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IRS ISSUES RULING APPLYING DIVERSIFICATION RULES TO ILLIQUID FUNDS

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On March 1, 2013, the Internal Revenue Service ("IRS") released PLR 201309011, which addresses the application of the section 817(h) diversification requirements to variable contracts that have invested in illiquid investment vehicles (the "Funds"). The ruling concludes that a diversification failure will not occur as the Funds liquidate their holdings and distribute cash to their investors, even though the distributions will cause the relative values of the Funds' remaining assets to exceed the applicable asset concentration limits (*e.g.*, a single investment of a Fund might exceed 55 percent of the Fund's total value as a result of a distribution). The conclusion is based on Treas. Reg. section 1.817-5(d), which provides generally that a discrepancy with the concentration limits will not violate section 817(h) "unless such discrepancy exists immediately after the acquisition of any asset and such discrepancy is wholly or partly the result of such acquisition." To our knowledge, PLR 201309011 is the first ruling addressing this aspect of the regulations.

BACKGROUND ON SECTION 817(h)

Section 817(h)(1) generally provides 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.

A segregated asset account must meet these requirements at the end of each calendar quarter or within 30 days thereafter. With respect to new segregated asset accounts, the regulations provide a "start-up rule" under which the account is considered adequately diversified until its first anniversary. The regulations include a parallel rule with respect to a segregated asset account's "liquidation period," under which the account is considered adequately diversified for the one-year period beginning on the date a "plan of liquidation" is adopted (or a two-year period if the account is a real property account).

As described above, and pertinent to the new ruling, Treas. Reg. section 1.817-5(d) provides as follows:

> "*Market fluctuations.*—A segregated asset account that satisfies the [section 817(h) requirements] at the end of any calendar quarter … shall not be considered nondiversified in a subsequent quarter because of a discrepancy between the value of its assets and the diversification requirements *unless such discrepancy exists immediately after the acquisition of any asset and such discrepancy is wholly or partly the result of such acquisition.*" (Emphasis added.)

If a diversification error causes a variable contract to lose its status as an annuity or life insurance contract, then absent correction through a closing agreement with the IRS the loss of status is permanent, even if the segregated asset account is adequately diversified in subsequent calendar quarters. 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 gross income, *i.e.*, tax deferral on the inside build-up is lost.

FACTS

The taxpayer in PLR 201309011 is a foreign insurer that elected pursuant to section 953(d) to be treated as a domestic corporation for U.S. tax purposes. The taxpayer issues variable contracts based on "Separate Accounts." Each Separate Account invests all its assets in a corresponding Fund. Each Fund is an "insurance-dedicated" partnership, *i.e.*, it is a look-through entity under Treas. Reg. section 1.817-5(f) and therefore each Separate Account is treated as holding a proportionate share of its corresponding Fund's assets when

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applying the diversification test. The Funds invest primarily in other "Investment Vehicles," such as partnerships. The investment manager for the Funds also manages some of the underlying Investment Vehicles, but not others. The ruling refers to these as the "Affiliated Investment Vehicles" and the "Unaffiliated Investment Vehicles," respectively. The ruling does not state that the Investment Vehicles are insurance-dedicated, and it otherwise appears that they are not.

According to the ruling, the Investment Vehicles have suspended or restricted redemptions due to significant investment losses they have suffered in recent years, *i.e.*, they have become illiquid. In the case of the Unaffiliated Investment Vehicles, the redemption restrictions are beyond the Funds' control. In the case of the Affiliated Investment Vehicles, the same manager also manages the Funds, but the ruling notes that (1) the manager imposed the redemption restrictions on all investors in the Affiliated Investment Vehicles based entirely on non-tax considerations and in accordance with the manager's obligations under federal securities laws to protect all such investors, and (2) the Funds' interests in the Affiliated Investment Vehicles are *de minimis* compared to the ownership interests of the other investors.

The Funds themselves have received redemption requests, *e.g.,* as a result of variable contract owners exercising their contractual rights to reallocate cash values from the Funds to other investment options under the contracts. The Funds have been unable to meet these redemption requests due to the liquidity constraints being imposed by the underlying Investment Vehicles. This led the Funds' manager to exercise a right it possessed to suspend the Funds' obligations to fulfill such requests and initiate steps to redeem all the interests in the Funds pursuant to a "Proposed Transaction" described in the ruling.
Under the Proposed Transaction, each Fund will distribute cash to its investors (*e.g.,* the taxpayer life insurance company), including cash the Fund currently holds and cash it receives in the future from the Investment Vehicles and other Fund investments. The Funds will not use this cash to purchase other assets or increase their investments in any current holdings. The life insurance company will transfer the cash it receives in accordance with contract owners' instructions, *e.g.,* by reallocating the cash to other investment options under the contracts that are not based on the Funds. This process will continue until each Fund has redeemed all interests therein, which will occur as soon as reasonably practicable but is expected to take multiple calendar quarters.

