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# Investor Control: Will You Know It When You See It?[1]

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Since the 1970s taxpayers purchasing and selling variable life insurance and annuity contracts have been wary of the "Investor Control Doctrine." With the 1984 passage of the diversification requirements in section 817(h) of the Internal Revenue Code (the "Code"),[3] and the issuance of the accompanying regulations in 1986, some have taken the position that the Investor Control Doctrine was subsumed by the diversification requirements. Others have suggested that the doctrine is unclear and would be difficult to sustain other than in extreme circumstances that would otherwise violate more established and judicially tested form-over-substance principles. The Internal Revenue Service (IRS), however, has continued to put taxpayers on notice that the Investor Control Doctrine retains its vitality even after enactment of the diversification requirements and continued judicial development of form-over-substance standards. For example, it has continued to issue guidance in the form of revenue rulings and to provide taxpayers private letter rulings.

On June 30, 2015, the U.S. Tax Court reaffirmed the viability of the Investor Control Doctrine in *Webber v. Commissioner*.[4] The case serves as a valuable example of what not to do with regard to the investment of assets supporting a variable life insurance contract purchased through a private placement transaction. In the end, however, the *Webber* court leaves a lot of questions unanswered—most significantly, the elusive answer to how to define investor control. The case leaves taxpayers with a little less gray area but significant uncertainty about how to address arrangements that are, for example, not squarely within the facts of the safe harbor established in Rev. Rul. 2003-91,[5] in which all investment decisions were made in the sole and absolute discretion of the company and its investment manager, but that are not clearly as egregious as the transaction at issue in *Webber*. While it does not provide all the answers to what type of behavior will be respected, through its analysis, the decision provides a clarion call to those seeking to structure or enter into private placement variable contracts as to the facts that a court could consider to be relevant to analyzing the presence of inappropriate investor control.

This article examines the Investor Control Doctrine, as explained and applied by the U.S. Tax Court in *Webber*, and considers some of the open questions that remain after June 30, 2015. In doing so, it points out the factors the court indicated taxpayers will continue to need to consider.

## INVESTOR CONTROL DOCTRINE

From the standpoint of the contract holder, earnings on assets supporting life insurance and annuity contracts accrue on a tax-deferred basis. Simply stated, there is no tax to the contract holder until there is an actual or deemed distribution of those earnings. In the case of a life insurance contract, those earnings can effectively be fully excluded from taxable income if the only distribution under the contract is in the form of a death benefit. This deferral treatment is consistent with the concept of constructive receipt. The insurance company, and not the contract holder, owns the assets supporting the life insurance company's obligations under the contract. A contract holder has to give up valuable rights, including control over the assets supporting the contract, through premiums paid to purchase the contract. Similarly, the contract holder forfeits valuable assets when it receives distributions of the earnings under the contract, *e.g.*, diminution of benefits under the contract or surrendering the rights to remain insured.

Looked at another way, a policyholder's only right under an insurance contract is to get paid under the terms of the contract. The insurance company can invest the premium dollars it receives in any manner it chooses, as long as it pays the policyholder in accordance with such terms. In the case of a variable contract, the fund or investment that serves as the basis upon which the policyholder is to be paid is merely an index. The insurance company is not obligated to actually make the subject investment. Thus, if a policyholder is able to direct the insurance company how to invest its premium dollars, it is exercising the dominion and control over the investing activity that is arguably the exclusive province of the insurance company.

The government faced these questions: What happens if the purchaser of the contract doesn't give up total control over the assets or is exercising extra-contractual dominion and control? Should the logic of constructive receipt continue to shield the earnings credited to the contract from tax before a distribution if the contract holder is exercising the rights of the owner of the assets, including making all the investment decisions concerning the assets? Moreover, what actions may a policyholder take before it will be deemed to be the owner of the assets? If the contract holder directs the purchase of particular assets, who truly maintains the valuable rights of asset ownership? The Investor Control Doctrine was developed by the government to address just these types of situations.

