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October 29, 2007

HAND DELIVERED

CC:PA:LPD:PR (REG-118719-07)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20024

Re: Comments of the Committee of Annuity Insurers on the Proposed Regulations under IRC Section 817(h) (REG-118719-07)

Dear Sir or Madam:

On behalf of the Committee of Annuity Insurers (the "Committee"), we are writing in response to the request for comments on the proposed regulations under section 817(h) that the Treasury Department and the Internal Revenue Service (the "Service") published in the Federal Register on July 31, 2007.¹ The Committee is a coalition of 32 life insurance companies representing more than two-thirds of the annuity business in the United States.² The Committee's member companies are among the nation's largest and most prominent issuers of annuity contracts, including variable annuity contracts. We appreciate this opportunity to comment on the proposed regulations.

As an initial matter, we would like to commend the Treasury Department and the Service for their ongoing efforts to provide needed guidance under section 817(h). Published guidance in the form of Rev. Rul. 2007-7, 2007-7 I.R.B. 468 (clarifying that investors described in Treas. Reg. section 1.817-5(f)(3) are not members of the "general public" for investor control purposes) and Rev. Rul. 2005-7, 2005-1 C.B. 464 (addressing the look-through rule in the context of tiered fund structures) has helped resolve open issues. In addition, the Service's continued

¹ Unless otherwise indicated, all references to sections are to sections of the Internal Revenue Code of 1986, as amended.

² The Committee was formed in 1982 to address federal legislative and regulatory issues relevant to the annuity industry and to participate in the development of federal tax and securities law policy regarding annuities. A list of the member companies is attached.

willingness to issue private letter rulings on section 817(h) issues, such as PLR 200730004 (addressing the look-through rule for insurance-dedicated funds that offer shares directly to qualified plans), has given taxpayers needed guidance in the area. We appreciate these efforts, as well as the more recent proposed amendments to the regulations under section 817(h). Our comments on those proposed amendments are set forth below.

1. The proposed amendment to Treas. Reg. section 1.817-5(a)(2) should be adopted and further modifications should be made to the remediation procedures for inadvertent diversification failures.

The Committee supports the proposed amendment to Treas. Reg. section 1.817-5(a)(2) that would remove the sentence from the regulations dictating that the payment required to correct inadvertent diversification failures must be based on the amount of tax that would be owed by all of the contract owners whose contracts are based in whole or in part on the non-diversified segregated asset account. In that regard, on June 12, 2007, the Committee filed comments on Notice 2007-15, 2007-7 I.R.B. 503, in which we advocated significant changes to the current procedures for addressing inadvertent diversification failures. As stated in those comments, we believe that the correction procedures under section 817(h) should be modified to provide the Service with flexibility to more appropriately address various fact patterns and to better achieve the following important goals:

- (1) encourage taxpayers to establish compliance practices and procedures,
- (2) promote compliance by providing limited fees for voluntary corrections,
- (3) provide for fees and sanctions in graduated steps to ensure that there is always an incentive for prompt correction, and
- (4) provide for sanctions that are reasonable in light of the nature, extent, and severity of the violation.

The current procedures for correcting inadvertent diversification failures do not achieve these important goals. Instead, they discourage taxpayers from approaching the Service to address diversification problems by providing a financial sanction for non-compliance that is greatly disproportionate to any harm to the government that an inadvertent failure might cause. Accordingly, we encourage the Treasury Department and the Service to adopt the proposed amendment to Treas. Reg. section 1.817-5(a)(2), and we continue to urge that the remediation procedures for correcting inadvertent diversification failures be modified along the lines we proposed in our June 12 comment letter.

2. The proposed amendments to Treas. Reg. section 1.817-5(f)(3) should be adopted, but clarified to provide a safe harbor to address plan “disqualification.”

The proposed regulations would expand the list of persons set forth in Treas. Reg. section 1.817-5(f)(3) (“permitted investors”) to include (i) qualified tuition programs as defined in

section 529 (“Qualified Tuition Plans”); (ii) trustees of certain foreign pension plans; and (iii) certain Puerto Rican segregated asset accounts. As a general matter, permitted investors can invest directly in an insurance-dedicated mutual fund, REIT, partnership, or trust (collectively, an “IDF”) without jeopardizing “look-through” treatment for the IDF under Treas. Reg. section 1.817-5(f). This treatment is provided because allowing a permitted investor direct access to an IDF does not enable an investor to choose between investing in the same pool of assets on a taxable or tax-deferred basis, and therefore does not give rise to the concerns Congress expressed in enacting section 817(h).

The Committee appreciates and fully supports expansion of the permitted investors list in the manner proposed. The expansion is consistent with sound tax policy and the intent of section 817(h), and also has the potential of reducing costs by increasing competition and facilitating economies of scale. Moreover, providing Qualified Tuition Plans with direct access to IDFs will encourage insurance companies to be more active in the Qualified Tuition Plan market, which could increase advertising and awareness of these plans and promote the broad participation in them that Congress envisioned.

