USES FOR LIFE INSURANCE BEYOND TAXES

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A. INTRODUCTION: LIFE INSURANCE USES AND WHO SHOULD OWN A LIFE INSURANCE POLICY

1. Uses of Life Insurance:
   a. as an investment
   b. as asset protection
   c. to meet family needs and replace lost income
   d. to provide liquidity for estate taxes and other expenses at death
   e. to fund buy-outs at death

2. Who Should Own the Policy?
   a. The Insured
   b. The Insured’s Spouse
   c. The Insured’s children
   d. A Revocable Trust
   e. An LLC or Partnership
   f. An Irrevocable Trust

B. NON TAX REASONS FOR RETAINING A POLICY

1. Cash surrender value is high and can support the policy and/or provide a source of liquidity to the owner.

2. Insured is uninsurable or the cost of insuring is prohibitive.

3. New products may not offer the returns of the existing policies, due to guarantees, minimum crediting, riders.

4. There are creditor protection aspects with life insurance policies.

C. NON TAX PLANNING WITH A POLICY

1. Usually not probate property

2. Usually passes outside of Will or Revocable Trust

3. Private

4. The main use for life insurance is to meet a liquidity need. And, because of increased exemption amounts and the ability to delay payments, the estate tax liquidity need is one of the LEAST compelling. Instead, consider the following.

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1 The text in this item 4 is taken from an outline for the program: USES FOR LIFE INSURANCE: BEYOND TAXES, presented at the 2017 Seattle Estate Planning Institute and prepared by Christopher P. Cline, Riverview Trust Company, 900 Washington Street, Suite 900 Vancouver, WA 98660 Phone: (360) 759-2478 E-mail: chriscline@riverviewbank.com, used with permission.
a. Paying for Long-Term Care

If estate taxes are the least compelling, long term care insurance is probably the most compelling liquidity need. As we all live longer, the fear of needing extensive care as we age is growing. Everyone has heard stories of people having to spend their last dollars on care, only to find themselves on public assistance anyway.

Even wealthier people, who on paper could “self-insure,” are looking into long-term care coverage because they may have specific estate planning goals like giving a certain amount to heirs or to charity, or because their wealth is tied up primarily in illiquid assets that would create a hardship if they had to be sold to pay for such care.

There are, of course, traditional long-term care policies, the sole purpose of which is to provide true insurance only in the event that the insured is unable to meet a certain number of “activities of daily living.” These policies, however, are becoming more expensive and more restrictive in the costs they will cover. The key to obtaining such policies is to apply while still young; most applicants are turned down because, by the time they are worried enough to apply, they are either too old or too sick to qualify.

An alternative to the traditional policy is a life insurance policy that also can provide long-term care benefits. This type of policy can take several forms. Some policies (typically whole life) allow the insured to add a “long term care rider,” which allows the insured, upon meeting certain conditions, to access on an income tax free basis some of the cash value in the policy. This type of rider offers less care insurance than a traditional long term care policy, but does provide a death benefit if the policy is still in force. This means that, unlike long-term care policies, the premiums paid are not wasted in the event the insured dies without ever needing such care.

Another type of policy is one that is designed to provide both long term care and death benefits, but that are skewed more in favor of long term care than life insurance. Such products (Moneyguard being the most popular) often require larger up-front payments, which are invested by the insurance company. They tend to offer less care coverage than long term care policies, but more than care riders attached to conventional life policies. The downside is that the death benefit is limited to little more than the amount paid in to the policy. This may make it a better choice for those more concerned about long-term care and less about death benefit.

The important thing to remember in this area is that the landscape is constantly changing, and talking with a knowledgeable insurance agent on a regular basis is critical. For example, care riders cannot be added to guaranteed life products, but recently a “hybrid” guaranteed product has been created. So create partnerships with the knowledgeable insurance professionals in your area and buy them a lot of lunches.

b. Equalizing Gifts

One of the biggest problems in estate planning is how to treat children (or other heirs) equally when a specific asset is supposed to pass to a particular child. The stereotypical example occurs when the parent, who owns a closely-held business, has one child who works in that
business and one child who does not. The parent would like to give the business to the child who works in it, and find some way to make equalizing gifts to the other children who do not.

This creates two potential problems. The first (which is beyond the scope of this paper) is how to fairly value the business to determine what is “equal.” This is a perennial challenge. The second problem is how to come up with other assets equal in value to that of the business. This is where insurance comes in.

Product design is critical. If the business owner is planning on building additional wealth outside the business, so that insurance is needed only as a stop-gap, then term insurance might be adequate. If the value of the business could potentially increase significantly, then VUL might be appropriate (bearing in mind, of course, that it could fail to build up significant cash value, which could make the problem worse). If most of the income from the business is put back into it, so that cash flow is a challenge, then a no-lapse guaranteed product would be the most cost-effective solution.

Ownership of the policy also could be a challenge. The easiest solution is for the insured to own it outright, although that, of course, increases his or her estate and could result in a federal or state estate tax problem. The insured could simply give the policy to the beneficiaries who don’t work in the business, along with cash gifts to pay premiums, and let the death benefit pass directly to them. This simple approach, however, requires that the beneficiaries actually make the premium payments.

c. Ensuring Cash Flow for a Trust Beneficiary

Many trust beneficiaries view trusts as their own personal piggy banks. This is always a challenging situation, but especially when the trust asset is illiquid (like real estate) or uses its cash flow for operations (like closely-held businesses). Having insurance payable to such a trust allows the trustee to “care” for the asset and still make adequate distributions to the beneficiary. This is especially important during the period an estate is administered following the insured’s death, when business operations may be temporarily unstable.

In particular, advise business owner clients who have spouses that rely on revenue from the business but who don’t participate in it to consider adding a policy (probably a guaranteed life product, to keep premiums to a minimum) to their estate plans.

d. Providing for People Outside of an Estate Plan

As anyone who has administered an estate or administrative trust can tell you, not every beneficiary should be named in the will or trust. Some beneficiaries are difficult, and giving them the ability to see reports and object to them can create administrative nightmares. Others are pariahs, the mere presence of whom antagonizes the other beneficiaries (the significant other of a surviving spouse, when the other beneficiaries are children of the surviving and predeceased spouses, for example).
Using insurance to fund gifts outside an estate plan can, under the right circumstances, solve the problem and keep beneficiaries separated from one another.

e. **Replacing Income Before Adequate Wealth Has Been Built**

This is the classic (perhaps most basic) use for life insurance: replacing an income stream to support a spouse or children in the event of the income earner’s death. Typically it involves salary replacement. This is a place where term policies work very well. And so in some ways, this is a fairly obvious, self-explanatory example.

However, there is an opportunity here to dig a little deeper by looking at insurance as an asset class. Before talking about the insurance, find out their future savings needs and talk with the client about his or her ability to meet those needs. Using the insurance as a savings vehicle may make some sense if the client has a hard time putting money aside. The important

f. **Business Succession (Buy/Sell, Key Person)**

Another classic use for insurance. Largely self-explanatory, the most important aspect here is product design. For example, the amount that you need to buy out a deceased partner today may not be the amount that you need five years from now, when insurability might be an issue. A variable product may not be reliable enough (especially if the value of the business goes up as the value of the underlying insurance assets goes down). A guaranteed product will be attractive by price, but offers little future flexibility. Perhaps an old fashioned whole policy with the availability of paid-up additions is the best bet.

The other issue is who should own the policy. Old wisdom was that the company should not own the policy because a portion of the death benefit would be included in the deceased owner’s estate, thus increasing the estate tax due. On the other hand, in a typical cross-purchase arrangement, each owner held policies on the other owners, so there would be no inclusion of death benefits.

**g. Spousal Trusts**

Some clients may be interested in making lifetime gifts, but may have lingering concerns that the surviving spouse may run out of funds during his or her retirement. One way around this problem might be to create two trusts, one with the husband as grantor and the wife as initial beneficiary, and the other with wife as grantor and husband as initial beneficiary. Each trust could hold insurance on the life of the grantor-spouse. The trusts may grant each spouse a “Crummey” withdrawal right over the trust created for his or her benefit, or they may be funded with larger “unified credit” gifts. Each trust would last for the lifetimes of both spouses; on the second spouse’s death, both trusts would pass to the couple’s children or other beneficiaries according to the terms of the dynasty trust provisions that are established at the second death.

However, while such spousal trusts may create opportunities, they must be carefully drafted to avoid estate tax inclusion of the policy proceeds in each insured’s estate under the
“reciprocal trust” doctrine. Under the reciprocal trust doctrine,\textsuperscript{2} if two grantors create trusts for the benefit of each other or each other’s families that (a) are interrelated and (b) leave each grantor in the same economic position as if they had not created the trusts, the two trusts will be “unwound.” As a result, each grantor will be deemed to be the grantor of the trust for her benefit or the benefit of her own family and the trust property will be included in that grantor’s estate under §2036 and §2038. In this particular context, in which each spouse sets up a trust for the other, application of the reciprocal trust doctrine would result in each spouse being the grantor of the trust for his or her own benefit, and the assets of that trust would be includible in that spouse’s taxable estate.

Indeed, the IRS prevailed before the Tax Court on a reciprocal trust argument in a situation that did not even involve a trust.\textsuperscript{3} This case involved four siblings, three of whom each had three children. All four siblings and the spouses of three of them (the fourth was unmarried) made annual exclusion gifts to all of their nieces and nephews. This plan was suggested to the siblings by their long-time accountant, who also prepared the gift tax returns, as a device that would allow each of them to take advantage of his annual exclusion giving under §2503. Because each sibling had the same number of children, each niece and nephew received an equal amount of property each year. Including the transfer to his own children, each sibling claimed on his gift tax return for the two years at issue that both he and his spouse made nine separate gifts, each covered by the annual exclusion; the gifts to the nieces and nephews totaled approximately $120,000 per year. The IRS argued that these gifts should be “uncrossed” under the reciprocal trust doctrine, and that each sibling and his spouse should be deemed to have given the $120,000 to their own children in both of those years. The Tax Court sided with the IRS, ruling that not only was a gift tax due (plus interest), but also the spouses of each of the siblings were liable for the accuracy-related penalty under Code §6662(a), because none of the spouses ever personally consulted with the accountant (only the siblings themselves escaped the penalty, because they met with the accountant).

To prevent the application of the doctrine, the trusts should be slightly different from each other. For example, the Tax Court\textsuperscript{4} found that the reciprocal trust doctrine did not apply to trusts created by spouses for each other’s benefit under which one spouse had a power of appointment, while the other did not. The court ruled that each spouse must receive equal property rights to those they gave up in order for the doctrine to apply. In that case, the doctrine did not apply because only one spouse was given a power of appointment. Although the Tax Court has also found that trusts created by spouses for each other’s benefit should be unwound,\textsuperscript{5} the reasoning behind this decision has been rejected by at least one Circuit Court.\textsuperscript{6} When drafting trusts of a type contemplated here, the careful estate planner will want to grant unequal rights to the spouses in the trusts. For example, the trust that husband creates for wife might be for her benefit alone during her lifetime, while the trust wife creates for husband might be a “pot” trust, under which distributions can be made to husband and children during husband’s lifetime.

\textsuperscript{3} Sather v. Commissioner, T.C. Memo 1999-309.
\textsuperscript{4} Levy Est. v. Commissioner, T.C. Memo 1983-453.
\textsuperscript{5} Bischoff Est. v. Commissioner, 69 T.C. 32 (1977).
\textsuperscript{6} Green Est. v. United States, 68 F.3d 151 (6th Cir. 1995).
Despite such drafting efforts, however, clients should still be informed that this technique is not free from the threat of audit, in light of the position of the IRS with respect to reciprocal transfers. At least one ruling offers insight as to how to draft spousal trust to provide for unequal rights and avoid application of the reciprocal trust doctrine. Husband and wife each proposed to create irrevocable life insurance trusts ("ILITs") at the same time for the benefit of each other. Each trust would be the owner of an insurance policy on the life of the respective grantor, and each grantor would contribute cash to the trust. Additionally, each spouse would serve as trustee of the other's trust. The trusts were identical in many respects and different in many respects as well. However, the IRS emphasized the many differences that existed between the two trusts. For example, husband's Trust grants wife the right to withdraw specified amounts of principal after the first son's death. Husband's Trust also grants wife a lifetime power of appointment, effective at the first son's death, in favor of husband's issue, their spouses, or any trust created primarily for their benefit. In contrast, wife's Trust provided that husband could not be a beneficiary until three years after her death and only if his net worth and compensation do not exceed certain thresholds. After the recitation of differences between the two trusts, the IRS simply concluded, without further analysis, that they were not interrelated. The IRS did not engage in the second prong of the reciprocal trust doctrine—whether the trusts leave each grantor in the same economic position as if they had not created the trusts. The IRS ruled that (i) neither the husband's Trust nor the wife's Trust would be includible in the husband's gross estate for federal estate tax purposes by application of the reciprocal trust doctrine and (ii) neither the husband's Trust nor the wife's Trust would be includible in the wife's gross estate for federal estate tax purposes by application of the reciprocal trust doctrine.