The "Investor Control" Doctrine has its roots in Supreme Court jurisprudence. In *Helvering v. Clifford*,[6] the taxpayer contributed

securities to a trust and named himself as the trustee. The trust directed him, as trustee, to pay the income to his wife for five years. At the end of five years, the trust was to terminate and the corpus would revert to the taxpayer. The trust instrument authorized the taxpayer to vote the shares held by the trust and to decide what securities would be bought or sold. The trust instrument also afforded him "absolute discretion" to determine whether income should be reinvested rather than paid out. According to the Court, the taxpayer's control over the securities remained essentially the same before and after the trust was created. As for the taxpayer's "dominion and control" over the asset, the Court stated that "it seems clear that the trust did not effect any substantial change."[7] In the end, the Court concluded that, based on "all considerations and circumstances," the taxpayer retained the attributes of an owner, and should be treated as the owner of the trust assets for federal tax purposes.[8]

In the 1970s, the IRS began facing situations in which contract holders were exercising significant control over the management and investment of assets supporting variable insurance contracts. Beginning in 1977, the IRS began issuing guidance on when a contract holder taxpayer exercises sufficient control over variable product assets that it would be appropriate to treat the contract holder, and not the insurance company, as the owner of the assets supporting the contract for federal tax purposes. The result of such treatment is that any earnings on such assets would be taxed currently—the benefit of deferral would be lost.

The first formal guidance setting forth the Investor Control Doctrine is Revenue Ruling 77-85. Rev. Rul. 77-85[9] deals with an investment annuity contract issued by an insurance company and purchased by a taxpayer. The premium was deposited into a separate account held by a custodian. The policyholder had a power to sell, purchase, or exchange securities; to invest and reinvest principal and income; to vote the shares; to exercise option relating to assets; and to surrender the policy. The IRS, looking to the Supreme Court's guidance in *Clifford*, concluded the taxpayer, not the insurance company, should be considered the owner of the assets, as he possessed significant incidents of ownership. Thus, any interest, dividends, and other income derived from securities held in the separate account should be includable in the gross income of the taxpayer.[10]

The IRS also addressed situations when separate accounts supporting variable contracts invest, not in securities selected directly by the policyholder, but in shares of mutual funds with their own investment manager. In Rev. Rul. 81-225,[11] the IRS concluded that the policyholder had sufficient investor control when the mutual fund shares were available for purchase by the general public wholly apart from the annuity arrangement. When investments in the mutual fund shares were controlled by the insurance company and the fund only functioned as an investment vehicle, however, the IRS concluded that the insurance company was the owner of the assets because the shares were not available to the general public. Similarly, in Rev. Rul. 82-54, the IRS stated that the control over individual investment decisions must not be in the hands of the policyholders in order for the insurance company to be considered the owner of the mutual funds.[13]

Taxpayers challenged the Investor Control Doctrine and two courts considered whether the doctrine was valid and whether it had been properly applied by the IRS. In both cases, the IRS prevailed and the Investor Control Doctrine was sustained. In *Christoffersen v. United States*,[14] a unanimous Eighth Circuit concluded that the owners of a variable annuity contract were the beneficial owners of the assets that supported the contract because the contract holders had "surrendered few of the rights of ownership or control over the assets in the sub-account."[15] According to the court, the fact that the assets were formally owned by the insurance company was not dispositive; rather, the court looked to "actual command" over the assets.[16] The second case to address the validity of the investor control rules, *Inv. Annuity, Inc. v. Blumenthal*,[17] was dismissed by the appellate court due to lack of jurisdiction. The trial court had concluded that Rev. Rul. 77-85 was invalid.

Congress entered the picture in 1984 with enactment of the investment diversification rules of Code section 817(h). That section establishes the minimum number of assets that may be held and percentage of ownership of those that must be satisfied for a variable life or annuity contract to be treated as such for federal income tax purposes. Regulations promulgated under section 817(h) provide guidance on how to meet these requirements and set forth look-through rules permitting taxpayers to look through a fund to the individual assets held by the account, if certain ownership limitations are met. Some practitioners have argued that section 817(h) supplants the Investor Control Doctrine but most disagree with this approach, and the IRS has continued to apply the Investor Control Doctrine, including issuing private letter rulings and other guidance to assist taxpayers as they review the application of these rules to their fact pattern.[18]

The IRS and Treasury continue to publish formal guidance on investor control. In Rev. Proc. 99-44,[19] the government provided relief to certain annuities purchased in connection with sections 403(a), 403(b) or 408(b), stating that arrangements will not be disqualified merely because they are invested in publicly available funds. This ruling resolved some long-standing ambiguity about how the Investor Control Doctrine applies to certain qualified plans. Rev. Ruls. 2003-91 and 2003-92 provide detailed guidance on the application of the Investor Control Doctrine, setting out a safe harbor for taxpayers in Rev. Rul. 2003-91 and providing clarification on the application of the doctrine to certain partnerships in Rev. Rul. 2003-92.[20] Finally, in 2008, Treasury and the IRS issued Notice 2008-92,[21] which

announced, among other things, that the IRS would not assert a violation of investor control against insurance-dedicated money market funds participating in Treasury's temporary guarantee program for money market funds.

