CHAPTER 8

The Cash Value Beneficiary Defective Inheritor's Trust—Creating a More Flexible and Comprehensive Wealth Accumulation and Retirement Plan—Advanced Planning Issues: Part 2—Current Issues Regarding the Valuation of Life Insurance Policies and Advanced Wealth and Retirement Planning with Private Placement Life Insurance

LAWRENCE BRODY, JD, LL.M., AEP®

LESLIE C. GIORDANI

ROBERT G. ALEXANDER, JD, LL.M., EPLS, AEP®

ROBERT W. CHESNER, JR.

Lawrence Brody, JD, LL.M., AEP® (Distinguished): Bryan Cave LLP.

Leslie C. Giordani, JD: Giordani, Swanger, Ripp & Phillips, LLP.

Robert G. Alexander, JD, LL.M., EPLS, AEP®: Alexander & Klemmer, S.C.

Robert W. Chesner, Jr.: Giordani, Swanger, Ripp & Phillips, LLP.

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Synopsis

§ 8.01 INTRODUCTION TO THE CASH VALUE BENEFICIARY DEFECTIVE INHERITOR'S TRUST (THE "CASH VALUE BDIT"): CREATING A MORE FLEXIBLE AND COMPREHENSIVE WEALTH ACCUMULATION AND RETIREMENT PLAN

- **[1] General Introduction**
- **[2] Summary of the 2009 Article**
- **[3] Summary of the 2010 Article—Advanced Planning Considerations**
- **[4] The Two Components of Comprehensive Wealth Accumulation and Retirement Planning**
- **[5] An Introduction to the Beneficiary Defective Inheritor's Trust ("BDIT")—The Ultimate Structure to Protect Wealth**
  - **[a] Creating the "Ideal Plan"**
  - **[b] Description and Design of the BDIT**

[6] Constructing an Efficient, Comprehensive Wealth Accumulation and Retirement Plan by Including Cash Value Life Insurance

[7] The Cash Value BDIT—"CVBDIT"

[8] The Conclusions of the Weber and Hause Financial Analyses

[9] The Cash Value BDIT is a Better Life Insurance Trust

[10] Conclusion—The Superior Planning Benefits of the Cash Value BDIT

[11] Funding the Cash Value BDIT—An Overview of Private Split-Dollar and Premium Financing Arrangements

[a] Introduction

[12] Analysis of Split-dollar Arrangements

[a] Introduction

[b] The 2003 Split-Dollar Final Regulations

[c] Summary Description of Split-Dollar Arrangements

[13] Analysis of Premium Financing Arrangements

[a] Introduction

[b] Illustration of a Typical Private Premium Financing Arrangement Introduction

[14] Critical Planning Note with Respect to Funding the CVBDIT with Private Split-Dollar and Premium Financing Arrangements

[15] Conclusions Regarding Funding the Cash Value BDIT Using Split- Dollar and Premium Financing Arrangements

[16] The Cash Value BDIT—Modern Portfolio Theory and Life Insurance

[17] Conclusions Regarding the Cash Value BDIT, Modern Portfolio Theory and Life Insurance

[18] Relevance of the Previous Two Articles to the Present Discussions

§ 8.02 CURRENT ISSUES REGARDING THE VALUATION OF LIFE INSURANCE POLICIES

[1] The Critical Question: What is the "Fair Market Value" of a Life Insurance Policy for Tax Purposes?

[a] Introduction

[b] A Brief History of the Issue of Policy Fair Market Value—How We Got Where We Are Today

[2] A Strategic Issue: Understanding The Concept of the Interpolated Terminal Reserve ("ITR")

[3] Policy Valuation for Income Tax Purposes

[a] Generally

[b] Sales of Life Insurance Policies

[c] Sales of Policies by a Trustee

[d] The Life Settlement Market

[e] Policy Valuation and the Life Settlement Market

[4] Valuation of Policies for Estate and Gift Purposes

[5] Gift Tax Transactions Involving Policy Valuation

[6] Estate & Gift Tax Reporting Issues—IRS Form 712

[7] Section 2035—Estate Tax Inclusion Issues

[8] Four Case Studies Illustrating the Complexity of Valuing a Life Insurance Policy

[a] *Matthies v. Commissioner*, 134 T. C. 141 (2010)

[b] *Cadwell v. Commissioner*, 136 T.C. No. 2 (2011)

[c] *Lowe* and *Schwab*

[d] The Tax Court Values the Policy

[e] The Conclusion

§ 8.03 ADVANCED WEALTH AND RETIREMENT PLANNING WITH PRIVATE PLACEMENT LIFE INSURANCE AND PRIVATE PLACEMENT VARIABLE ANNUITIES

[1] Introduction

[2] Private Placement Life Insurance ("PPLI") and Private Placement Variable Annuities ("PPVA")

[a] Introduction

[b] Private Placement Variable Universal Life Insurance ("PPLI")

[c] Private Placement Deferred Variable Annuities ("PPVA")

[d] Additional Considerations with Private Placement Life Insurance

[3] What PPLI is Not

[4] The U.S. Client

[5] Foreign Trusts with U.S. Beneficiaries

§ 8.04 GENERAL TAX CONSIDERATIONS

[1] U.S. Federal Income Tax Benefits

[2] Other Potential Tax Benefits

[3] Transfer Tax Planning

[4] Private Placement Insurance and the Irrevocable Trust

§ 8.05 STRUCTURING PRIVATE PLACEMENT LIFE INSURANCE

[1] The Economics of a Private Placement Life Insurance or Annuity Contract

[a] Typical Structure of PPLI or PPVA

[b] Fees, Expenses, and Taxes

[2] Investment Considerations

[3] Pricing Considerations

[4] Legal Considerations: Asset Protection

[5] Other Considerations

[6] Product Design Issues

[a] Generally
[b] IRC § 7702 Compliance
[c] Cash Value Accumulation Test (“CVAT”)
[d] Guideline Premium Test (“GPT”) and Cash Value Corridor Test (“CVCT”)
[e] §7702A MEC Testing
[7] Section 817 Special Rules for Variable Contracts: Diversification Under IRC § 817(h) and the Investor Control Doctrine
[a] Generally
[b] Diversification
[c] Treatment of Funds
[i] Insurance Dedicated Funds
[ii] Non-Insurance Dedicated Funds
[iii] Look through Rules
[iv] “Double Look-Through” Allowed for Second-Tier IDFs
[v] IDF May Invest in Non-IDFs
[vi] Lingering Issues: Can a PPLI Separate Account Invest in an Adequately Diversified Mix of Non-IDFs?
[vii] Can Foreign Policy Owners Invest in IDFs?
[d] Investor Control
[i] Conduct Deemed to be Investor Control
[ii] Is the Asset Allocator Model Viable?
[iii] Conclusion
[8] Insured Lives
[9] Loan Spread and Loan Provisions
[10] Extended Maturity Option
[11] Cost of Insurance
[12] Investment Return Issues (“Force-Outs”)
§ 8.06 PRIVATE PLACEMENT LIFE INSURANCE—PRACTICAL REALITIES
[1] Solicitation
[2] Underwriting
[3] Policy Servicing
§ 8.07 U.S. TAX TREATMENT OF ANNUITIES
[1] Qualifying as an Annuity
[2] Section 72: Annuity Contract Defined
§ 8.08 U.S. SECURITIES TREATMENT OF PPLI AND PPVA
[1] Qualification as an Accredited Investor and Qualified Purchaser
[2] Special Considerations for Offshore Policies

§ 8.09 TAX TREATMENT OF LIFE INSURANCE AND ANNUITIES—A CLOSER LOOK

[1] Introduction to Federal Income Tax Treatment of U.S. Citizens and Residents As Compared with Non-resident Aliens ("NRAs")

[2] Income Tax Rules Applicable to U.S. Taxpayers Who Own Life Insurance Policies

[a] Non-Taxation of Internal Build-Up

[b] Distributions During Policy Term

[i] Non-Modified Endowment Contract Distributions

[ii] Modified Endowment Contract Distributions

[c] Surrender or Maturity of Policy

[d] Policy Proceeds

[e] Transfer for Value Rule

[f] Section 4371: Excise Tax on Life Insurance Premiums Paid to Foreign Insurers

[g] Section 1035: Tax-Free Exchange

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

[a] Generally Similar to Rules for U.S. Taxpayers

[b] Taxable Amounts Subject to Withholding

[4] Transfer Tax Rules Applicable to U.S. Taxpayers Who Own Life Insurance Policies

[a] U.S. Estate Tax Rules

[b] U.S. Gift Tax Rules

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

[a] Taxation of Transfers of U.S.-Situated Assets

[b] Section 2105

[6] Income Tax Rules Applicable to U.S. Taxpayers who Own Annuities

[a] Tax During Accumulation Period

[b] Tax During Annuitization Period

[c] Tax Following Annuitant's Death

[7] Income Tax Rules Applicable to Non-U.S. Taxpayers who Own Annuities

[a] Generally Similar to Rules for U.S. Taxpayers

[b] Withholding

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

[8] Transfer Tax Rules Applicable to U.S. Taxpayers who Own Annuities

[9] Transfer Tax Rules Applicable to Non-U.S. Taxpayers who Own Annuities

§ 8.10 PRIVATE PLACEMENT LIFE INSURANCE—SELECTION OF JURISDICTION AND CARRIER DUE DILIGENCE

§ 8.11 PRIVATE PLACEMENT LIFE INSURANCE—PROFESSIONAL INVOLVEMENT
[1] Introduction
[2] Legal Advisor
[3] Insurance Broker
§ 8.12 PLANNING STRATEGIES
[1] Domestic vs. Offshore PPLI/PPVA
[a] In General
[b] Statutory Asset Protection
[2] Planning for the U.S. Taxpayer
[a] Domestic Gifting Trust Ownership of Policy
[b] Irrevocable Life Insurance Trusts (on a Grand Scale)
[i] Lifetime Exclusion Gifting
[ii] Private Split-Dollar Funding
[iii] The Impact of Section 684 on Offshore ILITs and CVBDITs
[3] Planning for Foreign Non-Grantor Trusts with U.S. Beneficiaries
[a] What is a Foreign Non-Grantor Trust (“FNGT”)?
[b] Background: Pre-1996 Tax Framework
[c] Post-1996 Tax Framework
[d] Tax Consequences of Foreign Non-Grantor Trust
[i] Distributable Net Income (“DNI”)
[ii] Undistributed Net Income (“UNI”)
[iii] Accumulation Distributions
[e] PPLI as a Solution to the Accumulation Distribution Problem
[i] In General
[ii] Modified Endowment Contract (“MEC”)
[4] Planning for Foreign Persons Residing Temporarily in the U.S.
§ 8.13 INVESTMENT CONSIDERATIONS AS TAX RATES INCREASE
§ 8.14 FOREIGN BANK ACCOUNT REPORT (FBAR) REGULATIONS
§ 8.15 PRIVATE PLACEMENT LIFE INSURANCE AND HEDGE FUNDS
[1] Introduction: Why Hedge Funds?
[2] Benefits and Risks of Hedge Funds
[3] Superior Risk-Adjusted Returns
[4] Types of Hedge Funds and How They Produce Investment Returns
[a] Generally
[b] Long/Short Equity Market Neutral
[c] Merger Arbitrage
[d] Convertible Arbitrage
[e] Relative Value Arbitrage

[f] Event Driven
[g] Regulation D
[h] Fixed Income Arbitrage
[i] Distressed Securities
[j] Long/Short Equity Directional
[k] Emerging Markets
[l] Macro Funds
[5] Tax Characteristics of Hedge Funds
[6] SEC Issues
[7] Coordination with Private Placement Variable Life Insurance
[8] Conclusion
§ 8.16 SUMMARY OF THE POSSIBLE ADVANTAGES AND DISADVANTAGES OF PRIVATE PLACEMENT LIFE INSURANCE AND PRIVATE PLACEMENT VARIABLE ANNUITIES
[1] Possible Advantages of PPLI
[2] Possible Disadvantages of PPLI
§ 8.17 PUTTING PRIVATE PLACEMENT LIFE INSURANCE ALL TOGETHER
§ 8.18 EXHIBITS

§ 8.01 INTRODUCTION TO THE CASH VALUE BENEFICIARY DEFECTIVE INHERITOR'S TRUST (THE "CASH VALUE BDIT"): CREATING A MORE FLEXIBLE AND COMPREHENSIVE WEALTH ACCUMULATION AND RETIREMENT PLAN

[1] General Introduction

This article is the third in a series discussing how to combine modern trust drafting and cash value life insurance to create a more flexible and comprehensive wealth accumulation and retirement plan than may be more effective for the appropriate client than conventional planning options such as traditional tax qualified plans, 401(k)s, NIMCRUTS and traditional wealth planning trusts.

The first article[1] discussed in detail the axioms of modern wealth transfer and asset protection planning, the Beneficiary Defective Inheritor's Trust ("BDIT"), perhaps the most efficient and effective wealth transfer and asset protection legal structure available to modern planners, the concept of cash value life insurance as a separate

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[1] Robert G. Alexander and Michael W. Halloran, *The Cash Value Beneficiary Defective Inheritor's Trust (The "Cash Value BDIT"): Creating a More Flexible and Comprehensive Wealth Accumulation and Retirement Plan*, NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION ¶ 7 (2009).

uncorrelated asset class and a very powerful wealth accumulation and retirement planning vehicle and how to combine all of these topics into a the planning concept known as the Cash Value BDIT ("CVBDIT")—a more flexible and comprehensive wealth accumulation and retirement plan.

The second article[2] reviewed the materials presented in the first article and then discussed in detail how to supercharge the funding of life insurance premiums into the CVBDIT using private split-dollar and premium financing arrangements. The second part of this article was an in-depth discussion of modern portfolio theory and life insurance.

This present article, the third in the series, builds on the concepts presented in the first two articles and discusses the critical issues involved in the proper valuation of a life insurance policy as well as the possibility of high net worth client's increasing the planning benefits of the CVBDIT as a wealth accumulation and retirement planning strategy by using private placement life insurance as an asset held by the CVBDIT.[3]

Before entering into a detailed discussion of the two topics which are the focus of this third article, it is important that the reader is grounded in the materials presented in the first two articles. Therefore the following parts of this §8.01 will briefly review the contents of the first two articles.

Note to the reader: Larry Brody did not participate in the preparation of this article other than in § 8.02. Leslie C. Giordani and Robert W. Chesner, Jr. did not participate in the preparation of §§ 8.01 and 8.02 of this article. A non-participating author did not give any advice, review, edit or make any comments to the participating authors of a particular Section regarding these materials. The content (including the opinions, methods and conclusions expressed in any Section are the sole responsibility of the participating authors of that Section. A non-participating author does not necessarily endorse or express any approval (express or implied) of the content, methods and conclusions of any Section(s) her or she did not participate in.

[2] Summary of the 2009 Article

The 2009 edition of the *New York University Review of Employee Benefits and Executive Compensation* included an article written by Robert G. Alexander, J.D. LL.M., EPLS, AEP and Michael W. Halloran, CLU, ChFC, CFP®, AEP entitled *The Cash Value Beneficiary Defective Inheritor's Trust (The "Cash Value BDIT"): Creating a More Flexible and Comprehensive Wealth Accumulation and Retirement*

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[2] Lawrence Brody, Robert G. Alexander and Gary L. Flotron, *The Cash Value Beneficiary defective Inheritor's Trust: Advanced Planning Issues—Split-Dollar and Premium Financing Arrangements and Modern Portfolio Theory and Life Insurance*, NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION ¶17 (2010).

[3] The relevance of these two topics to the dynamics of the CVBDIT is discussed in §8.01[16] *infra*.

Plan.[4] The article examined how the planning concept the authors' referred to as the "Cash Value Beneficiary Defective Inheritor's Trust" (the "CVBDIT") can provide clients with a more flexible, comprehensive retirement and wealth accumulation plan than traditional retirement and other planning vehicles including traditional tax qualified retirement plans, 401(k)s, NIMCRUTS and traditional wealth planning trusts. The reason is that a Cash Value BDIT combines 1) the comprehensive wealth accumulation and retirement planning benefits of well-designed cash value life insurance as part of a properly balanced, diversified financial and retirement plan[5] with 2) the wealth transfer and asset protection features of a multi-generational Beneficiary Defective Inheritor's Trust ("BDIT").[6] The authors demonstrated that if properly coordinated, the combination of cash value life insurance with a BDIT can provide clients with a more flexible wealth accumulation and retirement plan because they will have more options with respect to accessing retirement funds during lifetime (often on a tax-free or tax-deferred basis) than may be available with traditional plans, enhanced opportunities to accumulate more wealth, significant opportunities to plan leveraged income tax strategies, and the ability to protect wealth from transfer taxes, divorcing spouses and creditors forever. The authors also illustrated how the enhanced planning features of a Cash Value BDIT will allow clients to maintain control over their wealth both during their lifetime and at death, allow clients to compound and protect wealth on a multi-generational basis, provide flexibility to alter the client's planning in order to react to changed circumstances in the future, and minimize (and often eliminate) financial, tax and legal risks.[7]

Alexander and Halloran concluded that the Cash Value BDIT is, perhaps, the ultimate opportunity to protect, preserve and dramatically grow family wealth and allow clients (and eventually their families for multiple generations) access to accumulated wealth for retirement and other purposes on a tax-advantaged or tax-free

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[4] Alexander & Halloran, *supra* note 1, at 4.

[5] Independent insurance consultant Richard M. Weber (Pleasant Hill, CA) provided valuable insights, advice and guidance with respect to the concept of cash value life insurance as a separate uncorrelated asset class and generously allowed the authors to incorporation portions of the white paper he co-authored with Christopher Hause into the 2009 article: Richard M. Weber and Christopher Hause, *Life Insurance as an Asset Class; A Value-added Component of an Asset Allocation*, copyright 2008 (unpublished manuscript on file with the authors).

[6] The Beneficiary Defective Inheritor's Trust ("BDIT") was created by Attorney Richard A. Oshins (Las Vegas, Nevada) in the mid-1970's. Attorney Oshins provided invaluable insights, advice and guidance to Alexander and Halloran in the preparation of their 2009 article, including his generous permission and encouragement to incorporate into that article both planning concepts and significant portions of materials originally published under his name.

[7] Alexander & Halloran, *supra* note 1, at 4.

basis without disturbing the client's beneficial enjoyment of the transferred property.[8]

[3] Summary of the 2010 Article—Advanced Planning Considerations

The 2010 edition of the New York University Review of Employee Benefits and Executive Compensation included an article written by Lawrence Brody, JD, LLM, AEP® (Distinguished), Robert G. Alexander, JD, LLM, EPLS, AEP® and Gary L. Flotron, M.B.A., CLU, ChFC, AEP® entitled *The Cash Value Beneficiary Defective Inheritor's Trust: Advanced Planning Issues—Split-Dollar and Premium financing Arrangement and Modern Portfolio Theory and Life Insurance.*[9] The purpose of this article was to build on the concepts presented in the 2009 article and examines in detail two additional, critically important advanced planning considerations with the Cash Value BDIT:

1. Appropriate planning techniques to adequately fund the life insurance premiums necessary for a successful Cash Value BDIT by utilizing private split-dollar and premium financing strategies.
2. An in-depth analysis of how to manage wealth within the Cash Value BDIT incorporating modern portfolio theory and life insurance (expanding on the original studies by Weber and Hause).

Prior to examining the materials presented in this third article it is essential that the reader understand the foundational concepts presented in the 2009 and 2010 articles. Without being grounded in these concepts the reader may find it difficult to successfully navigate through and thoroughly understand the topics presented in this third article. Therefore, the following section is a comprehensive summary of the original article, including an explanation of:

1. the two essential components of comprehensive wealth accumulation and retirement planning;
2. the Beneficiary Defective Inheritor's Trust ("BDIT")—the ultimate structure to accumulate and protect wealth;
3. how to construct an efficient, comprehensive wealth accumulation and retirement plan by including cash value life insurance; and
4. the Cash Value BDIT ("CVBDIT")—combining cash value life insurance with the BDIT.

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[8] *Id.* at 42.

[9] Lawrence Brody, Robert G. Alexander and Gary L. Flotron, The Cash Value Beneficiary defective Inheritor's Trust: Advanced Planning Issues—Split-Dollar and Premium Financing Arrangements and Modern Portfolio Theory and Life Insurance, NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION Ch. 17 (2010). This § 8.01[3] and the following §§ 8.01[4]-[15] have been abstracted, revised and edited from major portions of the original 2010 article with the permission of the authors of that article.

[4] The Two Components of Comprehensive Wealth Accumulation and Retirement Planning[10]

Maximizing efficient, comprehensive wealth accumulation and retirement planning has two major components: 1) accumulating wealth in tax efficient financial vehicles, and 2) protecting wealth by owning and managing it in the most efficient tax and legal structures. One of the major thesis of the original 2009 article is that the proper coordination of cash value life insurance with a BDIT may be the most flexible, comprehensive and efficient structure to accomplish both of these goals. Quoting from well know experts in the wealth planning profession, the authors stated that harnessing the power of efficient, tax-free compounding perhaps is the most important concept in financial and estate planning, a concept that includes both income tax free and wealth transfer tax free compounding:[11]

Recently a concept that has received significant attention in the wealth and retirement planning community is the importance of cash value life insurance in modern, comprehensive wealth accumulation and retirement planning. The reason is obvious, cash value life insurance takes advantage of the single most important concept in financial and retirement planning—income tax free compounding. At the 2009 43rd Annual Philip E. Heckerling Institute on Estate Planning, nationally known estate planning attorney Jonathan Blattmachr stated that the most important concept in financial planning is income tax free compounding. In the context of wealth transfer planning, he opined that income tax free compounding is more important than getting 30% valuation discounts, or using GRATs and other advanced wealth shifting techniques.[12]

Interestingly, during the mid-1970s both Professor Casner and Professor Cooper opined that the transfer tax free, multi-generational trust was the most important planning technique to erode or completely avoid the transfer tax system because a properly designed dynasty trust can provide clients and their families with transfer tax free wealth compounding in perpetuity.[13] Despite the imposition of the Generation

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[10] *Id.* at 4.

[11] *Id.*at 5-6.

[12] See also: JONATHAN G. BLATTMACHR, WEALTH PRESERVATION AND PROTECTION FOR CLOSELY-HELD BUSINESS OWNERS (AND OTHERS) 132-138 (Libby Publishing Incorporated 1993); and Blattmachr, *Creative Uses of Life Insurance in Estate and Financial Planning*, 44th NAEPC Annual Conference (2007).

[13] COLUMBIA LAW REVIEW 161 (March 1977, reprinted in 1979 to reflect the Revenue Act of 1979 by the Brookings Inst.). References hereunder will be made to the Brookings Inst. version.

Hearings before the House of Ways and Means Comm., 94th Cong., 2nd Sess. Pt. 2 1335 (1976) (statement of Prof. A. James Casner).

Skipping Transfer Tax ("GSTT"),[14] one of the theses of this article is that the dynastic Beneficiary Defective Inheritor's Trust ("BDIT") may be the best vehicle currently available to minimize or eliminate the effect of the transfer tax system due to the nature of its transfer tax-free compounding, income tax leveraging and the fact that in most instances a skilled practitioner can leverage or finesse the GSTT exemption limitation ($3.5 Million—2009). Although not advanced by Professors Casner and Cooper, a perpetual BDIT is also the best vehicle to 1) avoid family wealth diminution from creditors and 2) provide additional wealth shifting opportunities by means of the BDIT design feature known as the income "tax burn".[15]

[5] An Introduction to the Beneficiary Defective Inheritor's Trust ("BDIT")—The Ultimate Structure to Protect Wealth[16]

[a] Creating the "Ideal Plan"[17]

The Beneficiary Defective Inheritor's Trust ("BDIT") undoubtedly is one of the most powerful estate, tax and asset protection strategies available to planning professionals.[18]

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[14] IRC Chapter 13, §§ 2601 through 2664.

[15] The term "tax burn" refers to the transfer tax free shifting of wealth to the Cash Value BDIT resulting from the primary trust beneficiary (the "Inheritor/Beneficiary of the BDIT) personally paying the income tax on income earned by the trust. These payments do not result in taxable gifts to the trust or the trust beneficiaries. Rev. Rul. 2004-64. When the trust beneficiary pays income tax on phantom income, he/she is "burning up" his/her assets not held in trust.

[16] Alexander & Halloran, *supra* note 1, at 6–9.

[17] Alexander & Halloran, *supra* note 1, at 9–10.

[18] The Beneficiary Defective Trust, the original version of the BDIT, was created by attorney Richard A. Oshins in the 1970s. For complete technical explanations of the BDIT see Richard A. Oshins, Robert G. Alexander & Kristen E. Simmons, *The Beneficiary Defective Inheritor's Trust (BDIT)—Finessing the Pipe Dream*, CCH Practitioner's Strategies, (Nov. 2008) and Richard A. Oshins, *The Beneficiary Defective Inheritor's Trust ("BDIT")*, (2008), revised and edited with additions by Robert G. Alexander and titled *The Beneficiary Defective Inheritors Trust (BDIT): Creating the Ideal Wealth Transfer and Asset Protection Plan* (2009) (unpublished manuscripts, on file with the authors) [hereinafter Oshins, *Creating the Ideal Wealth Plan (2009)*]. See also: Jerome M. Hesch & David A. Handler, *Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth*, 68 N.Y.U. TAX. INST. ON FED TAX'N, (2009); Michael D. Mulligan, *Fifteen Years of Sales to IDITs—Where Are We Now?*, 35 ACTEC J.227 (2009); Steve R. Akers, *Transfer Planning, Including Strategies to Maximize Benefits of GRATs and Sales to Grantor Trusts Given Recent Market Declines*, (May 2009) (unpublished manuscript, on file with the author at Bessemer Trust, N.A.); Steven B. Gorin, *Beneficiary Grantor Trusts and PLR 200949012*, TAX MGMT. EST. GIFTS AND TRUSTS J. (2010); Gideon Rothschild, Douglas J. Blattmachr, Michael M. Gans, & Jonathan G. Blattmachr, *Alaska Trusts: IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate,* (unpublished manuscript, on file with the authors); Jonathan G. Blattmachr, Michael M. Gans, & Elvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 78*, 35 ACTEC J. 106 (2009); Jonathan G. Blattmachr & Diana S. G. Zeydel, *Calculating the Grantor Portion*

The BDIT enables clients to implement an ideal comprehensive wealth, retirement and asset protection structure because it includes all of the client's potential desires and goals and maximizes the lifetime control, use, enjoyment and management of the client's wealth. In the authors' experience the "bundle of rights" that a knowledgeable client desires to include in his/her wealth accumulation and retirement plan (if these are attainable) will consist of all the following:

1. the opportunity for income tax deferred (and preferably tax-free) wealth compounding;
2. the ability to access the income from his/her property until his/her death;
3. the ability to have his/her assets available for his/her use and enjoyment until his/her death;
4. the right to decide who will receive his/her property at his/her death or during lifetime if the client decides to give the property away;
5. the power to determine in what form and when his/her beneficiaries ultimately will inherit the accumulated wealth;
6. the right to manage, control and use his/her wealth until death;
7. the ability to protect his/her wealth from creditors, including divorcing spouses, in perpetuity;
8. the opportunity for income tax benefits and estate tax savings;
9. the ability to keep the client's wealth outside the wealth transfer tax system in perpetuity, and
10. the ability to "rewrite" the plan in order to react to changed circumstances.

A properly structured BDIT will allow clients to achieve all ten (10) of these goals with essentially no financial, tax and legal risk.

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of a Trust with a 5 x 5 Demand Power, LISI EST. PLAN. NEWSLETTER (Jan. 2010), at 1575 *available at* http://www.leimburgservices.com; Robert G. Alexander and Kristen Simmons, *Enhancing Advanced Wealth Planning and Asset Protection Strategies: Combining Cash Value Life Insurance with a Beneficiary Defective Inheritors Trust (BDIT)*, CCH Practitioner's Strategies (Nov. 2009); *The Beneficiary Defective Inheritors Trust: The Best Thing Since Sliced Bread? Maybe, for the Right Client . . .*, Northwestern Mutual Life Insurance Company, Advanced Planning Bulletin (Sept. 2009); Robert G. Alexander, *The Beneficiary Defective Inheritors Trust: Creating the Ideal Wealth Transfer and Asset Protection Plan*, Estate Planning, Society of Financial Service Professionals (May 2010); Steven B. Gorin, *Beneficiary Defective Grantors Trusts (BDGT)*, ABA RPPT Business Planning Group, June 2, 2010 Telephone Conference, http://www.abanet.org/dch/committee.cfm?tom=rp519000.

[b] Description and Design of the BDIT

Essentially, the BDIT is a third-party settled trust designed: (1) to give the client (who is both a trustee and the initial primary beneficiary of the trust) control and beneficial enjoyment of trust property such that the client can use and manage the trust assets without compromising the trust's ability to avoid transfer taxes at the client's death, and (2) to protect the trust assets from the client's creditors. After the death of the client (the primary beneficiary), control of the trust passes to subsequent primary beneficiaries, often on a *per stirpes* basis, subject to change through the exercise of a special power of appointment by the client.[19] In addition to receiving control of the trust, the subsequent primary beneficiaries also receive the benefits of trust-owned property such as: (1) transfer tax avoidance, (2) creditor protection, including protection from a divorcing or separated spouse, and (3) potential income tax savings, including state income tax savings if the trust situs is a state with no state income tax.[20]

The critical concept empowering the BDIT is the axiom that assets received by gift or inheritance from a third party and retained in a properly structured trust are protected from unnecessary exposure to the client's "predators", including the IRS (unnecessary income and wealth transfer taxes), judgment creditors, a divorcing spouse, disgruntled family members and business partners. In fact, assets held in trust are more valuable than assets owned outright because "a person can receive more rights in a trust than he can obtain by owning property outright, provided that the transfer to the trust is funded by a third party. Since a transferor can confer more rights and benefits by making transfers in trust than giving the property outright, it would also be reasonable to conclude that virtually all significant gifts and bequests should be made in trust and that the term of the trust should be as long as permitted under the law."[21]

Consequently, a client's assets should be retained in the trust to enable the beneficiary to obtain more benefits than the beneficiary could obtain with outright ownership. This can be accomplished by selecting the primary beneficiary of the trust (hereinafter sometimes referred to as the "Inheritor/Beneficiary" of the BDIT) as the

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[19] Pursuant to IRC § 2041, a special power of appointment is the power to appoint property on any terms or conditions to anyone other than the power-holder himself/herself, the power-holder's creditors, the power-holder's estate or the creditors of the power-holder's estate. Of particular importance to the BDIT strategy is that the special power of appointment held by the Inheritor/Beneficiary prevents the possibility of inadvertent gift tax consequences when the Inheritor/beneficiary sells his or her assets to the BDIT.

[20] The following are examples of states with no individual income tax: Florida, South Dakota and Nevada. Also, the following are examples of states that impose no income tax on trust income: Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming.

[21] Oshins, R., *supra* note 18 at 27-11.

controlling trustee (a "Beneficiary Controlled Trust"). The primary beneficiary, as trustee of the trust, can be given virtually identical rights in the trust property as he or she would have with outright ownership. In addition, the trust can offer insulation from creditor and divorce problems, as well as estate tax protection that do not result from outright ownership. Thus, the failure to hold and manage wealth in a properly designed trust is often a critical and very costly mistake. The primary beneficiary can be given all of the following rights "in trust" that could also be given with outright ownership: (1) the right to access the income, (2) the right to access the principal subject to a broad ascertainable standard, (3) the right as trustee to manage and control the property, (4) the right to use the property, and (5) the right to transfer the property during life and to determine who will receive the property after the beneficiary's death.[22] In essence, these bundles of rights (which are incorporated into the Cash Value BDIT) are the functional equivalent of outright ownership.

A standard third-party, discretionary trust becomes "beneficiary-defective" when it is drafted so that a single primary beneficiary of the trust (one person, the Inheritor/Beneficiary) is treated as the owner of the trust for all income tax purposes pursuant to the IRC's grantor trust rules.[23] Specifically, pursuant to IRC §§ 678(a) and (b) and 671 the general rule is that a person other than the grantor is treated as the owner of the trust income if that person has the power to withdraw trust corpus or income pursuant to a *Crummey* power of withdrawal and the power is allowed to lapse within the "five or five" exceptions of IRC §§ 2514(e) and 2041(a)(2). If the *Crummey* power is given to only one primary beneficiary (the Inheritor/Beneficiary of the BDIT), the *Crummey* power is allowed to lapse as to that beneficiary and the trust otherwise is not treated as a grantor trust as to the original trust grantor, the primary beneficiary (the Inheritor/Beneficiary) will be considered the grantor of the trust for all income tax purposes. The lapsed *Crummey* power (1) requires the primary beneficiary to pay the income taxes on the income generated by the trust[24] and (2) also permits the beneficiary to engage in transactions with the trust income tax free.[25] Significantly, this also allows trust assets to grow income and wealth transfer tax-free, which compounds the multi-generational accumulation of wealth in the trust.[26]

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[22] Steven J. Oshins, *Opportunity Shifting: A Life Insurance and Estate Planning Technique*, The Journal of Financial Service Professionals, 30 (May 1999).

[23] Under the grantor trust rules, a person (the "grantor") who transfers property to a trust and retains certain powers or interests is treated as the owner of the trust property for income tax purposes. As a result, the income and deductions attributable to the trust are included in the grantor's income to the extent of the "owned "portion of the trust. IRC §§ 671–679.

[24] IRC §§ 671, 678.

[25] Rev. Rul. 85-13, 1985-1 C.B. 184.

[26] At the 2009 43rd Annual Philip E. Heckerling Institute on Estate Planning, nationally known estate

With respect to the primary beneficiary (Inheritor/Beneficiary), a BDIT combines the benefits of a traditional intentionally-defective grantor trust (IDGT)[27] created for others with the enhanced wealth, transfer tax and asset protection advantages of a trust created and funded by a third party for the benefit of the beneficiary.

Because of the enhanced planning benefits available through a BDIT, particularly the control of the trust and the access to and enjoyment of the trust property by the client [who is the primary beneficiary (Inheritor/beneficiary) of the trust], many clients who otherwise are reluctant to do comprehensive planning or make significant *inter vivos* wealth transfers now can enjoy the benefits of advanced wealth and asset protection planning with minimal personal, financial and tax risk.

