Using Private Placement Insurance Products to Achieve Tax Efficiency for High Net Worth Investors

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Although no one can predict what Congress will do at any point, it is quite likely we will see higher income tax rates in the near future, along with an increase in federal estate tax rates and a decrease in available income tax deductions. For high net worth investors, private placement insurance contracts could be the solution to tax planning in an unfriendly tax environment. These investment vehicles allow for investment customization and provide for the possibility of stronger and more consistent investment performance, while also offering attractive tax benefits. The author explains several options within the realm of private placement insurance, and analyzes the related investment and tax planning issues.

Introduction

This article is designed to provide an overview of the benefits of private placement life insurance (PPLI) and private placement variable deferred annuity products (PPVA) for ultra-high net worth investors. PPLI is an institutionally priced variable universal life policy designed for accredited investors and qualified purchasers as defined under federal securities law. The policy allows for customized investment options which may include alternative investments such as hedge funds. PPVA is an institutionally priced variable deferred annuity which allows for customized investment options as well.

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In spite of volatile equity markets, the retail variable life and annuity marketplaces, according to *The IRI Fact Book,* have $1.5 trillion of assets under management.[1] Obviously, this is no small amount of capital.

How has so much capital found its way into variable insurance products? The use of the phrase "good investment" with life insurance has long been considered to be an oxymoron. Traditional life insurance products have been too laden with heavy front-end sales charges and limited investment flexibility for sophisticated buyers such as high net worth individuals and large institutions. This sales phenomenon has occurred in spite of the significant tax advantages that life insurance enjoys in comparison to other financial products.

The evolution of the PPLI and PPVA marketplaces for high net worth individuals has its origins with the growth of the hedge fund industry for high net worth investors. The sophisticated hedge fund investor whose yields are regularly driven down by the substantial tax rates imposed on ordinary income and short-term capital gains is acutely aware of the tax inefficiency of hedge funds. Hedge fund managers have attempted to utilize various investment swaps (also known as total return swaps) to convert a portion of the investment income into long-term capital gain; however, none of these strategies offers the comprehensive tax advantages of PPLI.

Private placement insurance products still represent a small percentage of the assets under management within life insurance company separate accounts. The author's non-scientific review would suggest that private placement insurance assets are dispersed as follows:[2]

- Private Placement Group Variable Deferred Annuity Contracts—$25 billion;
- High Net Worth Private Placement Assets: domestic—$7.5 billion; offshore—$2.5 billion.

The relative paucity of separate account assets in high net worth PPLI is largely the result of marketing and distribution problems. Unlike retail life insurance, this relatively complex life insurance product does not have the high commission structure to support a "big bang" for the marketing "buck." Traditional life insurance agents with commission levels as high as 95 percent of target premium (commissionable premium level) will frequently sell against PPLI as a better option for the client. This is a case of mistaken identity, by which I mean that the traditional life insurance agent confuses the insurance dollar allocated for a traditional insurance need with an investment

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[1] Insured Retirement Institute, *IRI Fact Book 2011*, at 48.

[2] Based on the author's informal non-scientific survey of senior management of several domestic and offshore life insurers.

dollar being reallocated for a more tax-advantaged investment return. Nevertheless, PPLI is an excellent choice for traditional estate planning/wealth transfer planning purposes. As the cliché goes, you need to follow the money to understand why the life insurance industry has not sold more PPLI.

The lack of high net worth PPLI premium volume to this point in time has nothing to do with the viability and planning and investment benefits of PPLI relative to retail variable insurance products, but rather results from the lack of agent compensation for selling the product. It is the most complex insurance product that compensates the life insurance agent like an investment product. This article will examine and address the benefits of private placement insurance products, planning uses for these products, and relevant tax authority.

Variable vs. General Account Insurance Products

Variable insurance products are different from general account (or "fixed") insurance products. In the latter, the contractual promises of the insurance contract are supported by the insurer's general account assets, i.e., the assets of the insurance company. These assets are invested according to state insurance regulation—largely in investment grade fixed income assets and mortgages.[3] State insurance law allows for a minimal amount of investment exposure in equities—public or private.[4] The financial solvency tests (also known as risk-based capital ratios) of the independent rating agencies also consider the liquidity of the general account assets as part of the company's financial strength to meet its contractual promises. These general account assets are subject to the claims of the insurer's creditors.

Separate account assets, while also assets of the insurer, are segregated by state insurance statutes from the claims of the insurer's general creditors.[5]

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[3] American Council of Life Insurers, *ACLI Fact Book 2011*, at 28, available at http://www.acli.com/Tools/Industry%20Facts/Life%20Insurers%20Fact%20Book/Pages/GR11-198.aspx. As of the end of 2010, U.S. life insurers had $3.5 trillion in general account assets and another $1.9 trillion in separate account assets. Long-term bonds represented 72.5 percent of total general account assets. Stocks represented only 2.5 percent of general account assets. Mortgages represented 9.2 percent of general account assets with the majority committed to commercial mortgages. Cash holdings represented 1 percent of general account assets.

[4] See N.Y. Ins. L. § 1405; TIAA-CREF Newsl., Summer 2011, at 3. TIAA-CREF, a life insurer domiciled in New York, provides a good example of the application of the rules of a state insurance regulator on general account investments. Investments in U.S. real estate are limited to 20 percent of the general account. Investments in U.S. common stock and non-preferred equity securities are limited to 20 percent. Investments in emerging market debt are limited to 4 percent. Investments in below-investment grade bonds are limited to less than 10 percent.

[5] Mass. Gen. L. §§ 175 and 132F are a good example of the typical separate account insurance laws. Separate account investments are segregated bookkeeping entries of the insurer. They are not trusts or held in a separate legal entity. Separate account investments belong to and are titled in the name of the insurance company. The policyholder has no right

The investments of the insurer's separate account for variable life insurance and annuity policies provide a direct pass-through of investment performance to policyholders. These investment funds within retail variable insurance products are largely registered funds or subaccounts managed by mutual fund companies.

