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VIA ELECTRONIC MAIL

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Financial Institutions & Products
1111 Constitution Avenue, NW, Room 3554
Internal Revenue Service
Washington, DC 20224

Re: Committee of Annuity Insurers Follow-Up Comments on Notice 2007-15

Dear Mr. Drees:

On behalf of the Committee of Annuity Insurers (the "Committee"), we are writing to thank you and your colleagues at the Internal Revenue Service (the "Service") and the Treasury Department for meeting with us on January 15th regarding the Government's proposed response to comments received on Notice 2007-15. As you know, in June 2007 the Committee filed comments on the Notice, focusing on potential improvements to the procedures available to correct inadvertent failures to satisfy the diversification requirements of section 817(h). We appreciate your willingness to share with the Committee your proposed approach to updating the various correction procedures and providing the Committee with an opportunity to have additional input.

As an initial matter, we would like to commend you and your colleagues at the Service and the Treasury Department for your efforts to update the various correction procedures. In particular, we greatly appreciate the manner in which the Service and the Treasury Department have reached out to the life insurance industry and encouraged and facilitated an open dialogue between the industry and the Government to resolve the issues that have detracted from the utility of the existing correction procedures. We believe that this endeavor has been very productive, and we hope that its success will encourage similar efforts in other areas in the future. The Committee's specific comments on the proposal you outlined to us regarding section 817(h) are set forth below.

1. Comments Regarding Dollar Cap

During our meeting, you indicated that a dollar cap equal to the lesser of \$5 million or 5% of the total value of the segregated asset account would apply with respect to the “toll charge” required to correct inadvertent diversification failures under the new procedures. The Committee suggested a dollar cap on the toll charge in its June 2007 comment letter, and we are pleased that the new procedures will incorporate a cap. There are two aspects of the proposed dollar cap that we believe warrant further clarification in the final published revenue procedure:

a. Scope of dollar cap

It would be helpful if the final revenue procedure would clarify whether the dollar cap applies “per segregated asset account,” or whether it applies “per submission to the Service.” In that regard, a diversification compliance problem can affect multiple segregated asset accounts that a life insurance company establishes in support of the variable contracts it issues. For example, a single valuation error or a single mistake in following established compliance procedures could cause more than one segregated asset account to exceed the applicable limits. If the dollar cap applies to each segregated asset account that exceeds the applicable limits, the resulting toll charge could still be an extremely high amount, resulting in a sanction that greatly outweighs the harm caused by the inadvertent error. As a result, if the dollar cap is to be set at the level you identified, we strongly urge that it apply on a “per submission to the Service” basis, such that a life insurance company would not be subject to disproportionate sanctions resulting from a single error that affects multiple segregated asset accounts.

b. Deficiency interest

The current toll charge calculation described in Rev. Proc. 92-25 includes both an “income on the contract” component and a “deficiency interest” component. For situations in which this toll charge calculation is used, it would be helpful if the final revenue procedure would clarify whether the dollar cap applies to both components in the aggregate, or whether it applies only to the income on the contract component.

2. Comments Regarding Alternative Toll Charge

The second aspect of the updated correction procedures for diversification failures that you described to us during our recent meeting was an alternative toll charge calculation. Under the alternative, as we understand it, the toll charge would equal “100% of the error,” *i.e.*, the dollar amount by which the applicable diversification limit was exceeded. The Committee offers the following comments on the alternative toll charge calculation:

a. Examples

As a general matter, we think it would be helpful for the final revenue procedure to include examples illustrating how the alternative toll charge would be calculated in various circumstances, including where multiple diversification limits are exceeded (*e.g.*, a single

investment exceeds 55% of the segregated asset account's total value and two investments of the same account exceed 70% of its total value).

b. Timing issues

It also would be helpful if the final revenue procedure would clarify the date as of which the alternative toll charge should be calculated. As you know, a segregated asset account must be diversified on the last day of each calendar quarter, or on any day within 30 days thereafter. The values of the assets held by the segregated asset account likely will fluctuate during this 30-day period, meaning that the alternative toll charge calculation could differ depending upon the day on which the calculation is made. In addition, a segregated asset account might fail to be diversified for more than one calendar quarter (*e.g.*, two successive calendar quarters), and a question could arise as to how the alternative toll charge is calculated in such cases. It would be helpful if the final revenue procedure could clarify these timing issues. However, if the Service and the Treasury Department believe that such clarifications would delay issuance of the new procedures, these issues could be addressed as individual cases are brought to the Service.

