

**MEMO# 31439**

October 17, 2018

# **IRS Issues Guidance on Section 817(h) Diversification Requirement and Single Security Initiative**

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October 17, 2018 TO: ICI Members

Tax Committee SUBJECTS: Tax RE: IRS Issues Guidance on Section 817(h) Diversification Requirement and Single Security Initiative

The Internal Revenue Service (IRS) has issued guidance addressing the diversification requirements under section 817(h) as applied to a new common mortgage-backed security, referred to as the Single Security Initiative. [Revenue Procedure 2018-54](#) allows taxpayers that hold investments in one or more segregated asset accounts on which variable contracts are based to elect to treat these new Uniform Mortgage Backed Securities (UMBS) as having deemed issuers for purposes of section 817(h).

## **Background**

Pursuant to the Single Security Initiative and under the direction of the Federal Housing Finance Agency (FHFA), the Federal Home Loan Mortgage Corporation (Freddie Mac) will align key features of its securities with those of the Federal National Mortgage Association (Fannie Mae, and together with Freddie Mac, the GSEs) to create the new UMBS. The UMBS then will be issued by both GSEs with substantially similar terms and will trade primarily in the “To-Be-Announced” (TBA) market. Once the UMBS begin trading, investors that acquire UMBS in TBA trades generally will not know the issuer of the security to be delivered until 48 hours prior to settlement. This uncertainty raises the possibility that a segregated asset account could fail the diversification requirements under section 817(h).

## **In General**

Rev. Proc. 2018-54 provides an election to certain taxpayers permitting them to deem “generic GSE securities” as issued in part by Freddie Mac and in part by Fannie Mae, pursuant to a “deemed issuance ratio” determined by the FHFA annually. The portions deemed issued by each are determined by the deemed issuance ratio applicable to the year in which the taxpayer entered into the TBA contract under which the generic GSE security was to be delivered. The deemed issuance ratio continues to apply for purposes of section 817(h) regardless of the actual issuer of the generic GSE securities that are delivered, for as long as the electing taxpayer holds the generic GSE security. The deemed-issuance ratio also remains constant, even as the generic GSE securities pay down

and if the taxpayer disposes of some of its generic GSE securities.

The revenue procedure will apply to the extent that (1) an electing taxpayer holds generic GSE securities in a segregated asset account on which a variable contract issued by the taxpayer is based; or (2) the electing taxpayer's generic GSE securities are treated under Treas. Reg. § 1.817-5(f) as being held in a segregated asset account on which a variable contract issued by some other person is based.

A "taxpayer" for this purpose is (1) an insurance company that issues variable contracts within the meaning of section 817(d), and (2) an investment company, partnership, or trust that qualifies for "look-through" treatment under Treas. Reg. § 1.817-5(f). A "generic GSE security" is a TBA-eligible security that a buyer acquires by taking delivery pursuant to a TBA trade in which, at the time the buyer enters into the contract, the buyer cannot know the actual issuer of the securities to be delivered under the contract.

### **Deemed Issuance Ratio**

The FHFA will determine and publicize the deemed issuance ratio at least three weeks prior to the start of each calendar year. It will determine the ratio based on the ratio of TBA-eligible securities issued by Fannie Mae and Freddie Mac during a 24-month period ending not earlier than October 31 immediately preceding the year to which the new ratio will apply. The ratio must be two whole numbers; the FHFA is permitted to round this observed ratio to whatever extent it considers appropriate.

For example, to determine the deemed issuance ratio for 2019, the FHFA could look at the ratio of TBA-eligible securities issued by Fannie Mae and Freddie Mac during the 24-month period ending on October 31, 2018. If the ratio of TBA-eligible securities for this period is 59 percent Freddie Mac and 41 percent Fannie Mae, then the FHFA may determine that the deemed issuance ratio for 2019 is 60 percent Freddie Mac and 40 percent Fannie Mae. Thus, a taxpayer who makes the election to use the deemed issuance ratio would treat any generic GSE securities that it holds as 60 percent issued by Freddie Mac and 40 percent issued by Fannie Mae for section 817(h) diversification purposes.

### **Deemed-Issuance-Ratio Election**

A taxpayer makes the election to use the deemed issuance ratio by attaching a statement to the taxpayer's income tax return for the first taxable year for which the taxpayer wants the election to apply. The statement must be titled, "Section 817(h) Deemed-Issuance-Ratio Election" and must include the taxpayer's name, address, and taxpayer identification number (TIN). The election is applicable to all the taxpayer's generic GSE securities acquired under TBA contracts that were entered into for quarters ending in the year specified in the election and for quarters ending in all subsequent taxable years in which the election is effective. A taxpayer may revoke a deemed-issuance-ratio election only with the prior written consent of the IRS.

### **Effective Date**

Rev. Proc. 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.

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