Closing Agreements Concerning Variable Annuity Contracts

Notice 2000–9

PURPOSE

This notice reminds issuers of variable annuity contracts that the special rules of § 817(h)(3) of the Internal Revenue Code and § 1.817–5(h)(3) of the Income Tax Regulations do not apply in determining whether the investments of a segregated asset account with respect to those contracts are adequately diversified for purposes of § 817(h). For a limited period of time, this notice also permits issuers of failed variable annuity contracts based on one or more accounts that would have satisfied the special rules for accounts with respect to variable life insurance contracts to obtain the relief described in § 1.817–5(a)(2) through a reduced payment amount.

BACKGROUND

Section 817(h) of the Code provides that a variable contract (other than a pension plan contract) based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract if the investments made by the account are not adequately diversified in accordance with regulations prescribed by the Secretary. Section 1.817–5(a)(1) of the regulations provides generally that a variable contract is not treated as an annuity, endowment, or life insurance contract for any calendar quarter period in which the investments of an account on which the contract is based are not adequately diversified. Thus, any income on the contract within the meaning of § 7702(g) is treated as ordinary income received or accrued by the contract holder during that period and any subsequent period.

Under § 1.817–5(b)(1), the investments of a segregated asset account are considered adequately diversified for purposes of § 817(h) only if–

(1) No more than 55% of the value of the total assets of the account is represented by any one investment;

(2) No more than 70% of the value of the total assets of the account is represented by

any two investments;

(3) No more than 80% of the value of the total assets of the account is represented by any three investments; and

(4) No more than 90% of the value of the total assets of the account is represented by any four investments.

In addition, § 817(h)(2) and § 1.817–5(b)(2) provide a safe harbor under which the investments of a segregated asset account are considered adequately diversified if the account meets the requirements of § 851(b)(3), and no more than 55% of the value of the total assets of the account is attributable to cash, cash items, government securities, and securities of other regulated investment companies. For purposes of testing diversification, all securities of the same issuer are treated as a single investment, and each government agency or instrumentality is treated as a separate issuer. *See* § 1.817–5(b)(1)(ii).

Under § 817(h)(3), the investments made by a segregated asset account with respect to a variable life insurance contract are treated as adequately diversified to the extent the account is invested in securities issued by the United States Treasury. Section 1.817–5(b)(3) provides alternative diversification requirements for a segregated asset account invested in United States Treasury securities. Both § 817(h)(3) and § 1.817–5(b)(3) apply only to segregated asset accounts with respect to variable life insurance contracts; neither applies to such accounts with respect to variable annuity contracts.

Under § 1.817–5(a)(2), the investments of an inadequately diversified segregated asset account are nevertheless treated as diversified if three requirements are satisfied. First, the issuer or holder of a variable contract based on the account must show that the failure to satisfy the diversification requirements was inadvertent. Section 1.817–5(a)(2)(i). Second, the account must satisfy the diversification requirements within a reasonable time after discovery of such failure. Section 1.817–5(a)(2)(ii). Third, the issuer or holder of the variable contract must agree to make such adjustments or pay such amounts as may be required by the Commissioner with respect to the period or periods during which the investments of the account were not diversified. The amount required to be paid by the Commissioner shall be based upon the tax that would have been owed by the contract holders if they were treated as receiving the income on the contract for the periods during which one or more accounts were not adequately diversified. Section 1.817–5(a)(2)(iii).

Rev. Rul. 91–17, 1991–1 C.B. 190, provides that if a variable contract does not satisfy the diversification requirements set forth in regulations under § 817(h), then the income on such contract is a nonperiodic distribution under what is now § 3405(e)(3). Thus, the insurance company is subject to certain recordkeeping, reporting, withholding and deposit obligations under §§ 3402, 3403, 3405, 6047, 6302 and 7501. In addition, if the company's failure to meet those obligations is not due to reasonable cause, the company could be subject to the penalties described in §§ 6651, 6652(e), 6652(h), 6656(a) and 6704.

Section 7121 authorizes the Secretary to enter into closing agreements relating to the internal revenue tax liability of a person. Rev. Proc. 92–25, 1992–1 C.B. 741, provides the procedure by which the issuer of a variable contract that fails to satisfy the requirements of § 817(h) may request the relief described in § 1.817–5(a)(2) of the regulations. That relief is in the form of a closing agreement pursuant to which the Internal Revenue Service and the issuer agree to treat the assets of the nondiversified account as adequately diversified for purposes of § 817(h) for the period or periods of nondiversification. For periods in which the highest rate specified in § 1 of the Code is no greater than 31 percent, the amount due from the issuer of a variable annuity contract under the closing agreement is the sum of–

(1) 20% of income on annuity contracts from which payments have not been made as of the end of the period; plus

(2) 15% of income on annuity contracts from which payments have been made as of the end of the period; plus

(3) any interest computed under § 6621(a)(2) of the Code as if the amounts computed under (1) and (2) were underpayments by the contract holders for their tax year(s) containing the period(s) of nondiversification.