Life insurers have done a marvelous job of manufacturing and distributing variable insurance products. It also helps that the life insurance industry has a very powerful lobbying group in Washington, D.C., the American Council of Life Insurers (ACLI).[6] In the face of volatile insurance markets, life insurers introduced policy riders to variable annuities which provide for a guaranteed long-term investment return that is reasonably competitive in the current marketplace and not available in competing investment products along with the tax deferral enjoyed by annuity contracts. Even in the volatile equity markets of the last two to three years, life insurers selling variable annuities have managed to add $141 billion of new premiums in 2011.[7]

Tax Advantages of Life Insurance

Life insurance has enjoyed significant tax advantages for decades. In general, life insurance offers five distinct tax benefits:

1. *Tax-deferred "inside build-up" of policy cash values:*[8] This is the "sacred cow" of the life insurance industry, which has preserved the tax preferred treatment of life insurance for decades. Over the past 25 years, numerous proposals to change the tax treatment of life insurance have disappeared in a matter of hours after issuance. For example, during the Clinton Administration a proposal to tax the inside build-up of life insurance was withdrawn from consideration in a matter of days. At the beginning of the Obama Administration, an annual reporting requirement for life insurers

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to direct the purchase and sale of a separate account asset. Income and losses pass through to the policyholder. Separate account assets are included in the annual financial statements of the life insurer. The separate account assets are reported to the state insurance commissioner in the state of domicile in the "Green Book."

[6] The American Council of Life Insurers, headquartered in Washington, D.C., is the trade association for over 300 hundred life insurers representing over 90 percent of the assets and premiums of the U.S. life insurance industry. For more information, see http://www.acli.com.

[7] Noah Buyahar, "U.S. Variable Annuity Sales as Prudential, MetLife Report Gains," Bloomberg Online (Feb. 17, 2011), available at http://www.bloomberg.com/news/2011-02-16/u-s-variable-annuity-sales-rise-led-by-prudential-metlife.html.

[8] See IRC § 7702 (tax law definition of life insurance). Unless specifically otherwise indicated, all references to "Section" are to the Internal Revenue Code of 1986 as amended (the IRC) or the regulations thereunder.

was proposed, requiring reporting for separate accounts with 10 or fewer policyholders. This proposal seemed to disappear to the bottom of the heap very quickly, never seen or heard from again. The collective clout of the industry and its agents results in a powerful political force.

2. *Non-recognition of capital gains:* A policyholder has the ability to switch investment options within the product without triggering taxation, because life insurance separate accounts—and not the policyholders—are legally the owners of the investments within variable insurance products. The life insurer receives a reserves deduction equal to its investment income.[9]
3. *The option of tax-free access to policy cash values through a partial surrender of the cash value and low-cost policy loans:* Life insurance policies receive LIFO treatment. A policyholder may take a partial surrender of the cash value and recover his tax basis in the contract first. Policy loans with a net cost of approximately 25-50 basis points per annum also receive income-tax-free treatment. The policy's basis is its cumulative premiums.[10] A policyholder who has recovered his basis in the contract has a contractual right to a policy loan, which allows the policyholder to borrow up to 90 percent of the policy cash value.[11]
4. *Income-tax-free death benefit:*[12] The policy cash value grows on a tax-free basis. The policyholder can access investment gains within the policy on a tax-free basis during lifetime, and beneficiaries receive the death benefit income-tax-free.
5. *Estate-tax-free death benefits through the use of third-party ownership of the policy:* A policy can be owned by a third party such as an irrevocable life insurance trust (ILIT). Section 2042 provides that, as long as the insured does not retain any incidents of ownership within the policy, the death proceeds will not be included in the taxable estate of the decedent.[13]

The legislative intent behind these tax advantages is rooted in social policy designed to encourage household savings and insurance protection, i.e., insurance for "widows and orphans." The insurance industry has fiercely

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[9] IRC §§ 807(a) and (b) provide that a life insurer receives a reserves deduction equal to the investment income of the separate account.

[10] See IRC §72(e)(6).

[11] See IRC § 72(e)(5).

[12] See IRC § 101(a)(1).

[13] See IRC § 2042(2).

guarded these longstanding benefits in the Internal Revenue Code over the years through a well-organized and funded effort.

Development of PPLI

Drawbacks of General Account Products for High Net Worth Individuals. Investors, both high net worth and regular folks, have long realized the potential opportunities of life insurance as a tax-advantaged investment. The life insurance industry has marketed permanent life insurance as a supplemental retirement vehicle for decades. Traditional general account life insurance products produce conservative investment results, however. The policy's investment return or crediting rate is tied to the investment return of the insurer's general account assets. The crediting rate for permanent policies issued by mutual life insurance companies is reflected in the life insurer's dividend scale. Stock life insurance companies issue interest-sensitive policies. The investments of the general account are restricted by statute and are primarily comprised of investment grade bonds and mortgages.

General account products have been primarily distributed through the general agency system for the last century. These products were designed for mass distribution and carry high front-end sales loads in order to compensate the life insurance distribution system. Because these sales loads provide an adverse reduction, or "drag," on the investment performance of the general account policies, they have had little investment appeal to sophisticated long-term investors despite any tax advantages that the products might offer.

COLI Policies. Corporate Owned Life Insurance (COLI) buyers are generally Fortune 500 companies that use permanent life insurance to recover the costs of funding supplemental executive retirement programs (SERPs) and post-retirement benefits. The corporation is generally the applicant, owner, and beneficiary of a policy insuring the life of a senior executive covered under the SERP. PPLI has not been used in COLI transactions featuring alternative investments as underlying fund option. Most COLI policies have been issued as registered variable universal life policies featuring registered funds (mutual fund) clones.

VUL Policies. The introduction and distribution of Variable Universal Life insurance (VUL) increased dramatically over the last two decades, in the wake of the bull market. Sales of VUL comprised 40 percent to 50 percent of life insurance company sales. VUL is a separate account product that offers multiple investment options in a manner similar to mutual funds. Assets of the separate account are not subject to the creditors of the insurer in the event of default. These assets are legally owned by the life insurer.

The investment performance of these investment funds is a direct pass-through to the policyholder and allows the policyholder to participate in various investment markets. However, the sophisticated investor is still limited to the investment selections of the insurer as well as the presence of high front-end sales loads.

Targeting the High Net Worth Marketplace. The high net worth PPLI marketplace had its start in the offshore marketplace. Small offshore life insurers such as Isle of Man Assurance created customized VUL policies for wealthy American families in the early to mid-1990s. A number of onshore and offshore companies seemed to pursue the development and marketing of PPLI for the high net worth marketplace concurrently. Tremont, the former hedge fund consulting company, developed a Bermuda-domiciled carrier focused on providing a tax efficient solution for hedge fund investors. The Italian life insurer Generali also provided a U.S. tax-qualified PPLI solution from a Guernsey-domiciled life insurer in the 1996-1997 timeframe.

