

IRS Provides Guidance for certain Money Market Funds related to Section 817(h) Diversification Testing and Adviser Contributions

BACKGROUND

Section 817(h) Diversification Testing for Government Money Market Funds

On May 5, 2016, the Internal Revenue Service (IRS) issued [Notice 2016-32](#), which provides guidance regarding diversification requirements under Internal Revenue Code (IRC) section 817(h) for a segregated asset account that invests in a money market fund (MMF) that is a government MMF as defined in Rule 2a-7 of the 1940 Act. Rule 2a-7 requires that for a MMF to be defined as a government MMF, 99.5 percent or more of its total assets must be invested in cash, government securities, and/or repurchase agreements that are collateralized by cash items or government securities. Under the newly amended Rule 2a-7, non-government MMFs must be prepared to impose liquidity fees and may impose redemption gates. Government MMFs may impose these fees but are not required to. Demand for government securities is expected to increase because of this change, as some existing MMFs are expected to convert to government MMFs.

Variable contracts typically include different groups of assets as investment strategies available to their policy holders. These groups of assets may be considered a segregated asset account under IRC regulation section 1.817-5(e). Each of these segregated asset accounts must be adequately diversified under IRC Section 817(h). In order to be adequately diversified, there are limits on the percentage of total assets that can be invested in a small number of issuers. Under IRC Section 817(h)(6), each United States Government agency or instrumentality is treated as a separate issuer. Only a limited number of United States agencies or instrumentalities issue securities that a government MMF is allowed to hold under Rule 2a-7. Given the expectation that some existing MMFs will convert to government MMFs, increased demand for certain government securities may exacerbate MMFs' difficulty in acquiring the assets needed to qualify as a government MMF and satisfy diversification requirements under IRC Section 817(h) and Reg. 1.817-5.

Summary of Relief – Section 817(h) Diversification Testing for Government Money Market Funds

The Treasury Department and IRS determined that variable contracts should be able to offer government MMFs as an investment option. Notice 2016-32 explains that the Treasury Department and the IRS intend to amend Reg. Section 1.817-5 because of the anticipated increased demand for government securities and the expected difficulty in acquiring these assets. The Notice provides an alternative diversification requirement under Section 1.817-5 for a segregated asset account that invests in a government MMF. This

alternative diversification requirement provides that a segregated asset account within the meaning of Section 1.817-5(e) is adequately diversified for purposes of section 817(h) if:

- 1) No policyholder has investor control: and
- 2) Either:
 - a) The account is a government MMF under Rule 2a-7(a)(14): or
 - b) The account invests all of its assets in an “investment company, partnership, or trust” as defined in Reg. 1.817-5(f)(1) that satisfies the look-through rules in Reg. 1.817-5(f) and qualifies as a government MMF under Rule 2a-7(a)(14).

Background – Adviser Contributions to Money Market Funds

In addition to guidance related to diversification testing, the IRS provided temporary relief for certain MMFs that receive contributions from their advisers as the MMFs transition to comply with changes to certain Securities and Exchange Commission (SEC) rules. Changes to SEC rules will require certain MMFs to transition to a floating Net Asset Value (NAV) method prior to October 14, 2016. In connection with that transition, some MMF sponsors may wish to make contributions to the MMF to raise the NAV to \$1.00000 per share before the MMF’s NAV begins to float. If the distribution requirements in sections 852 and 4982 apply to an adviser contribution (the “distribution requirements”), it may be impossible or impractical for the advisers of some MMFs to make contributions that raise the MMFs’ NAVs to \$1.0000, so that shareholders will receive the same value per share both before and after the transition to a floating NAV. If contributions from an adviser are subject to the distribution requirements, then, to increase the value of an MMF’s portfolio by a given amount, an adviser may need to contribute more than ten times that amount to “gross up” the contribution for both a 90-percent distribution requirement and tax on the undistributed amount.

Summary of Relief - Adviser Contributions to Money Market Funds

The Treasury Department and the IRS believe that it is in the interest of sound tax administration to apply section 852 in a manner that will support the efforts of the staff of the SEC Division of Investment Management to facilitate a smooth transition to compliance with SEC MMF Reform Rules. The Treasury Department and the IRS believe that excluding certain adviser contributions from Investment Company Taxable Income (ICTI) for purposes of the distribution requirements in section 852(a) is important to facilitate those contributions but do not believe the contributions should be excluded from the MMF’s income for other federal tax purposes. [Revenue Procedure 2016-31](#) applies to a top up contribution that is received by an MMF as part of a transition to implement the floating NAV reform before the October 14, 2016 compliance deadline. The contribution will be included in the calculation of ICTI for purposes of determining ICTI under IRC section 852(b)(1), but is excluded from the calculation of ICTI for purposes of calculating the distribution requirements under IRC section 852(a)(1). This means that the MMF will be required to pay tax on the amount of the contribution (section 852(b)(1)), but that the additional income received in the form of a contribution will not need to be distributed to shareholders in order to satisfy the 90% distribution requirement (section 852(a)(1)). The tax paid on the contribution income will allow that income to be considered “distributed” for excise tax purposes as long as the MMF elects to make an estimated tax payment under Section 4982(c)(4)(A)(i) during the 2016 calendar year. No excise tax should be incurred on the contribution amount if the estimated tax payment is timely made.

It is important to note that Revenue Procedure 2016-31 applies only to a top up contribution that is received by an MMF as part of a transition to implement the floating NAV reform before October 14, 2016. Any top up contribution made after October 14, 2016 would not be eligible for relief under Revenue Procedure 2016-31.

Additionally, an MMF should consider the potential impact the payment of tax could have on distributable income, where a book to tax difference is created for the amount of tax as the tax paid by the MMF would be a non-deductible expense that would generally be added back to ICTI for purposes of 852(b)(1) and 852(a)(1). This impact is not directly discussed in Revenue Procedure 2016-31, but would presumably create additional income that would need to be included in the calculation of distributable income. This

additional impact would need to be considered when the adviser determines the amount of contribution to make to the MMF, or which expenses to waive.

Next Steps

Please review the respective links for the full text of the [Notice](#) and [Revenue Procedure](#).

Contacts

Teresa Matter

Senior Manager, Deloitte Tax LLP
+1 303 298 6577

Eric Byrnes

Director, Deloitte Tax LLP
+1 973 602 6710

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