FEATURE:
INSURANCE

By **Gerald R. Nowotny**

# Frozen Cash Value Life Insurance

A sophisticated tax planning solution for ultra-high-net-worth taxpayers

Frozen cash value (FCV) is best known as a private placement flexible premium variable adjustable (universal) life insurance policy that's issued by offshore life insurance companies domiciled in tax-haven jurisdictions such as Bermuda or the Cayman Islands. In 1995, when Craig Hampton developed FCV insurance, the private placement life insurance (PPLI) industry for high-net-worth individuals was in its infancy. Awareness among client advisors was missing.[1] The passage of time and growth of the PPLI industry for FCV life insurance has increased awareness of the product. However, it's virtually unknown by tax attorneys and CPAs, as well as life insurance agents with wealthy clients. The evolving tax landscape suggests that FCV is a planning tool that should be considered as part of integrated income and estate tax planning.

## Future Landscape

The future tax landscape is clouded with problems for high-income and net-worth taxpayers. The expiration of the Bush tax cuts at the end of 2012, before any actual tax reform, will result in an immediate tax increase for high-net-worth investors. The top marginal tax bracket will increase to 39.6 percent. The addition of the new Medicare tax on unearned income for married taxpayers with adjusted gross income in excess of $250,000 will increase this to 43.4 percent. The phase out of itemized deductions will increase the effective tax rate by 1 percent to 2 percent.

The long-term capital gains rate will increase to 20 percent. The Medicare tax will then increase this to 23.8 percent. Additionally, most states tax long-term capital gains rates as ordinary income. As a result, most investors will be looking at a combined rate of long-term capital gains of 27 percent to 30 percent, as most states tax capital gains at regular rates.[2] Dividends will no longer receive preferential taxation and will return to being taxed at ordinary rates.

The estate tax is also coming back with a vengeance. Unless Congress intervenes, the estate and gift tax rates will increase to 55 percent, and the exemption will decrease to $1 million per taxpayer from the current level of $5.12 million. The President's recent budget proposal also seeks to limit the benefit of deductions for high-income taxpayers.

## Evolution

My experience with FCV policies goes back to 1999, when Scottish Life and Annuity offered an FCV policy. The life insurer secured a favorable opinion from a large law firm. In fact, I've reviewed at least four favorable opinions on FCV from large law firms over the course of the last 10 years.

Since that time, a number of offshore life insurance companies have offered FCV coverage. Most offer the coverage through carriers that haven't made an election under Internal Revenue Code Section 953(d) to be treated as a U.S. taxpayer. However, I'm aware of an offshore carrier that issues the policy through its IRC Section 953(d) electing carrier. Recently, two new specialty life insurers have emerged in Puerto Rico that offer both traditional PPLI as well as FCV policies.[3]

## How It Works

The policy is intentionally designed to violate IRC Section 7702, the tax law definition of life insurance. The other legal considerations for the policy are imposed under the insurance laws of the jurisdiction

**Gerald R. Nowotny** is an attorney in Avon, Conn.

where the coverage is issued. Generally speaking, all of the carriers issue the coverage as variable life insurance. A separate account isolates policy assets from the insurer's general account assets.

The separate account assets are segregated from the claims of the insurer's creditors on general account assets. The policyholder has no legal, equitable, direct or indirect ownership of any assets held by the separate account. The policyholder also has no voting rights with respect to any securities held in the insurer's separate account. The life insurer carries the investment account assets on the balance statement that it submits to insurance regulators as part of its annual filing.

Generally, FCV policies require an initial payment in U.S. dollars. Additional payments into the policy are at the policyholder's discretion. The insurer has the sole discretion to accept premium payments in kind (non-cash), including stocks, bonds, certificates of deposit and other commercial paper. Typically, the offshore life insurer has the ability in its sole discretion to distribute benefits payments in kind as well.

