Private Placement Life Insurance and Annuities:

Applications for U.S. and Non-U.S. Taxpayers

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I. Introduction to Private Placement Life Insurance and Annuities

A. A Tax, Estate, and Investment Planning Tool with Multiple Applications

Successful advisors of high net worth individuals employ a holistic approach to their clients' planning, one that addresses all of the clients' goals simultaneously, rather than focusing on component goals in isolation. It requires the advisor to construct a plan that encompasses multiple areas of concern in a simple and understandable manner, that meets clients' needs, and that recognizes the interrelationship of those areas. Essentially, it means that advisors must consider investments, income taxation, transfer taxation, asset security, and philanthropy in unison to achieve optimal results.

This article examines private placement life insurance ("PPLI", also known as private placement variable life insurance) and private placement variable annuities ("PPVA"), two core planning strategies that allow holistic advisors to address a wide variety of client needs. As an investment tool, both PPLI and PPVA enable access to sophisticated investment strategies used regularly by high net worth investors. As an income tax planning tool, PPLI reduces income tax liability because it permits such investments to grow income tax-free.[1] As an estate planning tool, PPLI has multiple applications that mitigate estate tax liability and facilitate the orderly disposition of assets at death.[2] In contrast, PPVA is designed to supplement the client's estate during life. As an asset security vehicle, PPLI and PPVA offer both financial privacy and, in some cases, significant protection from future creditors. And, finally, PPLI and, particularly, PPVA represent powerful tools for augmenting philanthropic goals.

High net worth advisors appreciate that what a client "keeps" is more important than what a client "earns." Thus, successful advisors must understand and be able to implement tax-advantaged and asset-protected structures for their clients' passive investments. Because their underlying vehicle is a life insurance policy or commercial annuity, PPLI and PPVA present established and conservative opportunities for tax-efficient investing in a protected environment. Life insurance and annuities as financial products have had a long history in the United States as tax-advantaged investment products that have little associated legislative risk. Recognizing this benefit, certain carriers with well-established operations both inside and outside of the U.S. have decided to offer variable policies and annuities as "private placements" in the high net worth marketplace. Such policies are fully compliant with U.S. tax rules and are, therefore, fully entitled to the preferential tax treatment that life insurance and annuities enjoy under the U.S. tax system. They are also much less expensive compared to their traditional retail equivalents, and they provide access to sophisticated investment funds. Finally, PPLI and PPVA acquired from non-U.S. based insurers offer additional asset protection benefits and cost savings as compared with equivalent products acquired in the U.S.

In addition to the income tax benefits U.S. clients seek primarily when purchasing PPLI or PPVA, there are ancillary attributes of these products that clients often view as "icing on the cake." For example, with PPLI, many clients view the death benefit payable in addition to the cash value as simply an expense associated with the policy; however, the death benefit element has

[1] PPVA defers the payment of income tax liability, but, unlike PPLI, it does not allow the investments to grow completely income tax-free.

[2] This article assumes the application of the income, estate, and gift tax system in effect as a result of the American Taxpayer Relief Act of 2012.

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many potentially useful estate planning applications. In addition, both PPLI and PPVA provide financial privacy and asset protection benefits that are of significant importance to the high net worth client. Finally, the simplification of the client's yearly tax compliance is frequently underappreciated in the planning stages, but clients tout it as a very important benefit once the policy has been in place for a few years.

B. Private Placement Variable Universal Life Insurance ("PPLI")

PPLI policies are generally structured as variable universal life contracts offered as "private placements" in the high net worth marketplace. A variable universal life policy allows not only flexibility with respect to the timing and amount of premium payments, death benefit options and levels, and withdrawals from the policy, but also allows the policy owner to allocate cash value amounts across a wide-range of investment options. PPLI policies are generally much less expensive than their retail equivalents (thus allowing for better investment accretion of premium contributions) and provide access to alternative investment classes such as hedge funds, hedge funds of funds, commodities, real estate, and options. PPLI is much less expensive than its retail equivalents for several reasons, the primary reason being agent compensation. Agent compensation for retail policies can be as high as 120% of the first year premium. Agent compensation for PPLI policies tends to be expressed as a percentage of cash value typically ranging from 0.20% to 0.50% annually with minimum front-end premium-based compensation.

To qualify as a PPLI purchaser, prospective policy owners who are U.S. persons must meet the criteria for "accredited investors" ("AIs") and "qualified purchasers" ("QPs") under Securities and Exchange Commission ("SEC") rules.[3] Non-U.S. persons, while not required to satisfy the accredited investor and qualified purchaser rules for U.S. securities law purposes, are also required by most insurance carriers to qualify as AIs and QPs. The primary purpose for this requirement is ease of administration for the carriers and funds, who do not want to distinguish between fund investors but rather want to ensure AI and QP status for all investors in the fund.

C. Private Placement Deferred Variable Annuities ("PPVA")

PPVAs are generally structured as deferred variable annuities. With a deferred variable annuity, the annuity owner makes one or more purchase payments to the insurance company. The contract assets (i.e., cumulative payments and accreted investment return) grow on a tax-deferred basis until the contract is annuitized and payments based on the annuitant's life expectancy commence. The annuity funds are invested through a separate account in various investment options, which the annuity owner chooses, and the annuity owner accepts the investment risk and benefits of the investment performance of the account assets. Due to the variable nature of the annuities, the distributions fluctuate with the underlying investment return. PPVAs vary from traditional deferred variable annuities because: (i) there are typically no surrender charges; (ii) the costs are typically less (not unlike PPLI without the application of the cost of insurance); and (iii) PPVAs allow for greater flexibility with investment options to include alternative asset classes such as hedge funds and funds of funds.

[3] Private placement products offered by U.S. carriers to U.S. persons are subjected to SEC regulations. *See infra* Section II.C.

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With all annuities, the pay-out period is determined once the annuitization occurs (i.e., pay-out commences). Typically, the pay-out option is either life contingent, where the payments are guaranteed for as long as the annuitant is living, or period certain, where the pay-out is guaranteed for a certain period of time (e.g., 10 years, 20 years, etc.), or a combination of life with period certain. With a period certain pay-out option, if the annuitant dies during the guaranteed period, the designated beneficiary can continue to receive the annuity payments for the remainder of the period certain, or elect to take a lump sum payment of the present value of the remaining guaranteed payments. If only a life contingent pay-out option is elected, if the annuitant dies, the undistributed accumulated amount reverts to the insurance company, instead of being paid to a designated beneficiary.

II. Ensuring Compliance as a U.S. Qualifying Product

A. U.S. Tax Treatment of Life Insurance

To qualify as life insurance for U.S. tax purposes and enjoy the tax benefits associated with life insurance, all life insurance policies must satisfy the requirements of § 7702 of the Internal Revenue Code of 1986, as amended ("Code").[4] Furthermore, to ensure that policy cash values accrue tax-free, all variable contracts, whether life insurance or annuities, must comply with the diversification requirements of § 817(h) and with the investor control doctrine.[5]

1. Qualifying as a Life Insurance Contract

To qualify for the advantages afforded life insurance under the U.S. Tax Code, a policy must satisfy the definition of life insurance under § 7702. Under this section, a "life insurance contract" must (a) be treated as a life insurance contract under applicable state or foreign law and (b) meet one of two alternative tests, (i) the cash value accumulation test ("CVAT") or (ii) a two-part test consisting of the guideline premium test ("GPT") and the cash value corridor test ("CVCT").[6] The purpose of these tests is to ensure that the primary goal of acquiring the contract is to secure life insurance by disqualifying policies created for their investment component without regard to the actual relationship between the cash value and the contractual death benefit.

a. Cash Value Accumulation Test ("CVAT")

Section 7702(b) establishes the cash value accumulation test. A contract satisfies this test if, by the contract's terms, "the cash surrender value of the contract may not at any time exceed the net single premium that a policyholder would have to pay at such time to fund future benefits under the contract" (effectively a certain relationship must exist between the cash value

[4] § 7702(a). All "section" and "§" references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, unless otherwise stated.

[5] Significant portions of this paper have been derived from Giordani, Ripp, and Reed, "Using Life Insurance and Annuities in the U.S. Tax Planning for Foreign Clients," 39 *Tax Management International Journal* (Mar. 2010).

[6] § 7702(a).

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and the death benefit at any point in time).[7] The CVAT assumes a maturity no earlier than the insured's age 95 and no later than the insured's age 100, and is generally applied to test whole life contracts.[8]

b. *Guideline Premium Test ("GPT") and Cash Value Corridor Test ("CVCT")*

Sections 7702(c) and (d) set forth the guideline premium requirements and the cash value corridor test, respectively. A policy satisfies the GPT if the sum of the premiums paid under the contract does not at any time exceed the "guideline premium limitation" at that time.[9] The CVCT is satisfied if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value.[10] At age 40, the applicable percentage is 250%, decreasing in increments to 100% at age 95.[11]

2. Section 7702A: Non-MEC vs. MEC

a. *7-pay Test*

A policy will be considered a modified endowment contract ("MEC") under § 7702A if it was entered into after June 21, 1988 and it fails to meet the 7-pay test under § 7702A(b).[12] A contract fails to meet the 7-pay test if the accumulated amount the policy owner pays under the contract at any time during the first seven contract years exceeds the sum of the net level premiums that the policy owner would have paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums.[13] Generally speaking, non-MECs are characterized by a premium paid over several years (typically four to seven), or even for the duration of the policy, and MECs are characterized by a one-time, initial premium payment. As will be discussed in more detail below, the income tax treatment of distributions from a policy while the insured is still living are quite different for policies that are MECs vs. non-MECs and careful consideration to these differences is important.

b. *Treatment of Material Changes*

When a withdrawal is taken from any life insurance contract (whether individual or survivorship) it is typical that the death benefit will be lowered by the same amount of the withdrawal. This is to keep the net amount at risk (the difference between the cash value and death benefit) the same as it was immediately prior to the withdrawal. An insurance company will typically require new medical evidence to keep the death benefit at pre-withdrawal

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[7] *See* §7702(b)(1).

[8] *See* §7702(b).

[9] § 7702(c)(1).

[10] § 7702(d)(1).

[11] *See* § 7702(d)(2).

[12] *See* § 7702A(a).

[13] § 7702A(b).

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levels. This may or may not be something the insured is willing to undertake as there may have been a deterioration of the insured's health.

If the death benefit on a policy insuring a single life is decreased within the first seven policy years, the 7-pay test described above is applied as if the policy had originally been issued at the reduced benefit level and this could cause the policy to become classified as a MEC.[14]

With respect to policies insuring more than one life (commonly referred to as survivorship or second-to-die policies) the rules regarding material changes are slightly different. For purposes of determining the MEC status of a second-to-die contract, § 7702A(c)(6) effectively states that any death benefit reduction below the lowest death benefit level during the first seven policy years will be treated as though the policy was originally issued at the reduced death benefit.[15] Unlike the normal rule for single life contracts, which applies only for the first seven years from the date of issue, the rule for survivorship policies is perpetual and is a permanent extension of the look-back rule for MEC testing. This Code section applies for any survivorship contract entered into or materially changed on or after September 14, 1989.

Simply stated, if a withdrawal is taken from a fully funded second-to-die life contract and the death benefit is lowered, the policy will become a MEC under § 7702A(c)(6), which is likely not a desirable result.

This is particularly important for policies in which the maximum amount of premium was paid into a contract with the lowest death benefit possible, as is typically the case with a PPLI policy. In addition, such a policy structure has been, and continues to be a popular retirement planning technique. Many of these retirement planning scenarios are presented to clients where there are planned withdrawals to basis and then policy loans (to fund a retirement, college education, etc.). The client and advisors should perform a careful analysis with respect to the future use of the policy values during the lifetime of the insured when utilizing a fully funded (i.e., maximum 7-pay premium) design PPLI survivorship policy.