In Rev. Rul. 2003-91, which was at issue in *Webber*, the IRS provided a "safe harbor" for taxpayers. The IRS concluded that the insurance company would be treated as the owner of the assets in the separate account provided the insurance company and its investment manager made all investment decisions regarding those assets. The policyholder could not select or recommend particular investments for the subaccounts; the policyholder could not communicate directly or indirectly with any investment officer; there could be no arrangement, plan, contract or agreement between the policyholder and the insurance company or investment manager regarding the investment strategy.[22] Drawing on the *Clifford* decision, Rev. Rul. 2003-91 makes it clear that the determination of whether an arrangement involves investor control depends on all the facts and circumstances.

## THE *WEBBER* CASE

### A: The Entities

It is against the backdrop of this 40-year history that the *Webber* case arose. Jeffrey T. Webber was a venture-capital investor and private-equity fund manager. He founded and managed a series of private-equity partnerships that provided "seed capital" to startup companies. Separately, he provided consulting services to startup ventures through his own firm, which was usually the managing director or the general partner of venture-capital partnerships. Mr. Webber retained the authority to make investment decisions for the partnerships. He invested in and served on the boards of 24 companies at various times prior to Dec. 31, 2007.

Mr. Webber hired a personal accountant and an attorney for his estate planning. In 1999, the attorney suggested a tax-minimization strategy through the purchase of private placement life insurance policies from Lighthouse, a Cayman Islands life insurance company. The policies would be held in a grantor trust and the attorney and the Alaska Trust Co. would act as co-trustees, although Mr. Webber could remove or replace the trustees at any time. The trust beneficiaries included Mr. Webber's family, and Mr. Webber was named as a discretionary beneficiary. The trust purchased two flexible premium variable life insurance policies from Lighthouse.

At the request of Mr. Webber, the first trust was dissolved and all the assets were moved to a Bahamian grantor trust in 2003. The Bahamian grantor trust was listed as the nominal owner of the two policies until Mr. Webber decided to move the trust assets back to a domestic grantor trust. Thus, the Bahamian trust was the nominal owner of the policies in 2006 and 2007, the tax years at issue. Mr. Webber was the grantor and treated as the owner of the Bahamian Trust for federal income tax purposes.

### B: The Policies

The policies insured the lives of two of Mr. Webber's relatives: the stepgrandmother of Mr. Webber's then wife and his aunt. Each policy had a minimum guaranteed death benefit of $2,720,000, which was payable in all events so long as the policy remained in force. Each policy required Lighthouse to establish a separate account pursuant to the Cayman Islands Insurance Law. Lighthouse transferred most of the mortality risk premium to Hannover Re. The parties agreed that the policies met the requirements of section 7702 and were modified endowment contracts (MECs) within the meaning of section 7702A.[23]

The premium, less annual administrative and mortality charges, was allocated to separate accounts. If the assets in the separate account were insufficient to defray each year's mortality and administrative charges, the policyholder had to make an additional premium payment; otherwise, the policy would lapse. Upon the insured's death, the beneficiary would receive the greater of the minimum guaranteed death benefit or the value of the separate account. Also, the policies permitted the policyholder to add additional premiums if necessary, and the Alaska Trust made an additional premium payment of $35,046 in 2000, making the total premiums paid on the policies $735,046.

Prior to the deaths of the insureds, the policyholders had the right to assign the policy; to use it as collateral for a loan; to borrow against it; and to surrender it. The policies reserved the company's right to reject the policyholder's request to assign it or use it as collateral for a loan. The policies' terms also significantly restricted the amount of cash that the policyholder could extract from the policies by surrender or policy loan.