Following the issuance of Revenue Ruling 2003-91 and Rev. Rul. 2003-92, many carriers were concerned over the tax treatment of in-kind premiums and benefit payments with respect to the investor control doctrine. This is a common law doctrine that views the degree of policyholder control over policy investments. A violation of this doctrine results in the policyholder forfeiting the tax benefits of life insurance under Section 7702 and annuities under IRC Section 72.[4]

Under most FCV contracts, the death benefit is equal to the sum of guaranteed, specified amount of death benefit, plus the cash value on the date of death, plus the policy's mortality reserve value on the claim date. This amount is essentially the cumulative premiums plus or minus investment experience along with a death benefit corridor, which most carriers express as a fixed percentage between 102.5 percent and 110 percent. One Puerto Rican life insurer issues policies with a fixed amount of coverage—$1 million above the initial premium and mortality reserve.

The cash value under most FCV policies is defined as the fair market value of all assets constituting the policy fund, less any policy loans and less any accrued unpaid fees or expenses due under the terms of the policy. The cash surrender value of the FCV policy is the lesser of: (1) the cash value, or (2) the sum of all premiums paid under the policy, computed without regard to any surrender charges and policy loans, under the terms of the policy.

The surrender and loan proceeds are tax-free under any circumstance and provide the policyholder with access to policy assets on a tax-free basis.

The policy's cash value increases or decreases depending upon the investment performance of the policy's separate account. FCV policies typically don't provide for or guarantee any minimum cash value. The life insurer holds the appreciation of the assets (in excess of the amount of cumulative premiums) in a separate account, known as a mortality reserve, within the insurer's separate account, solely for the purposes of funding the payment of the death benefit payable under the FCV policy.

Under most FCV contracts, the policyholder may take a partial surrender of the policy cash value up to the amount of cumulative premiums within the policy. The policyholder may also take a policy loan of up to 90 percent of the policy's cumulative premiums. The policy loan terms will vary from company to company. The significance of a partial surrender versus a policy loan is that the partial surrender won't leave the policy with a liability. The surrender and loan proceeds are tax-free under any circumstance and provide the



## Hypothetical Policy

*Compounding the investment income without taxation creates a significant benefit over over the taxable account*

| Year | Net Taxable Investment ($)Value | End of Year Policy Cash ($) Value | Death Benefit($) | Net Taxable Investment (%) IRR | Death Benefit IRR (%) |
|---|---|---|---|---|---|
| 1 | $10,564,000 | $10,000,000 | $11,167,572 | 5.64% | 11.68% |
| 10 | 21,489,508 | 10,000,000 | 30,284,242 | 5.64 | 11.72 |
| 15 | 31,502,114 | 10,000,000 | 52,810,959 | 5.64 | 11.75 |
| 20 | 46,179,894 | 10,000,000 | 92,155,773 | 5.64 | 11.75 |
| 30 | 99,238,319 | 10,000,000 | 281,081, 594 | 5.64% | 11.75 |

— Grerald R. Nowotny

policyholder with access to policy assets on a tax-free basis.

"Hypothetical Policy," this page, provides a good example of FCV coverage for a male insured, age 62. The net investment return is 12 percent per year. The death benefit corridor is 105 percent. The net taxable investment account assumes that all of the income is taxable at ordinary rates—47 percent for a New York City resident.[5] The compounding of the investment income without taxation over time creates a significant advantage over the taxable account.

## Taxation

The FCV policy isn't designed to meet the tax law definition of a life insurance contract under Section 7702. Specifically, FCV policies, by design, don't meet either:

The first issue is determining which jurisdiction's law is the applicable law governing the FCV policy, and the second issue is whether the policy meets that applicable law.

(1) the cash value accumulation test in Section 7702(b), or (2) the guideline premium test of Sections 7702(c) and (d).[6]

The critical tax questions regarding the FCV policy are:

1. Does the policy qualify as a life insurance contract under the applicable law of the jurisdiction, and if so, is it a life insurance contract for purposes of Section 7702(a)?
2. What are the U.S. federal income tax results to the policyholder as a result of its ownership of the policy during the insured's lifetime?
3. What are the U.S. federal income tax results to the beneficiary when the company pays the death benefit upon the insured's death?
4. Are there any other U.S. federal income tax rules that must be complied with to ensure favorable U.S. income tax results?

