Offshore Life Insurance Planning for U.S. Clients

*by Leslie C. Giordani and Derry W. Swanger,**
Austin, Texas

Introduction

As the investment power of U.S. high-net worth individuals continues to grow steadily, many such individuals are asking their legal and financial advisors about tax-advantaged structures for passive investments and, more particularly, whether such structures exist offshore. A life insurance policy that is U.S.-tax compliant, especially one offered by an established offshore carrier, presents an excellent, conservative investment opportunity. Life insurance as a financial product has a long history in the U.S. as a tax-advantaged investment vehicle and has minimal legislative risk by virtue of the substantial lobbying influence of powerful groups, including the U.S. life insurance industry. Certain carriers in the offshore life insurance market offer "private placement" or, more appropriately, "customized" policies that are fully compliant with U.S. tax rules. With proper policy design, an investor can place wealth in a tax-free investment environment at a low cost, achieve protection against future creditor risk and local economic risk, gain financial privacy, and enjoy superior flexibility with regard to the policy's underlying investments.

The offshore life insurance market is in the growth and development phase, and there are significant traps for the unwary. Accordingly, it is important for the legal practitioner who counsels high net worth private clients for whom offshore life insurance planning is advantageous to understand the tax, investment, and pricing aspects of life insurance generally, and to be able to weigh the advantages and disadvantages of an offshore private placement policy against a domestic retail policy or a domestic private placement policy. It is equally important that the practitioner be attuned to jurisdictional issues when planning the offshore life insurance structure, and that the practitioner engage the services of a knowledgeable intermediary, such as an experienced insurance broker that dedicates itself to the offshore marketplace, to be involved in the design of the product, the selection of the carrier and attendant due diligence issues, and the ongoing service and compliance matters related to the policy.

The U.S. Client[1]

Private placement variable life insurance offers to U.S. qualified investors[2] the ability to select asset management beyond the predetermined asset management choices offered in retail variable life insurance products. This is attractive to high net worth clients who may have existing investment managers that they would prefer to designate to manage policy investments. Due to the expense associated with regulatory pressures imposed by federal and state securities laws and by state insurance boards, many domestic companies will agree to engage a policy owner's pre-selected investment manager only with a premium commitment of $20,000,000 or more. Therefore, the client market for domestic private placement variable life insurance is relatively narrow. Offshore insurance companies, on the other hand, are not subject to the same regulations imposed in the U.S. and therefore are able to engage the policy owner's investment managers with a smaller premium commitment. As a general rule, the U.S. client who

*Copyright 2000. Leslie C. Giordani and Derry W. Swanger. All rights reserved. Leslie C. Giordani and Derry W. Swanger are partners in the Austin, Texas law firm of Osborne, Lowe, Helman & Smith, L.L.P., where they practice in the areas of domestic and international estate planning, including offshore life insurance planning. Ms. Giordani and Mr. Swanger gratefully acknowledge the valuable input of the principals in Insurance Distributors International (Bermuda) Ltd., a Bermuda-based insurance brokerage company. The authors also sincerely appreciate the research and editorial assistance of Jennifer C. Lepold of Osborne, Lowe, Helman & Smith, L.L.P.

[1] While offshore life insurance planning is also available for other types of clients, such as U.S. non-resident aliens with U.S. beneficiaries and other foreign persons, the tax and planning issues for these types of clients is beyond the scope of this article. *See* Hugh T. McCormick, *Life Insurance Products,* J. TAXATION INV. at 46-56 (Autumn, 1999), for a more thorough treatment of U.S. tax issues for policy holders who are not U.S. taxpayers.

[2] Many practitioners and offering memoranda for offshore policies reference "qualified purchaser" or "accredited investor" standards as used in U.S. securities law to describe a suitable investor. In the offshore context, this should be considered a guideline and not a strict requirement, as the offshore policy would not actually be subject to SEC regulation.

desires an offshore policy, with respect to which a pre-selected manager of the policy owner is engaged, should have a net worth of at least $20,000,000[3] and should be prepared to make a total premium commitment of at least $5,000,000.

Generally, the client's motivations for investing in a private placement life insurance policy differ quite a bit from the reasons that U.S. persons typically purchase life insurance. Its value in the high net worth market is as an investment vehicle, optimally used for the most tax inefficient components of an investor's portfolio. The purchase of death benefit is secondary. Usually, therefore, the core goals for acquiring an offshore private placement variable life insurance product are to take advantage of the income tax and possible estate tax savings, to maximize investment choices, and to incur as little cost as possible in doing so. There are additional advantages of investing in an offshore private placement life insurance that will be discussed in detail below.

