Special Report

Recent Developments Affecting Hedge Fund Investing Through Private Placement Life Insurance

by Leslie C. Giordani

Leslie C. Giordani is a partner in the Austin, Texas, law firm of Giordani, Schurig, Beckett & Tackett, L.L.P., where she practices in the areas of domestic and international estate planning, including a significant concentration in private placement life insurance planning. Ms. Giordani gratefully acknowledges the research and editorial assistance of Amy P. Jetel, an associate of Giordani, Schurig, Beckett & Tackett, L.L.P.

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Inflammatory press releases and news articles[1] regarding recent revenue rulings[2] on the investor control doctrine and proposed changes to the Internal Revenue Code (IRC) section 817(h) diversification rules[3] have caused quite a stir in the general public's view of the propriety of investing in hedge funds through life insurance. By citing this type of investing as a "tax-avoidance investment scheme" that puts "legitimate products at risk,"[4] such press coverage can only place these investment products in a bad light. What the authors of these releases and articles ignore, however, is the fact that the recent developments are merely narrowing one small aspect of the law affecting life insurance, and are not a general shutdown on using private placement life insurance as a tax-preferred investment vehicle or on investing policy assets in hedge funds. The life insurance arrangements that are affected by this legislative change were simply designed in compliance with the Treasury Regulations promulgated under section 817(h), and are not the abusive schemes that the popular press rendition might lead us to believe. Therefore, investing in hedge funds through private placement life insurance remains a viable planning tool, and the recent developments in the law affect only the design of these products.

A brief history of the investor control doctrine and section 817(h) will be helpful in understanding why these changes are occurring and how private placement life insurance policies should be structured in light of the new developments in the law.

The Investor Control Doctrine. In the 1970s, before the enactment of section 817, the Internal Revenue Service (the Service or the IRS) became concerned that taxpayers were avoiding income tax by "wrapping" their investments in "investment annuity contracts," which created "the possibility of major tax shelter abuse."[5] In these transactions, each "investment annuity contract" paid an annuity based on the investment return and market value of the contract's segregated asset account. A third-party custodian, typically a bank, held and invested the contract's assets in accordance with the annuity owner's directions.[6] In response to this perceived abuse, the Service issued four revenue rulings between 1977 and 1982 describing circumstances under which the owner of a variable annuity or life insurance contract would be treated as the owner of (and accordingly taxed on the income of) the assets underlying the contract because of the owner's control of the investment of those assets.[7] Ultimately, in *Christoffersen v. United States,*[8] the United States Court of Appeals for the Eighth Circuit adopted the Service's position. These "investor control" authorities, discussed below, applied to variable annuity and life insurance contracts the well-established federal income tax principle that a person is treated as the owner of an asset, regardless of who holds legal title to it, if the person possesses significant incidents of control and ownership over the asset.

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[1] *See, e.g.,* Tom Herman, "Tax-Avoidance Device Is Attacked," *Wall St. J.,* Jul. 17, 2003; Treasury Press Release JS-591, *Treasury Works to Stem the Inappropriate Use of Life Insurance and Annuity Contracts,* Jul. 23, 2003, *Doc 2003-17255 (1 original page), 2003 TNT 142-23*; Treasury Press Release JS-605, *Treasury and IRS Continue Crackdown on Abuse of Life Insurance and Annuity Contracts,* Jul. 29, 2003, *Doc 2003-17640 (1 original page), 2003 TNT 146-34*.

[2] Rev. Rul. 2003-91, 2003-33 I.R.B. 347, *Doc 2003-17246 (6 original pages), 2003 TNT 142-18*; Rev. Rul. 2003-92, 2003-33 I.R.B. 350, *Doc 2003-17252 (7 original pages), 2003 TNT 142-19*.

[3] REG-163974-02, *Doc 2003-17640 (1 original page), 2003 TNT 146-11*.

[4] Tom Herman, "Tax-Avoidance Device Is Attacked," *Wall St. J.*, Jul. 17, 2003.

[5] *See Investment Annuity, Inc. v. Blumenthal,* 442 F. Supp. 681, 693 (D. D.C. 1977), *rev'd on procedural grounds,* 609 F.2d 1 (D.C. Cir. 1979), *cert. denied,* 446 U.S. 981 (1980).