## Life Insurance Contract

Does the FCV policy qualify as a life insurance contract under Section 7702(a) or under applicable law? Section 7702 defines a life insurance contract for all purposes of the IRC, including the death benefit exclusion under IRC Section 101(a). To qualify as a life insurance contract under Section 7702, a policy must be a life insurance contract under the applicable law and must satisfy one of two alternatives: (1) the policy must meet the cash value accumulation test of IRC Section 7702(b), or (2) the policy must both meet the guideline premium test of IRC Section 7702(c) and satisfy the cash value corridor test of IRC Section 7702(d).[7]

Section 7702 requires that a contract be considered "life insurance" under the insurance laws that apply to the contract. The applicable law may be the insurance laws and regulations of a particular U.S. state or the laws of a foreign jurisdiction.[8] The first issue is determining which jurisdiction's law is the applicable law governing the FCV policy, and the second issue is whether the policy meets that applicable law.

Typically, the applicable law is the law of the jurisdiction to which the insurer is subject, which is generally the law of the jurisdiction in which the

company resides. The policy will expressly specify which jurisdiction's (Bermuda, Cayman Islands, Puerto Rico) law governs the policy. Presumably, the insurer is licensed and regulated in the jurisdiction and will issue and deliver the policy in and administer the policy from the jurisdiction where the life insurer is domiciled. The controlling jurisdiction for the life insurer should be very clear in the policy's private placement offering memorandum.

The jurisdiction of the insurer is the law that controls the policy's issuance and the legal interpretation of its terms. This result is consistent with general industry practice, as explained in the seminal article, "The New Federal Tax Definition of a Life Insurance Contract" by Jeffrey P. Hahn and John T. Adney:

> New Section 7702 begins with the instruction that, for all purposes of the Code, a "life insurance contract" is any contract, which is a life insurance contract under the "applicable law" and meets the mathematical tests of either paragraph (1) or paragraph (2) of section 7702(a). The phrase "applicable law" is intended to refer to State law, territorial law, or foreign law—the local body of law controlling the issuance and interpretation of the contract—and to encompass such rules as those governing non-forfeiture values and required policy provisions.... [If a] contract is treated as a life insurance contract under local law; it will be so treated for Federal tax purposes if it also complies with the statute's mathematical tests.[9]

The second issue is whether the policy is, in fact, a valid life insurance contract under the laws of the foreign jurisdiction. An offshore life insurer should be able to produce a legal opinion from reputable legal counsel in the foreign jurisdiction under whose insurance regulations and law where the FCV policy qualifies as a life insurance contract.

If the insured is a U.S. citizen, following his death, the IRS might argue that U.S. insurance laws should be applied to determine if the policy is a life insurance contract. Unless there's some other legal nexus with the United States beyond the fact that the insured is a U.S. citizen, this legal argument shouldn't prevail. Therefore, it's important that the mechanics of soliciting, underwriting and issuing the FCV policy occur offshore to avoid an argument that it's a policy issued in the United States.

The pertinent legal issue is the determination of what law applies to the contract. In this case, the issuance by a non-U.S. insurance company of a policy that's delivered and administered outside the United States is the critical factor. As a result, it's unlikely that a sufficient nexus exists with the United States to trigger application of U.S. insurance laws to the FCV contract.

The death benefit under the FCV policies in the marketplace is always greater than the policy's cash value (the minimum guaranteed specified amount as of the date of issuance of the policy). This amount will vary by carrier from 102.5 percent to 110 percent or a fixed amount above the policy's mortality reserve. The carriers operating in the FCV marketplace all believe (supported by legal opinion) that U.S. state insurance laws would treat the policy, in substance and form, as a life insurance contract.

The policy isn't a "life insurance contract" as defined in IRC Section 7702. The policy by its terms won't meet either of the two actuarial tests in the definition of life insurance (cash value accumulation test or guideline premium/cash value corridor) in IRC Section. 7702(b)-(d).

If the policyholder is a non-U.S. person, there should be no U.S. tax consequences during the insured's lifetime. Since the carrier is a non-U.S. person (most insurers issuing the FCV policy issue the policy from the non-electing carrier for IRC Sec 953(d) purposes), any income that the policy might be considered to generate during this period would be income that's derived from non-U.S. sources. The United States shouldn't impose

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federal income taxes on a non-U.S. person deriving non-U.S. source income.

