other four insurance product correction procedures released in conjunction with Rev. Proc. 2008-41, the new diversification procedure retains the prior toll charge methodology (*i.e.*, the Rev. Proc. 92-25 Toll Charge). However, it also offers an alternative toll charge method, which in many cases will prove to be more attractive, and also establishes a dollar cap that limits the amount of the toll charge regardless of whether the traditional or alternative toll charge methodology is used.

The alternative toll charge is based on the degree of nondiversification and has been referred to colloquially as the "100% of the error" toll charge. This reference derives from the fact that the alternative toll charge equals "100 percent of the amount by which the [segregated asset] account's interest in a single investment exceeded the applicable limitation" of the diversification regulations.[21] For example, assume that the total value of a segregated asset account is $100. It could invest up to $55 in a single asset without exceeding the

55 percent limit of Treas. Reg. § 1.817-5(b)(1)(i)(A). Under these facts, if the diversification error resulted from a $56 investment in a single asset, the alternative toll charge would equal $1, *i.e.*, the excess of the actual investment over the permitted investment. Likewise, if the error resulted from a $56 investment in asset #1 and a $16 investment in asset #2, so that the combination of the two investments exceeded the 70 percent limit of Treas. Reg. § 1.817-5(b)(1)(i)(B) by $2, the toll charge would equal such $2 excess.

The alternative toll charge is determined as of the 30th day after the end of the calendar quarter of nondiversification. In response to public comments on an earlier draft of Rev. Proc. 2008-41, the procedure clarifies that if the nondiversification spans multiple calendar quarters the alternative toll charge is based on the quarter that produces the highest amount. This avoids a duplicative calculation that counts the same error more than once. In another departure from Rev. Proc. 92-25, deficiency interest is not required under the alternative toll charge, presumably because it is not a proxy for the tax the policyholders would owe if treated as having received the income on the affected contracts.

Both the traditional Rev. Proc. 92-25 Toll Charge and the new alternative toll charge are subject to a dollar cap under Rev. Proc. 2008-41. Specifically, the amount that an issuer is required to pay to correct a diversification failure is capped at the lesser of $5 million or 5 percent of the total value of the nondiversified segregated asset account.[22] Like the alternative toll charge, the dollar cap is determined as of the 30th day following the end of the calendar quarter and is based on the calendar quarter that produces the highest amount if the failure spans multiple quarters. The cap is not increased by deficiency interest, but if the error affects multiple segregated asset accounts the cap is determined separately for each account.

The dollar cap is a positive development in that it addresses one of the main criticisms of Rev. Proc. 92-25, namely, that the prior procedure could produce extremely large toll charges even for relatively minor diversification failures. Placing an upper limit on the toll charge, even at a $5 million level, is an improvement, especially when combined with the alternative toll charge methodology summarized above. However, the alternative toll charge does little to provide relief for inadvertent diversification failures that are caused by a loss of a Look-Through Entity's status as such.

As described above, the diversification regulations provide that a segregated asset account is treated as directly holding a Look-Through Entity's assets rather than holding shares of the Look-Through Entity. Most retail variable contracts are structured so that a segregated asset account invests exclusively in shares of a single Look-Through Entity, making this look-through treatment critical to a contract's compliance with the diversification rules. If the Look-Through Entity inadvertently loses its status as such (*e.g.*, by offering shares to a person who is not permitted to hold them),[23] the segregated asset account is treated as holding only a single investment (shares of the Look-Through Entity). In such case, the alternative toll charge seemingly would equal 45 percent of the total value of the Look-Through Entity's assets. The alternative toll charge would always exceed the "lesser of 5 percent or $5 million" cap, making the alternative toll charge meaningless in these cases. The insurance industry has asked the Service and the Treasury Department for published guidance that would prevent diversification failures in such circumstances if the issuer followed appropriate procedures to ensure that only permitted investors hold interests in a Look-Through Entity.[24] While they have not issued such guidance to date, the Service and Treasury Department recently indicated that they might consider doing so in the future.[25]

The cap is not increased by deficiency interest, but if the error affects multiple segregated asset accounts the cap is determined separately for each account.