[6] *Id.* at 685.

[7] It is important to note that each of the four rulings dealt with variable annuities and not variable life insurance contracts. While there exist good arguments to the effect that variable life insurance is distinguishable and should be distinguished from variable annuities, this article will concede such arguments for the purpose of simplicity. The Service apparently has taken the position that there is no distinction. *See, e.g.,* PLR 200244001 (May 2, 2002).

[8] 749 F.2d 513 (8th Cir. 1984), *cert. denied,* 473 U.S. 905 (1985).

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Rev. Rul. 77-85. The Service's first response to this perceived abuse, Revenue Ruling 77-85,[9] concludes that the annuity owner is, for federal income tax purposes, the owner of the separate account assets when (i) the annuity owner controls the investment of the separate account assets, (ii) has the power to vote any securities in the account, and (iii) can withdraw any or all of the assets at any time. The ruling analogizes the investment annuity contract to a pledge arrangement in which assets are set aside in the separate account to purchase an annuity. The ruling emphasizes that, even though the annuity owner does not have title to the separate account assets under state law, and that the separate account assets constitute the insurer's assets for state insurance law purposes, the annuity owner is treated as the owner of the assets for federal income tax purposes.

Rev. Rul. 80-274. The second ruling, Revenue Ruling 80-274,[10] similarly concludes that a savings and loan association depositor is, for federal income tax purposes, the owner of a certificate of deposit (CD) underlying a variable annuity contract when the depositor transfers the CD to a life insurance company in exchange for a variable annuity contract and the insurance company is expected to hold the transferred CD for the depositor's benefit.

Rev. Rul. 81-225. The centerpiece of the investor control authorities is the third ruling, Revenue Ruling 81-225,[11] which applies the investor control principle to five different situations. In four of the situations, the annuity owner, rather than the insurance company, is considered the owner of the mutual fund investments underlying the annuity contracts. In the final situation, the insurance company, rather than the annuity owner, is considered the owner of those investments.

In the first situation (Situation 1), the segregated account underlying the annuity contracts holds only shares of a single, publicly-available mutual fund managed by an independent investment adviser. Situation 2 is similar to Situation 1, except that the insurance company or one of its affiliates manages the publicly available mutual fund. Situation 3 also is similar to Situation 1, except that the segregated asset account underlying the annuity contracts consists of five sub-accounts on which the performance of the annuity contract would depend. The annuity owner retains the right to allocate or reallocate funds among the five sub-accounts during the life of the annuity contract. Situation 4 is similar to Situation 2, except that the shares of the mutual fund are not sold directly to the public, but are available only through the purchase of an annuity contract or by participation in a separate investment plan account offered by the insurance company. Situation 5 also is similar to Situation 2, except that the shares in the mutual fund are available only through the purchase of an annuity contract.

The ruling concludes that the annuity owners in the first four situations have sufficient control and other indicia of ownership to be considered the owners of the underlying mutual fund shares for federal income tax purposes. In each of these situations, the mutual fund shares are available for purchase by other members of the general public either directly (as in Situations 1, 2, and 3) or indirectly (as in Situation 4). Consequently, each annuity owner is deemed to have a prohibited degree of control over the underlying mutual fund shares because the annuity owner's position in each of these situations is "substantially identical to what his or her position would have been had the mutual fund shares been purchased directly (or indirectly, as in Situation 4)" and the insurance company is "little more than a conduit between the policyholders and their mutual funds shares."

In contrast to Situations 1, 2, 3, and 4, however, the ruling concludes that, in Situation 5, the insurance company, rather than the annuity owner, is the owner of the mutual fund shares for federal income tax purposes. It reaches that conclusion because (i) the mutual fund's sole function is to provide an investment vehicle that allows the insurance company to meet its obligations under its annuity contracts and (ii) the mutual fund is available only through the purchase of the annuity.