The amount due from the issuer of a variable life insurance or endowment contract is the sum of–

(1) 28% of the income on the contracts; plus

(2) any interest computed under § 6621(a)(2) of the Code as if the amounts computed under (1) were underpayments by the contract holders for their tax year(s) containing the period(s) of nondiversification.

The Service has continued to exercise its authority under § 7121 and § 1.817–5(a)(2) to enter into closing agreements using these rates, even though the highest rate specified in § 1 now is greater than 31 percent. Except as provided below, it will do so until further notice.

The Service has become aware of situations in which segregated asset accounts with respect to variable annuity contracts satisfied the special rules of § 817(h)(3) and § 1.817–5(b)(3) that apply to accounts underlying variable life insurance contracts, but did not satisfy the general diversification requirements of § 1.817–5(b)(1) or (2).

SCOPE

This notice applies to any issuer of a variable annuity contract seeking relief under § 1.817–5(a)(2) of the regulations, if that contract failed to satisfy the diversification requirements of § 817(h) solely by reason of one or more inadequately diversified segregated asset accounts that would have satisfied the requirements of § 817(h)(3) and § 1.817–5(b)(3) if the contract been a variable life insurance contract.

PROCEDURE

An issuer requesting relief under this notice shall request a closing agreement under the terms and conditions of Rev. Proc. 92–25. In computing the amount due under the closing agreement, however, the following rates shall be substituted for the 20% and 15% rates provided in § 4.02(1)(A) and (B) of that procedure:

(1) 3.5%, if not more than 75% of the value of the

total assets of the account is represented by Treasury securities for the period or periods of nondiversification;

(2) 2.5%, if more than 75% but not more than 90% of the value of the total assets of the account is represented by Treasury securities for the period or periods of nondiversification; and

(3) 1.5%, if more than 90% of the value of the total assets of the account is represented by Treasury securities for the period or periods of nondiversification.

If a contract is based on more than one nondiversified segregated asset account, the rate shall be determined based on the account with the lowest percentage investment in Treasury securities. Likewise, if the segregated asset account(s) failed the requirements of § 1.817–5(b)(1) or (2) for more than one calendar quarter, the rate for all quarters shall be determined based on the quarter in which the account had the lowest percentage investment in Treasury securities.

EFFECTIVE DATE

This notice is effective January 13, 2000, the date this notice was made available to the public.

EXPIRATION DATE

This notice applies only to requests for closing agreement relief that are received on or before August 1, 2000. Requests received after that date must meet all of the requirements, including the payment amounts, set forth in Rev. Proc. 92–25.

DRAFTING INFORMATION

The principal author of this notice is Gary Geisler of the Office of the Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Mr. Geisler on (202) 622-3970 (not a toll-free call).

Comments on Items for Year 2000 Published Guidance Priority List

Notice 2000–10

The Department of Treasury and Internal Revenue Service request public comment about items that should be included in the Guidance Priority List for 2000.

IRS and Treasury's Office of Tax Policy use the Guidance Priority List (GPL) each year to identify and prioritize the tax issues that should be addressed through regulations, rulings, and other published administrative guidance. Public input is invited as part of the process of formulating the GPL to ensure that the agency's resources focus on the guidance items that are most important to taxpayers and tax administration.

No particular format is required for comments submitted in response to this Notice. However, it will be helpful for comments both to briefly describe the item that is recommended for inclusion on the GPL and to explain why there is a need for guidance. In addition, comments may present an analysis of how the issue should be resolved.

Please submit all comments by February 14, 2000. Written comments should be sent to:

Internal Revenue Service
Attn: CC:DOM:CORP:R
(Notice 2000–10)
Room 5228
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand delivered between the hours of 8 a.m. and 5 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:DOM:CORP:R
(Notice 2000–10)
Room 5228
1111 Constitution Avenue, N.W.
Washington, D.C.

Alternatively, comments may be submitted electronically via e-mail to the following address:

Sharon.Y.Horn@M1.IRSCOUNSEL.TREAS.GOV

All comments will be available for public inspection and copying in their entirety.

For further information regarding this notice, contact David Schneider of the Office of Assistant Chief Counsel (Income Tax and Accounting) at (202) 622-4890 (not a toll-free call).