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IRS Notice Helps Government Money Market Funds Satisfy Diversification Rules

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In 1989, the IRS and the Treasury Department issued final regulations under section 817(h),[1] prescribing minimum standards for diversification of the investments of insurers' separate accounts supporting nonqualified variable life insurance and annuity contracts. The purpose of both the statute and the implementing regulations, according the legislative history of the enactment, essentially was to bolster the "investor control" doctrine that the IRS had articulated in a series of revenue rulings.[2] While these regulations generally have stood the test of time, discrete changes have been made in them over the years,[3] and another such change was described in an IRS Notice issued last May. In Notice 2016-32,[4] the IRS announced that insurers' separate accounts or sub-accounts (technically, segregated asset accounts) that qualify as government money market funds (government MMFs) under SEC rules do not need to satisfy the diversification requirements in the section 817(h) regulations, as long as no policyholder has investor control over the account. More specifically, the Notice said that the regulations would be amended at some future date, but that pending such action, taxpayers could make use of the new, more favorable treatment for government MMFs by relying on the Notice itself. The Notice thus represents a quick and constructive reaction by the IRS to a change in the investment landscape affecting life insurers' variable products, demonstrating an IRS willingness to step in and help when relief is needed and warranted.

BACKGROUND

What prompted such a liberalization? It turns out that the source of the IRS action was a step taken by a companion government agency, the Securities and Exchange Commission (SEC). By way of background, in July 2014 the SEC adopted new regulations regarding money market mutual funds, requiring such funds to provide a floating net asset value (NAV) and to impose "fees and gates" in some circumstances.[5] Importantly, these new requirements do not apply to a government MMF, defined as a money market fund that invests 99.5 percent or more of its total assets in cash, government securities, or fully collateralized repurchase agreements. Not surprisingly, it is anticipated that the number of government MMFs will increase, perhaps substantially, thereby increasing demand for the types of government securities in which such funds invest. As the Notice gently puts it, "some MMFs are expected to convert to government MMFs, resulting in increased demand for government securities."

Variable life insurance and annuity contracts, of course, may be based on segregated asset accounts that either invest in money market funds or are themselves money market funds. In view of the SEC rule change, government MMFs may be preferable to the non-governmental variety as funding media for variable products, avoiding a floating NAV and side-stepping the possible difficulties of establishing fees and gates for money market funds supporting such products. That said, it is necessary for the separate account or sub-account supporting these products to comply with the section 817(h) regulations. Under those regulations, a segregated asset account must hold at least five investments in accordance with specified concentration limits, *e.g.*, no more than 55 percent of the value of the assets can be represented by a single investment. For purposes of those limits, moreover, all securities of the same issuer are treated as a single investment, although in the case of government securities section 817(h) itself treats each government agency or instrumentality as a separate issuer. Thus, for a segregated asset account that intends to invest solely in government securities, there must be securities of at least five government agencies or instrumentalities available in the financial markets.

The juxtaposition of the investment diversification requirements imposed by the section 817(h) regulations against the attractiveness of using government MMFs as the funding media for variable products posed a challenge. Given the anticipated increase in demand for government securities that are appropriate investments for money market funds and the relatively small number of government agencies that currently issue such securities, insurers issuing variable products and mutual fund companies providing the products' funding media were concerned that it may become difficult for an insurance-dedicated government MMF to satisfy the section 817(h) requirements in the future. To alleviate this situation, representatives of the life insurance industry and the mutual fund industry approached the IRS, requesting guidance that would provide special relief from the section 817(h) requirements for insurance-dedicated government MMFs.

THE NOTICE

Happily, the IRS responded to the joint industries' request by issuing Notice 2016-32, announcing that the Treasury Department and the IRS intend to amend the section 817(h) regulations because "variable contracts should be able to offer government MMFs as an investment option." Even more helpful, the Notice

went on to state that "[p]ending the promulgation and effective date of future administrative or regulatory guidance," taxpayers can rely on an "alternative" diversification test set forth in the Notice. According to this alternative test, a segregated asset account will be treated as adequately diversified for purposes of section 817(h) if (1) no policyholder has investor control, and (2) either (a) the segregated asset account itself is a government MMF under the applicable SEC rules or (b) the segregated asset account invests all of its assets in an insurance-dedicated "investment company, partnership, or trust" as defined in Treas. Reg. section 1.817-5(f)(1) that qualifies as a government MMF under the SEC's rules.

The Notice's requirement that no policyholder has "investor control" is a reference to the investor control doctrine that is described in the IRS's rulings and that motivated the enactment of section 817(h) in the first place. The investor control doctrine holds that the owner of a variable contract is the taxpayer on the income and gains of the underlying separate account's assets if the contract owner directly or indirectly controls the investment decisions with respect to those assets. The investment diversification requirements imposed by the section 817(h) regulations are premised on the notion that any such control is defeated, or at least materially dampened, where the separate account (or sub-account) must invest in a multiplicity of assets from different issuers.[6]

In particular, the diversification requirements rendered it impossible for a variable contract to be based on a single, publicly available mutual fund, which was the point of the IRS's ruling, Rev. Rul. 81-225, that Congress effectively blessed in the section 817(h) enactment. But as the preamble to the regulations made explicit, the diversification requirements do not fully occupy the investor control field. The doctrine of investor control remains alive and well separately from the regulations, a proposition the IRS has asserted in a number of rulings and that the Tax Court seconded in a recent decision of note.[7] In issuing the Notice, the IRS apparently wanted to clarify that while it was not concerned with having multiple government agency issuers, adherence to the investor control doctrine remained essential.