### C: Investment of Policy Assets

The policies stated that no one but the investment manager may direct investments and deny the policyholder any "right to require Lighthouse to acquire a particular investment" for a separate account. The policyholder was allowed to transmit "general investment objectives and guidelines" and to offer specific investment recommendations to the investment manager. In 2006 and 2007, Butterfield Private Bank and Experta Trust Co. served as the investment managers ("Investment Manager") of the separate account. Lighthouse was required to perform "know-your-client" due diligence, to avoid violating certain laws and to ensure that the investments met the diversification requirements of section 817(h). No records existed showing Lighthouse or the Investment Manager performed independent research or meaningful due diligence with respect to any of Mr. Webber's investment directives.

Lighthouse established several companies to hold the investments in the separate accounts, including Boiler Riffle Investments, Ltd. ("Boiler Riffle"), a Bahamian company. These investment funds were owned by Lighthouse but not available to the general public or to any other Lighthouse policyholder.

Mr. Webber's attorney explained to Mr. Webber that it was important for tax reasons that Mr. Webber not appear to exercise any control over the investments by Lighthouse, and he instructed Mr. Webber not to communicate directly with Lighthouse or the Investment Manager. Instead, Mr. Webber communicated with Lighthouse or the Investment Manager through his attorney or his accountant. There were more than 70,000 emails documenting this communication.

During the years at issue, most of Mr. Webber's investment objectives for the policies were effectuated through a special-purpose entity (SPE). Mr. Webber offered, via his attorney or accountant, "recommendations" about assets in which the SPE should invest. According to the facts presented in the case, every investment the SPE made was an investment that Mr. Webber had recommended and virtually every security the SPE held was issued by a company in which Mr. Webber had a personal financial interest.

Mr. Webber's attorney was aware of the Investor Control Doctrine, but concluded that it would not apply because Mr. Webber would not be in "constructive receipt" of the assets held in the separate accounts.

**D: The IRS Challenge**

The IRS examined Mr. Webber's 2006 and 2007 federal income tax returns. The IRS requested to interview Mr. Webber's accountant and issued a summons, but Mr. Webber's attorneys moved to quash the summons. The IRS eventually interviewed the accountant and concluded that the Lighthouse structure was a "sham"; that the SPE was a Controlled Foreign Corporation (CFC) whose income was taxable to Mr. Webber under section 951 through the Bahamian trust; and that Mr. Webber was subject to tax on the income that the SPE derived from the investments it held for the policies' separate accounts, because Mr. Webber was deemed to own the assets in the separate accounts under the Investor Control Doctrine. The IRS issued Mr. Webber a notice of deficiency, and he sought review in the Tax Court.

## TAX COURT'S OPINION

The Tax Court, in a lengthy and detailed opinion, agreed with the IRS that the arrangement among Mr. Webber, the Bahamian trust, Lighthouse and the Investment Manager violated the Investor Control Doctrine. In so doing, the Court considered a number of challenges from Mr. Webber, each of which may factor into subsequent application of, and challenges to, the Investor Control Doctrine.

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**A: Burden of Proof**

When contesting the determinations set forth in a notice of deficiency, a taxpayer bears the initial burden of proof. If the taxpayer produces "credible evidence with respect to any factual issue," the burden of proof will shift to the Commissioner if certain conditions are met. According to *Higbee v. Commissioner*, "credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted." The Court stated that the taxpayer must have "cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews" to qualify for a shift in the burden of proof.

The Tax Court held the burden of proof remained on Mr. Webber because he failed to "cooperate with reasonable requests by the Secretary for witnesses, * * *, meetings, and interviews."[25] The court found Mr. Webber did not introduce "credible evidence" on the central factual issues in this case because he did not fully cooperate with the IRS' discovery requests by rejecting the request to interview his accountant. The IRS had to issue the summons, and Mr. Webber's attorneys moved to quash it. Thus, the Court held that Mr. Webber failed to cooperate with reasonable requests by the Secretary and burden of proof remained on Mr. Webber.

While this may appear to be a mere procedural matter in this case, it does present an interesting question. As a result of this ruling, Mr. Webber is put in the position of having to prove a negative—that he exerted no control over the investments made to support the life insurance policies. The Court goes to great lengths in this case to provide evidence of the control that Mr. Webber did, in fact, exert over the Investment Manager and other parties to the transaction. It is interesting to ask, however, whether the IRS would have had an easy time proving the existence of investor control if the burden had been with the IRS.