3. Section 817: Special Rules for Variable Contracts

If the client desires to invest in a variable contract (whether a life insurance variable contract such as PPLI or a variable annuity such as PPVA), then additional requirements must be satisfied under § 817 to ensure that the cash value grows tax-free. Under this section, the investments made by a segregated asset account on which a variable contract is based must be "adequately diversified."[16] Further, the policy owner cannot engage in conduct deemed to be "investor control." If the account is not adequately diversified or if the contract owner violates the investor control doctrine, the contract owner will be deemed to directly own all of the policy's

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[14] § 7702A(c)(2)(A).

[15] § 7702A(c)(6)(A) and (B).

[16] § 817(h)(3).

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assets, thereby causing the separate account's income to be currently taxable to him or her.[17]

a. Diversification

(1) Test

The diversification requirements of § 817(h) require that assets of the segregated asset account of a variable contract (the "account") be invested in an "adequately diversified" mix of investments.[18] To be adequately diversified, the account must be invested in the securities of at least five (5) different issuers, and

- no more than fifty-five percent (55%) of the value of the total assets of the account may be represented by any one (1) investment,
- no more than seventy percent (70%) of the value of the total assets of the account may be represented by any two (2) investments,
- no more than eighty percent (80%) of the value of the total assets of the account may be represented by any three (3) investments, and
- no more than ninety percent (90%) of the value of the total assets of the account may be represented by any four (4) investments.[19]

For these purposes, all securities of the same issuer, all interests in the same real property project, and all interests in the same commodity are treated as a single investment.[20]

(2) Timing

The diversification rules must be satisfied on the last day of each quarter of a calendar year (i.e., March 31, June 30, September 30, and December 31) or within thirty (30) days after the last day of the quarter to be considered adequately diversified for such quarter.[21]

[17] *See* Rev. Rul. 2007-7 IRB 469; Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12; PLR 200601007; PLR 200601006; PLR 200244001.

[18] *See* § 817(h).

[19] Regs. § 1.817-5(b)(1)(i).

[20] Regs. § 1.817-5(b)(1)(ii).

[21] Regs. § 1.817-5(c)(1).

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(3) Grace Period, Inadvertent Failure, and Market Fluctuations

For a segregated asset account that is not real property, quarterly diversification must be satisfied at the end of the first calendar quarter after the one-year anniversary of the segregated asset account. For a segregated asset account that is real property, the segregated asset account is considered adequately diversified upon the earlier to occur of (a) its fifth anniversary or (b) the anniversary on which the account ceases to be a real property account.[22]

In the event that diversification is not met at the end of a calendar quarter, the issuer or holder of the segregated account must demonstrate to the Internal Revenue Service ("IRS") that the failure was inadvertent, and it must be cured within a reasonable time after discovery. Furthermore, the IRS may impose a fee for the period(s) in which the segregated asset account was not adequately diversified.[23]

The Treasury Regulations do provide for a "market fluctuations" exception. In effect, if the diversification requirements are violated solely as a result of market fluctuations and not as the result of the acquisition of any asset, the segregated asset account will be deemed to be adequately diversified.[24]

(4) Treatment of Funds

In some cases, a segregated asset account may "look through" an investment company, partnership, or trust (such as a mutual fund, hedge fund, or hedge fund of funds) to its underlying investments to determine whether or not it meets the diversification rules outlined above. In other words, investment in a fund is not treated as a single investment; rather, it is treated as an investment in the various funds in which the partnership itself is invested, thereby making it easier for the separate account to satisfy the diversification requirements of § 817(h). Investment companies, partnerships, and trusts may qualify for such "look-through" treatment if (a) all the beneficial interests in the investment company, partnership, or trust are held by insurance company segregated asset accounts and (b) public access to the investment company, partnership, or trust is available exclusively through the purchase of a variable contract.[25] If the account qualifies for such treatment, then beneficial interests in investment companies, partnerships, and trusts held by the account

[22] Regs. § 1.817-5(c)(2)(i), (ii).

[23] Regs. § 1.817-5(a)(2).

[24] Regs. § 1.817-5(d).

[25] Regs. § 1.817-5(f)(2)(i). Funds satisfying these two requirements are generally referred to as "insurance-dedicated funds" ("IDFs"). Notwithstanding the general rule that only insurance company segregated asset accounts may hold interests in the investment company, partnership or trust, there are some exceptions that allow other investors to hold such interests. *See* Regs. § 1.817-5(f)(3); *see also* Rev. Rul. 2007-7 I.R.B. 469 (addressing the exception of investors described in Regs. § 1.817-5(f)(3) from inclusion as members of the "general public").

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will not be treated as single investments of the account; rather, a pro rata portion of each asset of the investment company, partnership, or trust will be treated as an asset of the account.[26]

(a) *Insurance Dedicated Funds*

Funds meeting the look-though requirements described above are generally referred to as "Insurance-Dedicated Funds."

(b) *Non-Insurance Dedicated Funds*

Funds that do not meet the look-through requirements described above are generally referred to as "Non-Insurance Dedicated Funds."

b. *Investor Control*

(1) *Conduct Deemed to be Investor Control*

A variable contract may also lose its tax-preferred status if the contract owner engages in conduct deemed to be "investor control." Investor control may occur when the contract owner directs investment strategy or makes investment decisions for the segregated asset account, including determining the specific allocation of the assets of the segregated asset account or requiring the manager of the account to acquire or dispose of any particular asset or to incur or pay any particular liability of the account.[27] Likewise, to avoid investor control, there cannot be any prearranged plan or agreement between the account manager and the policy owner to invest any amounts in any particular asset or subject to any particular arrangement.[28] With regard to the management of any account assets, the account manager cannot consult with or rely upon the advice of any person that the account manager knows is a policy owner, beneficiary of a policy, a beneficial owner of any entity that is a policy owner, or a fiduciary or beneficiary of a trust, the trustee of which is a policy owner.[29] The investor control doctrine was set forth in a series of private letter rulings and revenue rulings issued by the IRS dating back to 1977, primarily dealing with variable annuity contracts. A full review of the investor control doctrine and

[26] Regs. § 1.817-5(f)(1).

[27] *See* Rev. Rul. 2003-91, 2003-2 C.B. 347; PLR 200601006.

[28] Rev. Rul. 2003-91, 2003-2 C.B. 347; PLR 200601006; PLR 200420017.

[29] Rev. Rul. 2003-91, 2003-2 C.B. 347. *Cf* CCA 200840043 (Oct. 3, 2008). In CCA 200840043, which resulted from a withdrawn PLR, the Service opined that direct investment by the segregated asset account in assets that are available to the general public will result in a violation of the investor control doctrine; but most commentators have stated that the Service's position was unsupported by existing law and represented a material departure from the Service's previous statements on this doctrine.

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its history is beyond the scope of this article.[30] However, it is worth noting that in June of 2015, in Webber v. Commissioner, 144 T.C. No. 17, the Tax Court agreed with the IRS and found that its consistent articulation of the doctrine in administrative rulings over the course of almost 40 years was entitled to judicial deference. The facts in Webber clearly indicated that the taxpayer had extensive involvement and influence over the investment decisions made with respect to the separate account and the court delivered an exhaustive opinion that found support for the investor control doctrine in Supreme Court precedents dating back to the earliest days of the federal income tax.

(2) Special Issues Relating to Managed Separate Accounts

(a) Definition

Many PPLI and PPVA contracts are structured to permit the policy owner to select from a group of asset management choices, wherein one or more independent "asset allocators" who are professional investment managers have an account management agreement with the insurance company to construct and manage, with full discretion, one or more separate accounts. The account investments may consist of one or more non-IDF hedge funds in which the number and proportion of account assets meet the § 817(h) diversification test. The account managed by the manager or allocator is available only to insurance companies in connection with their variable contracts. This arrangement is generally known as a "managed separate account," or "the allocator model."

(b) Rev. Rul. 2003-91 and Related Rulings

In Rev. Rul. 2003-91, the IRS appeared to generally confirm the validity of the managed separate account or allocator model, but the statement of facts in the ruling provided that the contract holder in that situation "may not communicate directly or indirectly with [the insurance company] concerning the selection or substitution of [the independent investment advisor]."[31] Because an allocator might sometimes be brought to the attention of an insurance carrier by a policy owner or a policy owner's advisor, this language in the ruling has caused some practitioners to become a bit concerned about whether the policy owner's suggestion of an allocator might give rise to a finding of

[30] The Investor Control Doctrine is a highly complex set of concepts derived from case law and IRS rulings. A full treatment of it is beyond the scope of this chapter. For an in-depth discussion, see Giordani and Chesner, 870 T.M., *Private Placement Life Insurance and Annuities.*

[31] 2003-2 C.B. 347.

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investor control. Adequate diversification of the separate account does not prevent the IRS from finding that the contract holder should still be treated as the owner of the assets in the account due to his control over the investments.[32]

The IRS has consistently held that a contract holder may freely allocate the investments of the separate account among the insurance company's available choices without being deemed the owner of the separate account for federal income tax purposes.[33] If the contract holder instead selects an independent party that has been approved by the insurance company as a separate account management option to make investment decisions, it seems unlikely that the IRS would find that the contract owner's recommendation of an allocator is a form of control, unless there is an "arrangement, plan, contract, or agreement" between the contract holder and the allocator with regard to the investments of the separate account.[34] One qualification, therefore, is that the allocator (i.e., the investment adviser) should be selected from a list of available allocators provided and previously approved by the insurance company, and the contract holder should not mandate that his or her own allocator be used. The IRS has provided guidance on this issue by approving an arrangement under which the contract holder's "influence over the way the investments are managed will be limited to selecting an investment manager from a pool of investment managers whose credentials have been evaluated and approved by [the insurance company]. These investment managers may be recommended to [the insurance company] by one or more [contract holders]. [The insurance company] will be under no obligation to approve any such recommendations. Moreover, once [the contract holder] makes an initial selection, the investment manager can only be changed by [the insurance company] and not by [the contract holder]."[35] Presumably, however, a policy owner can change from one investment manager approved by the insurance company to another investment manager approved by the insurance company under authority of the line of rulings previously discussed.[36]

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

33 *See, e.g.,* Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; PLR 200244001; PLR 9752061.

34 Rev. Rul. 2003-91, 2003-2 C.B. 347; I.R.B. 2003-33.

35 PLR. 9752061.

36 *See* Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11.

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In summary, a finding of investor control depends on "all of the relevant facts and circumstances."[37] The recommendation of an allocator by a policy owner (or his or her advisor) to the insurance company, without other factors, arguably should not support a finding of investor control. It seems that as long as the insurance company, in its sole discretion, has the sole authority to hire and fire the allocator and the contract holder has no actual control over the allocator's investment decisions, the allocator model should not run afoul of the investor control doctrine.

