

# Tax Court decision treats insurance contract holder as owner of assets

In a recent decision, the United States Tax Court reaffirmed a version of the substance-over-form doctrine specific to life insurance products - the Investor Control Doctrine. *Webber v. Commissioner* (144 T.C. No. 17) involved a venture capitalist who, as part of his financial plan, purchased private placement life insurance (“PPLI”) products on the lives of two elderly relatives using a foreign grantor trust.

PPLI, sometimes called an insurance wrapper, is a form of variable life insurance, in which the cash value and the death benefit is determined by the performance of investments owned by the policy. With PPLI, the premiums paid on the insurance policy are placed in separate accounts and invested at the direction of an investment manager hired by the insurer. The potential tax benefits associated with trust-owned PPLI are two-fold: first, income and gains compound income tax-free as the cash value of the policy grows; second, the death benefit received upon the death of the insured is free from federal estate tax and income tax.

The substance-over-form doctrine is nearly as old as the income tax. It is customarily invoked when a person continues to exercise dominion and control over assets to which he or she has relinquished legal title. A substance-over-form determination generally results in all the income tax attributes of the affected assets being attributed to and reportable by the person exercising dominion and control – their deemed owner. Such was the outcome in *Webber*. Unanswered by the case are the transfer tax implications of the determination. Generally, a finding of retained dominion and control renders any gift incomplete and the value of the affected assets subject to estate tax inclusion in the Taxpayer’s estate.

The version of the substance-over-form doctrine developed by the Internal Revenue Service (IRS) with respect to insurance and related products, including but not limited to PPLI, is called the Investor Control Doctrine. The incidents of ownership upon which the Investor Control Doctrine rests typically involve the ability to direct the custodian to purchase or sell securities, vote the shares acquired, as well as the exercise of any other right or option relating to the assets and the power to extract money from the structure (e.g., assigning the policy, borrowing from the policy, pledging the policy or its underlying assets as security, the ability to surrender or otherwise modify the policy, etc.). In *Webber*, the post-execution behavior of the taxpayer in direct contravention of the provisions of the governing documents, particularly with respect to investments in start-up and portfolio companies that could only have occurred with his direct influence, was found to have repeatedly demonstrated his retained dominion and control over the involved assets.

While it was taxpayer’s behavior with respect to the structure’s assets which invoked the Investor Control Doctrine, the taxpayer tried to argue, among other things, that the Investor Control Doctrine had not survived the enactment of Internal Revenue Code § 817(h). Under § 817(h), a separate account is not recognized as being held within a life insurance contract unless its investments are sufficiently diversified. Without the protection of the life insurance contract, the policyholder would be taxed on the tax attributes of the assets as their deemed owner. The Tax Court disagreed with the taxpayer, stating that Congress did not intend to usurp the Investor Control Doctrine when it enacted Internal Revenue Code § 817(h).

It is important to note that in *Webber*, the taxpayer's advisors had put in place certain protocols that, for the most part, complied with later-issued guidance from the IRS providing a safe harbor for designing compliant variable insurance products. See Rev. Rul. 2003-91. However, the Tax Court found that, as a factual matter, those protocols were systematically circumvented. PPLI remains a viable planning option, but only where the taxpayer and his or her advisors exercise the self-discipline to operate within the spirit, and the letter, of a properly drafted structure.

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