As a result of the Proposed Transaction, the taxpayer life insurance company expects that a discrepancy may arise between each Fund's holdings and the section 817(h) diversification requirements. In particular, the ruling states that "[a] lthough neither Fund will increase or otherwise modify its non-cash holdings as part of the Proposed Transaction, each cash distribution a Fund makes will reduce its overall holdings such that the relative value of the Fund's remaining assets, expressed as a percentage of each Fund's reduced overall holdings, will increase."

EXAMPLE

The following example illustrates how a discrepancy could arise under the Proposed Transaction. Assume that, at the end of a calendar quarter, a Fund has the following assets with the following values that satisfy the percentage limitations under Treas. Reg. section 1.817-5(b):

Assets	Value (in $$)	Value (as %)	Combined % Value	817(h) Discrepancy?
Asset #1	$550	55%	largest asset = 55%	55% limit = No
Asset #2	$150	15%	top 2 assets = 70%	70% limit = No
Asset #3	$100	10%	top 3 assets = 80%	80% limit = No
Asset #4	$100	10%	top 4 assets = 90%	90% limit = No
Asset #5	$100	10%		
Total	$1,000	100%		

Now assume that the Fund receives a cash payment from Asset #5 that terminates its interest therein. At that point, the Fund has the following assets with the following values that satisfy the percentage limitations under Treas. Reg. section 1.817-5(b):

Assets	Value (in $$)	Value (as %)	Combined % Value	817(h) Discrepancy?
Asset #1	$550	55%	largest asset = 55%	55% limit = No
Asset #2	$150	15%	top 2 assets = 70%	70% limit = No
Asset #3	$100	10%	top 3 assets = 80%	80% limit = No
Asset #4	$100	10%	top 4 assets = 90%	90% limit = No
Cash	$100	10%		
Total	$1,000	100%		

Now assume that the Fund distributes the cash it received with respect to its prior Asset #5. If the value of the Fund's remaining assets does not change, a discrepancy will arise between the values of those assets and the percentage limits of Treas. Reg. section 1.817-5(b) at the end of the next calendar quarter, as follows:

Assets	Value (in $$)	Value (as %)	Combined % Value	817(h) Discrepancy?
Asset #1	$550	61%	largest asset = 61%	55% limit = Yes
Asset #2	$150	17%	top 2 assets = 78%	70% limit = Yes
Asset #3	$100	11%	top 3 assets = 89%	80% limit = Yes
Asset #4	$100	11%	top 4 assets = 100%	90% limit = Yes
Total	$900	100%		

As the foregoing example shows, a discrepancy with the asset concentration limits could arise merely because the Fund distributes cash to its investors. The taxpayer sought a ruling that any such discrepancy would not run afoul of section 817(h).

ANALYSIS AND CONCLUSION

The ruling summarizes the section 817(h) diversification requirements, and in particular cites to Treas. Reg. section 1.817-5(d). That regulation provides that a segregated asset account that satisfies the concentration limits as of the end of a calendar quarter will not be considered nondiversified in a subsequent quarter because of a discrepancy between the value of its assets and the concentration limits "unless such discrepancy exists immediately after the acquisition of any asset and such discrepancy is wholly or partly the result of such acquisition." The ruling provides the following gloss on the regulation:

> Treas. Reg. [section] 1.817-5(d) does not provide an exception to the diversification requirements of [section] 817(h). In the interests of sound tax administration, the regulation clarifies that neither holding assets in nor disposing [of] assets from a segregated asset account, which otherwise satisfied the diversification requirements at the end of the preceding calendar quarter (or within 30 days thereafter), does not give rise [sic] to a failure to meet the diversification requirements in a subsequent quarter.

The ruling then observes that, under the Proposed Transaction, neither Fund will increase or otherwise modify its non-cash holdings. As a result, (1) the anticipated discrepancies with the concentration limits "will result from the disposition [of the Funds' assets] and the related distributions to the contract-holders," and (2) "[n]o potential discrepancy will exist immediately after the acquisition of any asset [or] either wholly or partly as the result of the acquisition of any asset." Based on these observations and the facts summarized in the ruling, the IRS concludes that under Treas. Reg. section 1.817-5(d) neither Fund will fail the section 817(h) diversification requirements in the calendar quarter in which any discrepancy arises pursuant to the Proposed Transaction or in any subsequent calendar quarter.