(c) Note of Caution

A final note of caution in connection with the allocator model may be warranted, however. It is entirely possible that due to the IRS's apparent public policy stance of limiting (wealthy) taxpayers' ability to invest in hedge funds within life insurance contracts, the IRS could take a very inflexible approach when it comes to allocations to hedge funds. This approach would involve an absolute prohibition of subscriptions by insurance carriers to hedge funds that are not "insurance-dedicated." Thus, under the allocator model, even though the policy owner selects only the allocator, and does not select the underlying non-insurance-dedicated hedge funds among which the allocator invests separate account assets, the IRS might nonetheless find that investor control exists under the rationale of Rev. Rul. 2003-91 simply because the insurance company (albeit at the direction of the allocator) has subscribed to a non-insurance-dedicated hedge fund. Therefore (the IRS's argument would go), despite the fact that the separate account is adequately diversified within the meaning of § 817(h) among the non-insurance-dedicated funds, the policy owner has indirect investor control due to the fact that the separate account holds as one or more of its investments a fund that is not available exclusively through the purchase of a variable contract, and access to which is not limited to insurance company segregated accounts. Although the IRS has not made this argument—and it is a weak argument at best—the possibility, however remote, that the IRS will attempt to use it underscores the fact that the tax consequences of using the asset allocator model remain less clear than the tax consequences of using an IDF.

B. U.S. Tax Treatment of Annuities

[37] Rev. Rul. 2003-91, 2003-2 C.B. 347.

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1. Qualifying as an Annuity

As with life insurance, annuities are tax-favored investments under the Code. Unlike life insurance, however, the primary income tax benefit of an annuity is derived from the compounding effect of the tax deferral on the investment gains within the contract, rather than the avoidance of income tax, as with investment in a life insurance policy. Generally, under § 72(a), gross income includes any amount received as an annuity under an annuity, endowment, or life insurance contract. The income tax effect of an annuity depends, however, on numerous factors, such as whether the tax is being applied to a distribution during the annuity's accumulation period or annuitization period and whether the distribution occurs after the death of the holder of the annuity contract or after the death of the annuitant (assuming that the holder and the annuitant are different persons).

2. Section 72: Annuity Contract Defined

To qualify as an annuity, the annuity contract must satisfy the requirements of § 72. An annuity is a contract, generally issued by an insurance company, providing for regular payments to an annuitant and, potentially, to a beneficiary following the annuitant's death. The Treasury Regulations state that to be considered "amounts received as an annuity," such amounts should be:

- received on or after the annuity starting date;
- payable at regular intervals; and
- payable over a period of at least one year from the annuity starting date.[38]

Further, the total of the amounts payable must be determinable as of the annuity starting date.[39]

Payments may also be considered amounts received as an annuity if they are paid under a variable annuity contract, despite the fact that the total of the amounts payable under the variable contract may not be determinable as of the annuity starting date, if the amounts are to be paid for a definite or determinable time.[40] If, because of positive investment experience in the variable annuity contract or other factors, the payment with respect to the annuity exceeds the investment in the contract (adjusted for any refund feature) divided by the number of anticipated periodic payments, then only part of the payment will be considered an amount received as an annuity.[41] The excess is an "amount not received as an annuity."

C. U.S. Securities Treatment of PPLI and PPVA

[38] Regs. § 1.72-2(b)(2).
[39] Id.
[40] *See* Regs. § 1.72-2(b)(3).
[41] Id.

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1. Qualification as an Accredited Investor and Qualified Purchaser

When considering whether their clients qualify as PPLI or PPVA purchasers, advisors initially must ensure that their U.S. clients meet the criteria for accredited investors and qualified purchasers under SEC rules.[42] Private placement variable insurance products offered by U.S. carriers to U.S. persons are subject to SEC regulations. Each purchaser generally must be a qualified purchaser under § 2(a)(51) of the Investment Company Act of 1940 and an accredited investor under § 501(a) of Regulation D of the 1933 Act.[43]

2. Special Considerations for Non-U.S. Policies

Offering memoranda for PPLI policies and PPVA contracts by non-U.S. carriers typically reference qualified purchaser or accredited investor standards, as used in U.S. securities law, to describe suitable investors. In the international context, this should be considered merely a guideline and not a strict requirement because non-U.S. policies are not actually subject to SEC regulations. However, if the premiums of a non-U.S. PPLI policy or PPVA contract are to be invested in funds that do require investors to be "qualified purchasers" and "accredited investors," then carriers and the underlying funds will normally require that the policy owner must be a "qualified purchaser" and an "accredited investor" for that purpose.

III. Tax Treatment of Life Insurance and Annuities

A. Introduction to Federal Income Tax Treatment of U.S. Citizens and Residents As Compared with Non-Resident Aliens ("NRAs")

As a predicate for a discussion of the U.S. federal income tax treatment of life insurance and annuities and the planning that can be accomplished therewith, it is important to briefly address the general taxing framework applicable to NRAs, as compared with the tax rules applicable to U.S. citizens and residents. U.S. citizens and U.S. residents are taxed on their worldwide income, regardless of the source of that income and whether it is "connected" to any U.S. business.[44] This worldwide income is subject to the regular tax rates set forth under § 1.

NRAs, on the other hand, are taxed only on income from U.S. sources.[45] This includes gross income "effectively connected" with the conduct of a U.S. trade or business and gross income not connected with a U.S. trade or business but from other U.S. sources.[46] The NRA's effectively connected income is taxed at the regular tax rates applicable to U.S. citizens and residents.[47]

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[42] *See generally*, 15 USC § 80a-2(a)(51) (Section 2(a)(51) of the Investment Company Act of 1940, defining "qualified purchaser"); 17 CFR § 230.501(a) (Section 501(a) of Regulation D of the 1933 Act, defining "accredited investor").

[43] *See* id.

[44] *See generally*, § 1; see also Regs. § 1.1-1(b).

[45] *See* §§ 2(d), 871.

[46] *See* § 871. Income from other U.S. sources generally includes the amount received from sources within the U.S. as interest, dividends, annuities, and other fixed or determinable annual or periodical ("FDAP") gains, profits, and income. *See* § 871(a). Importantly, U.S.-source income also includes income from annuities and life insurance contracts issued by U.S. life insurance companies as well as foreign branches of U.S. life insurance companies. *See* Rev. Rul. 2004-75, 2004-2 C.B. 109.

[47] § 871(b).

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Income from other U.S. sources is taxed at a rate of 30%, or a lower rate set by a tax treaty or tax convention.[48] This tax is applied, however, only on amounts that otherwise constitute gross income under the Code.[49] Therefore, when planning for NRAs, the practitioner must first determine whether the income would be includable in gross income under general tax principles. Then, the practitioner should consider the source of the income, including only income from U.S. sources in the total taxable income.

As with any planning involving the laws and rules of other jurisdictions, it is important to consider the potential impact of any income tax treaty between the U.S. and another country. The U.S. is party to more than 50 bilateral income tax treaties.

B. Income Tax Rules Applicable to U.S. Taxpayers Who Own Life Insurance Policies

1. Non-Taxation of Internal Build-Up

If a life insurance contract qualifies as life insurance under § 7702, the accreted value on the investment in the contract, or basis, of that policy (i.e., inside build-up) is not taxed to the contract owner during the policy's term.[50] This provides a particular benefit to investors seeking to invest tax-efficiently. Through the acquisition of a PPLI policy, such investors can invest in assets that generate taxable returns and avoid the income tax ordinarily associated with such returns.

2. Distributions During Policy Term

a. Non-Modified Endowment Contract Distributions

If withdrawals are allowed under a life insurance policy, the policyholder taking a withdrawal will receive cash from the insurer in exchange for a partial surrender of the policyholder's rights under the policy.[51] If the policy is not a MEC under § 7702A (a "non-MEC"), then the withdrawal can be effectuated tax-free up to the premium previously paid with respect to the policy, subject to certain limitations (the "premium first" rule).[52] To the extent that the withdrawal exceeds the policyholder's basis in the contract, the withdrawal will be fully taxable to the extent of the accumulated income in the cash surrender value.[53] The investment in the contract as of any date is the "aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income" at the time such amount was received.[54]

48 § 871(a); *see also* Regs. § 1.871-12. This tax is generally imposed through withholding at the source. § 1441.

49 Regs. § 1.871-7(a)(2). The Regulations refer to the taxation of annuities as an example, stating the amount of an annuity which is subject to tax under § 871 is determined in accordance with § 72. *Id*.

50 § 7702(g). If the contract fails to qualify as life insurance under the provisions of § 7702, then the income on the contract will be taxed to the contract owner annually. *Id.*

51 *See* Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis with Forms* ¶ 2.05[2] (2nd ed. 2004) (hereinafter referred to as "Zaritsky").

52 § 72(e)(5). Withdrawals made within the first 15 years of the policy's life may be subject to so-called "recapture" tax. § 7702(f)(7).

53 § 72(e)(5)(A).

54 § 72(e)(6).

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Often it is beneficial to avoid policy distributions for at least the first seven to ten (and even fifteen) policy years for several reasons. First, this provides opportunity for the values to enjoy the power of compounding and accrete in a tax-free environment beyond the basis of the contract. Second, due to the application of the Guideline Premium Test and 7-Pay Test under § 7702, an early policy distribution may trigger a recalculation of the Guideline Premium Test and 7-Pay test potentially causing the policy to become a MEC.

When a policy distribution is desired, it is typically better to withdraw an amount up to or equal to the basis in the contract as there are no current tax implications to doing so provided the policy remains in force. Once distributions equal basis (typically referred to as "withdrawals"), further distributions should then be taken as policy loans. Policy loans operate in a similar fashion to a loan from a § 401(k) plan. The policy owner is effectively borrowing its own accreted value with a promise to pay the sum back, with interest, at some future period of time. The net loan interest costs are typically between zero and 0.50%.

Policy loans and pledges or assignments of the policy, however, are generally not treated as distributions and do not reduce the death benefit under the policy.[55] To the extent that a policy loan is not repaid prior to the death of the insured, the amount of such loan (and any accrued but unpaid interest associated therewith) will be deducted from the death benefit proceeds prior to payment to the beneficiaries.

b. *Modified Endowment Contract Distributions*

The tax impact of the life insurance contract is different, however, if the policy is a MEC under § 7702A. The key planning consideration in deciding whether to structure a policy as a MEC or a non-MEC is whether (a) the policy owner expects to require access to policy funds during the policy term, or (b) the purpose of the policy is to pass wealth from one generation to the next without requiring access to policy cash values. If the policy owner does not plan or desire to withdraw money from the policy, then a MEC policy may be preferable due to the superior tax-free compounding effect achieved by a one-time, up-front premium payment and a smaller necessary relationship between the cash and death benefit, thus effectively reducing the insurance cost.

If the policy is structured as a MEC, an "income-first" rule will apply, and any withdrawals from the policy (whether classified as a "withdrawal" or "policy loan") will be fully taxable up to the amount of any gain in the policy assets prior to the withdrawal.[56] Furthermore, these withdrawals will be taxed at ordinary income tax rates. Also, the withdrawal will be subject to a ten percent penalty if the insured is under 59 ½ years of age. To the extent that the withdrawal amount exceeds the policy's accumulated income, the

[55] § 7702(f)(7); Zaritsky ¶ 2.05[2][b].

[56] § 72(e)(10)(A).

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remainder of the withdrawal will be tax-free as a withdrawal of the investment in the contract.[57] For purposes of determining the amount includable in gross income, all MECs issued by the same company to the same policy owner within any calendar year shall be treated as one MEC.

3. Surrender or Maturity of Policy

When a life insurance policy is fully surrendered, or if a policy matures because the insured reaches the age to which that individual was insured,[58] the policyholder will have ordinary income to the extent that the amount received by the policyholder exceeds the policyholder's investment in the contract.[59] Extended maturity riders are required to avoid this result when insureds live to advanced ages.

4. Policy Proceeds

Under § 101(a)(1), life insurance proceeds are not included in the gross income of the insurance policy's beneficiary, absent the application of the "transfer for value" rules of § 101(a)(2) or certain other exceptions noted in § 101.

