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IRS RULES LIFECYCLE FUNDS COMPLY WITH INVESTOR CONTROL DOCTRINE

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In PLR 201105012 (Oct. 14, 2010), the IRS addressed the application of the investor control doctrine to certain "Lifecycle Insurance Funds." The Lifecycle Insurance Funds are insurance-dedicated mutual funds, meaning they generally are available only in support of variable contracts.[1] Each fund follows a "target date" investment strategy, where the underlying investments gradually become more conservative as a targeted retirement date approaches. Prior to the transaction that the taxpayer life insurer proposed, each Lifecycle Insurance Fund invested exclusively in shares of other insurance-dedicated mutual funds. The taxpayer proposed allowing the Lifecycle Insurance Funds to invest some or all of their assets in certain mutual funds and investment partnerships that are not insurance-dedicated, but rather are available directly or indirectly for investment by members of the general public. The IRS concluded that the proposed investments would not violate the investor control doctrine. As a result, for federal income tax purposes, the insurer (rather than the variable contract holders) is treated as owning the separate account assets underlying the 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.[2] 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 were 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 separate account assets typically will be considered the owner of those assets for federal income tax purposes.[3] 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.[4]

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 must 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.

THE PROPOSED INVESTMENT STRUCTURE IN PLR 201105012

The Lifecycle Insurance Funds in PLR 201105012 are funds-of-funds in which a top-tier, insurance-dedicated mutual fund invests in certain lower-tier funds. Prior to the proposed transaction, the lower-tier funds were other insurance-dedicated mutual funds. The taxpayer proposed modifying the composition of the lower-tier funds to include certain mutual funds and investment partnerships that are not insurance-dedicated. In particular, the taxpayer proposed allowing the Lifecycle Insurance Funds to invest some or all of their assets in "Public Funds" and "Central Funds."

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The Public Funds are mutual funds that offer shares for purchase directly by members of the general public, without having to purchase a variable contract. The Central Funds also are "publicly available" in this sense, albeit indirectly rather than directly. In that regard, the Central Funds are available to certain entities and accounts that the taxpayer's affiliates manage (such as the Public Funds), and members of the general public can invest directly in those entities and accounts. Thus, public access to the Central Funds is available indirectly without purchasing a variable contract. Some of the Central Funds are available to a wide array of other entities and accounts, and other Central Funds were created specifically for investment by Public Funds that follow a lifecycle or target date investment strategy. The ruling calls this latter category of Central Funds the "Lifecycle Central Funds."

The taxpayer indicated to the IRS that the proposed investments in Public Funds will give the investment manager greater discretion and flexibility in managing the Lifecycle Insurance Funds, with the accompanying potential of achieving better performance results and greater investment risk diversification for variable contract holders. Similarly, the taxpayer indicated that the proposed investments in Central Funds will broaden the investment options of the Lifecycle Insurance Funds and allow them to take advantage of certain operational efficiencies and the expertise of other investment managers. With respect to the Lifecycle Central Funds (*i.e.*, the subset of Central Funds described above), the taxpayer indicated that it expects the proposed investments in such funds to occur gradually over several years, but ultimately they could represent a significant portion of a top-tier Lifecycle Insurance Fund's investments, potentially exceeding its investments in other types of lower-tier funds.

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Each Lifecycle Insurance Fund's investments in Public Funds and Central Funds will comply with the investment diversification requirements of Internal Revenue Code section 817(h) and the regulations thereunder. However, the percentage of a Lifecycle Insurance Fund's investments in any Public Fund or Central Fund will not be fixed in advance of a contract holder's investment and may be changed by the investment manager at any time. In that regard, the investment manager will use its sole and absolute discretion regarding the nature and extent of any investments in Public Funds or Central Funds. Contract holders will have the ability only to allocate premiums and cash values among the sub-accounts of the insurer's separate account that correspond to the Lifecycle Insurance Funds.

CONCLUSION IN PLR 201105012

The IRS concluded in PLR 201105012 that the Lifecycle Insurance Funds' proposed investments in Public Funds and Central Funds will not run afoul of the investor control doctrine. As a result, such investments will not cause the variable contract holders to be treated as owning the assets underlying their contracts for federal income tax purposes.

In reaching this conclusion, the IRS noted that the investor control doctrine applies based on all the relevant facts and circumstances. With regard to the facts presented, the IRS observed that shares of the Lifecycle Insurance Funds themselves are not publicly available. In addition, the IRS noted that all investment decisions regarding the Lifecycle Insurance Funds are made by the investment manager in its sole and absolute discretion, and that a variable contract holder cannot direct a Lifecycle Insurance Fund's investment in any particular asset nor is there any agreement or plan with the contract holder regarding such an investment. Finally, the IRS observed that the investment strategies of the Lifecycle Insurance Funds are "sufficiently broad to prevent a variable contract holder from making particular investment decisions through investment in a Lifecycle Insurance Fund," and that only the insurer can add or remove investment options under the contracts. Based on these facts, the IRS concluded that no investor control violation arises.

CONSISTENCY WITH EARLIER RULINGS

The IRS has reached this same conclusion in the context of other funds-of-funds that proposed including public mutual funds in their lower-tier investments. For example, in PLR 200601006 (Sept. 30, 2005), the IRS reached a similar conclusion with respect to insurance-dedicated lifecycle funds that proposed investing a portion of their assets in public mutual funds, subject to certain self-imposed limits (which were redacted from the public version of the ruling). Likewise, in PLR 200420017 (Feb. 2, 2004) and PLR 9839034 (June

30, 1998), the IRS reached a similar conclusion with respect to insurance-dedicated funds that proposed investing exclusively in shares of public mutual funds. Furthermore, in PLR 200025037 (Mar. 24, 2000) and PLR 9748035 (Aug. 29, 1997), the IRS reached a similar conclusion with respect to insurance-dedicated funds that invested a portion of their assets in public mutual funds and the remaining portion in various debt and/or equity securities. As a result, it seems clear that an insurance-dedicated fund-of-funds arrangement in which the lower-tier investments are comprised partially or wholly of public mutual funds will not necessarily run afoul of investor control principles, as long as such investments otherwise comply with those principles—including the investment manager retaining sole and absolute discretion over which public funds will be used in the arrangement.

END NOTES

[1] More specifically, "insurance dedicated" means that, except as otherwise permitted by Treas. Reg. section 1.817-5(f)(3), all the beneficial interests in the Lifecycle Insurance Funds are held by one or more insurance companies and public access to the Lifecycle Insurance Funds is available exclusively through the purchase of a variable contract.

[2] 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.

[3] 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).

[4] One question that sometimes arises under the investor control doctrine is whether offering too many investment options effectively enables the policyholder to choose among specific investments and thereby exercise impermissible control over the separate account assets. While the IRS rulings have not drawn specific lines in this regard, one ruling favorably described a variable contract that offered 20 investment options. *See* Rev. Rul. 2003-91. That figure, however, was not described as an upper limit for all purposes of the investor control doctrine. Rather, the standard expressed in the rulings to date is that a policyholder's choices should be limited to "broad, general investment strategies" in order to remain consistent with investor control principles. *See, e.g.*, Rev. Rul. 82-54.

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