It appears that the interrelatedness prong is fairly easy to avoid, as evidenced in this ruling. Even though the two trusts were established simultaneously, the fact that each trust had unequal provisions to meet the differing needs of the respective spouse is enough to avoid the reciprocal trust doctrine.

**D. BUSINESS PLANNING WITH A POLICY**

1. Some of the benefits of life insurance for the closely-held business owner include the following:

   a. Life insurance is an effective way of providing the funds needed to buy a deceased owner's interest in the business pursuant to a buy-sell agreement.

   b. Life insurance also can provide capital to assist the business in surviving the loss of a key employee or the owner.

   c. Life insurance can be an important employee benefit for the owner and the employees of the business.

   d. Life insurance policies are often protected against claims against the business owner personally which often arise as a result of personal guarantees of debt, failure to

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7 PLR 200426008.
properly maintain the business entity, or suits against the owner as an officer or director of the business entity.

e. Life insurance provides liquidity for the business owner’s family to ensure that they are not financially dependent on the business after the owner’s death and to meet the estate tax burden that may arise upon the owner’s death without having to sell the business.

2. Closely-held businesses and business owners use life insurance for a variety of reasons, and pay for the policy (i) out of the assets of the business, (ii) with a cost sharing arrangement, (iii) with compensation paid to the employee; or (iv) third party premium financing arrangements or other loan arrangements.

a. The business and its owners use life insurance primarily because it provides the liquidity that is absent in a closely-held corporation. This liquidity, in the form of a death benefit, will support the owner’s family at the death of the owner when the business may fail or suffer cash flow problems as a result of the owner’s death.

b. Even if the business does not suffer at the death of the owner, the loss of the decedent/owner’s salary (if still working) can be a serious blow to his or her dependents.

c. The liquidity represented by the death benefit also provides the means by which the business can pass to the succeeding owners with the least impact on business cash flow.

d. The tax-free build-up of the cash value in a policy also provides a great deal of benefit for a closely-held business and its owners.

e. It is a fund, if the policy is owned by the business, which can be used to meet cash flow needs of the business, if necessary, and its death benefit can be used to hire key replacements.

f. The cash flow can also be used to support a retirement plan for the company’s employees.

g. With respect to the owners, since the closely-held business can result in the owner being subject to creditor claims through personal guarantees of business debt, the creditor protection of life insurance policies are especially valuable, and the death benefit provides a fund for the family when, perhaps everything else is lost.

h. Just the knowledge of its existence and the fact that the family is provided for through the life insurance policy, may allow the owner to take the risks that ultimately make the business successful.

i. In a closely-held business, life insurance provides certainty, which is a valuable commodity when starting up, running and retiring or succeeding from a business that survives on the basis of the efforts of a small number of people.
3. At the Inception of the Business: Buying the Business.

a. Many times a purchaser retains the previous owner as a consultant in the business in order to take advantage of the previous owner’s expertise and contacts.

b. The prior owner could enter into a split dollar arrangement with the company, as an employee, thereby ensuring that the owner’s family will receive insurance proceeds at the owner’s death. If the policy is held in an insurance trust, an even greater benefit would pass to the owner’s family, since the sale proceeds received by the owner would be includable in his or her estate, whereas the assets in an irrevocable trust may escape estate taxation.

c. If the purchase price of the company is reduced by the amounts to be paid under the split dollar arrangement (in an attempt to defer taxable income by the owner, albeit at ordinary income rates, rather than capital gain rates), the Service may recharacterize the transaction as payments for purchase of stock, which would not receive benefits of the split dollar arrangement.

4. Obtaining Business Credit.

a. When borrowing money from a third-party lender, a closely-held company’s ability to repay the loan, from the lender’s standpoint, is dependent on the owner’s ability to repay the loan. Lenders will oftentimes require the company or the owners to purchase life insurance on their lives, making the lender the beneficiary of the policy during the term of the loan.

b. The payment of the policy premiums by the company will be non-deductible since it is for the benefit of the company, in enabling it to get the loan, under Section 264. However, if the lender takes out the policy on the owner/insured’s life, so long as certain requirements set forth in Rev. Rul. 75-46 are met, the lender can deduct the premium payments as ordinary business expenses under Section 162.

5. Attracting Employees.

a. Split dollar arrangements are not that advantageous for non-employee company owners because of the phantom income that occurs in the flow through entities and the dividend treatment of a C corporation, although it will allow an owner to leverage his or her gift tax exclusions. It is much more advantageous for employees, both for their retirement and estate planning, although its utility has been reduced (but not eliminated) by the recent final split dollar regulations discussed in the outline.

b. Group term life insurance allows employees (and owner-employees) who are otherwise uninsurable due to health or hobbies, or insurance is prohibitively expensive due to age, health or hobbies, to obtain life insurance for their families. In addition, if they irrevocably assign their benefits to an irrevocable trust, then their families will receive the proceeds estate tax free, so long as the employee survives the transfer by three years. One disadvantage of group term life insurance is that the healthy younger employees will discover that they can obtain insurance at a cheaper cost by themselves, rather than paying through the group term life insurance, since the group policy takes into account factors that do not apply to them. Many times this is
addressed by requiring such employees to maintain a certain level of group term life insurance to keep the insured pool as high as possible which will keep the premiums lower for the older employees/owners.

6. Protecting the Business Owner’s Family and other Owners.

   In a closely-held business, oftentimes the business provides the primary source of economic support for the owner and family and is both the cause and possibly the solution for the death taxes, if any, that arise at the owner’s death, unless the family has an alternative source to meet these needs, such as insurance.

7. If there is no insurance, what are the alternatives?
   a. Continue to pay such expenses as they arise, if the business can support it.
   b. Borrow the funds. Consider the cost of borrowing, even if a lender would be willing to lend money on the strength of the business when the owner has died.
   c. Create an investment fund in the business. However, investments in a C corporation could be subject to accumulated earnings tax. This alternative requires the company to set aside funds on a regular basis that may be needed for the business. It also requires a great deal of discipline and foresight on the part of the owners.
   d. Sell the business. If the estate or family takes back a promissory note, the estate or family becomes a creditor of the business. Furthermore, they may not be able to wait for the note payments to pay the estate taxes or to meet the family needs.

8. Buy-Sell Agreements.

   a. If the company is a sole proprietorship, a buy-sell agreement would be between the owner/estate and the potential purchaser, who would agree to buy the business upon the death or retirement of the owner. The purchaser usually holds a policy on the owner’s life. If the purchaser is an employee, the company could bonus out funds to assist the purchaser with paying the premiums. The employee could also enter into a split dollar arrangement with the company, whereby the company loans money to the employee who pays the premium. It is not possible to have a redemption agreement (discussed below) in a sole proprietorship, unless the purchaser has the right to purchase at least one share (or some interest) in the company prior to the redemption.

   b. If there is more than one owner, then the agreement can either be a redemption agreement or cross-purchase agreement, both of which can be funded with insurance if the sale takes place upon the death of an owner.

   (1) In a redemption agreement, the company agrees to buy, and the owner agrees (on behalf of his estate and heirs) to sell, the interest at his death. The company would own the insurance policy, pay the premiums and be the beneficiary of the policy (see discussion on corporate owned life insurance above).

      i. With a redemption agreement in place, when the company purchases a deceased owner’s interest, the value and proportionate interest of the remaining
owners’ ownership in the company is increased. However, the basis of the remaining owners’ interest remains unchanged.

ii. Another drawback of a redemption is that state law can restrict a company’s ability to redeem stock if the company’s financial position is not that strong, or state law can require the consent of the other owners to the redemption, which may not be forthcoming if any other owner sees better uses for the insurance proceeds.

iii. Finally, any insurance policy held by the company is subject to the company’s creditors, which does not provide a great deal of security to the family of the insured owner.

iv. When the last remaining owner is living, the company no longer needs the insurance policy on his or her life. At that point, it would be advantageous for the owner if the company distributed the policy to the owner who thereafter transferred it to an irrevocable trust.

-- The transfer of the policy to the insured is exempt from the transfer for value rules; however, the value of the policy may be includable in the owner’s taxable income as a distribution from the company, depending on the nature of the entity.

-- If the company is a flow-through entity, the distribution will not be taxable to the extent the value is less than the owner’s basis in the company interest. Since, in a redemption, that basis was not increased by the prior redemptions of stock that occurred as each owner died, the owner’s basis may not provide much protection against taxable income, especially if the policies had built up a large amount of cash value through premium payments or investment returns on the cash value.

-- If the company is not a flow-through entity, the distribution will either be compensation or a dividend. The owner will also end up with the death benefit includable in his estate as the policyowner, and will have to address the three year rule of Section 2035 to remove it from the estate.

v. If the policy remains in the company, upon the owner’s death, regardless of whether or not the owner is a controlling owner (one who owns 50% or more of the voting rights in the company), the proceeds will not be includable in the owner’s estate, so long as the proceeds are payable to or for the benefit of the company. However, the value of the company (and the owner’s interest) will be increased by the value of the insurance proceeds.

(2) In a cross-purchase agreement each owner will be contractually obligated to sell his ownership interest in the company upon his death (or at certain other times) to the other owners, and the other owners are obligated (or have a right) to buy the interests.

i. Each of the other owners usually carries life insurance on each owner’s life in order to be able to meet his or her obligation (or right) to purchase a pro-rata share of the deceased owner’s ownership interest. In the event here are more than two owners, the number of policies required to effect the purchase would be N (number of owners) multiplied by N-1.

ii. A cross-purchase agreement can require a substantial number of policies (with the resultant cost) and the need to purchase policies on each owner’s life may disproportionately cost younger members more since older insureds are more expensive.
iii. When one owner dies, the policies the decedent owned on the other owners, which will be includable in the decedent’s estate, should be transferred to remaining owners to continue the agreement (since each owner now owns a larger interest in the company as a result of the purchase of the deceased owner’s interest, the additional policy received from the deceased owner’s estate will be helpful to meet the increased purchase price obligation when another owner subsequently dies).

iv. Alternatively, the policies could be distributed to the company if the parties had entered into a wait and see type of buy-sell, as discussed below.

c. These policy transfers will be contractual obligations of the decedent, and, as a result, could be treated as claims against the estate, rather than taxable bequests, which will not reduce the decedent’s exemption from estate taxes available to his or her family.

(1) If the business is a corporation, when planning for the distribution of the decedent’s policies on the other owners’ lives to non-insureds (the owners other than the insureds), the transfer for value rules should be kept in mind, since these transfers are being made pursuant to contractual obligations and are therefore made for consideration.

(2) If the decedent’s policies are transferred to each insured, the transfer will fit within the exceptions to the transfer for value rules; however, the death benefit will be includable in the insured’s estate. Even if the insured subsequently transfers the policies, there will still be estate tax inclusion for three years after the subsequent transfer. If the non-insured transferees were also partners in a partnership, the transfers should fall within the transfer for value exception.

d. A “wait and see” plan utilizes the cross-purchase and redemption plan within one buy-sell agreement. Life insurance policies are owned by and payable to the co-owners who have an option to purchase the decedent’s interest in the company, but if any one of them (or all of them) elect not to so purchase the interest, the company must purchase the decedent’s interest, so it also holds policies on the owner’s lives.

(1) Alternatively, the company can hold the initial right to purchase the stock (in a redemption), and the shareholders purchase what the company does not purchase.

(2) Usually, this is not an “all or nothing” plan, and each of the policies doesn’t cover the entire value of the ownership interests. As such, many times the owner’s purchase some portion of the decedent’s interests, and the company purchases the remainder.

(3) If the company will purchase the decedent’s entire interest, and does not have a large enough insurance policy, the other owners could lend the money to the company out of the proceeds they each receive, from the policies they own.
8. Family Buyouts.

a. If one or more family members work in the company but there are other family members who are not employees, there could be problems with the control and direction of the company. Employee owners usually take money out of the company in the form of compensation and benefits leaving the non-employee owners with very little receipts, if anything. As a result, there is pressure on the employee owners to sell the business, which would allow the entire family to benefit from the sale proceeds.

b. A buyout can take place either at the time the original owner dies and the family is about to inherit the company so that the family employees buy out the estate’s ownership interest, or it can take place anytime after the original owner’s death when frictions arise. A buyout funded with life insurance can enable the employee’s family members to purchase the interests outright.

c. A buy-out funded with life insurance can also remove a reluctant spouse from the business. In many situations, although it would be more appropriate to bequeath the company to family members who are working in the business and not to the spouse, who is uninvolved, the spouse, or a marital trust for his or her benefit, receives the business because of the decedent’s desire to defer the estate tax with the use of the marital deduction from estate taxes.