[6] Constructing an Efficient, Comprehensive Wealth Accumulation and Retirement Plan by Including Cash Value Life Insurance[28]

A properly designed BDIT will allow clients to successfully achieve each of the

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planning attorney Howard Zaritsky stated that because of the power of tax-free compounding, generally, all irrevocable trusts should be grantor trusts. This increases the benefits of everything else the client wants to do. The following is an illustration of the power of transfer tax free wealth compounding using a multi-generational dynasty trust: if the client dies at age 89 with a total accumulated wealth in the Cash Value BDIT of $1,428,956, the wealth transfer tax free value of the trust (assuming a growth rate of 6% and 30 years between generations) at the end of one generation will be $8,289,268; at the end of two generations the total value of the trust will be $47,609,338; and at the end of three generations the total value of the trust will be $273,443,518.

[27] An intentionally defective grantor trusts is an irrevocable trust intentionally drafted so that all of the trust income either is taxed to the trust grantor or a third party. IRC §§ 671–679. For a sample of the many excellent discussions of planning and drafting techniques with IDITs, see Michael D. Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, Est. Planning (Jan. 1996); Fred Nicholson, *Sale to a Grantor Controlled Trust: Better than a GRAT?* Tax Mgmt. Memorandum (Feb. 22, 1996); H. Allan Shore and Craig T. McClung, *Beyond the Basic SUPERFREEZE—An Update and Additional Planning Opportunities*, Taxes (Jan. 1997); Michael D. Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14?*, 32 U. Miami Philip E. Heckerling Inst. On Est. Plan. ¶15 (1998); Steven J. Oshins, et. al, *Sale to a Defective South Dakota Dynasty Trust: Leveraging Your Trust into Perpetuity*, Communique (Apr. 1998); Michael D. Weinberg, *Analysis of the IDIOT Trust®, Interview of Michael D. Weinberg, JD*, Insights & Strategies (Apr. 1998); Jerome M. Hesch, *Installment Sale, SCIN and Private Annuity Sales to a Grantor Trust: Income Tax and Transfer Tax Elements*, Tax Mgmt. Est., Gifts and Trusts J., (May/June 1998); Richard A. Oshins, *Defective Trusts Offer Unique Planning Opportunities*, Fin. And Est. Plan.—Est. Plan. Rev. (Aug. 20,1998); Richard A. Oshins and Steven J. Oshins, *Protecting & Preserving Wealth into the Next Millennium*, Trusts & Est. (Sept/Oct 1998); Steven J. Oshins, *Sales to Grantor Trusts: Exponential Leverage Using Multiple Installment Sales*, Probate & Property (Jan/Feb 1999); Michael D. Weinberg, *Reducing Gift Tax Liability Using Intentionally Defective Irrevocable Outstanding Trusts*, J. Asset Protection (Jan/Feb 1999); Elliott Manning and Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, Tax Mgmt.

[28] Alexander & Halloran, *supra* note 1, at 9–15.

attributes listed above and create what the authors believe may be the ideal comprehensive wealth accumulation and retirement plan (hereinafter the "Ideal Plan").

By combining the BDIT with a tax-free capital accumulation investment such as cash value life insurance, planners can dramatically increase a client's ability to accumulate and protect wealth provided that the "cost" to obtain this type of treatment is not too severe. For most estate owners, the cost to purchase the life insurance component of this planning strategy is negligible relative to the many significant benefits which can be obtained, principally the ability to allow the investment component of cash value life insurance to grow income tax free. However, keep in mind that tax-free compounding is somewhat exponential, and, therefore, usually a sufficient amount of time is necessary to achieve significant growth in the investment component. Fortunately, in addition to the traditional benefit of the death component of the cash value life insurance product, the death benefit feature also creates both a hedge and a windfall against the premature death of the insured in which event there will not have been a sufficient amount of time for the investment component of the insurance policy to grow significantly.

As a result of the limitations on traditional qualified retirement planning, establishing and funding a Cash Value BDIT may be the simplest and most economical retirement planning alternative available for the employer/client.

Life insurance companies in recent years have shied away from illustrating the use of cash value life insurance as a "private pension plan" because of overly-aggressive and inappropriate policy illustrations and marketing techniques. However, the use of cash value life insurance as a viable alternative to traditional qualified retirement plans is a well-accepted and important practice in the financial planning community. In a college textbook first published in 1959 and still being published and used today as a standard textbook in life insurance courses, renowned insurance professor Dr. Dan M. McGill, Ph.D., CLU (Professor Emeritus at The Wharton School of the University of Pennsylvania) wrote that:

> Life insurance policies can be an important source of supplemental retirement income funds. The policy proceeds can obviously be an important source of funds for the surviving spouse. These funds can supplement any other source of retirement income available from corporate pensions, IRAs, other qualified plans, investments, and Social Security.
>
> Life insurance can even provide supplemental retirement funds to the insured individual. This can be accomplished by utilizing the cash value of the life insurance prior to the insured's death. Some policies, such as universal life policies, allow partial withdrawals of cash value amounts without terminating the policy itself. Under any life insurance policy having a cash value, the policy-owner can always gain access to the funds by either taking out a policy loan or

surrendering the policy for the entire cash surrender value.[29]

[7] The Cash Value BDIT—"CVBDIT"[30]

A second major thesis in the original article is that many individuals who are building a comprehensive wealth accumulation and retirement planning portfolio should seriously consider the value of including lifetime uses of cash value life insurance in a well-balanced plan. There can be an important synergy of investment plus cash value life insurance that can serve at least as well as a properly balanced plan focused on passing wealth to the next generation and/or a plan focused on providing retirement income that does not include cash value life insurance, all with potentially less volatility and market valuation risk.

Based on the study by Weber and Hause, the original article examined the concept of modern portfolio theory ("MPT") and the importance of cash value life insurance as a separate, uncorrelated asset class[31] However, in concert with Weber and Hause, the authors noted that in the context of this discussion, before delving to a comprehensive analysis of various planning strategies, it is very important to keep in mind that the focus of the discussion on MPT, asset diversification and comprehensive wealth accumulation and retirement planning is not about the efficacy of portfolio investments vs. life insurance; rather the purpose of the discussion is to illustrate a possible synergy of assets that can produce more total "accumulated wealth value",[32] potentially with more net income, and less market value adjustment risk.

[8] The Conclusions of the Weber and Hause Financial Analyses[33]

The Weber and Hause white paper provides a detailed analysis of the concept of cash value life insurance as a separate uncorrelated asset class and then demonstrates how to construct an efficient, comprehensive wealth and retirement plan by using cash value life insurance. Weber and Hause analyze various wealth accumulation and retirement planning strategies including utilizing strategies of buying term insurance and investing the difference, strategies which focus solely on the cost of term insurance vs. cash value insurance, strategies which focus on accumulated wealth and death benefit planning and strategies focusing on planning for retirement income. The Weber and Hause study concluded that regardless of whether the client's strategy is to 1) buy

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[29] DANIEL M. McGILL, McGILL'S LIFE INSURANCE, 4TH EDITION 214 (Edward E. Graves Ed., The American College 2002).

[30] Alexander & Halloran, *supra* note 1, at 15.

[31] *Id.* at 10–13.

[32] The term total "accumulated wealth value" as used throughout this article refers to the total compounded rate of return of the investment portfolio (if any) plus the life insurance death benefit (if any). In their white paper, Weber and Hause refer to this term as the "legacy value".

[33] Alexander & Halloran, *supra* note 1, at 21–22.

term and invest the difference or 2) combine an investment strategy with or without cash value life insurance, the lifetime use of cash value life insurance synergized with a portfolio of investments can provide a higher net-after tax retirement income and provide a higher total "accumulated wealth value" with less volatility than using an investment portfolio by itself.

In the original 2009 article Alexander and Halloran conducted their own independent financial analyses of the mathematics of utilizing cash value life insurance as an important component in comprehensive wealth accumulation and retirement planning.[34] Their independent study corroborated the results of the Weber and Hause white paper, and independently demonstrated that the Cash Value BDIT strategy will produce more total "accumulated wealth value" for the client than either the pure retirement plan or other planning alternatives such as a NIMCRUT. The differences between the Alexander and Halloran analyses and the Weber and Hause analyses relate to the fact that the Weber and Hause analyses are based on a combined total "accumulated wealth value" consisting of an investment portfolio and the life insurance death benefit, whereas the Alexander and Halloran analyses focuses on the cash value build-up in the life insurance policy. Regardless of the differences, both analyses demonstrate the powerful wealth accumulation and retirement planning value of the Cash Value BDIT vs. other traditional planning techniques. The reader is referred to

The original 2009 article then analyzed the planning value of cash value life insurance, including the tax-free build-up in a policy that qualifies as a life insurance policy under IRC §7702, the cost of moving into an income tax free accumulation vehicle, advanced

Transfer tax planning with cash value life insurance, accessing the cash value, and the CVBDIT as a better life insurance trust.

[9] The Cash Value BDIT is a Better Life Insurance Trust[35]

The Cash Value BDIT can be used as an enhanced version of a traditional, funded irrevocable life insurance trust (ILIT). Although the BDIT can buy life insurance on the life of anyone on whom the trust has an insurable interest, generally, the life insurance will insure the life (lives) of one (or more) of the trust beneficiaries including the person who is the Inheritor/Beneficiary of the BDIT. However, remember that if the life insurance is owned on the life of the Inheritor/Beneficiary, two adjustments must be made in the BDIT design in order to avoid estate tax inclusion under IRC §2042:

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[34] *Id.* at 22–25.

[35] *Id.* at 37–38.

1) All decisions with respect to life insurance insuring the life of the Inheritor/Beneficiary must be made by a non-insured trustee. Generally, planners should use an independent trustee to make these decisions; and
2) The insured (the Inheritor/Beneficiary) cannot have a power of appointment or any other "tax sensitive" powers over the life insurance or its proceeds.

Until there is adequate cash flow in the Cash Value BDIT to pay premiums (and fund the installment note if the Inheritor/Beneficiary enters into an installment sale with the Cash Value BDIT, which is often a significant purpose of the Cash Value BDIT strategy) the premium funding strategy either will involve using a donor/donee split-dollar arrangement or a premium financing transaction either with the insured or with a third-party lender loaning money to the trust to provide a source of premiums.

[10] Conclusion—The Superior Planning Benefits of the Cash Value BDIT[36]

In the 2009 article Alexander and Halloran make the following conclusions.

1) Without question cash value life insurance is an important, but often overlooked, component in modern wealth, retirement, tax and asset protection planning because it takes advantage of the single most important concept in financial and retirement planning—income tax free compounding. Also, cash value life insurance may be viewed as an important, uncorrelated, separate asset class which, pursuant to the principals of Modern Portfolio Theory, should be considered as part of any diversified, well balanced investment portfolio.
2) The dynastic BDIT is, perhaps, the best wealth transfer and asset protection technique available both to compound wealth transfer tax-free in perpetuity and to asset protect clients' wealth and the wealth of their descendants forever.
3) Cash value life insurance owned by a BDIT will allow the beneficiary/insured to access policy cash values often on a tax-free basis and will significantly expand and compound the value of the assets owned by the trust.
4) The use of dynastic BDIT planning properly coordinated with cash value life insurance, traditional wealth shifting techniques and premium financing techniques can provide dramatic opportunities to create a family "wealth pool" which will benefit clients and their

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[36] Alexander & Halloran, *supra* note 1, at 41–42.

descendants in perpetuity.

5) The Cash Value BDIT is, perhaps, the ultimate opportunity to protect, preserve and dramatically grow family wealth and allow clients (and eventually their families for multiple generations) access to accumulated wealth for retirement and other purposes on a tax-advantaged or tax-free basis without disturbing the client's beneficial enjoyment of the transferred property.

[11] Funding the Cash Value BDIT—An Overview of Private Split-Dollar and Premium Financing Arrangements

[a] Introduction

Until there are sufficient assets in the Cash Value BDIT ("CVBDIT") to generate the cash flow necessary to pay the insurance premiums required to fund the appropriate cash value life insurance policy, premium payments most likely will be planned using either a private split-dollar arrangement or a premium financing arrangement. Because the CVBDIT transaction cannot involve any planning arrangement utilizing gifts to the trust (other than the initial gift of $5,000 by the third party settlor of the trust), traditional methods of funding irrevocable trusts by means of gifting cannot be used without destroying the income, estate and generation skipping tax planning built into the CVBDIT.[37] Consequently, annual exclusion gifts, gifts utilizing the $1 million lifetime applicable exclusion amount, gift transfers of existing policies, GRAT funding techniques and other creative funding techniques with gift tax consequences (whether or not a gift tax is actually paid) are not appropriate techniques to fund a Cash Value BDIT. However, the Cash Value BDIT typically is created as part of an integrated wealth transfer and asset protection plan in which the client (who is the primary beneficiary of the CVBIT and usually referred to in this article as the "Inheritor/ Beneficiary") sells income producing assets properly structured in discountable, pass-through entities such as S-corporations, family limited partnerships ("FLPs") and family limited liability companies ("FLLCs") to the CVBDIT in exchange for an installment note. If the transaction is planned properly, cash flow from the sale of the discountable entities will be sufficient to pay interest on the installment note, and, hopefully, there will be sufficient cash flow remaining after the interest payments to pay the premiums on the life insurance policy insuring the life of the primary beneficiary (Inheritor/Beneficiary).[38] However, if there is insufficient cash flow to fund the insurance premiums, or, if the transaction does not involve the sale of assets to the CVBDIT, planners must look for other techniques to fund the insurance premiums

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[37] For citations to complete technical analyses of the BDIT see *supra* note 18.

[38] See Oshins, R. *supra* note 18 for illustrations of cash flow projects with respect to note sales to the BDIT.

which do not involve gifts to the trust. Fortunately, properly structured private split-dollar and premium financing arrangements are excellent techniques to provide the funding necessary for a successful Cash Value BDIT transaction in situations where the CVBDIT does not have sufficient cash flow to fund the life insurance premiums.

[12] Analysis of Split-dollar Arrangements

[a] Introduction

Historically split-dollar life insurance plans, which have been around from many years, have been arrangements between employers and employees or corporations and shareholders. More recently, split-dollar arrangements have been used in the context of family wealth transfer planning where the arrangement is between family members, family members and an irrevocable trust, between two trusts, or between a trust and a partnership. Private split-dollar arrangements frequently are used in wealth transfer planning when a large life insurance policy is purchased and the annual premium payment will create a large taxable gift. In these situations, the private split-dollar arrangement will reduce the amount of the gift to a small fraction of the total premium. The primary benefit of these types of arrangements is that the life insurance proceeds are kept outside of the insured's estate and the arrangement minimizes the amount of the gift that must be made each year to the traditional irrevocable trust in order to fund the premium payments.

[b] The 2003 Split-Dollar Final Regulations[39]

In 2003 the IRS published Final Regulations detailing a set of complex rules governing both new split-dollar arrangements created after September 17,2003 and older split-dollar arrangements that are "materially modified" after September 17, 2003. The Final Regulations also govern private premium financing arrangements, which, under the Regulations, are treated as private split-dollar arrangements. Interestingly, it appears that the Final Regulations create new and better planning opportunities for both private split-dollar and premium financing arrangements that are used for purposes of wealth transfer planning. As further authority for these planning opportunities, there have been a series of private letter rulings in which the IRS has approved private split-dollar arrangements such as those discussed in this article. As a final observation, keep in mind that the Final Regulations indicate that IRS Notice 2002-8 will have continued application to private split-dollar arrangements. Notice 2002-8 made it clear that the tax principles governing employment split-dollar arrangements can be applied to certain types of private split-dollar arrangements. Consequently, equity split-dollar arrangements involving donor/insureds and donee/

[39] 68 FR 54336-01, 2003-46 I.R.B. 1055 (Wednesday, September 17, 2003), Treas. Regs §§ 1.61-22, 1.83(e), 1.83-6(a)(5), 1.301-1(q) and 1.7872-15.

trusts that are established after September 17, 2003 are treated as loans between the donor and the trust, and the trust will have to pay adequate interest on the loans or be subject to the interest-free loan rules of IRC § 7872 and §§ 1271-1275.

[c] Summary Description of Split-Dollar Arrangements[40]

Essentially, a split-dollar life insurance arrangement is an agreement established by two parties for the purpose of splitting the premium costs and benefits (the cash value and death benefit) of a cash value life insurance policy. Pursuant to the Final Regulations, private split-dollar arrangements will be governed by one of two mutually exclusive tax regimes: (i) the economic benefit regime or (ii) the loan regime. The key to determining which regime applies to a particular arrangement is to properly identify which party to the arrangement owns (or is treated as owning) the policy. As a general rule, the economic benefit regime applies if the donor is the owner of the insurance policy. This is referred to as the "endorsement method". The loan regime will apply when the donee (such as a trust) is the owner of the insurance policy. This is referred to as the "collateral assignment method."

Noted life insurance experts Howard M. Zaritsky and Stephan R. Leimberg summarize private split-dollar arrangements as follows:

> Private split-dollar life insurance is an arrangement. . .between a donor (often the insured or the insured's spouse or an entity such as an FLP or LLC), and a donee (often adult financially mature children or an irrevocable life insurance trust [or a CVBDIT] for one or more generations), whereby the donor pays all or a portion of the premium on a life insurance policy, and reserves a right to recover the donor's premium payments from the cash surrender value, if the policy is cancelled, or at the insured's death from the death benefit. . ..
>
> On the insured's death, the donor typically receives a portion of the proceeds equal to the amount of premiums the donor has paid. The donee [the trust] is named beneficiary and receives the balance of the proceeds. The objective of the private split-dollar is to provide the donee [the trust] with the benefit of insurance protection at a tax cost equal to a fraction of the premium otherwise payable. The cost of this inexpensive coverage is a reduction in the amount payable at the insured's death [to the trust].
>
> Generally, a split-dollar arrangement can be established in either of two ways: the "endorsement method" or the "collateral method". Under the endorsement method [generally taxed under the economic benefit regime as detailed in the Final

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[40] Part section has been abstracted, revised, and edited from Michael F. Amoia, Kristen E. Simmons and Robert C. Slane, *Utilizing Private Split Dollar in Estate Planning*, NAEPC Journal of Estate & Tax Planning (June 2009), http:www.naepc.org.journal, at p.2. Hereinafter this article will be referred to as "Amoia".

Regulations], the donor buys and owns the policy. The donee names the beneficiary and agrees to reimburse the donor for the donor's share of the premiums. Under the collateral assignment method [generally taxed under the loan regime as detailed in the Final regulations], the donee is the original purchaser and owner of the policy and pledges its cash surrender value as security for the donor's premium payments. The gift tax consequences of a split-dollar arrangement do not, however, depend on the form of the arrangement, but rather on the substance of the details.[41]

[13] Analysis of Premium Financing Arrangements

[a] Introduction

A premium financing arrangement "is a series of loans to an irrevocable trust in order to fund a substantial life insurance policy. The lender may be a bank, a family business, the insured or a family member".[42] Although funding the premium payments with loans may avoid the problem of taxable gifts, under the final split-dollar Regulations almost all premium loan arrangements will be governed by the loan regime split-dollar rules.[43] However, economic benefit regime (endorsement method) split-dollar arrangements will not be treated as premium loans. A premium financing arrangement used to fund large premium payments which otherwise would create taxable gifts is an alternative to private split-dollar arrangements. Premium loans are used to create the cash flow necessary to pay the life insurance premiums, replacing the gifts of the premiums to the life insurance trust or third party owner. The loan is paid back during the insured's life or from the death proceeds.

Premium financing arrangements are analogous to the old collateral assignment equity split-dollar arrangements. Pre-Final Regulations private arrangements generally were structured as follows. The insured (donor) paid the premiums and the donor/insured and the donee/trust had a collateral assignment in favor of the donor up to the amount of the premiums paid. The donee/trust owned the equity cash value of the policy and paid an annual term premium. Keep in mind that for grandfathered arrangements there are no authorities which have determined whether or not the equity constitutes additional income to the donee/insured and a gift to the donee/trust.[44]

Under the Final Regulations the premium financing arrangement is taxed under the

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[41] Zaritsky & Leimberg, *infra* note 200, at § 3.02[2][e].

[42] LEE SLAVUTIN ET AL., PPC'S GUIDE TO LIFE INSURANCE STRATEGIES §5.05.1 (11th ed. 2009).

[43] Treas. Reg. § 1.7872-15(a)(2).

[44] See Rev. Proc. 2002-8, 2002-1 C.B. 398.

loan regime.[45] The insured (or a third party) loans the premiums payments to the donee/trust, and the insured/donor has a collateral assignment up to the amount of the loan. The donee/trust owns all of the cash value equity in the policy. The donee/trust pays the AFR to the donor/insured. The advantage of the loan regime is that the cash value equity is not subject to income and gift taxes. The disadvantage of the loan regime is that the donee/trust must pay the higher AFR rather than the lower term rate.

There are several other important issues to keep in mind with premium financing arrangements, include the following. First, the loan must be a "real" loan as provided in Treas. Reg. § 1.7872-15(a)(4)(i); certain "sham" interest provisions will be disregarded. Second, if the premium loan involves a variable life insurance policy, using the policy as security for the loan could subject the lender to the margin loan limits and registration requirements of the Federal Reserve Board.[46] Third, the arrangement may be subject to the reporting requirement of Regulation U.[47] Fourth, there are estate tax issues for loans from family corporations or family partnerships to life insurance trusts; however with properly drafted irrevocable life insurance trusts and entity governing agreements there should be neither any direct incidents of ownership in the insurance policy and, therefore, estate tax inclusion under IRC § 2042, nor any prohibited powers under IRC §§ 2036,2038 and 2041. Fifth, if the insured or another family member loans the premium payments to the trust, as security for loan(s), the arrangement must provide for a collateral assignment against the death proceeds or the policy cash value. Sixth, if Sixth, if the trust assets are a source of income to pay the note interest, the IRS might argue that the note is not a bona fide debt; rather it might be construed as a non-qualified retained interest which is disregarded under IRC § 2702 with the result that the loan proceeds will be treated as a gift to the trust. In order to avoid the IRC § 2702 problem the trust should have sufficient additional assets (other than the life insurance policy) to provide both adequate security for the note payments and sufficient cash flow to make the required interest and principal payments as they become due. Seventh, with both private split-dollar and premium financing arrangements an "exit strategy" is needed to unwind the structure and, under the economic benefit regime (endorsement method), have the trust purchase the policy from the owner, or, under the loan regime (collateral assignment method), pay off the lender.

[b] Illustration of a Typical Private Premium Financing Arrangement Introduction

While the facts of individual situations of premium financing will vary, in a typical

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[45] Treas. Reg. § 1.7872-15(a)(2).

[46] 12 C.F.R. Section 221.2 et al.

[47] 12 C.F.R. Section 221.3 et al.

transaction, the proposed insured, as grantor, will create an irrevocable life insurance trust to become the owner of a new policy on his or her life (or on the lives of himself or herself and his or her spouse on a survivorship basis). The insurance trust will pay all or a portion of the premium payments due on the policy with funds borrowed from an unrelated third party such as a commercial lender (although in some variations the loan could be from the insured, the insured's spouse or other family member, or a family business entity such as a FLP or FLLC). For purposes of this example, the loan will be from an unrelated third party. The trust will pay interest on the loan, annually in advance, usually with funds received directly or indirectly from the grantor/insured, either as part of the initial trust funding or as annual gifts; the principal of the loan will be repaid at the end of the term of the loan or at the insured's death. The grantor/insured will guarantee the third party's loans to the trust and/or pledge assets as security for its loans.

Under a typical variation, the grantor will lend the funds to his or her grantor trust to allow the trust to pay premiums on the policy owned by the trust, with interest paid annually or accrued, in either case at the AFR, and the principal paid at the insured's death. Keep in mind the complex issues involved if the trust's interest obligation to the grantor is to be paid, directly or indirectly, by the grantor, under the final split-dollar Regulations, discussed in § 8.01[12][b] *supra*. In some transactions, both of the insureds in a survivorship policy will loan the premiums to their trust, and in others, the grantor's loan will be made with the proceeds of a third party loan to the grantor. Finally, the lender in these situations might be a related entity (such as a controlled corporation or a family limited partnership for family limited liability company) or the grantor's employer.

[14] Critical Planning Note with Respect to Funding the CVBDIT with Private Split-Dollar and Premium Financing Arrangements

It is *absolutely critical* that readers keep in mind the following planning points with respect to funding the CVBDIT with either private split-dollar or premium financing arrangements. The split-dollar arrangement must be a contributory arrangement, which means that each year the BDIT must, from its own funds, contribute the economic benefit portion of the premium. Therefore, initially the trust independently must be funded with assets sufficient to make these payments. As explained throughout this article, this funding may involve the Inheritor/Beneficiary selling assets for fair market value to the trust for an installment note with guarantees used in place of the traditional 10% "seed money" which usually is gifted to the trust in the traditional note sale to an intentionally defective irrevocable trust ("IDIT"). With the BDIT there never can be any gifts (intentional or unintentional) to the trust by anyone other than the initial $5,000 gift to the trust by the original settlor. Gifts to the BDIT (intentional or unintentional) by anyone other than the original settlor will destroy the tax planning build into the BDIT. As an alternative, consider initially funding the BDIT by means

of an independent loan from the Inheritor/Beneficiary on an interest accrued basis. In a private premium financing arrangement, the arrangement must accrue interest at the AFR and pay the accrued interest with the principal at the end of the term so that the Inheritor/Beneficiary is not deemed to have made a gift to the trust. In either case, it is absolutely critical that the arrangement is structured so that the Inheritor/Beneficiary never is deemed to have made a direct or even an indirect gift to the trust.

[15] Conclusions Regarding Funding the Cash Value BDIT Using Split-Dollar and Premium Financing Arrangements

As stated in the introduction to § 8.01[11], until there are sufficient assets in the Cash Value BDIT to generate the cash flow necessary to pay the insurance premiums required to fund the appropriate cash value life insurance policy, practitioners need to consider planning strategies to fund the CVBDIT that do not involve gifts to the trust, other than the initial gift to the trust by the Settlor. As explained in § 8.01[14], private split-dollar and premium financing arrangements properly structured to avoid any gifts and unwanted tax consequences to the trust or the Inheritor/Beneficiary may be the perfect techniques to provide the funding for a successful Cash Value BDIT transaction.

[16] The Cash Value BDIT—Modern Portfolio Theory and Life Insurance[48]

This Section of the article examined and analyzed the application of modern portfolio theory (MPT) to the management of wealth contained within the Cash Value Beneficiary Defective Inheritor's Trust (CVBDIT), including permanent cash value life insurance. A brief history, background and description of MPT were presented, and CVBDIT investment portfolios, including family businesses and life insurance, were considered. An overview of the main modern types of permanent cash value life insurance were presented, as well as the nature of the insurance company assets that support the cash values contained within the life insurance policies. The academic,

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[48] The authors gratefully and greatly acknowledge the assistance of independent insurance consultant Richard M. Weber, MBA, CLU, AEP® (Distinguished) of The Ethical Edge, Inc. of Pleasant Hill, California in the preparation of this article. For the past 20 years Mr. Weber has written, lectured and practiced innovated, consumer-oriented processes which apply financial planning and statistical modeling techniques to the evaluation, selection and management of life insurance policies. He has provided invaluable insights, advice and guidance, as well as inspiration, with respect to the issues discussed within this section of the article. Additionally, he has generously granted permission to incorporate into this article significant portions of materials that he has previously published, most significantly the following seminal research white paper with coauthor Christopher Hause, FSA, MAAA, CLU:

> Richard M. Weber and Christopher Hause, *Life Insurance as an Asset Class: A Value Added Component of an Asset Allocation*, Ethical Edge Insurance Solutions, LLC, Pleasant Hill, California, 2009.

scholarly and professional literature on life insurance in the context of a portfolio were explored. Life insurance as an asset class was considered and analyzed, plus an examination of the allocation of assets to building an efficient investment portfolio by including life insurance. Finally, the authors presented and analyzed the selection of life insurance by applying MPT to create a portfolio of different life insurance policy types, or styles, based on risk tolerances and other preferences of the trustee and the Inheritor/Beneficiary.

[17] Conclusions Regarding the Cash Value BDIT, Modern Portfolio Theory and Life Insurance

While modern portfolio theory (MPT) is not so "modern" anymore, it is indeed relevant and applicable to the management of wealth within the Beneficiary Defective Inheritor's Trust (BDIT). While some BDITs may contain well diversified portfolios, most BDITs are comprised of family businesses, real estate and/or farms and ranches, and are in need of some investment vehicle that can provide diversification.

The authors have thoroughly examined and analyzed the concept of life insurance as an asset class and concluded that permanent cash value life insurance is a unique, separate asset class by itself within MPT. As such, permanent cash value life insurance has the ability to diversify, enhance and complement other assets in an investor's portfolio, thereby adding to a comprehensive wealth accumulation strategy.

The authors reviewed existing studies of the effects on the risk and return of bond portfolios with and without life insurance and concluded that life insurance can enhance a portfolio by raising the return and lowering the risk—the very essence of an "efficient frontier." In addition, life insurance can significantly increase the after-tax retirement income when combined with other assets in a portfolio.

Importantly, the authors asked the question whether it is possible that permanent cash value life insurance policies could provide diversification to the family business, real estate, and/or farm or ranch portfolio of assets most often contained within the BDIT and, through a correlation coefficient of less than one (+1) with these family enterprises, lower the risk of the portfolio of family businesses within the BDIT according to Harry Markowitz's MPT. By examining proxies for the correlation coefficients of family businesses and types of life insurance policies the authors have concluded that permanent cash value life insurance can provide diversification to the family business, real estate, and/or farm or ranch portfolio of assets most often contained within the BDIT, consequently, enhancing and lowering the risk of the portfolio of family businesses within the BDIT according to Harry Markowitz's MPT.

Lastly, the authors reviewed the concept of applying the techniques of MPT to build a portfolio of life insurance policies of different policy types or styles. Similar to an investment portfolio, assets were allocated to different policy types or styles based on the risk tolerance and other preferences of the policy owner. A comparison was shown

of the differences between selecting only one of three types of policies, as opposed to selecting choices of portfolios consisting of a combination of policies. Once again the comparison demonstrated the synergistic effects of diversification and MPT.

[18] Relevance of the Previous Two Articles to the Present Discussions

Having digested the concepts presented in the first two articles of this series the reader should be in an excellent position to appreciate the relevance of the current two topics (valuation of life insurance policies and private placement life insurance) to a thorough understanding of how the CVBDIT can create a more flexible and comprehensive wealth accumulation and retirement plan. Because the proper planning of cash value life insurance (in all its many varieties) is a critical component of the strategy, it is critical to understand how life insurance policies are valued relative to the various types of policies that may be included in the planning as well as the various types of planning and transactions that may be a part of on-going CVBDIT planning during the course of a lifetime. A thorough discussion of private placement life insurance is warranted because it can be an important asset class for high net worth clients who understand the extraordinary wealth accumulation and retirement planning opportunities inherent in the CVBDIT.

§ 8.02 CURRENT ISSUES REGARDING THE VALUATION OF LIFE INSURANCE POLICIES[49]

[1] The Critical Question: What is the "Fair Market Value" of a Life Insurance Policy for Tax Purposes?

[a] Introduction

> [These cases] demonstrate the difficulty that arises in valuing life insurance policies, and the fact that the tax law has not kept pace with the changing nature of life insurance policies generally. Practitioners advising participants in qualified and nonqualified plans should be very careful in giving firm valuations for the more modern types of life insurance policies. The precise calculation will always require careful analysis of cash values and the value of insurance coverage provided, as well as the cash surrender charges, but at least the insurers and plan participants now have relatively clear guidelines from which to determine such

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[49] The contents of § 8.02 have been abstracted, edited and revised from Lawrence Brody, Esq. (2011), a white paper on file with the author and used by permission; Keith Buck, *Life Insurance Valuation: What Advisors Need to Know*, LISI Estate Planning Newsletter 1638 (May 10, 2010) at http://www/leimbergservices.com; and Howard Zaritsky on Lowe: Tax Court Rules on Value of Life Insurance Policy Distributed by Welfare Benefit Plan, LISI Income Tax Planning Newsletter 9 (May 23, 2011) at http://leimbergserivces.com. Both LISI articles are used by special permission of Leimberg Services by arrangement with the National Association of Estate Planners and Councils (NAEPC).

values.[50]

A critical issue with respect to both lifetime and testamentary wealth transfer and asset protection planning is the proper determination of the fair market value of a life insurance policy for tax purposes. Regardless of whether the life insurance policy is owned individually, by a business entity (such as a corporation, partnership, or limited liability company) or by a trust such as the CVBDIT, all forms of life insurance are purchased, premiums are funded, ownership and beneficiaries are changed, and policies are sold, gifted, assigned, transferred and encumbered in almost an infinite variety of ways. Currently, with respect to each of these transactions one of the most critical yet often overlooked issues is the proper valuation of the policy for tax purposes.

As if these tax planning issues in and of themselves are not sufficiently difficult to sift through, practitioners also must contend both with the mechanics of actually valuing the policy (and these mechanics can vary from one insurance company to the next) and the myriad of new product designs and planning techniques that are ever evolving at a rapid pace.[51] Even transactions involving similar policies from different carriers, purchased at the same time and involving similar legal structuring can result in dramatically different answers to the question of the fair market value of the policies under review. Consequently, clients often ask why it is that in some cases the value of a policy reported by the insurance carrier is considerably higher than the policy's cash surrender value. Another question that often is asked is whether the client must use the policy value reported by the carrier when filing the federal gift tax return, or whether a different (and perhaps more advantageous) value can be used, and if so, how.[52] These and similar questions suggest that the issue of the correct fair market value of a life insurance policy in any given circumstance can be a very difficult issue to properly determine. Consequently, the correct valuation of a life insurance policy not only can be fraught with a great deal of uncertainty, unfortunately an incorrect valuation has the potential for 1) unwanted taxes (including interest and penalties) and disqualification of transactions; 2) disputes and litigation among related and interested parties; 3) breach of fiduciary responsibilities; and 4) ultimately may result in malpractice claims against the professional planner.