5. Transfer for Value Rule

If an interest in the policy is transferred for valuable consideration, the death benefit proceeds distributed are included in gross income under § 101(a)(2). This is known as the transfer for value rule. Under this exception, the death benefit proceeds will be includable in gross income and subject to income tax to the extent the death benefit proceeds exceed the consideration paid, plus any additional premium paid after the transfer (i.e., the basis in the contract).

It is important to note that valuable consideration must be present and it is possible that consideration can occur even in the absence of cash. There are four important exceptions to the transfer for value rule that allow transfers to (a) the insured, (b) a partner of the insured, (c) a partnership of which the insured is a partner, or (d) a corporation in which the insured is a shareholder or officer. In these situations, the transfer will not cause the death benefit proceeds to be includable in gross income of the beneficiary. Transfers can also occur and not trigger the provisions of § 101(a)(2) through a § 1035 exchange as more fully described below.

6. Section 4371: Excise Tax on Life Insurance Premiums Paid to Foreign Insurers

If a policy is issued to a U.S. taxpayer by a foreign insurance company that has not elected to be taxed as a U.S. company under § 953(d), a tax equal to one percent of the value of each premium paid will be assessed. The taxpayer must file Form 720 to pay the tax at the time of the premium payment.

[57] § 72(e)(10)(A).

[58] Most carriers offer, either as part of the policy itself or an endorsement to the policy, a maturity extension benefit allowing the policy to mature at the later of the stated maturity or the death of the insured thus avoiding any adverse tax consequences of living past the stated maturity of the policy.

[59] §§ 72(e)(5)(A), 72(e)(5)(E).

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7. Section 1035: Tax-Free Exchange

Section 1035 allows for the tax-free exchange of a life insurance policy to another life insurance policy or annuity and an annuity to another annuity while maintaining the basis (i.e., cumulative life insurance premiums or annuity deposits) of the old contract. There are several important nuances to be aware of to perfect a tax-free exchange under § 1035.

These rules do not apply to any exchange having the effect of transferring property to any person other than a U.S. taxpayer. Furthermore, these rules do not apply to an annuity contract exchanged for a life insurance contact.

With respect to annuity exchanges, the contracts must be payable to the same person or persons. It is possible, however, to exchange one annuity for two or more annuities, or two life insurance policies for a single annuity contract. Within the limits above, it is also permissible to exchange a contract by a domestic insurer for one issued by a foreign insurer (and presumably vice versa) provided, however, that the annuity qualifies under § 72 and the life insurance policy qualifies under §§ 7702 or 7702A.

Mechanically, more often than not, the policy owner assigns all ownership rights to the original insurer and the original insurer then transfers the value of the life insurance or annuity to the new insurer at which time the new insurer issues an annuity contract or life insurance policy to the policy owner. Extreme care should be exercised to ensure the new annuity contract or life insurance policy continues to qualify, respectively, under §§ 72 and 7702 (or § 7702A in the case of a MEC contract). A MEC cannot be exchanged for a non-MEC.

C. Income Tax Rules Applicable to Non-U.S. Taxpayers who Own Life Insurance Policies

1. Generally Similar to Rules for U.S. Taxpayers

An NRA will be subject to tax on amounts received under a life insurance contract only to the extent that such amounts would be included in the gross income of a U.S. citizen or resident. Thus, the rules governing the taxation of life insurance discussed above generally apply equally to an NRA as to a U.S. citizen or resident.

2. Taxable Amounts Subject to Withholding

The primary difference between the taxation of NRAs and U.S. citizens and residents is the difference in tax rates applied to each. To the extent that amounts received by an NRA under a life insurance contract are taxable, they will generally be subject to the thirty percent tax under § 871 and withholding under § 1441, rather than the ordinary income tax rates under § 1.

D. Transfer Tax Rules Applicable to U.S. Taxpayers Who Own Life Insurance Policies

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While a detailed review of the transfer tax rules affecting a U.S. taxpayer who transfers a life insurance policy or its proceeds is beyond the scope of this article,[60] a high-level outline of those rules is helpful to understanding some of the planning concepts addressed herein.

1. U.S. Estate Tax Rules

For U.S. estate tax purposes, § 2042 provides that the gross estate of a U.S. citizen or resident includes the proceeds of insurance on the decedent's life, if those proceeds are (i) receivable by the executor of the decedent's estate or (ii) receivable by any other beneficiary if the decedent possessed certain "incidents of ownership, exercisable either alone or in conjunction with any other person." The term "incidents of ownership" refers to the decedent's rights to the economic benefits of the policy and includes the powers to:

(1) change the beneficiary;
(2) surrender or cancel the policy;
(3) assign the policy;
(4) revoke an assignment of the policy;
(5) pledge the policy for a loan; and
(6) obtain a loan against the policy's surrender value.[61]

The proceeds of a policy on the decedent's life will also be includible in the decedent's gross estate to the extent that the decedent possessed incidents of ownership in the policy and transferred or released those incidents or powers within three years of the decedent's death.[62] One way to avoid that look-back is to transfer the policy via sale for full and adequate consideration, which also has the effect of avoiding any U.S. gift tax on that transfer. In order to avoid the implications of the transfer for value rule under § 101(a)(2), the client will typically transfer the policy to an ILIT or other trust that is treated as a "grantor trust" as to the client under the rules of §§ 671-678.

2. U.S. Gift Tax Rules

In the scope of domestic life insurance planning, U.S. taxpayers typically encounter the U.S. gift tax in one of two contexts: financing policy premiums through gifts; or valuing a policy that is being gifted (or transferred in a sale intended to avoid a gift).

Because the financing of premiums through gifts generally involves transfers of cash from the insured donor to the donee (which is often an irrevocable life insurance trust ("ILIT") established by the donor), the gift tax implications are relatively straightforward, invoking either the donor's annual exclusion amount under § 2503(b) or lifetime exclusion amount under § 2505(a). The most significant hurdles to be dealt with in that planning are ensuring that annual exclusion gifts actually qualify for exclusion under § 2503(b) and structuring the ILIT to avoid inclusion in the insured donor's estate under § 2042 or § 2035. One particular strategy for financing policy

[60] For a more thorough treatment of these rules, *see* Zaritsky ¶ 3.03; Budin, 826-2nd T.M., *Life Insurance*, I.C, I,G.
[61] Regs. § 20.2042-1(c).
[62] § 2035(a).

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premiums at minimal transfer tax cost is a split-dollar life insurance arrangement, which is addressed below in Section IV.B.2.b.

The gift tax value of a life insurance policy is determined under the principles set forth in Regs. § 25.2512-6(a), which provides that the value is (i) the cost of a single premium policy of the same specified amount issued on a person the same age as the insured or (ii) the policy's interpolated terminal reserve, provided that such reserve approximates a value reasonably close to the policy's full value. Due in part to a PPLI policy's status as a variable contract, its gift tax value generally equals its cash surrender value as of the valuation date.

E. Transfer Tax Rules Applicable to Non-U.S. Taxpayers who Own Life Insurance Policies

1. Taxation of Transfers of U.S.-Situated Assets

For estate tax purposes, like under the income tax rules, U.S. citizens and residents are taxed on their worldwide assets.[63] In contrast, non-resident, non-citizens ("NRNCs") are generally taxed only on transfers of U.S.-situated assets.[64]

As noted with respect to income tax planning, it is also important to consider the potential impact of any estate tax treaty between the U.S. and another country. The U.S. is, however, party to only 15 estate and/or gift tax treaties.[65] Therefore, the circumstances in which an estate and/or gift tax treaty will be applicable are much more limited than the application of the income tax treaties.

2. Section 2105

The Code provides for significantly different treatment of death benefits payable at the death of a U.S. citizen or U.S. resident compared with death benefits payable at the death of an NRNC.

Section 2105 specifically provides that "the amount receivable as insurance on the life of a non-resident not a citizen of the United States shall not be deemed property within the United States."[66] Therefore, the death benefits payable with respect to the life of an NRNC decedent are not subject to U.S. estate tax, regardless of whether (a) the decedent held incidents of ownership over the insurance policy, (b) the death benefits are payable to the NRNC's estate, or (c) the beneficiary is located inside or outside of the U.S.

This rule is specific to insurance on the life of the NRNC, however. If the NRNC decedent owned insurance that is situated in the U.S. on the life of another individual, then the value of that policy will be includable in the NRNC's gross estate for U.S.

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[63] *See* §§ 2001, 2031.

[64] *See* §§ 2101, 2103.

[65] The United States has estate and/or gift tax treaties with Australia, Austria, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Switzerland, and the United Kingdom. *See also* U.S. – Canada Income Tax Treaty, Arts. II 2(b)(iv), XXXVI3(g), XXIX B.

[66] § 2105(a).

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estate tax purposes.[67] Insurance on the life of someone other than the decedent is situated in the U.S. if the insurer issuing the policy is a domestic (rather than a foreign) insurer.[68]

F. Income Tax Rules Applicable to U.S. Taxpayers who Own Annuities

1. Tax During Accumulation Period

If the annuity contract holder is a natural person, income on the annuity contract will generally not be taxable during the accumulation period of a deferred annuity. If, however, the annuity holder opts to take a non-annuity distribution ("NAD") (which may take the form of a withdrawal, loan, assignment, or pledge), then the distribution will typically be subject to tax as ordinary income to the extent of the income on the contract.[69] The distribution may also be subject to a withdrawal penalty tax equal to 10% of the income in the contract if the holder is less than age 59 ½.[70] If a non-annuity distribution exceeds the income on the contract, the excess distributed will not be subject to tax, but the distribution will reduce the owner's investment in the contract. If the holder takes a loan against the annuity contract, or assigns or pledges the contract, then the investment in the contract will be increased by the amount included in the holder's gross income as a result of that loan, assignment, or pledge.[71]

If a non-natural person is proposed as the annuity contract holder, additional care must be taken to ensure that the contract will still qualify as an annuity. Otherwise, income on the contract will be taxable to the holder as ordinary income during both the accumulation and annuitization periods. A non-natural person will not be taxed on the contract income if the non-natural person merely holds the annuity as an agent for a natural person. Section 72(u)(3) sets forth additional exceptions to the non-natural person rule, including exemptions for annuity contracts that are acquired by a decedent's estate, annuity contracts held under a § 401(a) or § 403(a) plan, an IRA, or a § 403(b) program, and immediate annuities.[72]

2. Tax During Annuitization Period

During the annuitization period, each payment under an annuity has two components: (i) income on the annuitant's investment in the contract and (ii) principal.[73] Generally, a part of each annuity payment constitutes a return of the cost of the annuity and is excluded from income. The remainder of the payment is income to the annuitant. For U.S. citizens and residents, the return on the annuity is taxed at

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[67] *See* § 2033; *see also* Zeydel & Chung "Estate Planning for Noncitizens and Nonresident Aliens: What Were Those Rules Again?" 106 *J. of Taxation* 20 (Jan. 2007).

[68] Regs. §§ 20.2104-1(a)(4), 20.2105-1(e); Spielman, *U.S. International Estate Planning* ¶ 10.03[14][a][iii] (2008). Non-U.S. insurance companies that have filed an election under § 953(d) to be treated as a domestic corporation should be considered "domestic insurers" for this purpose. *See* Regs. §§ 20.2104-1(a)(4), 20.2105-1(e); § 953(d). Therefore, such insurance is situated in the United States and includable in the NRNC's gross estate for U.S. estate tax purposes.

[69] *See* § 72(e)(2)(B), (4). With respect to the tax rate applied to NADs, U.S. citizens and resident aliens are subject to the standard rate structure for gross income. *See* §§ 1, 72. NRAs, on the other hand, are generally subject to a flat 30% tax and withholding on the income derived from the NAD. *See* §§ 871(a), 1441.

