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Planning Ahead: Revenue Procedure Could Help Separate Accounts Comply With Section 817(h) When Investing in a New Type of Mortgage-Backed Securities

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Last October, the IRS issued Revenue Procedure 2018-54,[1] addressing the treatment of certain new residential mortgage-backed securities (MBS) under the section 817(h)[2] investment diversification requirements. Life insurance companies have traditionally been major investors in mortgage instruments, including the MBS issued by the Federal National Mortgage Association (Fannie Mae) and similar securities issued by the Federal Home Loan Mortgage Corporation (Freddie Mac), and so the IRS's focus on such investments by life insurers is not surprising.[3] Indeed, after the enactment of section 817(h) in 1984, authorizing regulations prescribing minimum standards for diversification of the investments of insurers' separate accounts supporting nonqualified variable annuity and life insurance contracts, the statute was amended in 1988 to make clear that each U.S. government agency or instrumentality was to be treated as a "separate issuer" of securities under those regulations.[4] The specific purpose of the amendment, which overturned a rule in proposed regulations, was to enable insurers to satisfy the diversification requirements when their separate account portfolios consist primarily of Fannie Mae, Freddie Mac and other government agency securities, such as in a government bond fund.[5]

Under the section 817(h) regulations, the investments of a life insurer's separate account or subaccount—technically a "segregated asset account," in the terminology of the regulations—must meet a minimum diversification standard in order for the holder of a nonqualified variable annuity or life insurance contract based on that account to receive the normal income tax treatment accorded to such a contract. That standard generally requires that no more than 55 percent of the account's investments be attributable to any one "issuer," no more than 70 percent to any two issuers, and so on.[6] Hence, to apply this standard, an insurer must be able to identify the issuer of the securities in which its separate account invests. As explained below, in the case of certain derivatives (specifically, forward contracts) involving a new type of Fannie Mae and Freddie Mac security that is being developed, the issuer of the securities ultimately delivered in the transaction could be either of those entities. This new guidance attempts to address the temporary uncertainty over who will be the issuer of the delivered securities, which could have presented some planning difficulties for investment managers responsible for diversification compliance.

THE PROBLEM AND THE SOLUTION, IN BRIEF

Under the direction of the Federal Housing Finance Agency (FHFA), Fannie Mae and Freddie Mac have been working on a "Single Security Initiative" that will conform the terms of the mortgage-backed securities they issue. Prior to this initiative, Fannie Mae and Freddie Mac had issued MBS with terms specific to each, and one goal of the initiative is to make Fannie Mae and Freddie Mac MBS fungible on a forward market for such securities, known as the "To-Be-Announced" or "TBA" market, to enhance liquidity for loan originations and to reduce borrowing costs for home buyers. Once the initiative is launched on June 3, 2019, investors will be able to enter into forward contracts to purchase these securities—called "Uniform Mortgage-Backed Securities" or "UMBS"—without specifying Fannie Mae or Freddie Mac as the issuer.[7] Thus, the securities actually delivered under TBA contracts for UMBS could be issued by Fannie Mae, Freddie Mac or a combination thereof. Hence, the issuer(s) of the UMBS to be delivered to an insurer's separate account under TBA contracts for the UMBS will not be known until close in time to their delivery, presenting a potential challenge where compliance with the diversification requirements is concerned.[8]

This difficulty was called to the attention of the Treasury Department and the IRS early in 2018, prompting the IRS's issuance of Revenue Procedure 2018-54 on Oct. 16, 2018. In brief, Revenue Procedure 2018-54 addresses this issue by allowing a life insurance company, or an "insurance-dedicated fund" (IDF)[9] in which the insurer's separate account invests, to elect up-front to treat the securities that will be delivered under TBA contracts in UMBS transactions as being issued proportionally by Fannie Mae and Freddie Mac for section 817(h) diversification testing purposes. The proportion to be used in the testing will be published annually by the FHFA, based on historical data and expressed as a ratio, and the ratio that applies when the TBA contract is entered into will remain constant for all securities delivered under that contract.

DETAIL ON THE NEW GUIDANCE

Let's look further at the details of this new election and its consequences.