In their seminal article[53] Buck and Leimberg state that there are many tax and

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[50] *Howard Zaritsky on Lowe: Tax Court Rules on Value of Life Insurance Policy Distributed by Welfare Benefit Plan*, LISI Income Tax Planning Newsletter 9 (May 23, 2011) at http:// leimberg-serivces.com.

[51] See Brody, *supra*, note 2, and § 8.02[2], *infra*.

[52] See Buck, *supra*, note 49 at 2.

[53] *Id.* at 2.

non-tax reasons that may require the value of a life insurance policy to be determined. In some circumstances, such as ascertaining the value of a cash value life insurance policy for net worth purposes, the value can easily be determined by simply contacting the insurance company and requesting the policy's current cash surrender value.

However, there are other circumstances where determining the value of a life insurance policy is much more difficult. For example:

1. When a policy is being gifted to a trust, heirs or a charity;
2. When the owner has predeceased the insured and the policy is being valued for purposes of completing the deceased owner's estate tax return;
3. When a policy is being distributed by an employer or from a qualified retirement plan;
4. When a policy is being sold by one party to another.

As a starting point to discuss these issues, Buck and Leimberg suggest that practitioners must become familiar with the different rules that govern life insurance valuation; the different methodologies used by life insurance companies; why certain product types tend to have higher valuations than others; and the best practices for determining life insurance policy valuations.[54]

In the past the issue of the proper value of a life insurance policy seemed to be rather straight forward. Planners could look to the Internal Revenue Code (hereinafter the "Code") and the Regulations (hereinafter the "Regs") for a simple, definitive answer to the question. However, in recent times the answer has become far more complex, less definitive and at the same time ever more critical. An incorrect answer to the question can lead to disastrous tax results including the imposition of unwanted tax, interest and penalties. With respect to sales and exchanges of policies, life insurance and qualified plans, and life insurance as executive compensation, improper policy valuation may have disastrous income tax consequences. With respect to transactions involving gifts of policies, improper valuation not only may result in the imposition of additional gift tax, penalties and interest, but otherwise well planned family transactions subject to Chapter 14 special valuation rules may implode because of improper policy valuation. Policies which, for one reason or another, are brought back into the gross estate for estate tax purposes because of improper valuation issues likewise can cause a myriad of estate and generation skipping transfer tax problems. Lastly, improper policy valuation could implode qualified plan transactions and otherwise appropriate charitable planning.

Ultimately the answer to the question of a life insurance policy's fair market value

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[54] *Id.* at 2.

may depend on why the question is being asked. There is one answer (such as it is) for some, limited income tax purposes, but not necessarily for others. There is another answer (such as it is) for gift tax purposes. Making the question even more difficult is that insurance carriers are increasingly reluctant to take a stand on the answer to the question. Adding additional complexity to the issues is the emergence of a developing market for some policies—the life settlement market—which determines what a willing buyer would pay for those specific types of policies involved in the life settlement market. However, the issue of policy fair market value in the life settlement market only applies to those types of policies involved in that specific market. Finally, there is no specific answer as to how to determine the donor's income tax deduction for gifts of policies to a charity, and in any event, a qualified appraisal will be required to determine the fair market value of a policy involved in charitable transactions.

[b] A Brief History of the Issue of Policy Fair Market Value—How We Got Where We Are Today[55]

Many years ago, the issue of valuing a permanent life insurance policy purpose for taxation issues was relatively simple. The valuation standard was "interpolated terminal reserve" or ITR. In an era where the only permanent product was whole life, this was an easy calculation. In most instances, after about five years, this value was very close to the cash surrender value. The IRS held that the Interpolated Terminal Reserve was the appropriate value for all federal tax purposes in Revenue Ruling 59-195 where the IRS stated:

> It is the position of the Internal Revenue Service that, in order to avoid the possible inconsistency of two different valuations of the same insurance contract for Federal income tax and for Federal gift tax purposes, the method of valuation prescribed by section 25.2512-6 of the Gift Tax Regulations should be followed for Federal income tax purposes in situations similar to the instant case.
>
> Accordingly, it is held that where an employer purchases and pays the premiums on an insurance policy on the life of one of its employees and subsequently sells such policy, on which further premiums must be paid, to the employee, the value of the policy, for computing taxable gain to the employee in the year of purchase, is its interpolated terminal reserve value at the date of the sale, plus the proportionate part of any premium paid by the employer prior to the date of the sale which is applicable to a period "subsequent to the date of the sale."

This approach was generally followed by the courts.

This simplicity in valuation ended for two reasons. The first was the development

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[55] See Larry Brody, *What's Hot—What's Not—2011* (2011), a white paper on file with the author. This portion of the paper was prepared by Thomas F. Commito, JD, LLM, CLU, ChFC, AEP (Distinguished).

of permanent life policies other than whole life. These policies, most notably universal life, generally do not have a "terminal reserve". The second was the development of the ″pension rescue″ technique, where policies were generally purchased from a profit sharing plan for the policy's cash surrender value. Specifically, in response, to pension rescue, the IRS issued Revenue Procedure 2005-25:

> . . . the fair market value of an insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection may be measured as the greater of: A) the sum of the interpolated terminal reserve and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, and B) the product of the PERC amount (the amount described in the following sentence based on premiums, earnings, and reasonable charges) and the applicable Average Surrender Factor described in section 3.04 of this revenue procedure. The PERC amount is the aggregate of: (1) the premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums, plus (2) dividends applied to purchase paid-up insurance prior to the valuation date, plus (3) any amounts credited (or otherwise made available) to the policyholder with respect to premiums, including interest and similar income items (whether credited or made available under the contract or to some other account), but not including dividends used to offset premiums and dividends used to purchase paid up insurance, minus (4) explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated, or otherwise reversed at a later date, minus (5) any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

The "Average Surrender Factor" described above applies only to distributions from qualified plans and is defined as:

> . . . if the contract provides for explicit surrender charges, the Average Surrender Factor is the unweighted average of the applicable surrender factors over the 10 years beginning with the policy year of the distribution or sale. For this purpose, the applicable surrender factor for a policy year is equal to the greater of 0.70 and a fraction, the numerator of which is the projected amount of cash that would be available if the policy were surrendered on the first day of the policy year.

In response to the Revenue Procedure, insurers have been faced with a dilemma in valuing universal life policies. Many companies provide multiple values to a policyowner, leaving it up to the professional advisors of the client to determine which value represents "fair market value". Also insurers have established various substitutes for universal policies to equate with "interpolated terminal reserve". These range from cash surrender value, to tax reserves, to statutory reserves.

[2] A Strategic Issue: Understanding The Concept of the Interpolated Terminal Reserve ("ITR")[56]

ITR is a critical concept to understand with respect to the proper valuation of a life insurance policy. An insurance company must set aside a reserve each year to meet its contractual obligations to the policy owner. The terminal (yearend) reserve typically will be greater than the policy's cash value in the early years of the contract.[57] When a taxable event occurs at any time other than the policy's anniversary date, the reserve on the date of the event must be interpolated, i.e. extrapolated by using both the last policy anniversary date reserve and the reserve on the next anniversary date.[58]

When the ITR guidance was originally issued by the IRS in the early 60's,[59] the two most prominent types of life insurance products were Annual Renewable Term (ART)[60] and Whole Life (WL).[61] ART provides death benefit protection for one-year

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[56] Buck, *supra* note 49 at 3-5.

[57] See Leimberg and Doyle, Tools and Techniques of Life Insurance Planning—4th Edition—2009 (National Underwriter Company) (to order a copy, visit http://www.nationalundenvriterstore.com/product/Tools-Techniques-of-Life-Insurance Planning—4th.6164.109.aspx or call 800-543-0874. Buck, *supra* note 49, endnote 19.

[58] As an example see Buck, *supra*, note 49, endnote 10. For instance, assuming the policy had been in force for some time, if the reserve as of the last anniversary date is $15,000 and the reserve for the next anniversary date is $20,000 and a gift of the policy is made exactly six months after the last anniversary then the interpolated terminal reserve would be $17,500 (half of the $5,000 increase in reserves, $2,500, is added to the $15.000 last anniversary reserve). The computational process is:

Step 1: State the policy's terminal reserve at the end of the "next policy year."

Step 2: State the policy's terminal reserve at the end of the "prior policy year."

Step 3: The difference between the Step 1 and Step 2 result is the increase in the terminal reserve for a full year. If the valuation date occurs—say four months (1/3rd of a year) after the anniversary date of the policy. 1/3rd of the increase would be added to the prior year's (Step 2) terminal reserve to estimate (interpolate) the terminal reserve on the date of the taxable event.

Any "unearned premium" as of the date of the taxable event would be added to this amount. To compute the unearned premium:

Step 1: State the premium paid from the anniversary date of the policy to the date of the taxable event (e.g. gift).

Step 2: Multiply the premium actually paid by the "remaining percentage of the year" (e.g. in the example above, assuming an annual premium was paid, multiply the premium by 2/3rds).

If there is a Joan outstanding on the valuation date, that amount would be subtracted. (See IRS Form 1712. Part JJ). In other words the value of the policy can be reduced by the amount of any loans against the contract.

[59] Rev. Rul. 59-159, Interpolated terminal reserve, 1959-1 C.B. 18.

[60] The key characteristic of Term insurance is that the insurer assumes a death benefit risk only for a finite period of time. At the end of the term, coverage terminates. At that point typically, there are no

(Text continued on page 8-37)

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non-forfeiture rights (e.g. cash values) afforded to Term policyholders. The insured must die for any payments to be made and no death benefit will be paid unless the insured dies within the specified term. If the insured survives the specified term, absent an exercised renewal provision, the contract expires and provides no payment of any kind.

For many years, Term was sold in an "annual renewable term" (ART a/k/a Yearly Renewable Term or YRT) format. ART typically featured a premium that increased each year to track the presumed increase in the likelihood of mortality as (i) the insured ages and as (ii) time moves farther and farther from the underwriting process that took place before the policy's inception.

ART was guaranteed to be "renewable" for some number of years (rarely less than 4 or 5 and sometimes until age 70 or beyond) as long as the policy-owner paid the next premium. The ever increasing premiums often could or would change annually from a stipulated initial amount and the ultimate years' premiums were guaranteed only to be below very high levels.

For much of the past 15 years or so, sales of ART contracts have given way to much more cost-effective policies that feature a level (and usually guaranteed) premium for a specified number of years. The duration of these "level term" policies is usually between 10 and 20 years, but sometimes longer. Level Term policies are usually renewable beyond the "level" period, but the premiums will be unattractive for those who are not able to favorably pass through the underwriting process again. T. Malarkey and S. Leimberg, "Innovative Planning With No-Lapse Guarantee Life Insurance" Estate Planning. Journal, Jul. 2005.

Whole life ("WL") as its name implies, is a contract designed to provide level death benefit coverage over the entire lifetime of the insured. It can be kept "permanently." It is the oldest and for many years the only form of cash value insurance (CVJ). Whole life has had many names and variations over the years (e.g., adjustable WL participating and nonparticipating WL, current assumption WL modified and increasing premium WL). The form of WL that is most commonly available today is usually a fairly straightforward version of the product Level or fixed periodic premiums are computed on the assumption that the contract can be retained-assuming premiums are paid—for as long as the insured lives. Premiums are level (higher than actual term costs in early years and lower than the cost of insurance in later years) to make the WL contract affordable for as long as the policy owner wants and is able to pay premiums. Policy cash values, what the policy owner can realize if the policy is surrendered and the insurer is no longer liable for a continuing obligation to keep the coverage in force) are an outgrowth and natural by-product of the level premium system. WL policies are issued with a table that illustrates the guaranteed fixed cash values the owner of the contract can obtain in any given year, by either borrowing or surrendering the policy. T. Malarkey and S. Leimberg, "Innovative Planning With No Lapse Guarantee Life Insurance," Estate Planning, Journal, Jul. 2005. Buck, *supra* note 49, endnote 11.

[61] Whole life ("WL") as its name implies, is a contract designed to provide level death benefit coverage over the entire lifetime of the insured. It can be kept "permanently." It is the oldest and for many years the only form of cash value insurance (CVJ). Whole life has had many names and variations over the years (e.g., adjustable WL participating and nonparticipating WL, current assumption WL modified and increasing premium WL). The form of WL that is most commonly available today is usually a fairly straightforward version of the product Level or fixed periodic premiums are computed on the assumption that the contract can be retained-assuming premiums are paid—for as long as the insured lives. Premiums are level (higher than actual term costs in early years and lower than the cost of insurance in later years) to make the WL contract affordable for as long as the policy owner wants and is able to pay premiums. Policy cash values, what the policy owner can realize if the policy is surrendered and the insurer is no longer liable for a continuing obligation to keep the coverage in force) are an outgrowth and natural

only and does not have a reserve value because the policy matures at the end of each policy year.[62] Therefore, the value (normally) of ART is simply the unearned premium for the remainder of the policy year. Unearned premium is premium which has been paid to the insurer but on the valuation date has not been earned by the insurance company. However, it is interesting to note that the authors are aware of secondary markets where even one year term policies have a fair market value and can be bought and sold accordingly.

Whole Life Insurance provides permanent protection and an insurance company is legally required to maintain reserves on its balance sheet with respect to its unmatured obligations (i.e. expected future death benefit claims). With Whole Life the terminal reserve value (i.e. the value of the reserves for a particular policy at the end of the policy year) are known in advance. Thus, it is possible to "interpolate" the terminal reserve value of the policy to reflect a valuation prior to the end of the policy year. For instance, if the transaction date occurred exactly one quarter of the year after a policy's anniversary date, the terminal reserves of the year preceding and the year following the taxable event would be interpolated to reflect that timing.

Subsequent to the date that the IRS originally issued the ITR guidance, the life insurance industry has developed numerous new product types, including but not limited to: Universal Life;[63] Variable Life;[64] Variable Universal Life (VUL);[65] Indexed

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byproduct of the level premium system. WL policies are issued with a table that illustrates the guaranteed fixed cash values the owner of the contract can obtain in any given year, by either borrowing or surrendering the policy. T. Malarkey and S. Leimberg, "Innovative Planning With No Lapse Guarantee Life Insurance," Estate Planning, Journal, Jul. 2005. Buck, *supra* note 49, endnote 12.

[62] When a policy "matures" it means that the policy's cash value equals the death benefit at the last life expectancy.

[63] Universal life ("UL") is a "flexible-premium" "current assumption" "adjustable death benefit" type of CVI contract. These contracts are also referred to as flexible premium adjustable life. UL was developed in the late 1970s and early 1980s, as interest rates soared and the change in dividend rates of WL policies significantly lagged behind the interest rates available in the market. In comparing UL policies to WL, the key difference is that UL does not have a fixed premium. Rather, a UL contract is flexible and can generally accept a premium, at any given time, from a very small amount up to the tax limits of the contract. The incredibly flexible premium of a UL policy allowed policyholders more freedom to adapt their future cash flow premium commitments to the dynamically changing interest rate world and their own financial situations and constantly varying needs. Mechanically, as long as there is enough cash inside a UL policy to support that month's charges, the policy will continue to provide full coverage for another month. That said, the actual *recommended* premium for a UL policy is a function of (l) how long the coverage is desired, (2) the number of years the owner wishes to pay premiums, and (3) the assumed rate of interest backing the policy. As these factors change, cash outlay toward premiums can change; further, a policy owner can diverge from a given course at any time. This makes UL a very flexible policy that can be adapted to a client's constantly varying financial cash flow and needs circumstances. T. Malarkey and S. Leimberg, "Innovative Planning With No-Lapse Guarantee Life Insurance," Estate Planning Journal, Jul. 2005.

Universal Life (IUL); Guaranteed No-Lapse Universal Life (NLGUL);[66] Private Placement Life Insurance (PPLI) and 5, 10, 15, 20, and 30 year level term (unlike ART

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[64] Variable life insurance ("VL") is essentially a WL policy that allows the policy owner to select among (and typically switch annually or more often between, or rebalance among) a menu of insurer-determined investments similar in many respects to stock, bond, and money market mutual funds. VL provides a guaranteed minimum face amount (death benefit) and a level premium but differs from classic WL in three important ways: First premiums (after the insurer charges for expenses and sales costs and mortality costs) are poured into an investment account that is financially separate and legally distinct from the general investment fund of the insurance company. The general account assets are limited by reserving requirements to be invested primarily in bonds and mortgages. For those policyholders who are willing to accept any significant exposure to—and are desirous of the upside potential of equities, variable life is a good choice. The trade-off is that variable life contracts shift investment risk entirely to policy owners. This means the insurer provides *no* guarantees (or very limited ones) with respect to policy cash values. Instead, investment risk-and potential growth in both cash values and death benefits-are shifted to the policy owner. Cash values in a VL contract are determined as of a given point in time based on the policy owner's share of the market value of the assets in the separate account Thee death benefit in a VL contract is variable. lt may grow or shrink (but not below a stated and guaranteed minimum) according to a formula based on the separate account's investment performance. T. Malarkey and S. Leimberg. "Innovative Planning With No-Lapse Guarantee Life Insurance," Estate Planning. Journal, Jul. 2005.

[65] Variable universal life ("VUL") combines the flexible premium design of UL with VL's ability to choose the asset allocation supporting the contract. Sometimes called flexible-premium variable life or universal life II. VUL is an attempt to capture the best features of UL and VL. VUL policy owners can-within limits-determine the timing and amount of premium payments, eliminate one or more premium payments entirely (assuming cash value is great enough to pay current mortality and expense charges), increase or decrease death benefits (within limits and assuming evidence of insurability with respect to increases). make withdrawals of cash without generating a loan against the policy and without interest charges (assuming there is enough cash value to pay current mortality and expense charges), and select between two death benefit options-one level and the other equal to a level pure insurance amount plus the policy's cash value. T. Malarkey and S. Leimberg. "Innovative Planning With No-Lapse Guarantee Life Insurance," Estate Planning Journal, Jul. 2005.

[66] The NLGUL asset class is unique; it features (relatively inexpensive) permanent death benefit guarantees at the expense of cash value performance. Analytically, NLGUL policies typically offer very attractive guaranteed death benefit internal rates of return (IRR) up to, and a bit past, life expectancy. (It is not uncommon to see these death benefit IRRs approach, and go beyond, an after-tax rate of 7% even beyond life expectancy). The economics behind a WL contract involve only "prospective" accounting. That is, the current value of a WL contract is, actuarially speaking, equal to the present value of future liabilities. Jess the present value of future premiums and earnings. In other words, the dollars that a carrier must have on "reserve" today to meet the promises implicit in a WL policy must equal the difference between what the carrier will someday pay to a beneficiary (assuming premiums are paid and the policy is kept in force) and what the carrier will receive in premiums and investment returns between now and then. These calculations, resulting in the policy's reserve and then, in turn, the policy's cash value, are done prospectively, only. There is no specific accounting as to the dates premiums in the past were actually received, etc. In order for the mechanics of a UL policy to work, the accounting processes were, to steal a term of contemporary America, flip-flopped. A UL accounting system, resulting in a policy's reserve and cash value, operates retrospectively, only. What premiums have been paid, what monthly charges have come out and what interest has been credited—all of that results in today's cash value. T.

products, insurance companies have to set aside reserves for level term products). The problem is that it is difficult to apply the outdated ITR guidance to this new generation of products. For example, all of these newer products have a reserve value associated with them. However, unlike the case with Whole Life, with the new product types, the terminal reserve value is not known or published ahead of time. It isn't known until the end of the policy year. Therefore, it impossible to follow the dictates of the regulations to "interpolate" the terminal reserve value prior to the end of the policy year.

In addition, when the ITR guidance was originally issued there really was only one type of reserve value. Today there are several different types of reserve values, including the following.[67]

1. Tax Reserve ("Tax")—Reserve value used in the determination of an insurance company's federal income tax.
2. Statutory Reserve ("Stat")—Reserve reported in an insurance company's statutory financial statement filed with the state insurance departments. The primary difference between this and the tax reserve is the interest rate used. In a low interest rate environment, there may be very little practical difference between the Tax and Stat reserves.
3. AG 38 Reserve (can be either Tax or Stat)—Reserve for a UL policy with a no lapse secondary guarantee (i.e., a GUL). The AG 38 reserve is generally greater than the basic Tax or Stat reserve used for current assumption products that do not provide long-term death benefit guarantees.
4. Deficiency Reserve For policies with secondary guarantees (e.g., a GUL), in some cases the calculation of Minimum Reserves is required. Deficiency Reserves are the excess of the Minimum Reserves over the AG 38 Basic Reserves. The AG 38 reserve including the deficiency reserve will be greater than the AG 38 reserve not including the deficiency reserve.

The question that insurance companies face is which of these reserves should be used for purposes of calculating ITR and, therefore, the correct fair market value of the life insurance policy under consideration? For universal life products without long-term death benefit guarantees, are the companies supposed to use the Tax or Stat reserve? For universal life products with long-term death benefit guarantees, are they supposed to use the Tax or Stat basic AG 38 reserve? More importantly, are the companies

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Malarkey and S. Leimberg, "Innovative Planning With No-Lapse Guarantee Life Insurance," Estate Planning Journal, Jul. 2005.

[67] See also § 8.02[5], *infra*.

supposed to include the deficiency reserve, if any? Obviously, the reserve used and reported by the insurance carrier can make a big difference in the ITR value that the insurance company reports for the policy and, therefore, the fair market value of the policy under consideration.

Due to the fact that the IRS has not updated the original ITR guidance to reflect the newer generation of life insurance products or the fact that there are now several possible reserve values for a policy, insurance companies individually have reached different conclusions on how to apply the ITR guidance. This has resulted in different companies having different methodologies for calculating ITR which means that the value for a similarly situated life insurance policy from one company to another may be dramatically different.[68]

Due to the ambiguity involved, a few insurance companies, have chosen to use alternate methodologies that aren't even based on any type of policy reserve. For example, a few insurance companies simply report the cash surrender value or the cash accumulation value as the ITR value of a policy; and a few others use what is known as the California Method,[69] whereby they take the average of the cash surrender value and the cash accumulation value and report that as the ITR value.[70]

[3] Policy Valuation for Income Tax Purposes

[a] Generally[71]

In certain income tax situations, the IRS has provided more recent guidance regarding the value of a life insurance policy. In 2005, primarily in reaction to certain perceived valuation abuses occurring with fully insured defined benefit plans [412(i)

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[68] See Exhibit 3 for examples of these differences.

[69] The California Department of Insurance apparently created the California Method in order to assist smaller insurers that didn't have sophisticated systems in place to calculate their statutory reserves for universal life products. This method permits life insurance companies to calculate statutory reserves for a product simply by taking the mean of the cash surrender value and the cash accumulation value. Some carriers adopted this methodology for purposes of calculating ITR, and although it appears to be on the decline, it remains a methodology used by a small numbers of carriers for ITR reporting purposes for certain products types. Buck, *supra* note 49, endnote 17.

[70] NOTE: When doing an ownership change in conjunction with a 1035 exchange from a non-guaranteed product into a GUL, it may be beneficial for your client to do the ownership change first and base the gift on the value of the old product. If your client does the 1035 exchange first, your client may find out the hard way that the value of the new GUL product, and thus the gift amount, is considerably higher. Also, if an insurance company provides an ITR value for a GUL product, ask if they included the deficiency reserve. If so, request that they also provide the value without the deficiency reserve, if any. Buck, *supra* note 49 at 6.

[71] Buck, *supra* note 49 at 6-7.

plans], the IRS issued Revenue Procedure 2005-25.[72] This revenue procedure applies for purposes of Internal Revenue Code (hereinafter the "Code") Sections 402 (qualified plan distributions), 83 (employer distributions to an employee in conjunction with the performance of services), and 79 (cost of permanent benefits provided under a group life plan). The revenue procedure indicates that the general rule for income tax purposes for which the revenue procedure applies is that the value of life insurance is its fair market value ("FMV"). Conceptually, this is no different than the guidance provided for estate and gift tax purposes.[73] However, the revenue procedure provides a safe harbor value that does differ from the estate and gift tax rules. The safe harbor value is the greater of ITR or PERC (Premiums plus Earnings less Reasonable Charges). PERC is a newly created formula for determining the value of a policy in the above situations. It should be noted that there are actually two different PERC formulas. With respect a distribution of a life insurance policy from a qualified plan, the PERC formula can take into account an average surrender factor of as much as 30%.[74]

As a result of the creation of the PERC formula, it may appear that this revenue procedure provides more clarity when it comes to the valuation of a life insurance policy for income tax purposes. However, this is not necessarily the case. With ITR being a component of the safe harbor value, there will still be considerable uncertainly as insurance companies continue to struggle with how to calculate ITR for products other than whole life insurance.

[b] Sales of Life Insurance Policies [75]

Another situation where the value of a life insurance policy can become problematic involves the sale of a life insurance policy. If the policy is being sold to an unrelated third party, then the value generally should be whatever the parties agree it is. In reality this is the very essence of the concept of fair market value. However, if the policy is being sold to a related party (e.g. a grantor trust to a grantor trust), then gift or other issues may arise.[76] Incidentally, if the sale is from an employer to an employee, or a

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[72] S. Leimberg and C. Ratner, "Valuation of Life Insurance: Rev. Proc. 2005-25 Provides New Guidance." Estate Planning, August 2005, Vol. 32, No. 8, Pg. L 13: Valuation Gaming with Life Insurance Policies: Don't Bet on It" 110 Tax Notes 627 (Feb. 2006).

[73] See § 8.02[4] *infra* for the definition of fair market value with respect to the estate and gift taxes.

[74] An average surrender factor is not permitted for purposes of Code Sections 83 or 79. Also, when requesting a PERC value from an insurance company, make sure to specify which PERC value your client needs.

[75] Buck, *supra* note 49 at 7.

[76] The issue of fairness and potential conflicts of interest and potential surcharges of trustees must be considered. For instance, consider a sale of a $10.000.000 by the trustee of one trust on the life of a 75 year old sickly individual to another grantor trust in order to avoid a transfer for value problem. If the

qualified plan to a plan participant (or to a trust on behalf of the plan participant), then Revenue Procedure 2005-25 should be determinative of the minimum value needed to avoid adverse income tax consequences.

Code Section 2035 provides that if a policy that would have been includible in the insured's estate pursuant to Code Section 2042 is transferred and the insured dies within three years of the date of the transfer, then the entire death benefit is pulled back into the insured's taxable estate. However, an exception exists if the transfer is a bona fide sale for adequate and full consideration. In order to avoid the adverse consequences of the three year rule, an insured oftentimes will sell the policy to an irrevocable life insurance trust (ILIT), another type of irrevocable trust or an adult child for "adequate and full consideration." Unfortunately, the IRS has provided no formal guidance as to what constitutes adequate and full consideration for this purpose. If the value that the policy is sold for is not sufficient, the IRS could assert that there is a gift component and a part gift/part sale results. In addition, it would appear that at least a portion, if not all, of the death benefit would be pulled back into the insured's estate pursuant to Code Section 2035. There is a private letter ruling (PLR) which may provide some indication of the IRS' position on this issue. In PLR 9413045, which has no precedential value, the IRS indicated that ITR would constitute adequate and full consideration. Of course, knowing what practitioners now know about the uncertainty surrounding ITR, one wonders if the IRS will retain this position in the future.

[c] Sales of Policies by a Trustee[77]

Sometimes an insured has created an ILIT or other irrevocable trust, the terms of which are no longer satisfactory. In this situation a common strategy is for the insured to create a new irrevocable trust with more acceptable terms and have the trustee of the old trust sell the life insurance policy owned by it to the new trust. Since the insured has to seed the new trust with a gift,[78] the insured quite likely wants to keep the purchase price as low as possible. In this case the goals of the old trustee may conflict with the goals of the insured. The trustee owes a fiduciary duty to the beneficiaries of the trust, and pursuant to such duty should seek to sell the policy for its fair market

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insured dies shortly after the sale, will the beneficiaries of the selling trust argue that the Trustee could have realized much more had the policy not been sold—or if sold to a life settlement company? See Sales by a Trustee commentary in the text.

[77] Buck, *supra* note 49 at 8.

[78] For installment notes sales to intentionally defective grantor trusts, the generally recognized rule of thumb is that the debt-to-equity ratio should be 9;1, which means that the seed money normally is equal to 10% of the sale price. This issue is discussed in detail in Alexander & Halloran, supra, note 1, and in Richard A. Oshins and Robert G. Alexander, *The Beneficiary Defective Inheritor's Trust BDIT): Creating the Ideal Wealth Transfer and Asset Protection Plan* (2009), unpublished manuscript on file with the authors.

value. To do otherwise could constitute a breach of fiduciary duty.[79] The question here is, "What constitutes its fair market value?" Can the trustee sell the policy for its cash surrender value? What about for its ITR value? Does the trustee have an obligation to see if there is a secondary market for the policy, and if so, use that value? There are no clear answers here and, therefore, the value used will likely depend upon the specific facts involved. As always, with respect to these issues practitioners need to be keenly aware of the potential conflicts that exist and the fact that the trustee must resolve potentially serious fiduciary liability issues.[80]

If the risks of a valuation dispute are great, such as where the new trust is being established to exclude a beneficiary of the old trust, practitioners may want to suggest that the client use the most conservative value available which may involve seeing if there is a secondary market value. A sign-off and indemnity/hold-harmless agreement by adult beneficiaries of the selling trust also might be considered. Given the risk of fiduciary liability, trustees also might consider petitioning a court of competent jurisdiction to establish the correct policy valuation.

[d] The Life Settlement Market

Currently one of the most interesting income tax issues involves the purchase or transfer of a policy out of a qualified plan, especially when its value by design is artificially low. This occurs by reducing the policy's value by imposing large surrender charges in the early years of the policy, which surrender charges are structured to disappear sometime after the policy is transferred. This type of transaction often is referred to as a "springing" cash value policy. A second method of structuring this type of transaction is to purchase a large face amount policy and reduce the face amount after transferring the policy. A third method is to purchase a policy with high initial costs and exchange it after transferring the policy. As a fourth method planners could structure the transaction as some combination of the previously described methods. Lastly, a variation of this type of transaction involves the acquisition of a similar type of policy by an employer, which then is transferred to an employee when its value once again is artificially low.

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[79] Almost all major estate planning conferences such as the University of Miami School of Law Philip E. Heckerling Institute on Estate Planning have presentation each year regarding these issues. See for example the following sample of articles regarding these issues from The Annual Notre Dame Tax and Estate Planning Institute : L. Paige Marvel, *What a Fiduciary Should Know to Stay Out of Tax Trouble*, 1997:4; Dominic J. Campisi, *Risk Management for Trust Investment Decisions*, 2004:8; William C. Weinsheimer, *Developing "Best Practices" Approach to Trust Services to Minimize Litigation*, 2005:30; and Roy M. Adams, *The Task of Matching Beneficiaries' Entitlements to Beneficiaries' Requests*, 2008:23. Many treaties and white papers address these issues, such as *Loring: A Trustee's Handbook*, New York, Little Brown and Company, 7th ed. 1994 and Robert G. Alexander, *Trust Administration & Trustee Selection: A Study Guide*, Milwaukee, Alexander Law Offices, S.C., 2009.

[80] *Id.*

With respect to each these transactions the issue of policy valuation was complicated by IRS 1989-1 C.B. 662, Notice 89-25 and Announcement 94-101, 1994-35 I.R.B. 53, which both warned that such springing cash value policies distributed out of qualified plans could not be valued using their cash surrender value. Planners in this arena also need to heed the ruling in *Mattias v. CIR*, 134 T.C. 6 (2010), a case of first impression, based on the law prior to the IRS rules in this area (discussed below) holding that valuing a policy distributed out of a qualified plan could not be based on its cash surrender value.

One of the issues that needs to be resolved is exactly what is the fair market value of a policy for transfers out of qualified plans or as compensation? Is it the cash surrender value, the reserve value, the cash surrender value or the Interpolated Terminal Reserve? Note that in Rev. Rul. 59-195, 1959-1, C.B. 18, the IRS held that a policy's value for income tax purposes should be determined consistent with its gift tax valuation under the Section 2512 Regulations, described below.

[e] Policy Valuation and the Life Settlement Market

For purposes of life settlement "market" values the question is whether the "market" is organized well enough to provide a fair market value for all policies, or only for policies for older, less healthy insureds, or only where a life settlement offer is actually received? The Section 83 Regulations had long provided that the fair market value of a policy transferred as compensation was its cash surrender value. For example, see Reg. Sec. 1.83-3(e), prior to its amendment in 2005 by the Final Split-Dollar Regulations discussed below. Planners also need to be aware of the expanded definition of policy fair market value in the Section 61 regulations issued as a part of the Final Split Dollar Regulations (requiring taking into account the cash value and all rights under the policy, other than life insurance protection), and the provisions of those Regulations ignoring surrender charges in valuing the transfer of interests in Post-Final Regulation split-dollar policies.[81]

Practitioners also must consider the issue of the correct valuation of a policy for other income tax purposes such as a sale to a family member or to an irrevocable insurance trust (in an attempt to avoid the Section 2035 three year rule, discussed below which is not covered by the safe harbors described below. Arguably, those safe harbor amounts could be (but need not be) used for other income tax purposes. The next issue to consider is whether the gift tax value of the policy can be used? See Rev. Rul. 59-159, above. In any area in which the PERC formula doesn't apply, this ruling should apply. Lastly, what about the life settlement value of a policy which meets that market's criteria?

In a precursor to the policy valuation rules discussed below, the Final Split-Dollar

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[81] See Brody, *supra* note 2.

Regulations defined the value of a split-dollar policy as its cash value (excluding surrender charges), plus all other rights under the policy as property for Section 83 purposes, Reg. Sec. 1.83-3(e). The 2005 Regulations provide a safe harbor rule for determining the fair market value of a policy for these limited income tax purposes. The safe harbor is the greater of the ITR value (adjusted for unearned premiums) or the PERC amount—Premiums plus Earnings minus Reasonable Charges (adjusted by an interest factor for Section 402 purposes). Note again that this is only a safe harbor value—it is arguably higher than the policy's actual value. Also note Rev. Rul. 59-159, relying on gift tax values, which should apply for any other income tax purposes. Finally, because this is only a safe harbor value, a qualified appraisal of the fair market value of the policy could be used, even for these limited income tax purposes.

