

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 301.7121-1: Closing Agreements.
(Also Part I, Section 817; 1.817-5.)

Rev. Proc. 2008-41

SECTION 1. PURPOSE

This revenue procedure provides a procedure by which an issuer of a variable contract may remedy an inadvertent failure of a variable contract to satisfy the diversification requirements of § 817(h) of the Internal Revenue Code. Rev. Rul. 91-17, 1991-1 C.B. 190, is amplified; Rev. Proc. 92-25, 1992-1 C.B. 741, is superseded; Notice 2000-9, 2000-1 C.B. 449, is obsolete.

SECTION 2. BACKGROUND

.01 Definition and tax treatment of a variable contract.

(1) Section 817(d) defines the term “variable contract” to mean a contract that (a) provides for the allocation of all or part of the amounts received under the contract to an account that, pursuant to state law or regulations, is segregated from the general asset accounts of the company, and (b) provides for the payment of annuities, or is a life insurance contract, or provides for funding of insurance on retired lives. In the case of an annuity contract or a contract that provides funding of insurance on retired lives, the

amounts paid in or the amounts paid out are required to reflect the investment return and the market value of the segregated asset account. In the case of a life insurance contract, the amount of the death benefit (or the period of coverage) must be adjusted on the basis of the investment return and the market value of the segregated asset account.

(2) Section 817(h) of the Code provides that a variable contract (other than a pension plan contract) based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract if the investments made by the account are not adequately diversified in accordance with regulations prescribed by the Secretary.

(3) Section 1.817-5(a)(1) provides that a variable contract is treated as based on a segregated asset account for a calendar quarter period if amounts received under the contract (or earnings thereon) are allocated to the account at any time during the period. Section 1.817-5(e) of the Income Tax Regulations provides that a "segregated asset account" consists of all assets the investment return and market value of each of which must be allocated in an identical manner to any variable contract invested in any of such assets. Section 1.817-5(g) illustrates the application of this provision.

(4) Section 1.817-5(a) provides that, if a variable contract that is a life insurance contract under applicable law is not treated as a life insurance or endowment contract under § 7702(a), the income on the contract for any taxable year of the policyholder is treated as ordinary income received or accrued by the policyholder during such year in accordance with § 7702(g) and (h). Likewise, if a variable contract is not treated as an annuity contract under § 72, the regulation provides that the income on the contract for

any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year in the same manner as a life insurance or endowment contract under § 7702(g) and (h).

.02 Diversification requirements.

(1) Section 1.817-5(b)(1) provides that the investments of a segregated asset account are adequately diversified for purposes of § 817(h) only if--

(a) No more than 55% of the value of the total assets of the account is represented by any one investment;

(b) No more than 70% of the value of the total assets of the account is represented by any two investments;

(c) No more than 80% of the value of the total assets of the account is represented by any three investments, and

(d) No more than 90% of the value of the total assets of the account is represented by any four investments.

For purposes of § 1.817-5, all securities of the same issuer, all interests in the same real property project, and all interests in the same commodity are each treated as a single investment. In the case of government securities, each government agency or instrumentality is treated as a separate issuer.

(2) Section 817(h)(2) provides a safe harbor under which the investments of a segregated asset account are adequately diversified for purposes of § 817(h) if (a) the account meets the requirements of § 851(b)(3), and (b) no more than 55% of the value of the total assets of the account are assets described in § 851(b)(3)(A)(i) (i.e., cash, cash items (including receivables), Government securities, and securities of other

regulated investment companies).

(3) Under § 1.817-5(c)(1), a segregated asset account that satisfies the requirements of § 1.817-5(b) as of the last day of any calendar quarter period (or within 30 days after that last day) is considered adequately diversified for that period.

.03 Recordkeeping, reporting, withholding, and deposit requirements for nondiversified contracts.

An issuer of a variable contract that fails to satisfy the requirements of § 817(h) may have record-keeping, reporting, withholding, and deposit obligations. An issuer that fails to meet these obligations also may be subject to penalties. See Rev. Rul. 91-17.

.04 Authority to enter into closing agreements. Under § 7121, the Secretary is authorized to enter into an agreement in writing with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any period. Such agreement is generally final and conclusive, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact.

.05 Correction procedure for failure to satisfy the diversification requirements of § 817(h).

(1) Section 1.817-5(a)(2) provides that, in the event of an inadvertent failure to diversify, the investments of a segregated asset account are nevertheless treated as satisfying the diversification requirements of § 1.817-5(b) for one or more periods if --

(a) the issuer or holder of the variable contract shows that the failure to satisfy the diversification requirements was inadvertent;

(b) the investments of the account satisfy the diversification requirements within a

reasonable item after discovery of the failure; and

(c) the issuer or holder agrees to make such adjustments or pay such amounts as the Commissioner may require.