The earliest marketing and sales activity in the domestic high net worth PPLI marketplace that the author is able to document occurred around 1993 with CIGNA.[14] John Hillman and John Fischer purchased a small Pennsylvania term insurer under rehabilitation in 1996 and converted the company, American Guardian Life (AGL), into a specialty life insurer focused on PPLI and PPVA. American General (a subsidiary of AIG) started a joint venture with Templeton funds in 1998 and then bought out Templeton in 1999. Sun Life of Canada entered the marketplace along with New York Life in the early part of 2000-2001.[15]

Some of the larger life insurers have exited the marketplace—Sun Life, MassMutual, New York Life, and Nationwide. The two leading carriers in the domestic marketplace currently are Philadelphia Financial Life Assurance and American General. PPLI represents a small market for these very large carriers but requires a high degree of "touch" and service for a very demanding and well-advised clientele. The specialty life insurers that focus exclusively on high net worth private placement are designed to "manufacture" and service customized insurance contracts.

PPLI policies were created with the following question in mind: How can a sophisticated high net worth investor combine the strong tax advantages

[14] The prolific Philadelphia-based life insurance agent Alvin Block was the earliest and most significant PPLI producer in the high net worth marketplace. He motivated CIGNA to offer the same product technology to his family office clients who invested in hedge funds. The author has spoken with Mr. Block numerous times over the years regarding the private placement life insurance business and more specifically his involvement in the business.

[15] The author over the last decade has had personal relationships with the senior management of life insurers operating in the high net worth private placement insurance business.

of life insurance with a life insurance product that offers customized investment options and is institutionally priced?

As previously mentioned, the PPLI assets are not subject to the claims of the insurer's creditors in the event of the insurer's default. PPLI had initially been available in the corporate marketplace with very high minimum premiums, or alternatively in the offshore market with under-capitalized noninstitutional quality carriers. But the marketplace has changed in the last several years to make PPLI available at a lower premium threshold.

Overview of Securities Law Authority for PPLI

PPLI is a non-registered security for federal and state securities law purposes. The product is available to accredited investors and qualified purchasers as defined in federal securities law. The Securities Act of 1933 provides an exemption under Section 4(2) from securities registration for accredited investors as defined in Rule 501(a) of Regulation D under the Securities Act.[16] An accredited investor is defined as an investor with a net worth of at least $1 million and joint income of at least $300,000 in each of the last two years, with the likelihood of continuation in the current year.[17]

PPLI offerings are exempt from the Investment Company Act of 1940 under Section 3(c)(1) and 3(c)(7) offerings. Under Section 3(c)(1) the number of beneficial owners is limited to 99 investors.[18] Investors must be accredited investors or qualified purchasers. A qualified purchaser has investable assets of at least $5 million. Under Section 3(c)(7) the number of beneficial owners is limited to 499 investors.[19] The investors must be qualified purchasers. New SEC proposals would exclude the value of an investor's principal residence from investable assets.[20]

Overview of Tax Law Applicable to PPLI

Definition of Life Insurance. The tax law definition of life insurance is found in Code Section 7702. Two different definitions of life insurance are provided and the policyholder must select the definition to be used at the time of the policy's issuance and maintain that definition throughout the policy's life. The cash value accumulation test tends to be used more in COLI transactions.[21] This actuarial test provides for a lower initial death benefit

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[16] See 17 CFR § 230.501.

[17] See id.

[18] Investment Company Act of 1940 § 3(c)(1).

[19] Investment Company Act of 1940 § 3(c)(7).

[20] SEC Release Nos. 33-9287; IA-3341; IC-29891; File No. S7-04-11.

[21] See IRC § 7702(b).

relative to the initial premium, but has a larger net amount at risk in older ages near actuarial life expectancy (age 82). The net amount at risk is the difference between the policy's total death benefit and cash value. The net result is that the higher mortality cost in the older ages does not produce cash value accumulation as high as the second test—guideline premium test/cash value corridor.

Most high net worth PPLI transactions use the guideline premium test, which also utilizes the cash value corridor requirement found in Section 7702.[22] The guideline premium test using the cash value corridor provides the policy with better long-term cash accumulation. The cash value corridor reduces the amount of net amount at risk over the life of the policy. For example, at age 90, the policy no longer requires any risk transfer in excess of the policy cash value, i.e., the policy death benefit and cash value can remain equal.

Modified Endowment Contract Rule. Section 7702A provides that a modified endowment contract (MEC) is a life insurance policy that is overfunded in the initial years of its existence based upon the timing and amount of premiums paid in relation to its death benefit. The MEC rules are essentially designed to discourage policy premium front-loading in the manner in which Congress believes too closely resembles the way an investor would make his or her investment in an annuity product.

The determination of whether a life insurance policy is an MEC is based on complex actuarial calculations and what is known as the "seven-pay" test. Generally, a policy is an MEC where, for example, the cumulative premiums paid at any time during the first seven years of the contract exceed the sum of the maximum net level premiums that could have been paid on or before such time, if the contract provided for paid-up future benefits after the payment of seven level annual premiums. Effectively, this test requires that the premiums paid into the policy be made over several years, as opposed to a single up-front payment. The seven-pay test, through complex actuarial assumptions and calculations, can be passed for a premium payment period of only four years.

The following repercussions arise following characterization of a life insurance policy as an MEC:

- Loans taken from or secured by the policy are generally deemed to be distributions of earnings from the policy.[23]
- All distributions, including payments upon the lapse or surrender of an MEC policy, are generally taxable as ordinary income up to the

[22] See IRC § 7702(c).

[23] See IRC § 72(e)(10).

amount by which the cash surrender value of the policy exceeds the cumulative amount of premiums paid into the policy.[24]

- A 10 percent additional income tax is imposed on all distributions made prior to the insured attaining age 59½—provided, however, that this penalty shall not apply where the insured is disabled, or where such distributions are part of a series of substantially equal periodic payments extending over the life of the taxpayer.[25]

Where an insurance policy is not characterized as an MEC, loans can generally be made from the policy on a "tax-free" basis. This result will ordinarily still be achieved in cases where the cumulative loans are in excess of the cumulative premiums paid into the policy

The policy's cost basis is its cumulative premiums. Loans and partial surrender of the cash value are the primary mechanism whereby the policy owner is permitted to have access to a portion of the investment account during the insured's lifetime. As such, non-MEC status is of critical importance in order to obtain the full benefits of this planning.

Investment Diversification of Variable Insurance Policies. The taxation of variable insurance products is covered in Code Section 817(h). Treasury Regulations 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 are not found in retail variable life and annuity products such as direct investment in real estate and commodities.[26]

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.[27] Therefore, a fund must have at least five investments in order to meet the diversification requirements.