If the policyholder is a U.S. person and the policy is a "life insurance contract under applicable law," but fails the legal requirements of Section 7702 to qualify as a life insurance contract, the policyholder should be subject to tax on the income on the contract under the rules of IRC Section 7702(g).

Section 7702(g) sets forth the U.S. income tax rules for any contract that's a life insurance contract under the applicable law, (but) that doesn't meet the definition of a life insurance contract under IRC Section 7702(a) (which states that the policy has to meet the cash value accumulation test or the guideline premium and cash value corridor requirements).

> The right of the policyholder under the contract, as interpreted under the applicable law governing the contract, is the determining factor.

Section 7702(g) provides that if a contract is a life insurance contract, but doesn't meet the tax law definition of life insurance of Section 7702, then the policyholder is taxable each year on the "income on the contract," which is defined to mean the sum of: (1) the increase of the net surrender value of the contract during the taxable year, and (2) the cost of life insurance protection provided under the contract during the taxable year, over the premiums paid during the contract year.[10]

The first factor in computing the annual income on the contract is the increase in the net surrender value of the contract, other than on account of premium payments. IRC Section 7702(f)(2)(B) defines "net surrender value" as an amount "determined with regard to surrender charges but without regard to any policy loan." In contrast, IRC Section 7702(f)(2)(A) defines "cash surrender value" to be "its cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends."[11]

Proposed Treasury Regulations Section 1.7702-2 defines the cash value of a policy as being:

> the greater of (i) the maximum amount payable under the contract (determined without regard to any surrender charge or policy loan), or (ii) the maximum amount that the policyholder can borrow under the contract." The proposed regulation goes on to provide that cash value of a policy does not include the amount of "any death benefit payable by reason of the death of the insured.[12]

The legislative history of Section 7702 provides that "cash surrender value is defined in the Act as the cash value of any contract (that is, any amount to which the policyholder is entitled upon surrender and, generally against which the policyholder can borrow) determined without regard to any surrender charge, policy loan or reasonable determination dividend."[13]

The Senate report similarly explains that the cash value of a life insurance contract is interpreted as the amount to which a policyholder is entitled upon surrender of the policy and against which the policyholder may borrow.

The right of the policyholder under the contract, as interpreted under the applicable law governing the contract, is the determining factor. This definitional understanding is consistent with the definition of cash surrender value and net surrender value in Section 7702, as well as the practice of the U.S. life insurance industry.[14]

The academic community agrees with Congress in its interpretation. In the textbook, *Life Insurance*, Professors Kenneth Black, Jr. and Harold D. Skipper, Jr. explain that the cash surrender value in a life insurance policy "represents the amount made available, contractually, to a withdrawing policyholder who is terminating his or her protection." It's the rights of the policyholder under the contract that determine the cash surrender value.[15]

The rights, obligations and relationship between a policyholder and an insurance company arise solely from and are governed by the terms of the policy contract between the parties. The IRC doesn't define or regulate the rights, obligations and relationship between a policyholder and an insurance company, but instead sets the tax results that arise from different policy structures. No legal authority exists in which the cash value or cash surrender value or other such material term of a life insurance policy is defined or interpreted.

Under the terms of the typical FCV policy, the cash surrender value is strictly limited to exceed the



sum of the premiums paid under the policy, less prior partial surrenders and outstanding policy loans. Accordingly, it's impossible for there to be an increase of the net surrender value that's not attributable to premium payments. This means that there should never be any income on the contract under IRC Section 7702(g)(1)(B)(i)(I) by virtue of increases in the net surrender value.[16]

The second factor in computing the annual income on the contract is the cost of life insurance protection provided under the contract during the taxable year. IRC Section 7702(g)(l)(D) defines the cost of life insurance protection to equal the lesser of costs as determined under "uniform premiums (computed on the basis of 5-year brackets—Table I) prescribed by the Secretary by regulations" or "the mortality charge (if any) stated in the contract."[17]

The typical FCV policy has a specified "mortality charge stated in the contract" based on the policy's cash value corridor (102.5 percent to 110 percent or a fixed amount, for example, $1 million) that's determined by multiplying a cost of insurance rate by the net amount at risk. The net amount at risk is the difference, as of a processing date, between the policy's death benefit and its cash value. Offshore life insurers use the identical methodology used by a domestic carrier in determining the annual mortality charge for its life insurance policies, which are designed to comply with the requirement of Section 7702. As a result, an FCV policy should have income on the contract each year in an amount equal to the actual mortality charges imposed under the policy during that year.