For this purpose (and for purposes of this revenue procedure), income on the contract is computed under § 7702(g)(1)(B), without regard to § 7702(g)(1)(C), and is computed using the period or periods of nondiversification instead of the "taxable year" referred to in § 7702(g)(1)(B). Thus, for example, income attributable to each segregated asset account on which a contract is based (including accounts that at all times were adequately diversified) is included in the computation of income on the contract.

(2) Rev. Proc. 92-25, 1992-1 C.B. 741, set forth the procedure by which an issuer of a variable contract could request the relief described in § 1.817-5(a)(2) with regard to an inadvertent failure to satisfy the diversification requirements of § 817(h). Among the requirements set forth in Rev. Proc. 92-25 was a requirement that the issuer pay an amount under the closing agreement based on all the income on the annuity contracts that invested in the nondiversified accounts, including income with regard to accounts that were adequately diversified.

(3) Notice 2000-9, 2000-1 C.B. 449, reminded issuers of variable annuity contracts that the special rules of § 817(h)(3) and § 1.817-5(b)(3), concerning diversification of accounts with respect to variable life insurance contracts, do not apply with respect to variable annuity contracts. Notice 2000-9 provided a one-time procedure to cure diversification failures that resulted from a misapplication of that rule. That procedure applied to requests for closing agreement relief that were received on or before August 1, 2000.

.06 Changes to correction procedure. In Notice 2007-15, 2007-7 I.R.B. 503, the Service requested comments as to how various correction procedures -- including those for inadvertent failures to satisfy the diversification requirements of § 817(h) -- may be improved. This revenue procedure incorporates a number of changes that taxpayers suggested in response to Notice 2007-15. Most significantly, this revenue procedure (1) updates the model closing agreement set forth in Rev. Proc. 92-25, and (2) provides both an alternative computation of the amount due under the closing agreement and an overall limit on the amount that must be paid.

SECTION 3. SCOPE

This revenue procedure applies to any issuer of a variable contract that inadvertently failed to satisfy the diversification requirements of § 817(h), provided the issuer is entitled to relief under § 1.817-5(a)(2). For purposes of this revenue procedure, the term "issuer" is any company that issues a contract that is a variable contract under § 817(d) and is intended to satisfy the diversification requirements of § 817(h). The term also includes a company that insures a contract holder under a contract originally issued by another company.

SECTION 4. PROCEDURE

.01 Request for ruling. An issuer that seeks relief under this revenue procedure must submit a request for a ruling that meets the requirements of Rev. Proc. 2008-1, 2008-1 I.R.B.1 (or any successor). Additionally, the submission must --

- (1) identify the period or periods during which the investments of the segregated asset account did not satisfy the diversification requirements;
- (2) show that the failure to diversify was inadvertent;

(3) demonstrate that the investments of the account were brought into compliance with the diversification requirements within a reasonable time after discovery of the failure; and

(4) if the amount required to be paid is determined under section 4.03(2) of this revenue procedure, describe the method used to compute the amount of income that all holders of contracts based on the account would be treated as receiving during the period or periods of nondiversification if the account were not treated as adequately diversified under §1.817-5(a)(2). (This computation is to be made without regard to contracts that were completely surrendered during the nondiversification period.) Otherwise, indicate whether the amount required to be paid was determined under section 4.03(3) or section 4.04(4) of this revenue procedure.

.02 Closing agreement. The issuer must also submit a proposed closing agreement, in triplicate, executed by the issuer, using the model closing agreement in section 6 of this revenue procedure. The amount shown in Section 1(A) of the proposed closing agreement is the amount determined under section 4.03 of this revenue procedure for all of the contracts covered by the agreement.

.03 Determination of amount required to be paid.

(1) In general. Except as provided in section 4.03(4) of this revenue procedure, the issuer must remit to the Service the lesser of the amount determined based on income on the contracts under section 4.03(2) of this revenue procedure, or the amount determined based on the amount by which the segregated asset account was nondiversified under section 4.03(3) of this revenue procedure.

(2) Amount determined based on income on the contracts. The amount required

to be paid based on income on the contracts is the sum of the following amounts for variable annuity contracts and for variable life insurance or endowment contracts, as applicable:

(a) With regard to variable annuity contracts, an amount equal to the sum of --

(i) 20% of income on annuity contracts from which payments have not been made as of the end of the period; plus

(ii) 15% of income on annuity contracts from which payments have been made as of the end of the period; plus

(iii) any interest computed under § 6621(a)(2) as if the amounts determined under sections 4.03(2)(a)(i) and (ii) of this revenue procedure were underpayments by the contract holders for their tax year(s) containing the period(s) of nondiversification; and

(b) With regard to variable life insurance or endowment contracts, an amount equal to the sum of --

(i) 28% of the income on the contracts; plus

(ii) any interest computed under § 6621(a)(2) as if the amount determined under section 4.03(2)(b)(i) of this revenue procedure were an underpayment by the contract holders for their tax year(s) containing the period(s) of nondiversification.

