

are held by one or more general or segregated asset accounts of insurance companies (or affiliated companies), or by fund managers (or affiliated companies) in connection with the creation or management of the RIC or trust. "In authorizing Treasury to prescribe diversification standards, the conferees intend that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors \* \* \* A H.R. Conf. Rep. at 1055."

Section 1.817-5(f)(1) of the regulations implements the Congressional directive to prescribe diversification standards by providing that if look-through treatment is available, a beneficial interest in a RIC, real estate investment trust, partnership, or trust that is treated under sections 671 through 679 as owned by the grantor or another person (investment company, partnership or trust) will not be treated as a single investment of a segregated asset account for purposes of testing diversification. Instead, a pro rata portion of each asset of the investment company, partnership, or trust will be treated as an asset of the segregated asset account.

Section 1.817-5(f)(2) provides more detailed rules for determining whether look-through treatment is available. Under § 1.817-5(f)(2)(i), the look-through rule applies to any investment company, partnership, or trust if: (A) All the beneficial interests in the investment company, partnership, or trust are held by one or more segregated asset accounts of one or more insurance companies; and (B) public access to such investment company, partnership, or trust is available exclusively through the purchase of a variable contract. Section 1.817-5(f)(iii) provides exceptions to the general ownership limitations of § 1.817-5(f)(2)(i), specifically permitting life insurance company general accounts, managers of the investment company, partnership or trust, pension or retirement plan trustees, and certain individuals whose investment falls into one of two limited classes.

Under § 1.817-5(f)(2)(ii), the look-through rule applies to a partnership interest that is not registered under a Federal or State law regulating the offering or sale of securities. Unlike § 1.817-5(f)(2)(i), satisfaction of the non-registered partnership look-through rule of § 1.817-5(f)(2)(II) is not explicitly conditioned on limiting the ownership of interests in the partnership to certain specified holders.

Under § 1.817-5(f)(2)(iii), the look-through rule applies to a trust that is treated under sections 671 through 679

as owned by the grantor or another person if substantially all of the assets of the trust are represented by Treasury securities.

Section 1.817-5(g) provides examples of the application of the look-through rules of § 1.817-5(f). Example (3) of § 1.817-5(g) provides an example of the application of the § 1.817-5(f)(2)(ii) non-registered partnership look-through rule.

### Explanation of Provisions

This document contains proposed amendments to 26 CFR part 1 under section 817(h). These proposed amendments would remove § 1.817-5(f)(2)(ii), which requires taxpayers to look through an interest in a nonregistered partnership, as defined in § 1.817-5(f)(2)(ii), to determine whether a segregated asset account supporting a variable contract is adequately diversified within the meaning of section 817(h) and § 1.817-5. In addition, the proposed regulations would conform the other provisions of § 1.817-5 to the removal of § 1.817-5(f)(2)(ii), and would remove Example (3) of § 1.817-5(g).

The application of § 1.817-5(f)(2)(i) to interests in nonregistered partnerships will be unchanged by the removal of § 1.817-5(f)(2)(ii). Thus, look through treatment will be available for interests in a nonregistered partnership if: (A) All the beneficial interests in the nonregistered partnership (other than those described in § 1.817-5(f)(3)) are held by one or more segregated asset accounts of one or more insurance companies; and (B) public access to such nonregistered partnership is available exclusively (except as otherwise permitted in § 1.817-5(f)(3)) through the purchase of a variable contract.

### Reasons for Change

The Treasury Department and the IRS are concerned that § 1.817-5(f)(2)(ii) is not consistent with Congressional intent because it is not explicitly subject to the public availability limitation of section 817(h). The Treasury Department and the IRS believe that removal of § 1.817-5(f)(2)(ii) will eliminate any possible confusion regarding the prohibition on ownership of interests by the public in a non-registered partnership funding a variable contract.

In addition, the Treasury Department and the IRS understand that certain taxpayers are purchasing contracts invested in partnerships that rely on the nonregistered partnership rule of § 1.817-5(f)(2)(ii) to satisfy the diversification requirements of section 817(h). The Treasury Department and

the IRS are concerned that these contracts are funded by interests in partnerships that are also available to certain limited classes of investors, specifically individuals that are "qualified purchasers" within the meaning of 15 U.S.C. 80a-2(a)(51) or "accredited investors" as defined in Regulation D of the Securities Act of 1933.<sup>2</sup> The Treasury Department and the IRS believe that Congress intended to treat qualified purchasers and accredited investors as part of the general public when determining whether an investment is available for the purchase by the general public. Elimination of § 1.817-5(f)(2)(ii) will limit access to interests in non-registered partnerships to the same holders that are permitted under § 1.817-5(f)(2)(i), which does not include either qualified investors or accredited investors.

### Proposed Effective Date

The Treasury Department and the IRS intend revocation of § 1.817-5(f)(2)(ii) and Example (3) of § 1.817-5(g) to be effective on the date the final regulations are published in the **Federal Register**. The revocation will be effective for all investments in nonregistered partnerships, including investments made prior to the effective date of the revocation that relied on the look-through rule of § 1.817-5(f)(2)(ii) to satisfy the diversification requirements of section 817(h) and the regulations and do not meet the requirements of § 1.817-5(f)(2)(i). However, arrangements in existence on the effective date of the revocation of § 1.817-5(f)(2)(ii) will be considered to be adequately diversified if: (i) Those arrangements were adequately diversified within the meaning of section 817(h) prior to the revocation of § 1.817-5(f)(2)(ii) and (ii) by the end of the last day of the second calendar quarter ending after the effective date of

<sup>2</sup> The Treasury Department and the IRS understand that many of the partnership interests that are available under these arrangements are interests in partnerships that operate as hedge funds, often established and operated in foreign jurisdictions. In many cases, interests in these partnerships are available for purchase directly by the general public as well as through the purchase of a variable contract. Taxpayers that purchase a variable annuity or life insurance contract are indirectly investing in partnership interests that are available for direct investment by the general public. By indirectly investing in these partnership interests through the purchase of a variable contract taxpayers defer tax on partnership earnings that might otherwise be currently taxable. The Treasury Department and the IRS believe that these arrangements (often marketed as "insurance wrappers") are the type of overly investment oriented insurance and annuity arrangements that Congress sought to prevent when it enacted the diversification rules of section 817(h).