SOCIETY OF ACTUARIES

Article from:

Taxing Times

May 2009 – Volume 5 – Issue No. 2

SURPRISING INVESTOR CONTROL ADVICE FROM IRS

By Joseph F. McKeever and Bryan W. Keene

Last October, the Internal Revenue Service ("IRS") released chief counsel advice memorandum 200840043 (the "CCA Memo"), addressing the "investor control" doctrine. The CCA Memo concludes that "[w]here a segregated asset account directly invests in assets available to the general public, the policyholder … is the owner of the assets in the segregated asset account." Taken at face value, this conclusion suggests that the IRS believes that any segregated asset account ("SAA") that is comprised of a pool of individual securities (such as a traditional "managed account" within the issuer's separate account), rather than shares of an "insurance-dedicated" mutual fund or partnership, will run afoul of the investor control doctrine. As discussed in this article, such a conclusion would be deeply flawed based on the administrative, congressional, and judicial precedents involving the investor control doctrine. As a result, it is possible that other facts described in the CCA Memo but not addressed in its analysis might have affected the ultimate conclusion. Nonetheless, the conclusion is troubling given that managed separate accounts have long been utilized in connection with variable contracts.

BACKGROUND ON THE INVESTOR CONTROL DOCTRINE

For federal income tax purposes, a life insurance company normally is treated as the owner of the separate account assets it holds in support of variable annuity and life insurance contracts it issues. The IRS established a limited exception to this treatment, however, in a series of revenue rulings colloquially known as the "investor control" rulings.[1] Under those rulings, the policyholder, rather than the insurance company, is treated as the owner of the separate account assets if he or she has sufficient incidents of ownership in them. The result is that the tax benefits of the insurance contract are lost, and the policyholder is currently taxable on income generated by the separate account assets.

The investor control rulings are predicated on the view that an investor should not be able to choose between purchasing a security directly, thereby subjecting the earnings to current taxation, or "wrapping" the investment in a variable contract, thereby deferring current taxation on those earnings. To this end, the rulings reflect the view that the party who directs the selection, management, and disposition of the assets of a SAA typically will be considered the owner of those assets for federal income tax purposes.[2]

In applying this principle, the investor control rulings often focus on the "public availability" of the investments supporting the contract. If the same investment is available without regard to the contract, *i.e.*, if it is publicly available, and the policyholder can either directly or indirectly instruct the insurance company to purchase that investment, then the policyholder has sufficient incidents of ownership in the investment to be viewed as its owner for tax purposes. Of course, almost every individual asset held in support of a variable contract (stocks, bonds, *etc.*) is "publicly available" at some level. As a result, the doctrine cannot reasonably be viewed as focusing only on whether any *particular* investment is publicly available—if this was the standard, virtually no variable contract would pass muster under the doctrine. Rather, the investor control analysis has focused—and should focus—on whether, in the aggregate, the assets supporting the contract represent a pool of investments that is available only through the purchase of a variable insurance product. Insurance-dedicated mutual funds and partnerships can pool publicly available assets together in this manner, but so can traditional managed separate accounts.

THE CCA MEMO IN GENERAL

The CCA Memo describes a private letter ruling request that the taxpayer-insurer withdrew after the IRS reached a tentative adverse position. In such situations, applicable IRS procedures authorize the IRS Chief Counsel's Office to send a memorandum to the IRS field office with jurisdiction over the taxpayer's return to inform the field of the withdrawn ruling request and the Chief Counsel Office's negative views thereon.[3] Like a private letter ruling, a chief counsel advice memorandum has no precedential value; it cannot be cited or relied upon as precedent.[4]

THE FACTS INVOLVED IN THE WITHDRAWN RULING REQUEST

The taxpayer was a foreign insurer that made an election to be treated as a domestic insurer pursuant to section 953(d). It filed, then withdrew, a ruling request with the IRS regarding variable contracts it intended to issue. Each contract was to be based on a different SAA that the taxpayer would establish for that contract. The CCA Memo explains that the policyholder could recommend the investment advisor for the SAA and, subject to certain limitations, the insurer would accept the recommendation. The policyholder also could complete a questionnaire regarding "investment horizons, investment goals, risk tolerance, risk profile, comfort with investments in different regions (*i.e.*, Latin America, Eastern Europe, Far East, Western Europe, Australia), and comfort level with different types of investment vehicles (*e.g.*, real estate, ADR's, partnerships, etc.)." Other than this information, there would be no agreements or communications between the policyholder and the insurer or the investment advisor regarding the SAA's investments, and the investment advisor would make all investment decisions in its "sole and unfettered discretion." Finally, and apparently most important to the IRS analysis, the parties "anticipated that the segregated asset accounts will directly invest in assets available to the general public."

