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Recent IRS Rulings Highlight Investor Control Issues for Fund of Funds Arrangements

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The opinion issued two years ago by the United States Tax Court in *Webber v. Commissioner of Internal Revenue* [1] seems to have reinvigorated interest in the "investor control" doctrine among insurance and investment professionals (the tax professionals, of course, had never stopped worrying over it). But starting long before then and continuing to date, life insurers and the managers of the funds supporting their variable products have demonstrated a steady desire to comply with the doctrine, as evidenced in the many private letter rulings they have sought from the Internal Revenue Service (IRS).

By way of background, the investor control doctrine may be described as the proposition, articulated by the IRS in a series of revenue rulings dating back to 1977, that the owner of a variable life insurance or annuity contract who controls the selection and disposition of the life insurer's separate account assets supporting the contract is treated as owning those assets for federal income tax purposes. The result in such a case is that the contract owner is currently taxable on the income and realized gains from those assets.[2]

What's more, the impermissible control by the contract owner may be indirect as well as direct. For example, the ability to allocate policy values among publicly-available funds—meaning funds in which a person can invest without purchasing an insurance contract—can constitute investor control under the IRS rulings.[3] This is the case even though the contract owner has no input into the assets in which the publicly-available funds are invested or the insurer's decision to make the publicly-available funds available as investment options under a variable contract.[4] Because the impermissible control can be indirect, ascertaining the doctrine's boundaries can be difficult and open to debate, and yet crossing the line may trigger a material tax liability that no one expected to incur. In its opinion in *Webber*, the Tax Court accorded the IRS's rulings "Skidmore deference,"[5] meaning the court would give credence to the IRS's long-standing position in and of itself, although the court also stated that it would have found the taxpayer to have owned the separate account assets based on an independent analysis of the tax law's precepts of property ownership.

While the IRS had not published official guidance on the investor control doctrine in almost a decade prior to *Webber*, the agency has consistently spoken to the doctrine's contours in responding to a significant number of private letter ruling requests from insurers and fund managers. And within the past decade, many of those requests, and the rulings issued in response, dealt with the concern that indirect investment in publicly-available funds could, depending on the structure employed, fall on the wrong side of the doctrine. Three recent private letter rulings, the subject of this article, represent a continuation of this trend.

Specifically, late in 2016 the IRS released PLRs 201651002 and 201651012,[6] followed by the release of PLR 201705003 earlier this year,[7] addressing the investor control doctrine in the context of insurance-dedicated funds of funds.[8] The IRS concluded that, for federal income tax purposes, the life insurance company that invests in each top-level, insurance-dedicated fund described in the rulings would be treated as the owner of the fund, *i.e.*, the investor control doctrine would not apply.

PLRs 201651002 AND 201651012

In PLRs 201651002 and 201651012, which are substantively identical, the IRS was asked to delineate the treatment of an insurance-dedicated fund, denominated the "Portfolio" in the rulings. The Portfolio represented a new series of a "Fund," which was organized as a business trust registered under the federal securities laws. The Portfolio elected to be classified as a partnership for tax purposes and, because it was insurance-dedicated, qualified for look-through treatment under the IRC section 817(h) regulations.[9]

According to the rulings, variable contract owners will be able to allocate amounts under their contracts to an investment option that corresponds to the Portfolio, and the insurance company's separate account will then invest in the Portfolio. Further, the Portfolio will invest substantially all of its assets in "Underlying Funds" consisting of "a variety of eligible third-party mutual funds, other third-party variable insurance investment options, or both." Although the rulings are not explicit on the point, this reference to mutual funds appears to mean publicly-available mutual funds as distinguished from insurance-dedicated funds or managed separate accounts, which appear to encompass the rulings' reference to "variable insurance investment options."

Importantly, the Portfolio's investment manager (who was affiliated with the issuing insurer) will make investment decisions for the Portfolio in its sole and absolute discretion, without notice to or approval by the contract holders. While the Portfolio's allocations between debt and equity asset classes would be expected to fall within certain ranges identified in the rulings (the details of which were redacted in the rulings as released to the public), the rulings indicate that the allocations to particular Underlying Funds will change over time and there could be no expectation that current or past positions in any Underlying Fund will be maintained in the future. Also important to the IRS's conclusions, the rulings recite that a contract holder "will have no current knowledge of [the] Portfolio's specific assets," although information about the Portfolio's holdings would be available in SEC filings and reports to shareholders. The rulings also recite certain other facts consistent with the facts in Revenue Ruling 2003-91,[10] such as the absence of an agreement with a contract owner regarding particular investments of the Portfolio and the inability of an owner to direct investment in a particular asset or to recommend a particular investment or investment strategy.