(3) Amount determined based on the amount by which the segregated asset account was nondiversified. The amount determined based on the amount by which the segregated asset account was nondiversified is an amount equal to 100% of the amount by which the account's interest in a single investment exceeded the applicable limitation of § 1.817-5(b). Thus, for example, if a segregated asset account's

investment in a single security exceeded both the 55% limitation of § 1.817-5(b)(1)(i)(A) and the 70% limitation of § 1.817-5(b)(1)(i)(B), the amount determined under this section 4.03(3) is the total amount by which the investment would need to be reduced in order to satisfy both requirements and comply with the rules of § 817(h) and § 1.817-5(b). This amount is determined as of the 30th day after the last day of each calendar quarter for which the segregated asset account was not diversified. If nondiversification spans multiple calendar quarters, the amount payable under this section is based on the calendar quarter that produces the highest amount.

(4) Limitation on amount required to be paid. Notwithstanding section 4.03(2) or section 4.03(3) of this revenue procedure, as applicable, the amount required to be paid shall not exceed the lesser of \$5,000,000 or 5% of the total asset value of the segregated asset account on the 30th day after the last day of each calendar quarter for which the segregated asset account was not diversified. If nondiversification spans multiple calendar quarters, the amount payable under this section is based on the calendar quarter that produces the highest amount. The limitation applies on a per segregated asset account basis, and is not increased by any interest computed under § 6621(a)(2).

.04 Payment of amount. The issuer is required to pay the amount determined under section 4.03 of this revenue procedure within 60 days of the date of execution of the closing agreement by the Service. Payment shall be made by check payable to the "United States Treasury" delivered, together with a fully executed copy of the closing agreement, to Internal Revenue Service, Receipt & Control Stop 31, 201 W. Rivercenter Blvd., Covington, KY 41011.

.05 Correction of contracts. The issuer is required to have satisfied the requirements of § 817(h) and § 1.817-5(b) of the regulations within a reasonable time after the discovery of the failure to satisfy those requirements.

.06 Required representations. The submission must include representations to the effect that (1) the issuer is within the scope of section 3 of this revenue procedure; (2) the issuer properly computed the amount required to be paid with regard to the contracts in accordance with section 4.03 of this revenue procedure; and (3) the issuer has brought the contracts into compliance with the requirements of § 817(h) and § 1.817-5(b) of the regulations. The representations must be executed under penalties of perjury by an appropriate party (as set forth in section 7.01 of Rev. Proc. 2008-1 (or its successor)). The issuer must retain documentation available for audit to support the representations.

.07 Electronic submission. The information required under this revenue procedure may be submitted to the Service electronically, in read-only format, on a CD-ROM. Adobe Portable Document is a suitable format. Other formats may be arranged on a case-by-case basis. The issuer must provide a total of three CD-ROMs, one for each of the three copies of the closing agreement.

SECTION 6. MODEL CLOSING AGREEMENT

Effective as of date executed by Internal
Revenue Service _____

CLOSING AGREEMENT AS TO FINAL DETERMINATION

COVERING SPECIFIC MATTERS

UNDER SECTION 817(h)

THIS CLOSING AGREEMENT ("Agreement") is made pursuant to section 7121

of the Internal Revenue Code (the "Code"), by and between ***[Insert Taxpayer name, address and EIN]*** ("Taxpayer") and the Commissioner of Internal Revenue (the "Service").

WHEREAS,

A. Taxpayer is the issuer of one or more variable contracts, as defined in § 817(d) (without regard to § 817(h)) (the "Contracts"), which are based, in whole or in part, on a segregated asset account (the "Account") and that provides for the allocation of amounts received under the variable contracts to the Account.

B. Pursuant to Rev. Proc. 2008-41, 2008-29 I.R.B., the Service may treat the investments of a segregated asset account on which a variable contract is based as satisfying the diversification requirements of § 817(h) and § 1.817-5(b) of the Income Tax Regulations for periods during which there was an inadvertent failure to diversify.

C. By letter dated ***[Insert date]*** Taxpayer submitted to the Service, pursuant to Rev. Proc. 2008-1, 2008-1 I.R.B. 1 ***[or successor, if applicable]*** and Rev. Proc. 2008-41 a request for this Closing Agreement that ***[Insert account name]*** (the Account) be treated as adequately diversified under § 817(h) for the period ***[Insert period of nondiversification]*** ("the period of nondiversification").

D. Taxpayer represents that the failure of the Account to satisfy the requirements of § 817(h) is eligible for relief under Rev. Proc. 2008-41.

E. Taxpayer represents that the failure of the investments in the Account to satisfy the requirements of § 1.817-5(b) was discovered on ***[Insert date]***, and the investments came into compliance with those requirements on ***[Insert date]***.