Final regulations under Code §§ 79, 83, 401 and 402 were issued on August 29, 2005, effective on that date, but applicable to policy transfers or distributions on or after February 13, 2004. Planners need to review carefully the current version of Reg. Sec. 1.83-3(e), treating the cash value (not surrender value) and all other rights under the policy (other than current insurance protection) as property under Section 83. The only exception to the rules is for transfers of pre-Final Regulation Split-Dollar policies where only the cash surrender value is treated as property. For sales of policies from qualified plans for less than fair market value, the Section 402 regulations are prospective as to the effect of the sale on plan qualification. Finally, the preamble to the final regulations contains a curious warning about gift tax valuation for transfers of "unusual" policies.

[4] Valuation of Policies for Estate and Gift Purposes[82]

For estate and gift tax purposes the Internal Revenue Service (IRS) has provided specific guidance as to the value of a life insurance policy. Treasury Regulations 20.2031-1 and 25.2512-1 provide that the value of a life insurance policy, just like any other type of property, is its fair market value ("FMV"). This is the price that the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. The fair market value is determined by reference to all the facts and circumstances relating to the transfer.[83]

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[82] See Buck, *supra* note 49 at 2-3.

[83] For example, when an insured is in imminent danger of dying on the transaction date (say within 12 months of death), the IRS is likely to argue that the impossibility)' of valuing the insurance makes the use of the standard "interpolated terminal reserve plus unearned premium" an inappropriate method of valuing the contract. Reg. Sec. 25.2512-1 imply that the Service will use all relevant facts and circumstances and probably value such an irreplaceable policy at a price closer to the death benefit. "The value rises in inverse ratio to the length of the insured's life expectancy." Estate of Prichard v. Comm'r. 4 T.C. 204, 1944: U.S. v. Ryerson, 312 U.S. 260, 1941: Reg. Sec. 2512-L 54 Harvard L. Rev. 895: PLR

Until the last decade or so, there was no organized market for life insurance policies. In most cases a policy owner had no choice other than to surrender the policy back to the life insurance company that issued the policy. The advent of the secondary market (i.e., life settlement market)[84] has created an opportunity for policy owners to sell their policies to third party investors for an amount significantly greater than the cash surrender value. However, the secondary market is generally limited to the purchase of policies on older, unhealthy insureds and larger policies. Therefore, younger, healthier insureds may still have to look to the insurance company as the only market for their life insurance policies. To date, the IRS has neither insisted on nor opined on whether or not prices in the settlement market must (or can) be considered in the determination of valuation for tax purposes. Due to the fact that in the past there were no organized market forces available to determine the FMV of a life insurance policy (and there still isn't one for most insureds), the IRS issued regulations in the early 1960's to provide guidance as to what constitutes the fair market value of a life insurance policy for estate and gift tax purposes. In Treasury Regulations 20.2031-8 and 25.2512-6 the IRS indicated that the value of a life insurance policy is based on the cost of a hypothetical "comparable contract." For newly issued (contracts transferred immediately after purchase or those within their first year) policies, FMV is the "cost" of the policy (i.e., the gross premiums paid by the transferor). For policies which are "single premium" (one in which one premium, paid on the date the policy is issued, funds the contract completely for the life of the insured) or "paid-up" (one in which no further premiums remain to be paid),[85] the value is the single premium which the issuing company would charge currently for a comparable contract of the same amount on the life of a person the insured's age at the time of the transfer.[86] For policies that have been in force for some time and that have continuing premiums, FMV can be approximated by using Interpolated Terminal Reserve (ITR) plus unearned premiums. However, this method may *not* be used if such approximation is not reasonably close to the full value (e.g., the insured is terminally ill).[87]

9413045. It is likely in such situations that the IRS will claim the value of such a contract approaches the death benefit payable. Probably, the IRS will require that the policy be valued by ascertaining (based on the federal midterm rate as a discount rate) the present value of the right to receive the death benefit on the valuation date)—although at some point it is likely the Service will resort to use of the secondary market for such valuations.

[84] See Leimberg. Callahan, Casey. Magner. Reed. Rybka, and Siegert, Tools and Techniques of Life Settlement Planning, National Underwriter Company (2008).

[85] Note that premium offset policies (so called "vanishing premium" contracts) are not considered paid-up contracts because—technically—the policy owner must continue to pay premiums under the contract. See Buck, *supra* note 49, endnote 7.

[86] Reg. Sec. 25.2512-6(a), Example 3.

[87] See Buck, *supra* note 49, endnote 4.

[5] Gift Tax Transactions Involving Policy Valuation[88]

Gift tax transactions involve transfers of policies from an insured to a third party owner, such as a life insurance trust (an ILIT), an intentionally defective irrevocable trust (an IDIT), a beneficiary defective inheritor's trust (a BDIT) or a completed gift self-settled domestic asset protection trust (a DAPT). These transactions can be structured either as a gift, subject to the Section 2035 three year "look back" rule or as a "full value" sale to a grantor trust, arguably not subject to the Section 2035 three year "look back" rule (under its full and adequate consideration exception), nor the transfer for value rule of Section 101(a)(2) (under either the exceptions for transfers to the insured or for carry-over basis transactions). See Rev. Rul. 2007-13, 2007-11 IRB, relying on Rev. Rul. 85-13, 1985-1 C.B. 184). For further discussion of these issues see the material below discussing what "full value" is (or might be) in this context.

The usual gift tax valuation of a policy is set out in Reg. Sec. 25. 2512-6(a). That Regulation Section requires use of the cost of a "comparable" policy, since there traditionally was no market for life insurance policies. This Regulation provision, based on early Supreme Court cases, in effect, has been unchanged for decades. For example, see *Guggenheim v. Rasquin*, 312 U.S. 254 (1941) dealing with a single premium policy gifted when the premium was paid, and *U.S. v. Ryerson*, 312 U.S. 260 (1941) dealing with a similar policy gifted later. Planners also should consider Reg. Sec. 20.2031-8 (a) (2), the estate tax analog of Reg. Sec. 25.2512-6(a), regarding the valuation of a policy on the life of another owned by the decedent.

For a single premium policy, its gift tax value is its replacement cost. Rev. Rul. 78-137, 1978-1 C.B. 280, concluded that since there was no comparable contract providing the same economic benefits (the entire bundle of rights provided in the original policy), the ITR approximation of the Section 2512 Regulations, discussed below, had to be used. For a new policy, its gift tax value is the premium paid.

For a more usual policy on which further premiums are due (even if they are to be paid out of policy values) and which has been in force for some time (an undefined term), because replacement cost would be hard to determine, the Regulations provide that its gift tax value may be approximated by the policy's interpolated terminal

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[88] There are many reasons why one party may want to make a gift of life insurance to another. These include removing the policy and its proceeds from the donor's creditors' reach. preventing the policy and its proceeds from being subject to federal estate tax (even if a gift tax is incurred. it is on the typically significantly lower lifetime value of the contract), transferring wealth and financial security through a vehicle that makes the donee Jess likely to squander than if the gift were made in cash or securities, and creating a source of liquidity for the donee to use to help pay the insured's estate taxes and other administration expenses and settlement costs. All these advantages are obtained at no loss of income to the donor and. in fact, if the donee takes over premium payments, a gift of a life insurance policy may increase the donor's spendable income. Buck, *supra* note 49, endnote 4.

reserve (its "ITR" value), plus any prepaid premiums. Note that this formulation is not mandatory. Also note that the formula does not provide for a reduction in the ITR value for policy loans, although line 58(e) of Part II (Living Insured) of Form 712 does. The type of policy and the insured's health are not relevant considerations in the ITR determination. Also, with respect to this issue see Rev. Ruls. 81-198, 1981-2 C.B. 188 holding that a policy that had been in force for seven years had been "in force for some time" and 79-429, 1979-2 C.B. 321 reaching a similar conclusion for a policy which had been in force for only three year. There are no other authorities on this issue.

Note that the ITR concept only applies directly to traditional whole life policies (which were the only kind of permanent policy available when the Regulations were adopted), where premiums are fixed and policy cash values are guaranteed to increase at stated intervals during the life of the policy. Consequently values between anniversary dates can be interpolated on a daily basis.

However, the ITR concept is used for universal, no lapse guarantee, and variable life policies as well in which there are no guaranteed increases in the cash surrender values. One of the sample Form 712s attached as Exhibit 3 acknowledges that fact.

Planners also should note the potential effect of a "shadow account" used in a no-lapse guarantee universal life policy to support a substantial ITR value even when cash values are low or even non-existent. There are several special reserve calculations for these types of policies, which are higher than the reserves for policies without a secondary guarantee feature. One of those special reserves (the contingency reserve) produces the higher ITR values.

Finally, as discussed earlier, planners need to determine which "reserve" does the carrier use in determining a policy's ITR value—the reserve value for the policy used in determining its income tax liability (the tax reserve) or the statutory reserve for the policy filed with the state insurance department (the statutory reserve)?[89] The tax reserve should be lower, because of the higher interest rate assumption in the tax reserve especially in a high interest rate environment.

For annually renewable term insurance, the gift value should only be the unearned premium. However, for level term policies there is a reserve on the carrier's books which will determine value and will produce a result well in excess of the unearned premium—a surprising result.

Reg. Sec. 25.2512-6(a) also provides that if, "due to the unusual nature of the contract" (an undefined phrase) the regulation formula does not reasonably approximate its full value (also an undefined phrase), it may not be used (with no indication of what may be used instead). Presumably, a standard policy issued by an insurer

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[89] See § 8.02[2] *supra* for a discussion of the various types of reserves.

would not be subject to this exception. Is it possible this phrase limits the use of the ITR formula to traditional whole life policies? If so, planners need to determine what can be used for other types of policies.

Planners need to be aware of *Pritchard v. CIR*, 4 T.C.204 (1944), holding that "normal" policy gift tax values don't apply if the insured is "near death" (an undefined term)—at that point, fair market value approaches the policy's full face value. In *Pritchard* the insured died within 32 days of the sale of the policy. See also PLR 9413045, holding the policy's gift value controls for a gift of a survivorship policy, if the insureds weren't "near death" (also undefined in the ruling).

All of these valuation rules were developed before the life settlement market provided any measure of a policy's real fair market value in the market, based on the usual willing seller/willing buyer test since there was no willing buyer before the life settlement is made. Therefore the current issue is whether the value of a policy for gift tax purposes is its potentially higher value in the life settlement market or the regulation formula? For example planners might want a higher value in some situations, such as in a gift of a policy to a charity, where policy owners would need an independent appraisal for a gift of a policy worth $5,000 or more to charity, under Section 170(f)(ii)(c).

The following are additional issues to consider with respect to valuation issues created by the life settlement market.

1. Does it matter if a settlement offer has been received?
2. What if the policy would qualify for a settlement, but no offers were solicited?
3. If the IRS knows about a settlement offer, could it force planners to use the higher settlement value on the theory that the ITR formula was not mandatory, and the higher settlement offer was the policy's fair market value?

[6] Estate & Gift Tax Reporting Issues—IRS Form 712[90]

For situations involving the transfer of a life insurance policy for estate and gift tax purposes, the value of the policy generally must be reported on IRS Form 706 (estate tax return) or 709 (gift tax return).[91] The instructions for Forms 706 and 709 stipulate

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[90] See Buck, *supra* note 49 at 6.

[91] Technically, the value of a gift of life insurance is established by the policy's "replacement cost," i.e. what an insurer would charge if—on the date of the gift—the insured purchased a "comparable contract" of the same amount on his/her life from the insurer that issued the original policy. Reg. Sec. 25.2512-6. Stated another way, the value is the amount it would cost to replace the contract in question—on the valuation date with a comparable contract. If the policy in question is "new" (essentially

that if the value of a life insurance policy is being reported, then an IRS Form 712 ("Life Insurance Statement") should be attached for each policy.[92]

Form 712 comports with the IRS guidance on life insurance valuation and requires that certain values be reported on the form, such as ITR and gross premiums paid. What is important for practitioners to know is that this form is filled out by the insurance company and the form requires that an officer of the company certify that the information listed is "true and correct." What this means is that once an insurance company adopts a methodology for calculating ITR, they are unlike to deviate from this methodology. They likely want to ensure that they are treating all insureds who request Form 712 values the same.

This can create a dilemma if either the practitioner or the client is unhappy with the ITR value reported on the Form 712. It is unlikely that practitioners will be able to get the insurance company to change their figure; however this doesn't mean they should not try to do so. Since Forms 706 and 709 indicate that the Form 712 should be attached, you are probably stuck with attaching the insurance company value and are now in the position of trying to explain it away. If you don't attach the Form 712, you may be red flagging the client for an IRS inquiry. Regardless of what you decide to do with the Form 712, if you do decide to use another value, the instructions to Form 712 indicate that you must provide a full explanation as to how the value was determined.

The instructions to Form 712 indicate that for single premium or paid-up policies, the amount shown on the Form may not be relied on where the surrender value of the policy exceeds its replacement cost. These instructions seem to imply that for all other policies, the Form 712 value may be relied on for gift purposes. The practice of carriers in reporting values on Form 712 apparently is not consistent, with some carriers only reporting the ITR value and other carriers reporting the policy cash value or its surrender value. Consequently, consider requesting all possible values for a policy before deciding what value to use for reporting the transaction. Some carriers have begun providing a series of values, leaving the determination (which they take the position is a legal issue) up to the adviser. For example, see the sample letters attached as Exhibit 3, setting out a series of possible values, in response to a request for a

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in its first year), the gift value is the gross premium paid by the donor to the insurer. Reg. Sec. 25.25 12-6(a).

Example 1. For policies on which further premiums are payable, the Regulations mandate that value is the sum of the "interpolated terminal reserve (the reserve adjusted to the date of the gift) and any portion of the premium paid to the insurer before the date of the gift that has not been earned by the insurer as of that date." This article will focus primarily on the valuation of policies on which further premiums remain to be paid as of the date of the taxable event. Buck, *supra* note 49, endnote 18.

[92] NOTE: Only request a Form 712 from an insurance company if the policy value is needed for estate or gift tax purposes. If requesting the value of a policy for other purposes, request a letter or other documentation from the insurance company.

policy's gift value. Also note the disclaimers contained in one of those letters about calculating the PERC value.

The gift value (or values) reported on recent Forms 712 are substantially higher than cash values, sometimes dramatically so, perhaps indicating a new conservatism by earners. These values should be known before the policy is transferred, not after. It should be possible in advance to discuss with the carrier the value(s) to be provided, or at least the methodology to be used to determine values.

Given the uncertainty in determine a policy's gift tax value, practitioners should consider hiring an appraiser to value the policy. Note again that the ITR formula is stated to be an approximation of a non-paid up policy's value, which may be used—not must be used—to determine its value. The instructions to Form 712 require a full explanation if the value of a policy is not based on a Form 712 value. Consequently, should the appraisal discuss why the Form 712 value wasn't used?

The following are some practical tips regarding policy valuation that may help practitioners with respect to the Form 712 issues discussed above:[93]

1. When requesting the value of a policy from an insurance company, be specific about what value you are looking for (e.g., is it the value for gift, income or some other purpose).
2. Start out the valuation process by informally requesting the value from the insurance company. For example, instead of asking the carrier to send you a Form 1712, have some idea what the ITR value on the 712 will be before they send it to you. This might make it easier for you to argue for and obtain an alternative value before the insurance company has formally issued the Form 712.
3. Ask the insurance company how they calculated the value that they have informally provided to you. Knowing their methodology can put you in a better position to determine if the value you have been provided is reasonable.
4. If possible, negotiate the value with the insurance company. Most insurance companies probably won't be willing to change the number they put on the Form 712, but some companies may be willing to do so due to the ambiguities involved. It certainly doesn't hurt to ask. You may have more success going through an insurer's Advanced Marketing or Actuarial department as opposed to Client Services (a.k.a., Policyholder Services), as the former are more likely to be familiar with the issues involved and the latter are likely just

[93] Buck, *supra* note 49, at 8.

following what is laid out in their company's written "policies and procedures" manual.

5. If all else fails and the client is still unhappy with the value of the policy, be prepared to consider another approach, such as obtaining an independent qualified appraisal.

[7] Section 2035—Estate Tax Inclusion Issues

Another issue to consider is what is the value of a policy sold to avoid Section 2035 under its full and adequate consideration exception? Is the value the policy's gift tax value or the amount necessary to replace it in the insured's estate for estate tax purposes—an amount equal to the policy proceeds? Planners should compare TAM 8806004 dealing with a single life policy owned by the insured, holding that full value was its face amount, with PLR 9413045 dealing with a survivorship policy owned by one of the insureds, holding that its value was its gift value, assuming the insureds weren't "near death". For a survivorship policy sold by one of the insureds, Section 2035 would not seem to apply, since Section 2042 would not apply if the owner were to die within three years of the sale if the other insured were still alive because there would be no policy proceeds to which Section 2042 could apply.

TAM 8806004 relied on *Allen v. U.S.*, 293 F. 2d 916 (10th Cir. 1961) for the proposition that adequate consideration to avoid Section 2035 would be an amount which replaced the asset in the insured's estate. In PLR 9413045, the IRS compared this situation with *Allen*, above, and held that, although the policy was being sold by trusts that were not included in either insured's estate, since the funding of those trusts had been subject to transfer tax, it didn't matter that the purchases didn't enhance the insured's estates.

The sale of the policy needs to have economic significance to be respected—a gift of cash to a trust which is recycled back to the insured, without tax consequences, should be suspect. In any event, what does the insured have to lose by attempting a full value sale—is he or she any worse off than having gifted the policy? As noted above, the sale would trigger the transfer for value rule of Section 101(a)(2), unless the sale were to a grantor trust (or the trust were otherwise an exempt transferee under that rule).

Finally, consider the implication of these rules in a life settlement sale. There, the policy is sold in an arm's length sale, but for less than its face amount. Consequently could the theory of the *Allen* case and the TAM apply if the insured dies within three years of the sale?

[8] Four Case Studies Illustrating the Complexity of Valuing a Life Insurance Policy[94]

[a] *Matthies v. Commissioner*, 134 T. C. 141 (2010)

Four recent tax court cases are excellent illustrations of the difficulty in determining the value of life insurance policies for tax purposes as discussed in the previous Sections Because of the complexity of the valuation issues discussed below, these cases warrant detailed examination of the court's valuation process, each case illustrating the difficulty of determining the correct fair market value of a life insurance policy in any given situation. *Ultimately, it appears, this issue may have to be resolved on a case by case basis*.

A survivorship contact on the lives of a husband and wife was sold by a profit sharing plan to the insured husband, who was also a beneficiary of the plan. The Court focused on two issues: (1) Was the purchase of the policy from the plan a "bargain sale" that would result in gross income to the purchaser in an amount equal to the difference between the fair market value of the policy and the amount paid for it?; and (2) What is the proper value of the policy (amount realized) for purposes of computing gain?

The taxpayer/petitioners argued that the value of the policy was essentially its cash value net of charges that would generally apply if the policy were surrendered rather than sold at the time of the transfer. The Service countered that the policy should be valued without regard to surrender charges. This, of course, would significantly increase the amount the taxpayer realized in the bargain sale transaction and result in a much higher tax. The Court agreed with the IRS that the transaction was, in fact, a bargain sale. It also followed the Service's position that the taxable amount was the excess of the policy's cash surrender value—without regard to surrender charges—over the amount of the taxpayer's basis, the premiums that had been paid by the owner for the policy. This case is a reflection on valuation distortion techniques that triggered.

This case is a reflection on valuation distortion techniques that triggered the amendment of Code Section 402 which generally provides for the taxation of distributions from qualified plans. The 2005 amendments to Section 402(a) were specifically intended to result in ″bargain sale″ treatment in cases involving a distribution of an insurance contracts having value in excess of the amount paid to the

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[94] See: Larry Brody, *What's Hot — What's Not — 2011* (2011) a white paper on file with the author. This portion of the paper was prepared by Thomas F. Commito, JD, LLM, CLU, ChFC, AEP (Distinguished). The *Lowe* and *Schwab* case studies are abstracted and edited from Howard Zaritsky's excellent commentary in LISI Income Tax Planning Newsletter #9 (May 23, 2011) at http://www.leimbergservices.com. Used by special permission of Leimberg Services by arrangement with Robert G. Alexander and the National Association of Estate Planners and Councils (NAEPC).

plan by the distributee. The Treasury Decision announcing those amended Regulations makes it clear the IRS was aware that surrender charges can be structured in such a way that the fair market value of a contract can be distorted if they are included in the policy's valuation: life insurance contracts have been marketed that are structured in a manner which results in a temporary period during which neither a contract's reserves nor its cash surrender value represent the fair market value of the contract. For example, some life insurance contracts may provide for large surrender charges and other charges that are not expected to be paid because they are expected to be eliminated or reversed in the future (under the contract or under another contract for which the first contract is exchanged), but this future elimination or reversal is not always reflected in the calculation of the contract's reserve. If such a contract is distributed prior to the elimination or reversal of those charges, both the cash surrender value and the reserve under the contract could significantly understate the fair market value of the contract. Thus, in some cases, it would not be appropriate to use either the net surrender value (i.e., the contract's cash value after reduction for any surrender charges) or, because of the unusual nature of the contract, the contract's reserves to determine the fair market value of the contract. The *Matthies* Court referred to portions of this document in its opinion: This Court has not previously addressed the tax treatment of a bargain sale of a life insurance policy under section 61 or 402(a) or the application of the "entire cash value" standard under the applicable regulations. In adopting the 2005 final section 402(a) regulations, the IRS stated that it was responding to the question under the then-existing regulations of whether "entire cash value" includes a reduction for surrender charges. T.D. 9223, 2005-2 C.B. 591. Here, the Court, when forced to choose between two different valuation methods for the transaction selected the one in keeping with the spirit of the regulatory guidance issued by the IRS in recent years, even though all of this guidance was not specifically cited.

The IRS had imposed a 20 percent underpayment penalty on the taxpayers for negligence in addition to the unpaid tax. However, the Court decided that the case was essentially a case of first impression, that it involved ″uncertainty″ under applicable law, and that as a result there was a reasonable basis for the taxpayers' position in this case. Since the ″reasonable basis″ standard is applicable in determining whether a tax return is negligent, no penalty was imposed. In a footnote to the portion of the opinion addressing the penalty issue, the Court referred to IRS guidance concerning so-called "springing" life insurance policies. These were policies in which the surrender charges are deliberately disproportionately high in the early years of a policy (such as in the first five years), then by design after the transfer diminish and finally disappear very rapidly. These contracts were crafted specifically to accomplish the apparent valuation reduction attempted in the *Matthies* case. In deciding not to impose a negligence penalty, the Court noted that the Matthies' policy could be differentiated from the more abusive "springing" policies addressed in the IRS guidance because the Matthies'

policy was designed to contain front-loaded surrender charges, but the charges were not completely phased out until the 20th policy year.

Practitioners should take away two insights from *Matthies*: First, there is no single method by which the fair market value of a policy must be determined for purposes of taxing a bargain sale. Second, it is likely the IRS will ignore surrender charges in the determination of a policy's value if their inclusion would understate the fair market value calculation.

[b] *Cadwell v. Commissioner*, 136 T.C. No. 2 (2011)

In *Cadwell*, the taxpayer argued that the value of the policy to be included in his income was equal to the policy's cash surrender value. The Tax Court dismissed the use of cash surrender value with the following:

> According to Rev. Proc. 2005-25 . . . the surrender charge should be disregarded for valuation purposes. The surrender charges apply in decreasing amounts beginning in the life insurance policy's first year and are reduced to zero in the life insurance policy's 15th year. In other words, any holder of the life insurance policy beyond 15 years could redeem the life insurance policy for its stated cash value with no penalty. Accordingly, it will be disregarded for purpose of valuing petitioner's interest in the life insurance policy.

The Tax Court concluded that the "PERC" value was the appropriate measure, on the following basis:

> Accordingly, we conclude that the PERC value of petitioner's interest in the life insurance policy is $70,529.28 Neither party contends that the alternative valuation measure allowed pursuant to Rev. Proc. 2005-25, *supra*, would result in a higher valuation. Additionally, neither party contends that petitioner's life insurance policy is subject to any liabilities . . . Accordingly, we hold that petitioner must include in gross income the cash value of the life insurance policy of $70,529.

This result leads to a number of interesting concerns. First, it is not clear why the IRS argued only that the PERC value was appropriate, and did not also look at the "interpolated terminal reserve" value. The Revenue Procedure places the value at the greater of the two. In response to the IRS' non-argument, the Court essentially concludes that the interpolated terminal reserve must be less. On the other hand, maybe the IRS did not argue ITR since the policy involved was a universal life policy. We do not know the answer to these questions, so we continue to be in the dark as to what ITR is in the universal life context. Also, the Court accepts the Revenue Procedure's determination of value. However, the Revenue Procedure is clearly labeled as a "safe harbor" — it is not a definitive test of "fair market value" which is the underlying standard of all valuation issues. Fair Market Value is also the standard for Regulation 1.402(a)-l(a) (2).

[c] *Lowe* and *Schwab*

In *Lowe v. Commissioner,* T.C. Memo. 2011-106 (May 19, 2011), the Tax Court held that the value of a variable universal life insurance policy distributed from a nonexempt trust with respect to a welfare benefit plan, and taken into income by the distributee, was the fair market value of the policy, after consideration of certain surrender charges.

Frederick was the sole shareholder of Smart Money Strategies, Inc., an S corporation, and he and his wife, Dushanka, were employees. The company adopted an employee welfare-benefit plan under Sections 419 and 419(A), and the taxpayers were the only covered employees. The plan provided death and severance benefits, which it funded partially by buying a $4,213,485 variable universal life insurance policy on Frederick's life, which policy carried a $75,000 annual premium. The policy had a vanishing surrender charge, that declined as the termination date grew later, and which was eliminated 14 years after the policy's effective date. Dushanka was the named beneficiary of the policy on Frederick's life.

Smart Money contributed money to the plan each year, and the trustee paid the premiums. In late 2003, Smart Money terminated its participation in the plan and trust, which caused ownership of the policy to transfer from the trust to Frederick. On the distribution date, the accumulated value of the policy without regard to surrender charges was $140,901, and the value of the policy after surrender charges was zero.

The taxpayers did not report any income from distribution of the policy. The IRS claimed that the value of the policy for income tax purposes under Section 402 was $140,901, ignoring the surrender charges, and assessed a deficiency. The IRS also assessed a $10,050 accuracy-related penalty under Section 6662(a). The JRS moved for summary judgment as to the valuation of the policy for purposes of Section 402(b)(2).

[d] The Tax Court Values the Policy

The Tax Court (Judge Laro) held that Section 402(b)(2) requires that a life insurance policy distributed from a nonexempt employee trust be valued for income tax purposes at its fair market value as of the date of distribution, and that the surrender charges may need to be taken into account, but that genuine issues of material fact remained as to the fair market value of the policy distributed in this case.

The taxpayers argued that the value of the policy should be determined under Section 83, and that it must be reduced by the amount of the surrender charges payable upon termination of the policy. The IRS argued that the value should be determined under Sections 402(b)(2) and 72, without regard to any surrender charges.

The Tax Court held that Section 83 did not apply, because where two statutes overlap in application, the more specific provision takes precedence over the more

general provision. Section 83 provides rules for the taxation of property transferred to an employee in connection with services performed by that employee. Section 402(b)(2) provides "the amount actually distributed" or made available to a distributee by a nonexempt employee trust must be included in the distributee's gross income pursuant to the annuity rules of Section 72. The policy here was transferred to the taxpayer by way of a distribution from a nonexempt employee trust, which is specifically contemplated by Section 402(b). Thus, Section 402(b) is more specifically applicable than Section 83, and the former must be applied, rather than the latter.

As Section 402(b)(2) controls the tax consequences of the policy distributed to the taxpayers, the value of the policy is determined under Section 72. Section 72(e) prescribes rules for the tax treatment of amounts received under a life insurance contract which are not received as annuities, and states that, in general, any nonannuity amount received before the annuity starting date is includable in gross income to the extent allocable to income on the contract. Section 72(e)(3)(A) requires that the amount included in gross income, should not exceed the excess (if any) of "the cash value of the contract (determined without regard to any surrender charge) immediately before the amount is received" reduced by the taxpayer's "investment in the contract". The cash value of the policy determined without regard to surrender charges was $140,901.

The taxpayer's investment in the contract is defined as the amount of consideration paid for the contract less amounts previously received under the contract that were excludable from gross income. The taxpayers paid no consideration for the contract, so the court treated their investment in the contract as zero. Thus, the maximum amount the taxpayers must include as gross income under Section 72(e)(3) would be the cash value of the policy without regard to surrender charges, or $140,901.

The court then noted, however, that Section 402(b)(2) does not require that Section 72 be read "in isolation," but only that Section 72 be a guide to allocating the value of the policy between taxable income and a nontaxable return of the investment in the contract. Section 402(b)(2) provides that the "amount actually distributed" to the distributee is taxable under Section 72. The "amount actually distributed" is thus the amount that the taxpayers must include in their gross income, subject to the limitation imposed by Section 72(e)(3)(A). The court noted that "amount actually distributed" under Section 402(b)(2) is not synonymous with the accumulated cash value of the policy.

The taxpayers received distributions of life insurance policies from a nonexempt employee trust and the court held that the phrase "amount actually distributed" was defined differently in the regulations under Section 402(a) (distributions from exempt employee trusts) and Section 402(b)(2) (distributions from nonexempt employee trusts). A life insurance policy distributed from an exempt employee trust should be determined without regard to surrender charges, but a policy distributed from a

nonexempt employee trust is its fair market value, which may include surrender charges.

The court added, however, that "the fair market value of an insurance contract can be a "slippery concept", the determination of which requires further analysis." The court explained that the only value that the taxpayers received from the distributions of their policies was a small amount of insurance coverage attributable to premiums, and that the court lacked sufficient data from which to calculate the fair market values of what the taxpayers actually received. Therefore, summary judgment was refused.

The IRS announced in 2004 and 2005 that the cash value of a life insurance policy distributed by a qualified plan trust would not be reduced by surrender charges. The IRS has issued no similar rulings or regulations relating to distributions from nonqualified plan trusts, but the Tax Court has now provided firm rules in both Lowe and its earlier decision in *Schwab v. Commissioner*, allowing the use of surrender charges to reduce the value of a policy distributed from such a trust and taxable to the distributee under Section 402(b)(2).

In *Schwab v. Comm'r*, 136 T.C. No. 6 (2011) the Tax Court held that taxpayers who received life-insurance policies from a multiple-employer welfare benefit trust designed to conform with Section 419A(f)(6) that had surrender charges in excess of their stated values, had to include the fair market value of the policies in their gross income, but that valuing the policies should reflect properly the surrender charges and other conditions imposed by the insurance company, including the value of paid-up insurance coverage remaining on the policies as of the date of distribution.

The Tax Court (Judge Holmes) held that the taxpayers had taxable income because of the terminating distribution of their policies to them from their nonqualified Section 419A(f)(6) plan. The court noted that Section 402(b)(2) governs the income taxation of distributions from nonqualified plans, such as the plan maintained by the taxpayers.

That section taxes the distributee on the "amount actually distributed or made available" and that these amounts are taxed "under section 72 (relating to annuities)." The Tax Court held that taxing an amount actually distributed under the rules for annuities does not mean that these amounts are annuities, but only that the taxability of whatever amount was "actually distributed" has to be computed by using the rules of Section 72 on recovery of the taxpayer's investment in the contract.

The Tax Court stated that the amount on which the taxpayers were taxable was not merely the policy's cash value, but the value of "all other rights under such contract." The court noted that the regulations then in effect, which were also the regulations applicable to this transaction, as requiring that the "entire cash value" of life insurance policies be determined without regard to surrender charges.

The court noted that the taxpayers' policies required years more of steep premium payments, and substantial parts of their values were tied to the fluctuations of a broad

stock-market index. These policies are unlike traditional whole life policies that can only grow over time. The value of these policies could rise or fall with the stock market.

The policies, the court stated, should be valued more like mutual funds, and the surrender charges "look very much like a back-end load." The court noted that the parties had argued primarily about whether the surrender charges should be considered at all in valuing the policies, and had introduced very little evidence regarding the actual values of the policies. The court concluded that the policies had little value apart from the small amount of the insurance coverage that was attributable to the single premium that the corporation had paid on each policy three years earlier. The court then stated:

Though the value is small the calculation is daunting because of ambiguity in the record, and we make only a tentative effort to ascertain exact figures. After distribution, the premiums covered [Michael] Schwab for up to 54 days and [Kathryn] Kleinman for 24 days in Schwab's case, until he paid a premium to keep the policy going, and in Kleinman's, until her policy lapsed. By applying the base rates for the guaranteed maximum monthly cost of insurance rates ($.446 for Schwab, $.4043 for Kleinman) to the days covered, we attribute the following amounts: to Schwab, $1,900.33; to Kleinman, $765.62—a total of $2,665.95. Section 72 generally treats as taxable the amount distributed less any amount allocable to a taxpayer's investment in the contract-and for Schwab and Kleinman, whose corporation had paid the premiums without including them in their income, the amounts invested in their contracts were zero. We therefore conclude that $2,665.95 is the "amount actually distributed" under section 402(b) and therefore included in taxable income under section 72.

[e] The Conclusion

Lowe and *Schwab* demonstrate the difficulty that arises in valuing life insurance policies, and the fact that the tax law has not kept pace with the changing nature of life insurance policies generally. Practitioners advising participants in qualified and nonqualified plans should be very careful in giving firm valuations for the more modern types of life insurance policies. The precise calculation will always require careful analysis of cash values and the value of insurance coverage provided, as well as the cash surrender charges, but at least the insurers and plan participants now have relatively clear guidelines from which to determine such values.