(1) The spouse may not be the mother of the family members working in the company and/or may not want to rely on those family members to produce enough cash from the business to support him or her (which can cause friction on a personal level). However, as a result of the estate taxes and the fact that the company may be the primary source of support of the spouse, the company ends up in the spouse’s hands.

(2) A buyout by the family members working in the company, funded with insurance, will remove the spouse from the business and give him or her an alternative source of assets for his or her support. An alternative form of buyout, using a promissory note, does not remove a spouse from the business. It only converts the spouse from an owner to a creditor of the business and the family.

E. USING THE POLICY FOR CHARITABLE GOALS

1. Reasons to consider gifting an existing policy to charity.

a. Old policies may no longer be needed by the donor/insured. Although the availability of life settlements for non-chronically or terminally ill insureds, may mean more policies may be sold and fewer such policies are gifted to charities. These settlements may also have valuation implications for policies gifted to charity.

b. Future premium payments by the donor – either directly or as gifts to the charity – may be fully deductible.

c. Future premium payments by the donor – either directly or as gifts to the charity – may be fully deductible.
d. There is no cost to the charity to manage the asset (although variable policies may require some active management). However, the charity may have to deal with the issue of paying premiums out of its funds to keep the policy in force if the donor stops making gifts to do so – called “donor fatigue” – or selling or surrendering the policy.

2. Gifts from the Charity’s perspective

   a. The charity should have both intake guidelines for which types of policies it will accept and guidelines for administering policies it owns. Without a set of guidelines as to which types of policies a charity will consider accepting, it runs the risk of owning and having to manage policies which will require premium gifts by the donor for his or her life, which may increase over time, and/or policies which are unstable and may expire before the insured.

   b. The charity should also consider a pre-gift letter or memo to prospective donors about accepting policy gifts. Without a clear message to potential donors of policies, a charity risks alienating donors who might expect their favorite charity to automatically accept – with thanks – any policy they wish to donate.

   c. Finally, the charity should consider the internal administrative issues raised by managing policies it owns on its donors – today’s policies are generally “buy and manage”, not “buy and hold” policies.

3. The gift allows a larger gift to charity with little or no impact on other assets going to the insured-donor’s spouse or children, but the policy proceeds will no longer be available to the insured’s estate for liquidity or to his or her spouse and children for support or other needs.

4. There is no insurable interest issue in such gifts, as there might be if the charity acquired a new policy on the life of a donor.

5. Designating a Charity as beneficiary of Policy.

   a. This serves the same function as a bequest of an equivalent amount from the insured’s estate, but avoids probate.

   b. It enables the donor/insured to change his or her mind about the gift; both as to the amount of the gift and the ultimate charitable (or non-charitable) beneficiary(ies).

   c. The donor/insured owns and can still utilize the cash values. In an era of increasing income tax rates (including the 3.8% healthcare tax on investment income), the ability to access policy cash values income tax-free (by withdrawing up to basis and borrowing thereafter in non-modified endowment contracts) will likely make this strategy more appealing.

   d. The donor/insured will be able to get an income tax deduction if and when the policy is later gifted to charity.

   e. There is no income tax deduction to the donor for the value of the premiums paid, since the donor has retained incidents of ownership in the policy, in violation of the partial interest rule.
f. There is no income tax deduction to the donor for the value of the premiums paid, since the donor has retained incidents of ownership in the policy, in violation of the partial interest rule.

g. The estate of the insured will include the value of the proceeds, under Section 2042, but will receive an offsetting estate tax deduction for the proceeds passing to charity. Sections 2042(2) and 2055(a).

h. An irrevocable designation of a charity as beneficiary.

(1) Such a designation of a policy in which the donor/insured retains an incident of ownership is a nondeductible gift.

(2) There is no income tax deduction under the partial interest rule.

(3) There is likewise no gift tax deduction, for the same reason. But there is likely a completed gift for gift tax purposes each year, perhaps measured by the "economic benefit" of the death benefit assigned, which would not qualify for the gift tax charitable deduction (again, because of the partial interest rule).

(4) Future premiums paid to the insurer on behalf of the charity would also not be deductible, for the same reason.

(5) There will be estate tax inclusion of the policy proceeds in the insured's estate for estate tax purposes, with an offsetting charitable deduction.

F. INSURANCE AS AN INVESTMENT

1. Life insurance has its own unique characteristics, most notably a death benefit. But cash-value policies also hold underlying investments. To begin any discussion of life insurance as an investment, it is important to understand how the various insurance products work. This, in turn, requires an understanding of the types of products available, the way that they are illustrated and the expense structure behind them.

2. Insurance Product Types

There are a multitude of insurance products, each developed as the needs of the clients and the demands of the market have changed.

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8 The text in this item F is taken from an outline for the program: USES FOR LIFE INSURANCE: BEYOND TAXES, presented at the 2017 Seattle Estate Planning Institute by Mary Ann Mancini and Christopher P. Cline and prepared by Christopher P. Cline, Riverview Trust Company, 900 Washington Street, Suite 900 Vancouver, WA 98660 Phone: (360) 759-2478 E-mail: chriscine@riverviewbank.com, used with permission.

a. **Term Insurance**

In its purest form, life insurance is simply the insurance company gambling on the insured’s life. The company decides each year how much it must be paid for it to assume the risk that the insured will die in that year and that the company will then have to pay the stated death benefit to the insured’s beneficiaries. The amount it must be paid, in the form of an annual premium, is determined based upon actuarial assumptions about the insured, including the insured’s gender, age, personal habits (e.g., smoking and skydiving) and medical condition and history. For example, an insurance company will accept a small premium from a 25-year-old healthy nonsmoker with no family history of illness; the annual premium on such a person for a $1 million death benefit might be $1,000 or less. In other words, the insurance company is willing to gamble on the very unlikely chance that the insured will die in exchange for being able to keep the premium. On the other hand, a 98-year-old smoker would have to pay about $1 million for the same policy because the company is pretty certain that the insured will die that year and is not willing to gamble its own money. This kind of “pure” insurance is called “term insurance.” Term insurance is used primarily to provide security for younger insureds (or for group insurance, with a large risk pool) because the premiums become prohibitively expensive as the insured gets older.

b. **Whole Life**

As an alternative to term insurance, the insured can buy “whole life insurance,” the premiums for which consist of a term insurance component and an investment component. In the case of our 25-year-old above, the premium for a whole life policy with a $1 million death benefit might be twice as much, with $1,000 going to pay the cost of his term insurance and the balance (after the commissions are paid to the agent) going into an investment account regulated by the state insurance commissioner. This investment account grows over time and becomes a part of the death benefit that is paid. For example, if the cash value in the policy grows to $750,000 by the time the insured is age 50, the portion of the premium paid each year allocated to the term component of the policy gets smaller because now the company is only insuring the insured’s life for $250,000. Because the value of the investment account increases over time, the premium never increases (as it does under term insurance) because the amount of the premium necessary for real insurance decreases. If the insured lives long enough, the cash value in the policy increases to the point where it equals the death benefit, at which point the insurance company simply gives the money to the insured. This usually happens at age 100. The owner of the policy can withdraw the cash value in the policy at any time or can borrow against it; however, if the policy has too little cash, it can lapse.

c. **Universal Life**

In response to the high interest rates of the late 1970s and early 1980s, the insurance companies developed “universal life insurance,” which is similar to whole life insurance, but provides flexibility in the amount of premium the policy owner pays. The policy owner can pay larger premiums in the early years of the policy and then lower premiums (or none at all) later if the cash value in the universal life policy drops below a given level, however, the owner will have to pay additional premiums; otherwise, the policy will lapse.
With universal life, the policy holder gives up the certainty of a guaranteed premium in exchange for a lower current cost and more flexibility in paying premiums. In reality, however, the insurance companies were not guaranteeing anything more than they were with whole life. Rather, they were repackaging their guarantees to allow this flexibility by applying the same interest and mortality assumptions used for reserves, but also transferring the premium sufficiency risk to the policyholder. If more money was needed because the interest crediting rate dropped or mortality costs increased, then more premiums would be due. If the additional premiums were not paid, the policy would eventually terminate without value when the policy assets were used up by those increased costs. Because this new risk was often not explained by insurance agents and, therefore, was not understood by policyholders, many policyholders paid less than was needed to keep the policies alive, thinking that the quoted premiums were a promise of no future increases. As a result of this confusion, some believe that universal life created a “legacy of disappointment and broken promises for policyholders and advisers alike.”

d. Variable Universal Life

A decade later, after the significant rise in value of the stock market, policy owners grew tired of having the cash values of their insurance policies invested in “safe” regulated investments approved by the insurance commissioner (typically bonds and government-backed mortgages). The insurance industry responded with “variable universal life insurance.” Variable universal life is a universal life product, but the cash value of the policy can be invested in one of several investment packages offered by the insurance company. For example, the insurance company may offer mutual fund packages allowing investments 100% in stocks or 50% in stocks and 50% in bonds. The policy owner is limited to the investment packages offered by the insurance company, which typically have above average costs. These higher costs may be offset, over time, by the fact that the growth of the assets inside the insurance policy occurs free of income tax liability. Note, however, that this investment flexibility can work both ways. If the policy owner invests primarily in equities and the stock market is doing well, the cash value will build in the policy faster than expected, which means that the future premiums can be much smaller. On the other hand, if the stock market drops in value significantly, the policy owner may have to pay significantly larger premiums than originally quoted.

As with universal life, policyholders tended to view the optimistic illustrations provided by agents as a promise that the product would perform and premiums would not increase. However, the significant fluctuation in values in the stock market has demonstrated that projections for premiums in variable universal life products are not reliable. As with universal life, variable universal life products proved to be a disappointment to many.

e. Newer Products

As the market entered the new millennium, interest rates declined and the “tech bubble” burst. Insurance buyers were tired of universal and variable universal life products, so insurers began to

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11 Id. at 52.
offer new products to meet investors’ needs.\textsuperscript{12}

(1) No-Lapse Guarantee Universal Life

To address the fatigue of insurance illustrations that outperformed actual results, insurance companies developed no-lapse guaranteed products (NLG), which offered a guaranteed death benefit but little or no cash value. As already mentioned, a traditional universal life policy lapses if the cash value is insufficient to cover that policy’s ongoing charges for insurance and expenses. Conversely, NLGs stay in effect for the guaranteed period, usually the insured’s life, if all premiums are timely paid, even if the cash value is insufficient. Initially attractive, NLGs became more expensive and harder to come by as interest rates stayed low and the levels of reserves insurance companies needed to retain got higher. The new reserving guidelines for existing NLG policies, which were adopted in 2012, and low interest rates caused the market share for this product to drop.\textsuperscript{13} Further, the lack of cash value inside a NLG policy limits the ability to convert this type of policy to a different type if the insured’s planning objectives change.

(2) Traditional Universal with Durational Guarantees

Durational guaranteed products marry the flexibility of traditional universal life with a “durational” guarantee, typically until life expectancy, and some cash value build-up. Durational guaranteed premiums are lower than NLG premiums because the durational guarantee requires the insurance companies to maintain less in reserve. The risk with durational guaranteed products is that future premiums could increase if the insured lives beyond his or her life expectancy. This type of policy would work best for middle-aged insureds that have adequate time to build cash value inside the policy, which would provide for flexibility if the insured’s planning objectives change.

(3) Variable and Private Placement

As discussed, variable life insurance is riskier than cash value insurance, but creates the possibility of greater returns. Though initially disappointing after the Tech Bubble burst after the 1990’s, variable universal life has seen a resurgence following the run-up in equity markets after 2008 financial crisis. In an effort to obtain even better return, sophisticated and wealthy investors are using “private placement” insurance, which is a type of variable policy that allows investments in non-SEC registered funds.\textsuperscript{14} Private placement insurance is best suited for younger investors that have low risk aversion and are knowledgeable about investments.

\textsuperscript{12} All references in this section are adapted from Warshaw & Bragdon, \textit{Current Trends in Life Insurance Choices and Strategies}, 42 Est. Plan. J. (March 2015).

\textsuperscript{13} Revisions to Actuarial Guideline XXXVIII (also known as AG 38) adopted by the National Association of Insurance Commissioners.