Rev. Rul. 82-54. In the final revenue ruling, Revenue Ruling 82-54,[12] the annuity owners direct the insurance company to invest in the shares of any or all of three mutual funds that are not available to the public. One mutual fund invests primarily in common stocks, another in bonds, and a third in money market instruments. Annuity owners can allocate their premium payments among the three funds and have an unlimited right to reallocate contract values among the funds prior to the maturity date of the annuity contract. The ruling concludes that the annuity owners' ability to choose among general investment strategies (stocks, bonds, or money market instruments) does not constitute sufficient control to cause the annuity owners to be treated as the owners of the underlying mutual fund shares. In its analysis, the Service reiterated its position in Revenue Ruling 81-225, namely, that the public availability of the investments in Situations 1-4 caused the annuity owners to be treated as owners of the underlying investments for income tax purposes. Specifically, the Service explained:

> In each of the four situations the mutual fund shares were available for purchase not only by the prospective purchasers of the annuity contracts, but also by other members of the general public. The policyholders' position in each situation was substantially identi-

[9]1977-1 C.B. 12. The ruling holds that the annuity owner's gross income under section 61 includes interest, dividends, and other income from the separate account assets in the year received by the custodian because the assets are not owned by the insurer, for federal income tax purposes, and are not subject to exclusion under section 801(g)(1)(B) governing segregated accounts.

[10]1980-2 C.B. 27.

[11]1981-2 C.B. 12,

[12]1982-1 C.B. 11.

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cal to what it would have been had the mutual fund shares been purchased directly by the policyholders.

Christoffersen v. United States. In 1984, the United States Court of Appeals for the Eighth Circuit upheld the investor control theory of Revenue Ruling 81-225 in *Christoffersen v. United States.*[13] The taxpayers in *Christoffersen* purchased a variable annuity contract that reflected the investment return and market value of separate account assets. The taxpayers had the power to direct the investment of premiums in any one or all of six publicly-traded mutual funds, to reallocate their investment among the funds at any time, to make withdrawals, to surrender the contract, and to apply the contract's accumulated value to provide annuity payments. These facts indicated to the court that the taxpayers effectively owned the separate account assets. The court therefore held that:

> [u]nder the long recognized doctrine of constructive receipt, the income generated by the account assets should be taxed to the [annuity holders and not the issuing insurance company] in the year earned, not at some later time when the [annuity holders] choose to receive it. This is the essence of Rev. Rul. 81-225, which we find persuasive.[14]

Section 817(h): Background. After the Eighth Circuit decided *Christoffersen* and the Service had issued these four revenue rulings, Congress enacted section 817, which is aimed at discouraging the use of variable annuities and life insurance primarily as investment vehicles. Because section 817(h) and its regulations were enacted after the investor control authorities, and because they address some of the same issues as those authorities, many in the insurance industry concluded that section 817(h) superceded the investor control doctrine.[15] The discussion below will reveal why this conclusion was a logical one.

Diversification Test. In order to qualify as life insurance, variable life insurance policies must comply with section 817(h), which outlines the requirements of diversification of variable life insurance separate accounts. In its simplest form, each "segregated asset account" must contain at least five investments, and no one investment may represent more than 55 percent of the value of a separate account's assets, no two investments may constitute more than 70 percent, no three investments may comprise more than 80 percent, and no four investments may make up more than 90 percent of the separate account's value. Failure to meet the diversification requirements under section 817(h) will result in taxation of the cash value accumulation as ordinary income to the policy owner.

The diversification rules also encompass other concepts that are of specific relevance to the situation in which the investments of the underlying separate account(s) are hedge funds or hedge funds of funds. Most notably, there are provisions under the regulations to section 817(h) that permit "look-through" treatment for certain investment structures, such as private investment partnerships. In other words, if the partnership meets certain requirements, the separate account will be treated as being invested in the various investments of the partnership, rather than being invested in the partnership itself. Generally, the regulations to section 817(h) allow look-through treatment for hedge fund investments that meet the following two-part test:[16]

1. all the beneficial interests in the partnership (or other investment vehicle) must be held by one or more segregated asset accounts of one or more insurance companies (subject to certain limited exceptions); and

2. access to the partnership (or other investment) must be exclusively through the purchase of a variable contract.