The cliché "the devil is in the details" is a fitting statement to describe the application of the rules. Treasury Regulations Section 1.817-5 provides detailed guidance on the investment diversification rules. The regulations interpret these rules for investment asset classes that are rarely seen in retail variable insurance products and only recently in private placement insurance

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[24] See id.

[25] See IRC § 72(v), (t).

[26] See Gerald R. Nowotny, "Private Placement Group Variable Annuity Contracts—A Market Overview for Tax-Exempt and Foreign Investors," 29(2) J. Tax'n Invs. 49 (Winter 2012).

[27] See IRC § 817(h) and Treas. Reg. § 1.817-5(b).

products for the high net worth marketplace. Partly this has to do with the limitations of each jurisdiction's life insurance non-forfeiture rules dealing with death benefit liquidity as well as the liquidity necessary for policy loans and policy surrender. As a result, most retail variable insurance products have registered funds that provide for daily liquidity and daily mark-to-market for investment fund net asset valuation purposes.

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 does not meet the diversification requirements on the last day of each quarter.[28] The regulations provide a one-year start-up period that begins the day a fund receives its initial funding.[29] Real property accounts have a five-year period to meet the diversification requirements.[30]

A fund that was previously diversified but for the appreciation or depreciation of securities within the portfolio continues to remain diversified.[31] 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. A portfolio of Treasury securities is considered to be automatically diversified.[32]

An important aspect of the investment diversification rules is the so-called "look-through" treatment of certain securities. The rules provide look-through treatment only to funds that are exclusively available through variable insurance company separate accounts. Revenue Rulings 2003-91 and 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.[33] 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 receive look-through treatment providing the ability to look through to the underlying securities of the fund. The Service ruled that these non-partnerships would no longer receive look-through treatment under Treasury Regulations Section 1.817-5(f)(ii) since the ability to invest in the fund was not exclusively available to policyholders of variable insurance products. These so-called "publicly available" securities would be treated as a single security for investment diversification testing purposes.[34]

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[28] See Treas. Reg. § 1.817-5(c).

[29] See Treas. Reg. § 1.817-5(c)(2)(i).

[30] See Treas. Reg. § 1.817-5(c)(2)(ii).

[31] See Treas. Reg. § 1.817-5(d).

[32] See Treas. Reg. § 1.817-5(b)(ii)(A), (B).

[33] Rev. Ruls. 2003-91, 2003-2 CB 347; 2003-92, 2003-2 CB 350.

[34] See Treas. Reg. § 1.817-5(f)(3).

The regulations look to the investment diversification rules under Section 851(b)(4) for registered investment companies as well.[35]

Investor Control Doctrine. In a life insurance or annuity contract, it is the policyholder (owner) that has the ability to control and manage the incidents of ownership associated with the policy. One of the incidents of ownership is the ability to control the investment decisions or fund selection within the policy. Two notions of investor control exist.

The first notion is the subject of several rulings and cases dealing with "wrapping" publicly available investments. The Service has ruled a number of times regarding the ability of a policyholder to "wrap" investments that are "publicly available," i.e., not limited exclusively to life insurance company separate accounts,[36] and it was ultimately decided in *Christoffersen v. United States*[37] that the taxpayer and not the insurance company should be taxed on the policy's underlying income.

The second notion presents the more serious problem. It deals with the idea that a policyholder retains so much direct or indirect control over investments that the policyholder is deemed to be in constructive receipt of the underlying investments within the policy. As a consequence, the policyholder forfeits the substantial tax advantages of life insurance and annuities. Ultimately, this second notion of investor control requires a fact specific determination.

Operational and Administrative Considerations. As previously stated, one of the principal advantages of PPLI and PPVA is the ability to customize investment options within the policy. How is this process accomplished? The life insurer performs an investment due diligence review of the proposed investment manager. Some life insurers outsource this task to consultants with special asset classes. This due diligence review will consider the personal and business background of the investment principals; investment track record; assets under management; and business history, as well as business model.

Following the creation of an insurance dedicated fund (IDF) by the investment firm, the life insurer will sign a participation agreement to subscribe to the fund. The investment manager is responsible for certifying to the life insurer on a quarterly basis that it has met the investment diversification requirements of Section 817(h) and is in compliance with the investor control doctrine. The investment manager will normally report the net asset value

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[35] See Treas. Reg. § 1.817-5(f)(1).

[36] See Rev. Ruls. 77-85, 1977-1 CB 12; 80-274, 1980-2 CB 27; 81-225, 1982-2 CB 12; 82-54, 1982-1 CB 11.

[37] 749 F2d 513 (8th Cir 1984), *cert. denied*, 473 U.S. 905 (1985).

of the policyholder's investment on a monthly or quarterly basis depending upon the underlying investment strategy.

The PPLI private placement memorandum (PPM) is like the U.S. Constitution—it is a living and breathing document. The PPM may be amended on an ongoing basis to add new investment options. These amendments normally do not require any advance filing with the department of insurance within the jurisdiction where the policy was issued or the insurer's domicile.

U.S. vs. Offshore Insurance Domiciles

Domestic PPLI. PPLI is available in both the domestic and offshore marketplaces. The decision of which offering to purchase is a function of the investor's personal tax planning needs. Generally, the domestic offering for a U.S. taxpayer provides coverage through an institutional-quality carrier with a long track record, independent third-party ratings, and extensive regulatory oversight by the various states and industry groups. The domestic carrier may be able to accommodate a much larger policy investment due to the greater availability of reinsurance. The only limiting factor is the availability of reinsurance. Currently, the reinsurance market has capped mortality risk at $65 million per policy. The availability of reinsurance is two to three times greater in the domestic market than in the offshore market.

The policy must satisfy the tax definition of life insurance under Section 7702 in order to preserve the tax advantages for a U.S. taxpayer or resident alien. A trade-off in the domestic market is the imposition of a state premium tax. State premium taxes vary between 1 percent and 3 percent, depending upon the state. However, two states, Alaska and South Dakota, have instituted the lowest premium taxes (below 1 percent).

The financial impact of the state premium tax within the product is approximately 15 to 20 basis points on the policy's internal rate of return over the long term. A federal tax known as the DAC (Deferred Acquisition Cost) is an additional cost within the product. This tax is amortized by the carrier through a 0.80 percent to 1 percent premium load within the product.