PRIVATE PLACEMENT VARIABLE LIFE INSURANCE

Tax Considerations

U.S. Federal Income Tax Benefits

The U.S. federal income tax advantages of life insurance are the same onshore and offshore. First, earnings on policy cash values, including dividends, interest, and capital gains, are not taxable to the policy owner as they accumulate within the policy, so the cash value grows much faster when compared to a taxable investment portfolio.[4] Consider the following example of a taxed investment versus accumulation inside an offshore life insurance policy. The example assumes single-life coverage on a 40 year-old male, with a $2,000,000 annual premium for five years, a 10% rate of return net of investment management fees (half of which is taxed as ordinary income [at 39.6%] and half of which is taxed as long term capital gains [at 20%]), and 50% annual turnover in the investment portfolio.

Year	Taxed Investment	Life Insurance Cash Value	Life Insurance Death Benefit
1	2,150,000	2,130,000	44,130,000
5	12,495,000	12,786,000	54,786,000
10	17,955,000	19,525,000	54,786,000
20	37,076,000	47,022,000	63,009,000
30	76,556,000	117,614,000	136,433,000
40	158,078,000	294,712,000	309,447,000
50	326,411,000	731,260,000	767,823,000

In addition to tax-free accumulation, withdrawals and policy loans by the policy holder can be used to access policy assets during the lifetime of the insured. Generally, such withdrawals and loans are received income tax free.[5] Finally, the proceeds payable at the death of the insured are excluded from the taxable income of the beneficiary,[6] and with proper structuring, may also be excluded from the taxable estate of insured.[7]

Other Tax Benefits

Offshore life insurance enhances the tax advantages described above because state premium taxes should not be payable when the client completes all aspects of the transaction offshore.[8] This results in a savings of approximately 2.35% of the premium. In addition, when the policy issuer is a foreign company that has not made an Internal Revenue Code ("IRC") § 953(d) election to be taxed as a domestic corporation,

[3] Net worth issues come into play in the context of an insurance company's financial underwriting process. In general terms, there must be sufficient net worth to justify the insurance coverage.

[4] *See* IRC § 72; IRC § 7702(g)(1)(A). Some income (*e.g.,* dividends) attributable to policy assets may nevertheless be subject to taxation (*e.g.,* by source withholding).

[5] If a policy is a modified endowment contract ("MEC") as defined by IRC § 7702A, however, proceeds of a loan or withdrawal are taxed as ordinary income to the extent of any gain in the policy cash value prior to the loan or withdrawal. To avoid this taxation, therefore, it is crucial that MEC status be avoided when it is intended that the policy cash value be accessible during the insured's lifetime through loans or withdrawals. On the other hand, because of the higher insurance related costs of non-MECs, if a policy is designed to pass wealth from one generation to the next without a need to access policy cash value during the insured's lifetime, non-MEC status is not crucial. Generally, non-MECs are characterized by a premium paid over five or six years, and MECs are characterized by a one-time, up-front premium payment.

[6] *See* IRC § 101(a)(1).

[7] *See* IRC § 2042. Generally, as long as the premium payor does not retain "incidents of ownership," the policy proceeds will be excluded from his or her estate for estate tax purposes.

[8] *See,* generally, Gerald R. Nowotny, *Rastafarian Life: Creative Planning Opportunities Using Offshore Life Insurance,* J. ASSET PROT. at 12 (July/Aug. 1999) (approximately 30 states impose the premium tax). State insurance taxes generally should not apply as long as the policy is negotiated, applied for, issued, and delivered offshore. However, the state laws applicable to the policy owner, insured, and beneficiary must be examined carefully on a case-by-case basis. In addition, although the constitutionality of such statutory provisions might be questionable, some states impose a "direct procurement tax" to collect the premium tax for transactions on the lives of state residents that take place out-of-state.

the federal deferred acquisition cost ("DAC") tax that otherwise might be assessed on the premium (which is usually about 1% of premiums paid) can be avoided. However, unless an offshore life insurance company has made an election under IRC § 953(d), 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. citizen or resident.[9] Consequently, the absence of the state premium tax and federal DAC tax, along with no or low premium sales loads, contributes to the substantially improved yields compared to taxable investments, as illustrated above, even taking into account the possible imposition of 1% federal excise tax.

Transfer Tax Planning

In addition to the considerable income tax benefits of life insurance planning, many clients also desire a flexible framework for transferring wealth to their children or multiple future generations in a transfer tax efficient manner. For example, a senior generation can pass assets in a leveraged manner to the next generation with minimal transfer tax liability by creating an irrevocable life insurance trust and by funding the insurance purchase using a private split dollar premium sharing arrangement.[10] When a client's net worth suggests the need for removing substantial assets from the estate tax base, a combination of offshore life insurance, a private split dollar arrangement, and a traditional irrevocable life insurance trust can be very effective.

