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Deemed-Issuers Election under Section 817(h)

On October 16, the IRS issued guidance on the application of the Section 817(h) diversification test to specified agency-issued mortgage-backed securities underlying annuity and life insurance contracts. Under Revenue Procedure 2018-54 (the “Rev Proc”), taxpayers may elect to treat these mortgage-backed securities as being issued proportionately by the Federal Home Loan Mortgage Association (“Freddie Mac”) and the Federal National Mortgage Association (“Fannie Mae”) based on a ratio announced annually by the Federal Housing Finance Agency.

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Background on Variable Contracts. For a holder of a variable annuity or variable life insurance contract (collectively, “variable contracts”) to avoid current taxation on income from the assets held in the segregated asset accounts, the assets must meet a diversification test under Section 817(h) of the Internal Revenue Code of 1986, as amended (the “Code”). The test limits the concentration of investments and is applied to interests in nonpublicly available investment companies, partnerships, or trusts (including regulated investment companies) on a look-through basis. All securities of the same issuer are treated as a single investment, and each U.S. government agency or instrumentality is treated as a separate issuer.

Background on the Mortgaged-Backed Securities Market. Each of Freddie Mac and Fannie Mae currently issue mortgage-backed securities pursuant to forward contracts in To-Be-Announced (“TBA”) transactions, but with terms that differ somewhat from those of the other agency. To standardize these issuances, the agencies are in the process of creating a uniform mortgage-backed security (“UMBS”) that will have the same key terms and features. Each of Fannie Mae and Freddie Mac will be able to issue UMBS going forward.

When the UMBS trade in the TBA market, investors will not know the issuer (Fannie Mae or Freddie Mac) until 48 hours prior to delivery. Since Freddie Mac and Fannie Mae are separate government agencies, a segregated asset account (or a look-through investment entity held by such account) participating in a TBA transaction for a UMBS would not be able to apply the Section 817(h) diversification test at the time of the transaction, absent IRS relief.

The Rev Proc. To allow greater certainty on the application of Section 817(h) to UMBS acquired in the TBA market, the IRS issued the Rev Proc, which allows insurance companies issuing variable contracts and their underlying look-through investment entities (either, a “taxpayer”) to make a “deemed-issuance-ratio” election (the “election”). The election will apply to all of the taxpayer’s securities that are issued by a government-sponsored entity in a TBA trade (such as the UMBS) if, at the time of entering into the TBA contract, the taxpayer had no way of knowing the actual issuer. For a security to which the election applies, the security will be treated as issued in part by Freddie Mac and in part by Fannie Mae, regardless of which agency actually issues the security. The portion treated as issued by each agency will be determined by the deemed-issuance ratio in place for the year in which the taxpayer entered into the TBA. For as long as the taxpayer holds such security, the deemed-issuance ratio will remain constant. Three weeks prior to each calendar year, the Federal Housing Finance Agency will publish the deemed-issuance ratio that taxpayers must use for all TBAs with respect to UMBS entered into during that calendar year, with the ratio to be based on the proportion of eligible securities issued by Fannie Mae and Freddie Mac during the two-year period ending on October 31 of the year preceding the year to which the ratio will apply.

To make the election, taxpayers must include a statement with their tax returns for the first taxable year to which they want the election to apply. The statement must be titled “Section 817(h) Deemed-Issuance-Ratio Election,” indicate that the taxpayer elects the deemed-issuance ratio election, and include the taxpayer’s name, address and taxpayer identification number. The election will only be revocable with consent of the IRS via a private letter ruling.