\textsuperscript{14} For further discussion regarding private placement life insurance and annuities see below, also see 870 T.M., \textit{Private Placement Life Insurance and Annuities}.  

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(4) **Index Universal Life**

A fast growing recent life insurance product is index universal life insurance (IUL). In an IUL policy, cash values are eligible to receive “indexed interest crediting,” which uses an equity index, such as the S&P 500, to determine the interest rate credited to the policy, rather than a fixed interest rate. The return on the cash value is often capped at 10%–12% in return for a guaranteed floor of 0%–2%. IUL is less risky (but with less growth potential) than variable life, but more risky (and with much more growth potential) than traditional universal life.

(5) **Choosing Among These Products.**

As this brief introduction to product types has demonstrated, there is a confusing list of different insurance products to choose from. Although the only way to make an informed decision about product selection is with the advice of an experienced life insurance advisor, there are a few different approaches that can help prepare you and your client for that discussion.

The client discussion needs to start with the fact that insurance should be chosen by appropriateness, not price. These are highly sophisticated financial products, not appliances at a big box store. In order to implement this change in perspective (after all, most people buy insurance like they buy refrigerators), having the right approach is important.

First, Dick Weber from the Ethical Edge at the 2017 Seattle Estate Planning Institute recommended looking at the different insurance products as an investor might, taking into account the insured’s risk tolerance. This is an important first step in assessing how a client might react in the future to owning a particular insurance product. Some clients may appreciate analyzing policies as they would other investments. Others may prefer the flow chart approach. The important thing is to be familiar enough with the different insurance products that an advisor can talk through them with clients in a way best suited to the client.

Regardless of approach, however, the key is to try to move the conversation toward need and product design, and away from price.

3. **Pricing and Performance**

   a. Determining policy pricing and performance requires knowledge of three factors:

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   \text{Pricing/Performance} = \text{Cost of Insurance Charges} + \text{Policy Expenses} - \text{Policy Interest and Earnings}^{15}
   \]

   b. The largest single cost is cost of insurance charges, which is the amount the insurance company deducts from policies to cover its anticipated payments of death claims. Policy

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15 For a more complete discussion, see Cline & Flagg, *The Prudent Investor and Trust Owned Life Insurance*, 116 ABA Trust & Investments 34, 37 (March/April 2007).
expenses is a catchall category that covers the insurer’s marketing, taxes, wrap fees, and premium loads (which includes sales commissions and taxes). A policy’s interest and earnings are amounts that are credited to a policy based on the type of policy (whole and universal are required to be invested in the insurer’s conservative portfolio, variable and PPL are invested in separate accounts using investments directed by the policyholder, and term and guaranteed policies are not credited with any earnings). The actual earnings credited can vary between policies, even when they have the same gross earnings, if the insurers’ expenses are different.

As this very brief discussion has shown, determining policy pricing and performance is practically impossible even for the insurance expert, much less the average consumer or estate planner. In fact, the policy expenses are often referred to as a “black box,” because insurance companies don’t reveal the exact make-up of these expenses.

4. The Problem with Illustrations

a. After the appropriate type of policy is chosen, policy owners need to deal with the policy illustration, or projection of premium payments, presented by the agent selling the policy. In the late 1970s and early 1980s, with the advent of universal life, insurance companies and agents were among the first to either own or have access to personal computers to run the illustrations for this more complex product.16 Unfortunately, however, technology has yet to yield policy illustrations that adequately inform purchasers of the risks involved.

b. Constrained by insurance regulation and industry tradition, policy illustrations, even so-called “in force” illustrations, continue to project constant return assumptions.17 For example, a policy illustration that shows an 8% return (the most that can ever be illustrated is 12%) assumes that the investments inside the policy generate an 8% return every year, year in and year out.

c. The problem, however, is that no investment generates such a flat-line return. For example, suppose a 10% return is being illustrated. If $1,000 is invested and it generates 10% each year for five years, the value of the investment will be $1,611 at the end of the period. If, on the other hand, the investment earned, in each successive year, 10%, 20%, 0%, 30% and 10%, the average percentage return would still be 10% over the five years, but the investment would be worth only $1,544.18

d. When this limited view provided by in-force illustrations is added to the opaque nature of pricing and performance, the result is that illustrations are essentially useless as tools to compare policies.

e. A better way to illustrate, albeit one that is must be provided by a third-party consultant, is the “Monte Carlo” simulation, under which software runs a significant number of permutations, or “runs,” of outcomes, all of which lead to the same average percentage return.

16 Weber, When is a Premium Not a Premium? 59 J. Fin. Serv. Prof. 34 (July 2005).
17 Id. at 36.
18 Id. at 35.
This exercise tells a potential buyer of insurance the percentage likelihood that the policy will remain in force and will not require additional premiums. This analysis, however, is limited to analyzing the performance of a single policy. When buying insurance, or when considering a policy change (like a tax-free exchange under Internal Revenue Code section 1035), it is tempting to compare in-force illustrations to assess relative performance. Tempting, but wrong. The Society of Actuaries determined that using illustrations to compare one policy to another is improper. This is due, in part, to the fact that "illustrations create the illusion that the insurance company knows what will happen in the future and that this knowledge has been used to create the illustration." The truth, of course, is that illustrations simply reflect the current state of policy (its return and cost assumptions) at the moment it is run.

5. Fiduciary Oversight of Insurance: Cochran and French

   a. In 2009, Cochran v. KeyBank, N.A., was issued, the first published case dealing with the application of the Prudent Investor Act to an irrevocable life insurance trust.

   (1) In 1987, the grantor created an irrevocable life insurance trust for the benefit of his two daughters. Just before KeyBank took over as trustee, the trust assets included three insurance policies and one annuity, all of which had a death benefit of approximately $4.8 million. The insurance advisor wrote to the beneficiaries' mother (who at that point was divorced from the grantor), recommending that those insurance products be exchanged for two variable universal life policies (VUL Policies). By the time KeyBank took over as trustee, the underwriting for the exchange of policies had already begun, with the grantor having submitted to the physical exams. Within two months of having assumed its responsibilities as trustee, KeyBank approved the exchange of policies. The new policies had a collective death benefit of $8 million.

   (2) Two years later, concerned about the effect of the market downturn on the VUL policies, KeyBank retained an outside insurance consultant to audit those policies. The consultant concluded that the policies likely would lapse before the grantor's life expectancy was reached. Further, the grantor's personal finances also had declined during the same period, and he was unable to add additional resources to the trust. The grantor's original insurance advisor (who had sold the VUL policies to the trustee) recommended at about that time that KeyBank exchange the VUL policies for a single policy with a guaranteed (but significantly reduced) death benefit of about $2.8 million (the death benefit for both VUL policies at the time was about $8 million). Seven months after KeyBank made this decision, the grantor died and the death benefit of about $2.5 million were paid to the trustee. Had KeyBank not entered into the exchange, it would have been paid the $8 million death benefit from the VUL policies.

   (3) Three months after the grantor's death, the beneficiaries filed a claim against KeyBank for breach of fiduciary duty. The appellate court, in upholding the trial

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19 Id. at 35.


court’s ruling in favor of the bank, rejected the beneficiaries’ arguments both that KeyBank breached its duties under the Indiana Prudent Investor Act (Indiana Act) and that it breached its more general fiduciary duties. The appellate court addressed four different areas of potential breach under the Indiana Act. First, Keybank did not imprudently or improperly delegate its duties under the Indiana Act by eventually following the insurance advisor’s recommendation because there was no delegation; KeyBank hired its own independent consultant to review the recommendation. Second, KeyBank did not disregard its independent consultant’s recommendations; although that consultant found that retaining the VUL policies was acceptable, it also found the exchange acceptable, eventually recommending it. Third, KeyBank did not fail to adequately investigate possible alternatives to either keeping the VUL policies or exchanging for the recommended policies. This was so even though the trial court noted that KeyBank’s process of review was “certainly less than perfect.”

Fourth, the appellate court refused to review the transaction in hindsight. It held as follows:

“KeyBank’s decision to exchange the VUL policies for the John Hancock policy was eminently prudent, reduction in death benefit notwithstanding. That a ‘wait and see’ approach may also have been a prudent course of action does not alter the propriety of the exchange. We now know, in hindsight, that the economy improved and [the grantor] died unexpectedly less than a year after the 2003 Exchange took place – given those facts, of course, we understand that the Beneficiaries wish that KeyBank had made a different decision. But keeping in mind only the facts and circumstances at the time KeyBank made its decision, we cannot say that its decision violated [the Indiana Act].”

b. A second “insurance exchange” case also came out in favor of the corporate trustee. In this case, Wachovia Bank took over as trustee of an irrevocable trust that held two underperforming life insurance policies.

(1) After months of evaluation and consultation with the grantor and his lawyers, the bank replaced the underperforming policies with new “no lapse” products sold through the bank’s insurance division, which offered the same death benefit at a lower premium. The policy exchange generated a significant (but industry standard) commission to the bank. Concerned about the size of the commission, the beneficiaries sued the bank for self-dealing. The bank relied on a provision in the trust agreement that allowed the trustee to invest trust property without regard to conflicts of interest or lack of diversification. Further, the exchange of policies had been extensively analyzed by the grantor’s estate planning attorneys. The beneficiaries argued that the trustee acted in bad faith, because it sent the grantor a conflicts waiver that the grantor refused to sign, but the bank proceeded with the exchange anyway. They also argued the bank violated the Prudent Investor Act.

(2) The Seventh Circuit, affirming the district court’s ruling, held that the trust agreement’s express waiver of conflicts relieved the bank of liability, as did the language

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22 Id. at 1138.
23 Id.
waiving the duty to diversify. Further, the lack of consent from the grantor (which was sought by the bank but was not obtained) was not an indication of bad faith, because the trust agreement did not specifically require the consent of the beneficiaries or the settlor, and such consent is not needed in the absence of such language. Finally, the court noted that the transaction was a "win-win" for both the trust and the bank. The court also observed that the bank kept the family informed about the transaction, the grantor had instructed the bank to explore an exchange, and the family’s lawyers worked closely with the bank in working out the details of the exchange.

c. In general, these cases seem to have come out the right way. Despite many flaws in its administrative process in the Cochran case, KeyBank took the right steps in analyzing the trust assets and their ongoing fitness to the purposes of the trust and the existing economic environment. And in French, Wachovia also took the right analytical steps, even though it may have made life harder for itself by proceeding even after it asked for, but did not receive, a conflict waiver.

(1) Specifically, the following points about the decision are important:

   (i) In Cochran, the court resisted the temptation to look at the actual results, and applied the standard required under the Prudent Investor Act, even though the trustee’s behavior was not perfect. This does not sound significant, but particularly in the case of corporate fiduciaries courts sometimes seem willing to stretch the facts to find liability.

   (ii) The most important fact in both cases was the independent review of the proposal. If Keybank relied solely on the recommendation of the grantor’s insurance advisor, or had Wachovia relied on internal analysis, it is unlikely that the courts would have reached the same result.

   (iii) Process can win over other facts. Both banks escaped liability because they were able to prove their process, despite some missteps. This allowed the court to provide the appropriate standard of review: was the decision appropriate at the time, and not viewed in hindsight.

(2) These cases point to an important fact about insurance reviews. Regular analysis by a third party of a policy’s viability, and of the other options that may be available, is very important, even if the policy owner is not a fiduciary.

G. INSURANCE AS INVESTMENT: PRIVATE PLACEMENT INSURANCE

1. "Private placement life insurance" refers to policies that have features that are not available in other policies available for sale to the general public. It is designed to appeal to high net worth individuals who are interested in funding the policy with a large up-front premium payment and want to achieve an advantageous investment return for such premium amounts transferred into the policy. This section will review how private placement life insurance policies (both "on-shore" and "off-shore") works, and the planning opportunities and pitfalls that pertain to private placement life insurance. This section will not address private placement annuity products.
a. What is Private Placement Life Insurance ("PPLI")?

(1) PPLI is an individually tailored variable universal life ("VUL") insurance policy.\(^{25}\)

(2) There are two types of PPLI: (1) "off-shore" PPLI which are policies offered for sale and purchased outside of the United States from a carrier that operates outside of the United States which may or may not be "US compliant" as described below; and (2) "on-shore" PPLI which are policies that are offered for sale and purchased in the United States through US carriers.

b. Overview of Benefits of PPLI

(1) Customized investment options.

(i) In non-PPLI policies offered by US carriers, the most diversified and diverse investment products offered under variable life insurance products. What investments a US carrier offers inside of these policies are regulated by the applicable state insurance regulatory office as well as the SEC.\(^{26}\)

(ii) On shore PPLI carriers are also regulated by the same applicable state insurance regulatory office as well as the SEC but under those rules can offer more varied investment options so long as it is available only to "accredited investors". Therefore, the difference between US non-private placement carrier offerings and onshore private placement carrier offers are based only on the carriers' risk tolerance, flexibility and customer base.

