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UNDERSTANDING PRIVATE PLACEMENT LIFE INSURANCE[1]

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I. INTRODUCTION

"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 article 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 article will not address private placement annuity products.

II. PRIVATE PLACEMENT LIFE INSURANCE

A. What is Private Placement Life Insurance ("PPLI")?

1. PPLI is an individually tailored variable universal life ("VUL") insurance policy[2].

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.

3. Overview of Benefits of PPLI

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[1] October 12, 2016.

[2] 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.

a. Customized investment options.

(1) 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.[3].

(2) 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.

(3) 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.[4] However, with the lack of such regulatory requirements also comes less regulatory protection.

b. Beneficial Tax Treatment Available to All Policies

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

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)[5] (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.[6]

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

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[3] 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.

[4] 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.

[5] 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 noncan 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.

[6] See Section 832(b)(1).

(a) Section 72(e) 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.

(i) 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.

(ii) Additional amounts withdrawn that exceed the owner's investment in the contact are taxed as ordinary income.

(b) 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.

(c) MEC rules

(i) 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.

(ii) 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.

(iii) The consequences of the policy being a MEC is found in Section 72(e) which are as follows:

(aa) 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.

(bb) Loans from the policy will be considered distributions.

(cc) 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).

(dd) 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.

(ee) 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.[7] 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.[8]

(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 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.

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[7] 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.

[8] 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.

(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.[9]

(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).[10]

B. Regulatory Requirements of PPLI

1. On-shore PPLI and Federal Law:

a. 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.

(1) 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"[11] and (iv) any entity in which all the entity owners are "accredited investors."[12]

b. 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.)

(1) 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

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[9] 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.

[10] Section 101(a)(2).

[11] 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).

[12] See 17 C.F.R. Section 230.501.

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.[13]

2. On-shore PPLI and State law.

a. 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. 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.

3. Off-shore PPLI and Federal law.

a. 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.[14] 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.

b. 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.

c. 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.

(1) 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.

(2) Section 953(d) Election.

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[13] The US Investment Company Act of 1940, as amended, Section 2(a)(51).

[14] See 17 C.F.R. Sections 230.901 and 903.

(a) 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.

(b) 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.

(c) 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.[15]

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

III. QUALIFICATION AND TAXATION OF PPLI AS LIFE INSURANCE

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

[15] 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".

treatment of its death benefit under Section 101 (subject to the transfer for value rules), as discussed below.

A. 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.[16]

1. 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.[17] and off-shore jurisdictions, but the adequacy of risk shifting and risk distribution will vary among jurisdictions.

a. 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.[18]

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

c. If the risk that exists is so small as to be non-existent or negligible, then the contract will not be considered insurance.[19]

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)

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[16] 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).

[17] Helvering v. LeGierse, 312 U.S. 531 (1941).

[18] See Notice 2009-47, 2009-24 I.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.

[19] 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.

a. 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:

(1) Cash Value Accumulation 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.[20]

(a) 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.

(b) 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.

(2) Guideline Premium 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).

b. 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).

2. Taxation and the Diversification Requirements and the Investor Control Rules

a. 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.

[20] Section 7702(b) of the Code.

b. There are several means of 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[21], (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.

c. An exhaustive discussion of the Section 817 rules and the investor control rules are beyond the scope of this outline[22]. 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.

(1) 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).[23] As a result, the policy is taxed under Section 7702(g).

(2) 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.

(3) 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.

b. Diversification Requirement of Section 817:

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[21] See, e.g., Christoffersen v. United States, 749 F.2d 513, 515-16 (8th Cir. 1984), cert. denied, 473 U.S. 905 (1985).

[22] 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.

[23] Section 817(h)(1).

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).

(1) 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."[24]

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

(b) If the investments aren't adequately diversified, then Section 7702(g)[25]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.[26]

(2) 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.

(a) The General Diversification Test[27] 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.

(b) The Safe Harbor Test[28] 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.

(c) The Alternative Test for Variable Life Contracts[29] is met if and to the extent that such segregated account is invested in securities issued by the U.S.

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[24] H.R. Conf. Rep. NO. 98-861, at 1055 (1984).

[25] 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)…".

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

[27] Code Section 817(h)(1); Treas. Reg. 1.817-5(b)(1).

[28] 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).

[29] Code Section 817(h)(3); Treas. Reg. 1.817-5(b)(3).

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.

(3) Section 817(h)(4) provides a "look-through" rule for Regulated Investment Companies ("RIC")[30]. 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.

c. Prohibition Against Investor Control

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.[31] 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.[32]

(1) In the 1970s, the IRS became concerned that taxpayers were avoiding recognition of income by "wrapping" their investments in "investment annuity

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[30] 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.