Irrevocable Life Insurance Trust. An irrevocable life insurance trust is a commonly used estate planning technique. The trust should be a foreign trust for legal purposes (because it is important that the policy have a foreign owner), but it may be best to structure the trust as a trust that is domestic for tax purposes in order to avoid the onerous foreign trust reporting requirements, but, more importantly, to avoid the potential negative application of IRC § 684.[11] The classification of a trust as domestic for tax purposes can be accomplished by satisfying the definitional requirements set forth in IRC § 7701.[12]

Because it is important for the settlor's gift to the irrevocable life insurance trust to be a completed gift for gift tax purposes, the settlor should not retain a special testamentary power of appointment.[13] In addition, the settlor should retain no powers under the trust agreement that would cause the trust assets to be includable in the settlor's estate for estate tax purposes.[14] Moreover, the allocation of generation-skipping transfer ("GST")[15] tax exemption (if available) to the initial funding (as well as ensuring that additional assets contributed to the trust also are GST tax exempt) permits the policy proceeds to be received and passed free of GST tax as well.[16] This planning effectively removes the death proceeds from the estate of the settlor/insured and the assets in the trust will also avoid the GST tax.

As noted above, it is important that the trust, as owner of an offshore life policy, be foreign for ownership purposes in order to reduce the nexus between the policy and the U.S. jurisdiction where the client resides. This should negate an argument that the policy was acquired onshore and, therefore, would possibly be subject to state premium tax.

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[9] *See* IRC § 4371.

[10] A number of other transfer tax planning opportunities exist utilizing life insurance, but a full discussion of all of such opportunities is beyond the scope of this article.

[11] Under some circumstances, a U.S. person transferring property to a foreign trust (for tax purposes) may be required to pay income tax. Specifically, IRC § 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 IRC § 684 do not apply to the extent that the transferor or any other person is treated as the owner of the trust under IRC § 671. However, an open question currently exists as to whether gain will be recognized under IRC § 684 upon the *death* of a U.S. person who was treated as the owner of a foreign trust during that person's lifetime. Moreover, some tax commentators have questioned whether the imposition of IRC § 684 in the context of a life insurance trust will create a constructive sale immediately before the grantor's death sufficient to trigger the transfer for value rules of IRC § 101.

[12] Under IRC § 7701, 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. This test creates a strong statutory bias in favor of a trust being foreign. For example, under this test, a trust will be foreign even if it was created by a U.S. person and has all U.S. beneficiaries, if one foreign person has control over a "substantial" type of decision regarding the trust.

[13] *See* Treas. Reg. § 25.2511-2(b).

[14] *See* IRC §§ 2036 to 2041.

[15] The GSTT is a transfer tax (in addition to the estate tax) that is imposed at a flat rate of 55% on transfers that skip a generation. The purpose of this tax is to prevent the avoidance of estate tax at the skipped generation. That is, in the absence of GSTT, clients could, for example, leave property directly to their grandchildren, without subjecting that property to a transfer tax at their children's generation.

[16] *See* IRC § 2642.

Private Split Dollar Premium Sharing Arrangement.[17] Private split dollar arrangements occur when two parties share insurance premium costs and policy values in an arrangement that exists outside the context of an employment or entity-based relationship. Private split dollar usually occurs in a family arrangement, with a family member paying a majority portion of the insurance premium. With correct structuring of the arrangement, such portion should not constitute a taxable gift. The policy owner (usually the irrevocable life insurance trust) pays the portion of the premium equal to the economic benefit amount.[18] Upon the earlier to occur of the termination of the split dollar arrangement or the death of the insured, the policy owner reimburses the premium amount paid by the family member out of the policy's cash value or death benefit, as the case may be.

Estate planners traditionally have used private split dollar for the purpose of leveraging gift tax payments and GST tax exemptions, while excluding the owner's share of the death benefit from the insured's estate. Through the use of private split dollar, it is possible to shift wealth at a very low gift tax cost, at the same time keeping the death benefit proceeds out of the insured's gross estate for federal estate tax purposes. The insured derives the estate tax advantages of private split dollar when he does not have any incidents of ownership in the policy on his life, and when no portion of the death benefit proceeds are payable to the insured's estate.[19]

Until fairly recently, private split dollar was uncharted territory. To date, there exist no rulings or other legal authorities concerning the income tax consequences of private split dollar arrangements in the "family" context. One theory regarding the income consequences of a private split dollar arrangement holds that it should be treated as a series of loans with below-market interest rates under IRC § 7872. In effect, the interest-free loan is from the party paying the premium to the owner of the policy. If that is the case, the application of IRC § 7872 would require the owner of the policy to realize interest income equal to the applicable federal rate on the amount of the premium paid by the "lending" family member. Private Letter Rulings 9636033 and 9745019 are the only rulings in which the Internal Revenue Service (the "Service") has considered a private split dollar arrangement. In those rulings, the taxpayer asked the Service to rule upon certain gift and estate tax questions, but not income tax issues. In each case, the Service ruled favorably to the taxpayer with regard to the gift and estate tax issues, but declined to express an opinion regarding the application of IRC § 7872.