(iii) Off-shore PPLI policies, since they are usually not subject to regulation by a US state or the SEC, usually have a greater range of permissible investments, limited only by the off-shore jurisdiction’s regulatory requirements, which is oftentimes much broader than US regulatory requirements.\(^{27}\) However, with the lack of such regulatory requirements also comes less regulatory protection.

(2) Beneficial Tax Treatment Available to All Policies

(i) Tax-Free build-up Inside the Policy

\(^{25}\) The policy doesn’t have to be a variable universal policy. Any type of policy offered by the carrier could be considered private placement, but the ability to create separate accounts that are not subject to the claims of the carrier’s creditors (with the possible exception of certain off-shore Section 7702(g) policies) and the premium flexibility of VUL policies means that most private placement policies are VUL policies.

\(^{26}\) See, e.g., Texas Insurance Code, Chapter 425, Subchapter C “Authorized Investments and Transactions for Capital Stock Life, Health and Accident Insurers” for an example of a statutory list of what an carrier doing business in Texas can invest in; and see Securities Act of 1933 discussed in the outline.

\(^{27}\) See e.g., Bermuda “Insurance Code of Conduct” which came into effect on July 1, 2010 and which all commercial carriers must comply with by December 31, 2010 under Section 4 of its Insurance Code, 1978, in which its description of best practices for what a carrier doing business in Bermuda can invest in adopts a “prudent person” standard as part of its investment policies but contains no list of approved investments.
If Section 7702(a) is applicable to the policy (discussed below) and if the carrier meets the definition of a life carrier under Section 816(a)\(^{28}\) (and if the rules of Section 817 and the investor control rules discussed below are satisfied), the investments inside of the policy are considered to be owned by the carrier and not the policy owner. As a result, the income earned inside of the policy is taxable to the carrier and not the policy owner.\(^{29}\)

(ii) Withdrawal of a Portion of Policy Value Tax Free

Section 72(c) provides that any amounts received from a life insurance contract are considered first to come from the policyholder’s investment in the contract and to such extent are income tax free.

Loan proceeds from the policy are income-tax free regardless of the owner’s investment in the contract, and the interest charged by the carrier on such loans are paid out of the cash value of the account.

Additional amounts withdrawn that exceed the owner’s investment in the contract are taxed as ordinary income.

Investment in the contract under Section 72 refers to the aggregate amount of premiums paid for the policy plus dividends applied to paid up additions in death benefit (or applied to the premium) minus any amounts received to the extent such amounts received were excludable from gross income.

—MEC rules

A “MEC” or modified endowment contract is defined in Section 7702A and is a policy that is considered to be funded too quickly and the rules were enacted by Congress due to the concern that investors would use a life insurance policy to hold investments in order to avoid being taxed on the income.

A policy can be a MEC from the outset (and single premium policies are invariably MECs) or it can become a MEC if it fails the “7-pay test” of Section 7702A(b). The 7-pay test provides that if the accumulated premiums paid at any time in the first 7 years of the policy exceed the sum of the net level premiums which would have been required to meet the tests for a life insurance contract under Section 7702(a) (discussed below), then the policy is a MEC. Furthermore, under Section 7702A(c)(3) if there is a “material change” to the policy then the MEC rules are applied at such time of such change and if the policy fails, then it becomes a MEC.

\(^{28}\) Under Section 816(a), an carrier is a company (i) more than one half of the business of which is issuing insurance or annuity contracts, or reinsuring risks underwritten by other insurance companies; see Rev. Rul. 83-132, 1983-2 C. B. 270, and (ii) in which more than 50 % of the company’s “total reserves” must consist of (a) “life insurance reserves,” and (b) unearned premiums and unpaid losses on noncancelable or guaranteed renewable A&H policies (to the extent not included in life insurance reserves). “Life insurance reserves” are defined in Section 816(b) as amounts (i) computed or estimated on the basis of recognized tables and assumed rates of interest, (ii) set aside to liquidate future unaccrued claims arising from life insurance contracts and (iii) are required by law.

\(^{29}\) See Section 832(b)(1).
The consequences of the policy being a MEC is found in Section 72(e) which are as follows:

Any distribution from the policy is treated as taxable to the extent there is any gain in the policy at ordinary income tax rates. Only when such gain is fully recognized will the remaining distributions be considered a tax-free return on the policyholder’s investment in the contract.

Loans from the policy will be considered distributions.

Dividends paid from a MEC will be considered distributions (as will dividends used by the carrier to repay principal or pay interest on a policy loan).

Amounts distributed will also be subject to a ten (10) % tax if made prior to the time the owner has attained the age of 59 ½ years.

If the policy is pledged or used as collateral, there is an argument that by doing so the policyholder has accessed the financial benefits of the policy cash value and as a result, it shall be treated as a distribution from the policy.

c. These benefits can be further improved by lower costs that can exist in a PPLI policy or that can be negotiated downward by the owner of a PPLI policy.

(1) Agent Commissions. The PPLI buyer may be able negotiate considerably lower agent commissions or negotiate commissions that are based on growth in the value of the policy and taken ratably over the life of the policy, rather than a set commission most of which is charged up-front against the initial premiums. Since agent commissions are paid by the carrier out of the premium, if these commissions are lowered, more of the premium is added to the VUL accounts. Alternatively, it is possible to take the agent commission (the bulk of which is typically paid up-front in the first year) and pay it from each year premium on a ratable basis. Finally, it is possible at times to pay that cost directly to the carrier rather than have it taken out of the premium, but the availability of this option is based on the jurisdiction’s regulatory requirements and is more often found in off-shore PPLI.

(2) Mortality and Expenses (“M & E”) charges. These are fees that the carrier charges within the premium for its administration of the policy and takes into account the

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30 Gerald Nowotny noted in his 2012 article “Private Placement Life Insurance and Annuities 101-A Primer”, (jdsupra.com, 8/28/2012) that traditional variable life insurance products have a commission structure that “pays the agent 55-95% of the target (commissionable) premiums in the first policy year” and commissions in subsequent years on premiums vary by carrier from 2-5% of the premium as well as .25-.35% of the policy’s account value.

31 See, e.g., anti-rebating regulations that exist in many US states which provide that the agent may not give back anything of value to the policy owner, including rebating commissions; arguably reducing the commission or stretching the payment of the commission over a period of years or basing it upon investment return rather than the more usual commission structure could arguably violate these statutes.
risk that the insured may not live long enough for the company to make a profit from the policy, in light of the costs it expends to maintain the policy.

(3) Cost of Insurance (COI) charges. These are fees paid to the carrier within the premium for the pure investment risk is it taking on by issuing the policy and COI charges are based on the difference between the policy cash value and the policy’s face amount.

(4) Surrender charges are typically not charged in Private Placement insurance products.

d. PPLI has all the benefits of the more typical VUL policy as well.

(1) The assets held in the policy for investment are held in separate accounts, not the insurance companies’ general account, thereby protect the assets from the claims against the carrier. 32

(2) The payout of the death benefit is not subject to income tax under Section 101(a) of the Code (subject to the transfer for value rules). 33

2. Regulatory Requirements of PPLI

a. On-shore PPLI and Federal Law:

(1) On-shore PPLI is a non-registered security under the Securities Act of 1933 provided it is available only to “accredited investors”. Qualification as “accredited investor” is particularly important since it will mean the sale of the policy is exempt from registration under the Securities Act.

(i) The definition of an “accredited investor” is found under Rule 501(a) of Regulation D of the Securities Act of 1933 (“Reg. D”). The definition includes, among other individuals and entities, (i) any individual with a net worth (or joint net worth with a spouse) of at least $1 million, (ii) any individual whose annual income is $200,000 (or joint income with a spouse) of at least $300,000) in the last two years, with the reasonable expectation that it will continue in the current year, (iii) a trust with assets in excess of $5 million that was not formed to acquire the securities offered and whose purchase of the security was directed by a “sophisticated person” 34 and (iv) any entity in which all the entity owners are “accredited investors.” 35

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32 See discussion of off-shore PPLI utilizing frozen cash value concept and possible result that amounts in excess of premiums paid may be a part of the carrier’s general accounts.

33 Section 101(a)(2).

34 A person who has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description. 17 C.F.R. Section 230.501(e).

35 See 17 C.F.R. Section 230.501.
(ii) On-shore PPLI can be offered to “qualified purchasers” under the Investment Company Act of 1940, which results in the carrier not having to register under the Act. (Most companies are already registered and the registration of the policy under the Securities Act of 1933 is the larger expense, making the qualification as accredited investor the more important qualification.)

A “qualified purchaser” includes (i) an individual who owns at least $5 million of qualifying investments, (ii) a trust, partnership, corporation or limited liability company which holds more than $5 million in qualifying investments, and is established by or held for the benefit of two or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, and (iii) trusts, partnership, corporation or limited liability company that was created by a qualified purchaser and the trustee (or person authorized to make investment decisions) is a qualified purchaser which was not formed to acquire the securities offered.36

b. On-shore PPLI and State law.

(1) Each state has its own securities laws, but most apply the same rules as the Federal rules. However, each state, unlike Federal law, also regulates the business of insurance that takes place within its borders.

(2) Accordingly, on-shore PPLI must also satisfy the applicable state’s requirements on the policies, including the state’s approval of the product being offered (with its individually tailored provisions), and the pricing of an on-shore PPLI can be affected by state insurance regulatory rules on premium taxes, solicitation, and negotiated agent commissions can all affect the issuance of an on-shore PPLI.

c. Off-shore PPLI and Federal law.

(1) Off-Shore PPLI relies on an exemption from the Securities Act of 1933 found in Regulation S, which exempts from registration offers and sales that occur outside of the United States. Sales and offers are considered to occur outside of the United States if they are actually made outside of the United States where there is no directed selling efforts occurring in the United States.37 There are still certain requirements of the Securities Act of 1934 (and certain anti-fraud provisions in these Securities Acts) that apply to off-shore PPLI. There are also the securities law requirements of the off-shore jurisdiction that the PPLI must satisfy.

(2) An off-shore PPLI must satisfy the regulatory requirements for insurance of the applicable off-shore jurisdiction. Regulatory requirements for off-shore insurance companies are usually less onerous in many jurisdictions than in the United States so carrier due diligence is important. Furthermore, regulatory requirements for securities and for investment managers is also less onerous in many jurisdictions than in the United States, so without SEC and state security law oversight, the investor must be more diligent in investigating the risks of the investments held in the policy.

36 The US Investment Company Act of 1940, as amended, Section 2(a)(51).
37 See 17 C.F.R. Sections 230.901 and 903.
(3) For Federal tax purposes an off-shore PPLI can be US compliant and treated, for Federal tax purposes as though it was a US carrier by making a Section 953(d) election.

(i) This is true for Federal tax purposes, not for Federal securities law purposes and so long as the carrier is not doing business in any particular US state, the state regulatory laws will also not apply to the carrier.

(ii) Section 953(d) Election.

The Section 953(d) election permits an off-shore carrier to be treated as a domestic corporation for US income tax purposes, even though it is not doing business in the United States.

The Section 953(d) election is important because, without it, amounts received by the carrier’s separate accounts in the policy from sources within the United States would be subject to withholding taxation under Section 871(a) at a 30% rate.

Also, if the off-shore carrier does not make the Section 953(d) election, the policy owner will incur a 1% Federal excise tax charged against any premiums paid into the policy.\(^{38}\)

(4) US Compliant Insurance Companies and FATCA

(i) The Foreign Account Tax Compliance Act ("FATCA") was introduced as part of the HIRE Act of 2010. It requires foreign financial institutions ("FFIs") to sign an agreement to provide information to the IRS regarding U.S. account holders or face a 30% withholding obligation on any withholdable payment.

(ii) The final FATCA Regulations specifically excluded foreign insurance companies who have made an Section 953(d) election from the definition of a "U.S. person" unless such entity was licensed to do business in a US state. Most U.S. compliant off-shore carriers avoid being licensed in a US state because to do so meant that they would be subject to that state’s regulatory and tax regimes.

(iii) As a result, such carriers have reporting and potential withholding requirements under the FATCA rules.

(iv) Notice 2013-69 entitled "Related Updates to Regulations," the IRS and Treasury Department announced that they "intend a modification to the definition of "U.S. person" in the FATCA Regulations to include US compliant off-shore carriers, unless the carrier was a "specified carrier"” which is a company that sells policies with cash values of more

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\(^{38}\) See Section 4371, however, as a US compliant insurance carrier, the carrier cannot deduct its acquisition costs against its premium income immediately but must amortize the costs over a period of time which can be as long as 120 months under Section 848. (Insurance carriers generally have a large amount of up-front costs when a policy is issued ("acquisition costs") and as a result, a policy does not become profitable until after some period of time has passed. The inability to deduct such costs immediately is sometimes referred to as a “DAC tax”.