A U.S. policyholder purchasing an FCV policy will be taxable currently on the income on the contract that accrues during a given taxable year. In this case, since there will never be any increase in the policy's net surrender value that's not attributable to premiums paid, the amount of the income on the contract year will equal the actual mortality charges imposed under the policy during that year.

## Tax Results

What are the U.S. tax results to the beneficiary of an FCV policy upon the insured's death?

If the beneficiary is a non-U.S. person, the death benefit shouldn't be subject to any U.S. federal income tax. The death benefit would be a payment from non-U.S. sources and in these circumstances the U.S. wouldn't impose a tax on payments of non-U.S. source income to a non-U.S. person.

If the beneficiary is a U.S. person, IRC Section 7702(g) governs the taxation of the death benefit. Specifically, IRC Section 7702(g)(2) provides that:

> if any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the excess of the amount paid by reason of the death of the insured over the net surrender value of the contract shall be deemed to be paid under a life insurance contract for purposes of section 101 and subtitle B.[18]

The focus in the investor control doctrine is on what types of interaction or control a policyholder, in fact, may have with respect to separate account investments.

IRC Section 101(a)(l), following the rule in effect since the advent of the U.S. federal income tax law in 1913, provides that, with certain limited exceptions, "gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract if such amounts are paid by reason of the death of the insured."[19]

When IRC Section 7702(g) is applied to the policy, the beneficiary receives the excess of the death benefit over the net surrender value as an income tax-free death benefit, while the net surrender value amount is a tax-free distribution from the policy since it is, by definition, always less than or equal to the policyholder's income tax basis in the policy (that is, cumulative premiums paid).

## U.S. Tax Rules

For a variable contract (such as a variable universal life insurance policy) to be treated as a life insurance policy



as defined in Section 7702 for U.S. income tax purposes, the applicable local law separate account (referred to as a "segregated asset account" in the IRC) underlying such a contract must meet the investment diversification requirements specified in IRC Section 817(h) and Treasury Regulations Section 1.817-5.

As a result, the FCV policy must comply with these diversification requirements, and the insurer must require the investment manager it engaged to comply with these requirements at all times with respect to the separate account. Every insurer currently offering FCV policies takes the position that the policy must meet the diversification requirements of IRC Section 817(h).[20]

Many life insurers in both the domestic and offshore marketplace distinguish between policyholder control and the insured, in their analysis of the investor control doctrine.

In addition to these diversification requirements, the Internal Revenue Service has, in the past, taken the position that if a policyholder is able to control the selection of the assets held and maintained in the separate account, he'll be treated as owning the separate account assets for income tax purposes and, thus, will be currently taxable on any gain the in the contract (that is, growth in cash value above basis).

Specifically, in the late 1970s, the IRS began to question the deferral of tax on annuities that permitted a policyholder to control the underlying assets. This concern led to a series of revenue rulings that treat the policyholder as the owner of and, therefore, as taxable on the investments underlying the contract in certain circumstances[21] (the "investor control" doctrine).

The application of the investor control doctrine depends on the specific facts and circumstances of a particular transaction. The focus is on what types of interaction or control a policyholder, in fact, may have with respect to separate account investments. This can only be determined in the context of a specific situation. In offshore life insurance transactions, certain items create the presumption of investor control. These presumptions may include the ability of the policyholder to participate in the selection of the investment manager and investments and the ability of the policyholder to contribute assets in kind and receive surrender proceeds in kind.

An underlying premise of the doctrine is that the owner of a variable contract receives the benefit of any increases or decreases in value of the underlying separate account assets. That's only partially the case here (the death benefit reflects the investment performance of separate account assets, but the cash surrender value doesn't), which arguably suggests that the investor control doctrine shouldn't apply to the policy.