The high net worth PPLI marketplace has undergone consolidation in the last two years. Large traditional life insurers such as Sun Life, New York Life, and Nationwide have exited the marketplace. PFLAC has recently acquired the private placement insurance business from The Hartford, giving PFLAC an additional $35 billion of assets under management in variable separate accounts. American General has operated successfully over the last 12 years. These offerings have minimized the importance of offshore domicile options.

Additionally, Puerto Rico, a U.S. Commonwealth, has emerged as a new jurisdiction. As a Commonwealth, Puerto Rico is not subject to the compliance

requirements of the Foreign Account Tax Compliance Act (FATCA).[38] Policyholders are not subject to the Report of Foreign Bank and Financial Accounts (FBAR) requirements.[39] Effectively, Puerto Rico is an "onshore offshore" jurisdiction. The Puerto Rican Congress approved legislation for international life insurers, e.g., life insurers issuing policies to non-Puerto Rican life insurers. At the present time, two Puerto Rican specialty life insurers—Ashley Cooper Life International Insurer SPC and U.S. Commonwealth Life Insurance Company—issue private placement insurance contracts. The companies were formed in response to the increased scrutiny and regulation of transactions in offshore jurisdictions.

Offshore PPLI. The asset protection opportunities available in certain tax-haven jurisdictions may point an investor toward an offshore purchase. A combination of asset protection planning and the policy's exempt status under the rules of the foreign jurisdiction make it a good choice. Generally, most offshore life insurance jurisdictions have adopted separate account legislation that exempts the separate account assets from the claims of the insurer's creditors. These rules parallel the separate account treatment found in domestic offerings. The policy is also exempt from the claims of the policyholder's creditors. Tax haven jurisdictions have adopted sophisticated trust legislation to protect the assets of a trust. The Cook Islands and Nevis are two well-known jurisdictions with favorable treatment of trusts from an asset protection standpoint. The Cook Islands has abolished the Statute of Elizabeth, which recognizes judgments from a jurisdiction forcing creditors to bring a new legal action. The Cook Islands also has a short statute of limitations—two years.[40]

From an insurance standpoint, the difference in the insurance regulatory environment provides the opportunity to offer offshore PPLI with investment options that are less liquid. Investment options within a domestic VUL, for example, may be restricted to the extent that they provide little investment liquidity. Offshore PPLI may provide access to non-SEC-approved offshore investments that are unavailable in the United States. All U.S. states have adopted nonforfeiture laws, which require paying the policyholder in cash within six months from the time of notification for policy loan or surrenders. Similarly, most U.S. states have adopted statutes with respect to the timeliness of the death benefit payment.

Generally, a death benefit payment made after a 30-day period carries an interest penalty, which can be as high as 12 percent in some domestic

[38] Subtitle A of Title V of Hiring Incentives to Restore Employment Act, P.L. 111-147 (2010) (codified at IRC §§ 1471-74).

[39] 31 CFR Part 1010.350.

[40] Cook Islands International Trust Act of 1984. Nevis has very similar legislation; it has also abolished the Statue of Elizabeth and has a two-year statute of limitations. Similarly, it has a "beyond a reasonable doubt" standard as the burden of proof for fraudulent conveyance.

jurisdictions. While many states would allow, by means of a policy endorsement, an in-kind death benefit of the limited partner interest, Revenue Rulings 2003-91 and 2003-92 have placed in question the ability to use this endorsement from the standpoint of the investor control doctrine.[41] While an offshore insurance regulator would allow for much greater flexibility in this area, the in-kind benefit is still subject to the same federal tax considerations regarding the investor control doctrine.

As a result, both domestic and offshore life insurers have opted for a deferred payment endorsement. Depending upon the jurisdiction, a life insurer may have the ability to delay payment from six months up to an indefinite amount of time. Offshore PPLI may allow investment options such as private placement offerings for venture capital, private equity, and leveraged buyout which tend to have longer "lock up" periods. Domestic carriers will frequently only allow a lock up and payment deferrals of up to one year. These investment offerings are generally highly illiquid. Many states have approved carrier endorsements for deferred payment on policy benefits.

The offshore PPLI acquisition may also confer a cost savings through avoidance of a state premium tax. Avoidance of the state premium tax may confer a 15-20 basis point advantage on the return over the long-term. Generally, a person seeking life insurance who is a U.S. taxpayer or who wants to name beneficiaries who are U.S. taxpayers should purchase a policy that is compliant with Section 7702 through an insurer which has made a Section 953(d) election.[42] The Section 953(d) election is a corporate election that allows the insurer to be treated as a U.S. taxpayer; this removes the risk of the carrier being "dragged" onshore as a U.S trade or business because it is insuring U.S. lives. (If such dragging were to happen, the risk to the policyholder is that the policy would need to be repriced for U.S. corporate taxes, which would have a devastating impact on the policyholder. As a result, a U.S taxpayer should purchase a policy from an insurer that has made this election.)

A U.S. non-resident alien may also purchase PPLI from an offshore carrier. For such a non-resident, the policy need not be U.S. tax compliant. As a result, the policy can maintain a minimal ratio of death benefit-to-cash value. Generally, European-styled unit-linked policies have a death benefit which is 101 percent to 110 percent of the cash value. Most jurisdictions around the world confer tax-advantaged treatment to life insurance, and many countries are adopting the concept of worldwide taxation. These policies do not require a carrier which has made the Section 953(d) election.

The Section 953(d) election is still important for a non-resident alien who purchases a policy that has U.S. investments which generate investment

[41] See supra note 33; notes 36–37 and accompanying text.

[42] See IRC § 953(d).

income subject to the 30 percent withholding tax on fixed and determinable periodic income under Section 871(a).[43] Section 1445 can create a withholding tax for investment in U.S. real estate and Section 871(b)(2) for effectively connected income (ECI) to a U.S. trade or business in the event the life insurer has not made a Section 953(d) election.[44]

Due to the small number of reinsurers operating in the offshore high net worth PPLI marketplace, the availability of reinsurance for large premium investments is roughly two to three times greater in the domestic market. While it is widely believed that that the pricing of offshore policies is more competitive than that for domestic policies, this claim may not be true. The offshore markets have few carriers in general and even fewer institutional quality carriers. The competition among institutional-quality carriers is not as great as in the domestic marketplace.

Bermuda and the Cayman Islands are the primary offshore jurisdiction for offshore insurers. Both have a long, stable history politically and economically. In choosing an offshore situs, political and economic stability are critical factors.

Tax Advantaged Wealth Accumulation Using PPLI

A sophisticated investor can use PPLI to enhance the after-tax accumulation of tax-inefficient investments by redeploying these investments (such as hedge funds) in a manner that promotes a significantly higher net after-tax return. Private placement insurance products are ideally suited to accomplishing this planning objective.