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than $50,000. This exception to the status as a U.S. person will include any off-shore private placement carrier.

3. Qualification and Taxation of PPLI as Life Insurance

a. Given the nature of PPLI with its focus on investment return, it is important that the PPLI be considered a life insurance contract and not an investment account, something that Congress has stated concerns about when enacting provisions addressing the tax-favored treatment of life insurance. Even if the policy loses its tax-free build up under Section 7702(a) (discussed below), so long as it is considered a life insurance contract, it is still possible to obtain the tax-favored treatment of its death benefit under Section 101 (subject to the transfer for value rules), as discussed below.

(1) The first requirement for the policy to be considered a life insurance contract is that it must be considered life insurance under applicable law, which means the law of the state in the United States where the policy originates or, if off-shore, the law of the country where the policy originates.39

(i) There are both statutory requirements for insurance policies and also common law requirements for policies. The common law requirements call for a certain amount of risk shifting and a distribution of risk among a group. These common law requirements exist in both U.S.40 and off-shore jurisdictions, but the adequacy of risk shifting and risk distribution will vary among jurisdictions.

Risk shifting is the risk of economic loss that arises upon the death of the insured which must be transferred from the insured to the carrier. The magnitude of how much risk is shifted will be an issue and it is found in the amount by which the death benefit exceeds the premiums paid.41

Risk distribution is the sharing of such mortality risk among a group of insured.

(ii) If the risk that exists is so small as to be non-existent or negligible, then the contract will not be considered insurance.42

39 See PLR 200919025 (May 8, 2009); and, see also, Staff of the Joint Committee on Taxation, 98th Congress, 1st Session, General Explanation of the Revenue Provisions of the “Deficit Reduction Act of 1984” at 646 (December 31, 1984).

40 Helvering v. LeGierse, 312 U.S. 531 (1941).

41 See Notice 2009-47, 2009-24 L.R.B. 1083 which established a safe harbor for contracts with a death benefit of equal to at least 105% for certain policies. This Notice was obsoleted by Rev. Proc. 2010-18, 2010-34 I.R.B. 270, that provided for safe harbors, but did not include the 105% requirement. The amount of risk in the policy affects the investment return, the lower the amount of risk the policy has to provide under applicable law, the lower the amount of the premiums that has to be paid to the carrier as cost of insurance and mortality risk expense, and therefore more of the premium may be retained in the cash value accounts of the policy.

42 See, e.g., Rev. Ruling 2005-40, 2005 CB 4, in which the fact that only 10% of risk was shared by unrelated insureds and the remaining 90% was borne by only one insured/policyholder in a parent subsidiary relationship results in the holding that the arrangement was not insurance.
b. Once that requirement is satisfied, the question becomes whether the policy is a “life insurance contract” as defined under Section 7702(a) (which results in the carrier being taxed on the taxable income realized in the policy accounts), or Section 7702(g), in which the policyholder is taxed on the taxable income realized in the policy accounts. The differences between these two Code Sections are considerable and have a great impact on how a PPLI policy is structured.

(1) Section 7702(a)

(i). There are two different definitions of life insurance under Section 7702(a) and the definition under which a particular policy initially falls must be maintained throughout the lifetime of the policy:

(ii) Cash Value Accumulation Test

This test requires that by the terms of the contract, the cash surrender value of the contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.43

This test limits the amount of account value of the policy to an amount necessary to purchase the same amount of death benefit for the insured at the insured’s attained age, assuming the individual dies between the ages of 95 and 100 years.

Due to higher mortality costs as the insured ages, the account value is permitted to grow larger (due to the single net premium required to purchase the policy’s benefits (the death benefit) at the insured’s attained age, health and death benefit option.

(iii) Guideline Premium Test

This test requires that the sum of the premiums paid under the policy may not exceed the “guideline premium limitation”, which is the greater of: the guideline single premium, which is the amount that would be required to fund future benefits under the policy, based on certain assumptions, including an interest rate of the greater of 6% or the guaranteed rate under the policy; or the sum of guideline level premiums, which is the level amount that would have to be paid over a period not ending before the insured reaches age 95, computed on the same basis as the guideline single premium, except that the interest rate is the greater of 4% or the guaranteed rate under the policy. In addition, in order to meet the guideline premium test, the ratio of policy death benefit to cash value must fall within the cash value “corridor”, established in the table set forth in Section 7702(d).

(iv) The key question, of course, is: “How can an adviser know whether a policy satisfies (and continues to satisfy) one of these definitions?” The short answer is: no adviser can, since the answer requires ongoing actuarial calculations. Policy illustrations will state whether the policy will comply with Section 7702(a) at issuance; the carrier should also monitor premium payments to assure continued compliance with Section 7702(a).

43 Section 7702(b) of the Code.
c. Aside from Section 7702, there is also certain diversification requirements and Investor Control Rules

(1) The diversification requirements of Section 817 and the investor control rules were both developed to address the Congressional concern that investors would use an insurance wrapper to achieve a better investment return than available outside of an insurance policy due to the tax-free build up available to life insurance policies. The investor control rules were developed by the IRS before the enactment of Section 817, and the IRS has continued to develop the investor control rules concurrently with Section 817 of the Code.

(2) There are several means of taxing the policy owner and not the carrier for the inside growth of a policy, including, (1) a finding that there exists no life insurance contract under state law, (2) there is a life insurance contract, but it does not satisfy the requirements of Section 7702(a) and is therefore taxed under Section 7702(g), (3) there exists a life insurance contract, it satisfies the requirements of Section 7702(a) but the owner of the contract has so much control over the investments inside the policy that it triggers the doctrine of constructive receipt, (2) there is a life insurance contract, it satisfies the requirements of Section 7702(a) but does not satisfy the requirements of Section 817, in which case the policy is subject to Section 7702(g) and (3) there is a life insurance contract, it satisfies the requirements of Section 7702(a) and Section 817, but fails the investor control rules. In this last example, the policy may not be subject to Section 7702(g) but instead, treated as an investment account owned by the owner of the contract directly.

(3) Section 817 Diversification Rules

(i) An exhaustive discussion of the Section 817 rules and the investor control rules are beyond the scope of this outline. However, of the two sets of rules, the investor control rules are of more concern to off-shore PPLI, given the greater flexibility permitted for investments held by a carrier in an off-shore jurisdiction and the often expressed desires of the owner of the contract to control those investments. Section 817, as described below, is a very mechanical set of rules and the carrier is usually responsible for compliance with those rules.

(ii) Section 817 addresses variable policies and states that if the requirements of Section 817 are not met, the policy is not considered a life insurance contract for purposes of Section 72 and Section 7702(a). As a result, the policy is taxed under Section 7702(g).

(iii) Section 817(h) of the Code provides that if a variable policy does not satisfy the diversification rules of the Section, then the policy will not be considered life insurance for purposes of Section 72 and Section 7702(a).

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45 The author recommends the article “Webber and the Investor Control Doctrine”, Jonathan G. Blattmachr and William E. Keenen, posted on August 2, 2016 in Tax Notes for a more in-depth discussion of these rules.
46 Section 817(h)(1).
(iv) In 1984, Congress enacted the diversification requirement of Section 817(h) with the intention to “discourage the use of tax-preferred variable annuity and variable life insurance primarily as investment vehicles.”

(v) Under Section 817, for a variable insurance policy to retain its tax advantages it must be adequately diversified as detailed in Treas. Reg. Section 1.817-5.

If the investments aren’t adequately diversified, then Section 7702(g) and not Section 7702(a) applies to the policy, the result of which is that any “income on the contract” (as defined in Section 7702(g)) must be included by the policyholder as ordinary income received or accrued by the policyholder during such year.

Investments of a segregated account are considered “adequately diversified” only if one of three tests, described below and known as the “general diversification test”, the “safe harbor test” and “the alternative test for variable life contracts” are met.

The General Diversification Test is satisfied provided that (i) no more than 55% of the value of the total assets of the account is represented by any one investment; (ii) no more than 70% of the value of the total assets of the account is represented by any two investments; (iii) no more than 80% of the value of the total assets of the account is represented by any three investments; and (iv) no more than 90% of the value of the total assets of the account is represented by any four investments.

The Safe Harbor Test is satisfied provided that (i) the account meets the diversification requirements of a regulated investment company under Section 851(b)(3) and the associated regulations, and (ii) no more than 55% of the value of the total assets of the account are cash, cash items (including receivables), government securities and securities of other regulated investment companies.

The Alternative Test for Variable Life Contracts is met if and to the extent that such segregated account is invested in securities issued by the U.S. Treasury, and such investments made by such account are treated as adequately diversified without regard to whether the General Diversification Test or the Safe Harbor Test are met.


48 Section 7702(g) states “If at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a)...”.

49 Treas. Reg. Section 1.817-5. Section 7702(g) is discussed later in the outline.

50 Code Section 817(h)(1); Treas. Reg. 1.817-5(b)(1).

51 Code Section 817(h)(2); Treas. Reg. 1.817-5(b)(2). (Interestingly, the Regulation refers to a non-existent code section, Section 851(b)(4).

52 Code Section 817(h)(3); Treas. Reg. 1.817-5(b)(3).
(vi) Section 817(h)(4) provides a “look-through” rule for Regulated Investment Companies ("RIC"). Under Reg. Sec. 1.817-5, the look-through rule applies if all interests in the RIC are held by carrier separate accounts and public access to the RIC is exclusively through an insurance policy. The consequence of the look-through rule is that the policy may be invested in one account, but so long as the account is invested in a RIC and the RIC itself meets the diversification requirements of Section 817, then the policy is considered adequately diversified.

(4) Prohibition Against Investor Control

(i) Under the investor control rules, if investor control is found, even if the contract satisfies the definition of a life insurance contract and even it is satisfies the requirements of Section 7702(a) and Section 817, the policy owner is considered the owner of the account and not the carrier.

(ii) An argument has been made that even if the investor control rules were violated, if the policy is still considered a life insurance contract under applicable law, it would still receive the tax-favored treatment of its death benefit under Section 101, as provided in Section 7702(g)(2), but as discussed below, that is not clear.

The IRS, supported by the U.S. Court of Appeals for the 8th Circuit, has taken the position that a variable life insurance policy owner who retains substantial control over the investment of assets underlying the policy may be treated as owner of the underlying assets, for Federal income tax purposes, even if they are adequately diversified under Section 817. This was confirmed by the Tax Court in 2015, in a case where the Tax Court treated Section 817 and the investor control rules as two separate requirements for life insurance policies.

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53 Generally, mutual funds are organized as registered investment companies. If they meet the standards they do not have to pay Federal income taxes on distributions of dividends, interest, and realized capital gains. Essentially, this income is passed through to the stockholders, who in this case is the PPLI policy.

54 See, e.g., Christoffersen v. United States, 749 F.2d 513, 515-16 (8th Cir. 1984), cert. denied, 473 U.S. 905 (1985), stating that "[u]nder the long recognized doctrine of constructive receipt, the income generated by the account assets should be taxed to the [annuity holders] 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." See also 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.

55 Webber v. Comm’r, 144 T.C. 324, 2015 U.S.T.C., LEXIS 27, 144 T.C. No. 17. Filed on June 30, 2015. The preamble to the proposed and temporary Treasury Regulations under Section 817(h) noted that “[t]he temporary regulations . . . do not provide guidance concerning the circumstances in which investor control of the investments of a segregated asset account may cause the investor, rather than the carrier to be treated as the owner of the assets in the account. . . . Guidance on this and other issues will be provided in regulations or revenue rulings under Code Section 817(d) relating to the definition of variable contracts.” Many practitioners took this to mean that Section 817 superseded the IRS rulings on investor control and the only requirements a policy must meet were set forth under Section 817.