§ 8.03 ADVANCED WEALTH AND RETIREMENT PLANNING WITH PRIVATE PLACEMENT LIFE INSURANCE AND PRIVATE PLACEMENT VARIABLE ANNUITIES

[1] Introduction

The following sections [§§ 8.03 – 8.15] of this article will examine two important wealth and asset protection strategies that typically fall outside the bounds of

traditional retirement, estate and asset protection planning. However, for high net worth clients these two strategies, which often go hand-in-hand, can significantly enhance the wealth planning opportunities for high net worth clients. The first strategy is private placement life insurance ("PPLI"), an investment-oriented strategy that can dramatically improve the tax efficiency of a client's investment portfolio and lifetime wealth accumulation planning. The second strategy is hedge fund investing, an investment strategy that has rapidly gained popularity among taxable investors in today's equity market environment due to its ability to deliver superior risk-adjusted returns in both bull and bear markets. As will be discussed in detail in this article [see §§ 8.13 – 8.15 below], hedge funds can be an important investment component of both private placement life insurance and private placement variable annuities.

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. Both private placement insurance products and hedge funds can be important planning opportunities in conjunction with a CVBDIT because, both individually and in combination, they can dramatically increase both the retirement and the "accumulated wealth value"[95] of the CVBDIT, which is one of the primary benefits of the CVBDIT strategy.

[2] Private Placement Life Insurance ("PPLI") and Private Placement Variable Annuities ("PPVA")

[a] Introduction

This section of the 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 (such as hedge funds) 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.[96] As an estate planning tool, PPLI has multiple applications that mitigate estate tax liability and

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[95] The term "accumulated wealth value" means the total compound rate of return of the investment portfolio (if any) plus the life insurance death benefits (if any).

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

facilitate the orderly disposition of assets at death.[97] In contrast, PPVA is designed to supplement the client's estate during life. As asset security vehicles, PPLI and PPVA offer both financial privacy and, in some cases, significant protection from future creditors.[98] And, finally, PPLI and, particularly, PPVA represent powerful tools for augmenting philanthropic goals (a topic beyond the scope of this article).

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 offshore offer additional asset protection benefits and cost savings as compared with equivalent products acquired in the U.S.

In addition to the income tax benefit 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 many potentially useful estate planning applications.[99] In addition, both PPLI and PPVA provide financial privacy and asset protection benefits that are of significant importance to the high net worth client.[100] 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.[101]

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[97] This article assumes the continued application of the estate tax system in effect on December 31, 2009 and after 2012.

[98] See Gideon Rothschild and Daniel S. Rubin, *Asset Protection—Riches Out of Reach* (2005), white paper on file with the authors.

[99] See Alexander & Halloran, *supra* note 1.

[100] *Id.*

[101] See § 8.15[1] *infra*.

[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% 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.[102] 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 pays periodic payments to the insurance company over a stated period of time. The contract assets (*i.e.*, cumulative payments and accreted investment return) grow on a tax-deferred basis until the contract is annuitized and payments to the annuitant commence. The annuity funds are invested through a separate account in various investment options, which the annuity owner chooses, and the annuitant 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

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[102] Private placement products offered by U.S. carriers to U.S. persons are subjected to SEC regulations.

to include alternative asset classes such as hedge funds and funds of funds.

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 certain, 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.), provided the annuitant is living. With a period certain annuity, it is possible that the annuitant could die during the pay-out period. Some annuities provide that under such a scenario, the undistributed accumulated amount reverts to the insurance company, instead of being paid to a designated beneficiary.

[d] Additional Considerations with Private Placement Life Insurance

Private placement variable life insurance is a special type of policy designed for wealthy individuals who want to make substantial investments. Private placement variable life (PPLI) has a number of unique features:[103]

1. It is a variable life policy that allows the policy owner to invest in a variety of sub-accounts;
2. It usually requires a substantial premium payment in the first year (e.g., $250,000);
3. More sophisticated investment vehicle such as hedge funds (aggressively managed investment funds often using high-risk, advanced strategies in an attempt to generate large profits) can be included in the menu of sub-accounts in these policies; and
4. The sales and administration expenses are lower than typical variable life policies and some expenses can be negotiated.

Because of these unique design features, private placement life insurance can give the high net worth investor an attractive combination of investment flexibility, tax-deferred growth, insurance protection, and low fees. Additionally, if the policy is purchased and owned in Beneficiary Defective Inheritor's Trust ("BDIT") the insured can take advantage of all the retirement, wealth accumulation and asset protection features of the Cash Value BDIT ("CVBDIT").

Individuals insured with large life insurance policies bring three advantages to the total pool of life insurance risks that insurers of more moderate size polices cannot bring to insurance carriers.

1) Better mortality rates. High net worth individuals tend to obtain better health care, consequently they live longer.

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[103] See Lee Slavutin, *PPC's Guide to Life Insurance Strategies*, Fort Worth, Thomson Reuters, 2009 at § 302.15.

2) Better persistency. Larger life policies tend to stay in force longer than smaller life insurance policies thus; insurance carriers have a greater opportunity to recoup up-front asset reserving requirements.

3) Larger premiums. Insurance carriers, similar to banks, act as spread managers. More assets allow greater opportunity to generate spread fees on assets within the policy, as well as mortality rate spreads.

As a result of these qualities it is advantageous for owners and trustees of large insurance policies to bring these positive pricing characteristics together in separate mortality pools, and not dilute these advantages with owners of smaller life insurance policies. This advantage is most readily apparent in private placement life insurance (PPLI) polices. PPLI policies, generally, can provide owners and trustees the following advantages over traditional variable life insurance policies:

1) Institutional pricing.

2) Broader array of subaccounts or investment alternatives. In addition to the usual complement of long only equity subaccounts and fixed income alternatives, hedge fund alternatives are available.

3) A consortium of carriers providing similar product. This provides greater diversification of carriers, yet allows for streamlined administration.

In an era of fiduciary scrutiny these advantages should not be overlooked.

Wealthy individuals and families who want (a) insurance protection, (b) the ability to invest in equity funds, (c) the tax deferral of insurance products, and (d) minimized fees may be attracted to PPVL products. However, despite their attractive features, potential purchasers of private placement life insurance need to understand that investments in private placement products are strictly regulated. The IRS has issued several rulings and regulations under IRC Sec. 817 to tighten the investor control rules. According to the "investor control doctrine", policy owners may only give basic guidance to the insurance company about investments (Rev. Rul. 2003-91). The insurance company, not the policy owner, should dictate which funds are available in the private placement variable life product. If the policy owner violates these rules, the product will lose the tax deferral on its cash value earnings. Additionally, there are specific diversification requirements [IRC Sec. 817(h); Reg. 1.817-5(b)] and "look-through rules" [Reg. 1.817-5(f); Rev. Ruls. 2003-92, 2005-7, and 2007-7]. Planners should review these rulings and regulations to properly advise clients interested in private placement products.[104]

As the investment power of high-net-worth individuals continues to grow, legal and

[104] All of the issues discussed in this paragraph are discussed in detail throughout this article.

financial advisors are frequently asked about tax-advantaged structures for passive investments. A life insurance policy that is U.S.-tax compliant, especially one offered by an established carrier, presents a conservative and cost-effective investment opportunity.[105] By virtue of the substantial lobbying influence of powerful interest groups, including the U.S. life insurance industry, life insurance as a financial product has had a long history in the United States as a tax-advantaged investment vehicle with minimal legislative risk. Certain carriers with well-established operations both inside and outside of the U.S. offer "private placement" (or, more appropriately, "customized") policies that are fully compliant with U.S. tax rules and are, therefore, fully entitled to the preferential tax treatment that life insurance enjoys. 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.

Despite the long-standing availability of variable universal life insurance products in the retail market, the PPLI and PPVA markets are still in their growth and development phase, and there are significant traps for the unwary. Accordingly, it is important for the advisor who counsels high-net-worth clients for whom private placement life insurance and annuity 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 private placement policy or a domestic retail policy. It is equally important for the advisor to be attuned to jurisdictional issues when planning the life insurance and annuity[106] ownership structure and for the advisor to engage the services of a knowledgeable intermediary, such as an experienced insurance broker that dedicates itself to the private placement market- place, to be involved in the design of the product, the selection of the carrier (and the attention to related due diligence issues), and the ongoing service and compliance matters related to the policy itself.

[3] What PPLI is Not

There are currently two insurance structures other than PPVUL on the market that have recently come under a significant amount of scrutiny by the Internal Revenue Service (the "Service" or "IRS"). These structures are Internal Revenue Code ("IRC") § 501(c)(15) insurance companies and equity acquisitions of offshore insurance

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[105] See Alexander & Halloran, *supra* note 1, and Brody, *supra* note 2.

[106] See Alexander & Halloran, supra, note 1, and Robert G. Alexander and Dallas E. Klemmer, *Creative Wealth Planning with Grantor Trusts, Family Limited Partnerships, and Family Limited Liability Companies*, ESTATE PLANNING AND COMMUNITY PROPERTY LAW JOUNRAL, Vol. 2, Book 2, (2010), pp. 329 et seq.

company stock. It is essential to understand that these structures are unrelated to the PPVUL structure discussed in this article.

The first structure mentioned, an IRC § 501(c)(15) insurance company, is statutorily defined in the Internal Revenue Code. IRC § 501(c)(15) was originally passed as a way to assist farmers who lacked easy access to the insurance market. The goal of IRC § 501(c)(15) was to allow these farmers to set up small insurance companies that would be considered tax-exempt, provided that they collected less than $350,000 in premiums a year and did not underwrite life insurance. Recently, however, ultra-high-net-worth investors, seeking to shelter assets from income taxation, have availed themselves of the tax benefits available to IRC § 501(c)(15) insurance companies. That is, as long as such an insurance company does not collect more than the $350,000 premium limit per year, it is allowed under IRC § 501(c)(15) to accumulate earnings on its investments income tax-free. Moreover, appreciated assets may be transferred to the corporation in exchange for stock when the company is initially capitalized. These insurance companies are legal under the letter of the law, and several of them have accumulated millions of dollars of tax-free earnings for their investors. However, the IRS apparently now perceives the use of IRC § 501(c)(15) insurance companies to be investor abuse in some cases. Accordingly, the IRS issued Notice 2003-35 in May 2004 to remind the public that an IRC § 501(c)(15) insurance company's primary purpose is to provide insurance, not investment opportunities.[107] Notice 2003-35 also advises that the IRS will begin active investigation of these entities in the near future.

The other insurance structure attracting the IRS's attention has as its purpose the conversion of hedge fund earnings from ordinary income and short-term capital gain income into long-term capital gain income. As mentioned above, hedge funds have become increasingly popular over the last several years due to their consistent outperformance of other investment strategies. This performance has driven investors to seek ways to avoid paying the high level of income tax typically attributed to hedge fund returns. The strategy involving the acquisition of offshore insurance company stock, sometimes referred to as the "equity transaction," involves a hedge fund manager or other investment service provider setting up an offshore insurance company. The organizer then seeks equity investors for the insurance company (i.e., investors interested in hedge funds), promising to allocate the investor's equity to a specified investment account, typically the investor's preferred hedge fund(s). The primary argument made by the IRS in connection with this structure is that the insurance company is not actually taking on insurance risk and therefore does not meet the definition of an insurance company.[108]

Both IRC § 501(c)(15) insurance companies and the equity transaction differ

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[107] IRS Notice 2003-35, I.R.B. 2003-23, May 9, 2003.

[108] *See* IRS Notice 2003-34, I.R.B. 2003-23, May 9, 2003.

greatly, in design and purpose, from a PPVUL structure. Potential PPVUL purchasers may hear the buzzwords "offshore insurance company" and "hedge fund" and immediately worry that PPVUL policies issued by offshore carriers are subject to the IRS scrutiny they have read about in recent newspaper articles.[109] This, however, is not the case.

[4] The U.S. Client

PPVUL insurance offers to U.S. qualified investors[110] the ability to select asset management beyond the limited asset-management choices offered in retail variable life insurance products. This is attractive to high-net-worth clients who may have investment mandates that involve more sophisticated strategies such as hedge funds. Due to the expense associated with regulatory pressures imposed by federal and state securities laws and by state insurance boards, some domestic companies have more limited investment platforms than their offshore counterparts. Because offshore insurance companies are not subject to the same bureaucracy and regulations imposed within the U.S., they are able to engage investment managers with greater ease.

Generally, the client's motivations for investing in a PPVUL 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 asset classes in an investor's portfolio. The purchase of death benefit is secondary. Usually, therefore, the core goals for acquiring a PPVUL 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 a PPVUL insurance policy issued offshore that will be discussed in detail below.

[5] Foreign Trusts with U.S. Beneficiaries

Private placement life insurance products offered by offshore carriers are also

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[109] *See, e.g.*, Johnston, David Cay, *Insurance Loophole Helps Rich*, N.Y. TIMES, April 1, 2003; McKinnon, John D., *U.S. May Curtail Hedge-Tax Haven Tied to Insurance*, WALLS. J., September 12, 2002.

[110] Many offering memoranda for offshore PPVUL policies reference "qualified purchaser" or "accredited investor" standards, as used in U.S. securities law, to describe suitable investors. In the offshore context, this should be considered merely a guideline and not a strict requirement because offshore policies are not actually subject to SEC regulations. However, if the premiums of an offshore PPVUL policy are to be invested in funds that do require investors to be "qualified purchasers," then the policy owner must be a "qualified purchaser" for that purpose. In the domestic context, because private placement products in the U.S. are subject to SEC regulations, each purchaser generally must be a "qualified purchaser" under section –2(a)(51) of the Investment Company Act of 1940, 15 U.S. C. §80a-2(a)(51), and an "accredited investor" under section 501(a) of Regulation D of the 1933 Act, 17 C.F.R. 230.501(a).

beneficial for other types of clients, such as foreign persons who have created foreign trusts with U.S. beneficiaries. Prior to the enactment of the Small Business Job Protection Act of 1996 (the "1996 Act"),[111] a foreign person could, with relative ease, establish a 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.[112] This was advantageous for several reasons. First, 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 would generally be treated, for U.S. income tax purposes, as that of the foreign person who was the grantor and would not be subject to U.S. federal income tax. Second, 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. Finally, 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.

The 1996 Act effectively eliminated the grantor trust status of these foreign trusts by treating a person as owning assets of a trust only if that person is a U.S. citizen, U.S. resident, or domestic U.S. Corporation.[113] 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 for U.S. federal income tax purposes.[114] When a trust has been classified as a foreign non-grantor trust, it is possible for the trust to defer U.S. federal income taxation because, ordinarily, the earnings of such a trust would not be taxed directly by the U.S., with certain exceptions.[115] However, when income is distributed from the trust to a U.S. beneficiary, it is taxable to such U.S. beneficiary. Specifically,

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[111] 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: (1) for U.S. beneficiaries who receive distributions from trusts created by foreign persons, and (2) for U.S. persons who create foreign trusts.

[112] 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. *See* IRC §§ 671–679.

[113] 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. Separate accounting is required for amounts transferred to the trust after September 19, 1995, together with all income and gains thereof.

[114] There are exceptions to this rule that are beyond the scope of this article. *See* Treas. Reg. § 1.672(f)-3.

[115] 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

a U.S. beneficiary is taxable on amounts of income currently distributed from the trust's worldwide distributable net income ("DNI").[116] 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.[117]

Furthermore, distributions from foreign non-grantor trusts of undistributed net income ("UNI") are classified as accumulation distributions and taxed according to the "throwback" rules. 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. 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 ONI and, if current year distributions exceed ON I, then on the trust's UNI. 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. The effect of the interest charge can cause an effective tax rate of 100 percent to apply after several years of accumulation.

Despite the effective elimination of foreign grantor trusts (created by foreign persons) and all of the attendant benefits, all 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. Life insurance 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 nontaxable under current law, if properly structured.[118] Finally, all amounts paid out of the policy to the policy beneficiary as death benefit proceeds are not subject to U.S. income tax.

For existing foreign non-grantor trusts with undistributed net income (and previously classified foreign grantor trusts with income accumulated after the 1996 Act), offshore PPVUL insurance can be an effective tool to stem the ever-increasing accumulation of taxable 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 further accumulation of distributable net income ceases.

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effectively connected with the conduct of a U.S. trade or business.

[116] 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.

[117] 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.

[118] In general, this means making withdrawals from a non-modified endowment life insurance policy up to the policy basis, then switching to policy loans. See note 18, *infra*.

Note that the trust may still contain pre-existing undistributed net income that is taxable to the U.S. beneficiary (and subject to the interest penalty) whenever the trustee makes a distribution in excess of DNI. Over time, however, cumulative distributions to the beneficiaries may exhaust this pre-existing UNI. Thereafter, the trustee may generally withdraw or borrow funds from the policy on a tax-free basis and then distribute those proceeds (also on a tax-free basis) to the U.S. beneficiary.

§ 8.04 GENERAL TAX CONSIDERATIONS[119]

[1] U.S. Federal Income Tax Benefits

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").[120] 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.[121]

The U.S. federal income tax advantages of life insurance are the same whether the policy is acquired onshore or 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.[122] Because earnings on policy cash values are generally not taxable, the policy's cash value grows much quicker than when compared to a taxable investment portfolio.[123] For an illustration of the economical of a private placement life insurance contract see § 8.13 *infra* and Exhibit 4.

In addition to the tax-free accumulation of the policy's cash value, withdrawals and policy loans by the policyholder can be used to access policy assets during the lifetime of the insured.[124] Generally, such withdrawals and loans are received income-tax free.[125] Finally, the proceeds payable at the death of the insured are excluded from the

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[119] For a more complete discussion of these topics see § 8.09 *infra*.

[120] § 7702(a). All "section" and "§" references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, unless otherwise stated.

[121] 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).

[122] *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).

[123] See Alexander & Halloran, *supra* note 1.

[124] *Id.*

[125] Note that if a policy is a modified endowment contract ("MEC") as defined by IRC § 7702A, proceeds of a loan or withdrawal are taxed as ordinary income to the extent of any gain in the policy cash value before the loan or withdrawal. To avoid this taxation, therefore, it is crucial that MEC status be

taxable income of the beneficiary,[126] and with proper structuring, may also be excluded from the taxable estate of the owner insured.[127]

[2] Other Potential Tax Benefits

Enhanced tax advantages are available to a client who, by completing all aspects of the transaction offshore,[128] acquires a PPVUL policy issued by an offshore carrier. First, no state premium tax is payable when a PPVUL insurance policy is issued offshore. This results in a savings, in most states, of approximately two to three percent of the premium. Second, the federal deferred acquisition cost ("DAC") tax and/or federal excise tax that is assessed on the premium of a policy issued by a foreign company will be less than the DAC tax paid on a similar policy issued onshore. The DAC tax on a policy issued onshore is generally about one to one and a half percent of premiums paid. The overall tax paid on a policy issued offshore will be less; however, the actual amount of the tax will depend on whether the policy is issued by a company that has elected to be taxed under IRC § 953(d) as a domestic corporation (the "953(d) election"). If the insurance company has made the 953(d) election, a reduced DAC tax of less than one percent of premium will normally apply. If the insurance company has not made the 953(d) election, no DAC tax will apply; however, a one percent U.S. federal excise tax on premium payments will be payable.[129]

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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, due to the higher insurance-related costs of non-MECs, MEC status does not need to be avoided when 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. Generally, non-MECs are characterized by a premium paid over five or six years, while MECs are characterized by a one-time, up-front premium payment.

[126] *See* IRC § 101(a)(1).

[127] *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. See also Alexander & Halloran, *supra* note 1.

[128] Most states in the U.S. impose a premium tax on life insurance policies. However, as long as the policy is negotiated, applied for, issued, and delivered offshore, state insurance taxes should not apply to an offshore PPVUL purchase. Nevertheless, state laws applicable to the policy owner, insured, and beneficiary must be carefully examined on a case-by-case basis. Furthermore, 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. Domestic producers have tried to capitalize on the fact that Alaska and South Dakota assess very low levels of premium tax, and thus offer prospective purchasers a low-cost alternative to offshore PPVUL. Recently, however, a major carrier reported that the Texas insurance authorities assessed a premium tax on premiums paid for an Alaska PPVUL policy issued on the life of a Texas insured and then successfully collected that assessment. As a result, the tax-savings opportunity offered by Alaska and South Dakota PPVUL policies has already been limited in Texas and is likely to see further limitation in other states.

[129] *See* IRC § 4371.

Overall, the absence of the state premium tax and reduced or no federal DAC tax offshore, along with no or low premium sales loads, contributes to the substantially improved yields compared to taxable investments, as illustrated above.

[3] 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 through an alternative premium-paying arrangement, such as an intrafamily loan.[130] When a client's net worth suggests the need for removing substantial assets from the estate tax base, private placement life insurance, a traditional irrevocable life insurance trust, and an alternative premium-paying arrangement can be a very effective combination.

[4] Private Placement Insurance and the Irrevocable Trust

> **Important note to the reader**: This section refers in general to irrevocable trusts and irrevocable life insurance trusts.[131] The CVBDIT strategy is a more efficient trust design, especially for the ownership of life insurance. The CVBDIT requires specific drafting and planning modifications which are not a part of traditional irrevocable trusts and traditional ILIT strategies and design. The special design features of the CVDIT are discussed in § 8.01, supra, and also are discussed in detail in Alexander & Halloran, *supra* note 1. Throughout this entire article the reader must keep in mind the important distinctions between tradition irrevocable trusts, ILITs and the CVBDIT.

An irrevocable life insurance trust ("ILIT") is a commonly used estate planning technique. When the ILIT will receive completed gifts which are in turn invested in an offshore private placement policy, the trust should be a foreign trust for legal purposes (because it is important that the policy have a foreign owner due to state regulatory concerns). Also, it may be best to structure the trust as one that is domestic for tax purposes in order to avoid the onerous foreign trust reporting requirements, and more importantly, to avoid the potential negative application of IRC § 684.[132] The

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[130] 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.

[131] See Alexander & Halloran, *supra* note 1 at §8.01[9].

[132] Under some circumstances, a U.S. person transferring property to a trust that is considered a foreign trust for tax purposes may be required to pay income tax on the transferred property. 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

classification of a trust as domestic for tax purposes can be accomplished by satisfying the definitional requirements set forth in IRC § 7701.[133]

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 testamentary power of appointment.[134] In addition, the settlor should retain no powers under the trust agreement that would cause the trust assets to be includible in the settlor's estate for estate tax purposes.[135] Moreover, the allocation of generation-skipping transfer ("GST")[136] 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.[137] This planning effectively removes the death proceeds from the estate of the settlor/insured and exempts the assets in the trust from the GST tax as well.

As noted above, it is important that the trust, as owner of an offshore life policy, be foreign for ownership purposes 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 could possibly therefore be subject to state premium tax.

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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 section 671, which will typically be the case with a foreign trust with U.S. beneficiaries. *See* IRC § 679. 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 IRC § 684 (unless that foreign grantor trust's assets receive a step-up in basis under IRC § 1014(a), which would not be the case in a traditionally structured irrevocable life insurance trust to which completed gifts have been made.) *See* Treas. Reg. §1.684-3(c).

[133] Under the regulations to IRC § 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. *See* Treas. Reg. § 301.7701-7.

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

[135] *See* IRC § 2036 to 2041.

[136] 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 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.

[137] *See* IRC § 2642.

§ 8.05 STRUCTURING PRIVATE PLACEMENT LIFE INSURANCE

[1] The Economics of a Private Placement Life Insurance or Annuity Contract

[a] Typical Structure of PPLI or PPVA[138]

To put into context the advantages inherent in PPLI or PPVA, one must be somewhat familiar with the economic operations inside those products. Again, even though these economics can seem complex, the following parts of this article will endeavored to describe those internal workings in a user-friendly manner.

Almost exclusively, policies of insurance or annuity contracts that are issued pursuant to a private placement are "variable" contracts. This means that when the insurance policy or annuity contract is issued and the contract holder pays his or her premium to the insurance company, that premium payment (after loads, as discussed below) is held in a separate, segregated account.[139] From there, the insurance company provides the new contract holder with a list of options into which those premium dollars may be invested, and the new contract holder selects from amongst those options how the holder's premium will be allocated.

Historically, the menu of investment options offered by insurance companies replicated common mutual funds, such as an S&P 500 Index fund, an International (EAFE) fund or a small cap fund. However, even though similar to common, publicly available mutual funds, the investment options presented by an insurance company were (and are still) available only to insurance accounts, not the general public. More recently, insurance companies have expanded their options to include hedge funds (typically, fund-of-funds).

Like the "traditional" investment options offered by insurance companies, these hedge funds-of-funds are available only through the purchase of an annuity or insurance contract, and are referred to as "insurance dedicated funds."[140] In this way,

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[138] Parts of the Section [a] and of Section [b] are abstracted, revised and edited from: Convergent Wealth Advisors, *Private Placement Life Insurance*, a white paper on file with the company and referenced the last sections of this article.

[139] The assets of a segregated account are separate and distinct from the general assets (and liabilities) of the insurance company. Nevertheless, the purchaser of an insurance or annuity contract must perform sufficient due diligence (or seek advice from legal counsel who specializes in insurance or from an insurance consultant) on the insurance company that is issuing the contract. This is important because, in the final analysis, the purchaser is entering into a contract with a third party and will have to rely on that third party to perform its obligations under that contract.

[140] Note, however, that often the underlying hedge funds into which the fund-of-funds manager invests are available outside of the insurance context, and consist of some of the best known managers in the hedge fund space.

a contract holder can choose to allocate his or her premium dollars among a variety of investments, including hedge funds, which are approved by an insurance company for inclusion on its platform.

[b] Fees, Expenses, and Taxes[141]

One of the more powerful evolutions in the PPLI and PPVA market has been the substantial increase in transparency of fees and expenses inside the contracts. Because these contracts are privately placed, the purchaser is provided clarity with respect to all fees and expenses charged. Accordingly, a contract purchaser has the opportunity to dissect his or her contract with a mind to negotiating those fees and expenses.

The following is an explanation of the fees, taxes and expenses which operate inside an annuity or insurance contract and of which the purchaser should be aware.

For life insurance, a contract holder's premium dollars are immediately subject to the following reductions (sometimes called "loads"):[142]

1. Federal Deferred Acquisition Costs Tax ("DAC Tax")—this is a tax imposed upon the insurance company, which it then passes through to its insureds. This is, on average, a 1.0% charge.
2. State Premium Tax—this charge is imposed by the state where the contract is issued (assuming that the contract purchaser has sufficient nexus with that state). The amount of this tax varies greatly from state to state; for example, currently Maryland's premium tax is 2%, while South Dakota's tax is negligible in large cases. Often times, clients will create trusts that are located in a low-tax jurisdiction to purchase the contract to avoid these taxes.[143]
3. Commissions (paid to the selling agent)—these commissions are based upon the amount of premiums paid and are deducted directly from the premiums as they are paid. Additionally, sometimes commissions are structured so that they are "trailing," that is, paid in small amounts over time from (and as a % of) the contract's cash value.

Below are expenses that are paid each year:

a. Insurance company mortality and expense charges (so-called "M & E")—"M & E" is something of a misnomer; these charges are simply

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[141] See Convergent, *supra* note 138.

[142] For clients who are willing to consider purchasing an insurance or annuity contract outside of the U.S., these clients typically will encounter contracts with lower fees (i.e. smaller loads). A discussion of purchasing a contract outside of the U.S. is beyond the scope of this article.

[143] A full discussion of state premium taxes is beyond that scope of this article, and of course, these taxes should be closely examined by a prospective contract purchaser prior to execution of a transaction.

the profit element for the insurance company.[144]

b. Cost of insurance ("COI")—this is the true cost of the insurance protection provided by the policy. It is analogous to the cost of term insurance, and is directly related to the net amount at risk ("NAR"), which conceptually is the difference between the promised death benefit and the cash value of the policy.[145]

c. Investment Management Fees—these charges are paid at the investment level and investment returns are reported to the separate account net of these fees. Of course, these particular charges would exist outside of the insurance/annuity context and thus are not unique to PPLI or PPVA.

Annuities are subject to the same charges described above, with these exceptions:

1. Because annuities typically do not provide a death benefit, there is no COI charge.
2. DAC taxes are not imposed.
3. Agent commissions for annuity contracts are typically significantly lower than those for insurance contracts.
4. Depending on the particular state at issue, state premium taxes are generally not applied to annuities or even if applied, are much lower than those applied to insurance.

Thus, from an economic standpoint, annuities have less "friction" inside the contracts than does insurance, but also do not possess the flexibility to access the cash value (and other benefits) that are inherent in insurance contracts as discussed above.

[2] Investment Considerations

As mentioned above, policy owners purchasing PPLI are typically offered investment platforms by the issuing carrier that include a wide array of typical equity and bond fund choices. Many carriers also offer extensive alternative investment choices such as hedge funds, hedge funds of funds, private equity, commodity funds, etc. Once

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[144] Whether the M & E charge is "current" or "guaranteed" is an important element for a contract purchaser to negotiate with the insurance company. "Current" charges can be changed by the insurance company at its discretion and could thus differ significantly over time (particularly as compared to the illustration provided by the carrier). As noted elsewhere in this article, one of the advantages of PPLI or PPA is that the contract purchaser can negotiate certain elements of the contracts with the insurance company. A purchaser should make sure that his or her insurance advisor assists him or her in considering whether to negotiate the variability of those charges.

[145] COI charges can also be "current" or "guaranteed" and thus, the footnote immediately above applies as much to COI as it does to M&E.

premiums have been contributed to the policy, a policy owner may later shift part or all of the cash value to another investment choice without tax consequences. Generally, the investment fund must be managed by a professional investment advisor, and the insurance company will perform due diligence to determine the fund's suitability as a selection available to policy owners. Note that some carriers may 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.

In some part due to reduced industry regulation in the offshore insurance market, a very broad universe of managers and investment styles is available to investors who purchase offshore PPLI insurance. The variety of investment choices and flexibility to add managers have also improved recently in the domestic market. Currently, hedge fund and fund of fund strategies are the most frequently selected investment vehicles in the PPLI market because they have had consistent returns in up and down markets and are usually tax-inefficient due to the investment strategies they employ.[146] Investors find that these investment choices work extremely well in a life insurance policy because of the policy's tax-advantaged nature. Moreover, policy owners receive protection of their investments through separate account legislation that exists in jurisdictions where offshore carriers typically reside as well as within the U.S.[147]

[3] Pricing Considerations

As stated in §8.05[1][b] *supra*, generally speaking, there are three principal insurance-related fees associated with PPLI insurance products: the premium load, the mortality and expense (or administration) charge ("M&E"), and the cost of insurance charge ("COI"). The noninsurance—related fees are asset management and, if applicable, custodial fees.

One of the deterrents to using domestic life insurance as a tax-advantaged investment vehicle for large premium amounts is the high level of fees associated with insurance products in the U.S. retail market, and in some cases, this remains true for domestic private placements. Although commissions vary greatly throughout the industry, purchasers can be charged sales commissions of greater than 10 percent of

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[146] For more detail on hedge funds see *infra.*

[147] In the event of a company default, the policy's cash values generally are not subject to the claims of the insurance company's creditors. In Bermuda, for example, the Segregated Accounts Companies Act permits any company to apply to operate segregated accounts, thereby enjoying statutory division between accounts. The effect of such statutory division is to protect the assets of one account from the liabilities of other accounts. Thus, the accounts will be self-dependent, with the result that only the assets of a particular account may be applied to the liabilities of such account.

their premium commitment.[148] Ongoing charges against a policy's cash value also vary, but often exceed charges against cash value in the offshore market due (in part) to the asset management fee component, which is generally higher for domestic private placements. Finally, domestic policyholders usually incur a surrender fee if they surrender a policy within a certain time-frame. Many offshore carriers do not assess such a fee.

The premium load in the offshore market is typically modest, approximately one percent of premiums paid or less. The M&E charge varies widely among carriers, depending on the carrier's pricing and profit strategy. The insurer also assesses the COI charge against the policy's cash value. This COI charge 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 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 single life product should be less than one percent per year. Generally, cost efficiencies exist offshore because carriers can offer lower administrative charges than domestic carriers due to lower overhead and franchise costs, lower or nonexistent entity-level taxes, and reduced operating costs due to less governmental regulation.

Because the federal tax advantages of life insurance are the same onshore and offshore, it is 1) the increased investment flexibility, 2) the reduction in costs resulting from state-premium-tax savings and lower sales loads and administrative charges, and 3) opportunities for enhanced asset protection that set offshore PPLI transactions apart from their domestic counterparts. As a consequence of these feature, PPLI can be a very effective component of the retirement and accumulated wealth value of the CVBDIT.

[4] Legal Considerations: Asset Protection

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 presents an excellent asset-protective vehicle for the high-net-worth client, especially when coupled with sophisticated offshore trust planning such as the CVBDIT. 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

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[148] Onshore, additional loads against premiums are state premium tax and a 1 to 1.5% federal DAC "tax."

company.[149] 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.[150] 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.[151]

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 offshore legislation may include specific exemption language and a pro-debtor protection regime. In addition, the laws of an offshore 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 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 the policy's assets because they are located offshore. The client will also enjoy investor confidentiality and financial privacy under the laws of many offshore jurisdictions, to which similar laws in the U.S. generally do not compare.

[5] Other Considerations

The PPLI life insurance market, and in particular the offshore PPLI 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, regulatory compliance, and reporting requirements to the policy purchaser in the form of lower fees. When insuring their risks, offshore carriers have the choice of contracting with any one or more of the world-class reinsurers participating in the worldwide life insurance market. Finally, offshore life insurance carriers should be able to offer a wider variety of products and a greater death benefit capacity as the client market expands.

Although U.S. clients typically draw from existing pools of cash or easily liquidated

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[149] See note 30, *supra.*

[150] 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.

[151] For a complete state-by-state treatment of the exemption statutes relating to life insurance and annuities, *see* DUNCAN E. OSBORNE AND ELIZABETH M. SCHURIG, ASSET PROTECTION: DOMESTIC AND INTERNATIONAL LAW AND TACTICS, Ch. 8 (four volumes, West Group, updated quarterly, 1995).

investments to fund a private placement policy,[152] 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 when a client prefers to invest noncash 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.[153]

[6] Product Design Issues

[a] Generally

Although some investors regard the life insurance component (i.e., the death benefit payable in excess of cash value) as an independently important feature, most investors are drawn to PPLI insurance for its tax benefits, investment flexibility, and price structure. Nevertheless, the life insurance component of the product is absolutely critical with regard to its tax treatment; if the product fails to qualify as life insurance under applicable U.S. tax rules, the U.S. tax benefits are lost completely. 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 PPLI insurance policies in a way that maximizes cash accumulation and also reduces the death benefit, so that the cost of insurance affects the cash value to the smallest extent possible. In other words, the policy design provides for the largest up-front infusion of cash with the correspondingly smallest death benefit purchase possible. There are also certain other product design issues that must be addressed in each case.