But the regulations further provide that partnerships that are not registered under a federal or state law regulating the offering or sale of securities (non-registered partnerships) will receive look-through treatment without meeting the above two requirements.[17] In short, a segregated account may be invested in a non-registered partnership alongside "public investors" (*i.e.*, investors who are not invested in the partnership through the purchase of a variable contract) without causing the cash value accumulation to be taxed as ordinary income. U.S. hedge funds and hedge funds of funds are typically structured as non-registered investment partnerships and, therefore, may be looked through to their underlying assets for purposes of applying the diversification tests of section 817(h). Recently, this non-registered partnership exception to the two-part test above has been the subject of controversy due to the fact that, despite the explicit language in the regulations to section 817(h), the Service has ruled as though the exception does not exist.

Did the Investor Control Doctrine Survive Enactment of Section 817? Recall in Rev. Rul 81-225, discussed above, that in the situations in which the mutual fund shares were available for purchase by other members of the general public, each annuity owner was deemed to have a prohibited degree of control over the underlying mutual fund shares, and was thus treated as owning the investments directly. But in the situation in which the mutual fund was available only through the purchase of a variable annuity, the Service ruled that the insurance company, rather than the annuity owner, was the owner of the mutual fund shares for federal income tax purposes. Because the regulation's non-registered partnership exception to the general look-through rules was enacted after Rev. Rul. 81-225 (and for many other reasons

[13]749 F.2d 513 (8th Cir. 1984), *cert. denied,* 473 U.S. 905 (1985).

[14]*Id.* at 516.

[15]For an excellent analysis of this issue, *see* David Neufeld, "The 'Keyport Ruling' and the Investor Control Rule: Might Makes Right?", *The Insurance Tax Review*, March 2003, p. 383.

[16]Treas. Reg. section 1.817-5(f)(2)(i).

[17]Treas. Reg. section 1.817-5(f)(2)(ii).

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that are outside the scope of this article), it is logical to conclude that the question of whether a segregated account may invest alongside public investors in a non-registered partnership and still qualify as life insurance is solely the province of section 817. As one commentator deftly put it, if the investor control doctrine survived enactment of section 817, then section 817 must have been a "nullity the day it was enacted" because application of both tests is "implicitly unworkable, confused, and confusing."[18] After all, Treasury Regulation section 1.817-5(f)(2)(ii) allows a non-registered partnership to be looked through to determine diversification — regardless of whether investment in the partnership is available to public investors. But if the investor control doctrine still applies to cause the assets of the segregated account to be owned by the policy owner for federal income tax purposes if investment in the partnership is available to public investors, then there was no point in applying look-through to determine diversification in the first place. Therefore, despite the fact that the regulation incorporates by reference certain aspects of the earlier investor control revenue rulings,[19] the seeming incompatibility of the two tests leads to the practical conclusion that the investor control doctrine, at least with regard to non-registered partnerships, did not survive the enactment of section 817(h).

However, the Service has taken the enforcement position that the enactment of section 817(h) did not supersede the four investor control revenue rulings or the Eighth Circuit's decision in *Christoffersen,* and has continued to rely on those authorities in issuing private letter rulings.[20] Until now, the IRS's position, which completely ignores the existence of Regulation section 1.817-5(f)(2)(ii), has been the subject of intense criticism and doubt as to whether the Service's faulty reasoning would stand up in court if challenged.[21]But not wanting their clients to be the test case, practitioners just grumbled and modified their policy designs to comply with the law as the Service (incorrectly) interpreted it. Now, the Treasury Department and the IRS have openly stated their intent to apply the general look-through rules to non-registered partnerships by issuing proposed regulations that eliminate the controversial exception.[22] The rulings leading up to this recent legislative development are summarized below.

[18]Neufeld, *supra* note 15.

[19]Treas. Reg. section 1.817-5(i)(2) (effective date exceptions referencing Rev. Rul. 81-225 and Rev. Rul. 77-85) and 1.817-5(f)(e)(iv) (application of the look-through rule not prevented by holdings that comply with Rev. Rul. 81-225 and Rev. Rul. 82-55).

[20]*See, e.g.,* PLR 200244001 (May 2, 2002), in which the Service rejected the taxpayer's argument that there is a regulatory exception to the diversification rules for non-registered partnerships; *see also* PLR 200010020 (Mar. 10, 2000)*; But see* PLR 9847017 (Aug. 21, 1998), in which the Service implied (but did not state) that a non-registered partnership that is available to investors other than through the purchase of a variable contract may be looked through.