After summarizing the investor control doctrine, the IRS in PLRs 201651002 and 201651012 concluded that for federal income tax purposes the life insurance company and not the variable contract holder "is the owner of [the] Portfolio and its underlying investment assets." In its discussion of the rationale for the rulings, the IRS, after emphasizing that application of the investor control doctrine depends on all the facts and circumstances, concluded that the contract owners "do not have any control over [the] Portfolio's investments, including [the] Portfolio's investments in the Underlying Funds." The agency also pointed to the facts that the investment decisions for the Portfolio would be made by the investment manager in its sole and absolute discretion and that it could change the investments without notice to or approval by the owners. Hence, according to the IRS, the Portfolio "is not an indirect means of allowing a variable contract holder to invest in an Underlying Fund."

PLR 201705003

PLR 201705003 involved three Portfolios that were formed as series of a state statutory trust (the "Trust"). According to the ruling, each Portfolio is or will be an insurance-dedicated regulated investment company and will correspond to an investment option under variable contracts purchased by individuals. Each Portfolio has an investment strategy that involves allocations among various asset classes in specified percentages. The Portfolios will gain exposure to those asset classes by investing in other regulated investment companies. In other words, each Portfolio will be a fund of funds. The lower-tier funds generally will include other insurance-dedicated funds that are series of the Trust as well as publicly-available funds.

Two of the Portfolios will allocate specified percentages of their assets among five different asset classes. The asset classes are the same for the two Portfolios, but the percentages allocated to each class appear to differ between them (presumably one Portfolio is more conservative than the other). These two Portfolios will achieve their desired asset allocation mixes by investing in "equity and fixed income passive index regulated investment companies," with a specified percentage of each Portfolio's allocations being to publicly-available funds.

The third Portfolio will invest specified percentages of its assets between two asset classes. It will gain exposure to the asset classes by investing in other insurance-dedicated funds or publicly-available funds "that seek to sample, but not replicate, the performance of third-party indices." The ruling does not say whether a particular percentage of those lower-tier funds are expected to be publicly available. In any event, to the extent that the ruling says specific percentage allocations among asset classes or publicly-available funds are expected for any of the Portfolios, the percentages themselves were redacted from the ruling.

An "Adviser" provides investment advisory services to the Trust. The ruling recites several facts regarding the Adviser's role and the policyholder's inability to direct a Portfolio's investments. In particular: (1) all investment decisions for each Portfolio will be made "solely by Adviser," (2) a policyholder "will not

be able to direct a Portfolio's investment in any particular asset or asset class" or "recommend a particular investment or investment strategy," and (3) there will be no agreement or plan with any policyholder "regarding a particular investment" of any Portfolio. The ruling also recites several facts regarding a policyholder's current or advance knowledge of a Portfolio's holdings: (a) the percentage of a Portfolio's assets invested in a particular lower-tier fund will not be "legally fixed" in advance of any policyholder's allocation to the Portfolio, (b) the percentages allocated to any particular lower-tier fund will be subject to change by the Portfolio's board at any time, and (c) as in the two prior rulings described above, a policyholder will have "no current knowledge of a Portfolio's specific asset composition," although each Portfolio's holdings will be available "as permitted by the SEC."

> An insurance-dedicated fund that is a "clone" of a publicly-available fund can present the question of whether the insurance-dedicated fund might be deemed to be publicly available in violation of the investor control doctrine ...