In this case, the Tax Court believed the facts demonstrated fairly conclusively that Mr. Webber was calling the shots when it came to the investments supporting the variable policies. We are left

to wonder how the Court might have ruled in a less clear-cut case. What if there is less overwhelming evidence? What if the Investment Manager did exercise some independence? If the taxpayer has the burden of proof, it may still be challenging to demonstrate the negative—that no investor control exists. But if the burden is on the government instead—because the taxpayer was cooperative and succeeded in shifting the burden to the government —what facts are required to demonstrate that the policyholder was exerting control? Are a few emails enough? In this case, this procedural matter may not have altered the outcome, but who bears the burden of proof in a future case may be a much more important matter and could affect the outcome of the case.

**B: The Investor Control Doctrine**

Having determined that Mr. Webber bore the burden of proof in this case, the Court then turned its attention to the core issue—whether, under application of the Investor Control Doctrine, Mr. Webber, and not Lighthouse, would be treated as the owner of the assets supporting the life insurance policies for federal income tax purposes. The Court looked to the history of the doctrine and laid out those facts that, in the Court's view, demonstrated the presence of investor control. According to the Court, the power to direct what specific investments will be held in the separate account would be the core "incidents of ownership" in determining the true owner of the assets in those accounts for federal tax purposes. For policyholders not to be treated as owners, control over individual investment decisions must not be in the hands of the policyholders. Other factors of "incidents of ownership" include the powers to vote securities in the separate account; to exercise other rights or options relative to the investments; to extract money from the account; and to derive "effective benefit" from the underlying assets.

Mr. Webber challenged the Court's deference to the published guidance of the IRS and Treasury Department, in particular Rev. Rul. 2003-91. While it is not customary for a court to defer to a revenue ruling, the Tax Court held that deference in this case was appropriate because the investor control rulings reflected a consistent and well-grounded process of development of the doctrine over more than 40 years and was based in judicial precedent.[27] In rejecting Mr. Webber's challenge, the Court relied on *Skidmore v. Swift & Co.*,[28] which found that deference was appropriate when the length of time an agency held specific views suggested that the position had been given careful consideration. The Court also relied on *Christoffersen v. United States*[29] to justify its deference to *Skidmore*. In *Christoffersen*, the taxpayers purchased a variable annuity supported by a separate account from a life insurance company. The Court of Appeals for the Eighth Circuit held that, although the taxpayers had surrendered a few ownership rights, the taxpayers were still the beneficial owners of the investment funds. From the Court's view, the payment of annuity premiums, management fees and the limitation of withdrawals to cash, rather than shares, did not reflect a lack of ownership or control. The Court made clear that *Inv. Annuity, Inc. v. Blumenthal*,[30] which held Revenue Ruling 77-85 invalid, could not apply here, because it was reversed due to the District Court's lack of jurisdiction.

Again, a different ruling on a procedural matter, in this case deference to IRS published guidance, might have produced a different outcome. To be sure, the Court goes to great lengths to lay out all the evidence that Mr. Webber was controlling the investment decisions affecting the policies. Furthermore, even without deferring to Rev. Rul. 2003-91, the Court could have constructed similar reasoning from judicial precedent; the Court's job was made easier by the IRS and Treasury's continued application and development of the Investor Control Doctrine. If the IRS had issued Rev. Rul. 77-85 and never revisited the Investor Control Doctrine, the outcome might have been different. But the Investor Control Doctrine was not a dusty relic of a 40-year-old revenue ruling; the IRS had continued to apply the doctrine, courts had considered its application, and even Mr. Webber and his legal team thought the doctrine viable enough that they determined that communication directly between Mr. Webber and the Investment Manager would violate the doctrine.

**C: Ownership of the Separate Account Assets**

The Court agreed with the IRS that Mr. Webber, under the Investor Control Doctrine, should be treated as the owner of the

investments in the separate accounts for federal income tax purposes. In reaching this conclusion, the Court considered whether he retained significant incidents of ownership and the actual level of control over investment that Mr. Webber exercised. The Court held Mr. Webber enjoyed significant incidents of ownership and all dividends, interest, capital gains, and other income received by the separate accounts during tax years were includible in his gross income under section 61.

Mr. Webber had the power to direct investments for the separate accounts by instructing the Investment Manager to buy, sell and exchange securities and other assets in which Mr. Webber wished to invest. All the facts presented in the opinion demonstrated that the Investment Manager merely followed Mr. Webber's recommendations. Virtually every security Boiler Riffle's separate account held (apart from certain brokerage funds) was issued by a startup company in which Mr. Webber had a personal financial interest. Mr. Webber recommended every investment the Investment Manager made. According to the Court, Mr. Webber produced no evidence establishing that either Lighthouse or the investment manager engaged in independent research or meaningful due diligence. Mr. Webber often negotiated a deal directly with a third party, and then recommended the Investment Manager implement the deal. In sum, Mr. Webber actively managed the assets in the separate accounts by directing the Investment Manager to buy, sell and exchange securities and other property as he wished.

