

Life insurance: Tax Court applies investor control doctrine to variable life insurance contracts

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In brief

On June 30, the Tax Court held in *Webber v. Commissioner*, T.C., No. 14336-11, 144 T.C. No. 17, 6/30/15 that a policyholder was liable for taxes on income earned on assets held in separate accounts supporting private placement life insurance policies, because he maintained sufficient control over the assets to be considered their owner for federal tax purposes. In its analysis, the court applied the investor control doctrine, which has been the subject of numerous IRS revenue rulings but until now not explicitly endorsed by the Tax Court.

In detail

The “investor control” doctrine provides that if a policyholder has sufficient incidents of ownership over the assets in a separate account supporting a variable life insurance or annuity policy, the policyholder rather than the insurance company will be considered the owner of those assets for Federal income tax purposes. Beginning in 1977, the IRS has asserted the doctrine in a number of revenue rulings. Most recently, two rulings issued in 2003 provide the IRS view on two prongs of the doctrine: Rev. Rul. 2003-91 treats the policyholder as owner of the assets if the policyholder exercises direct or indirect control over the assets; Rev. Rul. 2003-92 treats the

policyholder as owner of the assets if the assets are publicly available, i.e. available for purchase other than through the purchase of a life insurance or annuity contract.

In *Webber v. Commissioner*, the taxpayer, a venture-capital investor and private-equity fund manager, established a grantor trust that purchased private placement variable life insurance policies on the lives of two elderly relatives. The policies were purchased from a Cayman Islands insurance company, and the taxpayer and his family members were the designated beneficiaries of the life insurance policies. The premiums paid under the policy, less administrative charges, were held in a life insurance company separate account with

intention the policy would qualify as a life insurance contract.

A special purpose vehicle, Boiler Riffle Investments, Ltd. (Boiler Riffle) managed the investments of the separate account, which were companies, including start-up companies, with which the taxpayer was deeply familiar and in which the taxpayer also invested personally and through private equity funds he managed.

The taxpayer's advisor devised rules that were intended to prevent the IRS from asserting that the taxpayer had direct or indirect control over the assets of the separate account. In practice, however, the taxpayer made a very large number of investment “recommendations”

virtually all of which were followed without question.

The IRS examined the taxpayer's timely filed Federal income tax returns for the years in question and citing the "investor control" doctrine, concluded that the taxpayer was the owner of the separate account assets for federal income tax purposes. As a result, the IRS treated the taxpayer as having received the dividends, interest, capital gains, and other income realized by the separate account, and assessed deficiencies and accuracy-related penalties against the taxpayer.

The Tax Court agreed with the IRS. The court found that although the taxpayer and taxpayer's accountant took steps to limit the appearance that the taxpayer had control over investment decisions, in fact the taxpayer had managed the assets of the separate account and retained the

attributes of ownership of those assets.

Although it was not bound by the revenue rulings on investor control, the Tax Court afforded those rulings deference under *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944), given the Commissioner's consistent position over time and given the persuasiveness of the rulings. As a result, the court held that the taxpayer was the owner of the separate account assets and was subject to tax on the earnings of those assets. Because the taxpayer had relied in good faith on professional advice from credentialed tax advisors, however, the court held the taxpayer was not liable for accuracy-related penalties.

The takeaway

In its decision in *Webber*, the Tax Court agreed with the IRS position in Rev. Rul. 2003-91 that a policyholder

may be treated as the owner of assets supporting a variable life insurance contract if he or she exercises direct or indirect control over those assets. The court also explicitly concluded that the investor control doctrine survived the 1984 enactment of the diversification requirements of Section 817(h). The case could result in the IRS increasing its scrutiny of private placement life insurance contracts to determine the extent to which policyholders control the assets that support those contracts. Although the facts in the case are highly specific, both life insurers and policyholders should regard the case as a reminder that policyholders with variable life insurance and annuity contracts cannot exercise direct or indirect control over the assets supporting those contracts if they intend those contracts to be taxed as life insurance or annuity contracts for federal income tax purposes.

Let's talk

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