[31] 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.

[32] 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 superceded 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. Rul. 77-85. Treas. Reg. Section 1.817-5(f)(3)(iv) and -5(i)(2).

Nonetheless, as discussed below, the IRS has taken the enforcement position that the enactment of Code Sections 817 and 7702 did not supersede the investor control revenue rulings or the Eighth Circuit's decision in Christoffersen and has continued to rely on those authorities in issuing private letter rulings and Webber confirmed this position.

contracts" which created "the possibility of major tax shelter abuse."[33] 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.[34]

(2) 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.[35]

(a) 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[36]; where the carrier was expected to hold the assets transferred to the carrier by the policy owner for that owner's benefit[37], and where the assets held by the carrier were available to the general public.[38].

(b) 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.

(c) In the next revenue ruling, Revenue Ruling 82-54,[39] 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.

(3) Required Representations in the Early Private Letter Ruling Requests.

(a) 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

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

[34] 442 F. Supp. at 685.

[35] Rev. Rul. 77-85, 1977-1 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11.

[36] 1977-1 C.B. 12

[37] 1980-2 C.B. 27.

[38] 1981-2 C.B. 12.

[39] 1982 C.B. 11.

what the IRS considers important in this area.[40] 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.

(4) More Recent Rulings

(a) In Private Letter Ruling 9433030,[41] 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.

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

(aa) 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.

(bb) 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.

(cc) The investments in the separate accounts were available to the contract owner only through purchase of the insurance contract.

(dd) 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.

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[40] See, e.g., PLR 8427091 (April 5, 1984); PLR 8335124 (May 27, 1983).

[41] 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.

(b) In Private Letter Ruling 200025037,[42] 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.

(c) 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.[43] 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.[44]

(d) In Rev. Rul. 2003-91,[45] 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 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.

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[42] June 23, 2000.

[43] November 1, 2002.

[44] 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).

[45] 2003-2 C.B.347.

(e) However, in Rev. Rul. 2003-92,[46] 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.[47]

(f) In Rev. Rul. 2007-7,[48] 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.[49] 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.

(g) In Chief Counsel Advice Memorandum 2008400043,[50] 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 investment decisions would be made in the investment adviser's sole and unfettered discretion and that there would be no agreements,

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[46] 2003-2 C.B. 350; Rev. Rul. 2003-92 replicated the facts of PLR 200244001.

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

[48] 2007-1 C.B. 468.

[49] This effectively precludes the practice of carried interest by hedge fund managers.

[50] June 10, 2008.

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.[51]

(h) 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.[52] 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.

(i) In PLR 201105012,[53] 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.

(ii) 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.[54]

(5) The Tax Court Weighs in: The Webber case.

In this case[55], 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

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[51] There was also a problem with ripeness, since the ruling request involved only a proposal.

[52] 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).

[53] October 14, 2010.

[54] April 25, 2014.

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 Caymen 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 polcy, 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 caselaw 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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[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 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.

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

(a) 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.

(b) 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.

(c) 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.

(d) 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.

(e) 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.

(f) 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.

(g) 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.

(7) Managing PPLI under these Rules

(a) Insurance Dedicated Funds ("IDFs") and Separate Accounts

(i) 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.

(ii) 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.[56]

(iii) 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.

(iv) 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.

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

(vi) 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.

B. Section 7702(g)

[56] 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.

1. 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 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.

a. 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.

b. 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.

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

(1) Frozen Cash Value:

(a) 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.[57]

(b) 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.

(c) Issues presented by frozen cash value concept:

(i) 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.

(ii) 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).

(iii) The IRS has been proactive in the area of valuation of policies by prohibiting the use of surrender charges in valuing policies for income

[57] See NAIC's standard non-forfeiture law for life insurance form found at NAIC.org.

and employee benefit purposes, [58] stating at times that such charges are used to artificially depress such values. 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.

2. 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.

IV. HOW DOES PPLI 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.

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[58] 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."

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

1. 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.[59]

2. Costs

a. 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.

b. On-shore carriers are subject to a state imposed premium tax, which typically vary from below 1 % up to 3 %[60]

c. 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.

d. 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.

(1) 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).

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

F. 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, therefor the policies are more easily tailored to the individual desires of the policy

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[59] See National Association of Insurance Commissioners (NAIC), *Model Laws, Regulations and Guidelines.*

[60] 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.

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.

a. 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.

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

c. 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.

d. 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.