

MEMO# 1026

March 14, 1989

FINAL REGULATIONS PRESCRIBING DIVERSIFICATION REQUIREMENTS FOR VARIABLE ANNUITY CONTRACTS

- 1 - March 14, 1989 TO: TAX MEMBERS NO. 9-89 RE: FINAL REGULATIONS PRESCRIBING
DIVERSIFICATION REQUIREMENTS FOR VARIABLE ANNUITY CONTRACTS

The attached IRS final regulations prescribe diversification requirements for variable annuity contracts under Code section 817(h). Temporary regulations under section 817(h) were issued in 1986 (see Institute Memorandum to Tax Members No. 19-86, dated September 19, 1986) and have been modified since then (see Institute Memoranda to Tax Members No. 3-87, dated January 29, 1987; Tax Members No. 26-87, dated July 22, 1987; and Tax Members No. 20-88, dated April 12, 1988). The final regulations make numerous changes to the temporary regulations. Under the regulations a variable contract based upon a segregated asset account that inadvertently becomes nondiversified shall be treated as remaining qualified, provided that the issuer or holder of the contract pays the Commissioner an amount based on the tax that the policyholders would have been required to pay if they were treated as receiving the income on the contract during the period of nondiversification. The regulations further clarify that the failure of one segregated asset account to diversify shall not disqualify other accounts. As provided in the Technical and Miscellaneous Revenue Act of 1988, the regulations state that each agency or instrumentality of the United States is treated as a separate issuer for purposes of determining whether a variable annuity or variable life insurance contract that is based on a segregated asset account is adequately diversified. With respect to the start-up period rules, the final regulations provide that the determination of whether more than 30 percent of the amount allocated to a segregated asset account is attributable to contracts entered into more than one year before such date shall be made on the last day of a calendar quarter. In addition, any amount transferred to an account from a diversified account or any amount transferred as a result of an exchange pursuant to section 1035 with an unaffiliated company is - 2 - not treated as an amount attributable to contracts entered into more than one year before such date. The final regulations also clarify that the look-through rules applicable to underlying investment companies all of the interests in which are held by segregated asset accounts are also available to a segregated asset account where ownership of interests in the underlying investment company is available to the public if all the assets of the segregated asset account are attributable to: (i) premium payments made prior to September 26, 1981, (ii) premium payments made in connection with a qualified pension or retirement plan or (iii) any combination of such premium payments. A look-through rule is also provided for grantor trusts substantially all of the assets of which are Treasury securities. In addition, the regulations clarify that purchased put and call options on Treasury securities, interest

rate futures contracts on Treasury securities and options on such contracts are not treated as Treasury securities. We will keep you informed of further developments. Keith D. Lawson
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