[b] IRC § 7702 Compliance

As stated in §8.04[1] *supra*, 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”).[154] 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.[155]

In order to receive the U.S. tax advantages afforded to life insurance products, any

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[152] See Brody, *supra* note 2.

[153] In the foreign context, the rules governing such an exchange under IRC § 1035 should be closely examined due to statutory uncertainty in some circumstances.

[154] § 7702(a). All “section” and “§” references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, unless otherwise stated.

[155] Significant portions of this paper have been derived from Giordani, Ripp, and Reed, “Using Life

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, the policy must be a contract which is a life insurance contract under the applicable state and foreign law, but only if such contract meets either the cash value accumulation test (the "CVAT") or the two-pronged test composed of the guideline premium test ("GPT") and the 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.

[c] 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 and the death benefit at any point in time).[156] 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.[157]

[d] Guideline Premium Test ("GPT") and Cash Value Corridor Test ("CVCT")

IRC §7702(c) sets forth the guideline premium test and IRC §7702(d) describes the cash value corridor test. If the policy design suggests this alternative over the CVAT, it must satisfy both 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 percent, decreasing in increments to 100 percent at age 95.

[e] §7702A MEC Testing

Frequently, the design of life insurance planning is to maximize the growth of policy

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Insurance and Annuities in the U.S. Tax Planning for Foreign Clients," 39 *Tax Management International Journal* (Mar. 2010).

[156] See § 7702(b)(1).

[157] See § 7702(b).

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 funds the policy too heavily, thereby causing it to be classified as a modified endowment contract ("MEC"), he or she will pay tax on policy values that he/she accesses during the insured's lifetime at ordinary income rates to the extent of any gain in the policy assets before 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 under 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, 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 therefore preferable due to the superior tax-free compounding effect achieved by a one-time, up-front premium payment.

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 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.

Where insurance companies elect not to employ this decrease in the death benefit, arguably they could be adversely selected against. That is, an insured, knowing that his health has deteriorated, would be wise to withdraw all the basis in a policy and the insurance company would be left with a greater risk for which it is not appropriately compensated.

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.[158]

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

[158] § 7702A(c)(2)(A).

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.[159] 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 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.

[7] Section 817 Special Rules for Variable Contracts: Diversification Under IRC § 817(h) and the Investor Control Doctrine

[a] Generally

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."[160] 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 assets, thereby causing the separate account's income to be taxable to him or her.[161]

[b] Diversification

In addition to IRC § 7702 compliance, *variable* life insurance policies must also

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[159] § 7702A(c)(6)(A) and (B).

[160] § 817(h)(3).

[161] 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.

comply with the diversification requirements of IRC § 817(h), which requires that they be invested in an "adequately diversified" mix of investments. "Adequately diversified" means that a life insurance separate account must contain at least five investments, and no one investment may represent more than 55 percent of the value of a separate account's assets; no two investments may constitute more than 70 percent; no three investments may comprise more than 80 percent; and no four investments may make up more than 90 percent of the separate account's value.[162] 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.[163] Failure to meet these diversification requirements will cause the separate account to not be considered "life insurance," and consequently, the "policy" owner will be deemed to directly own all of the policy's assets, making the policy owner currently taxable on the policy's income.

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.[164]

For a segregated asset account that is not real property, quarterly diversification begins the first 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.[165]

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.[166]

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.[167]

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[162] Regs. § 1.817-5(b)(1)(i).

[163] Regs. § 1.817-5(b)(1)(ii).

[164] Regs. § 1.817-5(c)(1).

[165] Regs. § 1.817-5(c)(2)(i), (ii).

[166] Regs. § 1.817-5(a)(2).

[167] Regs. § 1.817-5(d).

[c] Treatment of Funds

[i] Insurance Dedicated 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.[168] If the account qualifies for such treatment, then beneficial interests in investment companies, partnerships, and trusts held by the account 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.[169]

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

[ii] Non-Insurance Dedicated Funds

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

[iii] Look through Rules

Before 2003, the Treasury Regulations allowed a life insurance separate account to "look through" a nonregistered investment partnership (such as a hedge fund or fund of funds) to its underlying investments to determine whether it met the diversification rules outlined above. In other words, the nonregistered partnership was not treated as a single investment, but as an investment in the various funds in which the partnership itself was invested, thereby making it easier for the separate account to satisfy the

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[168] 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").

[169] Regs. § 1.817-5(f)(1).

diversification requirements. By contrast, for a registered partnership (or other investment company or trust) to have received the same "look-through" treatment of nonregistered partnerships, it had to meet both of the following requirements:

(i) all of the beneficial interests in the partnership must be held by one or more segregated asset accounts of one or more insurance companies; and

(ii) access to the partnership must be exclusively through the purchase of a variable contract.

In other words, a registered partnership had to be an "insurance-dedicated fund" (or "IDF") to receive look-through treatment, but a nonregistered partnership did not. An amendment to the Treasury Regulations, proposed in 2003 and effective March 1, 2005, removed this "special" treatment for nonregistered partnerships. This means that a nonregistered partnership must now meet the above two requirements of an insurance-dedicated fund to be looked through to its underlying investments for purposes of the diversification rules.

Thus, under current Treasury Regulations, as long as a nonregistered partnership is organized as an IOF (and as long as that IDF is invested in an adequately diversified mix of investments), a separate account invested only in that partnership will be considered "adequately diversified," and thereby maintain its status as a tax-advantaged investment vehicle.[170]

[iv] "Double Look-Through" Allowed for Second-Tier IDFs

During the period in which those Regulations were proposed, the IRS extended the principles of those Regulations to fairly common real-world structures involving IDFs. In Revenue Ruling 2005-7, the IRS allowed a separate account to not only look through an IDF that is its direct investment, but also to look through any other IDFs in which the first IDF is invested. In other words, if IDF #1 holds an investment in IDF #2 that makes up more than 55 percent of IDF #1's investments (and would, therefore, seem to cause the separate account to fail the diversification rules), the separate account can still look through IOF #2 to its underlying investments to determine whether it is adequately diversified (and presumably any IDFs in which IDF #2 is invested, and so on). Thus, this favorable ruling allows a life insurance separate account to look through multiple levels of IDFs to determine whether it is adequately diversified under IRC § 817(h).

[v] IDF May Invest in Non-IDFs

Although the preceding conclusion seems to be a fairly obvious extension of the

[170] Although the amendment became effective March 1, 2005, nonregistered partnerships in existence at that time that were not IDFs but otherwise complied with IRC § 817(h) had until December 31, 2005, to comply with the new rules.

final Regulations, many insurance professionals remained concerned about an IDF's diversification when it invested not in other IDFs but in one or more non-IDFs. This was of particular concern for insurance-dedicated hedge funds of funds. The source of these professionals' concerns was their interpretation of the IRS's activity in this area as eventually leading to a complete disallowance of a separate account's direct or indirect investment in publicly available funds.

In Private Letter Ruling 200420017, the IRS alleviated at least some of those concerns by confirming that an IOF established as a fund of funds may, in fact, invest in one or more non-IDFs as long as it meets the requirements listed below.

(i) Although the owner of the life insurance contract may direct the separate account to be invested in one of the IDFs offered by the insurance company, the owner may not direct the IDF's investment in any particular underlying fund, and there must be no investment agreement or plan between the contract owner and the life insurance company or the investment manager.[171]

(ii) All decisions regarding the IDF's investment in the underlying non-IDFs must be made by the insurance company's investment manager in its sole and absolute discretion.

(iii) The IDF's investment strategies must be defined broadly (such as "conservative," "moderate," or "aggressive") so that the contract owner is unable to make specific investment decisions by directing the separate account to be invested in one of the available IDFs.

(iv) Only the life insurance company may add or remove investment options under the life insurance contract.

Note that these requirements address the contract owner's actual control over the separate account's investment, rather than mandating that the separate account have no direct or indirect contact with a non-IDF.

[vi] Lingering Issues: Can a PPLI Separate Account Invest in an Adequately Diversified Mix of Non-IDFs?

As outlined above, the final regulations have now made it clear that a life insurance separate account may invest in a single insurance-dedicated fund and be allowed to look through that fund to its underlying investments to determine whether it is adequately diversified. But the question that remains in the minds of some practitioners is whether a PPVUL separate account may directly invest in an adequately diversified mix of non-IDFs (i.e., at least five non-IDFs in the right proportions). The logical answer to this question is yes. However, many practitioners are not confident that the

[171] See § 8.07[d] for a thorough discussion of the issues regarding investor control.

IRS would take the logical position when it comes to this issue.

This lack of confidence in the IRS's reasoning abilities stems from a long history of apparent IRS hostility toward life insurance separate accounts. It has consistently been the IRS's view that, when a separate account is invested in funds that are available to the public, it allows the account holder to exhibit control over the separate account because he could effectively dictate an investment strategy for the separate account in the same way that he could choose investments for himself personally, but in a tax-free environment. Or, in the words of the IRS, account holders make the insurance company "little more than a conduit between [themselves] and their mutual fund shares," and their "position [is] substantially identical to what it would have been had the mutual fund shares been purchased directly."[172]

In short, although the logical interpretation of the statutes and regulations would lead to a conclusion that a PPLI separate account may invest directly in an adequately diversified mix of non-IDFs, a more conservative approach would be to avoid non-IDFs as direct investments of separate accounts until such an investment strategy is formally blessed by the IRS.

[vii] Can Foreign Policy Owners Invest in IDFs?

As stated above, in order for a fund to qualify as insurance-dedicated, it must restrict access to owners of variable contracts. IRC § 817(d) defines a "variable contract" as one: (1) that provides for the allocation of all or part of the amounts received under the contract to an account segregated from the insurance company's general asset accounts; (2) that either provides for the payment of annuities or is a life insurance contract; and (3) whose contract benefits-whether annuity payments or policy death benefit-reflect, or vary based upon, the investment return and the market value of the segregated account. For owners of contracts issued by certain foreign insurance companies, their ability to invest account assets in IDFs is subject to some uncertainty because IRC § 817(d)(1) requires that the account be segregated "pursuant to *State* law or regulation."[173]

In a 2002 private letter ruling dealing with issues unrelated to IRC § 817(h) or investor control, the IRS raised this definitional issue with respect to the segregated accounts of a foreign insurance company that had elected, under IRC § 953(d), to be taxed as a domestic insurance company.[174] After interpreting the word "State" to refer only to the 50 states and the District of Columbia for purposes of IRC § 817(d), the IRS stated that, had the insurance company not made the 953(d) election, then

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[172] Rev. Rul. 81-225

[173] Emphasis added.

[174] PLR 200246022 (August 13, 2002).

contracts issued by the company would not have qualified as variable contracts under IRC § 817(d), notwithstanding that the contracts otherwise met its definition. By interpreting "State" in this manner, the IRS has called into question whether the owner of a contract issued by a non-953(d) company may avail itself of the apparent investor control safe harbor offered by IDFs and whether an IDF manager may accept investments from such foreign-contract owners without jeopardizing both its fund's continuing qualification as an IDF and, theoretically, the continuing life insurance status of its existing investors' variable policies.

[d] Investor Control

[i] 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.[175] 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.[176] 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.[177] A complete review of the investor control doctrine and its history is beyond the scope of this section.[178]

[ii] Is the Asset Allocator Model Viable?

Many private placement variable life insurance and annuity contracts are structured to permit the policy owner to select from a group of asset management choices, among

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

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

[177] 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.

[178] For a more thorough examination of the investor control doctrine and its history, see Leslie C. Giordani & Amy P. Jetel, "Investing in Hedge Funds Through Private Placement Life Insurance," 6 *The Journal of Investment Consulting* 2, 79-82 (Winter 2003/2004).

which is one or more independent "asset allocators" who have an account management agreement with the insurance company to construct and manage with full discretion one or more separate accounts consisting of non-insurance dedicated hedge funds, and in which the number and proportion of funds meet the IRC § 817(h) diversification test. The account managed by the manager (*i.e.*, allocator) is available only to insurance companies in connection with their variable contracts. This arrangement is generally known as a privately managed separate account, or "the allocator model."

In Rev. Rul. 2003-91, the Service appeared to confirm generally the validity of this 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]."[179] 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 selection of an allocator might give rise to a finding of investor control. Adequate diversification of the separate account does not prevent the Service 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.[180]

The Service 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.[181] 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 Service would find that the selection 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.[182] One qualification, therefore, is that the allocator (*i.e.*, investment advisor) 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 Service 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

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[179] 2003-2 C.B. 347.

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

[181] *See, e.g.*, Rev. Rul. 2003-92; Rev. Rul. 2003-91; PLR 200244001; PLR 9752061.

[182] Rev. Rul. 2003-91, I.R.S. 2003-33 (July 23, 2003).

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]."[183] 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.[184]

In summary, a finding of investor control depends on "all of the relevant facts and circumstances."[185] The recommendation of an allocator by a policy owner 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 contract holder has no actual control over the allocator's investment decisions and the allocator may be selected by other policy owners to manage their separate accounts, the allocator model should not run afoul of the investor control doctrine.

A final note of caution in connection with the allocator model may be warranted, however. It is entirely possible that, due to the Service'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. 2003-92 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 IRC § 817(h) among the non-insurance dedicated funds, the policy owner has *indirect* investor control for the mere 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 Service will attempt to use it underscores the fact that the tax consequences of using the asset allocator model remain unclear.

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[183] PLR 9752061 (Sep. 30, 1997).

[184] Rev. Rul. 2003-92; Rev. Rul. 2003-91; Rev. Rul. 81-225; Rev. Rul. 82-54.

[185] Rev. Rul. 2003-91.

[iii] Conclusion

Hedge funds or hedge funds of funds as an investment of a private placement life insurance contract should not pose investor control concerns (assuming the funds are independently selected by the insurance company) as long as the investment structure of the fund is a limited partnership that meets the following two-part test:

(i) all the beneficial interests in the partnership must be held by one

(ii) access to the partnership must be exclusively through the purchase of a variable contract.

If the partnership meets these requirements, it will be "looked through" to its underlying investments for purposes of applying the IRC § 817(h) diversification test, and investor control will not be a concern due to the absence of public availability. *De facto* investor control, however, is still a significant consideration in the design, implementation, and administration of any private placement life insurance structure, and practitioners should carefully monitor their clients' actions to prevent a scenario that could lead to a finding of investor control. The hedge fund industry has responded to the IRS's recent activity by creating many insurance-dedicated funds and funds of funds. The continuation of this trend will sustain the viability of private placement life insurance as an attractive planning tool for high-net-worth investors who desire the superior risk-adjusted return characteristics of hedge funds and funds of funds.

[8] Insured Lives

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. 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 as defined under applicable law.

[9] Loan Spread and Loan Provisions

A sometimes overlooked detail in policy design is the client's ability to access policy cash values on a cost-advantageous basis.[186] Many carriers offer competitive charges for the accumulation of values inside the contract, but then charge a high spread on loan values. As mentioned previously, careful attention should be given to non-MEC qualification if a client desires access to policy cash values through withdrawals up to basis or loans.

[10] Extended Maturity Option

As life expectancies gradually increase, it is important to understand what happens

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[186] See Alexander & Halloran, *supra* note 1.

to the policy beyond the normal policy maturity age of 95 or 100. Some private placement life insurance contracts omit provisions related to this possibility. A forced return of cash values at an advanced age before death would result in a disastrous income-tax liability.

[11] Cost of Insurance

Competitive COI rates are essential to good policy performance but are often not a clearly identified cost. 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 offshore carriers have obtained reinsurance based on a blend of U.S. and non-U.S. lives, which results in higher costs.

Other carriers (both domestic and offshore) mark up the reinsurance cost of their COI rates to provide a higher profit margin, especially in early policy years, in what they hope will be an overlooked cost item. Finally, the bargaining power of the 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.

[12] Investment Return Issues (“Force-Outs”)

One of the most important nontax 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. Policyholders 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. If this is not possible, the insurance broker must pay careful attention to policy performance each year and pre-plan against this result.

§ 8.06 PRIVATE PLACEMENT LIFE INSURANCE—PRACTICAL REALITIES

[1] Solicitation

If an offshore life insurance company or its agents have solicited an offshore life insurance contract within the U.S., such solicitation may subject the transaction to a potential claim by the government of the state where the client resides for a 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 examination, complete other aspects of the underwriting process (such as the inspection report), and sign applications. Once the policy has been issued, the insurer should deliver the policy to its owner offshore. Finally, premiums should be paid by the offshore owner of the

policy (typically a trust) and not directly by the U.S. person who is funding the purchase of the policy.

[2] Underwriting

Planners must pay careful attention to the "insurance" nature of the life insurance contract, despite its desirable 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 such risk. Carriers typically require clients to divulge enough financial information to establish an insurable interest as well as the need for insurance. Clients also must submit detailed medical information and undergo an insurance-specific medical examination by a qualified physician, typically a board-certified internist. Even after these disclosures are made, a client could have medical or financial issues that will prevent her from acquiring the contract on an economical basis. An experienced life insurance professional can add tremendous value to the underwriting process.

[3] Policy Servicing

Affluent clients are not accustomed to dealing directly with insurance carriers, and some of the companies that offer PPVUL insurance contracts do not have personnel with the experience in the high-net-worth market to provide client service at the desired level. For these reasons, it is preferable for a qualified professional who does have such experience 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 has selected.

§ 8.07 U.S. TAX TREATMENT OF ANNUITIES

[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 (1) the ability to defer the payment of income tax on the annuity payments and (2) the compounding effect of the tax deferral, 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.[187]

Further, the total of the amounts payable must be determinable as of the annuity starting date.[188]

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.[189] 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.[190] The excess is an "amount not received as an annuity."

§ 8.08 U.S. SECURITIES TREATMENT OF PPLI AND PPVA

[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.[191] Private placement 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.[192]

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[187] Regs. § 1.72-2(b)(2).

[188] *Id.*

[189] See Regs. § 1.72-2(b)(3).

[190] *Id.*

[191] 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").

[192] See *id.*

[2] Special Considerations for Offshore Policies

Offering memoranda for PPLI policies and PPVA offered 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 offshore context, this should be considered merely a guideline and not a strict requirement because offshore policies are not actually subject to SEC regulations. However, if the premiums of an offshore PPLI policy or PPVA contract are to be invested in funds that do require investors to be "qualified purchasers" and "accredited investors," then it can be argued that the policy owner must be a "qualified purchaser" and an "accredited investor" for that purpose.

§ 8.09 TAX TREATMENT OF LIFE INSURANCE AND ANNUITIES—A CLOSER LOOK

[1] 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.[193] 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.[194] 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.[195] The NRA's effectively connected income is taxed at the regular tax rates applicable to U.S. citizens and residents.[196] 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.[197] This tax is applied, however, only on amounts that otherwise constitute gross income under the

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

[194] See §§ 2(d), 871.

[195] 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.

[196] § 871(b).

[197] § 871(a); see also Regs. § 1.871-12. This tax is generally imposed through withholding at the source. § 1441.

Code.[198] Therefore, when planning for NRAs, the practitioner must first determine whether the income would be includable in gross income under general tax principals. 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.

[2] Income Tax Rules Applicable to U.S. Taxpayers Who Own Life Insurance Policies

[a] 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.[199] 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.

[b] Distributions During Policy Term

[i] Non-Modified Endowment Contract Distributions

If withdrawals are allowed under a policy contract, 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.[200] 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).[201] 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.[202] 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,

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[198] Regs. §1.871-7(a)(2).

[199] § 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.*

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

[201] § 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).

[202] § 72(e)(5)(A).

to the extent that such amount was excludable from gross income" at the time such amount was received.[203]

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 withdrawal 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.[204] 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.

[ii] 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 the policy is structured as a MEC, an "income-first" rule will apply, and any withdrawals from the policy (whether classified

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[203] § 72(e)(6).

[204] § 7702(f)(7); Zaritsky ¶ 2.05[2][b].

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.[205] 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 remainder of the withdrawal will be tax-free as a withdrawal of the investment in the contract.[206] 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.

[c] 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,[207] the policyholder will have ordinary income to the extent that the amount received by the policyholder exceeds the policyholder's investment in the contract.[208] Extended maturity riders are required to avoid this result when insureds live to advanced ages.

[d] 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.

[e] Transfer for Value Rule

If the interest in the policy is transferred for valuable consideration, the 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. Transfers can occur and not trigger the provisions of § 101(a)(2) through a § 1035 exchange as more fully described below. Further, transfers from one entity to another may occur without triggering the implications of § 101(a)(2) if the taxpayer of each entity is the same (*i.e*.,

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[205] § 72(e)(10)(A).

[206] § 72(e)(10)(A).

[207] 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.

[208] §§ 72(e)(5)(A), 72(e)(5)(E).

moving a policy from one grantor trust to another).

[f] 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.

[g] 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.

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

[a] Generally Similar to Rules for U.S. Taxpayers

A non-resident alien ("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.

[b] 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.

[4] Transfer Tax Rules Applicable to U.S. Taxpayers Who Own Life Insurance Policies

[a] U.S. Estate Tax Rules

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,[209] a high-level outline of those rules is helpful to understanding some of the planning concepts addressed herein.

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.[210]

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.[211] 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

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[209] For a more thorough treatment of these rules, see Zaritsky ¶ 3.03; Budin, 826-2nd T.M., *Life Insurance*, I.C, I,G.

[210] Regs. § 20.2042-1(c).

[211] § 2035(a).

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.

[b] 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;[212] or valuing a policy that is being gifted (or transferred in a sale intended to avoid a gift).[213]

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 premiums at minimal transfer tax cost is a split-dollar life insurance arrangement, which is addressed below in § 8.12[2][b] *infra*.[214]

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.

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

[a] 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.[215] In contrast, non-resident, non-citizens ("NRNCs") are generally taxed only on transfers of U.S.-situated assets.[216]

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[212] See Brody, *supra* note 2.

[213] See § 8.02 *supra*.

[214] See also Brody, *supra* note 2.

[215] See §§ 2001, 2031.

[216] See §§ 2101, 2103.

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.[217] 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.

[b] 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."[218] 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. estate tax purposes.[219] 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.[220]

[6] Income Tax Rules Applicable to U.S. Taxpayers who Own Annuities

[a] 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,

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[217] 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.

[218] § 2105(a).

[219] 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).

[220] Regs. §§ 20.2104-1(a)(4), 20.2105-1(e); Spielman, *U.S. International Estate Planning* ¶ 10.03[14][a][iii] (2008). Offshore 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.

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.[221] The distribution may also be subject to a 10% withdrawal penalty.[222] 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.[223]

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.[224]

[b] 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. 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 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)." The exclusion is, however, limited to the holder's unrecovered investment in the contract.

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[221] 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.

[222] § 72(q).

[223] See § 72(e)(4).

[224] § 72(u)(3).

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

[c] 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 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.[225] 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.

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[225] 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.

[7] Income Tax Rules Applicable to Non-U.S. Taxpayers who Own Annuities

[a] 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.

[b] 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.

[c] 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" subject to current taxation under the "original issue discount" provisions of the Code.[226]

A "debt instrument" is broadly defined to mean a bond, debenture, note or certificate or other evidence of indebtedness.[227] 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.[228]

[8] 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

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[226] See §§ 163(e), 1275(a)(1)(B); Regs. § 1.1275-(1)(k).

[227] § 1275(a)(1)(A).

[228] 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.

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.[229] 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.[230]

[9] 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.[231] 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 not be deemed property within the U.S. The key to this argument would be to show that the

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[229] § 2039(a); Kathryn Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions* ¶ 13.04[1] (1998).

[230] § 2039(b).

[231] 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 offshore 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 offshore 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.

annuity contract involved an actual insurance risk at the time the transaction was executed.[232]

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.[233] 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.

§ 8.10 PRIVATE PLACEMENT LIFE INSURANCE—SELECTION OF JURISDICTION AND CARRIER DUE DILIGENCE

In addition to policy design, it is imperative that advisors think about issues related to the jurisdiction that will govern the life insurance policy and its issuer. Countries where offshore carriers are resident, such as Bermuda, the Bahamas, the Cayman Islands, and Guernsey, have separate account legislation that protects policy assets from claims against the carrier, whereas the Isle of Man and Liechtenstein (countries that also have resident carriers there) do not have such statutes. As is evident among the various state jurisdictions in the U.S.,[234] some of the offshore jurisdictions have specific creditor exemptions for life insurance while others do not. Additional 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 as part of the due diligence process. Because this endeavor is properly undertaken by a qualified insurance broker, it will be discussed in the section related to brokers below.

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[232] 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).

[233] PLR 200842013.

[234] See Alexander & Klemmer, *supra* note 106.

§ 8.11 PRIVATE PLACEMENT LIFE INSURANCE—PROFESSIONAL INVOLVEMENT

[1] Introduction

Although reduced regulatory controls and taxation offshore provide a wonderful environment for creative insurance structures, it is also this lack of regulatory oversight that demands the involvement of knowledgeable professional advisors in every offshore PPVUL insurance transaction. Similarly, in the case of a domestic private placement transaction, the carrier's ability to discriminate between policyholders and the unique nature of each transaction also suggests the advisability of engaging third-party legal and insurance advisors. The legal advisor will work with the client to plan and implement the life insurance 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.

[2] Legal Advisor

The legal advisor's role is fairly broad. The advisor will first educate the client on the various aspects of the life insurance planning and may recommend further estate planning vehicles such as an irrevocable life insurance trust structure. In addition, the advisor will analyze the structure with an eye toward tax compliance, negotiate contract points with prospective carriers, and work with the insurance broker to implement the policy while ensuring that the client's financial, medical, and personal information are processed with the highest degree of confidentiality. The legal advisor will also typically act as a communications liaison between the client and the insurance professionals.

Finally, it should be the legal advisor who confirms the financial solvency of the client before any transfers are made into a private placement policy.[235]

[3] Insurance Broker

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

Although carrier due diligence is important in the case of any private placement

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[235] Owing to the asset-protective nature of life insurance and the high-dollar amount of the typical premium, it is possible for a client to inadvertently make a fraudulent transfer when funding a policy. This is true irrespective of whether the policy is issued by a domestic or offshore carrier.

transaction, it is particularly critical when contemplating an offshore transaction. The offshore market is a mixed bag of smaller, newer carriers with very little capital on 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 aborted their recent attempts to enter the offshore marketplace.

The broker should also understand and assess the reinsurance treaties between carrier candidates and their reinsurers. Reinsurance treaties are contractual arrangements in which the carrier places some or all of the policy's "at risk" amount (i.e., the death benefit in excess of cash value) with other insurance companies or reinsurers.

Because most private placement 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 policyholder. The broker will also fulfill an ongoing role in annual reviews and will continue to oversee the policy from a tax-compliance standpoint.

§ 8.12 PLANNING STRATEGIES

[1] Domestic vs. Offshore PPLI/PPVA

[a] In General

As stated in §§ 8.05[1]-[3] *supra*, PPLI or PPVA issued by an offshore carrier has enhanced tax advantages because state premium taxes should not be payable when the client completes all aspects of the transaction offshore. 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 offshore, 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.[236] On the other hand, in the case of offshore 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 offshore, along with no or low premium sales loads, contributes to the substantially improved yields compared to taxable investments.

[b] Statutory Asset Protection

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,[237] life insurance represents an excellent asset-protective vehicle for the high net worth client, especially when coupled with sophisticated offshore 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.[238] 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.[239]

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 offshore legislation may include specific exemption language and a pro-debtor protection regime. In addition, the laws of an offshore 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 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 the policy's assets because they are located offshore. The client will also enjoy investor confidentiality and financial privacy under the laws

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[236] See § 4371.

[237] See Rothschild, *supra* note 98.

[238] 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. See also Rothschild, *Id.*

[239] For a complete state-by-state treatment of the exemption statues relating to life insurance and annuities, see DUNCAN E. OSBORNE AND ELIZABETH M. SCHURIG, ASSET PROTECTION: DOMESTIC AND INTERNATIONAL LAW AND TACTICS, ch. 8 (1995).

of many offshore jurisdictions, to which similar laws in the U.S. generally do not compare.

[2] Planning for the U.S. Taxpayer

[a] 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.[240] A previously-funded domestic trust—particularly a generation-skipping transfer ("GST") tax-exempt trust—thus becomes a natural PPLI purchaser.[241] 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 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.

[b] Irrevocable Life Insurance Trusts (on a Grand Scale)[242]

[i] Lifetime Exclusion Gifting

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

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[240] See Alexander & Halloran, *supra* note 1.

[241] 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.

[242] When reading this section readers need to keep in mind the TRA 2010 changes to the transfer tax rules and the differences in design between the CVBDIT and traditional irrevocable trusts and ILITs.

mechanism (such as a private split-dollar life arrangement structured as an intra-family loan).[243] 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.[244] 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.[245] 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.[246] 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.

For policies with total premiums in the range of the client's remaining gift tax lifetime exclusion of $1,000,000 (or, effectively, $2,000,000 for spouses),[247] 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 pay gift tax, where the transfer tax environment makes such an approach sensible.

[ii] 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.[248]

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.[249] The

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[243] See *infra* § 8.12[2][b][1] *infra*. See also Brody, *supra* note 2.

[244] See Regs. § 25.2511-2(b).

[245] See §§ 2036 to 2041.

[246] See § 2642.

[247] These exclusions are both $5,000,000 for 2011 and 2012.

[248] A comprehensive treatment of split-dollar planning and its history is beyond the scope of this article, but a detailed, technical discussion is included in Brody, *supra* note. 2.

[249] Treasury Regulations issued in 2003 pursuant to §§ 61 and 7872 provide for two basic approaches

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[250] and the repayment obligation can be deferred until the settlor-insured's death.[251] 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 of 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.[252]

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, due to their status as securities under U.S. securities laws.[253] Offshore 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 offshore.

[iii] The Impact of Section 684 on Offshore ILITs and CVBDITs

Most offshore carriers require that the policy owner have an offshore situs (due to

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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.

[250] See Regs. § 1.7872-15(d).

[251] 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).

[252] See Regs. § 1.7872-15(e)(4).

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

state regulatory concerns). Thus, if an ILIT invests in an offshore 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.[254] 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.[255] 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.[256]

In the event this "hybrid" trust structure is undesirable, however, the other option is to establish a domestic ILIT that then forms an offshore 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.

[3] Planning for Foreign Non-Grantor Trusts with U.S. Beneficiaries

[a] What is a Foreign Non-Grantor Trust ("FNGT")?

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

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

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[254] See § 679.

[255] See Regs. § 1.684-3(c).

[256] 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).

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.[257]

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.[258] 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.[259]

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 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.

[b] Background: Pre-1996 Tax Framework

The Small Business Job Protection Act was signed by President Clinton on August

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[257] § 7701(a)(30)(E).

[258] 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.

[259] § 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.

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.[260] 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.[261] 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.[262] 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.

[c] 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.[263] 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.[264] 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

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[260] 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").

[261] See generally §§ 671-679.

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

[263] 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.

[264] 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.

taxation because, with certain exceptions,[265] the earnings of such a trust would not ordinarily be taxed directly by the U.S. government. However, when the trust distributes its income to a U.S. beneficiary, the distribution is then taxable to the U.S. beneficiary.

[d] Tax Consequences of Foreign Non-Grantor Trust

[i] 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.

A U.S. beneficiary is taxable on any amounts of income currently distributed from the trust's worldwide DNI.[266] 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.[267]

[ii] 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.

[iii] Accumulation Distributions

Distributions from FNGTs of UNI are classified as accumulation distributions and

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[265] 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).

[266] 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.

[267] 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.

taxed according to the "throwback" rules.[268] 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.[269] 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 trust's UNI.[270] 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.[271] 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.[272] 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.

[e] PPLI as a Solution to the Accumulation Distribution Problem

[i] 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.[273] 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

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[268] 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.

[269] §§ 666(b), (c); § 667(a).

[270] *Id*.

[271] See § 668.

[272] 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).

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

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 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.

[ii] 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).[274] 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 59-1/2, the cost associated with these penalties may still be less than the throwback tax that would otherwise be incurred under the UNI rules.

[4] 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

[274] § 72(e)(10); (2)(B).

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.[275] 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.).[276] 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 by NRAs.[277] 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.[278]

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.[279]

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[275] By purchasing the annuity contract prior to moving to the U.S., the client can avoid a 1% excise tax on the purchase. NRNCs are exempt from this excise tax.

[276] Rev. Rul. 2004-75, 2004-2 C.B. 109; §§ 72, 2039.

[277] § 871(a).

[278] § 2039.

[279] As noted, the practitioner and the client should always carefully consider the tax impact to the

§ 8.13 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).

The tax regime in the U.S. is changing pursuant to the passage of Health Care and Education Reconciliation Act of 2010 which, beginning in 2013, imposes a 3.8% surcharge on net investment income.[280] Further, it is widely anticipated that the current administration will let the majority of, if not all of, the Bush tax cuts expire at the end of 2010 resulting in capital gains tax rates increasing to 20% from 15% and top ordinary income tax rates increasing to 39.6% from 35%. In summary, these tax rates changes will cause ordinary income to be taxed at a top rate of 43.4%, capital gains at 23.8% and tax on qualified dividends will increase to 43.4% from a low of 15% today. Further still, state income tax rates will increase in many jurisdictions.

The impact of these future 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. Table 2 presents a hypothetical comparison of a series of investments applying the higher future tax rates as compared to private placement life insurance.[281]

Under either scenario, PPLI generates the higher net investment return 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 will have a value of $24.5 million versus a value of $36.0 million within the PPLI policy. As a result of the power of compounding, after 40 years a taxable investment portfolio will have a value of $64.6 million versus a value of $157.5 million within the PPLI policy.

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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).

[280] See *Health Care Legislation Tax Provisions*, AALU Washington Report, Apr. 12, 2010, AALU Bulletin No: 10-40.

[281] These economic illustrations demonstrate that tax laws can dramatically affect the accumulate wealth value of the CVBDIT.