Private Letter Ruling ("PLR") 9745019 involved a split dollar collateral assignment arrangement pursuant to which the insured premium payer had only a security interest in an amount equal to the policy's cash value (payable upon termination of the split dollar agreement or at death, as the case may be) and possessed no other incidents of ownership. Similarly, PLR 9636033 involved a reverse split dollar collateral assignment arrangement pursuant to which the insured's spouse had only a security interest in an amount equal to the policy's cash value (net of any loans or other indebtedness secured by the policy), payable upon termination of the split dollar agreement or at the death of the insured, as the case may be, and the insured's spouse also possessed no other incidents of ownership. Because neither PLR 9745019 nor PLR 9636033 involved an equity split dollar arrangement, however, until the Service provides some guidance with regard to equity split dollar in a private split dollar arrangement, a risk exists that the Service would argue, under an analogy to TAM 9604001, that any equity build-up shifted to the policy owner constitutes an additional gift by the premium paying family member if such payer is entitled to receive something less than a return of his premium payment plus earnings thereon at the termination of the arrangement.[20]

Depending on the nature of the pricing of the economic benefit portion and the performance of the cash value, a private split dollar arrangement should "roll-

[17] A comprehensive treatment of private split dollar is beyond the scope of this article. For an interesting discussion of the subject in the offshore context, see Gerald R. Nowotny, *Rastafarian Private Split Dollar—The Dynamic Tax Duo of Offshore Life Insurance and Private Split Dollar,* J. ASSET PROT. (Sept./Oct. 1999).

[18] In second-to-die insurance, the value of the economic benefit (i.e., the cost of providing the "at risk" portion of the death benefit) is measured by reference to the U.S. 38 table. The U.S. 38 costs revert to P.S. 58 costs when one of the insureds dies. The U.S. 38 joint life rates are much lower than the P.S. 58 rates, typically a small fraction of the single-life rates.

In a single-life policy, the economic benefit is measured by the lower of the rates established in the P.S. 58 table that is set forth in Rev. Rul. 55-747, 1955-2 C.B. 228 or one-year term cost of the insurer, using a standard risk and an individually issued policy. The P.S. 58 costs rise dramatically as the client ages, forcing a need for a "rollout" or termination of the split dollar plan.

[19] *See* IRC § 2042.

[20] *See* Donald O. Jansen, *Private/Family Split Dollar Plans,* presentation to the AALU Educational Teleseminar (July 29, 1999). *See also, generally,* Yuhas and Fellows, *The Taxation of Split-Dollar Life Insurance: A Solution to the Dilemma,* TAXES at 252-261 (May, 1997); and Richard D. Landsberg, *Recent Rulings Highlight Options for Private Split-Dollar,* J. ASSET PROT. at 9-22 (Nov./Dec. 1998).

out," usually in or around the tenth to the fifteenth year. It will be helpful, over time, for offshore carriers to provide term products for single and joint and survivor life insurance that will have better rates than the tables with respect to which the economic benefit is otherwise calculated.[21] Currently, only a few offshore carriers have these alternative term rates available.

Investment Considerations

As mentioned above, a client who purchases an offshore private placement variable life insurance policy can designate her preferred investment manager for a reduced premium threshold requirement as compared to a policy that she might purchase in the domestic private placement market. Once contributed to the policy, a client may later shift investments to another investment manager without tax consequences. Generally, the investment advisor must be a professional investment advisor, and the insurance company will perform due diligence on the advisor to determine its suitability to manage the policy assets. In addition, some carriers charge a fee over and above their normal administrative fee against the policy cash value for the administrative work required to establish a new relationship with an investment manager.

Because of the absence of industry regulation, a broad universe of managers and investment styles is available to U.S. investors who purchase offshore life insurance. The U.S. client has the opportunity to invest in foreign securities and funds not otherwise open to U.S. investors and can invest policy assets in currencies other than the U.S. dollar.[22] In addition, clients usually can dictate that policy assets be invested in non-traditional products such as hedge funds. These "market-neutral" strategies that are attractive to investors because they reduce portfolio volatility, but may be tax inefficient because they typically generate high levels of taxable income, work well in a life insurance policy because of its tax-advantaged nature. Moreover, policy owners receive protection of their investments through the separate account legislation that exists in jurisdictions where offshore carriers typically are resident.[23]

Finally, there is a service issue that an offshore policy can resolve favorably. Domestic insurance agents are somewhat reluctant to provide client service on large domestic private placement policies because they are complex and highly regulated; it is often necessary for them to hire a third-party intermediary to provide servicing for these types of policies. In the offshore market, however, servicing by offshore insurance brokers is more straightforward because the investment universe is not restricted by SEC regulation, state imposed liquidity requirements, or state insurance regulation.

Pricing Considerations

Generally speaking, there are three principal insurance related fees associated with life insurance products: the premium load, the mortality and expense (or administration) charge ("M&E"), and the cost of insurance charge ("COI"). The non-insurance related fees are asset management and custodial fees.

One of the deterrents to using domestic life insurance as a tax-advantaged investment vehicle for large premium amounts is the high fees associated with insurance products in the U.S. retail market. Although commissions vary greatly throughout the industry, purchasers can be charged sales commissions of greater than 10% of their premium commitment.[24] Ongoing charges against a policy's cash value also vary, but typically exceed charges against cash value in the offshore market due (in part) to the asset management fee component, which generally is higher domestically. Also, policy holders usually incur a surrender fee if they surrender a policy within a certain time-frame. Many offshore carriers do not assess such a fee.