Presumably, however, the mere fact that a government MMF holds fewer assets than the regulations currently require (including, perhaps, holding only a single asset) will not, by itself, violate the investor control doctrine in the case of a government MMF, because otherwise the Notice's intended relief would be defeated. Thus, the Notice's proviso that "[n]o policyholder has investor control" was likely intended to mean no actual, direct control over the government MMF's investment activity, rather than the type of indirect control addressed in Rev. Rul. 81-225 that arises when a segregated asset account is based on a single investment. In other words, investment discretion for a government MMF must remain in the hands of the fund's investment manager rather than the policyholder in order for the Notice to apply.

Notice 2016-32 also referred to a segregated asset account that "itself is a government MMF" and to a segregated asset account that "invests all of its assets in an insurance-dedicated 'investment company, partnership, or trust'" that qualifies as a government MMF. The first of these references is directed at so-called "managed account" structures, such as where a sub-account of the insurer's separate account invests directly in individual government securities and the account qualifies as a government MMF under the SEC's rules. The second reference is directed at the prevalent structure in the retail variable insurance market, where a sub-account of the insurer's separate account invests in a single insurance-dedicated regulated investment company that, in turn, qualifies as a government MMF.[8]

THE EXTENT OF RELIEF, WITH A CONCLUDING THOUGHT

While the Notice thus represents a significant and helpful step forward, it is important to note the limits of the alternative rule

it announces. The new rule does not extend to so-called fund-of-funds structures, where a sub-account invests in an insurance-dedicated fund that, in turn, invests in a portfolio of lower-tier funds that includes an insurance-dedicated government MMF. In addition, the new rule does not extend to segregated asset accounts in which an insurance-dedicated government MMF is only one of several investments the account holds. Hopefully these limitations will not pose a problem, since these types of structures involve multiple investments in addition to government MMFs. Hence, the investment manager likely would be able to manage the assets in a way that would comply with the existing section 817(h) diversification requirements.

Regardless of any such limits on the reach of the Notice's relief, the existence of the Notice demonstrates the IRS's willingness to steer a practical course and react constructively to changes in the investment landscape affecting life insurers' variable products. Thus, when one contemplates "whence cometh our help," one typically does not look first to the IRS, but where relief is warranted, the Notice shows that the IRS should not be overlooked. ■

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ENDNOTES

1 Unless otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the Code). The regulations appear as Treas. Reg. section 1.817-5, promulgated in T.D. 8242, 1989-1 C.B. 215.

2 *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369 § 211(a) (1984) (adding section 817(h) to the Code); H.R. Conf. Rep. No. 98-861, at 1055 (1984) (providing legislative history on the purpose of section 817(h)). The investor control doctrine is addressed in Rev. Rul. 2003-92, 2003-2 C.B. 350, clarified and amplified by Rev. Rul. 2007-7, 2007-1 C.B. 468; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 82-55, 1982-1 C.B. 12; Rev. Rul. 81-225, 1981-2 C.B. 12, clarified and amplified by Rev. Rul. 2007-7, 2007-1 C.B. 468, and Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 80-274, 1980-2 C.B. 27; and Rev. Rul. 77-85, 1977-1 C.B. 12. *See also* Webber v. Commissioner, 144 T.C. No. 17 (June 30, 2015); Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984).

3 *See* T.D. 9185, 2005-1 C.B. 749 (revoking former Treas. Reg. section 1.817-5(f)(2)(ii) regarding look-through treatment for "nonregistered" partnerships); T.D. 9385, 2008-1 C.B. 735 (amending the regulations to address the remedy for inadvertent failures to comply with the diversification requirements and to expand the list of "permitted investors" under the look-through rules of Treas. Reg. section 1.817-5(f)(3)).

4 2016-21 I.R.B. 878.

5 *See* SEC Release No. 33-9616, IA-3879, IC-31166, Money Market Fund Reform; Amendments to Form PF, July 23, 2014.

6 *See* H.R. Conf. Rep. No. 98-861, at 1055 (1984) (stating that Congress intended the section 817(h) regulations to be "designed to deny annuity or life insurance treatment for investments that are publicly available to investors and investments which are made, in effect, at the direction of the investor. Thus, annuity or life insurance treatment would be denied to variable contracts (1) that are equivalent to investments in one or a relatively small number of particular assets (*e.g.*, stocks, bonds, or certificates of deposits of a single issuer); [or] (2) that invest in one or a relatively small number of publicly available mutual funds….").

7 *See*, *e.g.*, Rev. Rul. 2003-92, 2003-2 C.B. 350, clarified and amplified by Rev. Rul. 2007-7, 2007-1 C.B. 468. *See also* Webber v. Commissioner, 144 T.C. No. 17 (June 30, 2015).

8 "Insurance-dedicated" means that, except as otherwise permitted in the regulations, (1) all beneficial interests in the regulated investment company are held by segregated asset accounts of insurance companies and (2) public access to the regulated investment company is available exclusively through the purchase of a variable contract. *See* Treas. Reg. section 1.817-5(f)(2)(i). Being insurance-dedicated allows the segregated asset account to "look through" the regulated investment company when applying the diversification test, rather than applying the test by treating the interest in the regulated investment company itself as a single asset of the account. *See* Treas. Reg. section 1.817-5(f)(1).