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The *WRNewswire* is created exclusively for AALU Members by insurance experts led by Steve Leimberg, Lawrence Brody and Linas Sudzius. *WRNewswire #15.08.13 was written by Steve Leimberg, co-author with Howard Zaritsky of Tax Planning With Life Insurance, Publisher of Leimberg Information Services, Inc. (LISI) and Creator of NumberCruncher Software.*

TOPIC: INVESTOR CONTROL DOCTRINE CAUSES CURRENT INCOME TAXATION ON INCOME AND GROWTH INSIDE PRIVATE PLACEMENT VARIABLE LIFE CONTRACT

CITES: *Webber v. Commissioner*, 144 T.C. No. 17 (June 30, 2015); IRC Sections 72, 101(a), 817; Treasury Regulations Section 1.817-5.

SUMMARY: Jeffrey Webber established a grantor trust for his and his children's benefit that purchased "private placement" variable life insurance policies insuring the lives of two elderly relatives. The IRS concluded and the Tax Court agreed that Jeffrey retained sufficient control and incidents of ownership over the assets in the separate accounts to be treated as owner for Federal income tax purposes under the "investor control" doctrine and therefore he was currently taxable on income and gains produced within the policies. However, the Tax Court refused to impose accuracy-related penalties against Webber.

RELEVANCE: In this case, the investor control doctrine was invoked by the IRS to currently tax a policyholder who retained sufficient incidents of ownership over the underlying assets in this private placement variable life contact. And once again, the Tax Court warned us that it will look beyond what the parties *say* is happening and base taxation on what *really is happening*. When examining a transaction, particularly a new technique, to predict how it will be taxed, one must look – not only at the form – but also at its actual substance.

Results in income taxation, similarly to results in gift and estate taxation, will generally follow control. Stated in another way, tax liability attaches to command—exercisable directly or indirectly--of the rights and benefits of ownership in a real, substantial sense. As the saying goes, "Follow the money!"

This case does *not* stand for the proposition that private placement variable life insurance policies are in jeopardy. To the contrary, they can still, *if* properly arranged and administered, be used by clients to meet their wealth preservation goals.

For over 35 years, the IRS position has been that the diversification requirements of Treasury Regulations Section 1.817-5 do not prohibit the IRS from asserting that a contract owner's control over the investments in a segregated asset account from causing the contract owner, rather than the insurance company, to be treated as the owner of those assets for income tax purposes. During that same time, some commentators have insisted that the IRS was wrong. This case makes it clear that the tax court does support the IRS: That is, the IRS can add the factor of investor control to the diversification requirements of Code Section 817 which defines variable life insurance to determine if the variable policy will be respected for Federal income tax purposes.

Webber serves as a notice that in such variable life insurance arrangements, it is essential to create a clear barrier to the client's ability to dictate or influence the specific investments that underlie the funds offered under the policy and the importance of all of the parties continually following the terms of the policy.

Specifically, the policy-owner should be prohibited from exercising:

(1) The power to direct investments of the funds;

(2) The power to vote shares and exercise other options with respect to underlying securities of the funds;

(3) The power to extract cash at will from the policy's separate accounts; and

(4) The power in any other way to derive "effective benefit" from the investments in the separate accounts.

Finally, advisors should note that the Tax Court chose not to impose a 20 percent accuracy-related penalty asserted by the IRS, because the client relied in good faith on professional advice from competent tax professionals, who it found were not "promoters". To meet this standard, to protect your client, your client must obtain competent legal and accounting advice, and those professionals must do diligent research, reviewing and addressing of all of the relevant facts and issues. This should include pertinent IRS rulings, relevant judicial precedent, and opinion letters as well as law reviews and commentaries by experts in the field.

SOME TAX BACKGROUND: The "investor control" doctrine provides that if the policyholder's incidents of ownership over the assets of the funds underlying the policy become sufficiently comprehensive, *he* rather than the insurance company will be deemed to be the true owner of those assets for Federal income tax purposes. In that event, the deferral of income tax on the inside buildup will be lost and the investor will be taxed currently on the policy's investment income, as it is realized.

The critical "incidents of ownership" are powers to:

- decide what specific investments will be held in the accounts;
- vote securities in the separate accounts;
- exercise other rights or options relative to these investments;
- extract money from the accounts by withdrawal or otherwise and
- derive, in other ways, "effective benefit" from the underlying assets of the funds.

The "constructive receipt" doctrine prevents cash basis taxpayers from artificially deferring receipt of income to a later tax year. Under this doctrine, Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time.