The New Election

Under Revenue Procedure 2018-54, the proportional assumption as to the UMBS issuers applies if a "taxpayer" makes a "deemed-issuance-ratio" election with respect to its "generic GSE [government sponsored enterprise] securities." For this purpose, a "taxpayer" is defined as "(1) An insurance company that issues variable contracts within the meaning of § 817(d); and (2) An investment company, partnership, or trust . . . that qualifies for 'look-through' treatment under § 1.817-5(f)."[10] The taxpayer involved must file the election with its tax return for the first taxable year in which it wants the election to apply, adhering to the election form requirements spelled out in the revenue procedure,[11] and the election will continue to apply to all subsequent years unless the IRS agrees to a revocation request through a private letter ruling.[12] If the taxpayer joins in the filing of a consolidated return, the entity filing the return must specify which member or members of the group are making the election.[13]

The definition of "taxpayer" presents some ambiguity under these circumstances because both the insurance company and the IDF are treated as "taxpayers" that could potentially make conflicting elections. For example, consider an IDF that offers access to the fund through multiple insurance companies. The IDF may make an election under the revenue procedure, while an insurance company with separate accounts invested in the fund does not. Under these circumstances, which election controls? How are the diversification rules applied? Alternatively, if an IDF declines to make an election, can the insurance company effectively force the IDF's hand by making the election itself?

Securities Covered by the Election

A generic GSE security that can be covered by the election is defined in Revenue Procedure 2018-54 as (1) a security issued by Fannie Mae or Freddie Mac; (2) which is eligible for purchase in the TBA market; (3) which the buyer acquires through a TBA contract (or, if certain conditions are met, the buyer acquires through an assignment of a TBA contract before the parties know the identities of the actual issuers or acquires through a corporate acquisition); and (4) as to which the buyer has "no way of knowing the actual issuer(s) of the securities to be delivered under the contract" at the time the contract is entered into.[14] The revenue procedure's definition generally describes a so-called "unstipulated" trade of a UMBS on the TBA market, but the procedure expressly excludes "stipulated" trades and similar transactions where the issuer of the securities to be delivered is known in advance.[15]

Treatment of Securities Covered by the Election

Based on this election, a generic GSE security is deemed for section 817(h) purposes to be issued in part by Fannie Mae and in part by Freddie Mac, regardless of which one actually issued the securities delivered under the TBA contract. This treatment applies to generic GSE securities held directly by a segregated asset account and those held indirectly through an IDF.[16] The "deemed-issuance ratio" that applies when the TBA contract is entered into (more on this below) determines the portions deemed to be issued by Fannie Mae and Freddie Mac;[17] this ratio continues to apply thereafter to all securities delivered under that TBA contract for as long as the separate account (or IDF) holds them.[18] Electing taxpayers presumably will need to track the deemed issuers of the generic GSE securities delivered under different TBA contracts using different deemed-issuance ratios and differentiate those from other securities issued by Fannie Mae or Freddie Mac that the new guidance does not cover. This may prove to be no easy task.

Determination of the Deemed-Issuance Ratio

The deemed-issuance ratio is to be published by the FHFA at least three weeks before the start of each calendar year. The revenue procedure recites that the FHFA will determine the 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 Oct. 31 immediately preceding the year in which the new ratio will apply, subject to certain rounding rules.[19]

Effective Date of the Guidance

The guidance provided by Revenue Procedure 2018-54 "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" (*i.e.*, TBA contracts issued under the UMBS initiative).[20] The quarter-end date is referenced because the section 817(h) diversification testing is performed at the end of each calendar quarter. The UMBS initiative is expected to go live on June 3, 2019.[21]

CONCLUDING THOUGHTS

The TBA market, as noted, serves to provide liquidity for loan originations and help lower borrowing costs; and in issuing the revenue procedure, the Treasury and the IRS recognize the important role the insurance industry plays in the TBA market. Many companies, however, are still evaluating whether they will make the election, given the administrative complexity in doing so. And as with other guidance, some questions are still left open. For example, does an insurance company's election affect the securities it is treated as holding through an IDF or just the securities it holds directly, such as through a managed account? Also, while the revenue procedure clearly addresses the treatment of UMBS assets once they are actually delivered pursuant to a TBA contract, it does not discuss the treatment of the TBA contract itself prior to delivery of the referenced securities.