Although the Committee supports the proposed amendments to the list of permitted investors, we believe that certain issues relating more generally to permitted investors are in need of clarification. In that regard, the preamble requests comments on the clarity of the proposed regulations and how they can be made easier to understand. In response to that request, we believe that clarification is needed with respect to (1) what steps must an IDF take to verify that a person is, in fact, a permitted investor, and (2) what happens if it turns out that, despite the IDF’s verification efforts, the person was never a permitted investor or subsequently loses its status as such.

Clarity on these issues is critical because allowing a non-permitted investor to hold an interest in an IDF could result in the loss of look-through treatment for the IDF, which, in turn, could adversely affect any variable contract supported by a segregated asset account that also holds an interest in that IDF.³ The issues are particularly relevant to Qualified Tuition Plans and another class of permitted investor – qualified pension or retirement plans within the meaning of Treas. Reg. section 1.817-5(f)(3)(iii) (“Qualified Retirement Plans”) – both of which are subject to a variety of “qualification” requirements that could result in a plan’s “qualified” status if not met.⁴ Of course, from a practical perspective, it would be impossible or very difficult for an IDF to monitor or verify a plan’s initial or ongoing compliance with these various qualification requirements, and

³ See Treas. Reg. section 1.817-5(f)(2)(i) (stating that look-through treatment applies to an IDF only if (A) all beneficial interests in the IDF are held by one or more segregated asset accounts or other permitted investors and (B) public access to the IDF is available exclusively through the purchase of a variable contract or to permitted investors).

⁴ While it is generally presumed that a plan disqualification would result in the unavailability of the look-through rule, such a result is not explicitly described in the regulations or any other guidance.

even if an IDF could do so, it necessarily would need to rely on information provided by the plan.⁵ As a result, an IDF that offers beneficial interests to a Qualified Tuition Plan or a Qualified Retirement Plan necessarily takes a risk that the plan may turn out to be a non-permitted investor. In the case of Qualified Retirement Plans, this risk has discouraged IDFs from allowing such plans to acquire beneficial interests, despite the fact that the regulations clearly allow such investments. Similar concerns could arise with respect to Qualified Tuition Plans if they are added to the list of permitted investors as proposed.

To address these concerns, the Committee believes that the Treasury Department and the Service should further amend the regulations to include a safe harbor upon which an IDF could rely in allowing permitted investors to acquire beneficial interests in the IDF. Any such safe harbor should be simple and cost-effective for taxpayers to implement and for the Service to administer. For example, in the case of a Qualified Retirement Plan or Qualified Tuition Plan, the safe harbor could provide that if the plan represents that it satisfies all requirements necessary for qualified status at the time of the initial investment in the IDF, then, absent any knowledge by the IDF to the contrary, any “disqualification” of the plan would have no effect on the availability of look-through treatment for the IDF. As a condition to this safe harbor, the rule could provide that if the IDF subsequently learns that the plan was or had become disqualified, the IDF must require the plan to restore its qualified status or terminate its investment in the IDF within a reasonable time. The Committee has proposed such an approach in prior comments.⁶

The Service recently provided a similar safe harbor to specific taxpayers who received private letter rulings involving Qualified Retirement Plans that invest directly in IDFs.⁷ Prior to those rulings being issued, there was no guidance addressing this issue. Thus, the rulings represent a significant step towards giving full and proper effect to a provision of the regulations that has existed for almost 20 years. In addition, to a large extent, the substance of the recent rulings reflects the elements of guidance that the Committee has previously requested on this issue, as described above. The Committee certainly appreciates and supports the extent to which the recent rulings reflect the Committee’s prior suggestions for a safe harbor. However, the recent rulings condition the safe harbor that they provide on the taxpayer establishing and following very detailed practices and procedures that are set forth in the rulings. The prescribed procedures include

⁵ We also note that currently there is no determination letter process for certain permitted investors, *e.g.*, section 403(b) plans or section 457 plans, or for Qualified Tuition Plans.

⁶ See pages 11-14 of the Committee’s October 28, 2003, comment letter on the July 2003 proposed amendments to the regulations under section 817(h), REG – 163974-02. The Committee also requested guidance on this issue in an October 26, 2004, letter to Mr. Mark S. Smith (Attorney-Advisor, Office of Tax Policy, Treasury Department) and in an April 16, 2006, letter to Mr. Donald J. Drees (Senior Technician Reviewer, Internal Revenue Service (CC:FIP:4)).