Many life insurers in both the domestic and offshore marketplaces distinguish between policyholder control and the insured, in their analysis of the investor control doctrine. Specifically, some carriers view policy ownership by an irrevocable trust with an independent trustee subject to a fiduciary standard as a sufficient separation for investor control planning purposes. These trusts, regardless of their status as grantor or non-grantor trusts, ensure that the client retains no general power of appointment over the trust's corpus, including the life insurance policy. Other carriers feel that the trust should be a non-grantor trust since investor control is an income tax rule and non-grantor trusts are treated as separate taxpayers for income tax purposes.

Life insurers will also structure customized investment options within the policy using an independent (albeit friendly) investment advisor that has complete legal discretion with regard to investments based upon an investment policy statement or alternatively form an insurance dedicated fund as envisioned in Rev. Rul. 2003-91 and Rev. Rul. 2003-92. In any event, the investment advisor undergoes an independent due diligence review by the carrier and enters into a separate contractual relationship with the life insurer as investment manager.

If the investor control doctrine applies and the policyholder is a U.S. person, the policyholder wouldn't be taxed under Section 7702(g), but instead would be taxed directly on the investment earnings as if the

policyholder held directly the assets of the separate account. A policyholder who's not a U.S. person would be treated as holding directly the separate account assets and, as a result, could be subject to U.S. withholding taxes on the earnings thereon. The application of U.S. withholding taxes under IRC Section 871(a) would depend on the nature of the assets and other relevant facts that could only be addressed in the context of a specific transaction. Upon the insured's death, the beneficiary wouldn't be taxed on the death benefit.

One method for avoiding the application of the investor control doctrine is for the insurer to issue a traditional insurance contract, for example an FCV policy that's a non-variable contract. In that case, the policy cash value and mortality reserve would be determined exclusively by the investment performance of the insurer's general account assets. The insured's investment division would be responsible for the investment performance of general account assets.

The company would declare a crediting rate or policy dividend based on its investment performance, expense management and mortality experience. As I'll explain later, a wealthy high-net-worth investor could form his own insurance company that issues the FCV policy.

Based upon the regulatory authority of the insurance regulator in the jurisdiction of the company, the company could issue a traditional (non-variable) FCV policy. The company could also have all or most of its general account assets managed by the client or client's investment management firm. The crediting rate of the policy would be declared based upon the investment performance of the general account, expense management and mortality experience. This transaction wouldn't be subject to the provisions of IRC Section 817(h) or the investor control doctrine.

## Investment Diversification

Since the FCV is a form of a PPLI contract, it's important to discuss the investment diversification rules under IRC Section 817(h) and Treas. Regs. Section 1.817-5. Failure to meet the requirements of these tax provisions can disqualify the FCV contract for U.S. tax purposes.

Section 817(h) covers the taxation of variable insurance products. Treas. Regs. Section 1.817-5 provides a detailed overview of the investment diversification requirements of variable insurance products. The regulations address a wide range of investment alternatives that aren't found in retail variable life and annuity products, such as direct investment in real estate and commodities.[22]

Section 817(h) provides that investment diversification is tested separately in each fund within the policy. No single investment may represent more than 55 percent of the fund; two investments, 70 percent; three investments, 80 percent; and four investments, 90 percent. Therefore, a fund must have at least five investments to meet the diversification requirements.[23]

The regulations provide that diversification is tested on the last day of each calendar quarter, with a 30-day correction period in the event a fund doesn't meet the diversification requirements. The regulations provide a one-year start-up period that begins the day a fund receives its initial funding. Real property accounts have a five-year period to meet the diversification requirements.[24]

> An important aspect of the investment diversification rules is the look-through treatment of certain securities.