[70] § 72(q).

[71] *See* § 72(e)(4).

[72] § 72(u)(3).

[73] Regs. § 1.72-1(c)(1).

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ordinary income rates. Nonresident aliens are subject to a 30% tax and withholding under §§ 871 and 1441.

The taxable and nontaxable portions of the annuity are calculated using the "exclusion ratio." Application of the exclusion ratio limits gross income to "that part of any amount received as an annuity bearing the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date)."[74] The exclusion is, however, limited to the holder's unrecovered investment in the contract.[75]

Non-annuity distributions paid during the annuitization period are generally included in gross income and taxed as ordinary income to the recipient.[76]

3. Tax Following Annuitant's Death

Section 72(s)(1) requires that, in order for a contract to be treated as an annuity contract for U.S. income tax purposes, the contract must provide that:

> "(A) if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and
>
> (B) if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder."

In addition, § 72(s)(2) provides that, to the extent that the remaining portion referred to in § 72(s)(1)(A) is paid out to a designated beneficiary over the beneficiary's lifetime and the distributions begin within one year of the holder's death, then the remaining portion shall be treated as distributed in a lump sum on the date that the distributions begin.

While those provisions, which are subject to various exceptions for surviving spouses and for retirement-related annuities, direct the timing of the distributions and maximum duration of any deferral, it is § 691 that confirms the tax character of the distributions and provides the distinguishing disadvantage of annuities versus life insurance. Whereas life insurance proceeds are excludable from the beneficiary's gross income, § 691 identifies such distributions as income in respect of a decedent having the same character in the hands of the beneficiary as it did in the hands of the decedent. The result is that any deferred gains not taxed prior to the holder's death

[74] § 72(b)(1). The investment in the contract is defined as the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under the Code. § 72(c)(1). If the annuity is for life, the expected return is determinable based on the life expectancy of the annuitant, in accordance with tables prescribed by the Treasury Secretary. § 72(c)(3)(A). If the annuity is for a term certain, the expected return is the aggregate of the amounts receivable under the contract as an annuity.

[75] § 72(b)(2).

[76] *See* § 72(e)(2)(A); Regs. § 1.72-1(d). Under § 72(c)(2), special rules apply to contracts including a refund feature. Additional rules also apply to the taxation of distributions following the death of the annuitant. These rules are beyond the scope of this article. Persons dealing with such distributions should refer to § 72 and contact an experienced tax professional for additional information.

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will ultimately be taxed as ordinary income upon the beneficiary's receipt or deemed receipt, as the case may be. Moreover, since the annuity was likely included in the holder's gross estate for U.S. estate tax purposes, those deferred gains can potentially be subject to successive taxes.[77] This taxation of the annuity assets following the annuitant's death is the primary reason why life insurance is generally superior to annuities as a tax planning tool.

For clients who have charitable inclinations, however, an annuity can be an effective tool that allows the client to set aside funds in an annuity, avoid tax on the investment gains during their lifetime and leave the proceeds of the annuity contract to a designated charity or private foundation on their death. This allows the estate to take an unlimited charitable deduction for the fully accreted value of the annuity and the investment gains are never subject to income tax. The limitations on the deductibility of charitable contributions contained in IRC §170(b) are not applicable for federal estate tax purposes. This may be particularly attractive for clients with private foundations, where charitable deductions for contributions made while living are subject to more severe limitations depending on the character and operation of the private foundation.

G. Income Tax Rules Applicable to Non-U.S. Taxpayers who Own Annuities

1. Generally Similar to Rules for U.S. Taxpayers

As with life insurance, an NRA will be subject to tax on amounts received under an annuity contract only to the extent that such amounts would be included in the gross income of a U.S. citizen or resident. Thus, the rules governing the taxation of annuities discussed above generally apply equally to an NRA as to a U.S. citizen or resident.

2. Withholding

The primary difference between the taxation of NRAs and U.S. citizens and residents is the difference in tax rates applied to each. Amounts received by an NRA under an annuity contract will generally be subject to the 30% tax under § 871 and withholding under § 1441, rather than the ordinary income tax rates under § 1.

3. Original Issue Discount ("OID") Problem Applying to Non-U.S. Issued Private Placement Variable Annuity Contracts

There is an important exception that applies to annuities issued by certain foreign insurers. In 2002, the IRS issued final regulations under § 1275 clarifying that annuities issued by a foreign insurer that is not, or does not elect to be, subject to tax under subchapter L of the Code on income earned on the annuity contract will not be taxed as annuities under § 72. Instead, they will be treated as "debt instruments"

[77] Although § 691(c) allows the beneficiary to deduct a proportionate share of the U.S. estate taxes attributable to the annuity's includible value, in most cases that deduction does not entirely eliminate double taxation of the deferred gains.

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subject to current taxation under the "original issue discount" provisions of the Code.[78]

A "debt instrument" is broadly defined to mean a bond, debenture, note or certificate or other evidence of indebtedness.[79] While the very nature of a variable annuity seems to preclude treatment of the insurer's obligations as some form of indebtedness, a fixed annuity contract does constitute evidence of an indebtedness owed by the insurance carrier to the annuitant. As such, any accreted value of a fixed (whether immediate or deferred) annuity issued by a foreign insurer not subject to tax under subchapter L of the Code on income earned on the annuity contract will be currently taxable to the annuity's owner for U.S. tax purposes.[80]

H. Transfer Tax Rules Applicable to U.S. Taxpayers who Own Annuities

Under § 2039, with respect to U.S. citizens and residents, it is clear that the value of an annuity or other payment made under an annuity contract (the "annuity payment") is included in a decedent's gross estate if (i) the annuity payment is receivable by the beneficiary because the beneficiary survived the decedent and (ii) the annuity payment was payable to the decedent, or the decedent possessed the right to receive the annuity payment (alone or in conjunction with others), for life, for a period not ascertainable without reference to his or her death, or for a period which did not in fact end before his or her death.[81] The amount includible in the gross estate is limited to a part of the annuity payment proportionate to the amount of the purchase price contributed by the decedent.[82]

I. Transfer Tax Rules Applicable to Non-U.S. Taxpayers who Own Annuities

In contrast with life insurance, rights under an annuity contract issued by a U.S. domestic insurance company are generally considered U.S.-situated property includable in the gross estate of an NRNC.[83] Because no specific exclusion for annuity contracts exists like the exclusion for life insurance policies, most commentators believe that the rules applicable to U.S. citizens and residents under § 2039 also apply to determine whether an annuity payment made pursuant to a U.S.-situated annuity contract is subject to tax in the NRNC's estate. Some commentators, however, argue that because § 2105(a) does not specifically use the term "life insurance contract," but instead refers to "the amount receivable as insurance on the life of a non-resident not a citizen of the United States," an annuity contract could satisfy § 2105(a) and

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78 *See* §§ 163(e), 1275(a)(1)(B); Regs. § 1.1275-(1)(k).

79 § 1275(a)(1)(A).

80 While this rule typically applies only to fixed annuities and not to variable annuities, caution should be exercised with all foreign annuities, as it may be possible that different types of annuitization provisions in *variable* annuity contracts could trigger the application of § 1275.

81 § 2039(a); Kathryn Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions* ¶ 13.04[1] (1998).

82 § 2039(b).

83 *See* Regs. §§ 20.2104-1(a)(4), 20.2105-1(e); Spielman, *U.S. International Estate Planning* ¶ 10.03[14][a][iv] (1998); *see also Guaranty Trust Co. of N.Y. v. Comr.,* 16 B.T.A. 314 (1929) (distinguishing between insurance contracts and annuity contracts). Pursuant to the Treasury Regulations related to §§ 2104 and 2105, annuities "issued by or enforceable against a resident of the United States or a domestic corporation" are considered to be situated in the U.S. Regs. §§ 20.2104-1(a)(4), 20.2105-1(e). Under this rule, annuities issued by non-U.S. insurance companies that have made a 953(d) election to be treated as a domestic corporation ("953(d) carriers") should be considered situated in the U.S. and includable in the NRNC's gross estate for U.S. tax purposes. *See* Regs. §§ 20.2104-1(a)(4), 20.2105-1(e); § 953(d). Annuities issued by non-U.S. insurance companies that have not made a 953(d) election ("non-953(d) carriers") will not be considered situated in the United States and are not includable in the NRNC's gross estate. Therefore, NRNCs who are not engaged in pre-immigration planning and do not intend temporary U.S. residence should carefully consider whether investment in a policy issued by a U.S. domestic carrier or 953(d) carrier is appropriate, given the particular circumstances at hand. While investment in a policy issued by a domestic carrier or a 953(d) carrier may be appropriate, it may also be the case that the costs of such investment outweigh the benefits to the potential policy owner.

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not be deemed property within the U.S. The key to this argument would be to show that the annuity contract involved an actual insurance risk at the time the transaction was executed.[84]

A private letter ruling issued in October 2008 not only highlights a very limited exception to this rule for NRNC clients, but it also serves to demonstrate one of the many convoluted ways in which these rules sometimes apply. In this private letter ruling, annuity proceeds held by three life insurance carriers on behalf of an NRNC were not property situated within the U.S. under § 2105(b)(1) and were, therefore, excluded from the NRNC's gross estate under § 2103.[85] The decedent, an NRNC, was the beneficiary under an annuity owned by her brother, a U.S. citizen and resident of "State." Following her brother's death, the decedent failed to submit a claim prior to her own death to the insurance companies who issued the annuity contracts. Therefore, the proceeds of the annuities were still being held by the insurers. Relying on § 871(i), the IRS held that, under these facts, the annuities were equivalent to deposits being held by the insurers and were excluded from the decedent's gross estate for estate tax purposes under § 2103.

IV. Planning Strategies

A. Domestic vs. International PPLI

1. In General

PPLI or PPVA issued by an international carrier has enhanced tax advantages because state premium taxes should not be payable when the client completes all aspects of the transaction outside of the U.S. This results in a savings of approximately 2-3% of the premium in most states. Additional savings are also available through the acquisition of the variable contract internationally, regardless of whether the contract is purchased from a foreign company that has elected, under § 953(d), to be taxed as a domestic corporation (a "953(d) company") or a foreign company that has not made this election. Where the foreign company has not made the § 953(d) election, the effect of federal deferred acquisition cost ("DAC") tax that otherwise might be assessed on the premium (which is usually about 1-1.5% of premiums paid) can be avoided but a 1% U.S. federal excise tax on premium payments is payable for policies issued by a foreign insurer on the life of a U.S. resident.[86] On the other hand, in the case of international carriers that have made a 953(d) election and are therefore subject to the DAC regime, a reduced DAC of less than 1% of premium is the norm. Consequently, the absence of the state premium tax and reduced or no federal DAC tax outside of the U.S., along with no or low premium sales loads, contributes to the substantially improved yields compared to taxable investments or PPLI purchased in the U.S.

2. Statutory Asset Protection

[84] *See generally, Helvering v. Le Gierse,* 312 U.S. 531, 539-40 (1941) (highlighting risk-shifting and risk-distributing as essential elements of a life insurance contract).

[85] PLR 200842013.

[86] *See* § 4371.