The final regulations under Section 817, promulgated after the decision in Christoffersen and the four Revenue Rulings discussed herein, do not address the extent to which a contract owner may direct the investment of assets in a segregated account without being treated as the owner of the assets, even if such assets were adequately diversified. The final regulations do, however, incorporate by reference certain aspects of Rev. Rul. 81-225 and Rev.
In the 1970s, the IRS became concerned that taxpayers were avoiding recognition of income by “wrapping” their investments in “investment annuity contracts” which created “the possibility of major tax shelter abuse.”\textsuperscript{56} 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 and a third-party custodian held and invested the contract’s assets in accordance with the annuity owner’s directions.\textsuperscript{57}

(iii) In response to this perceived abuse, the IRS issued four Revenue Rulings between 1977 and 1982 describing circumstances under which the owner of a variable annuity or life insurance contract is treated as the owner of the underlying assets in the policy and therefore taxed on the income of the assets underlying the contract due to the owner’s control of the investment of those assets.\textsuperscript{58}

The instances in which the IRS found investor control in these rulings included situations where the annuity owner controlled the investment of the separate account assets, had the power to vote any securities in the account, and could withdraw any or all of the assets at any time\textsuperscript{59}; where the carrier was expected to hold the assets transferred to the carrier by the policy owner for that owner’s benefit\textsuperscript{60}, and where the assets held by the carrier were available to the general public.\textsuperscript{61}

In the last of the rulings, the IRS found that the assets were acquired solely to provide an investment vehicle that allowed the carrier to meet its obligations under its contracts and the carrier held all incidents of ownership over the assets. Accordingly, the carrier was held to be the owner of the assets for Federal tax purposes.

In the next revenue ruling, Revenue Ruling 82-54,\textsuperscript{62} the IRS concluded that the annuity owners’ ability to choose among general investment strategies (stocks, bonds, or money market instruments) did not constitute sufficient control to cause the annuity owners to be treated as the owners of the underlying mutual fund shares.


\textsuperscript{57} 442 F. Supp. at 685.


\textsuperscript{59} 1977-1 C.B. 12

\textsuperscript{60} 1980-2 C.B. 27.

\textsuperscript{61} 1981-2 C.B. 12.

\textsuperscript{62} 1982 C.B. 11.

In issuing private letters rulings on the issue of investor control, the IRS has set forth various representations required to support a holding that the carrier, and not the contract owner, owned the assets of the segregated asset account supporting a variable life insurance contract, which, although not binding on the Service (other than for the specific taxpayer to whom the Ruling was addressed) provides some guidance on what the IRS considers important in this area.\footnote{See, e.g., PLR 8427091 (April 5, 1984); PLR 8335124 (May 27, 1983).}

The representations the IRS looked for before providing a favorable ruling included a statement that the contract owner did not have a legally binding right to require the carrier or separate account to purchase any particular investment, there was no prearranged plan between the contract owner and the carrier to invest premiums or other amounts in a particular investment, the contract owner did not have any interest in any specific investment held by the carrier or the separate account, and the contract owner only had a contractual right to a cash payment under the terms of the policy. However, notwithstanding these prohibitions, the contract owner could be informed of the general investment strategy that would be followed by the carrier and could be permitted to choose among broad investment strategies.

More Recent Rulings

In Private Letter Ruling 9433030,\footnote{May 25, 1994. Presumably because the insurers which were issuing the policies had requested these rulings, they don't contain the kinds of investor control representations made in the rulings requested by contract owners, discussed in the text.} a carrier developed a variable universal life insurance contract for sale to financially sophisticated employers in non-registered private placement offerings. The contract owner was permitted to allocate premiums among special divisions of a separate account established exclusively for investment of the contract owner's premiums. The contract owner was permitted to choose the broad investment objectives. Other than the right to allocate premiums among the divisions, all investment decisions were made by the insurer.

The IRS focused on the following facts that distinguished this situation and led to a favorable ruling:

The contract owner did not possess direct control over the investment assets in the contract owner's separate account. Rather, the contract owner was limited to choosing between general investment strategies through the selection of one or more of the sub-accounts of the separate account.

Subject to general investment guidelines, the insurer alone had complete control to acquire and to dispose of the investment assets held in the contract owner's separate account and the contract owner had no authority over those assets.

The investments in the separate accounts were available to the contract owner only through purchase of the insurance contract.
The contract owner’s ability to allocate or reallocate the funds underlying the contract was limited to choosing among general investment strategies—the contract owner had no right to select particular investments.

In Private Letter Ruling 200025037, the IRS found that the carrier, and not the policy owner was the owner of the accounts for income tax purposes. In this arrangement, the carrier issued variable annuity contracts in which the net premiums on the variable contracts were held in a separate account maintained by the carrier. The assets of the separate account were allocated among sub-accounts of the separate account. The sub-accounts corresponded to investment options selected by the owner of the annuity contract. Each sub-account invested in shares of a portfolio of certain open-end diversified management investment funds that corresponded to the investment objective of the sub-account. The amount of net premiums allocated to each investment option could be selected by the contract owner and could be changed from time to time. All of the beneficial interests in the portfolios were held by one or more segregated asset accounts of one or more insurance companies, and public access to each portfolio was available only through the purchase of a variable contract.

The IRS reaffirmed the significance of the public availability of the assets underlying the sub-accounts of a separate account in determining whether the contract owner would be treated as the owner of the underlying assets in Private Letter Ruling 200244001, in which they found that the policy owner and not the carrier was the owner of the account for income tax purposes. In that adverse ruling, each separate account was divided into sub-accounts that invested in certain private investment partnerships (“PIPs”). The interests in the PIPs that supported the sub-accounts were available for purchase not only by a prospective purchaser of the life insurance contract, but also by a limited number of other qualified investors. The IRS ruled that the contract owners should be treated as owners of the interests in the PIPs, reasoning that this holding was consistent with Congress’ intent to deny life insurance treatment to investments that are publicly available to investors.

In Rev. Rul. 2003-91, the IRS found that the carrier was the owner of the accounts held various variable life insurance and annuity contracts the account for income tax purposes. The assets that funded the contracts were separated from the carrier’s other assets and maintained in separate accounts that were divided into several sub-accounts which offered various investment strategies. Interests in the sub-accounts were available solely through the purchase of the contracts and not available for sale to the public. The carrier engaged an independent investment adviser to manage the investments of each sub-account. The contract owner could allocate premiums and transfer funds among the sub-accounts, but could not select or recommend particular investments or investment strategies, nor communicate directly or indirectly.

66 November 1, 2002.
67 Because most hedge funds were organized as private investment partnerships at the time, some commentators believed that variable contracts wrapped around hedge funds were the target of the ruling, and that the ruling was inconsistent with the provisions of Treas. Reg. Sections 1.817-5(f)(ii) and 1.817-5(g), Example 3, as then in effect. See, e.g., Steve Leimberg’s Estate Planning Newsletter No. 564 (Leimberg Information Services, Inc. 2003).
with any investment officer of the carrier regarding the selection or quality of any specific investment or group of investments held in a sub-account.

However, in Rev. Rul. 2003-92, the contract owner was considered the owner of the accounts inside of the policy for income tax purposes. These contracts were for sale outside of insurance policies, but only to individuals who were qualified purchasers and accredited investors under the Federal securities laws. The assets supporting the contracts were held in separate accounts that were segregated from the carrier's other accounts and each separate account was divided into sub-accounts. Individuals who owned policies could allocate premiums and transfer funds among the sub-accounts. Each sub-account invested in partnership interests which were sold in private placement offerings only to qualified purchasers that were accredited investors and to no more than one hundred individuals. Each partnership had an investment manager that selected the partnership's investments. The ruling held that the individual was the owner of the interests in the partnerships for Federal tax purposes, because interests in the partnerships were available for purchase other than by purchasers of contracts from insurance companies (even though the individual purchasers had to be accredited investors). In a separate variation of the facts, the interests in the partnerships were available only through the purchase of an annuity or life insurance contract from an carrier and under these facts, the ruling concluded that the contract holder did not own the interests in the partnerships.

In Rev. Rul. 2007-7, an individual purchased a variable annuity or life insurance contract from a carrier. The assets funding the contract were held in a segregated asset account that invested in a Regulated Investment Company (RIC). The beneficial interests in the RIC were held by one or more segregated assets accounts of the carrier or by investors described in Treas. Reg. Section 1.817-5(f)(3), which include the general account of a life carrier or related corporation or a manager of an investment company partnership or trust or a related corporation, in both cases only if they received the same rate of return as the separate accounts held under the variable policies. The IRS held that these investors were not members of the general public for purposes of the investor control rules and that, therefore, the individual contract owner was not treated as the owner of an interest in the RIC.

In Chief Counsel Advice Memorandum 2008400043, the IRS Chief Counsel recommended that a favorable private letter ruling should be denied and the ruling request was retracted. Some of the facts that the IRS found troubling were that the contract owner would have the right to nominate — and the carrier would generally accept — an independent unrelated investment adviser for its segregated asset account, and would also have the right to submit a questionnaire to the investment adviser about its investment horizons, investment goals, risk tolerance, risk profile, comfort with investments in different regions of the world and different types of investments such as real estate, ADRs and partnerships. The countervailing facts that the

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70 See also PLR 2007010016 (Oct. 5, 2006), dealing with variable annuities sold only to charities to the same effect.

71 2007-1 C.B. 468.

72 This effectively precludes the practice of carried interest by hedge fund managers.

73 June 10, 2008.
investment decisions would be made in the investment adviser's sole and unfettered discretion and that there would be no agreements, understandings or communications between the contract owner and the insurer or the investment adviser regarding the investments, other than the questionnaire responses, were insufficient to persuade the IRS that investor control would not be a problem.\textsuperscript{74}

The most recent guidance is a series of private letter rulings holding that an carrier separate account may invest in a "fund of funds", which itself invests in publicly available investment funds, in certain circumstances. In all of these rulings, the fund of funds was available exclusively either through the purchase of a variable contract or to investors described in Treas. Reg. Section 1.817-5(f)(3) and the fund of funds had discretion to choose the investment funds and determine the asset allocation among them.\textsuperscript{75} The IRS likened this to selection by non-public mutual fund managers of publicly available individual stocks and bonds in Rev. Rul. 82-54, and distinguished the prior authorities prohibiting investment in publicly available investment funds – because in these rulings, the contract owners had no control or influence over the selection or mix of the publicly available investments, unlike the contract owners in the prior rulings, who could choose precisely the same investments as were available under the insurance contract by direct purchase outside the insurance contract.

In PLR 201105012,\textsuperscript{76} the IRS found no investor control existed in an arrangement involving what was referred to as "Lifecycle Insurance Funds", which was a series of funds that followed an investment strategy that gradually became more conservative as a targeted date (such as retirement date) grew nearer. These were insurance dedicated mutual funds (and not available unless purchased through an insurance contract). These insurance dedicated funds invested some or all of their assets in investments that were, however, available to members of the general public in what is referred to as a "fund of funds" arrangement. Using a facts and circumstances determination, the IRS found that the Lifecycle Insurance Funds themselves were not available to the public, all investment decisions were made by an investment manager and a policyholder could not direct the Fund to invest in any particular asset; nor was there any prearranged agreement or plan regarding investments. Furthermore, the IRS found that the investment strategies of the Lifecycle Funds were "sufficiently broad" that a policy holder could not make investment decisions by investing their policy in the Lifecycle Funds.

In PLR 201417007, the investment in an insurance dedicated fund, which in turn invested in publically available investments was still considered owned by the carrier.\textsuperscript{77}

The Tax Court Weighs in: The Webber case.

\textsuperscript{74} There was also a problem with ripeness, since the ruling request involved only a proposal.

\textsuperscript{75} PLR 201014001 (Apr. 9, 2010); PLR 200952009 (Dec. 24, 2009); PLR 200949036 (Dec. 4, 2009); PLR 200938018 (Sep. 18, 2009); PLR 200938006 (Sep. 18, 2009); PLR 200915006 (Apr. 10, 2009).

\textsuperscript{76} October 14, 2010.

\textsuperscript{77} April 25, 2014.
In this case, the Tax Court looked a situation where the facts were not going to lead to a favorable result. However, it is a situation that many clients hope to emulate and this is oftentimes the reason they inquire about off-shore PPLI, hoping they can do off-shore what they cannot do with US carriers, namely control the investments inside of the policy to the extent described in Webber but not be considered the owner of the assets for tax purposes.

In a nutshell, the facts of Webber were as follows. The taxpayer in Webber, through a foreign grantor trust, held PPLI policies issued by a Cayman Islands life insurance company. The policy premiums, after expenses, were placed in separate accounts for each policy. The carrier created special purpose companies to hold the investments in the separate accounts and these companies were not available to the general public. The terms of the policy provided a minimum death benefit so long as it stayed in force and at the insured’s death, the beneficiary of the policy was to receive the greater of the minimum death benefit or the value of the separate account inside of the policy. Such amount could be paid in cash or in-kind or in such other arrangement as agreed upon. Each policy permitted the policy owner to assign the policy, to use it as collateral for a loan, to borrow against it and to surrender it. The amount the owner could use for these purposes, however, was restricted to its cash surrender value and the cash surrender value was defined as total premiums paid (see discussion on below on Section 7702(g) and “frozen cash value”). The policy owner was permitted to select an investment manager for the separate accounts who would have the exclusive authority to select the investments, however, the policy owner was permitted to transmit general investment “objectives and guidelines” as well as offer non-binding specific investment recommendations to the investment manager. The investment manager was to perform due diligence on all investments involving non-publicly traded securities, but there was no record of such diligence being performed.