⁷ See PLR 200730005 (Apr. 27, 2007), PLR 200730004 (Apr. 27, 2007), PLR 200613028 (Dec. 15, 2005), and PLR 200607011 (Nov. 14, 2005).

obtaining an initial certification from each plan regarding its “qualified” status (with the failure to obtain a certification from any *single* plan resulting in the loss of the safe harbor with respect to *all* plans) and periodically obtaining recertifications from a threshold number of the investing plans.

As the Committee stated in our April 16, 2006, letter to Mr. Donald J. Drees regarding the first two of the recent private letter rulings, we believe that the “recertification” requirement that they impose is unnecessary to ensure compliance due to the independent tax incentives for a plan to maintain its qualified status. In that regard, severe and sweeping consequences accompany a plan disqualification, including current taxation of plan income and employer contributions, loss of deductions for the employer sponsor, and potential legal claims against the sponsor and other fiduciaries. As a result, a plan that is not “qualified” gains no tax advantage from being able to invest directly in an IDF, and allowing such investments presents no opportunity for tax arbitrage that would justify a high compliance hurdle to protect a revenue or policy goal. Rather, a compliance system such as we have proposed – based on good-faith reliance on up-front representations from the plan – is more than adequate. Given these considerations, the expense and burden of complying with the recertification requirement is disproportionate to any marginal compliance benefit that the requirement might provide. Finally, we believe that the scope of the safe harbor provided by the recent rulings is unduly limited because it is negated in its entirety if even a single plan fails to provide the required certification, rather than allowing the safe harbor to apply on a plan-by-plan basis.

In short, we believe that it is important that insurers retain flexibility to develop their own compliance procedures based on their own particular situations, including their computer systems, personnel, separate account structures, *etc.* As long as those procedures are designed to condition the acquisition of beneficial interests in an IDF by a person that claims to be a permitted investor on a good-faith reliance on a representation by the person as to its status as a permitted investor, the safe harbor should be available.

3. The proposed rule for Puerto Rican separate accounts should be clarified to eliminate potential misinterpretation and expanded to include accounts of any foreign insurer that makes an election under section 953(d).

The proposed regulations would expand the list of permitted investors to include Puerto Rican segregated asset accounts, provided that the requirements of sections 817(d) and (h) are satisfied (without regard to the requirement of section 817(d)(1) that the account be segregated pursuant to “State” law or regulation). As indicated above, the Committee supports the expansion of the permitted investors list in this manner. Allowing segregated asset accounts that otherwise satisfy the diversification requirements of section 817(h) to invest directly in IDFs is sound tax policy, in that it reduces the need for duplicative fund structures for arrangements that are designed and administered in the same manner as U.S.-based segregated asset accounts investing in the same IDFs. However, we believe that one aspect of the proposed amendment needs to be clarified to prevent potential misinterpretation and that the provision should be expanded to cover certain other segregated asset accounts.

a. *The proposed amendment regarding Puerto Rican segregated asset accounts should be clarified to eliminate circularity and potential misinterpretation.*

The *proviso* clause of the proposed amendment regarding Puerto Rican segregated asset accounts states that such an account will be a permitted investor “provided the requirements of section 817(d) and (h) are satisfied.” While we understand the desire to limit permitted investor status to Puerto Rican segregated asset accounts that are designed to comply with section 817(h), we believe that the reference to that section should be clarified to eliminate a circularity issue that arises from the language. For example, if a Puerto Rican segregated asset account were to follow the very common practice of investing all of its assets in shares of a single IDF, the account would satisfy section 817(h) only if the IDF qualifies for look-through treatment. For the IDF to qualify for look-through treatment, the Puerto Rican account must be a permitted investor. Thus, in order to be a permitted investor, the account must satisfy section 817(h), and in order to satisfy section 817(h), the account must be a permitted investor. The circularity of this provision could lead to confusion and misinterpretation. Accordingly, the Committee believes that it should be clarified. This clarification could be accomplished by amending the last sentence of the new provision, which sets forth a special rule for the portion of the *proviso* clause that references section 817(d)(1). For example, the last sentence could be amended by adding the following phrase at the end: “and paragraph (f)(1) shall be applied without regard to the Puerto Rican segregated asset account.”

b. *The proposed amendment regarding Puerto Rican segregated asset accounts should be expanded to include accounts of any foreign insurer that makes an election under section 953(d).*

The preamble to the proposed regulations states that the proposed change regarding Puerto Rican segregated asset accounts responds to a number of requests for guidance interpreting the term “variable contract” (as defined in section 817(d)(1)) to include a contract issued by a Puerto Rican company. The preamble also requests comments on whether a rule similar to the one proposed for Puerto Rican segregated asset accounts should apply to accounts segregated pursuant to the laws or regulations of territories other than Puerto Rico. In that regard, the Committee believes that the proposed rule should be extended to also cover the segregated asset accounts of any foreign insurer that makes an election under section 953(d) to be treated as a domestic corporation for U.S. tax purposes, subject to the same *proviso* clause described above (amended as we have suggested) regarding sections 817(d) and (h).