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High net worth clients in the U.S. often desire to globalize their holdings in a manner that protects them from future creditor risk as well as local political and economic turmoil. By virtue of its preferred status under certain state exemption statutes, life insurance represents an excellent asset-protective vehicle for the high net worth client, especially when coupled with sophisticated international planning. As a consequence of the separate account protection that typically exists in the jurisdictions where carriers reside, the insurance company must segregate the assets inside a private placement policy from its general account, which then protects the policy assets from the claims of the creditors of the life insurance company. In addition, some U.S. states exempt not only the debtor's interest in a life insurance policy's cash surrender value, but also the death proceeds themselves from the claims of creditors.[87] However, the exemption statutes vary from state to state, and in some cases, the domestic exemption statute is inadequate or restrictive as to the allowable exemption amount or the class of persons entitled to benefit from the exemption.[88]

Many international jurisdictions offer legislation related to life insurance contracts that is comparable to, or better than, similar legislation under U.S. state law. Such legislation may include specific exemption language and a pro-debtor protection regime. In addition, the laws of an international jurisdiction might allow the inclusion of spendthrift provisions in the policy itself, which limit the policy owner's rights in the policy, thereby affording another level of asset protection to the policy. If invested with a non-U.S. manager, the assets inside the separate account of the policy will not only receive protection from creditors by virtue of the exemption statute, but it will also be harder for a U.S. creditor to reach the policy's assets because they are located outside of the U.S. The client may also enjoy investor confidentiality and financial privacy under the laws of many international jurisdictions, to which similar laws in the U.S. generally do not compare.

B. Planning for the U.S. Taxpayer

1. Domestic Gifting Trust Ownership of Policy

In addition to the considerable income tax benefits of PPLI, holistic planning considerations may dictate the need for a flexible framework for transferring wealth to children or further generations in a transfer tax efficient manner. A previously-funded domestic trust—particularly a generation-skipping transfer ("GST") tax-exempt trust—thus becomes a natural PPLI purchaser.[89] The domestic trust's investment in PPLI allows that portion of the trust assets to grow income-tax deferred during the insured's lifetime; then, upon the insured's death, the trust receives the death benefit proceeds income tax-free. This works well for both grantor and non-grantor trusts. For grantor trusts—for example, a grantor trust that has received the

[87] Premiums paid with express or implied intent to defraud creditors, however, generally are not protected. Such premiums, plus interest, are usually recoverable by a defrauded creditor out of insurance proceeds.

[88] For a complete state-by-state treatment of the exemption statutes relating to life insurance and annuities, *see* Osborne & Schurig, "Life Insurance and Annuities," *Asset Protection: Domestic and International Law & Tactics* Chap. 8 (1995).

[89] The GST tax is a transfer tax (in addition to the estate tax) that is imposed on transfers that skip a generation and at a rate equal to the highest marginal estate tax rate. The purpose of this tax is to prevent the avoidance of estate tax at the skipped generation. That is, in the absence of the GST tax, clients could, for example, leave property directly to their grandchildren, without subjecting that property to a transfer tax at their children's generation.

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remainder interest of a successful GRAT, the assets can grow at an efficient, substantial rate without adding to the grantor's income tax base. In that case, the grantor or the grantor's spouse would be the likely insured. For non-grantor trusts where the current generation does not require distributions, the trustee can grow all or a substantial portion of the trust's assets without the impact of the compressed marginal income tax rates and without having to force out distributions of DNI (to avoid paying income tax at the trust level). The current generation of beneficiaries could serve as insureds (perhaps the already-well-heeled children of the trust's settlor). Note that, under either scenario, to the extent that the trustee needs to make distributions prior to an insured's death, the trustee can make a tax-free withdrawal or loan against the policy, if the policy is structured as a non-MEC.

2. Irrevocable Life Insurance Trusts (on a Grand Scale)

Given the size of the premiums required to purchase a PPLI policy (generally in excess of $2,000,000), traditional ILIT planning which relies on annual exclusion gifts to fund policy premiums, does not work well with PPLI. Thus, clients must either be willing to utilize their gift tax lifetime exclusions or engage in an alternative funding mechanism (such as a private split-dollar life arrangement structured as an intra-family loan).[90] By implementing either of these tools, the senior generation can pass assets in a leveraged manner to future generations at a significantly reduced transfer tax cost.

Regardless of the funding mechanism, it is important for the settlor's gift(s) to the ILIT to be completed gift(s) for gift tax purposes. For that reason, the settlor should not retain a testamentary power of appointment.[91] In addition, the settlor should retain no other power under the trust agreement that would cause the trust assets to be includible in the settlor's estate for estate tax purposes.[92] Moreover, the allocation of GST exemption (if available) to the initial funding (and any additional assets contributed to the trust) permits the policy proceeds to be received and passed free of GST tax as well.[93] This planning effectively removes the death benefit proceeds of the PPLI policy from the estate of the settlor/insured, while the assets in the trust will also avoid the GST tax.

a. Lifetime Exclusion Gifting

For policies with total premiums in the range of the client's remaining gift tax lifetime exclusion of $5,450,000 (or, effectively, $10,900,000 for spouses),[94] indexed for inflation, the funding of the ILIT is relatively straightforward. For policies with larger premiums, clients will have to attempt to employ some technique for transferring assets on a discounted basis (for so long as such opportunities exist under the U.S. transfer tax system) or will have to elect to

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[90] *See infra* Section IV.B.2.b.

[91] *See* Regs. § 25.2511-2(b).

[92] *See* §§ 2036 to 2041.

[93] *See* § 2642.

[94] The American Taxpayer Relief Act of 2012 mandated indexing for inflation of the lifetime gift tax exemption and the federal estate tax exemption.

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pay gift tax, where the transfer tax environment makes such an approach sensible.

b. Private Split-Dollar Funding

For the largest policies or for clients who have already used their gift tax lifetime exclusions, a private split-dollar life insurance arrangement presents an attractive funding alternative. Such arrangements have traditionally been one of the most popular and widely-used methods available for funding life insurance premiums in an intra-family gifting context.[95]

In a typical private split-dollar arrangement, the settlor of an ILIT that is a grantor trust for U.S. income tax purposes will loan the premium amounts to the trustee of the ILIT in exchange for the trustee's promise to repay the loans with interest.[96] The trustee's obligation is limited to repayment of the premiums plus accrued interest, meaning that, upon the insured's death, the trustee receives income and transfer tax-free the amount by which the death benefit proceeds exceed the accrued loan obligation. Moreover, under certain circumstances, the trustee's obligation can be non-recourse[97] and the repayment obligation can be deferred until the settlor-insured's death.[98] Upon the insured's death, the trustee receives the death benefit proceeds and satisfies the repayment obligation to the settlor's estate, thereby allowing the executor to use those loan repayment funds in satisfaction the estate tax liability attributable to the accrued loan obligations (which was a note receivable includible in the settlor's gross estate). Although that receivable was subject to estate tax, the excess death benefit proceeds should not be, as long as the ILIT and the split-dollar arrangement were properly structured to avoid the purview of § 2042.

Furthermore, because the growth of the PPLI policy's cash value and death benefit should far exceed the growth of the accruing repayment obligation, the trustee has effectively arbitraged the borrowed premium dollars. This is greatly facilitated by the fact that interest on a split-dollar loan obligation accrues at the applicable federal rate ("AFR") applicable to the month of the premium payment[99].

One important caveat to the preceding discussion is that U.S. securities laws seem to preclude split-dollar financing of domestic (U.S.-issued) PPLI policies,

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[95] A comprehensive treatment of split-dollar planning and its history is beyond the scope of this article.

[96] Treasury Regulations issued in 2003 pursuant to §§ 61 and 7872 provide for two basic approaches to split-dollar arrangements: the economic benefit regime and the loan regime. In this intra-family context, the loan regime is the most straightforward and likely the most effective. *See* Zaritsky ¶ 6.05 for further discussion of the two regimes and the circumstances in which one is favored over the other.

[97] *See* Regs. § 1.7872-15(d).

[98] *See* Regs. § 1.7872-15(e)(5)(ii). Note that the IRS takes the position that interest accrued under a split-dollar loan arrangement is personal, non-deductible interest to the ILIT and interest income to the grantor. Regs. § 1.7872-15c. However, to the extent that the arrangement is entered into between a grantor trust and its grantor, Rev. Rul. 85-13 suggests that there is no loan for federal income tax purposes, and thus none of the interest accrued during the grantor's lifetime is considered taxable interest income. Nevertheless, if repayment does not occur until the grantor has died, the IRS has an argument that the entirety of the accrued interest—and not just the interest accrued after the grantor's death—is taxable interest to the grantor's estate (and is simultaneously non-deductible to the trust).

[99] *See* Regs. § 1.7872-15(e)(4).

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due to their status as securities under U.S. securities laws[100]. International PPLI policies are not considered "securities" for such purposes and are, therefore, not subject to that financing limitation. As a result, clients interested in employing split-dollar arrangements to fund PPLI policies should strongly consider acquiring their policies outside of the U.S.

c. The Impact of Section 684 on International ILITs

Most international carriers require that the policy owner have a non-U.S. situs (due to state regulatory concerns). Thus, if an ILIT invests in an international PPLI policy, it must either set up a foreign company for purposes of owning the policy or the ILIT must itself have a foreign situs. If the ILIT is settled as a foreign trust for legal purposes, the settlor's counsel should also ensure that it is classified as a domestic trust for U.S. tax purposes, in order to avoid the potential, negative application of § 684.

Specifically, § 684 treats a transfer of property by a U.S. person to a foreign trust as a sale or exchange for an amount equal to the fair market value of the property transferred. Thus, the transferor is required to recognize gain on the difference between the fair market value of the transferred property and its basis. The rules set forth in § 684 do not apply to the extent that the transferor or any other person is treated as the owner of the trust under § 671, which will typically be the case with a foreign trust with U.S. beneficiaries.[101] However, upon the death of a U.S. person who was treated as the owner of a foreign trust during that person's lifetime, gain will be recognized under § 684 if such foreign grantor trust's assets do not receive a step-up in basis under § 1014(a). This will be the case in a traditionally-structured ILIT to which completed gifts have been made.[102] In order to avoid the application of § 684, Settlor's counsel can structure the ILIT to be classified as domestic for U.S. tax purposes by satisfying the definitional requirements set forth in § 7701.[103]

In the event this "hybrid" trust structure is undesirable, however, the other option is to establish a domestic ILIT that then forms a non-U.S. company as an asset of the trust to be the policy-owning vehicle. A simple "check the box" election under Treasury Regulations §§ 301.7701-1, 301.7701-2, and 301.7701-3 ensures disregarded entity treatment.

C. Planning for Foreign Non-Grantor Trusts with U.S. Beneficiaries

PPLI is also beneficial for other types of clients, such as foreign trusts with U.S. beneficiaries. This market is typically served by international carriers, including foreign subsidiaries of large U.S. carriers.

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[100] *See* C.F.R §§ 221.1-221.7 (Regulation U).

[101] *See* § 679.

[102] *See* Regs. § 1.684-3(c).

[103] Under the regulations to § 7701(a)(31), a trust is a foreign trust unless both of the following conditions are satisfied: (a) a court or courts within the U.S. must be able to exercise primary supervision of the administration of the trust; and (b) one or more U.S. persons have authority to control all substantial decisions of the trust. Regs. § 301.7701-7(a).

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1. What is a Foreign Non-Grantor Trust ("FNGT")?

In the simplest terms and as its name implies, a FNGT is a foreign trust that is not a grantor trust. Under § 7701(a)(31)(B), a foreign trust is any trust that is not a U.S. person. A trust is a U.S. person if it satisfies two requirements:

- a court within the United States is able to exercise primary supervision over the administration of the trust, and

- one or more United States persons have the authority to control all substantial decisions of the trust.[104]

A "grantor trust" is a trust that is treated, for U.S. federal income tax purposes, as having an owner—typically the trust's grantor (the person who transferred assets to the trust)—under the principles set forth in §§ 671-679.