Mr. Webber also had the power to vote shares and exercise other options by dictating what actions the Investment Manager would take with respect to its ongoing investments. The Court found that he repeatedly directed what actions the separate account should take in its capacity as a shareholder of the startup companies in which he was interested.

In addition, Mr. Webber had numerous ways to extract cash from the separate accounts. The terms of each policy permitted the policyholder to assign it; to use it as collateral for a loan; to borrow against it; and to surrender it. Mr. Webber contended that this case should be distinguished from *Christoffersen*, since there was a restriction on the amount he could extract. The Court held the restriction was trivial, however, and found Mr. Webber could, and did, extract cash from the separate accounts by various ways—for example, by selling assets to the separate accounts. According to the Court, he could extract cash at will.

Mr. Webber also had the power to derive other benefits. He used the separate accounts to finance investments that may have been a source of personal pleasure. He regularly used the separate accounts synergistically to bolster his other positions, by using the accounts as a source of investment funds.

*Mr. Webber's Counterclaims*

Mr. Webber contended that he should not be taxed on the income realized by the separate account during 2006–2007 because he was not in "constructive receipt" of this income. According to Mr. Webber, he faced a substantial limitation or restriction on access to the income because he could enjoy actual receipt of that income only by surrendering the policies for their cash surrender value. The Court found, however, that the constructive receipt doctrine could not apply in this case, because that doctrine addressed a different problem from the Investor Control Doctrine. Also, if Mr. Webber were treated as the real owner, he would be treated as having actually received what the separate accounts actually received, so "constructive receipt" was not necessary. Stated another way, application of the Investor Control Doctrine trumps, or reverses, the constructive receipt analysis.

Mr. Webber also argued that the Investor Control Doctrine should not apply to life insurance contracts, because revenue rulings regarding this doctrine addressed variable annuity contracts. Although Rev. Ruls. 2003-91 and 2003-92 applied the doctrine to segregated asset accounts supporting variable life insurance contracts, Mr. Webber contended those rulings were not thoroughly considered as to the application of investor control to life insurance. The Court disagreed. The Court held that the statutory language in section 817(d)(2) fully supported the IRS' position that variable life insurance and variable annuities should be treated similarly.

Mr. Webber also contended the Investor Control Doctrine should not apply in this case because the risk was shifted by purchasing the insurance products from Lighthouse. In his view, the doctrine should apply only when the policyholder occupied essentially the same position that he would have occupied if he had purchased the assets in the separate account directly. The Court concluded that the existence of insurance risk alone did not make Lighthouse the owner of the assets. Moreover, Lighthouse was reinsured by Hannover Re and the remaining risk was actually quite small. The Court also emphasized that, when the existing mortality risk was fully compensated by mortality risk charges paid by the policyholder, the insurer's obligation to pay a minimum death benefit does not determine who owns the separate account assets.

Mr. Webber argued that the Investor Control Doctrine could not apply to an insurance policy that satisfies the statutory definition under section 7702. The Court again rejected this contention, as the fact the policies constitute "life insurance contracts" under section 7702(a) did not determine the owner of the separate account assets for tax purposes. Alternatively, Mr. Webber argued

that, if the Investor Control Doctrine applied to treat him as the owner of the separate account assets, the tax results should be dictated by section 7702(g), which defined the "income of the contract" as "the increase in the net surrender value," plus "the cost of life insurance protection provided," minus "the premiums paid." The Court disagreed with this counterargument, as section 7702(g) only applied when the life insurance contract failed to meet the requirements under section 7702(a).

Finally, Mr. Webber contended section 817(h) would supersede the Investor Control Doctrine. The Court again disagreed. The Court pointed out that Congress expressed no intention to displace the Investor Control Doctrine. In section 817(h), Congress directed the Commissioner to promulgate standards for determining when investments in a segregated account, though actually selected by an insurance company, are made at the direction of the investor. According to the Court, it would be contrary to congressional intent if section 817(h) disabled the Investor Control Doctrine. The Court made clear that the enactment of section 817(h) did not displace the investor doctrine principles.