In contrast to the domestic market, the premium load in the offshore market is typically modest, perhaps around 1% of premiums paid. The M&E charge varies, but should be in the range of 60-70 basis points (0.6-0.7%) per annum on the policy's cash value. The insurer also assesses the COI charge against the policy's cash value, and it varies from year to year based on the "net amount at risk" and on the age, gender, and health status of the insured at the time of medical

[21] *See supra* note 18.

[22] Under any investment style, the policy owner should have *no* control over the investment decisions in the portfolios that they chose for their policy cash values. Rev. Ruls. 82-54, 1982-1 CB 12; 81-225, 1981-1 CB 11; 80-274, 1980-2 CB 27; and 77-85, 1977-1 CB 12. In addition, the investments must meet the diversification requirements contained in IRC § 817(h).

[23] In the event of a company default, the policy's cash values are outside of the claims of the insurance company's creditors. In Bermuda, for example, segregated account structures can be obtained only through a Private Act of Parliament. General legislation is expected to be forthcoming, however, as these petitions are becoming more and more routine. For a detailed discussion of segregated account companies in Bermuda and for a sample petition for a Private Act of Parliament, see Michael J. Burns and Monica Jones, presentation to The 2nd IBC Offshore Life and Annuities Forum (October 20, 1999).

[24] Onshore, additional loads against premiums are state premium tax and federal DAC tax.

underwriting. On average, over the life expectancy of the insured and depending on the earnings of the separate account, the *combination* of the M&E and COI loads on a joint and survivor product should be less than 1% per year and on a single life product should be less than 1.5% per year. Generally, the cost efficiencies exist because offshore carriers can offer lower administrative charges than domestic carriers due to lower overhead and franchise costs, lower or non-existent entity-level taxation, and the reduced cost associated with less governmental regulation.

In addition to the premium and cash value loads, the insured can expect to pay 25 basis points (0.25%) to 1.5% for asset management and custody (depending on the separate account value, the number of asset managers and custodians, and the actual fee schedules of the asset manager and custodian). Clients should also expect to pay legal fees associated with establishing the insurance structure and may sometimes incur a nominal underwriting fee.

Because the federal tax advantages of life insurance are the same onshore and offshore, it is the increased flexibility and reduction in cost resulting from state premium tax savings and lower sales loads and administrative charges that set offshore carriers apart from domestic carriers. There are other non-financial advantages offered in the offshore market that also merit discussion.

Legal Considerations

U.S. high net-worth clients often desire to globalize their holdings in a manner that protects them against future creditor risk and local political and economic turmoil. By virtue of its preferred status under applicable state exemption statutes, life insurance is an excellent asset protective vehicle, especially when coupled with sophisticated offshore planning. Because of the separate account protection that typically exists in the jurisdictions where carriers are resident, the insurance company must segregate the assets inside a private placement policy from its general account, which protects the 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 policy's cash surrender value, but also the death proceeds themselves from the claims of creditors.[25] 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.[26]

Many offshore 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 the offshore jurisdiction might allow the inclusion of spendthrift provisions in the policy so as to limit the policy owner's rights in the policy, thereby affording more asset protection to the policy.[27] If invested with an offshore 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 them because they are located offshore. The client will also enjoy investor confidentiality and financial privacy under the laws of many offshore jurisdictions that generally is not available in the U.S.[28]

Other Considerations

The offshore life insurance market is marked by the absence of high-pressure marketing that plagues the domestic retail life insurance market. In addition, offshore companies in smaller markets enjoy lower regulatory oversight and reporting obligations. Generally, offshore insurers pass on their reduced marketing costs and regulatory compliance and reporting as lower fees to the policy purchaser. When insuring their risks, offshore carriers have the choice of contracting with any one or more of the world-class reinsurers that participate in the offshore life insurance market. Finally, offshore life insurance carriers should be able to offer a wider variety of products and greater death benefit capacity as the client market expands.[29]

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

[26] For a complete state-by-state treatment of the exemption statutes relating to life insurance and annuities, see DUNCAN E. OSBORNE, ASSET PROTECTION: DOMESTIC AND INTERNATIONAL LAW AND TACTICS, Chapter 8 (1999).

[27] *See* Craig Douglas Hampton, Esq., *International Life Insurance Presents Unique Planning Opportunities,* 24 TAX MGMT. ESTATES, GIFTS TRUSTS J. No. 4 at 178 (1999).

[28] Special attention should be given, however, to tax collection and information exchange treaties between the selected jurisdiction and the U.S. For a detailed discussion of inter-governmental information exchange agreements, see Osborne, *supra* note 24 at Chapter 24A.

[29] For example, only a small number of offshore companies offer a joint and survivor product, which generally has the most inexpensive COI charges. However, as the market demand increases, it is assumed that additional offshore carriers will offer this type of product.