Trusts with foreign owners offer unique tax benefits because they can avoid U.S. income taxes in many situations. With a foreign owner, the foreign grantor trust is treated for U.S. income tax purposes as an NRNC, and the foreign grantor is taxed only on the trust's U.S.-source income. For this reason, foreign grantor trusts are not favored under U.S. tax policy, and Congress has taken steps to significantly restrict the opportunities for foreign persons to use these types of trusts.[105] Thus, unlike U.S. domestic trusts, which are not difficult to qualify as a grantor trust (assuming proper structuring), a foreign trust will only be a grantor trust in very limited circumstances. Specifically, a foreign trust qualifies as a grantor trust if:

- the trust is revocable;

- distributions from the trust may be made only to the trust's grantor or the grantor's spouse; or

- the trust is a compensatory trust.[106]

Instead, most foreign trusts are FNGTs with respect to which the foreign person who created the trust is not considered the owner of the trust's assets for U.S. tax purposes. These FNGTs are subject to draconian tax rules intended to eliminate the ability to defer the payment of income tax by U.S. beneficiaries of the trust. If a FNGT has one or more U.S. beneficiaries, all of the worldwide distributable net income ("DNI") in the trust should be distributed to the beneficiary or beneficiaries each year. If all of the trust's DNI is not distributed, it is carried forward as UNI in the trust. UNI, when distributed, is subject to additional interest charges–which have been compounded

[104] § 7701(a)(30)(E).

[105] The Small Business Job Protection Act of 1996 (P.L. 104-188) significantly restricted the tax advantages available to foreign individuals seeking to establish trusts with U.S. beneficiaries.

[106] § 672(f). In some circumstances, a U.S. beneficiary of a trust could be considered the owner of the trust that is otherwise owned by a foreign person if that U.S. beneficiary transfers assets to the foreign person for less than full and adequate consideration. *Id.* Also, any foreign grantor trust that was in existence prior to September 20, 1995, is "grandfathered" and will continue to be a grantor trust as to any property transferred to it prior to such date provided that the trust continues to be a grantor trust under the normal grantor trust rules. Regs. § 1.672(f)-3(a)(3). Separate accounting is required for amounts transferred to the trust after September 19, 1995, together with all income and gains thereof.

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over the length of time the UNI exists in the trust, on top of the regular tax owed by the trust's beneficiaries, as well as potential penalties.

2. Background: Pre-1996 Tax Framework

The Small Business Job Protection Act was signed by President Clinton on August 20, 1996. The 1996 Act changed income tax law and reporting related to foreign trusts in two significant areas: (i) for U.S. beneficiaries who receive distributions from trusts created by foreign persons, and (ii) for U.S. persons who create foreign trusts.[107] Prior to the enactment of the Small Business Job Protection Act in 1996 (the "1996 Act"), a foreign person could establish a foreign grantor trust with one or more U.S. beneficiaries. As with all grantor trusts, the foreign grantor was essentially treated as the owner of the trust for U.S. federal income tax purposes.[108] If a trust is classified as a grantor trust, the trust is essentially viewed as a pass-through entity, because the grantor is deemed to be the owner of part or all of the trust for U.S. federal income tax purposes. This was advantageous for several reasons. As long as the trust's assets were invested in property producing income from foreign sources or capital gain income from domestic or foreign sources, the income derived by the trust generally would, for U.S. income tax purposes, be treated as that of the foreign person who was the grantor and would not, therefore, be subject to U.S. federal income tax. Secondly, distributions from the trust to U.S. beneficiaries were classified as distributions from a grantor trust, so U.S. beneficiaries who received distributions from the trust were not subject to U.S. federal income taxation on such distributions.[109] Lastly, under the terms of the trust, there was usually no requirement for trust income to be distributed each year, so monies could accumulate in foreign grantor trusts as long as desired and be distributed to the beneficiaries income tax-free at some later time.

3. Post-1996 Tax Framework

The 1996 Act effectively eliminated the grantor trust status of these foreign trusts by treating a person as the owner of a trust's assets only if that person is a U.S. citizen, U.S. resident, or domestic U.S. corporation.[110] As a result, a foreign person who creates a trust is no longer considered the owner of the trust's assets, and the trust is classified as a non-grantor trust.[111] When a trust has been classified as a foreign non-grantor trust, it may still be possible for the trust to defer U.S. federal income taxation because, with certain exceptions,[112] the earnings of such a trust would not ordinarily be taxed directly by the U.S. government. However, when the

[107] *See* Harrison, Kirschner, & McCaffrey, "U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their U.S. Beneficiaries," *International Trust and Estate Planning* 1-2 (July 2008) (hereinafter referred to as "Harrison").

[108] *See generally,* §§ 671-679.

[109] Rev. Rul. 69-70, 1969-1 C.B. 182.

[110] Any foreign grantor trust that was in existence prior to September 20, 1995, is "grandfathered" and will continue to be a grantor trust as to any property transferred to it prior to such date provided that the trust continues to be a grantor trust under the normal grantor trust rules. Regs. § 1.672(f)-3(a)(3). Separate accounting is required for amounts transferred to the trust after September 19, 1995, together with all income and gains thereof.

[111] There are exceptions to this rule that are beyond the scope of this article. *See* Regs. § 1.672(f)-3. *See also* Harrison 2-7.

[112] Exceptions include certain income, dividends, rents, royalties, salaries, wages, premiums, annuities, compensations, remunerations, and endowments or other "fixed or determinable annual or periodic gains, profits, and income" ("FDAP" income) derived from the U.S. and income that is effectively connected with the conduct of a U.S. trade or business. *See* Giordani, Ripp & Jetel, "United States: Private Placement Life Insurance Planning," *Mondaq Business Briefing,* (11/24/09).

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trust distributes its income to a U.S. beneficiary, the distribution is then taxable to the U.S. beneficiary.

4. Tax Consequences of Foreign Non-Grantor Trust

a. Distributable Net Income ("DNI")

Generally, when distributions of distributable net income ("DNI") are made from a FNGT, the beneficiaries of the trust are taxed on their share of the distributions, and the trust receives a deduction from its taxable income to the extent of those distributions.[113]

A U.S. beneficiary is taxable on any amounts of income currently distributed from the trust's worldwide DNI.[114] The character of the income on trust assets when distributed to the U.S. beneficiary is determined at the trust level, even though the trust itself may not pay U.S. income tax on such income or gain.[115]

b. Undistributed Net Income ("UNI")

To the extent that DNI is not distributed in a taxable year to the trust beneficiaries, it is accumulated in the trust and becomes UNI, carried forward to the next tax year and beyond until it is finally distributed to the trust beneficiaries.

When a distribution is made from a FNGT, the distribution is first considered a distribution of the trust's DNI. If the distribution exceeds DNI, the excess is deemed to carry out any UNI that has accumulated in the trust. If the trust has no UNI, or if the distribution exceeds both the trust's DNI and UNI, then the excess is considered a distribution of trust principal. These principal distributions are not taxable income to the beneficiary.

c. Accumulation Distributions

Distributions from FNGTs of UNI are classified as accumulation distributions and taxed according to the "throwback" rules.[116] In general, the throwback rules tax accumulation distributions to a U.S. beneficiary at the tax rate that would have been paid if the income had been distributed in the year that the trust originally earned such income.[117] The net result is that, at the time of distribution, a U.S. beneficiary would be subject to tax first on the trust's current year DNI and, if current year distributions exceed DNI, then on the

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[113] For more information on FNGTs, *see supra* Section IV.C.1.

[114] This situation applies to discretionary distributions from foreign complex trusts; the situation would be somewhat different for U.S. beneficiaries of foreign simple trusts or foreign complex trusts with mandatory distribution provisions. *See* Harrison 23.

[115] Capital gain income is included in determining DNI, and retains its character in the hands of the U.S. beneficiary if distributed in the year that it was earned by the trust.

[116] *See* §§ 665-668. The throwback rules were imposed by U.S. lawmakers as a defense against the tax-deferral opportunities associated with the use of FNGT.

[117] §§ 666(b), (c); § 667(a).

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trust's UNI.[118] Additionally, when a distribution is made that is classified as UNI, an interest penalty is assessed and applied to the tax on the accumulation distribution.[119] This interest charge is compounded over the period during which the trust has UNI. The effect of the interest charge can cause an effective tax rate of 100% to apply after several years of accumulation. Furthermore, to the extent that capital gains are accumulated and distributed as UNI, they are stripped of their favorable tax character.[120] Thus, the longer UNI remains in the trust, the bigger the problem. And, to the extent that the trust is continuing to earn income, the problem will grow even larger each year that distributions are not sufficient to carry out the entirety of the trust's DNI.

5. PPLI as a Solution to the Accumulation Distribution Problem

a. In General

Despite the effective elimination of foreign grantor trusts (created by foreign persons) and all of the attendant benefits, all hope concerning favorable tax treatment is not lost. When planning on behalf of a trust to which these rules apply, the goal is to reclassify trust income as something that is exempt from income tax in order to mirror the structure of the old foreign grantor trusts. PPLI achieves this goal because income earned inside the policy is not taxed currently to the owner of the policy. Moreover, income distributed from the policy during the life of the insured is generally non-taxable under current law, if the distributions are properly structured.[121] Finally, all amounts paid out of the policy as a death benefit to the policy beneficiary are not subject to U.S. income tax at all.

For existing FNGTs with UNI (and previously foreign grantor trusts with income accumulated after the 1996 Act), PPLI can be an effective tool to stem the ever-increasing accumulation of income inside these trusts. In a typical situation, trust assets are used to pay life insurance premiums. As trust assets are gradually depleted by annual premium payments, the accumulation of income ceases. The trust still contains previously undistributed net income that is taxable to the U.S. beneficiary and subject to the interest penalty when the trustee makes a distribution in excess of DNI. However, in the case of trusts with large amounts of UNI, it may be advisable for the trustee to use trust assets to purchase at least one PPLI policy that is a MEC because a withdrawal from a MEC generates DNI that is taxed as such if distributed to the beneficiary in the same year as the withdrawal. This strategy allows distributions of trust assets in excess of current year non-insurance income to be taxed as DNI and avoid the throwback tax and penalty associated with a distribution of UNI. Finally, when the trust no longer has UNI, discretionary

118 *Id.*

119 *See* § 668.

120 For additional information regarding the throwback rules and the method of calculating the throwback tax, *see* Amy P. Jetel, "When Foreign Trusts Are Non-Grantor," 147 *Trusts & Estates* (April 2008).

121 In general, this means making withdrawals from a non-modified endowment life insurance policy up to the policy basis, then switching to policy loans.

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distributions can be made from the non-MEC life insurance policy via policy withdrawals or loans and, because these amounts are received by the trustee income tax-free, they are generally non-taxable when distributed to the U.S. beneficiary.

b. *Modified Endowment Contract ("MEC")*

Investment in a MEC policy can be a useful tool for a planner working with a FNGT that has a UNI problem. Purchasing a life insurance policy that is structured as a MEC can provide a mechanism for facilitating distributions from the FNGT without subjecting the beneficiaries of the FNGT to the throwback tax. Withdrawals from the MEC policy will be considered ordinary income (i.e., DNI) in the year of withdrawal (up to the amount of the difference between the cash value of the policy over the premiums paid into the policy).[122] Because distributions of DNI from a FNGT are not subject to the throwback tax, the trustee of the FNGT may distribute a sum equal to the amount of the withdrawal to the trust beneficiaries without the distribution being considered an "accumulation distribution." Despite the fact that the distributions from the MEC constitute ordinary income to the recipients, and a tax penalty of 10% may be incurred with respect to distributions made prior to age 59 ½, the cost associated with these penalties may still be less than the throwback tax that would otherwise be incurred under the UNI rules.