Based on these facts, the insurer requested rulings that (1) for federal tax purposes it would be treated as the owner of the assets comprising the SAA, and (2) the contracts would constitute variable contracts within the meaning of section 817(d). The IRS reached a tentative adverse position on the first requested ruling. This prompted the taxpayer to withdraw its entire request, which made it unnecessary for the IRS to address the section 817(d) issue.

THE IRS ANALYSIS AND CONCLUSION

The CCA Memo summarizes most of the various court cases and IRS rulings that address the investor control doctrine, including *Christoffersen v. United States*, Rev. Rul. 81-225, and Rev. Rul. 2003-92 (but, curiously, not Rev. Rul. 2003-91). The CCA Memo offers very little analysis of those authorities in the context of the facts presented. Rather, after summarizing those authorities the CCA Memo states only that "[u]nder Rev. Rul. 81-225, assets held directly by a segregated asset account that are available to the general public are owned by the policyholder for federal tax purposes. For this reason, we believe that the policyholder in the ruling request and not the Taxpayer would own the assets in the proposed segregated asset accounts for federal tax purposes."

> Historically, it was quite common for a SAA that supports a variable contract to hold individual securities—each of which is publicly available—rather than shares of an "insurance-dedicated" mutual fund, partnership or trust.

OBSERVATIONS

Historically, it was quite common for a SAA that supports a variable contract to hold individual securities—each of which is publicly available—rather than shares of an "insurance-dedicated" mutual fund, partnership or trust. The first variable annuity contract, developed by TIAA-CREF, was based on such a "managed account," as were the variable annuities at issue in *VALIC* when the Supreme Court concluded that variable annuities were securities.[5] Indeed, a number of insurance company separate accounts continue to follow this approach today, as evidenced by SEC registration filings.[6] The CCA Memo, however, suggests that such an approach violates investor control principles on its face, and that the only way to avoid such a result is to interpose an insurance-dedicated mutual fund, partnership or trust between the SAA and the individual securities that the SAA otherwise would hold. In our view, this conclusion is erroneous.

First, it was not the public availability of individual securities that caused an investor control problem to arise in the

CONTINUED ON **PAGE 32**

various IRS rulings. Rather, it was the policyholder's ability to pick *which* publicly available securities would support the contract. Thus, for example, in Rev. Rul. 77-85 the policyholder's ability to direct the SAA to sell, purchase, and exchange investments that the policyholder selected from an approved list of publicly traded securities and bank deposit instruments caused an investor control problem to arise. Likewise, in Rev. Rul. 80-274 the policyholder's ability to purchase and transfer specific certificates of deposit to the SAA supporting his variable contract created an investor control problem. Similarly, in Rev. Rul. 81-225, from which the CCA Memo draws its conclusion, it was the policyholder's ability to allocate cash values to purchase shares of a specific publicly available mutual fund that caused the problem. In each of these rulings, impermissible investor control arose because the policyholder could direct which publicly available assets the SAA would purchase or sell. By concluding that it was the public availability of the assets themselves that caused the problem, and not the policyholder's ability to pick and choose those assets, the CCA Memo overlooks this fundamental aspect of the investor control analysis.

Second, the CCA Memo is at odds with the IRS's analysis and conclusion in Situation 5 of Rev. Rul. 81-225. Situation 5 is premised on the view that the direct holding of individual securities in a separate account is consistent with the insurer—not the policyholder—being treated as the owner of the securities for federal tax purposes. In Situation 5, the SAA invested in shares of a mutual fund (the "XY Fund"), the shares of which were available only through the purchase of an annuity contract. Rev. Rul. 81-225 concludes that in Situation 5 the insurance company ("IC")—and not the policyholder—is the owner of the mutual fund shares for tax purposes. The IRS explained its conclusion as follows:

> In *Situation* 5, the shares of XY Fund are not separate investment assets; XY Fund is nothing more than the alter ego of IC. The sole function of XY Fund is to provide an investment vehicle to allow IC to meet its obligations under its annuity contracts. *This situation is equivalent for federal income tax purposes to the direct purchase by IC of the underlying portfolio of assets of XY Fund. IC possesses sufficient incidents of ownership to be considered the owner of these underlying assets for federal income tax purposes.* (Emphasis added.)

It is obvious from this reasoning that the authors of Rev. Rul. 81-225 believed that the direct holding of individual securities by the insurer did not by itself create an investor control problem. Indeed, it seems clear that the premise of the IRS conclusion that Situation 5 did not violate the investor control doctrine was that it was equivalent to direct ownership by the insurer of the underlying assets (which were, of course, individual securities such as stocks and bonds that are "publicly available"). And, given the prevalence of managed separate accounts in the early 1980s, this premise is not surprising.