While U.S. clients typically draw from existing pools of cash or easily liquidated investments to fund their offshore policy, unique planning opportunities exist in the offshore market due to the absence of regulatory oversight. For example, clients usually can make in-kind premium payments of property other than cash in situations when a client prefers to invest non-cash assets. Additionally, it is possible for a client to exchange an underperforming domestic or foreign policy for a more cost and tax-efficient policy on a tax-free basis.[30]

With offshore life insurance, it is possible for U.S. clients to invest assets offshore without subjecting themselves to the heavy U.S. federal reporting requirements that arise in the context of typical transfers offshore, for example to a foreign trust. U.S. clients investing in offshore life insurance typically will avoid the cost of the annual reporting requirements for offshore transactions and will enjoy the privacy of investing assets offshore without detailed reporting to a federal agency.[31]

Product Design Issues

Although most investors are drawn to offshore private placement variable life insurance for its tax benefits, investment flexibility, and price structure, few regard the life insurance component (i.e., the death benefit payable in excess of cash value) as an independently important feature. However, the life insurance component of the product is critical with regard to its tax treatment—if the product fails to qualify as life insurance under the applicable U.S. tax rules, the U.S. tax benefits are lost. Moreover, if the cost of insurance and other fees assessed against the assets within the policy are too high, the client loses the tax benefit as a practical matter by virtue of poor performance over time attributable to those high costs and fees.

Generally, planners design offshore private placement variable life insurance policies in a way that maximizes cash accumulation and that reduces death benefit so that the cost of insurance affects the cash value to the smallest extent possible. In other words, the policies may provide the largest up-front infusion of cash with the correspondingly smallest death benefit purchase possible. Nevertheless, there are certain other product design issues that must be addressed in each case.

IRC § 7702 Compliance

In order to receive the U.S. tax advantages afforded to life insurance, any policy issued by a carrier (including a foreign carrier) after December 31, 1984, must meet the definition of life insurance under IRC § 7702; that is, a contract which is a life insurance contract under the applicable law, but only if such contract meets the cash value accumulation test (the "CVAT") or the two-pronged test comprised of the guideline premium test ("GPT") and cash value corridor test ("CVCT"). The purpose of these tests is to disqualify policies created for their investment component without regard to the actual relationship between the cash value and the contractual death benefit. The two methods of testing for IRC § 7702 compliance will have significantly different results in any given client situation. The availability of actuarially tested products using both tests varies from carrier to carrier. Some carriers have products that meet both tests; others have products that meet only one of the tests. It is important for an experienced insurance professional or actuary to determine which test works best for a particular case.

CVAT. Under Code § 7702(b), a contract qualifies as a "life insurance policy" if the cash surrender value, at any time, does not exceed the net single premium that a policy holder would have to pay at such time to fund future benefits under the contract assuming a maturity no earlier than the insured's age 95 and no later than the insured's age 100. The CVAT is generally applied to test whole life contracts.

GPT and CVCT. Code § 7702(c) sets forth the guideline premium test and IRC § 7702(d) describes the cash value corridor test. If the policy design implicates this alternative over the CVAT, it must satisfy both of these criteria tests. A policy will satisfy 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. A contract falls within the cash value corridor if the death benefit at any time is not less than the applicable percentage of the cash surrender value. At age 40, the applicable percentage is 250%, decreasing in increments to 100% at age 95.

MEC Testing. Frequently, the design of offshore life insurance planning is to maximize the growth of policy cash values without jeopardizing the policy owner's ability to have tax free access to those values during the insured's lifetime. If the policy owner

[30] The rules governing such an exchange under IRC § 1035 should be closely examined. For further discussion on this matter, see Hampton, *supra* note 27 at 186.

[31] For a detailed discussion of the U.S. reporting requirements applicable to foreign trusts and related foreign entities, see OSBORNE, *supra* note 24 at Chapter 24 and related Appendix 2.

funds the policy too heavily and thus it is defined as a modified endowment contract ("MEC"), she will pay tax on policy values that she accesses during the insured's lifetime at ordinary income rates to the extent of any gain in the policy asset prior to the loan or withdrawal.

Pursuant to IRC § 7702A, a contract is a MEC if it was entered into after June 21, 1988, and it fails to meet the 7-pay test of IRC § 7702A(b). 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. Generally speaking, non-MECs are characterized by a premium paid over four or five years and MECs are characterized by a one-time, up-front premium payment. Of course, if the purpose of the policy is to pass wealth from one generation to the next without requiring access to policy cash values, MEC status is inconsequential, and a MEC structure is preferable due to the superior tax-free compounding effect achieved by a one-time, up front premium payment.

IRC § 817(h) Diversification

In addition to IRC § 7702 compliance, policies also must comply with tests under IRC § 817(h) in order to qualify as life insurance. Code § 817(h) outlines the requirements of diversification of variable life insurance accounts. In its simplest form, each "segregated asset account" must contain at least five investments, and no one investment may represent more than 55% of the value of a separate account's assets, no two investments may constitute more than 70%, no three investments may comprise more than 80%, and no four investments may make up more than 90% of the separate account's value.[32] Failure to meet the diversification requirements under IRC § 817(h) will result in taxation of the cash value accumulation as ordinary income.