After summarizing the investor control doctrine, PLR 201705003 notes that determinations under the doctrine depend on "all the relevant facts and circumstances." The ruling then concludes that, under the facts presented, the policyholders "do not have any control of the investments of the Portfolios, including the … investment in public … funds." The ruling then specifically focuses on the facts that the investment decisions for a Portfolio are made by the Adviser "in its sole and absolute discretion" and are "subject to change without notice to or approval by" the policyholders. The ruling also concludes that the policyholders do not have any more control than was the case in Revenue Ruling 82-54 or Revenue Ruling 2003-91, and that the Portfolios "are not an indirect means of allowing a [policyholder] to invest in public funds." Thus, based on the representations and facts presented, the ruling concludes that "each of Portfolio A, B and C's investments will not cause the [policyholders] to be treated as the owners of a Portfolio for federal income assets [sic] purposes."[11]

CONCLUDING THOUGHTS

The IRS has issued numerous private letter rulings over the years addressing the investor control implications of insurance-dedicated funds of funds.[12] Although not expressly discussed in the rulings, many appear to involve facts that are analogous to those involving "clone" funds, *i.e.*, insurance-dedicated and publicly-available funds that have identical (or nearly identical) holdings. An insurance-dedicated fund that is a "clone" of a publicly-available fund can present the question of whether the insurance-dedicated fund might be deemed to be publicly available in violation of the investor control doctrine by virtue of a policyholder's ability to achieve the same investment result by investing in either an insurance-dedicated fund or its publicly-available clone. Conceivably, a similar question could arise even in the absence of a clone fund if the policyholder can readily replicate the insurance-dedicated fund's holdings.

The facts of the past rulings that seem most relevant to the investor control analysis and that may have led previous taxpayers to seek those rulings include (1) varying degrees of active *versus* passive management of the underlying portfolios of lower-tier funds, (2) the extent to which the lower-tier funds would include publicly-available mutual funds *versus* insurance-dedicated funds, (3) the amount and timing of information available to the policyholders regarding the composition of the underlying portfolio of lower-tier funds, and (4) similarities and differences between the insurance-dedicated fund of funds and a publicly-available version of the same fund of funds.[13]

The Portfolios involved in the three recent private letter rulings summarized above appear to present some of these same factual issues. For example, PLRs 201651002 and 201651012 recited that the contract owners would have "no current knowledge" of the specific assets underlying their contracts, that the portion of a Portfolio's assets allocated to any particular lower-tier fund will change over time, and that there could be no expectation of current or past positions in any particular lower-tier fund being maintained in the future. These facts speak to a policyholder's ability to replicate a Portfolio's holdings.[14]

Similarly, in PLR 201705003 the taxpayer informed the IRS that a policyholder will have "no current knowledge of a Portfolio's specific asset composition," and that the percentage of a Portfolio's assets invested in a particular lower-tier fund will not be "legally fixed" in advance of any policyholder's allocation to the Portfolio. The ruling further states that each Portfolio will invest in "passive index" regulated investment companies, some of which "seek to sample, but not replicate, the performance of third-party indices." These facts also speak to a policyholder's ability to replicate a Portfolio's holdings.[15]

The IRS's published guidance on investor control does not mention these types of facts or explicitly identify a concern over a policyholder's ability to replicate the holdings of an insurance-dedicated fund. The discussion of such facts in the three recent private letter rulings (and those preceding them)

nonetheless suggest a concern, at least by the taxpayers, that an investor control issue could arise if an insurance-dedicated fund's holdings were so fixed and easily replicated that the fund, in effect, is also available for direct investment by members of the general public. In that regard, it is interesting to note that the IRS specifically concludes in each of the recent rulings that the Portfolios are not indirect means of allowing a policyholder to invest in publicly-available funds.

Overall, the IRS's recent rulings on the fund of funds arrangements represent relatively straightforward applications of the investor control doctrine. Despite the presence of certain facts suggesting some concern that the funds might be deemed to be publicly available, the taxpayers presented various other facts that aligned specifically with those in Revenue Ruling 2003-91. That ruling recites various facts and concludes that the investor control doctrine does not apply, which makes the ruling a safe harbor of sorts—or at least a helpful roadmap—for avoiding investor control problems. By aligning their facts to those in the 2003 revenue ruling as much as possible, the taxpayers seeking the recent private letter rulings helped ensure their favorable outcomes. For example, the taxpayers presented facts showing that the contract owners had no input into the investment strategy or investment decisions of the Portfolios, and that the Portfolios' investment advisers retained full discretion over all investment decisions. Such facts would seem to remain critical to finding a lack of impermissible investor control.