Furthermore, the conclusion in the CCA Memo appears to contradict section 817(h) and the regulations thereunder. Congress enacted section 817(h) to deny annuity or life insurance treatment for "contracts (1) that are equivalent to investments in one or a relatively small number of particular assets (*e.g.*, stocks, bonds, or certificates of deposit of a single issuer); [or] (2) that invest in one or a relatively small number of publicly available mutual funds …"[7] This legislative history makes it clear that a SAA supporting a variable contract can directly hold individual securities or shares of public mutual funds, as long as such holdings meet the diversification requirements.

In addition, section 817(h)(3), which provides a special rule for variable life insurance contracts, clearly contemplates that a SAA can directly hold U.S. Treasury securities, which are obviously publicly available securities. In this regard, section 817(h)(3) states "to the extent that any segregated asset account with respect to variable life insurance contracts *is invested in securities issued by the United States Treasury, the investments made by such accounts shall be treated as adequately diversified."* (Emphasis added.)

Consistently, examples in the section 817(h) regulations conclude that a contract will satisfy section 817(h) where the contract is based on one or more SAAs that hold individual, publicly available securities.[8] The CCA Memo's suggestion that a SAA must invest only in insurance-dedicated mutual funds, partnerships or trusts would render these provisions meaningless.

Finally, an unusual aspect of the CCA Memo is its lack of any discussion of Rev. Rul. 2003-91. In that ruling, the IRS identified certain favorable facts that would help avoid a finding of impermissible investor control, including the policyholder's inability to (1) select or even communicate views about the initial or subsequent investment advisor for the SAA, (2) recommend particular investments or investment strategies, or (3) communicate with the investment advisor regarding the selection, quality, or rate of return of any specific investment or group of investments held in the SAA. As indicated above, the facts of the CCA Memo state that the policyholder could select the investment advisor for the SAA, complete a questionnaire that would help the investment advisor develop an investment strategy for the SAA, and identify certain classes of assets (including by region) that the policyholder wished to include in (or exclude from) the SAA. Given the lack of any discussion of Rev. Rul. 2003-91 or any analysis of these facts in the CCA Memo, it is unclear whether or to what extent such facts influenced the IRS conclusion. However, given the deficiencies of a conclusion that a separate account which invests in publicly available securities has necessarily violated the investor control doctrine, it may be that these other factors played a role—albeit unstated—in the IRS decision not to rule favorably and to then issue the CCA Memo.

CONCLUSION

So, where does that leave us? To the extent that the CCA Memo reflects the view that a separate account which invests in publicly available securities has *ipso facto* violated the investor control doctrine, the CCA Memo is inconsistent with Rev. Rul. 81-225 and section 817(h) and its regulations. However, taxpayers who are filing ruling requests involving variable contracts should proceed cautiously if their separate accounts do not use a pass-through entity and instead invest directly in individual securities. Otherwise, they may find themselves the subject of a future chief counsel advice memorandum.

Joseph F. McKeever, III is a partner in the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *jfmckeever@davis-harman.com.*

Bryan W. Keene is a partner in the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *bwkeene@davis-harman.com.*

END NOTES

1 Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 82-55, 1982-1 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12, modified by Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12. *See also* Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984).

2 The investor control rulings state that this view is based on the judicial notion that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." Rev. Rul. 2003-91 (quoting Corliss v. Bowers, 281 U.S. 376 (1930)). This notion, in turn, is a specific application of the long-standing judicial doctrine that the substance of an arrangement, rather than its form, controls its characterization for federal tax purposes. *See, e.g.*, Gregory v. Helvering, 293 U.S. 465 (1935).

3 Section 7.07(2) of Rev. Proc. 2009-1, 2009-1 I.R.B. 1, 28.

4 I.R.C. section 6110(k)(3). Unless otherwise indicated, all references to sections are to sections of the Internal Revenue Code of 1986, as amended.

5 *See* Securities and Exchange Commission v. Variable Annuity Life Ins. Co. of America, 155 F.Supp. 521, 523 (D.D.C. Sep. 3, 1957), *aff'd*, 257 F.2d 201 (D.C. Cir. 1958), *rev'd*, 359 U.S. 65 (1959). *See also* Securities and Exchange Commission v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

6 It is, however, far more common today for registered variable contracts to be based on insurance-dedicated funds rather than managed separate accounts. As a result, the position reflected in the CCA Memo likely has more significance for private placement products, which use managed separate accounts more often.

7 H.R. CONF. REP. NO. 98-861, at 1055 (1984).

8 *See* Treas. Reg. section 1.817-5(g), Example (1) (concluding that section 817(h) is satisfied where a contract is supported by two SAAs, one of which holds a diversified pool of debt securities and the other of which holds interests in an insurance-dedicated partnership that, in turn, holds a diversified pool of securities). *See also* Treas. Reg. section 1.817-5(g), Example (3) (reaching the same conclusion with respect to a single SAA that holds individual debt securities and interests in a publicly-available partnership, as long as the debt securities and the partnership interests, considered together, are adequately diversified).