[21]*See, e.g.,* Steve Leimberg's Estate Planning Newsletter #564 (July 24, 2003); AALU Bulletin No. 03-75 (July 24, 2003); AALU Bulletin No. 02-125 (November 4, 2002).

[22]REG-163974-02.

The "Attack" on the "Abusive Use" of Life Insurance. Careful students of these issues should have concluded by now that the press coverage has been misguided and misleading in framing the recent developments affecting the investment of life insurance separate accounts in non-registered partnerships as "abusive tax-avoidance schemes" that are the subject of an IRS crackdown. The "attack" to which these media sources are referring are two new revenue rulings (Rev. Rul. 2003-91 and Rev. Rul. 2003-92) and the Treasury's recent announcement[23] of its intent to repeal section 1.817-5(f)(2)(ii) of the regulations. These authorities, discussed below, make it clear that non-registered partnerships will not be allowed look-through treatment unless (i) all of the beneficial interests in the partnership are held by one or more segregated asset accounts of one or more insurance companies and (ii) access to the partnership is exclusively through the purchase of a variable contract.

Rev. Rul. 2003-91. This ruling, issued on July 24, 2003, is generally favorable in that it confirms the principle that owners of variable life insurance and annuity contracts may allocate investments among a limited number of insurance-dedicated funds (i.e., funds that are available only through the purchase of a life insurance or annuity contract) without being deemed the owner of the contract for federal income tax purposes. Rev. Rul. 2003-91 describes the purchase of either a variable life insurance or variable annuity contract, the investments of which may be allocated by the contract holder among various sub-accounts. The ruling states that whether a contract holder has sufficient incidents of ownership to cause him to be the owner of the assets for federal income tax purposes "depends on all of the relevant facts and circumstances." In this regard, the Service relies on the fact that investment in the sub-accounts "is available solely through the purchase of a [variable c]ontract" as one of the relevant facts and circumstances in determining investor control, and it cites the early investor control authorities discussed above.

Rev. Rul. 2003-92. Despite the reliance of Rev. Rul. 2003-91, above, on the fact that investment in the sub-accounts is available solely through the purchase of a variable contract as one of the relevant "facts and circumstances" in ruling that the contract holder would not be deemed the owner of the contract for federal income tax purposes, that ruling does not deal specifically with a non-registered investment partnership. But Rev. Rul. 2003-92, issued on July 24, 2003, does. This ruling describes three situations in which the variable contracts are not registered under federal securities laws, and are sold only to "qualified purchasers" that are "accredited investors."[24] The assets supporting the contracts are held in a segregated asset account that invests

[23]Treasury Press Release JS-605.

[24]These ownership limitations are statutory terms of art, which, if satisfied, allow an investment to avoid federal regulation requirements. This type of contract is popularly referred to as "private placement."

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in interests in a non-registered partnership. In the first two situations, interests in the partnership are available for purchase other than by purchasers of variable annuity or life insurance contracts, and in the third situation, interests in the partnership are available only through the purchase of a variable annuity or life insurance contract. The Service held that, because interests in the partnerships in the first two situations are available to the "general public," the contract holder would be considered the owner of the assets in the segregated account for federal income tax purposes. But because the partnership interests in the third situation are available only through the purchase of a variable contract, the contract holder would not be deemed the owner of the segregated account. While the Service does discuss section 817 and the regulations thereunder, it does not mention the Regulation section 1.817-5(f)(2)(ii) look-through rule for non-registered partnerships. This ruling generally follows the reasoning of PLR 200244001, issued on May 2, 2002.