The policy has no surrender charges, and the sales loads and front-end policy administrative expenses are minimal. As a result, the cash value immediately exceeds the initial premium absent negative investment performance. In typical high net worth PPLI transactions, policies are designed to provide the least amount of insurance death benefit necessary in order to comply with the requirements of the Internal Revenue Code definition of life insurance while providing a minimal increase in the actual death benefit in excess of the cash value account accumulation.

How It Works. Table 1 depicts an example of such a policy design and affords a simple contrast to that of a typical taxable investment in a hedge fund.

In this example, the insured is a 50-year-old male who is a preferred non-smoker for medical underwriting purposes. He has $10 million in a hedge fund earning 15 percent per year after management fees. For this example, his marginal tax rate is assumed to be 47 percent (federal, state, and local).

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[43] See IRC § 871(a).

[44] See IRC §§ 1445, 871(b)(2).

Table 1: Hypothetical $10 Million PPLI Policy Designed for a 50-Year-Old Male

Year	Net Taxable Investment Value ($)	End of Year Policy Cash Value ($)	Death Benefit ($)	Net Taxable Investment IRR (%)	Policy Cash Value IRR (%)	Death Benefit IRR (%)
1	10,795,000	11,362,510	35,943,930	7.95	**13.62**	**259.44**
2	11,653,203	12,912,620	35,943,930	7.95	**13.62**	**89.60**
3	12,579,632	14,684,290	35,943,930	7.95	**13.65**	**53.18**
4	13,579,713	16,710,230	35,943,930	7.95	**13.69**	**37.68**
5	14,659,300	19,019,330	35,943,930	7.95	**13.75**	**29.15**
10	21,489,508	36,525,140	48,943,680	7.95	**13.84**	**17.24**
15	31,502,114	70,617,360	86,153,180	7.95	**13.91**	**15.44**
20	46,179,894	136,575,200	158,427,200	7.95	**13.95**	**14.82**
30	99,238,319	525,828,200	552,119,600	7.95	**14.13**	**14.32**
40	213,258,263	2,004,725,000	2,104,961,000	7.95	**14.17**	**14.31**

The policy is an MEC, which uses the guideline premium/cash value corridor definition of life insurance. The death benefit option is the increasing death benefit option (Option B) which includes the initial death benefit plus the accumulated cash value.

This investment is compared to a similar deposit into a hypothetical hedge fund life insurance policy. As Table 1 indicates, the cost of the tax-advantaged hedge fund is substantially lower than the cost of paying income taxes. The illustrated results project a total cost of 138 basis points in the early years dropping to approximately 80 basis points over time as the "price tag" to avoid income tax. (Among items that may affect this illustration with a "real" client are the actual age and health of the insured, his or her actual marginal tax rate, and the actual performance of the hedge fund.)

At the death of the insured, the insurer will pay out the policy death benefit (which includes the value of the separately managed hedge fund account) to the beneficiary designated by the owner of the policy income-tax-free. During the life of the insured, the policy can be cashed in for an amount equal to the value of the separately managed account without the imposition of surrender charges (which would normally apply in a traditional life insurance policy), or the owner of the policy may access cash value via the use of loans taken against the policy.

Cost/Benefit Analysis. The cash value of the life insurance policy is increased by the investment performance and yields on the variable sub-account (again, a hedge fund in our example), without any erosion for

income taxes. The cost of setting up this type of policy (including issuance costs, servicing fees, etc.) will generally be significantly less than the first year's income tax savings on the hedge fund returns. Annual charges including the cost of the insurance protection will be between 50 and 150 basis points.

In return for the policy owner's willingness to assume these costs, the policy owner and the beneficiary (or beneficiaries, should more than one be named) will not be subject to current taxation of the inside build-up of the policy cash value (the separately managed investment fund value and accumulated earnings). Moreover, if the policy is maintained until the death of the insured, the entire death benefit will be received by the beneficiary free of all U.S. income taxes, including all of the earnings from the hedge fund investments from inception of the policy.

If estate tax minimization is a planning consideration, the policy's ownership should be structured in a manner so that the policyholder does not retain any incidents of ownership over the policy under Section 2042. If the ownership of the policy is properly structured and the insured has no incidents of ownership over it, the policy death benefit will be exempt from federal estate taxes. The net benefit of sheltering the investment income and accumulations from income and estate tax is the equivalent of a 400+ percent incremental rate of return (in any given year) on investment vis-a-vis the ownership of income and estate taxable hedge fund investments. The compounding effect of this incremental advantage produces much larger advantages over time.

Planning Considerations. As a part of the estate planning process, PPLI offering policy investment options may prove to be the appropriate solution to help meet a variety of objectives. The expiration of the Bush tax cuts will have a deleterious effect on family wealth. The top marginal estate tax rate is scheduled to return to 55 percent. The exemption equivalent will drop from $5 million to $1 million per taxpayer. Clearly, for wealthy individuals, the issue of funding the payment of the federal estate tax will become extremely important once again. Ultimately, investment performance is the biggest factor in life insurance product performance. The difference in policy costs and reinsurance costs between carriers is not significantly different. Long-term investment performance can easily overcome the differential between these costs. Family offices and multi-family offices need the ability to include alternative investments within the fund selection of a life insurance policy. These wealthy families also prefer institutional pricing.

For wealthy individual investors who currently have traditional cash value life insurance policies, the possibility of securing a more aggressive investment alternative and a lower cost structure for their life insurance is

available These existing policies may be exchanged for new policies without the imposition of income tax on the accumulated earnings within the policy. The Code enables owners of such policies with the opportunity to exchange them for new policies on an income-tax-free basis. Section 1035 provides that an existing insurance policy may be exchanged for a new insurance policy on the same insured providing all of the federal and state formalities attendant to the exchange are completed between the insurance companies involved with the exchange. These rules enable the exchange to occur with no cash coming into the hands of the policy owner at any time during the process.

For example, it may therefore be possible for the wealthy investor with significant existing cash value life insurance that is owned in an irrevocable life insurance trust to seek the cooperation of the trustees of that trust in converting the existing policies into insurance policies that will provide enhanced benefits to family members. It is important to note that these trusts may be useful in providing the beneficiaries with income and support benefits during the life of the insured patriarch or matriarch. However, the insured is subject to medical underwriting requirements. The existing policy should not be exchanged until the new insurance offer is in place.