A fund that was previously diversified but for the appreciation or depreciation of securities within the portfolio continues to remain diversified. The regulations provide that all securities of the same issuer are treated as a single security for diversification purposes. All items of the same commodity are treated as a single security for diversification purposes. The IRS considers a portfolio of Treasury securities to be automatically diversified.[25]

An important aspect of the investment diversification rules is the look-through treatment of certain securities. The rules provide this treatment only to funds that are exclusively available through variable insurance company separate accounts. Rev. Rul. 2003-91 and Rev. Rul. 2003-92 were issued in response to a private letter ruling request by Keyport Life (now owned by Sun Life) regarding the look-through treatment of non- registered partnerships.[26]



The prior regulation was interpreted to mean that an investment through the life insurer's separate account into a hedge fund (a non-registered partnership) would provide the ability to look through to the underlying securities of the fund. The IRS ruled that these non-partnerships would no longer receive look-through treatment under Treas. Regs. Section 1.817-5(f)(ii) since the ability to invest in the fund wasn't exclusively available to policyholders of variable insurance products. These publicly available securities would be treated as a single security for investment diversification testing purposes.[27]

## Family Trust Investments

FCV is a tool for sophisticated tax and estate-planning situations. Its unique nature, combined with the tax advantages of life insurance, make FCV a very worthy structure. Here are two examples.

**1. Frozen cash value as a surrogate for a private placement variable deferred annuity (PVAA) contract.** Most ultra-high-net worth families don't have a traditional need for life insurance. In many cases, the family may have adequate liquidity to pay federal estate taxes or alternatively leave a large portion of their wealth to a private foundation. Other families may have transferred large amounts of wealth to a dynasty trust using advanced estate-planning techniques. Ultra-high-net-worth families haven't been purchasers of variable deferred annuities for a number of reasons, including: (1) lack of investment flexibility; (2) policy charges; and (3) taxation at death.

A trust may own a PPVA if the beneficial owners of the trust are individuals. This point is contrary to the belief of many investors and their advisors. A number of favorable PLRs have been issued on the application of IRC Section 72(u) regarding the non-natural person rule.[28] PPVA contracts allow for tax deferral of investment income.

In a trust-owned annuity, it's the death of the annuitant or measuring life that requires the distribution of any tax-deferred income under IRC 72(s)(6).[29] The payout must be within a five year period following the death of the annuitant or over the life expectancy of the beneficiary. The annuitization of the tax-deferred income provides for additional tax deferral. However, unlike the PPVA contract, the death benefit of the FCV contract is income tax free and paid in a lump sum upon the insured's death.

Ultimately, an FCV policy offers all of the benefits of traditional PPLI and stronger benefits than a PPVA. Investment income within the policy invested in an FCV will accrue on a tax-free basis. The MEC rules aren't applicable to an FCV policy. The trustee will be able to access the policy cash value on a tax-free basis up to the amount of cumulative premiums as a partial surrender of the cash value or policy loan. (See "Benefit Comparison," this page).

**Comments**

1. Both PPVA and FCV would offer a tax-deferred buildup.
2. FCV would allow for a partial surrender up to the amount of cumulative premiums or a policy loan. Both receive tax-free treatment. The PPVA would provide for taxable income at ordinary rates to the extent of taxable income. Alternatively, annuitization would provide for a stream of annuity payments that provide for a return of principal along with taxable gain.
3. FCV would provide for an income tax-free death benefit. The PPVA would provide for taxable distributions within five years of the annuitant's death either in a lump sum or paid over the life expectancy of the beneficiary as return of principal and taxable gain based on the exclusion ratio.

**2. FCV as a solution for undistributed net income (UNI) in foreign trusts.** Life insurance is an excellent

### Benefit Comparison

*Frozen cash value (FCV) vs. private placement variable annuity (PPVA)*

| Description | Frozen Cash Value | Private Placement Variable Annuity |
|---|---|---|
| Deferral of investment income | Yes | Yes |
| Tax-free distributions during lifetime | Yes | No |
| Taxation at death | No | Yes |

*— Grerald R. Nowotny*



way for foreign trusts to deal with UNI, particularly those that have U.S. beneficiaries. Life insurance doesn't eliminate the existing UNI, but cuts off the growth of any additional UNI in the foreign trust.