c. Additional guidance to address loss of look-through situations

Finally, while the Committee appreciates the availability of the alternative toll charge calculation you described, the alternative would appear to provide little relief for inadvertent diversification failures that are caused by a loss of look-through treatment of a regulated investment company, partnership, real estate investment trust, or grantor trust (each, a "Look-Through Entity") in which a segregated asset account invests. In many cases, a segregated asset account invests exclusively in shares of a single Look-Through Entity. If that entity inadvertently loses its look-through status, the segregated asset account is treated as holding only a single investment (shares of the Look-Through Entity), and the alternative toll charge thus seemingly would equal 45% of the total value of the Look-Through Entity's assets. In such case, the alternative toll charge would seem to always exceed the "lesser of 5% or \$5 million" cap, making the alternative toll charge meaningless in these cases.

As the Committee has stated in various comments submitted to the Service and the Treasury Department over the years, this is an area of great concern to the member companies of the Committee, particularly in situations where a loss of look-through treatment might occur due to a mistake that allows beneficial interests in a Look-Through Entity to be held directly by a person not permitted by Treasury Regulation section 1.817-5(f).¹ While the Service has provided helpful guidance in this area through private letter rulings,² we continue to urge the

¹ This could occur, for example, if the Service were to adopt a literal and strict interpretation of the regulations that look-through treatment is lost where a "disqualified" plan (*i.e.*, a plan that intended to be a "qualified pension or retirement plan" but is not) or a "failed" contract (*e.g.*, a life insurance contract that does not comply with section 7702) is inadvertently allowed to purchase a direct interest in the Look-Through Entity.

² *See, e.g.*, PLR 200613028 (Dec. 15, 2005).

Service and the Treasury Department to issue published guidance that would eliminate the severe and inappropriate consequences that could result from this type of “foot fault” in compliance with the diversification regulations, particularly in light of the fact that the alternative toll charge calculation described above does not appear to provide such relief.³ In that regard, we understand that the alternative toll charge (and the dollar cap) are not intended to be the “final answer” on this question of loss of look-through treatment, and the Committee is hopeful that this is an area in which an open dialogue with the Government can continue towards a reasonable and appropriate resolution through published guidance.

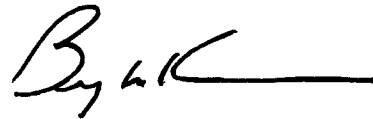
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We hope you find these comments helpful. Again, we commend you and your colleagues at the Service and the Treasury Department for the effort you have undertaken to update the various correction procedures. If the Committee can be of any further assistance to you in those efforts, please let us know.

Sincerely,



Joseph F. McKeever, III



Bryan W. Keene

cc: Sheryl B. Flum (Internal Revenue Service)
Katherine A. Hossofsky (Internal Revenue Service)
Melissa S. Luxner (Internal Revenue Service)
Mark S. Smith (Treasury Department)

³ Moreover, the dollar cap itself might provide little relief for this type of situation if, as described above, the cap is applied on a “per segregated asset account” basis rather than on a “per submission to the Service” basis. For example, a Look-Through Entity might lose its look-through status because it inadvertently sold shares to a person not permitted by Treasury Regulation section 1.817-5(f) (see footnote 1, *supra*). Because variable contracts typically make more than one Look-Through Entity available as investment options, it is quite likely that a diversification problem caused by an ineligible investor (such as a “disqualified” plan) will affect multiple segregated asset accounts. Thus, for example, if an insurance company inadvertently allowed a “disqualified” plan to purchase shares of 20 different Look-Through Entities (which could happen because the various plan participants allocate monies to different investment options), the resulting toll charge could be as high as \$100 million if the dollar cap is applied on a “per segregated asset account” basis. It is difficult to conceive of a situation where such a toll charge would be appropriate.