One of the failures of traditional life insurance trust planning is that there is generally limited availability of funds to provide lifetime benefits because of the cost structure and investment performance. It is not uncommon for grantors/insureds under such trusts to complain that there are no benefits available for their children "until I die." PPLI, with its potentially superior investment performance and lower cost structure, is uniquely suited to meet the income needs of such grantors as it enables more aggressive investments that may increase cash accumulations, which can be accessed as policy loans during their lifetime without compromising the integrity of the death benefits that the policy is designed to produce.

Tax Advantaged Wealth Accumulation Using PPVA

Product Basics. PPVA policies have no surrender charges and, like PPLI, the investment options may include sophisticated investment options such as hedge funds. The typical retail variable annuity pays the agent a commission equal to 4 percent to 6 percent of premiums paid into the policy, and has declining surrender charges over five to eight years. The contract additionally pays the agent, through the agent's broker-dealer, an asset-based charge of 25 to 35 basis points. Retail variable annuity contracts typically provide the policyholder with a wide range of mutual fund subaccounts. PPVA contracts have customized and negotiated sales loads that generally are equal to 1 percent to 2 percent of each premium deposited into the contract. These sales loads are much lower than those for retail variable annuity contracts.

The taxation of annuity contracts is governed by Section 72. PPVA contracts are also subject to the same investment diversification and investor control considerations as PPLI under Section 817(h) and Treasury Regulations Section 1.817-5. PPVA provides for tax deferral.

The retail variable insurance market offers immediate variable annuities, which provide for annuity payments to the annuitant within a year of the premium payment. Rather than provide a "fixed" payment, variable immediate annuities provide for payments that increase or decrease based upon the investment performance of the underlying investment(s) within the contract. The policyholder is able to make an election to determine fund selection. These contracts are not yet available with the high net worth PPVA marketplace. Generally, wealthy individuals have other sources of income and use insurance products for tax-advantaged accumulation rather than income planning.

The retail variable marketplace has evolved with a number of interesting product developments and features. Other features found in retail variable insurance products that are not found in PPVA products include the Guaranteed Minimum Death Benefit Rider and the Guaranteed Minimum Income Benefit Rider. These riders provide a guaranteed income at age 65 regardless of the underlying investment performance of separate account investments. Similarly, the policy also provides for a guaranteed accumulation payable at the death of the policyholder. These contracts come at a price. It is not uncommon for a life insurer in the current market to offer a 5 percent guaranteed return while charging 4 percent (including the policy's mortality and charge expense).

Cost/Benefit Analysis. It is not clear when and why variable deferred annuities garnered such a bad reputation among the financial press. When did tax deferral become such a bad thing? Most likely it is due to the product pricing and sales loads. PPVA contracts maximize the benefits of tax deferral with institutional pricing and sales loads. The investment flexibility and range of investment possibilities make PPVA contracts an ideal vehicle for registered investment advisors to utilize as part of the investment planning process. High net worth investors should consider a tax-free exchange (under Section 1035) from a retail variable annuity to a PPVA contract. The contract is ideally suited for managing asset classes that generate ordinary income such as interest, dividends, and short-term capital gains.

The sophisticated planning opportunities are not lost on ultra-high net worth individuals who may be heavily invested in tax-inefficient hedge fund strategies. Additionally, families with multigenerational wealth may already have significant investment assets managed outside the taxable estate in trusts. If these assets are held in grantor trusts, the income will be taxed to the settlor

for income tax purposes.[45] Non-grantor trusts are separate taxpayers. The top marginal tax bracket for trusts is reached with only $11,200 of income.[46]

Planning Example: Dynamic Annuity. Trustees can use PPVA contracts to perpetuate a family dynasty on a tax-deferred basis using PPVA contracts—a so-called dynasty annuity. The non-natural person rule of Section 72(u) provides that deferred annuities lose the benefit of tax deferral when the annuity owner is a non-natural person, but the legislative history of Sections 72(u) and 72(u)(1)(B) provides an exception for annuities that are "nominally owned by a non-natural person but beneficially owned by an individual."[47] This exception describes the typical arrangement in a personal trust. The IRS has reviewed this issue with respect to trusts at least eight times in private letter rulings and has ruled favorably for the benefit of the taxpayer in each instance.[48]

Section 72(s)(6) deals with the distribution requirements of an annuity owned by a non-natural person (e.g., a trust). It provides that the death of the primary annuitant is the triggering event for required distributions from the annuity contract.[49] The primary annuitant must be an individual. Distributions must begin within five years following the death of the primary annuitant for the trust-owned annuity. At death, the annuity account balance may be paid out over the life expectancy of the beneficiary, providing additional deferral.[50]

The dynasty annuity involves the purchase of a PPVA contract by the trustee of the family trust. The trustee selects young annuitants (grandchildren or great grandchildren) as the measuring lives of the annuity in order to maximize tax deferral within the PPVA contract. This structure maximizes tax deferral over the lifetime of the PPVA's young annuitant. In the case of a three-year-old grandchild, tax deferral could be accomplished for more than 80 years before a distribution is required.

The transaction can be summarized as follows:

- *Purchase of a PPVA contract:* The trustee of the family dynasty trust is the applicant, owner, and beneficiary of the PPVA contract(s).

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[45] See IRC §§ 671-679 for the different grantor trust rules.

[46] See IRC § 641.

[47] See IRC § 72(u)(1)(B).

[48] See, e.g. PLRs 199933033 (May 25, 1999); 199905015 (Nov. 5, 1998); 9639057 (June 24, 1996); 9204014 (Oct. 24, 1991); 9009047 (Dec. 5, 1989).

[49] See IRC § 72(s)(6)(A).

[50] See IRC § 72(s)(2)(C).

- *Selection of young annuitants:* The critical element in the maximization of tax deferral is the selection for each separate PPVA contract of a young annuitant(s) with the greatest potential of living to normal life expectancy. The trustee may purchase multiple policies with different individual annuitants to "hedge" against the possibility of exposing the trust to a tax burden as a result of distribution requirement caused by the pre-mature death of an annuitant.

All of the investment income and gains from the PPVA will accrue within the contract on a tax-deferred basis. Prior to the annuitant's death, the trustee may request a distribution from the life insurer in order to make a distribution to a trust beneficiary. At the death of the annuitant, the trustee will be required to make a distribution of the annuity based upon the life expectancy of trust beneficiaries over the life expectancy of trust beneficiaries (presumably the surviving children).