Most foreign trusts are treated as foreign non-grantor trusts, which are only taxed on their U.S. source income. The foreign trust rules impose draconian taxation on UNI for U.S. beneficiaries. The "throwback" rules were designed to prevent the deferral of taxable income for U.S. beneficiaries in foreign non-grantor trusts.[30]

Under the throwback rules, undistributed gains are taxed in the year of distribution to the beneficiary, including an additional interest charge imposed on the undistributed net income. It's assessed using compound interest instead of simple interest. The interest charge is designed to simulate taxation as if the undistributed income had been taxed in the year earned. Adding insult to injury, the UNI loses its tax character when distributed.[31]

The advantage of FCV is significant in planning for UNI. The premium contributions don't reduce the level of UNI within the trust, but cut off the incremental growth of the problem. The cash value growth within the policy isn't considered to be trust income for trust accounting purposes and doesn't add to the UNI problem. Tax-free distributions from the policy aren't considered distributions that are subject to the throwback rules. The ultimate death benefit is an income and estate tax-free payment to U.S. beneficiaries that wouldn't be subject to the throwback rules.

The FCV contract is an ideal structure to use in foreign non-grantor trust planning with U.S. beneficiaries from the inception of the trust. The problem of UNI will arise within the trust to the extent that FCV is used. The FCV has the investment flexibility to accommodate a wide spectrum of investment options with customization of the policy investment menu, including in kind premium payments.

As mentioned earlier in the article, an ultra-high-net-worth individual should give serious consideration to starting his own carrier. This concept is in effect a captive life insurer but focused on life insurance instead of property and casualty insurance. The capital requirements aren't excessive and an insurance management company (For example Marsh, Aon, etc.) can manage the operation for the high-net-worth taxpayer.

## Endnotes

1. Craig Hampton, "The Hampton Freeze—International Life Insurance Planning at its Best," *Offshore Inv.* (Oct. 1994), available at *www.offshoreinvestment.com/pages/index.asp?title=Offshore_Investment_-_Login&ID=1592&issueID=9806*. His later update, similarly titled and published in October 1995, is available at *www.offshoreinvestment.com/pages/index.asp?title=Offshore_Investment_-_Login&ID=1464&issueID=9806.*
2. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub.L 108-27, 117 Stat.752.
3. *See* Internal Revenue Code Section 953(d).
4. *See* Revenue Rulings 77-85, 1977-1, CB 12; 80-274, 1980-2, CB 27; 81-225, 1982-2, CB 12; 82-54, 1982-1, CB 11.
5. *See* Tax Foundation State Tax Rates 2000-2012, at *www.taxfoundation.org/article/state-individual-income-tax-rates-2000-2012.*
6. *See* IRC Section 7702(a).
7. *See* IRC Section 7702(b) and IRC Section 7702(c).
8. *See supra*, note 6.
9. *See* Jeffrey P. Hahn and John T. Adney, "The New Federal Tax Definition of a Life Insurance Contract," *Journal of the Society of CLU* (November 1984).
10. *See* IRC Section 7702(g).
11. *See* IRC Section 7702(f)(2)(A).
12. *See* Proposed Treasury Regulations Section 1.7702-2.
13. General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th).
14. Staff of the Joint Committee Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 646-47 (1984) ("Applicable law" means state or foreign law).
15. *See* Kenneth D. Black, Jr. and Harold D. Skipper, Jr. Life Insurance, 12th ed. (Prentice Hall 1994) at p. 177.
16. *See* IRC Section 7702(g)(1)(B)(i)(I).
17. *See* IRC Section 7702(g)(I)(D).
18. *See* IRC Section 7702(g)(2).
19. *See* IRC Section 101(a)(1).
20. IRC Section 101(a).
21. *See* Rev. Rul. 77-85, 1977-1 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; and Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 2003-91, 2003-2 C.B. 347. It also led to the enactment of IRC Section 817(h).
22. *See* IRC Section 817(h) and Treas. Regs. Section 1.817-5(b).
23. *See* IRC Section 817(h) and Treas. Regs. Section 1.817-5(b).
24. *See* Treas. Regs. Section 1.817-5(c)(2)(i).
25. *See* Treas. Regs. Section 1.817-5(b)(ii)(A), (B).
26. Rev. Ruls. 2003-91, 2003-2 CB 347; 2003-92, 2003-2 CB 350.
27. *See* Treas. Regs. Section 1.817-5(f)(3).
28. *See* IRC Section 72(u).
29. *See* IRC Section 72(s)(6).
30. *See* IRC Sections 667 and 668.
31. *See* IRC Section 667(a).