**D: Accuracy-Related Penalty**

Interestingly, after a lengthy opinion demonstrating all the different ways that Mr. Webber, with the aid of his attorney and accountant, exercised control over the assets supporting his variable life insurance policies, the Court declined to uphold the accuracy-related penalty the IRS imposed on Mr. Webber. Section 6662 imposes a 20 percent accuracy-related penalty upon the portion of any underpayment of tax that is attributable (among other things) to a substantial understatement of income tax. For the section 6662 penalty, the Commissioner bears the burden of production. If the Commissioner satisfies this burden, the taxpayer then bears the ultimate burden of production. If it is shown that the taxpayer acted in good faith, the penalty will not be imposed. A taxpayer can demonstrate reasonable cause and good faith by showing reliance on professional tax advice.

In this case, the Court held that Mr. Webber's reliance on his attorney's advice was reasonable, so he was not liable for the accuracy-related penalty. According to the court, the attorney was a competent tax adviser. He reviewed several opinion letters concerning the Investor Control Doctrine, which concluded that the Lighthouse policies would comply with U.S. tax laws and avoid application of the doctrine. By informing Mr. Webber that he concurred in these opinions, the attorney provided professional tax service to Mr. Webber and Mr. Webber relied on this advice in good faith. In addition, the fact that Mr. Webber did not attempt to hide his estate plan from the IRS also supported his testimony that he believed the strategy would successfully withstand the IRS scrutiny.

## DISCUSSION

The Tax Court's analysis in *Webber* is detailed and thorough, and few could argue that it reaches the wrong conclusion. Practitioners, including Mr. Webber's attorney, have continued to consider the Investor Control Doctrine a viable and important consideration when establishing and maintaining variable life insurance or annuity arrangements, especially in the private placement market. Adding the reasoning of *Webber* to the IRS guidance, especially the most recent statement in Rev. Ruls. 2003-91 and 2003-92, offers taxpayers some valuable guidance of what to do, and perhaps more importantly, what not to do.

Significant questions remain, however, and if *Webber* provides any lasting assistance to taxpayers considering purchasing a variable product, it is that it strongly reinforces the intensely factual nature of the investor control analysis. The timing of the *Webber* decision is important because private placement life insurance and annuity contracts are increasingly being purchased by high net worth individuals and arrangements are being used in a number of tax-planning arrangements. Similarly, private equity and other alternative investment firms are establishing insurance-dedicated funds that mirror publicly available investments they manage—commonly referred to as clone funds. Anyone contemplating entering into such an arrangement should carefully consider the Investor Control Doctrine and its application to the particular arrangement under consideration.

The Investor Control Doctrine applies at the time an arrangement is established as well as throughout the life span of the arrangement. There is no such thing as a "foot fault" or a correction option as there is in the diversification rules of section 817(h). Once a transaction fails investor control, it is essentially "game over." But given the factual nature of the analysis, there is little certainty for taxpayers, except that transactions fitting within the IRS guidance are probably sound and transactions resembling *Webber* are probably in trouble.

There are some clues to the facts that tend to demonstrate investor control and facts that tend to demonstrate a lack of control. For example, the relationships of the various parties to the transaction are important. If the policyholder is in a position to exert control over the insurance company, the investment adviser or any other party to the transaction in such a way that a party is likely to act at the policyholder's behest and not independently, there may be an investor control problem.

As the IRS guidance points out, communications between the policyholder and any of the parties involved in making investment decisions should be viewed carefully for influence or control. But left unaddressed is what type of communication, if any, is not a problem. What about sharing the name of the investment manager, past performance of a fund, and information on significant holdings of a fund? Does this rise to the level of

establishing the type of pre-arranged plan to invest in specific investments that Rev. Rul. 2003-91 was concerned with? How general must the description of the investment strategy of a fund or investment option be to satisfy investor control? What about proprietary investment formulas?

The relationship between the purchaser of a policy and the insurance company or investment manager must also be monitored. It is increasingly common that investment managers establish an insurance-dedicated fund that is a clone of a popular investment vehicle. The IRS has indicated that clone funds are sufficiently different from the publicly available fund, because of different cash flows and the need to comply with the diversification requirements, that these funds will not generally be viewed as publicly available.[31] But how should we view a transaction in which an existing customer of the fund manager decides to switch part of the investment from the public option to the insurance-dedicated fund through the purchase of a variable contract? Is it possible to construct sufficient communication walls between the client's general investments and the activities of the insurance-dedicated fund to avoid the appearance of investor control? Does the size of the organization matter? Can a household name investment management company succeed in creating the appropriate safeguards where boutique firms cannot?