The taxpayer, a US citizen, was the founder and manager of several private-equity partnerships that provided seed money to startup companies. He also provided consulting services to these startups through his consulting company. In these private-equity partnerships, there was a general partner partnership managed by the taxpayer. The limited partner interests in the partnership were offered to “sophisticated investors”. As the person managing the general partner entity, the taxpayer made investment decisions for the partnership.

The investments of the special purpose companies were almost exclusively in investments the taxpayer “recommended” and was invested in a start-up company in which the taxpayer had a financial interest (by acting on its Board, investing in its securities or through his private equity partnerships).

The Tax Court in Webber found that the IRS rulings on investor control were rooted in case law and deserved deference because it “reflects a body of experience and informed judgment that the IRS has developed over four decades.” As a result of the Tax Court holding, a policy must satisfy not only Section 817 under its reasoning, but also this body of investor control rulings.

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The Tax Court then went on to look at the facts and found that the taxpayer (i) had the actual power to direct investments, notwithstanding all of the provisions in the agreements giving that power to other entities, including the power to vote shares and exercise other options; (ii) had the actual power to benefit from the accounts because there were numerous ways the taxpayer could extract cash and, in addition, the investments that were made benefited his personal investments and possibly benefited him directly.

None of the Tax Court holdings could be a surprise, given the facts presented and if deference is given to the IRS body of law on the investor control rules.

Conclusions Drawn With Respect to Investor Control Requirements found in these Rulings and in Webber:

Except as otherwise permitted by Treas. Reg. Section 1.817-5(f)(3), all of the beneficial interests in the fund of funds and any sub-funds related to the fund of funds had to be held directly or indirectly by one or more segregated asset accounts of one or more insurance companies and public access to the fund can only be available through purchase of a variable contract.

There should not be any arrangement, plan, contract or agreement between the investment adviser (or a sub-adviser) and a variable contract owner regarding the availability of the fund of funds under the contract or the specific assets to be held by the fund of funds or any fund it invested in.

Other than a contract owner’s ability to allocate premiums and transfer amounts to and from the fund of funds, all investment decisions concerning the fund of funds should be made by the investment adviser (or sub-adviser) of the fund of funds in its sole and absolute discretion. In particular, the %age of a fund of fund’s assets invested in a particular publicly available fund should not be fixed in advance of any contract owner’s investment and had to be subject to change by the adviser (or sub-adviser) at any time.

A contract owner should not be able to direct a fund of fund’s investment in any particular asset or recommend a particular investment or investment strategy and there could not be any agreement or plan between the investment adviser (or sub-adviser) and a contract owner regarding a particular investment of the fund of funds.

A contract owner should only have a contractual claim against the carrier to receive cash from the carrier under the contract terms, amplified in some of the rulings by the statement that a contract owner could not have any legal, equitable, direct or indirect ownership interest in any assets of the fund of funds.

A contract owner should not be able to communicate directly or indirectly with the investment adviser (or any sub-adviser) concerning selection, quality or rate of return on any specific investment or group of investments held by the fund of funds, except for what is required to be presented in periodic reports to the fund of fund’s shareholders.
A contract owner should not have any current knowledge of the fund’s specific assets, except for what was required to be presented in periodic reports to the fund of funds shareholders.

4. Managing PPLI under these Rules
   
a. Insurance Dedicated Funds ("IDFs") and Separate Accounts

(1) IDFs are investment funds that are not available to the general public, but only through the carrier. Each IDF has an investment manager who manages the IDF in accordance with the investment strategies established by the investment manager and the carrier. The policy owner will select which IDFs the policy accounts will be invested in based on the expressed investment strategies of each IDF. The investment manager looks through the IDF at its investments and certifies that the investments held in the IDF are sufficiently diversified to meet the requirements of Section 817.

(2) Separate accounts are also invested based on certain investment strategies managed by the carrier’s investment managers and they are not looked through for purposes of Section 817. The accounts themselves, when taken together inside the policy must meet the diversification rules of Section 817. The policy owner would select the separate accounts managed by the investment managers and the policy investment would be allocated between the separate accounts. As with IDFs, these separate accounts are not available to the general public.79

(3) IDFs are oftentimes referred to as "fund of funds", which are independently managed types of funds, or "clone of funds" which are funds with investment objectives and strategies that mimic those of a fund managed by the same investment manager and available to the general public.

(4) US insurance companies may only to want add additional investment managers for an IDF (or the carrier’s investment manager may only want to add additional managers to manage a separate account) if the proposed investment manager already has several million dollars of assets under management. Many off-shore insurance companies may be more willing to utilize an investment manager with much lower amounts under management.

(5) A policyholder will only have a contractual claim against the carrier to receive cash under the contract terms.

(6) Finally, all of the representations listed above that preclude, among other representations, any communication or prearrangement between the policy owner and the investment manager must be adhered too.

5. Section 7702(g)

a. If a PPLI policy fails both tests of Section 7702(a) and/or the requirements of Section 817, then if the policy is still considered a life insurance contract, it is subject to the

79 Although see PLR 201105012 (February 4, 2011) in which the assets were available to the general public but the policy owner was still not considered the owner of the account under the investor control rules.
provisions of Section 7702(g). Under Section 7702(g), the "income on the contract" will be treated as ordinary income received or accrued by the policy owner during such year.

(1) The "income on the contract" is defined in the Section as the sum of the increase in net surrender value over the taxable year plus the cost of insurance protection provided under the contract for the taxable year over the premiums paid during the taxable year.

(2) The "cost of insurance protection" is defined in the Section as the lesser of (i) cost of individual insurance on the life of the insured as determined on the basis of uniform premiums (computed on the basis of 5 year age brackets) prescribed by the Secretary by regulations, or (ii) the mortality charge (if any) stated in the contract.

b. Planning for Policyholder Income Taxation under Section 7702(g):

(1) Frozen Cash Value:

(i) If the cash value never increases above the premiums paid, in a strict reading of the definition of the "income on the contract" there will be no income. This is the concept of "frozen cash value" and as a result of the non-forfeiture laws that exist in every state in the US, this concept is only utilized in off-shore PPLI.80

(ii) This planning restricts the policy owner from accessing the cash value in excess of the amount of premiums paid (through partial surrenders or loans of up to 90% of the premiums paid amount) during the insured’s lifetime, which results in a PPLI policy that is acquired for its death benefit and not for lifetime access to the growth in cash value.

(iii) Issues presented by frozen cash value concept:

If the policy is terminated, the policyholder loses all rights to the excess of cash value over premiums paid; this is also true for an exchange of a policy.

The financial strength of the carrier becomes very important, since if the carrier goes out of existence, the excess of cash value over premiums paid will be subject to claims of creditors, unless there are laws protecting such cash value excess. If there are laws that protect such excess for the benefit of the policyholder (such as separate accounts are not subject to the carrier’s creditor’s claims), that further supports the position that the separate accounts are owned by the policyholder and the excess cash value, as it arises, is taxable to the policyholder under Section 7702(g).

The IRS has been proactive in the area of valuation of policies by prohibiting the use of surrender charges in valuing policies for income and employee benefit purposes, 81 stating at times that such charges are used to artificially depress such values.

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80 See NAIC’s standard non-forfeiture law for life insurance form found at NAIC.org.
81 See Rev. Proc. 2005-25 (April 25, 2005) stating that “a surrender charge cannot be taken into account in determining an average surrender factor if it may be waived or otherwise avoided or was created for purposes of the transfer or distribution.”
The use of frozen cash value restrictions to avoid the tax consequences of Section 7702(g) may result in the same rejection of such restrictions by the IRS.

(2) The death benefit paid under this type of policy is an amount the carrier is contractually obligated to pay to the policyholder consisting of a small amount of death benefit based on the foreign jurisdiction’s requirements on the amount of risk required (which can sometimes be as low as 5% of the cash value, depending on the jurisdiction) plus a separate amount equal to the value of the assets held in the account that is allocated to the policyholder determined as of the date of the claim.

(3) Section 7702(g) provides that although the policy fails the tests of Section 7702(a), the excess of the death benefit over the net surrender value of an insurance contract subject to Section 7702(g) shall be treated as life insurance under Section 101. The beneficiary would receive an amount equal to the premiums paid as a tax free return of the policyholder’s investment in the contract under Section 72(e) and the remainder of the net surrender value of the contract would be ordinary income to the beneficiary.

6. How Does PPLI Actually Work?

a. An agent or carrier (some off-shore carriers do not utilize agents) must be identified who is experienced in the area in order to structure the policy and negotiate the costs of the same and determine the advisability from a policy perspective if the policy should be off-shore or on-shore.

b. If off-shore:

(1) The client must undergo medical and financial underwriting in a location where the major off-shore carriers do business or in an agreed country outside the U.S.

(2) The client’s advisors must determine if a US trust or a foreign trust as the policyholder is appropriate, or another entity should be utilized.

(3) The money for the premium must be moved off-shore.

(4) There are the additional complications of FATCA and possibly the FBAR (Report of Foreign Bank and Financial Accounts) reporting requirements.

c. The IDF or separate account must be put into place, if a new investment manager will be utilized by the carrier. Otherwise, investment allocation between separate accounts or to one or more IDFs must be made.

d. A large initial premium will then be invested, which, if a MEC, prevents the policyholder from reaching the growth in the cash value on a tax-free basis.

7. Major Differences Between Off-Shore and On-Shore PPLI

a. Flexibility of Investments Regulations.
Off-shore PPLI has access to off-shore investments that do not require or have not obtained SEC regulatory approval. The off-shore carriers themselves benefit from looser regulatory regimes and may offer investments in foreign-registered securities that are not available to U.S. investors. Additionally, off-shore insurers do not have the compliance burden of domestic consumer laws, typically state laws, that were designed to protect the less-sophisticated consumer.\textsuperscript{82}

b. Costs

(1) All carriers impose fees based on their (i) cost of insurance charges, (ii) mortality risk charge, (iii) expenses to offset risk of early termination of the policy, (iv) investment expenses, and (v) agent commissions, and these fees can vary widely, regardless of whether the carrier is off-shore or on-shore.

(2) On-shore carriers are subject to a state imposed premium tax, which typically vary from below 1% up to 3%\textsuperscript{83}

(3) Off-shore carriers, since they are not doing business in any US state, would not normally be subject to such tax but only subject to any tax imposed by their jurisdiction, if any.

(4) Deferred Acquisition Costs are costs incurred in issuing a policy, and such costs, under US tax law cannot be deducted as incurred, but instead amortized and deducted over a period of years. Accordingly, carriers will incur income with no offsetting deduction in current years. This is generally seen as a 1% to 1.5% cost of each premium payment.

(i) Off-shore carriers will not be subject to this US tax rule, unless they make an election to be U.S. compliant under Section 953(d).

(ii) Non-US compliant off-shore carriers, however, will be subject to 1% excise tax on premiums paid by US policy owners.

c. Weighing the Issues for US clients Considering Off-shore PPLI

(1) Off-shore policies are not as constrained by the U.S. securities regulatory environment, therefore the policies are more easily tailored to the individual desires of the policy holders and provided enhanced investment return due to the lack of state premium taxes and the administrative costs of a heavily regulated industry in the United States.

(2) However, the US client will be holding assets off-shore.

\textsuperscript{82} See National Association of Insurance Commissioners (NAIC), Model Laws, Regulations and Guidelines.

\textsuperscript{83} Alaska and South Dakota have implemented reduced state premium taxes to less than 1%. To take advantage of the tax advantages, one must have a contractual nexus to these states, the most common being either a trust, partnership or corporation domiciled in such states.
(i) The client will have to travel to the off-shore marketplace to undergo a physical examination and complete all required paperwork because off-shore PPLI must take place off-shore to avoid the imposition of US and state laws and regulations.

(ii) The policy will receive the benefit of the US tax laws only if the off-shore carrier makes the Section 953(d) election.

(iii) The policy (and policy owner) will not receive the benefits and protections of the US Federal and state securities laws, only the benefits and protections of the foreign jurisdiction.

(iv) The separate accounts in the policy will be held by a custodian, usually a foreign bank, and it is the bank's financial strength the client is concerned about more than the off-shore carrier's financial strength.

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i 1975-1 CB 55.
ii Section 2035.
iii Treas. Reg. Section 20.2042-1(c)(6).