The approximate cost of the PPVA contract is 40 basis points per year. The PPVA contract has the flexibility to add investment options to the contract. The customized account provides an open architecture allowing the investment advisor to manage based upon its asset allocation model and changes to the model. A $10 million single premium invested into a PPVA contract earning 8 percent per year over an 80-year period, e.g., would grow to $2.5 billion in the eightieth year. This small example illustrates the power of tax deferral compounding over a long time period.

Frozen Cash Value Policies

Product Basics. Restricted cash value private placement life insurance, also known as frozen cash value life insurance (FCV), is best known as a flexible premium variable adjustable (universal) life insurance policy that is issued by offshore life insurance companies domiciled in tax-haven jurisdictions such as Bermuda or the Cayman Islands. Also, as noted earlier, Puerto Rican companies are entering the market. One new specialty life insurer there now offers both traditional PPLI and FCV policies. The possibilities and benefits of a life insurance policy with a restricted cash value were originally described in the October 1994 issue of *Offshore Investment*.[51] The policy is intentionally designed to violate Section 7702,

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[51] Craig Hampton, "The Hampton Freeze—International Life Insurance Planning at its Best," Offshore Inv. (Oct. 1994), available at http://www.offshoreinvestment.com/pages/index.asp?title=Offshore_Investment_-_Login&ID=1592&issueID=9806. His later update, similarly titled and published in Oct. 1995, is available at http://www.offshoreinvestment.com/pages/index.asp?title=Offshore_Investment_-_Login&ID=1464&issueID=9806.

the tax law definition of life insurance. The other legal considerations are imposed under the insurance laws of the jurisdiction where the coverage is issued. Generally speaking, all of the carriers issue the coverage as variable life insurance. In most cases, the policy is issued by non-Section 953(d) electing carriers.

Under most FCV contracts, the death benefit is equal to the sum of the guaranteed specified amount of death benefit plus the cash value on the claim date plus the policy's mortality reserve value on that 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. Some insurers issue 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 any accrued unpaid fees or expenses due under the terms of the policy. The cash surrender value of the policy is the lesser of the cash value or 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.

Cost/Benefit Analysis. FCV policies do not provide for or guarantee any minimum cash value. The cash value increases or decreases depending upon the investment experience of the policy fund. The insurer holds the appreciation of the assets (in excess of the amount of cumulative premiums) in the separate account as a mortality reserve 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 tax-free 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 up to 90 percent of the policy's cumulative premiums. Loan terms vary from company to company. The significance of a partial surrender versus a policy loan is that the partial surrender will not leave the policy with a liability. The surrender and loan proceeds are tax-free under any circumstance, therefore the policyholder has access to policy assets on a tax-free basis.

Tax Law Analysis. For a U.S. taxpayer, the FCV policy is taxed under Section 7702(g). Technically, the taxation of the defective life insurance policy would result in the taxation of the policy's inside build-up as well as the mortality cost based upon the policy's net amount at risk. The net amount at risk is the difference between the policy death benefit and cash value. However, because the FCV contract defines the cash value as cumulative premiums, there is never any inside build-up under the contract. The net

amount at risk is limited to a fixed amount or percentage. Section 7702(g) provides that the death benefit is income tax-free under Section 101(a).[52]

A strong technical argument (although not supported by any existing rulings) can be made that the investor control doctrine is not applicable to FCV contracts. First, the contract is intentionally noncompliant with Section 7702. Second, it is designed so that there is no inside build-up of the cash value as defined within the policy form during the lifetime of the insured. Finally, because the policyholder is unable to access any benefits under the contract other than a portion of his cumulative premiums until death, there is a strong argument against any constructive receipt or control of investments within the policy.

Planning Considerations. FCV contracts are an excellent planning tool in certain situations. Large investment deposits into a traditional PPLI contract may not be possible due to the limitations of the life reinsurance market. The FCV contract provides better tax results than a PPVA contract during lifetime or at death. The single premium deposit is not subject to the MEC rules of Section 7702(a). The inside gain due to investment performance is not accessible during lifetime, but a substantial portion of the initial premium (90 percent) may be borrowed by the policyholder income-tax free.

Unlike a deferred annuity contract, which mandates taxable distributions at death under Section 72(s), the FCV contract provides for the payment of an income-tax-free death benefit at death. Also, the FCV contract is not subject to the non-natural person rules of Section 72(u); therefore the FCV contract may be considered in circumstances where an annuity would have been used but for the non-natural person rules.

The FCV contract might also be used in corporate-owned life insurance for funding SERPs and post-retirement benefit programs. The reduced death benefit corridor on the FCV contract due to the fact that it does not need to comply with the cash value corridor requirements of Section 7702 could reduce mortality charges within the contract substantially, as much as 40 to 50 basis points. The compounding effect of these savings within the contract over a long period can enhance accumulation significantly.

Example of an FCV Contract. Table 2 illustrates the operation of an FCV contract for a client who is 62 years old when the policy is issued. The initial premium is $10 million, and the investment return assumption is 12 percent (net in all years). The FCV contract is designed with a death benefit corridor of 105 percent of the initial premium. The long-term fractional reduction in the investment return is only 25 basis points. The death benefit is paid to the beneficiaries on a tax-free basis.

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[52] See IRC § 7702(g)(2).

Table 2: Hypothetical $10 Million FCV Policy Designed for a 62-Year-Old Male

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**

Conclusion

Private placement insurance contracts are unique investment vehicles that are grossly under-utilized by professional advisors. These institutionally priced variable insurance contracts allow for investment customization and provide for the possibility of stronger and more consistent investment performance. The tax advantages of life insurance and deferred annuities are well known, but not on this institutional platform. The cost of the insurance contract presents very little "drag" on investment performance. Ultimately, it is strength and consistentency that are the biggest catalysts in investment performance.

As outlined herein, there are several options within the realm of private placement insurance. Life insurance agents have not been and will not be the catalyst of the sector's growth due to a fundamental conflict of interest—their large commissions. Thus, it is up to professional advisors—lawyers, accountants, trust officers, and private bankers—to bring the planning possibilities to the attention of their clients. The long-term results can be stunning, providing families with generations of tax-advantaged wealth accumulation.

The thought of what lies ahead from a tax perspective for high net worth investors is daunting, to say the least. There is a very high likelihood we will see combined marginal federal and state income tax rates in excess of 50 percent, along with the return of higher federal estate tax rates and a reduction of available income tax deductions. High net worth investors will need to rely on their advisors to steer them to viable tax structures with an underpinning of strong statutory authority. The life insurance industry has managed to preserve the favorable taxation of life insurance and annuities. Tax professionals should not let their clients miss out on a good planning opportunity.