D. Planning for Foreign Persons Residing Temporarily in the U.S.

Investment in a variable annuity can be a highly successful planning technique for clients contemplating a temporary move to the U.S., but not planning to permanently relocate. Not only can the client defer U.S. federal income tax on inside build-up in the annuity during his or her stay in the U.S., the client can also avoid both federal income tax and federal estate tax if the annuity purchase and surrender are properly planned and implemented.

Prior to relocating, the client should acquire an annuity contract from a foreign insurer.[123] By funneling his or her non-U.S. assets into the annuity for the term of the client's U.S. residency, the client can avoid the tax on these worldwide assets that would otherwise be incurred as a result of the loss of NRA status. Then, when the client leaves the U.S. and resumes NRA status, the client can cash out of the annuity and resume the pre-residency status quo.

Purchase from a non-U.S. carrier is key to this temporary resident strategy. If the annuity contract is purchased from a U.S. insurer, or a foreign subsidiary of a U.S. insurer, then the contract will be a U.S.-situated asset subject to both federal income tax and federal estate tax (if the client were to die while resident in the U.S.).[124] If the contract is U.S.-situated, then when the client cashes out of the annuity upon returning to his or her home country, the client will receive U.S.-source income subject to the 30% federal income tax imposed on income earned

[122] § 72(e)(10); (2)(B).
[123] By purchasing the annuity contract prior to moving to the U.S., the client can avoid a 1% excise tax on the purchase. NRAs are exempt from this excise tax.
[124] Rev. Rul. 2004-75, 2004-2 C.B. 109; §§ 72, 2039.

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by NRAs.[125] Further, a U.S.-situated contract will also subject the client to mortality risk because the annuity contract will be included in the client's estate should the client pass away while residing in the United States.[126]

Also critical to the strategy is ensuring that the client does not surrender the annuity while still considered a U.S. resident. Otherwise, the client will lose the benefit of acquiring the contract from a foreign insurer as the client will be subject to all of the income from the surrender as part of the tax on the client's worldwide assets.

While a similar strategy could be implemented using life insurance, most clients will most likely want to pursue the strategy using an annuity, as the annuity purchase will generally be less expensive. If the client desires to receive a death benefit component, however, a life insurance purchase should be considered.

As with any planning involving foreign clients, the practitioner should assess the tax impact to the client in the client's home jurisdiction prior to implementing this strategy. Specifically, the practitioner should consider whether surrendering the annuity following a return to the client's home jurisdiction will result in negative tax consequences that would outweigh the benefit to the client of pursuing the strategy under U.S. tax law.[127]

V. Investment Considerations as Tax Rates Increase

While PPLI has multiple advantages as discussed throughout this article, one of PPLI's primary attractions is the tax advantages afforded life insurance under the Code. PPLI premiums accrete free of federal income tax during the life of the insured, and the death benefit passes to the beneficiary free of any federal income tax. A very favorable investment structure develops when coupled with underlying investments that are actively managed and which would typically generate investment income subject to ordinary income taxation (e.g., hedge funds, commodity funds, and high-yield taxable bonds).

For high income earners (individuals with adjusted gross incomes in 2016 in excess of $415,050; $466,950 for joint returns), the passage of the American Taxpayer Relief Act of 2012 resulted in capital gains and qualified dividend tax rates increasing to 20% from 15%, and top ordinary income tax rates increasing to 39.6% in 2013. Further, the passage of the Health Care and Education Reconciliation Act of 2010 resulted in the imposition of a 3.8% Medicare surcharge on net investment income. In summary, these tax rate changes resulted in the taxation of ordinary income at a top rate of 43.4% and the taxation of capital gains and qualified dividends at 23.8%. Further still, state income tax rates increased or will increase in many jurisdictions.

The impact of these tax changes is best exemplified by illustrative analysis. Table 1 presents a hypothetical comparison of a series of investments applying the current tax environment to private placement life insurance.

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[125] § 871(a).

[126] § 2039

[127] As noted, the practitioner and the client should always carefully consider the tax impact to the client in the client's home jurisdiction prior to implementing any U.S. planning strategy. The client's failure, while residing in the U.S., to comply with the tax, regulatory, and legal requirements imposed by the client's home jurisdiction could subject the client to civil and even criminal penalties under U.S. law. *See generally, Pasquantino v. U.S.*, 544 U.S. 349 (2005) (upholding wire fraud convictions of defendants in connection with scheme to evade Canadian liquor importation taxes).

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PPLI generates higher net investment returns over any reasonable investment horizon. Assuming four annual investment deposits of $2.5 million under current tax assumptions [Table 1], after 20 years, a taxable investment portfolio earning 8% will have a value of $21.8 million versus a value of $36.0 million within the PPLI policy. As a result of the power of tax-free compounding, after 40 years a taxable investment portfolio will have a value of $50.4 million versus a value of $157.5 million within the PPLI policy.

After 40 years, almost 213% more value emerges from the PPLI policy creating a compelling argument for PPLI on the tax advantages alone, notwithstanding the other benefits of PPLI discussed throughout this article.

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TABLE 1

Taxable Investment vs. PPLI
Current Tax Environment

			HYPOTHETICAL TAXED INVESTMENT PORTFOLIO				HYPOTHETICAL PPLI				
							Net Cash Value		Net Death Benefit		
Year	*Age*	*Annual Outlay*	*Ordinary/ STCG Income*	*Ordinary/ STCG Taxes*	*After Tax Portfolio Value*	*IRR*	*Amount*	*IRR*	*Amount*	*IRR*	*Cost as a % of Cash Value*
1	45	2,500	200	(93)	2,607	4.29%	2,615	4.60%	56,154	2146.16%	3.17%
2	46	2,500	409	(190)	5,326	4.29%	5,420	5.50%	58,959	338.20%	1.88%
3	47	2,500	626	(291)	8,162	4.29%	8,427	5.94%	61,966	151.65%	1.48%
4	48	2,500	853	(396)	11,119	4.29%	11,653	6.21%	61,966	88.56%	1.25%
5	49	0	890	(413)	11,596	4.29%	12,456	6.40%	61,966	61.78%	1.03%
10	54	0	1,097	(509)	**14,304**	**4.29%**	**17,576**	**6.83%**	27,594	12.57%	0.64%
15	59	0	1,354	(628)	17,646	4.29%	25,149	7.05%	33,700	9.38%	0.53%
20	64	0	1,670	(775)	**21,768**	**4.29%**	**36,013**	**7.15%**	43,936	8.31%	0.52%
30	74	0	2,541	(1,179)	33,125	4.29%	75,267	7.33%	80,536	7.58%	0.28%
40	84	0	3,867	(1,794)	**50,408**	**4.29%**	**157,494**	**7.41%**	165,369	7.55%	0.38%
50	94	0	5,884	(2,730)	76,709	4.29%	325,767	7.44%	329,024	7.46%	0.25%
56	100	0	7,570	(3,513)	98,685	4.29%	512,319	7.48%	512,319	7.48%	0.15%
		10,000	**165,457**	**(76,772)**							

Assumptions:
1. Earnings rate of 8%, net of management and custody fees, whether assets are invested in a taxed portfolio or PPLI.
2. All dollar values are shown in thousands.
3. Because it is assumed the assets are invested in tax-inefficient investments such as hedge funds and commodities, 100% short-term gains rates are used for the hypothetical taxed investment portfolio.
4. PPLI Non-MEC policy insuring the life of a Male, age 45, with a preferred non-tobacco rating.
5. Effective Income Tax Rates:

Ordinary Income/Short Term Gains Tax	39.6%
Investment Income Surcharge	3.8%
Total Federal Income Tax	**43.4%**
State Income Tax	3.0%
Total Income Tax	**46.4%**

VI. Reporting of Foreign Bank Accounts and Assets

A. Foreign Bank Account Report ("FBAR") Regulations

Another important planning issue that advisors should not overlook is the U.S. reporting obligations that may arise with respect to certain PPLI policies and PPVA contracts. U.S. persons with foreign bank and financial accounts have long been required to disclose annually information to the U.S. Treasury Department. In late February 2011, the U.S. Treasury Department issued final regulations on FinCEN Form 114, Report of Foreign Bank and Financial Accounts, commonly referred to as "FBAR."[128] Penalties for failure to report the required information can be severe, ranging from $10,000 to the greater of $100,000 or 50% of the balance of the account. Criminal penalties may also apply.

For purposes of FBAR filing, a United States person is a citizen or resident of the United States or an entity (including but not limited to a corporation, partnership, trust, or limited liability company) created under the laws of the U.S. or any state. Reportable accounts include the obvious, such as foreign bank and securities accounts. Life insurance policies issued by a foreign carrier are also reportable if the policy has a cash value. Although some foreign insurance

[128] 31 CFR § 1010.350.

companies elect to be treated as U.S. companies for tax purposes, the final regulations clarify that such an election does not relieve the U.S. owner from reporting the policy on the FBAR.[129]

A U.S. person has a reportable financial interest if that person is the owner of record or has legal title to, a foreign account, even if the account is held for the benefit of others. In addition, a U.S. person will need to report foreign accounts owned by an entity if that person's ownership of that entity exceeds 50%.

Individuals with signature or other authority over a foreign financial account are required to file an FBAR annually. The regulations provide a bright line test for determining whether an individual has such authority. If the foreign financial institution will act upon a direct communication from that individual regarding the disposition of assets in the account, the person is required to report the account on an FBAR annually.

Thus, non-U.S. PPLI and PPVA contracts should be reported on the FBAR of a person with a beneficial or legal interest in such contracts.

B. Form 8938-Statement of Specified Foreign Financial Assets

One of the provisions of The Foreign Account Tax Compliance Act ("FATCA") which became law in March 2010 requires individuals to report annually their interests in foreign financial accounts and foreign financial assets. The rules require individuals owning foreign accounts or financial assets to include IRS Form 8938, "Statement of Specified Foreign Financial Assets" with their annual income tax returns.

A "specified individual" (generally, a U.S. citizen or resident alien) who has an interest in one or more foreign accounts or financial assets must file Form 8938 if the aggregate fair market value of those foreign assets exceeds either $50,000 on the last day of the taxable year or $75,000 at any time during the year. These filing thresholds double for married individuals filing joint income tax returns ($100,000 on the last day of the year or $150,000 during the year). Higher filing thresholds apply to individuals residing outside the United States.

Currently there are two look-through rules applicable to individuals. First, the owner of a disregarded entity (such as a single-member limited liability company) is treated as having an interest in foreign financial assets owned by the entity for purposes of the Form 8938 filing requirement. Similarly, the grantor of a grantor trust is treated as owning the foreign financial assets of the trust.

The IRS anticipates issuing regulations that will require closely held domestic partnerships and corporations that earn predominately investment income to file Form 8938. Some domestic nongrantor trusts may also be required to file a Form 8938. Until the IRS issues such regulations, only individuals must file Form 8938.

The criteria for a Form 8938 filing requirement go far beyond the FBAR, however. Besides foreign accounts, individuals must also report other "foreign financial assets." Specified foreign financial assets include cash, custodial, or other financial assets maintained by a foreign financial institution, financial assets not held in an account maintained by a financial institution,

[129] 31 CFR § 1010.350 (c)(3)(ii). *See also*, Preamble to regulations.

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and any interest in a foreign entity.[130] Life insurance policies and annuities issued by foreign carriers are included as foreign financial assets required to be reported on Form 8938.

[130] § 6038D.

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