The extension of the proposed rule in this manner would be consistent with a 2002 private letter ruling in which the Service reached a similar conclusion. In PLR 200246022 (Nov. 15, 2002), the Service considered the treatment of annuity and life insurance contracts issued by a foreign insurer that made a section 953(d) election. Much like contracts based on a Puerto Rican segregated asset account, the contracts involved in the ruling would have qualified as “variable contracts” under section 817(d), except that they were based on accounts that were segregated from the issuer’s general asset accounts pursuant to foreign law, rather than pursuant to “State” law, as required by section 817(d)(1). The Service concluded that the accounts nonetheless would be treated as segregated pursuant to “State” law for purposes of section 817(d)(1). This, in turn, meant

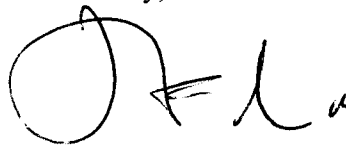
that the contracts issued by the section 953(d)-electing company would be treated as “variable contracts,” and that such contracts therefore must comply with section 817(h).

The Service’s conclusion in PLR 200246022 effectively treats segregated asset accounts of section 953(d)-electing life insurance companies in the same manner as the proposed regulations would treat segregated asset accounts of Puerto Rican life insurance companies. In both cases, contracts issued by the companies must satisfy section 817(h). Allowing a contract that must satisfy section 817(h) to be supported by a segregated asset account that holds beneficial interests in an IDF is clearly within the intent of the look-through rule and the regulations more generally. Accordingly, we believe that a logical and helpful extension of the proposed rule would be to make it available for segregated asset accounts of insurers that make elections under section 953(d) to be treated as domestic corporations for U.S. tax purposes. As described in the preamble to the proposed regulations, such an approach would address the issue of whether look-through treatment applies without implicating the issue of the proper meaning of the term “State” under sections 7701(a)(10) and 817(d)(1). This approach seems particularly appropriate here, given that the Service already has interpreted the term “State” as used in section 817(d)(1) to include a foreign jurisdiction exercising statutory or regulatory authority over the separate accounts of a foreign insurer that makes a section 953(d) election.

* * * * *

Again, the Committee appreciates this opportunity to comment on the proposed regulations. If you have any questions regarding these comments, please contact either of the undersigned. We can be reached *via* telephone at 202-347-2230 or *via* electronic mail at jfmckeever@davis-harman.com or bwkeene@davis-harman.com, respectively.

Sincerely,



Joseph F. McKeever, III



Bryan W. Keene

Enclosure

cc: Sheryl Flum (Internal Revenue Service)
Donald J. Drees (Internal Revenue Service)
James A. Polfer, Esq. (Internal Revenue Service)
Mark S. Smith, Esq. (Treasury Department)

The Committee of Annuity Insurers

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Allstate Financial, Northbrook, IL
AmerUs Annuity Group Co., Topeka, KS
AXA Equitable Life Insurance Company, New York, NY
Commonwealth Annuity and Life Insurance Co.
(a Goldman Sachs Company), Southborough, MA
Conseco, Inc., Carmel, IN
Fidelity Investments Life Insurance Company, Boston, MA
Genworth Financial, Richmond, VA
Great American Life Insurance Co., Cincinnati, OH
Guardian Insurance & Annuity Co., Inc, New York, NY
Hartford Life Insurance Company, Hartford, CT
ING North America Insurance Corporation, Atlanta, GA
Jackson National Life Insurance Company, Lansing, MI
John Hancock Life Insurance Company, Boston, MA
Life Insurance Company of the Southwest, Dallas, TX
Lincoln Financial Group, Fort Wayne, IN
Merrill Lynch Life Insurance Company, Princeton, NJ
Metropolitan Life Insurance Company, New York, NY
Nationwide Life Insurance Companies, Columbus, OH
New York Life Insurance Company, New York, NY
Northwestern Mutual Life Insurance Company, Milwaukee, WI
Ohio National Financial Services, Cincinnati, OH
OM Financial Life Insurance Company, Baltimore, MD
Pacific Life Insurance Company, Newport Beach, CA
The Phoenix Life Insurance Company, Hartford, CT
Protective Life Insurance Company, Birmingham, AL
Prudential Insurance Company of America, Newark, NJ
RiverSource Life Insurance Company (an
Ameriprise Financial Company), Minneapolis, MN
Sun Life of Canada, Wellesley Hills, MA
Symetra Financial, Bellevue, WA
USAA Life Insurance Company, San Antonio, TX

The Committee of Annuity Insurers was formed in 1982 to participate in the development of federal tax and securities law policies with respect to annuities. The member companies of the Committee represent over two-thirds of the annuity business in the United States.

10/29/2007