Owner Control. Another aspect of the diversification rules relate to owner control. While a policy holder is free to choose an investment manager to manage the policy's separate account (and to change managers if desired), the owner of the life insurance contract should have no control over the actual selection of investments by the separate account manager. The 1986 Temporary Regulations under IRC § 817(h) provide no guidance as to the circumstances in which investor control of the investments of a segregated asset account may cause the investor, rather than the insurance company, to be treated as the owner of the assets in the account. In PLR 9433030, the IRS required that the taxpayer make certain representations as a precursor to advance rulings on owner control. These representations include that (i) the policy holder does not have a legally binding right to require the insurance company or segregated account to purchase a particular investment, and a pre-arranged plan (regarding specific investments) must not exist; and (ii) a policy holder cannot have a legal or equitable interest in any investment held within the segregated account and must not communicate directly or indirectly with the investment officer for the insurance company or its affiliates.[33]

The tax compliance aspects of product design are of paramount importance. There are, however, other product design issues and contract points to consider in each case.

Number of Lives Insured

It is important in the illustration process to determine whether it is better from a planning perspective to purchase a single-life or joint and survivor product. Joint and survivor coverage is less frequently available in the offshore market, but availability should increase with market demand. As with domestic life insurance, the life being insured and the person funding the policy can be different persons, depending on age and health concerns, and assuming always that there is an "insurable interest" relationship.

Loan Spread and Loan Provisions

An often overlooked detail in policy design is the client's ability to access policy cash values on a cost advantageous basis. Many carriers offer competitive charges for the accumulation of values inside the contract, but charge a high spread on loan values or may have no loan clause in their contracts. As mentioned previously, careful attention should be given to non-MEC qualification if a client desires access to policy cash values.

Extended Maturity Option

As life expectancies gradually increase, it is important to understand what happens to the policy beyond the normal policy maturity age of 95 or 100. Offshore life insurance contracts often omit provisions related to this possibility. A forced return of cash values at an advanced age would result in a disastrous income tax liability.

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[32] *See also* Reg. 1.817-5.

[33] *See* Nowotny, *supra* note 8 at 13.

Cost of Insurance

Competitive COI rates are essential to good policy performance. As discussed above, COI rates vary depending on the age, gender, and health of the insured. In general, U.S. insureds can expect significantly lower COI rates than non-U.S. insureds. Some carriers have obtained reinsurance based on a blend of U.S. and non-U.S. lives, which results in higher costs. Other carriers mark up the reinsurance cost of their COI rates to provide a higher profit margin in what they hope will be an overlooked cost item. Finally, the bargaining power of the offshore carrier in the global reinsurance market often will be reflected in COI pricing, with superior pricing being obtained by larger carriers that can promise their reinsurers higher volume.

Split Dollar Capability

If the client's life insurance plan contemplates the use of a split dollar arrangement, it is important for the issuing company to offer competitive alternative term rates. This will minimize the economic benefit component of the split dollar premium payment, which generally is the component subject to gift tax. If the carrier does not offer term products from which split dollar plans can derive alternative rates, the economic benefit will be calculated with reference to the PS 58 tables in single life policies, which probably will produce a higher economic benefit amount than alternative term rates.

Investment Return Issues ("Force-Outs")

One of the most important non-tax design issues relates to whether a carrier will warrant against "force-outs" of cash value when the cash value grows more quickly than expected, thereby pushing up the required net amount at risk. Policy holders must pay tax at ordinary income rates on force-outs of cash. Accordingly, the optimal result is for the carrier to negotiate with the reinsurer to guarantee that the "at risk" portion will always remain sufficiently ahead of the cash value without the need to force cash out of the policy.

PRACTICAL REALITIES

Solicitation

If an offshore company or its agents have solicited an offshore life insurance contract in the U.S., such solicitation may subject the transaction to a potential claim by the state government of the state where the client resides for state premium tax payment. Some offshore carriers are more permissive than others in what they believe is allowable activity. The conservative approach is for the carrier and its agents to have no contact whatsoever with the client in the U.S. The client should travel outside the U.S. to negotiate the contract, take a physical exam, and sign any applications. Once issued, the insurer should deliver the policy to its owner offshore.

Underwriting

Planners must pay careful attention to the "insurance" nature of the life insurance contract, despite its tax and investment purposes. The insurance company must assume risk in the transaction, and the client must go through financial and medical underwriting that allows the carrier to assess that risk. Carriers typically require clients to divulge enough financial information to establish the need for insurance and an insurable interest. Clients also must submit detailed medical information and undergo an insurance specific medical examination by a qualified physician, typically a board certified internist. A conservative approach dictates that medical underwriting take place offshore. Even after these disclosures are made, a client could have medical or financial issues that will be a barrier to acquiring the contract on an economical basis. It is in the underwriting process that an experienced offshore life insurance professional can add tremendous value.