OBSERVATIONS

The ruling addresses a difficult situation that some segregated asset accounts have faced in recent years in connection with illiquid investments—how to maintain section 817(h) diversification compliance during an extended liquidation process. As noted above, the regulations under section 817(h) also include a special "liquidation period" rule in Treas. Reg. section 1.817-5(c)(3). In general, the rule prescribes a safe harbor under which the diversification requirements do not apply at all during the specified period, allowing the account to continue acquiring assets, disposing of assets, exchanging assets, and otherwise operating without regard to the concentration limits, but only for a specified period after adopting a plan of liquidation. The ruling, in effect, would seem to facilitate a longer liquidation period by relying on the rule of

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Treas. Reg. section 1.817-5(d). To be eligible for that rule, however, the account cannot acquire any new assets, and instead must limit its activity to disposing of assets and distributing the resulting cash to investors.

The ruling's conclusion under Treas. Reg. section 1.817-5(d) appears consistent with a similar rule under the section 851 diversification requirements applicable to regulated investment companies ("RICs"). Under those requirements, a RIC that is diversified at quarter-end will not lose its RIC status because of a discrepancy with the applicable concentration limits "unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition." The regulations under section 851 provide an example where a discrepancy arises due to a RIC's distributions to its shareholders, concluding that the discrepancy does not cause the RIC to lose its tax status. The facts of the ruling appear consistent with this example, in that the discrepancy with the section 817(h) concentration limits would arise as the Funds make distributions to their investors, not as a result of the acquisition of any assets.

Although the ruling endorses a potentially useful method of ensuring diversification compliance in liquidations that are expected to extend beyond the normal "liquidation period" safe harbor, the ruling includes several statements that seem to warn taxpayers against extending its reasoning to potentially aggressive transactions. For example, the ruling carefully addresses the fact that the same person manages the Funds and the Affiliated Investment Vehicles, stating that any liquidity restrictions being imposed by the latter are based entirely on non-tax reasons, *i.e.,* without an intent to circumvent section 817(h).

Likewise, the ruling addresses the fact that, although the Funds themselves will not "acquire" any new assets—a fact that was critical to their ability to rely on Treas. Reg. section 1.817-5(d)—the underlying Investment Vehicles could acquire new assets. One could envision an attempt to seize upon this distinction by structuring an arrangement so that all acquisition activity occurs within a non-insurance-dedicated fund at the lower-tier fund level, without attribution of that activity to the segregated asset account and thereby facilitating indefinite reliance on Treas. Reg. section 1.817-5(d). The ruling, however, is careful to explain that any acquisition activity by the underlying Investment Vehicles will either (1) be beyond the control of the Funds' manager, or (2) occur in the normal course of managing and liquidating the Affiliated Investment Vehicles and be limited to situations where the manager determines that it is "in the best economic interests of all investors in the Affiliated Investment Vehicles to acquire an asset in order to protect or preserve the value of existing investments or to prevent or limit losses on existing investments."

In other words, the ruling appears to demonstrate the willingness of the IRS to allow taxpayers to utilize Treas. Reg. section 1.817-5(d) in a way that effectively facilitates liquidation periods longer than the safe harbor period otherwise available, at least in situations where no gaming of the rules is involved. In other situations, the IRS may have concerns with taxpayers who try to stretch this result too far.

END NOTES

1. The ruling was issued on November 29, 2012. As used herein, the word "section" means a section of the Internal Revenue Code of 1986, as amended, or the regulations thereunder (as applicable).
2. A variable contract is defined in section 817(d).
3. Treas. Reg. section 1.817-5(b)(1)(i).
4. Treas. Reg. section 1.817-5(a)(1). A segregated asset account is defined in Treas. Reg. section 1.817-5(e) in somewhat oblique terms. As a practical matter, under the typical variable contract each variable investment option will constitute a segregated asset account within the meaning of this definition.
5. Treas. Reg. section 1.817-5(c)(2)(i).
6. Treas. Reg. section 1.817-5(c)(3).
7. Treas. Reg. section 1.817-5(a)(1).
8. Treas. Reg. section 1.817-5(a)(1). "Income on the contract" is computed using the rules of section 7702(g) and (h), applicable to life insurance contracts that do not comply with the section 7702 definition of a life insurance contract. Id.
9. Treas. Reg. section 1.817-5(f) provides that, if certain requirements are met, a segregated asset account's interest in a regulated investment company, partnership, real estate investment trust, or grantor trust is not treated as a single investment of the segregated asset account, and instead the account is treated as directly holding the assets of the entity. In other words, the entity is "looked through" when applying the diversification test.
10. For simplicity, the example assumes that the "cash" is a single investment of the Fund for purposes of the section 817(h) requirements. In reality, the cash could represent multiple investments under the section 817(h) requirements, e.g., it could be treated in part as a security issued by one or more depository institutions and in part as a government security issued by the Federal Deposit Insurance Corporation. See Treas. Reg. section 1.817-5(h)(1)(ii).
11. Section 851(d)(1).
12. Treas. Reg. section 1.851-5, ex. 5.