Clearly, *Webber* is not the last word in the Investor Control Doctrine. It provides additional guideposts for taxpayers. In many ways, it, along with Rev. Rul. 2003-91, helps focus the discussion and analysis on the facts that are likely to be most heavily weighed; e.g., the relationships between the parties and the communications between them. At the end of the day, however, taxpayers entering into variable contract private placement arrangements and organizations looking to establish insurance-dedicated funds could need more guidance from the IRS to be certain that their transaction will survive an investor control challenge. Until then, we are left with the tax version of Justice Stewart's famous standard—we know it when we see it. ■

*Note: The views expressed are those of the authors and do not necessarily reflect the views of Ernst & Young LLP.*

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**END NOTES**

1 With apologies to Justice Stewart—See *Jacobellis v Ohio*, 378 U.S. 184, 197 (1964).

2 The authors wish to thank Na Kim and Kristin Norberg for their assistance.

3 Unless otherwise noted, all references to the Code or to "sections" are to the Internal Revenue Code of 1986, as amended.

4 144 T.C. No. 17 (June 30, 2015).

5 2003-2 C.B. 347.

6 309 U.S. 331 (1940).

7 *Clifford*, 309 U.S. at 335.

8 *Id*. at 336.

9 1977-1 C.B. 12.

10 *See* Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; and Rev. Rul. 77-85, 1977-1 C.B. 12.

11 1981-2 C.B. 13.

12 1982-1 C.B. 11.

13 The IRS, relying on the published guidance as well as the holdings of *Christoffersen and Blumenthal,* issued a number of private letter rulings over the decades between issuance of Rev. Rul. 77-85 and the Tax Court's decision in *Webber*, further reinforcing the government's belief in the continued viability of the Investor Control Doctrine.

14 749 F.2d 513 (8th Cir. 1985), rev'g 578 F. Supp. 398 (N.D. Iowa 1984).

15 *Id.* at 515.

16 *Id.*

17 442 F. Supp. 681 (D.D.C. 1977), rev'd, 609 F.2d 1, 197 (D.C. Cir. 1979).

18 *See*, for example, LTR 201515001 (Oct. 10, 2014); LTR 200105012 (June 22, 2012); ILM 200840043 (June 10, 2008); LTR 200601007 (Sept. 30, 2005); LTR 200010020 (Dec. 6, 1999); LTR 9748035 (Nov. 28, 1997); LTR 9433030 (Aug. 22, 1994). It is worth noting that many believe that LTR 9433030 provided much of the reasoning employed by the IRS and Treasury in the guidance that was at issue in the *Webber* case.

19 1999-2 C.B. 598.

20 2003-2 C.B. 347 and 350.

21 2008-2 C.B. 1001.

22 Rev. Rul. 2003-91, supra note 20.

23 In this case, the parties expressly agreed that the contracts met the statutory definitions. Whether this was actually the case or a litigation strategy, it is unlikely that other situations will be as clear-cut. In many private placement transactions, investor control questions often lead to other questions, most notably satisfaction of the section 817(h) diversification requirements. Failure to meet those requirements could have broader implications for the parties to the transaction than failure to satisfy investor control alone presents. If a contract fails to meet the investor control requirements, the income is taxed currently to the contract holder. If other rules, like those under sections 817(h), 7702, 7702A or even 72(s) and 72(u), are not met, the contract may not qualify as a life insurance or annuity contract for federal income tax purposes, creating possible reserving or life company qualification questions for the issuing insurance company.

24 116 T.C. 438, 442 (2001).

25 *Webber, supra* note 4, at 45.

26 *Id.*, at 60–61.

27 *Id.*, at 65.

28 323 U.S. 134, 140, 65 S. Ct. 161, 89 L. Ed. 124 (1944).

29 749 F.2d 513 (8th Cir. 1985), rev'g 578 F. Supp. 398 (N.D. Iowa 1984).

30 442 F. Supp. 681 (D.D.C. 1977), rev'd, 609 F.2d 1 (D.C. Cir. 1979).

31 LTR 201417007 (April 25, 2014).