V. Conclusion

Like the other insurance product remediation procedures issued in 2008, Rev. Proc. 2008-41 is a considerable improvement on the prior correction procedure. Most importantly, the alternative toll charge and dollar cap should make it easier and less costly for insurers to remediate the adverse consequences of inadvertent diversification failures.

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End Notes

1 A pension plan contract is defined in Code section 818(a).

2 Treas. Reg. § 1.817-5(b)(1)(i).

3 Treas. Reg. § 1.817-5(b)(1)(ii). Treas. Reg. § 1.817-5(b)(1)(ii) also provides that all interests in the same real property project and all interests in the same commodity are each treated as a single investment. Treas. Reg. § 1.817-5(h)(1) defines the term 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."

4 Treas. Reg. § 1.817-5(f). The other investors that are permitted to hold interests in a Look-Through Entity include life insurance company general accounts, investment managers, and trustees of qualified pension or retirement plans. Such interests are subject to certain requirements. *See* Treas. Reg. § 1.817-5(f)(3).

5 Code section 817(h)(3); Treas. Reg. § 1.817-5(b)(3). For purposes of this special rule for variable life insurance contracts. the term Treasury security is defined as "a security the direct obligor of which is the United States Treasury," which excludes instruments such as options on Treasury securities. Treas. Reg. § 1.817-5(h)(2).

6 A segregated asset account is defined in Treas. Reg. § 1.817-5(e) in somewhat oblique terms. As a practical matter, under the typical variable contract each investment option will constitute a segregated asset account within the meaning of this definition.

7 *See* Treas. Reg. § 1.817-5(a)(1). "Income on the contract" is computed using the rules of Code section 7702(g) and (h), appli cable to life insurance contracts that do not comply with the Code section 7702 definition of a life insurance contract. *Id.*

8 Treas. Reg. § 1.817-5(a)(2).

9 *See* Treas. Reg. § 1.817-5(a)(2)(iii) prior to amendment by T.D. 9385, 2008-15 I.R.B. 735.

10 The proxy tax rates were 20% for annuity contracts "from which payments have not been made as of the end of the period," 15% for annuity contracts "from which payments have been made as of the end of the period," and 28% for life insurance contracts.

11 *See supra* note 5 and accompanying text.

12 The proxy tax rates were 3.5%, 2.5%, or 1.5%, depending on the degree of over-investment in Treasury securities. Thus, the rates were significantly lower than the 20% and 15% proxy tax rates for annuities under Rev. Proc. 92-25.

13 Letter from Joseph F. McKeever, III, and Bryan W. Keene, on behalf of the Committee of Annuity Insurers, to the Internal Revenue Service (June 12, 2007).

14 Diversification Requirements for Variable Annuity, Endowment, and Life Insurance Contracts, 72 Fed. Reg. 41,651 (July 31, 2007).

15 *Id.* at 41,652.

16 T.D. 9385, 2008-15 I.R.B. 735.

17 Treas. Reg. § 1.817-5(a)(2)(i) and Rev. Proc. 2008-41, §§ 3, 4.01(2).

18 Rev. Proc. 2008-41, § 3.

19 Rev. Proc. 2008-41, § 4.01.

20 Rev. Proc. 2008-41, § 4.06. The representations must be executed under penalties of perjury by an appropriate party. *Id.* It is unclear whether the Service contemplates a separate, signed document making the representations, or whether incorporation of the representations into the request for ruling, which must under standard procedures be accompanied by an executed penalties of perjury statement, will suffice.

21 Rev. Proc. 2008-41, § 4.03(3).

22 Rev. Proc. 2008-41, § 4.03(4).

23 *See supra* note 4.

24 The Service has issued private guidance to this effect. *See, e.g.*, PLR 200730005 (April 27, 2007).

25 *See* T.D. 9385, 2008-15 I.R.B. 735, 737.