In addition, the IRS concluded in PLRs 201651002 and 201651012 that the insurance company would be treated as owning the Portfolio and the Portfolio's "underlying investment assets" for federal income tax purposes. The Portfolio, however, had elected to be taxed as a partnership, and the insurance company technically would be purchasing an interest in the partnership. If taken literally, the conclusion of these rulings could mean that for all federal income tax purposes the life insurance company is treated as owning each asset of the partnership, rather than owning an interest in the partnership itself. Although the look-through rule in Treas. Reg. section 1.817-5(f)(1) treats the assets of an insurance-dedicated partnership as assets of a segregated asset account, such treatment is limited to the section 817(h) diversification requirements. It is not clear whether the IRS intended for the conclusion in these two rulings regarding the ownership of the partnership's assets to apply for income tax purposes beyond the IRC section 817(h) diversification requirements.

As a final point, turning back to the *Webber* case, it is interesting that none of the new rulings made any mention of the Tax Court's opinion in that case. Perhaps the IRS concluded that the court's holding on the extreme facts presented in that litigation was not all that pertinent to the situation of the taxpayers requesting the new rulings. ■

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ENDNOTES

1 144 T.C. 324 (2015). For further discussion of the *Webber* case, *see* Ann Cammack and Frederic J. Gelfond, "Investor Control: Will You Know it When You See it?" *Taxing Times*, March 2016, Vol. 12, No. 1, at p. 36.

2 In other words, the non-taxation of the contract's inside buildup is lost. Rev. Rul. 2007-7, 2007-1 C.B. 468; Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Proc. 99-44, 1999-2 C.B. 598; 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; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12.

3 *See, e.g.*, Rev. Rul. 81-225, *supra note* 2.

4 *See, e.g.*, PLR 201519001 (Oct. 10, 2014).

5 *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

6 Sept. 14, 2016.

7 Oct. 27, 2016.

8 An insurance-dedicated fund is a regulated investment company, real estate investment trust, partnership, or grantor trust that qualifies for look-through treatment under the section 817(h) regulations because (1) all beneficial interests in the entity are held by segregated asset accounts of insurance companies, and (2) public access to the entity is available exclusively through the purchase of a variable contract. *See* Treas. Reg. section 1.817-5(f).

9 *See id.*

10 Cited in note 2, *supra.*

11 The ruling also discusses the application of the excise tax under section 4982 to the Portfolios. That section imposes an excise tax on regulated investment companies ("RICs") that do not satisfy certain requirements relating to distributions of their income to shareholders. An exception to the excise tax exists under section 4982(f) for RICs whose shareholders are limited to life insurance company segregated asset accounts in connection with variable contracts. The IRS has recognized, as it did in PLR 201705003, that the potential application of this excise tax gives a RIC procedural standing to request a private letter ruling on investor control issues affecting the RIC. *See, e.g.*, PLR 201540004 (June 29, 2015). Because the IRS concludes in this case that the policyholders will not be treated as owning the Portfolios for federal income tax purposes, the ruling also concludes that "each Portfolio will be eligible for the exception from the excise tax imposed by section 4982."

12 *See, e.g.,* PLR 201540004 (June 29, 2015); PLR 201417007 (Dec. 19, 2013); PLR 201014001 (Dec. 8, 2009); PLR 200952009 (Sept. 16, 2009); PLR 200938018 (June 29, 2009); PLR 200938006 (June 29, 2009); PLR 200915006 (Dec. 23, 2008); PLR 200601006 (Sept. 30, 2005); PLR 200420017 (Feb. 2, 2004); PLR 200025037 (Mar. 24, 2000); PLR 9851044 (June 30, 1998); PLR 9839034 (June 30, 1998); and PLR 9748035 (Aug. 29, 1997).

13 *See* the rulings cited in note 12, supra.

14 *See* also PLRs 201540004 and 201014001, cited in note 12, *supra*, which noted this factor as part of the IRS's analysis.

15 Although not discussed in the ruling, the fact that the Portfolios also planned to invest in other insurance-dedicated funds, which themselves are not publicly available, could contribute to the uniqueness of the mix of assets held in the Portfolios, further distinguishing them from pure clones of publicly-available funds of funds.