Policy Servicing

Affluent clients are not accustomed to dealing directly with insurance carriers, and many offshore companies do not have personnel available to provide client service at the desired level. For these reasons, it is preferable for a qualified offshore life insurance broker to work as an intermediary between the client and the carrier to provide annual policy servicing, to explain and confirm information received from the insurance company, and to evaluate the continued and long-term market competitiveness of the carrier and the product that the client selected.

Selection of Jurisdiction and Carrier Due Diligence

In addition to policy design, it is imperative that advisors give thought to issues related to the offshore jurisdiction that will govern the life insurance policy and its issuer. Countries such as Bermuda, the Bahamas, the Cayman Islands, Guernsey, Isle of Man, and Luxembourg all have insurance-friendly legislation and are the jurisdictions where most offshore carriers reside. Some of these jurisdictions have specific exemptions for life insurance and separate account statutes, and some do not. Other jurisdictional issues include the level of regulatory oversight that the jurisdiction's governing bodies have over the insurance industry, the relative political and economic stability of the jurisdiction, the jurisdiction's international reputation, and the availability of professional resources in that jurisdiction.

In addition to jurisdictional issues, there are several carrier related issues that a client's advisors should analyze in the due diligence process. Since this endeavor is properly undertaken by a qualified insurance broker, it will be discussed in the section related to brokers below.

Professional Involvement

Although reduced regulatory controls and taxation offshore establish a wonderful environment for creative insurance structures, it is the lack of regulatory oversight that demands the involvement of knowledgeable professional advisors in every offshore insurance transaction. Typically, both a legal advisor and an insurance broker are essential in the planning, implementation, and servicing of an offshore life insurance policy. The legal advisor will work with the client to plan and implement the structure in relation to the client's overall tax and estate plan, and the insurance broker will oversee product design, pricing issues, and carrier selection.

Legal Advisor

The legal advisor's role is fairly broad. The advisor should first perform due diligence on the client to confirm financial solvency prior to any transfers into an offshore policy. The advisor will then educate the client on the various aspects of the life insurance planning and may recommend further estate planning such as an irrevocable life insurance trust structure or split-dollar arrangement. The advisor will also act as tax counsel, analyzing the structure with an eye toward U.S. tax compliance, and will work with the insurance broker to implement the policy. Finally, the advisor will act as a communications liaison between the client and the insurance professionals.

Insurance Broker

A knowledgeable insurance broker should ensure U.S. tax compliance and competitive pricing. It is also the broker's responsibility to make product recommendations, to select the appropriate offshore carrier, and to negotiate the contract and associated fees. Keeping jurisdictional issues in mind, the broker should perform extensive due diligence on carrier candidates. Careful examination of the offshore carrier ensures that it is capable of performing its obligations over the term contemplated by the policy.

The offshore market is a mixed bag of small, newer carriers with very little capital on the one hand, and wholly owned subsidiaries of large U.S. or multinational companies on the other. The carrier, its parent, and/or its principal reinsurer should have a good credit rating from A.M. Best, Moody's, Standard & Poor's, and/or Duff & Phelps. If the carrier is not substantial in its own right, it should have a guarantee from a parent corporation with regard to satisfying any carrier claims. The financial condition of the company (and its parent, if applicable) should be examined carefully. In the case of a subsidiary, the broker should evaluate the parent company's commitment to the offshore market as some large U.S. carriers have made aborted attempts to enter the offshore marketplace.

The broker should also understand and evaluate the reinsurance treaties between candidates and their reinsurers. Reinsurance treaties are contractual arrangements in which the offshore carrier places some or all of the policy "at risk" amount (death benefit in excess of cash value) with other insurance companies or reinsurers. Because most offshore policies have relatively large face amounts, most, if not all, of the death benefit will be covered by reinsurance. A skilled broker must evaluate this issue to ensure that the carrier has the capacity to issue the death benefit required in a particular case and that the carrier has competitive reinsurance rates.

The broker will determine from the carrier its process and requirements for underwriting. The broker also will analyze the carrier's mortality costs and assumptions and the carrier's servicing and administration capabilities. The carrier should have in-force illustration capability and resources for adequate reporting to the policy holder. The broker will also fulfill an ongoing role in annual reviews and will continue to oversee the policy from a U.S. tax compliance standpoint.

Conclusion

The ever increasing demand by U.S. high net worth investors for tax efficient investment structures suggests a prominent role for the cost effective manner of achieving a non-taxable investment environment that is embodied in offshore private placement variable life insurance. With proper policy planning and design, U.S. clients can enjoy the "best of both worlds," cost efficiency and tax efficiency, using a well established, safe, and conservative financial product.

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Correspondence with respect to College business may be addressed to Executive Director, The American College of Trust and Estate Counsel, 3415 S. Sepulveda Boulevard, Suite 330, Los Angeles, California 90034. Telephone: (310) 398-1888. Fax: (310) 572-7280. Web site: www.actec.org.