Proposed Changes to Section 817 Regulations. On July 29, 2003, less than one week after the Service issued the two previously discussed revenue rulings, the Treasury Department and the IRS proposed the repeal of Regulation section 1.817-5(f)(2)(ii), which, if repealed, would put to rest any debate over whether investment in a non-registered partnership must be restricted to those purchasing a variable contract to benefit from look-through in order to pass the diversification test under section 817(h). Consistent with statements made in a prior private letter ruling[25] and the reasoning adopted in Rev. Rul. 2003-92, the notice proposing the repeal of this regulation states the following:

> The Treasury Department and the IRS are concerned that section 1.817-5(f)(2)(ii) is not consistent with Congressional intent because it is not explicitly subject to the public availability limitation of section 817(h). The Treasury Department and the IRS believe that removal of section 1.817- 5(f)(2)(ii) will eliminate any possible confusion regarding the prohibition on ownership of interests by the public in a non-registered partnership funding a variable contract.[26]

Interestingly (in light of the fact that the Service ignored the existence of Regulation section 1.817-5(f)(2)(ii) in Rev. Rul. 2003-92 and PLR 200244001), the Treasury and the IRS concede in the notice that, "[u]nlike section 1.817-5(f)(2)(i), satisfaction of the non-registered partnership look-through rule of section 1.817-5(f)(2)(ii) is not explicitly conditioned on limiting the ownership of interests in the partnership to certain specified holders."[27] And the notice provides for a grace period for arrangements to be brought into compliance with the new law as long as those arrangements were "adequately diversified within the meaning of section 817(h) prior to the revocation of section 1.8175(f)(2)(ii)."[28] One could wonder how an arrangement could be considered adequately diversified under a regulation that the Service completely ignored in enforcing the diversification rules in the first place, but these ponderings may be best left to the academic realm. In practice, however, it is not likely that the IRS will argue that an otherwise satisfactory variable contract, the separate account of which invests in a non-insurance dedicated non-registered partnership, that timely brings itself into compliance after the repeal of section 1.817-5(f)(2)(ii) should not be allowed to receive the benefit of the grace period.

Lingering Issues: Is the Asset Allocator Model Viable? Many private placement variable life insurance and annuity contracts are structured to permit the policy owner to select from a group of asset management choices, among which is one or more independent "asset allocators" who have an account management agreement with the insurance company to construct and manage with full discretion one or more separate accounts consisting of non-insurance dedicated hedge funds, and in which the number and proportion of funds meet the section 817(h) diversification test (without regard to the exception under Regulation section 1.817-5(f)(2)(ii)). The account managed by the manager (i.e., allocator) is available only to insurance companies in connection with their variable contracts. This arrangement is generally known as a privately-managed separate account, or "the allocator model." In Rev. Rul. 2003-91, the Service appeared to confirm generally the validity of this model, but the statement of facts in the ruling provided that the contract holder in that situation "may not communicate directly or indirectly with [the insurance company] concerning the selection or substitution of [the independent investment adviser]." Because an allocator might sometimes be brought to the attention of an insurance carrier by a policy owner or a policy owner's adviser, this language in the ruling has caused some practitioners to become a bit concerned about whether the policy owner's selection of an allocator might give rise to a finding of investor control; adequate diversification of the separate account does not prevent the Service from finding that the contract holder should still be treated as the owner of the assets in the account due to his control over the investments.[29]

The Service has consistently held that a contract holder may freely allocate the investments of the separate account among the insurance company's available choices without being deemed the owner of the separate account for federal

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[25] PLR 200244001 (May 2, 2002).

[26] REG-163974-02.

[27] *Id.*

[28] "[A]rrangements in existence on the effective date of the revocation of section1.817-5(f)(2)(ii) will be considered to be adequately diversified if: (i) those arrangements were adequately diversified within the meaning of section 817(h) prior to the revocation of section 1.817-5(f)(2)(ii), and (ii) by the end of the last day of the second calendar quarter ending after the effective date of the regulation, the arrangements are brought into compliance with the final regulations."