In that regard, it is not entirely clear who the "issuer" of an outstanding forward contract or similar derivative is for purposes of section 817(h). For example, it could be the counterparty to the derivative contract, or it could be the entity that issued (or will issue) the underlying security the derivative references.[22] Revenue Procedure 2018-54 does not shed any additional light on this question, at least directly. However, if a taxpayer determines generally that for purposes of section 817(h) it is appropriate to treat an unsettled forward contract as issued by the issuer of the referenced security and the taxpayer has made an election under the revenue procedure with respect to the UMBS that will be delivered under its TBA contracts, then perhaps the taxpayer could apply the deemed-issuance-ratio treatment to those TBA contracts even while they remain unsettled. Again, the guidance does not expressly provide for such treatment. As a result, further clarification may be needed. As is often the case, guidance could beget more requests for guidance. ■

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ENDNOTES

1 2018-45 I.R.B. 769.

2 Unless otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the Code).

3 The mortgage-backed securities that Freddie Mac issues are called "participation certificates" rather than "mortgage-backed securities." For ease of discussion, we refer to both as "MBS" throughout this article.

4 *See* I.R.C. section 817(h)(6). The regulations appear as Treas. Reg. section 1.817-5, promulgated in T.D. 8242, 1989-1 C.B. 215. The purpose of both the statute and the implementing regulations, according to 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. *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 77-85, 1977-1 C.B. 12. *See also* Webber v. Commissioner, 144 T.C. 324 (2015); Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984).

5 H. Rep. No. 100-1104, at 176 (Conf. Rep.). Regulated investment companies (mutual funds) are subject to similar diversification requirements as variable contracts. However, the mutual fund rules allow for unlimited investments in government securities, whereas the variable contract rules subject government securities to the same diversification standards as other types of securities (albeit with the special rule described that treats each agency or instrumentality as a separate issuer). *See generally* section 851(b)(3).

6 Technically, the diversification rules impose percentage limits on a segregated asset account's "investments." For this purpose, however, the regulations provide that "[a]ll securities of the same issuer . . . are each treated as a single investment." Thus, the limits effectively apply to "issuers." *See* Treas. Reg. section 1.817-5(b)(1)(i) and (ii).

7 Freddie Mac, Single Security and the Common Securitization Platform (CSP), available at *http://www.freddiemac.com/mbs/single-security/#overview*.

8 The diversification test must be met only on the last day of each calendar quarter, and if it is not met on that day the manager has the next 30 days to comply. *See* Treas. Reg. section 1.817-5(c)(1). Thus, one would think that if the securities delivered in a TBA transaction cause a diversification problem, the manager would have plenty of time to address it. We understand that one concern with such an approach is that it would require the manager to liquidate or exchange the delivered securities for those of another issuer (for example, Fannie Mae for Freddie Mac), which could involve transaction costs and frustrate the FHFA's goals under the Single Security Initiative to enhance liquidity for loan originations and to reduce borrowing costs for home buyers.

9 The diversification test is applied by looking through any IDF in which a segregated asset account invests and treating the IDF's assets as held by the account. An IDF is a regulated investment company, real estate investment trust, partnership or grantor trust in which all beneficial interests are held by one or more segregated asset accounts and to which public access is available only through the purchase of a variable contract (with certain exceptions).

10 Section 3.01 of Rev. Proc. 2018-54 (sections of the procedure are hereinafter abbreviated as "RP sec.").

11 RP sec. 7.01.

12 RP sec. 7.02 and 7.03.

13 RP sec. 7.01.

14 RP sec. 3.03 and 3.04.

15 RP sec. 3.05.

16 RP sec. 6.01.

17 RP sec. 6.02.

18 RP sec. 6.03. Special rules apply if a generic GSE security is part of a "resecuritization program" that results in new securities being issued. RP sec. 6.04.

19 RP sec. 6.05.

20 RP sec. 8.

21 *See supra* note 7 and accompanying text.

22 *Compare* Rev. Rul. 83-69, 1983-1 C.B. 126 (treating publicly traded call options as "issued" by the issuer of the underlying security, not the counterparty, for purposes of the mutual fund diversification rules in section 851(b)(3)) and Treas. Reg. section 1.817-5(h)(2) (defining "Treasury security" for certain purposes of the variable contract diversification rules under section 817(h) as excluding put and call options on such securities). Apart from the foregoing regulation, we are not aware of any guidance directly addressing the treatment of derivatives for purposes of section 817(h). *See also* PLR 9125038 (Mar. 27, 1991; treating the counterparty as the issue of a repurchase agreement for purposes of section 817(h).