The court in this case noted that the "investor control" doctrine is complementary to - but addresses a different problem - than the constructive receipt doctrine and a finding of "constructive receipt" is not a prerequisite to its application.

FACTS: Jeffrey Webber is a highly successful venture-capital investor and private-equity fund manager. He established a grantor trust that purchased off-shore private placement variable life insurance policies insuring the lives of two elderly relatives. Jeffrey and various family members were named – through the trust – as the beneficiaries of these policies.

The premium paid for each policy, after deduction of a mortality risk premium and an administrative charge, was placed in separate accounts. The assets in these separate accounts, and all income earned thereon, were segregated from the general assets and reserves of the insurer and earmarked exclusively to the two insurance policies.

Jeffrey anticipated two results through this structure:

(1) When determining the applicable tax treatment for all income and capital gains realized on these investments (which he would otherwise have held personally), he would not be considered to have retained sufficient control and incidents of ownership over these assets;

(2) The ultimate payout from these investments, including all realized gains, would qualify as payable insurance death proceeds under IRC Section 101(a).

The money in the separate accounts was used to purchase investments in start-up companies with which Jeffrey was intimately familiar and in which he invested personally and through funds he managed. So, effectively, Jeffrey controlled both the companies in which the separate accounts would invest and all actions taken with respect to these investments inside the separate accounts.

Under the policies, Jeffrey was allowed to transmit general investment objectives and guidelines to the investment manager, who was supposed to build a portfolio within those parameters. The trust specified that 100 percent of the assets in the separate accounts could consist of high risk investments, including private-equity and venture-capital assets. Besides setting the overall investment strategy for a separate account, Jeffrey was permitted to offer specific investment recommendations to the investment manager.

Technically, the investment manager was free to ignore such recommendations and was supposed to conduct independent due diligence before investing in any non-publicly-traded security. However, it appears no independent research or meaningful due diligence was ever done; the investment manager and insurer appear to have *always* followed Jeffrey's investment directives. The investment manager never made any independent research, it never initialized an investment until Jeffrey's attorney had signed off; and it performed no due diligence apart from boilerplate requests for organizational documents and "know your customer" review. The investment manager did not initiate or consider any equity investment for the separate accounts other than the investments that Jeffrey recommended.

Jeffrey never communicated--by email, telephone, or otherwise--directly with the insurer or the investment manager. Instead, he relayed all of his directives, invariably styled "recommendations," through his attorney or accountant. But as noted above, the investment manager assigned to these policies took no action without approval from Jeffrey's lawyer or accountant, including how they should vote as shareholders and how they should respond to capital calls, participate in financing, and convert promissory notes to equity. Although the policies themselves denied Jeffrey the power to direct investments, the investment manager *always* followed Jeffrey's investment directions, the bulk of the investments in the policy were non-publicly-traded securities which would not have been obtainable – except though Jeffrey. Often, Jeffrey directly initiated and negotiated a deal with a third party and then "recommended" that pre-arranged deal to the investment manager. He made all key decisions regarding the actions the special company that held his policy's investments would take with respect to its ongoing investments.

Furthermore, the policy gave Jeffrey the ability to extract money from the separate account. He was permitted to borrow against it or surrender it, though these were limited to the premiums that had been paid. He could sell assets to the separate accounts. He could require the account to lend money to Jeffrey's corporation for an investment he wished to make, and even to purchase a promissory note that he owned. He even used funds indirectly from within the separate account to finance what in essence were personal investments (e.g. a winery, a resort, and a hunting lodge). In other words, he caused the investments in the separate accounts to mirror or complement his own personal investments and the portfolios of the private-equity funds he managed or to invest in his startup ventures.

Citing the investor control doctrine and other principles, the IRS concluded that Jeffrey retained sufficient control and incidents of ownership over the assets in the separate accounts to be treated as their owner for Federal income tax purposes. The Service consequently imposed deficiencies in his Federal income tax of $507,230 and $148,588 and accuracy-related penalties of $101,446 and $29,718 for 2006 and 2007, respectively.

Jeffrey's attorneys argued that for the IRS to win this case, the Service needed to prove that Jeffrey was in constructive receipt of the income in the separate account. The Tax Court rejected that argument, observing that the investor control doctrine, if imposed, was adequate to impose tax liability on Jeffrey.

The Tax Court agreed with the IRS with regard to the investor control argument, and found Jeffrey liable for the tax. It refused to impose accuracy-related penalties.

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