[29] Rev. Proc. 99-44, 1999-48 I.R.B. 598 ("[s]atisfiying the diversification requirements does not prevent a contract holder's control of the investments of a segregated account from causing the contract holder, rather than the insurance company, to be treated as the owner of the assets in the account").

income tax purposes.[30] If the contract holder instead selects an independent party that has been approved by the insurance company as a separate account management option to make investment decisions, it seems unlikely that the Service would find that the selection of an allocator is a form of control, unless there is an "arrangement, plan, contract, or agreement" between the contract holder and the allocator with regard to the investments of the separate account.[31] One qualification, therefore, is that the allocator (i.e., investment adviser) should be selected from a list of available allocators provided and previously approved by the insurance company, and the contract holder should not mandate that his or her own allocator be used. The Service has provided guidance on this issue by approving an arrangement under which the contract holder's

> influence over the way the investments are managed will be limited to selecting an investment manager from a pool of investment managers whose credentials have been evaluated and approved by (the insurance company]. These investment managers may be recommended to [the insurance company] by one or more [contract holders]. [The insurance company] will be under no obligation to approve any such recommendations. Moreover, once [the contract holder] makes an initial selection, the investment manager can only be changed by (the insurance company] and not by [the contract holder].[32]

Presumably, however, a policy owner can change from one investment manager approved by the insurance company to another investment manager approved by the insurance company under authority of the line of rulings previously discussed.[33]

In sum, a finding of investor control depends on "all of the relevant facts and circumstances."[34] The recommendation of an allocator by a policy owner or her adviser to the insurance company, without other factors, arguably should not support a finding of investor control. It seems that, as long as the contract holder has no actual control over the allocator's investment decisions and the allocator may be selected by other policy owners to manage their separate accounts, the allocator model should not run afoul of the investor control doctrine.

A final note of caution in connection with the allocator model may be warranted, however. It is entirely possible that, due to the Service's apparent public policy stance of limiting (wealthy) taxpayers' ability to invest in hedge funds within life insurance contracts, the IRS could take a very inflexible approach when it comes to allocations to hedge funds. This approach would involve an absolute prohibition of subscriptions by insurance carriers to hedge funds that are not "insurance-dedicated." Thus, under the allocator model, even though the policy owner selects only the allocator, and does not select the underlying non-insurance- dedicated hedge funds among which the allocator invests separate account assets, the IRS might nonetheless find that investor control exists under the rationale of Rev. Rul. 2003-92 simply because the insurance company (albeit at the direction of the allocator) has subscribed to a non-insurance-dedicated hedge fund. Therefore (the IRS's argument would go), despite the fact that the separate account is adequately diversified within the meaning of section 817(h) among the non-insurance-dedicated funds, the policy owner has *indirect* investor control for the mere fact that the separate account holds as one or more of its investments a fund that is not available exclusively through the purchase of a variable contract, and access to which is not limited to insurance company segregated accounts. Although the IRS has not made this argument — and it is a weak argument at best — the possibility, however remote, that the Service will attempt to use it underscores the fact that the asset allocator model remains a gray area.

Conclusion. Despite the inflammatory spin that press releases and news articles have put on the recent changes in the law, hedge funds or hedge funds of funds as an investment of a private placement life insurance contract should not pose investor control concerns (assuming the funds are independently selected by the insurance company) as long as the investment structure of the fund is a limited partnership that meets the following two-part test:

1. all the beneficial interests in the partnership must be held by one or more segregated asset accounts of one or more insurance companies; and

2. access to the partnership must be exclusively through the purchase of a variable contract.

If the partnership meets these requirements, it will be "looked through" to its underlying investments for purposes of applying the section 817(h) diversification test, and investor control will not be a concern due to the absence of public availability. *De facto* investor control, however, is still a significant consideration in the design, implementation, and administration of any private placement life insurance structure, and practitioners should carefully monitor their clients' actions to prevent a scenario that could lead to a finding of investor control. The hedge fund industry has begun a helpful response to the IRS's recent activity, evidenced by a growing number of newly-created insurance-dedicated funds and funds of funds. The continuation of this trend will sustain the viability of private placement life insurance as an attractive planning tool for high-net worth investors who appreciate the superior risk-adjusted return characteristics of hedge funds and funds of funds in their portfolios.

[30] *See, e.g.*, Rev. Rul. 2003-92; Rev. Rul. 2003-91; PLR 200244001; PLR 9752061.

[31] Rev. Rul. 2003-91.

[32] PLR 9752061 (Sept. 30, 1997).

[33] Rev. Rul. 2003-92; Rev. Rul. 2003-91; Rev. Rul. 81-225; Rev. Rul. 82-54.

[34] Rev. Rul. 2003-91.

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