F. Taxpayer represents that the amount determined under section ***[Insert 4.03(2),(3) or (4), as appropriate]*** of Rev. Proc. 2008-41 is \$ ***[Insert amount]***. Taxpayer represents that this amount has been computed correctly under the provisions of Rev. Proc. 2008-41.

G. To ensure that variable contracts that provide for the allocation of amounts received thereunder to Account are treated as annuity, endowment, or life insurance contracts, as applicable, Taxpayer and the Service have entered into this Agreement.

NOW THEREFORE IT IS HEREBY DETERMINED AND AGREED BETWEEN TAXPAYER AND THE SERVICE AS FOLLOWS:

1. In consideration for the agreement of the Service as set forth in section 2 below, Taxpayer agrees as follows:

- (A) Taxpayer will pay the Service \$ ***[Insert amount]*** at the time and manner described in section 3 below.

- (B) The amount paid pursuant to section 1(A) above is not deductible by Taxpayer, nor is such amount refundable, subject to credit or offset, or otherwise recoverable from the Service;
- (C) For purposes of Taxpayer's complying with its reporting and withholding obligations under the Code,
 - (i) neither the investment in the contract for purposes of § 72, nor the premiums paid for purposes of section § 7702 on any Contract can be increased by any portion of the amount set for the in section 1(A) above. If any such increases are made, they are entitled to no effect.
 - (ii) neither the investment in the contract for purposes of § 72, nor the premiums paid, for purposes of § 7702 on any Contract can be increased by any portion of the amount which Taxpayer represents to be the income on the contract for all of the Contracts in the aggregate. If any such increases are made, they are entitled to no effect.

2. In consideration of the agreement of Taxpayer set forth in Section 1 above, the Service agrees as follows:

- (A) To treat the investments of the Account as adequately diversified for purposes of § 817(h) during the period of nondiversification;
- (B) To treat no portion of the amount described in Section 1(A) above as income to the Contract holders;
- (C) To treat the failure(s) described above, and any corrective action described in Section 1(A) above, as having no effect on the date the Contracts were issued, entered into or purchased for purposes of any provision of the Code or regulations thereunder; and
- (D) To waive civil penalties for failure of Taxpayer to satisfy the reporting, withholding, or deposit requirements for income deemed received by Contract holders due to the Contracts' failure to satisfy the requirements of § 817.

3. Payment of the amount described in Section 1(A) above shall be made within 60 days of the date of execution of this Agreement by the Service. This payment must be made by check payable to the "United States Treasury," delivered, together with a copy of this executed Agreement, to Internal Revenue Service Center, Receipt & Control Stop 31, 201 W. Rivercenter Blvd., Covington, KY 41011.

4. This Agreement is, and shall be construed as being, for the benefit of

Taxpayer. Holders of contracts based on the Account are intended beneficiaries of this Agreement. This Agreement shall not be construed as creating any liability of Taxpayer to the holders of the contracts based on the Account.

5. Neither the Service nor Taxpayer shall endeavor by litigation or other means to attack the validity of this Agreement.

6. This Agreement may not be cited or relied upon as precedent in the disposition of any other matter.

NOW THIS CLOSING AGREEMENT FURTHER WITNESSETH, that the Service and Taxpayer mutually agree that the matters so determined shall be final and conclusive, except as follows:

1. The matter to which this Agreement relates may be reopened in the event of fraud, malfeasance, or misrepresentation of material facts set forth herein.

2. This Agreement is subject to sections of the Code that expressly provide that effect be given to their provisions (including any stated exception for Code § 7122) notwithstanding any other law or rule of law.

3. To the extent this Agreement relates to any tax period after the date on which it is executed, it is subject to any law, enacted after such date, that applies to that tax period.

IN WITNESS WHEREOF, the parties have subscribed their names in triplicate. By signing, the above parties certify that they have read and agreed to the terms of this document.

[Insert Taxpayer name]

Date Signed: _____ By: _____

Title: _____

COMMISSIONER OF INTERNAL REVENUE

Date Signed: _____ By: _____

Title: _____

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective July 21, 2008, the date of its publication in the Internal Revenue Bulletin.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Rul. 91-17, 1991-1 C.B. 190, is amplified to provide terms and conditions and a model closing agreement for use by taxpayers seeking the relief described in § 1.817-5(a)(2) of the regulations; Rev. Proc. 92-25, 1992-1 C.B. 741, is superseded; Notice 2000-9, 2000-1 C.B. 449, is obsolete.

SECTION 9. PAPERWORK REDUCTION ACT

The collections of information in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1752.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law.

Generally tax returns and return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this revenue procedure is Melissa S. Luxner of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure contact Branch 4 of that office at (202) 622-3970 (not

a toll-free call).