Under the future tax environment [Table 2], after 20 years, a taxable investment portfolio will have a value of $21.8 million versus a value of $36.0 million within the PPLI policy. Again, as a result of the power of compounding, after 40 years a taxable investment portfolio will have a value of only $50.4 million versus a value of $157.5 million within the PPLI policy. After 40 years, under the future tax environment scenario [Table 2] almost 213% more value emerges creating a compelling argument for PPLI on the tax advantages alone, notwithstanding the other benefits of PPLI discussed throughout this article.

TABLE 1

IMPENDING TAX LAW CHANGES INCREASE THE VALUE OF PPLI

Taxable Investment vs. PPLI

CURRENT TAX ENVIRONMENT

			Hypothetical Taxed Investment Portfolio				Hypothetical PPLI				
Year/	Age	Annual Outlay	Ordinary/ STCG Income	Ordinary/ STCG Taxes	After Tax Portfolio Value	IRR	Net Cash Value Amount	Net Cash Value IRR	Net Death Benefit Amount	Net Death Benefit IRR	Cost as a % of Cash Value
1	45	2,500	200	(76)	2,624	4.96%	2,615	4.60%	56,154	2146.16%	3.17%
2	46	2,500	410	(156)	5,378	4.96%	5,420	5.50%	58,959	338.20%	1.88%
3	47	2,500	630	(239)	8,269	4.96%	8,427	5.94%	61,966	151.65%	1.48%
4	48	2,500	862	(327)	11,303	4.96%	11,653	6.21%	61,966	88.56%	1.25%
5	49	0	904	(344)	11,864	4.96%	12,456	6.40%	61,966	61.78%	1.03%
10	54	0	1,152	(438)	***15,113***	***4.96%***	***17,576***	***6.83%***	27,594	12.57%	0.64%
15	59	0	1,467	(558)	19,251	4.96%	25,149	7.05%	33,700	9.38%	0.53%
20	64	0	1,869	(710)	***24,523***	***4.96%***	***36,013***	***7.15%***	43,936	8.31%	0.52%
30	74	0	3,033	(1,153)	39,794	4.96%	75,267	7.33%	80,536	7.58%	0.28%
40	84	0	4,922	(1,870)	***64,573***	***4.96%***	***157,494***	***7.41%***	165,369	7.55%	0.38%
50	94	0	7,987	(3,035)	104,783	4.96%	325,767	7.44%	329,024	7.46%	0.25%
56	100	0	10,678	(4,058)	140,099	4.96%	512,319	7.48%	512,319	7.48%	0.15%
		10,000	209,837	(79,738)							

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] Current effective Income Tax Rates:

Capital Gains Tax	15.0%
Ordinary Income Tax	35.0%
State Income Tax	3.0%
Total Income Tax	38.0%

TABLE 2

FUTURE TAX ENVIRONMENT - HIGHER TAX RATES

			Hypothetical Taxed Investment Portfolio				Hypothetical PPLI				
Year/	Age	Annual Outlay	Ordinary/ STCG Income	Ordinary/ STCG Taxes	After Tax Portfolio Value	IRR	Net Cash Value Amount	Net Cash Value IRR	Net Death Benefit Amount	Net Death Benefit 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] Future effective Income Tax Rates:

Capital Gains Tax	20.0%
Ordinary Income Tax	39.6%
Investment Income Surcharge	3.8%
Total Federal Income Tax	43.4%
State Income Tax	3.0%
Total Income Tax	46.4%

§ 8.14 FOREIGN BANK ACCOUNT REPORT (FBAR) REGULATIONS

Another important planning issue that should not be overlooked by advisors 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 annually disclose information to the U.S. Treasury Department. This information is reported on Treasury Form 90-22.1, Report of Foreign Bank and Financial Accounts, commonly referred to as "FBAR." The FBAR is required to be filed not only for outright ownership of an account, but also for accounts owned by entities in which the U.S. person owns a more than 50% interest and for various trust accounts. 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.

The FBAR and accompanying instructions were revised in the fall of 2008 to require more detail regarding reportable foreign accounts and expand the definition of United States persons required to file the FBAR. This revision sparked much attention in the professional and business press late in the spring of 2009, just before the June 30 filing deadline. In response to public comments on the revision, the IRS suspended the filing requirements for certain persons and certain types of accounts until June 30, 2010, pending the issuance of new regulations.

Proposed regulations were issued February 26, 2010. The new regulations provide some clarity, but questions remain. Because these regulations were issued in proposed form, they are subject to revision before being finalized. Guidance from the IRS was issued simultaneously with the proposed regulations, postponing the filing of 2009 FBARs for some U.S. persons until June 30, 2011.

The general FBAR reporting requirement remained the same in the wake of the proposed regulations and IRS guidance: a United States person having a financial interest in, or signature authority over, a bank, securities, or other financial account in a foreign country is required to file the FBAR.

Instructions for the 2008 FBAR expanded the definition of a United States person to include persons in and doing business in the U.S. Under the proposed regulations, however, the definition of a U.S. person is narrowed to mean a U.S. citizen, a U.S. resident, an entity formed in the U.S., or a trust or estate formed under the laws of the U.S.[282] Pending finalization of the regulations, the requirement to file an FBAR due June 30, 2010 is suspended for persons who do not meet the definition in the proposed regulations.

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[282] It should be noted that the proposed regulations make clear that an entity must file regardless of whether it has made a disregarded entity election. Additionally, the deemed owner of a trust under the grantor trust rules must also file.

Reportable accounts include the obvious, such as bank and brokerage accounts. The regulations make it clear that FBAR reporting is also required for other types of financial accounts, including insurance policies (with cash value) and annuity contracts where such policies or contracts were purchased outside the U.S. from a non-U.S. issuer. Thus, offshore PPLI and PPVA contracts should be reported on the FBAR of a person with a beneficial or legal interest in such contracts.

§ 8.15 PRIVATE PLACEMENT LIFE INSURANCE AND HEDGE FUNDS

[1] Introduction: Why Hedge Funds?

Although the unprecedented bull market of the 1990s led to tremendous accretions in wealth for many investors, the bursting of the tech bubble brought about an equal measure of lost fortunes. In the investment world, stock market volatility is expected, but the roller-coaster ride that many investors have experienced in recent years has given them a whole new concept (and fear) of "volatility." Although hedging strategies[283] have always been acknowledged as a way to reduce portfolio volatility, recent market conditions have highlighted *market-neutral hedge funds* as a way to achieve positive yearly returns with much less risk and significantly lower correlations to market movements.[284] In particular, market-neutral hedge funds of funds, which are diversified groups of hedge funds overseen and monitored by a "manager of managers, have become the investment product *du jour* for high-net-worth investors.

Although estate planning attorneys will not typically be called upon to recommend hedge funds of funds to their clients or to know their technical intricacies, they may receive questions about their legal structures and tax implications. Moreover, some uninformed advisors, including lawyers, have a knee-jerk reaction to the mention of hedge funds, thinking only that they are terribly risky. Many immediately recall Long Term Capital Management, the grossly over-leveraged fund whose default nearly collapsed financial markets in 1998. At a minimum, legal advisors to the high-net-worth client market should not automatically dismiss hedge funds as risky. In an ideal situation, advisors should understand the role that hedge funds can play in improving the risk/return profile of an investment portfolio,[285] know the various types of hedge funds, and have a general familiarity with how hedge funds produce their investment

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[283] "Hedging" is any investment that is taken in conjunction with another position in order to reduce directional exposure, which is the amount of risk that an unhedged position faces in the market as compared to the net exposure of positions involving long and short hedged relationships. A classic example of hedging is a farmer who enters into a futures contract for grain to lock in a particular price. The farmer removes any uncertainty about the price she will receive for grain, but she foregoes the possibility of receiving a higher price.

[284] See Brody, supra *note* 2.

[285] See Brody, *supra* note 2.

returns. Not only should all advisors have at least a working knowledge of these issues, they also should understand how hedge fund investing can dramatically increase the accumulated wealth value of the CVBDIT.

[2] Benefits and Risks of Hedge Funds

The incorporation of market-neutral hedge-fund-of-fund strategies in investment portfolios yields three primary benefits. First, it allows investors to access the highest level of investment management talent in the industry. Many of the most successful investment managers have left larger firms to join (or form their own) smaller firms that offer hedge fund products and embrace a wider array of trading strategies that enable them to deliver superior risk-adjusted returns to their customers. Second, it has been demonstrated in recent studies that "adding hedge funds to traditional stock and bond portfolios significantly improves overall returns at equivalent levels of risk."[286] Third, hedge funds can improve returns and reduce risk particularly well at times when markets are excessively volatile.[287]

The most commonly cited risk of hedge-fund investing is that hedge-fund products are not typically subject to the high level of regulation associated with mutual funds, for example. Most hedge funds are organized as private investment partnerships and investors must meet minimum net-worth or income criteria to invest.[288] In addition, reporting standards are less stringent for hedge funds than for mutual funds or separately managed accounts. For this reason, many hedge fund investors employ an investment consultant to perform due diligence on prospective hedge-fund managers. Investors also typically will prefer highly diversified hedge-fund-of-fund products over single-manager products to minimize the specific risks associated with a single manager. Another potential risk in hedge-fund investing is the over-use of leverage and derivatives. Again, hedge-fund investors typically will look to their investment consultant to monitor the appropriate use of leverage and derivatives by their hedge-fund-of-fund managers.

[3] Superior Risk-Adjusted Returns

By far the most compelling benefit of hedge-fund investing is that it produces superior risk-adjusted returns compared to traditional stock and bond asset classes. Over the past decade, hedge funds as an asset class have produced equity-like returns in both rising and declining markets, while maintaining the limited volatility of a bond portfolio.

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[286] R. McFall Lamm, Jr. & Tanya E. Ghaleb-Harter, *Do Hedge Funds Belong in Taxable Portfolios?*, J. OF WEALTH MGT., 1, 1–16 (Summer 2001).

[287] *Id.*

[288] See *infra.*

One of the hottest debates among investment consultants is what percentage of a taxable investor's portfolio should be allocated to hedge funds. Although some investment consultants limit their suggested allocations to hedge funds to the traditional 15–20 percent range, others suggest allocations consistent with portfolio optimization research indicating that a 50 percent allocation to hedge funds may be appropriate.[289]

[4] Types of Hedge Funds and How They Produce Investment Returns

[a] Generally

There are estimated to be more than 8,000 hedge funds representing more than $1.0 trillion in assets. The following list of principal categories of hedge funds is ordered from least to most volatile, and from lowest to highest expected returns. The first eight categories are considered "market neutral," while the remaining three categories are not.

[b] Long/Short Equity Market Neutral

This investment strategy seeks to profit by exploiting pricing inefficiencies between related equity securities, neutralizing exposure to market risk by combining long and short positions. One example of this strategy is to build portfolios made up of long positions in the strongest companies in several industries and taking corresponding short positions in those companies showing signs of weakness.[290]

[c] Merger Arbitrage

This strategy is sometimes called "risk arbitrage." It involves investment in event-driven situations such as leveraged buy-outs, mergers, and hostile takeovers. Normally, the stock of an acquisition target appreciates while the acquiring company's stock decreases in value. These strategies generate returns by purchasing stock of the company being acquired, and in some instances, selling short the stock of the acquiring company. Managers may employ the use of equity options as a low-risk alternative to the outright purchase or sale of common stock. Most merger arbitrage funds hedge against market risk by purchasing S&P put options or put option spreads.

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[289] *See* Lamm, *supra* note 286 at 11.

[290] Short selling involves the sale of a security not owned by the seller and is a technique used to take advantage of an anticipated price decline. To affect a short sale, the seller borrows securities from a third party in order to make delivery to the purchaser. The seller returns the borrowed securities to the lender by purchasing the securities in the open market. If the seller can buy that stock back at a lower price, a profit results. A short seller must generally pledge other securities or cash with the lender in an amount equal to the market price of the borrowed securities. This deposit may be increased or decreased in response to changes in the market price of the borrowed securities.

[d] Convertible Arbitrage

Convertible arbitrage involves purchasing a portfolio of convertible securities, generally convertible bonds, and hedging a portion of the equity risk by selling short the underlying common stock. Certain managers may also seek to hedge interest rate exposure under some circumstances. Most managers employ some degree of leverage, ranging from zero to 6:1. The equity hedge ratio may range from 30 percent to 100 percent. The average grade of bond in a typical portfolio is BB-, with individual ratings ranging from AA to CCC. However, because the default risk of the company is hedged by shorting the underlying common stock, the risk is considerably better than the rating of the unhedged bond indicates.

[e] Relative Value Arbitrage

This investment strategy attempts to take advantage of relative pricing discrepancies between instruments, including equities, debt, options, and futures. Managers may use mathematical, fundamental, or technical analysis to determine misvaluation. Securities may be mispriced relative to the underlying security, related securities, group of securities, or the overall market. Many of these funds use leverage and seek opportunities globally. Arbitrage strategies include dividend arbitrage, pairs trading, options arbitrage, and yield curve trading.

[f] Event Driven

Event-driven investing is also known as "corporate life cycle" investing. This involves investing in opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, bankruptcy reorganizations, recapitalizations, and share buybacks. The portfolios of some event-driven managers may shift in majority weighting between risk arbitrage and distressed securities, while others may be broader in scope. Instruments include long and short common and preferred stocks, as well as debt securities and options. Some managers may use leverage. Fund managers may hedge against market risk by purchasing S&P put options or put option spreads.

[g] Regulation D

Regulation D managers invest in Regulation D securities, sometimes referred to as "structured discount convertibles." The securities are privately offered to the investment manager by companies in need of timely financing, and the terms are negotiated. The terms of any particular deal are reflective of the negotiating strength of the issuing company. Once a deal is closed, there is a waiting period for the private share offering to be registered with the SEC. The manager can only convert into private shares and cannot trade them publicly during this period; the investment is therefore illiquid until it becomes registered. Managers will hedge with common stock until the registration becomes effective and then liquidate the position gradually.

[h] Fixed Income Arbitrage

This market-neutral hedging strategy seeks to profit by exploiting pricing inefficiencies between related fixed income securities, while neutralizing exposure to interest rate risk. Fixed income arbitrage is a generic description of a variety of strategies involving investment in fixed-income instruments, which are weighted in an attempt to eliminate or reduce exposure to changes in the yield curve. Managers attempt to exploit relative mispricing between related sets of fixed income securities. The generic types of fixed-income hedging trades include yield-curve arbitrage, corporate versus Treasury yield spreads, municipal bond versus Treasury yield spreads, and cash versus futures.

[i] Distressed Securities

Managers who strategically invest in distressed securities invest in, and may sell short, the securities of companies in which the security's price has been, or is expected to be, affected by a distressed situation. This may involve reorganizations, bankruptcies, distressed sales, and other corporate restructurings. Depending on the manager's style, investments may be made in bank debt, corporate debt, trade claims, common stock, preferred stock, and warrants. Strategies may be subcategorized as high-yield or "orphan" equities. Some managers may use leverage. Fund managers may also run a market hedge using S&P put options or put options spreads.

[j] Long/Short Equity Directional

These non-market-neutral funds consist predominantly of long equities, although they have the ability to hedge with short sales of stock and/or index options. These funds are commonly known as stock-pickers. Some funds employ leverage to enhance returns. When market conditions warrant, managers may implement a hedge in the portfolio. Funds may also opportunistically short individual stocks. The important distinction between "Long/Short Market Neutral" and "Long/Short Equity Directional" is that equity directional funds do not always have a full hedge in place. In addition to equities, some funds may have limited assets to invest in other types of securities.

[k] Emerging Markets

These non-market-neutral hedge funds invest in securities of companies or the sovereign debt of developing or "emerging" countries. Investments are primarily long. "Emerging Markets" include countries in Latin America, Eastern Europe, the former Soviet Union, Africa, and parts of Asia. Global emerging markets funds will shift their weighting among these regions according to market conditions and manager perspectives. Some managers invest solely in individual regions.

[l] Macro Funds

Macro funds invest by making leveraged bets on anticipated price movements of

stock markets, interest rates, foreign exchanges, and physical commodities. Macro managers employ a "top-down" global approach and may invest in any markets using any instruments to participate in expected market movements. These movements may result from forecasted shifts in world economies, political fortunes, or global supply and demand for resources, both physical and financial. Exchange-traded and over-the—counter derivatives are often used to magnify these price movements. These are the riskiest hedge funds.

[5] Tax Characteristics of Hedge Funds

For taxable investors, investing in hedge funds is a mixed blessing. On one hand, the previously discussed improvement that hedge funds bring to the risk/return profile of an investor's portfolio is a positive factor; on the other hand, the impact of hedge-fund investing on an investor's effective tax rate is generally negative. Due to the trading methodologies and types of transactions employed by hedge fund managers to generate their returns, nearly all hedge fund returns are taxable as ordinary income or as short-term capital gain, both of which are subject to the highest income-tax rates. For investors who are also subject to state income tax, this typically results in a tax rate on the investment earnings of hedge funds in excess of 40 percent. There are some hedge funds that produce returns taxable at long-term capital gain rates, but these funds are the exception rather than the rule.

For non-taxable vehicles that may comprise part of a high-net-worth client's estate plan, such as charitable remainder trusts ("CRTs") and private foundations, hedge fund investments can also prove to be problematic from a tax standpoint. Because most hedge funds and hedge funds of funds have as their legal structure a limited partnership, earnings of the fund typically constitute "unrelated business taxable income (UBTI)" to a CRT or private foundation. In the case of either a CRT or private foundation, UBTI can be detrimental to its intended non-taxable status.[291]

The way that CRTs and private foundations can nevertheless invest in hedge funds or hedge funds of funds is by electing to invest through the fund manager's "offshore feeder" fund. Because such funds are typically organized as companies rather than limited partnerships, they do not usually generate UBTI. Hedge fund managers organize these entities under the laws of an offshore jurisdiction in order to avoid the registered investment company rules and their accompanying SEC regulation.[292]

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[291] In the case of a Charitable Remainder Trust, any amount of UBTI in any taxable year will cause all trust income for that year to be subject to income taxation as if the trust were a regular non-exempt trust. Treas. Reg. § 1.664-1 (c). *See also*, *Leila* G. *Newhall, Unitrust v. Comr.*, 104 T.C. 236, 241–45 (1995). Private Foundations, on the other hand, are taxed only on their UBTI.

[292] *See also* PLRs 200315028 (Jan. 13, 2003), 200315032 (Jan. 14, 2003), and 200315035 (Jan. 14, 2003), where four charitable remainder trusts employed a controlled foreign corporation for investing in a leveraged hedge fund.

[6] SEC Issues

A hedge fund manager is exempt from the provisions of the Investment Company Act of 1940 (the "Act") if the fund can remain outside of the statutory meaning of an investment company subject to registration. These exclusions fall primarily under two sections of the Act.

> **Section 3(c)(1):** A fund need not register as an investment company if it has fewer than 100 beneficial owners and they are "Accredited Investors."
>
> **Section 3(c)(7):** Alternatively, a fund may avoid registration if it has fewer than 500 owners and they are Qualified Purchasers (i.e., "super-accredited" investors with higher net-worth and higher income requirements). Both Sections 3(c)(1) and 3(c)(7) of the Act also stipulate that the fund must neither make nor intend to make a public offering. There is no exemption if the hedge fund manager holds itself out to the public as an Investment Advisor.

An "Accredited Investor" within the meaning of rule 501 (a) of Regulation D promulgated under the U.S. Securities Act of 1933, as amended, is defined as one of the following:

(i) an individual with at least a $200,000 annual income or a net worth of at least $1 million; or

(ii) a corporation, partnership, LLC, business trust, or tax-exempt organization not formed for the purpose of investing in the hedge fund and having total assets in excess of $5 million.

A "Qualified Purchaser" is defined in section 2(a)(51) of the Act as one of the following:

(i) an individual with investable assets of at least $5 million; or

(ii) a corporation, partnership, LLC, business trust, or tax-exempt organization not formed for the purpose of investing in the hedge fund and having investable assets of at least $25 million. As a practical matter, hedge fund investors generally will need to qualify as Qualified Purchasers due to limitations imposed in a fund's offering documents.

[7] Coordination with Private Placement Variable Life Insurance

Investing in hedge funds within a private placement variable life insurance contract enables the investor to have her cake and eat it too. Because of the favorable tax characteristics of life insurance, clients can choose hedge fund investments for their positive risk/return characteristics without fear of the significant income-tax burden they often incur.

Most insurance carriers that offer private placement products not only permit hedge

funds as investments of separate accounts, they expect it. Moreover, in the non-SEC regulated environment that exists for offshore PPVUL products, the regulatory hassles that accompany admitting a hedge fund as an investment choice within a domestic policy are a non-issue.

Hedge funds or hedge funds of funds as an investment of a PPVUL insurance contract should not pose diversification concerns under IRC § 817(h) as long as the investment structure of the fund is a limited partnership, since limited partnerships are "looked through" to their underlying investments for purposes of applying the diversification test. Although investor control is still a significant consideration, especially in light of recent rulings issued by the IRS,[293] many hedge fund managers have responded to these rulings by creating insurance-dedicated funds or funds of funds. This should help reduce the risk of an IRS finding of investor control. Two issues of concern in the context of an investment in a hedge fund within a separate account of a private placement policy are valuation and liquidity. Although offshore carriers typically can administer policies when receiving monthly valuation data, domestic carriers may have problems with this because state insurance regulators may require more frequent valuation of policy assets. Although some hedge funds have systems that would allow them to provide daily valuation, most do not, making the less-regulated offshore insurance environment preferable in such cases.

Liquidity is a more difficult issue. Most hedge funds and hedge funds of funds provide in their organizing documents that part or the entire fund can be liquidated on no more than a quarterly basis. More importantly, many have "lock-up" periods that prevent any liquidation in the first investment year. Insurance carriers have a problem with year-long lock-up periods because if the insured dies, the carrier will want to pay the death benefit in cash. Accordingly, it is normal for a carrier to negotiate with a hedge fund manager in an effort to persuade the fund manager to waive its lock-up requirement in the case of the death of the insured in the first investment year.

[8] Conclusion

The compelling risk/return benefits that hedge funds bring to a taxable investor's portfolio are sometimes perceived to be offset by the tax inefficiency of hedge fund earnings. Using private placement life insurance products as the investment chassis for an investor's allocation to hedge funds can successfully meet a client's otherwise seemingly conflicting goals of investing in hedge funds and investing tax-efficiently. That is, with proper policy planning and design and carefully chosen hedge fund products, a client can enjoy the "best of both worlds," tax efficiency and superior risk-adjusted investment returns.

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[293] *See, e.g.*, Rev. Rul. 2003-92; Rev. Rul. 2003-91; Pvt. Letter Rul. 200244001.

§ 8.16 SUMMARY OF THE POSSIBLE ADVANTAGES AND DISADVANTAGES OF PRIVATE PLACEMENT LIFE INSURANCE AND PRIVATE PLACEMENT VARIABLE ANNUITIES[294]

[1] Possible Advantages of PPLI

Purchasing an insurance or annuity contract provides the protections historically associated with those products. As noted below, a need or desire for those traditional protections should be one of the primary motivations for a client to pursue PPLI. In addition to those traditional protections, there are certain other benefits to procuring an insurance or annuity contract and then investing in tax-inefficient, alternative investments inside the contract. For example, doing so:

- Renders moot the fact that earnings of alternative investments (outside of the insurance context) are taxed even though distributions are not made;
- Avoids the increasing complexity of K-1s, for which the client's accountant will likely give thanks;
- Avoids the necessity of waiting for late K-1s and thus avoids the scramble to complete returns in mid-October (again, something for which accountants will likely give thanks);
- A voids the difficulty of making estimated payments (on the alternative investments earnings) due to uncertain earnings estimates; and
- Provides, in certain states, some form of protection against creditors.

Even though these advantages may not be quantifiable, they are nevertheless real and should not be underestimated.

[2] Possible Disadvantages of PPLI

The primary disadvantage to being invested through an insurance or annuity contract is that the client relinquishes a material amount of control over the investments. To gain the income tax deferral provided to insurance or annuity products, the Internal Revenue Service requires (among other things) that the contract owner not have dominion over the underlying investments (the so-called "Investor Control" prohibition). The control that the contract owner is permitted to have is selecting from among the investment options provided by the insurance company and reallocating among those options from time to time. In our opinion, what the owner is

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[294] Sections 8.16 and 8.17 are abstracted, edited and revised from an article by Miles C. Padgett entitled "Private Placement Life Insurance, published in the Spring 2009 (Volume 11 No. 4) of The Journal of Wealth Management, and published as a white paper. By Convergent Wealth Advisors.

prohibited from doing is participating in any way in:

- The selection of the ultimate underlying investments;
- In setting or revising the investment strategy (or goals) for any of the investment vehicles listed as options by the insurance company; or
- The hiring or firing of the investment advisor or sub-advisor to the insurance dedicated funds.

In practical terms, the owner of the contract cannot simply wrap his or her favorite hedge funds with an insurance or annuity tax-deferral shield. Moreover, the contract owner cannot direct an insurance carrier to pursue a particular hedge fund strategy inside an insurance dedicated fund or to change strategy from "x" to "y." In our opinion, the contract owner can, as more and more insurance dedicated hedge funds and fund-of-funds are created with more and more variety of strategies, allocate and reallocate cash value, as permitted by the insurance carrier, among those insurance dedicated funds and their respective strategies.

In the final analysis, the client is purchasing an insurance or annuity contract, and the insurance company has chosen to make certain investment options (we have focused on hedge funds in this Primer, but there are clearly other investment options) available to support the insurance companies obligations under those contracts.

§ 8.17 PUTTING PRIVATE PLACEMENT LIFE INSURANCE ALL TOGETHER[295]

At this point, the reader is probably asking "what do I make of all this?" The answer is that one can make certain general observations regarding the topic and the type of client who would be a good candidate for PPLI or PPA:

1. A need or desire for the traditional protections provided by insurance or annuities should be a primary motivating factor in a client's decision to pursue PPLI or PPA.
2. On average, a client purchasing a private placement insurance contract should be committed to remaining in the strategy for at least 10 years—any shorter time horizon is likely detrimental from a pure economic standpoint.
3. On average, a client purchasing a private placement annuity contract should be committed to remaining in the strategy until at least reaching age 59 1/2.
4. If a client intends to pursue either PPLI or PPA, the client should be prepared to commit no less than $I million to $5 million to the

[295] See Padgett, *supra* note 294.

contract.

5. If a client is willing to trust the details of the investment strategy and manager selection to a hedge fund-of-funds manager, then the client is a good candidate for PPLI or PPA. In contrast, if a client feels the need to be materially involved regarding the setting of investment strategy or underlying investment selection, then that client is not a good candidate.
6. All things being equal, a healthy person with good insurability should consider pursuing PPI over PPA if that person is planning to hold the insurance contract until death. This is because death proceeds are income tax free (thus all gains inside the insurance contract ultimately escape income tax), whereas gains in an annuity contract are ultimately subject to income taxation regardless of whether the contract is held until death.
7. If a client already has a large commitment to alternative investments and as a practical matter does not anticipate using those assets during his or her lifetime (e.g., for spending needs), then that client should consider pursuing PPLI or PPA—particularly PPLI—for a material portion of those assets to shield them from income taxation and to participate in the protections provided by the products, e.g. the lottery ticket nature of insurance should the insured die prior to his or her life expectancy.[296]

Given the complexities involved, whether a client should pursue PPLI or PPA for a portion of his or her portfolio should be analyzed by the client with assistance of his or her team of advisors, including legal, tax and insurance counsel. At Convergent, even though we cannot advise clients on legal or insurance issues, we can assist clients and their advisors in analyzing the economics involved in PPLI or PPA.

In conclusion, we believe that clients with a significant allocation to tax-inefficient investments (such as alternative investments whose appreciation for the most part has historically been subjected to current taxation at the highest income tax rates) should at least consider owning a portion of this allocation inside of insurance or annuities due to the significant protection provided by these products traditionally and the income tax deferral for appreciation inside a properly designed contract provided under our current tax system. Ultimately, a client may decide that PPLI or PPA is not for him or her, but we at Convergent have provided this Primer in an effort to continue to bring

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[296] See Alexander & Halloran, *supra* note 1. If the insured dies during the early years of the policy, h/she wins on the mortality bet. If the insured dies in the later years of the policy, he/she wins on the investment component of the policy.

to our clients the latest and most powerful wealth management thinking.

§ 8.18 EXHIBITS

EXHIBIT 1

Chart Describing Life Insurance Products

And

Private Placement Life Insurance

Life Insurance Products

Term Life Insurance: This is the simplest form of life insurance. Policies cover a certain amount time period, i.e. 20 years. The death benefit doesn't usually come into play, as the insured usually does not die during the term of the policy. These policies generally do not build cash value, so they cannot invest in hedge funds

Cash Value Insurance: Generally refers to any policy with higher premiums because assets will build up cash value and be invested. Different types of cash value insurance products include:

Whole Life Insurance

- Covers for life
- Fixed premiums. Loans available
- Cash value typically invested in a account within the insurance company's general account, which is managed internally
- Underlying investment is not chosen by policyholder, so cannot invest in hedge funds

Universal Life Insurance

- Flexible premiums
- Cash value is invested by the insurance company, generally in a new money rate portfolio
- Underlying investment is not chosen by policyholder, so cannot invest in hedge funds

Variable Life Insurance

- Policyholder may choose the investment vehicle for cash value investment (stock, bonds, mutual funds) These funds may be managed by the insurance company or by outside advisors appointed by the insurance company.
- Because not limited to accredited investors, cannot invest in hedge funds

Variable Universal Life Insurance

- Variable and Universal policies are often sold as a combined product
- Flexible premiums and death benefit
- Policyholder may choose cash value investments
- Death benefit increases/decreases with performance of investments
- Tax-free growth on investment
- Because not limited to accredited investors, cannot invest in hedge funds

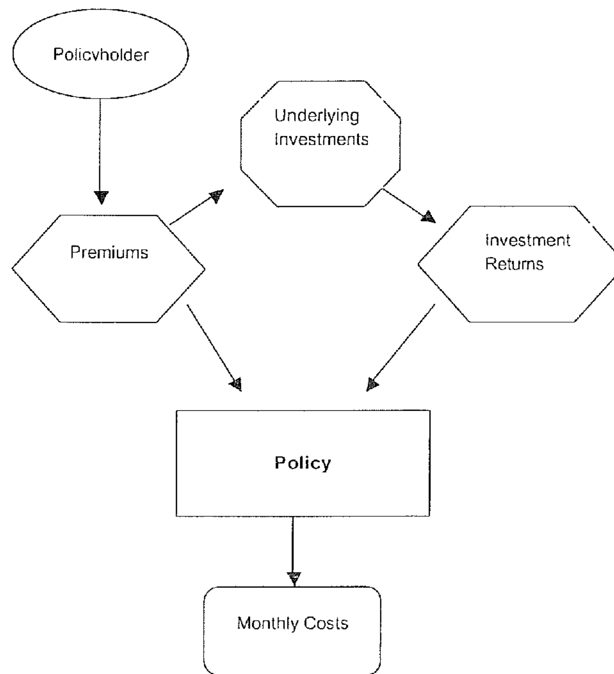
Private Placement Life Insurance

- Investor may chose underlying investments
- Tax-free growth on investment
- Income tax-free death benefit
- Product is generally customized to meet individual needs concerning premiums and death benefit
- Only open to a limited number of accredited investors
- May incorporate alternative investments such as hedge funds

EXHIBIT 2

Illustrating the Structure of a General Cash Value Project

Structure of a general cash value product



Monthly costs include: a) cost of insurance b) administration charges c) mortality and expense charges

EXHIBIT 3

LIFE INSURANCE POLICY QUOTATIONS

EXHIBIT F

ITR

Life Insurance Operations Center
P.O. Box 2030, Omaha, Nebraska 68103-2030
Tel (800) 347-7787 Fax (949) 462-3066

POLICY VALUATION QUOTE

Insured Name:

Policy Number:

Valuations for tax purposes can differ depending on how the policy is used and only you with an independent tax advisor can determine the appropriate fair market value for your situation As per your request, possible valuations for your life insurance policy are listed below:

Effective Date of Valuation: 05/02/2008

Interpolated Terminal Reserve (ITR) Value:	$746,763 34
Accumulated Cash Value:	$550,552 34
PERC Value:	$550,552 34

Financial transactions like loans, withdrawals, premium/loan payments, and monthly policy processing will affect these values.

If you would like more information, please contact your servicing producer listed above. If there is no one listed, please use the toll free number to contact a Life Insurance Operations Center service associate.

Life Insurance Operations Center - Client Services Department

MIDWEST REGIONAL LIFE OFFICE
7300 COLLEGE BLVD
STE 640
OVERLAND PARK, KS 66210

127

2933704.3

EXHIBIT F

P. 001

4333 Edgewood Road NE
Cedar Rapids, IA 52499

May 20, 2009

Policy Number:
Insured(s):

Dear Policy Owner:

Enclosed is the requested Form 712. Please note that Line 58(a) in Part II of Form 712 refers to the interpolated terminal reserve (ITR) in reaching the net total value of the policy in Line 58(f). ITR is generally considered to be the amount that is required to be held in reserves to cover the future liabilities of each policy. Currently, we believe there is no general agreement as to whether a universal life insurance policy has an ITR. However, we have included an ITR value in the form which best reflects our analysis of an ITR for such a policy.

The IRS issued guidance on the valuation of life insurance policies in Rev. Proc. 2005-25, issued on April 8, 2005. Under this guidance, the fair market value of a life contract generally is the greater of the interpolated Terminal Reserve ("ITR") or a formula amount involving Premiums that have been paid plus policy Earnings, minus Reasonable Charges ("PERC"). Please note that the PERC amount is not currently called for on IRS Form 712. Rev. Proc. 2005-25 came out after the creation of Form 712, and the form has not been updated to include PERC.

We understand that the fair market value of a life insurance policy for federal tax purposes is a question of tax law for the individual taxpayer. Transamerica cannot provide legal or tax advice and cannot determine the value of this policy for federal income tax purposes for you. You must seek out and rely on the advice of your own qualified tax and legal advisors.

To assist you in determining the fair market value of the policy, we are providing you certain information:

- The policy's reserve value
- A PERC Amount
- The policy's accumulation value and cash surrender value (accumulation value less surrender charges), as of the date of this letter.

Policy's Reserve Value	$499,603.00 as of May 1, 2009
PERC amount	$541,109.00 as of May 1, 2009
Policy's Accumulation Value	$540,664.54 as of May 20, 2009
Policy's Cash Surrender Value	$88,421.29 as of May 20, 2009

We have calculated the PERC amount under our interpretation of the formula set forth in Rev. Proc. 2005-25. Transamerica does not represent or guarantee its interpretation of the manner in which a PERC amount or Average Surrender Factor is determined will be accepted by the Internal Revenue Service.

We appreciate your business and this opportunity to be of service to you. If you have any questions or need additional assistance, please contact the Customer Service Department from 7:00 a.m. to 6:00 p.m. Central Time, Monday through Friday at 1-800-852-4678.

Thank you for choosing Transamerica!

Customer Service Department
Fax 1-866-622-5051
tli.customerservice@transamerica.com

cc:

Enclosure(s): IRS Form 712 - Life Insurance Statement

128

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EXHIBIT F

712 Gift Tax Quote

Insured:	
Policy Number:	020130938
Anniversary:	06/28
Effective Date:	01/31/10

(IRS Form 712, Part II, Living Insured)

Line 58a. Interpolated Terminal Reserve	$2,249,928.31
Line 58b. Proportionate Premium	$0.00
Line 58c. Dividends Credited	$0.00
Line 58d. Subtotal (58a+58b+58c)	$2,249,928.31
Line 58e. Loan Outstanding	$0.00
Line 58f. Net Total Gift Value* (58d-58e)	**$2,249,928.31**

Alternate Line 58 value: cash/account value of $124,332.73
Less outstanding indebtedness of $0.00
equals net total policy value of $124,332.73

129

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EXHIBIT F

ITR

Life Insurance Operations Center
P.O. Box 2030, Omaha, Nebraska 68103-2030
Tel (800) 347-7787 Fax (949) 462-3066

POLICY VALUATION QUOTE

February 3, 2010

Servicing Producer:

Insured Name:

Policy Number: VF51746140

Valuations for tax purposes can differ depending on how the policy is used and only you with an independent tax advisor can determine the appropriate fair market value for your situation. As per your request, possible valuations for your life insurance policy are listed below:

Effective Date of Valuation: 02/02/2010

Interpolated Terminal Reserve (ITR) Value:	$393,015.45
Accumulated Cash Value:	$200,526.45
PERC Value:	$249,266.93
Premiums Paid:	$317,258.00

Financial transactions like loans, withdrawals, premium/loan payments, and monthly policy processing will affect these values.

If you would like more information, please contact your servicing producer listed above. If there is no one listed, please use the toll free number to contact a Life Insurance Operations Center service associate.

Life Insurance Operations Center - Client Services Department

130

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EXHIBIT F

Attached is the information you requested to help determine the value of your life insurance policy for tax purposes.

There are many ways to value a life insurance policy. This often depends on your own specific situation such as whether the valuation is being done for gift and estate tax purposes or income tax purposes. Additionally, there is little guidance from the IRS. In recent decades, life insurance policies have changed, however, much of the IRS guidance is intended to address types of policies as they existed in the 1980s. As a result, taxpayers such as yourself are left with vague guidelines that may not apply to your specific situation.

Generally, the tax law requires that a life insurance policy be valued at its "fair market value." The "fair market value" is generally defined as the policy cash value and the value of all rights under the contract, including any supplemental agreements thereto, whether or not guaranteed.

Because this definition is somewhat vague, the IRS Revenue Procedure 2005-25 has provided guidance to determine the fair market value of a life insurance policy for transfers under Section 402 (transfers from qualified plans), Section 79 (permanent benefits under group term) and Section 83 (transfers of property from an employer to an employee). A summary of this guidance is provided as Appendix A. However, the text of the guidance also referred to Treasury Regulation 25.2512-6 to define the new rules that determine the value of a policy for gift tax purposes as the Interpolated Terminal Reserve (ITR) plus unearned premiums unless it should not be used "because of the unusual nature of the contract such approximation is not reasonable close to the full value". Therefore, although Rev. Proc. 2005-25 only applies to the transfers cited above it is possible that in the future, it may be extended to estate, gift and sale situations as a reasonable fair market value test.

Some professionals have also tried to collect an offer from a life settlement company to determine what an outside investor would pay for the contract. A value such as that is based on many more assumptions such as future premium payments to keep the policy in force, converting the policy to a permanent product and determining a reasonable rate of return for the transaction. To date, the IRS has not given any guidance that this valuation should be used to determine fair market value.

Appendix B is solely to assist you in your calculation of the fair market value of your life insurance policy for income tax purposes. In addition, you should consider the health of the insured to ensure that there are no known health risks that could increase the value of the contract because of the increased likelihood of death earlier than the mortality assumptions of the product as well as any features or benefits of the contract that may make it more valuable such as guarantees or conversion features. Please remember you must consult your tax advisors to determine the appropriate tax value of your policy. We do not provide legal or tax advice and can not guarantee that any particular value will be accepted for tax purposes.

Circular 230 Disclosure: Please be advised that this document is not intended as legal or tax advice. In addition, U.S. Treasury Regulations require us to inform you that "any tax information provided on this document is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. The tax information was written to support the promotion or marketing of the transaction(s) or matter(s) addressed and you should seek advice based on your particular circumstances from an independent tax advisor."

THE AXA EQUITABLE LIFE INSURANCE COMPANY
P.O. BOX 1047, CHARLOTTE, NORTH CAROLINA 28201-1047

EXHIBIT F

APPENDIX A

SAFE HARBOR VALUATION UNDER REVENUE PROCEDURE 2005-25

The following summarizes the safe harbor formula provided in Revenue Procedure 2005-25 for valuing a life insurance policy. The safe harbor formula "must be interpreted in a reasonable manner, consistent with the purpose of identifying the fair market value" of a policy.

In addition, the safe harbor formula cannot be interpreted in a manner that would understate the fair market value of the policy and associated distributions or transfers. For example, if an insurance policy has not been in force for some time, the value of the contract is best established through the sale of the particular insurance contract by the insurance company (i.e., as the premiums paid for that contract).

Safe Harbor Formula

The fair market value of a life insurance policy can be determined using the greater of:

(a) Adjusted ITR: The sum of the policy's interpolated terminal reserve ("ITR")[1] and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience; and

(b) Adjusted PERC Amount: the product of the "PERC amount" multiplied by the "Average Surrender Factor." The PERC amount is equal to "Premiums" plus "Dividends" plus "Other Earnings" minus "Reasonable Charges" and "Distributions."

Premiums: the premiums paid from the date of issue of the life insurance policy through the valuation date without reduction for dividends that offset those premiums.

Dividends: for non-variable policies, the dividends applied to purchase paid-up insurance prior to the valuation date. For variable policies, the dividends applied to increase the value of the contract (including dividends used to purchase paid-up insurance) prior to the valuation date.

Other Earnings: for non-variable policies, any amounts credited (or otherwise made available) to the policyholder with respect to premiums, including interest and similar income items (whether credited or made available under the contract or to some other account), but not including dividends used to offset premiums and dividends used to purchase paid up insurance. For variable policies, all adjustments (whether credited or made available under the contract or to some other account) that reflect the investment return and the market value of segregated asset accounts.

Reasonable Charges: explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated, or otherwise reversed at a later date.

Distributions: any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

Average Surrender Factor: for all valuations other than valuations applicable to distributions and sales of life insurance policies from qualified plans, the Average Surrender Factor is 1.0. For distributions or sales from qualified plans, the Average Surrender Factor is the unweighted average of the "applicable surrender factors" over the ten (10) years beginning with the policy year of the distribution or sale (i.e., a projected value). For this purpose, the applicable surrender factor for a policy year is equal to the greater of (i) .70 and (ii) the following fraction (determined as of the first day of the policy year):

projected cash surrender value[2]
projected (or actual) PERC Amount

The applicable surrender factor for a year in which there is no surrender charge is 1.0. In addition, a surrender charge can be taken into account only if (a) it is contractually specified at issuance, (b) it is expressed in the form of non-increasing percentages or amounts, (c) it cannot be waived or otherwise avoided and (d) it was not created for purposes of the transfer or distribution.

---

[1] A policy's terminal reserve is the amount of money that the life insurance company has set aside by law to guarantee the payment of policy benefits. It is determined once a year. The "interpolated terminal reserve" is a mid-year estimate of the terminal reserve value determined by adding the current year's increase to the prior year's reserve. Interpolated Terminal Reserve is generally understood to be applicable to whole life contracts and, accordingly, has not historically been used for variable universal life or universal life contracts.

[2] The projected cash surrender value is the projected amount of cash that would be available if the policy were surrendered on the first day of the policy year (or, in the case of the policy year of the distribution or sale of the life insurance policy, the amount of cash that was actually available on the first day of that policy year).

EXHIBIT F

APPENDIX B - LIFE INSURANCE POLICY VALUES

The following schedule is designed to assist the owner of a life insurance policy and the owner's tax and legal advisors in their calculation of the fair market value of the policy for tax purposes. We do not provide legal or tax advice and can not guarantee that any particular value will be accepted for tax purposes.

Insured: Policyholder:

Issuing Company:	AXA Equitable Life Insurance Company		
Policy Number:	158 205 864	Policy Name:	Athena Survivorship Universal Life II
As of:	December 31, 2009	Contract Issue Date:	September 10, 2008
Policy Account Value:	$229,809.87	Policy Cash Surrender Value:	$0.00

ADJUSTED ITR AMOUNT

Interpolated Terminal Reserve[1] (including unearned premiums) or Primary Benefit Reserve:	$97,019.28	
No Lapse Guarantee Basic Reserve:	$217,249.53	
Estimate of Prorated Dividends for Policy Year:		
Adjusted ITR Amount:	$314,268.81	
ADJUSTED PERC AMOUNT[2]		
PERC Amount		$229,809.87

Average Surrender Factor: This calculation applies only to valuations of policies that are distributed or sold by a qualified plan. For all other valuations, the Average Surrender Factor is 1.0.

Applicable Surrender Factors Over Ten-Year Period Beginning with Year of Transfer:[3]

Year	Projected Account Value	Projected Surrender Value	Applicable Surrender Factor (minimum 70)
1			
2			
3			
4			
5			
6			
7			
8			
9			
10			

Average Surrender Factor (average of applicable surrender factors):	1.0
Adjusted PERC Amount (PERC Amount x Average Surrender Factor):	$229,809.87

GREATER OF ADJUSTED ITR AMOUNT AND ADJUSTED PERC AMOUNT[4] $314,268.81

[1] Interpolated Terminal Reserve is generally understood to be applicable to whole life contracts and, accordingly, has not historically been used for variable universal life or universal life contracts. Therefore, statutory reserve is listed for contracts other than whole life.

[2] The PERC value is assumed to be the same as the policy account value because AXA Equitable and MONY policy account values are calculated as premiums paid to date plus earnings credited to the policy, less contract charges, distributions, withdrawals and partial surrenders. The policy charges are assumed to be reasonable per the safe harbor guidelines denoted in Rev. Proc. 2005-25.

[3] This calculation is only applicable if the policy is owned by a qualified plan, otherwise a surrender factor may not be considered for valuation purposes and the Average Surrender Factor should be entered as 1.0. If the policy is owned by a qualified plan, the values listed are for the beginning of the policy year (e.g. the Year 1 values correspond to the beginning of the current policy year or the end of the last policy year.) Thus, when comparing this schedule with the in force policy illustration, please note that the illustration values typically reflect the policy values at the end of the current policy year. Also, please note that the projected account value and projected surrender value are determined based on non-guaranteed values assuming current charges. The earnings assumptions are based on the policy's current crediting rate for universal life contracts and a 6% gross investment return for variable life policies. Actual results will be different and reflect actual earnings and charges as they occur. This schedule can be prepared using different assumptions if requested.

[4] This analysis is designed to calculate the safe harbor figures per Rev. Proc. 2005-25. These figures take into account lapse protection riders, but do not take into account all of the rights, riders or guarantees under the contract. Please consult with your tax and legal advisor to determine the appropriate tax value of your policy.

133

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EXHIBIT 4

Sample Financial Illustration of a Private

Placement Life Insurance Policy

Provided by:

Richard F. Swider

Richard F. Swider & Associates

Milwaukee, Wisconsin

John Hancock Magnastar Private

Placement Variable Life Insurance Company

This sample illustration is provided only for educational purposes.

JOHN HANCOCK
MAGNASTAR PRIVATE PLACEMENT
VARIABLE LIFE

Illustration for
Male Client
Female Client

Presented by
Richard F. Swider & Associates
759 N. Milwaukee Street
Suite 414
Milwaukee, WI 53202
(414) 223-4680

This illustration is designed to demonstrate how a variable life insurance policy operates and to show how premium payments affect policy cash values and death benefits based upon hypothetical investment returns. The policy values are hypothetical and not guaranteed. This illustration may not be used to predict or guarantee future investment results.

Magnastar Private Placement Variable Life is available exclusively through M Financial Group. M Financial Group is a nationwide organization of independent insurance, investment and executive benefit firms serving the financial needs of highly successful individuals and companies.

Policy/Certificate Issued by:
John Hancock Life Insurance Company (U.S.A.)
Boston, MA 02117

Policy/Certificate Distributed by:
John Hancock Distributors, LLC.
Member FINRA, SIPC
Boston, MA 02117

For use in the state of Florida only

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00 05/09/2011 Page: 1 of 13

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

POLICY/CERTIFICATE DESCRIPTION & IMPORTANT INFORMATION

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Magnastar Private Placement Variable Life is a flexible premium variable life insurance contract. The policy account values and, in some cases, the death benefit, will vary daily depending upon investment returns generated in the selected investment options, the amount of premiums paid, loans and withdrawals taken from the policy, and charges deducted from premiums and the policy account values to cover the costs of providing benefits. It is possible for the policy to lapse due to insufficient premium payments and/or poor investment results.

Magnastar Private Placement Variable Life is a private placement product, which can only be offered to a purchaser meeting the definition of both an accredited investor and a qualified purchaser.

Definitions of Accredited Investor

Ownership:	Individual	Corporation
Annual Income:	$200,000 or more for at least two years or, joint income of $300,000 or more for last two years.	
OR		
Net Worth:	$1,000,000 or more (excluding personal residence & furnishings, automobiles). Can be joint net worth.	$5,000,000 or more of assets

Definitions of Qualified Purchaser

Ownership:	Individual	Entity (Corporation, Trust, etc.)
Investments:	Personal investments valued at $5,000,000 or more. Investments include securities, mutual funds, financial contracts, cash equivalents, & real estate for investment purposes.	Entity's investments are valued at $25,000,000 or more. Investments exclude business buildings, stock in business controlled by the investor, pension assets, inventory and related business equipment.

This is an illustration only and is not an offer of sale. Any offer of sale must be preceded or accompanied by the current offering memorandums for the separate account and completion of the investor qualification questionnaire. Read the offering memorandums carefully before submitting premiums.

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00 05/09/2011 Page: 2 of 13

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

LEDGER ILLUSTRATION

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Non-Guaranteed Current Charges
Hypothetical Gross Rate of Return 7.00% (Net Rate 7.00%)

As illustrated, this policy will become a Modified Endowment Contract in Year 1
Values illustrated are as of end of policy year

Policy Year	Age	Annual Premium (1)	Net EOY Account Value (2)	Net EOY Surrender Value (3)	Surrender Value IRR (4)	Net EOY Death Benefit (5)	Death Benefit IRR (6)
1	68/72	10,000,000	10,591,794	10,591,794	5.92%	22,268,188	122.68%
2	69/73	0	11,183,752	11,183,752	5.76%	22,620,257	50.40%
3	70/74	0	11,812,036	11,812,036	5.71%	23,007,483	32.02%
4	71/75	0	12,478,148	12,478,148	5.69%	23,430,218	23.72%
5	72/76	0	13,184,119	13,184,119	5.69%	23,893,579	19.03%
6	73/77	0	13,933,264	13,933,264	5.69%	24,398,538	16.03%
7	74/78	0	14,727,196	14,727,196	5.69%	24,949,343	13.95%
8	75/79	0	15,568,002	15,568,002	5.69%	25,548,649	12.44%
9	76/80	0	16,457,954	16,457,954	5.69%	26,197,771	11.29%
10	77/81	0	17,399,649	17,399,649	5.69%	26,901,597	10.40%
		10,000,000					
11	78/82	0	18,478,962	18,478,962	5.74%	27,788,663	9.74%
12	79/83	0	19,620,558	19,620,558	5.78%	28,738,231	9.19%
13	80/84	0	20,823,251	20,823,251	5.80%	29,746,013	8.75%
14	81/85	0	22,083,330	22,083,330	5.82%	30,806,246	8.37%
15	82/86	0	23,407,150	23,407,150	5.83%	31,934,375	8.05%
16	83/87	0	24,792,561	24,792,561	5.83%	33,132,778	7.78%
17	84/88	0	26,242,105	26,242,105	5.83%	34,398,151	7.54%
18	85/89	0	27,754,035	27,754,035	5.83%	35,730,544	7.33%
19	86/90	0	29,332,394	29,332,394	5.83%	37,134,811	7.15%
20	87/91	0	30,980,286	30,980,286	5.82%	38,604,535	6.99%
		10,000,000					

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

Page: 3 of 13

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

LEDGER ILLUSTRATION

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Non-Guaranteed Current Charges
Hypothetical Gross Rate of Return 7.00% (Net Rate 7.00%)

As illustrated, this policy will become a Modified Endowment Contract in Year 1

Policy Year	Age	Annual Premium (1)	Net EOY Account Value (2)	Net EOY Surrender Value (3)	Surrender Value IRR (4)	Net EOY Death Benefit (5)	Death Benefit IRR (6)
21	88/92	0	32,700,009	32,700,009	5.80%	40,149,071	6.84%
22	89/93	0	34,491,064	34,491,064	5.79%	41,768,679	6.72%
23	90/94	0	36,357,484	36,357,484	5.77%	43,465,372	6.60%
24	91/95	0	38,303,986	38,303,986	5.76%	45,225,516	6.49%
25	92/96	0	40,337,480	40,337,480	5.74%	46,993,164	6.39%
26	93/97	0	42,479,823	42,479,823	5.72%	48,805,069	6.29%
27	94/98	0	44,743,274	44,743,274	5.71%	50,680,706	6.20%
28	95/99	0	47,143,621	47,143,621	5.69%	52,631,139	6.11%
29	96/100	0	49,695,475	49,695,475	5.69%	54,660,053	6.03%
30	97/101	0	52,449,256	52,449,256	5.68%	56,755,340	5.96%
		10,000,000					
31	98/102	0	55,448,256	55,448,256	5.68%	58,858,323	5.88%
32	99/103	0	58,789,331	58,789,331	5.69%	60,829,321	5.80%
33	100/104	0	62,599,168	62,599,168	5.72%	62,599,168	5.72%
34	101/105	0	66,655,900	66,655,900	5.74%	66,655,900	5.74%
35	102/106	0	70,975,529	70,975,529	5.76%	70,975,529	5.76%
36	103/107	0	75,575,090	75,575,090	5.78%	75,575,090	5.78%
37	104/108	0	80,472,726	80,472,726	5.80%	80,472,726	5.80%
38	105/109	0	85,687,753	85,687,753	5.82%	85,687,753	5.82%
39	106/110	0	91,240,738	91,240,738	5.83%	91,240,738	5.83%
40	107/111	0	97,153,585	97,153,585	5.85%	97,153,585	5.85%
		10,000,000					

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

LEDGER ILLUSTRATION

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Non-Guaranteed Current Charges
Hypothetical Gross Rate of Return 7.00% (Net Rate 7.00%)

As illustrated, this policy will become a Modified Endowment Contract in Year 1

Policy Year	Age	Annual Premium (1)	Net EOY Account Value (2)	Net EOY Surrender Value (3)	Surrender Value IRR (4)	Net EOY Death Benefit (5)	Death Benefit IRR (6)
41	108/112	0	103,449,613	103,449,613	5.86%	103,449,613	5.86%
42	109/113	0	110,153,654	110,153,654	5.88%	110,153,654	5.88%
43	110/114	0	117,292,150	117,292,150	5.89%	117,292,150	5.89%
44	111/115	0	124,893,255	124,893,255	5.91%	124,893,255	5.91%
45	112/116	0	132,986,949	132,986,949	5.92%	132,986,949	5.92%
46	113/117	0	141,605,154	141,605,154	5.93%	141,605,154	5.93%
47	114/118	0	150,781,861	150,781,861	5.94%	150,781,861	5.94%
48	115/119	0	160,553,264	160,553,264	5.95%	160,553,264	5.95%
49	116/120	0	170,957,901	170,957,901	5.96%	170,957,901	5.96%
50	117/121	0	182,036,810	182,036,810	5.97%	182,036,810	5.97%
		10,000,000					
51	118/122	0	193,833,686	193,833,686	5.98%	193,833,686	5.98%
52	119/123	0	206,395,057	206,395,057	5.99%	206,395,057	5.99%
53	120/124	0	219,770,467	219,770,467	6.00%	219,770,467	6.00%
		10,000,000					

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

Page: 5 of 13

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

LEDGER ILLUSTRATION

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

ALTERNATIVE LEDGERS

Based on 0.00% Gross Rate of Return (0.00% Net Rate of Return) and Current Charges, policy will lapse in year 27
Based on 0.00% Gross Rate of Return (0.00% Net Rate of Return) and Guaranteed Maximum Charges, policy will lapse in year 19
Values illustrated are as of end of policy year

		7.00% Gross Rate of Return 7.00% Net Rate of Return Guaranteed Maximum Charges			0.00% Gross Rate of Return 0.00% Net Rate of Return Current Charges			0.00% Gross Rate of Return 0.00% Net Rate of Return Guaranteed Maximum Charges		
Policy Year	Age	Net Outlay	EOY Net Surrender Value	EOY Net Death Benefit	Net Outlay	EOY Net Surrender Value	EOY Net Death Benefit	Net Outlay	EOY Net Surrender Value	EOY Net Death Benefit
1	68/72	10,000,000	10,591,794	22,268,188	10,000,000	9,897,848	21,024,000	10,000,000	9,897,848	21,024,000
2	69/73	0	11,175,300	22,603,162	0	9,760,355	21,024,000	0	9,752,130	21,024,000
3	70/74	0	11,781,482	22,947,971	0	9,622,427	21,024,000	0	9,592,472	21,024,000
4	71/75	0	12,409,645	23,301,590	0	9,483,160	21,024,000	0	9,415,514	21,024,000
5	72/76	0	13,058,982	23,666,793	0	9,342,032	21,024,000	0	9,217,341	21,024,000
6	73/77	0	13,728,360	24,039,731	0	9,199,752	21,024,000	0	8,993,070	21,024,000
7	74/78	0	14,416,271	24,422,605	0	9,054,908	21,024,000	0	8,736,634	21,024,000
8	75/79	0	15,120,996	24,815,066	0	8,906,384	21,024,000	0	8,440,700	21,024,000
9	76/80	0	15,841,073	25,215,821	0	8,753,014	21,024,000	0	8,096,941	21,024,000
10	77/81	0	16,574,642	25,626,054	0	8,593,753	21,024,000	0	7,694,835	21,024,000
		10,000,000			10,000,000			10,000,000		
11	78/82	0	17,369,031	26,119,548	0	8,498,610	21,024,000	0	7,280,487	21,024,000
12	79/83	0	18,176,480	26,623,090	0	8,393,117	21,024,000	0	6,784,822	21,024,000
13	80/84	0	18,995,863	27,135,590	0	8,269,241	21,024,000	0	6,191,238	21,024,000
14	81/85	0	19,821,550	27,651,062	0	8,114,467	21,024,000	0	5,469,967	21,024,000
15	82/86	0	20,650,914	28,174,042	0	7,930,633	21,024,000	0	4,590,099	21,024,000
16	83/87	0	21,484,322	28,711,647	0	7,705,648	21,024,000	0	3,519,689	21,024,000
17	84/88	0	22,321,129	29,258,535	0	7,433,629	21,024,000	0	2,214,024	21,024,000
18	85/89	0	23,160,942	29,817,396	0	7,099,995	21,024,000	0	615,751	21,024,000
19	86/90	0	24,010,843	30,397,728	0	6,698,418	21,024,000	0	0	0
20	87/91	0	24,862,696	30,981,405	0	6,218,408	21,024,000			
		10,000,000			10,000,000			10,000,000		

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

Page: 6 of 13

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

LEDGER ILLUSTRATION

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

ALTERNATIVE LEDGERS

		7.00% Gross Rate of Return 7.00% Net Rate of Return Guaranteed Maximum Charges			0.00% Gross Rate of Return 0.00% Net Rate of Return Current Charges			0.00% Gross Rate of Return 0.00% Net Rate of Return Guaranteed Maximum Charges		
Policy Year	Age	Net Outlay	EOY Net Surrender Value	EOY Net Death Benefit	Net Outlay	EOY Net Surrender Value	EOY Net Death Benefit	Net Outlay	EOY Net Surrender Value	EOY Net Death Benefit
21	88/92	0	25,736,720	31,599,544	0	5,602,613	21,024,000			
22	89/93	0	26,617,826	32,234,187	0	4,861,492	21,024,000			
23	90/94	0	27,517,043	32,896,625	0	3,973,309	21,024,000			
24	91/95	0	28,468,151	33,612,346	0	2,908,976	21,024,000			
25	92/96	0	29,465,548	34,327,364	0	1,623,231	21,024,000			
26	93/97	0	30,503,245	35,045,178	0	100,973	21,024,000			
27	94/98	0	31,581,376	35,772,225	0	0	0			
28	95/99	0	32,702,087	36,508,610						
29	96/100	0	33,900,951	37,287,656						
30	97/101	0	35,223,524	38,115,375						
		10,000,000			10,000,000			10,000,000		
31	98/102	0	36,802,177	39,065,511						
32	99/103	0	38,729,231	40,073,135						
33	100/104	0	41,157,080	41,157,080						
34	101/105	0	43,737,125	43,737,125						
35	102/106	0	46,478,908	46,478,908						
36	103/107	0	49,392,567	49,392,567						
37	104/108	0	52,488,876	52,488,876						
38	105/109	0	55,779,287	55,779,287						
39	106/110	0	59,275,966	59,275,966						
40	107/111	0	62,991,843	62,991,843						
		10,000,000			10,000,000			10,000,000		

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

Page: 7 of 13

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

LEDGER ILLUSTRATION

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

ALTERNATIVE LEDGERS

		7.00% Gross Rate of Return 7.00% Net Rate of Return Guaranteed Maximum Charges			0.00% Gross Rate of Return 0.00% Net Rate of Return Current Charges			0.00% Gross Rate of Return 0.00% Net Rate of Return Guaranteed Maximum Charges		
Policy Year	Age	Net Outlay	EOY Net Surrender Value	EOY Net Death Benefit	Net Outlay	EOY Net Surrender Value	EOY Net Death Benefit	Net Outlay	EOY Net Surrender Value	EOY Net Death Benefit
41	108/112	0	66,940,661	66,940,661						
42	109/113	0	71,137,022	71,137,022						
43	110/114	0	75,596,442	75,596,442						
44	111/115	0	80,335,414	80,335,414						
45	112/116	0	85,371,462	85,371,462						
46	113/117	0	90,723,208	90,723,208						
47	114/118	0	96,410,443	96,410,443						
48	115/119	0	102,454,198	102,454,198						
49	116/120	0	108,876,823	108,876,823						
50	117/121	0	115,702,068	115,702,068						
		10,000,000			10,000,000			10,000,000		
51	118/122	0	122,955,172	122,955,172						
52	119/123	0	130,662,957	130,662,957						
53	120/124	0	138,853,925	138,853,925						
		10,000,000			10,000,000			10,000,000		

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

Page: 8 of 13

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

INVESTMENT ALLOCATIONS, FEES & EXPENSES

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Below is a list of all available subaccounts for John Hancock Magnastar VUL along with the current investment management fees and fund operating expenses for each subaccount. All figures are annualized.

Subaccount	Allocation	Investment Management Fees	Operating Expenses
M Business Opportunity Value*		0.63%	0.25%
M Capital Appreciation*		0.90%	0.23%
M International Equity*		0.69%	0.25%
M Large Cap Growth*		0.49%	0.25%
500 Index B*		0.23%	0.02%
Active Bond*		0.60%	0.03%
All Cap Core*		0.78%	0.04%
All Cap Value*		0.84%	0.08%
Alpha Opportunities*		0.99%	0.06%
American Asset Allocation*		0.91%	0.04%
American Blue Chip Income & Growth*		1.03%	0.06%
American Bond*		0.98%	0.04%
American Fundamental Holdings*		1.01%	0.03%
American Global Diversification*		1.20%	0.03%
American Growth*		0.93%	0.05%
American Growth-Income*		0.88%	0.04%
American International*		1.10%	0.07%
American New World*		1.37%	0.14%
Balanced*		0.84%	0.34%
Blue Chip Growth*		0.78%	0.03%
Capital Appreciation*		0.72%	0.03%
Capital Appreciation Value*		0.93%	0.07%
Core Allocation Plus*		0.91%	0.09%
Core Bond*		0.61%	0.04%
Core Diversified Growth & Income*		0.39%	0.53%
Core Strategy*		0.49%	0.03%
Disciplined Diversification*		0.75%	0.14%
Emerging Markets Value*		0.95%	0.13%
Equity-Income*		0.79%	0.03%
Financial Services*		0.83%	0.08%
Fundamental Value*		0.76%	0.02%
Global Bond*		0.70%	0.07%
Health Sciences*		1.05%	0.09%
High Yield*		0.66%	0.04%
International Core*		0.53%	0.04%
International Equity Index A*		0.89%	0.13%
International Equity Index B*		0.30%	0.04%
International Opportunities*		0.88%	0.08%
International Small Company*		0.97%	0.15%
Investment Quality Bond*		0.59%	0.06%
JHT Franklin Templeton Founding Allocation*		0.96%	0.03%
JHT Global*		0.79%	0.09%
JHT International Value*		0.81%	0.12%
Large Cap*		0.76%	0.05%
Large Cap Value*		0.82%	0.03%
Lifestyle Aggressive*		0.90%	0.04%
Lifestyle Balanced*		0.77%	0.02%
Lifestyle Conservative*		0.73%	0.03%
Lifestyle Growth*		0.78%	0.03%
Lifestyle Moderate*		0.75%	0.03%
Mid Cap Index*		0.47%	0.03%
Mid Cap Stock*		0.84%	0.05%
Mid Value*		0.96%	0.05%
Money Market B*		0.24%	0.04%
Natural Resources*		1.00%	0.04%
Optimized All Cap*		0.68%	0.02%
Optimized Value*		0.69%	0.04%

* Illustrations incorporate a current, non-guaranteed asset credit for these subaccounts.

** Availability of Magnastar Funds is subject to prior completion of due diligence. Fees and expenses for these funds are subject to change. These funds may also have severe restrictions on the timing of premium allocations, withdrawals, surrenders, transfers, loans, and payment of death benefit proceeds. See the prospectus or offering memorandum for complete information on these funds.

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00 05/09/2011 Page: 9 of 13

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

INVESTMENT ALLOCATIONS, FEES & EXPENSES

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Subaccount	Allocation	Investment Management Fees	Operating Expenses
PIMCO VIT All Asset Portfolio*		1.37%	0.20%
Real Estate Securities*		0.70%	0.04%
Real Return Bond*		0.68%	0.04%
Science & Technology*		1.05%	0.05%
Short Term Government Income*		0.57%	0.19%
Small Cap Growth*		1.06%	0.04%
Small Cap Index*		0.48%	0.03%
Small Cap Opportunities*		0.92%	0.15%
Small Cap Value*		1.06%	0.05%
Small Company Value*		1.04%	0.05%
Smaller Company Growth*		0.95%	0.11%
Strategic Bond*		0.67%	0.05%
Strategic Income Opportunities*		0.69%	0.07%
Total Bond Market B*		0.20%	0.05%
Total Return*		0.68%	0.04%
Total Stock Market Index*		0.49%	0.03%
U.S. High Yield Bond*		0.72%	0.04%
Utilities*		0.82%	0.08%
Value*		0.74%	0.05%
U.S. High Yield Bond*		0.73%	0.06%
Utilities*		0.83%	0.10%
Value*		0.74%	0.06%
Magnastar Funds**			
Alternative Funds	100.00%	0.00%	0.00%

Based upon the above allocation, this illustration assumes a hypothetical investment management fee of 0%, a hypothetical operating expense of 0%.

Based upon the assumed fund allocations, the following are calculated annual net rates for various hypothetical annual gross rates of return:

Gross Rate of Return	Net Rate of Return
12.00%	12.00%
8.00%	8.00%
4.00%	4.00%
0.00%	0.00%

Net rate of return is calculated after subtractions for investment management fees and subaccount operating expenses.

* Illustrations incorporate a current, non-guaranteed asset credit for these subaccounts.

** Availability of Magnastar Funds is subject to prior completion of due diligence. Fees and expenses for these funds are subject to change. These funds may also have severe restrictions on the timing of premium allocations, withdrawals, surrenders, transfers, loans, and payment of death benefit proceeds. See the prospectus or offering memorandum for complete information on these funds.

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00 05/09/2011

Page: 10 of 13

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

ILLUSTRATION NOTES

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

The hypothetical rates of return and values shown are illustrative only and should not be construed as a representation of past or future investment results. The illustrated policy values might not be achieved if actual rates of return or policy charges differ from those assumed or if premiums are not paid as illustrated. Actual rates of return may be more or less than those shown and will depend on a number of factors including the investment allocation made to the variable accounts by an owner and the performance of the accounts.

At the time the policy is purchased, the policyowner may elect either the Guideline Premium Test (GPT) or Cash Value Accumulation Test (CVAT). Once the policy/certificate is issued, the election cannot be changed.

Under the CVAT, the policy must maintain a minimum ratio of death benefit to cash value. Therefore, in order to ensure that the policy qualifies as life insurance, the policy's total death benefit may increase as the policy account value increases. Under the GPT, there is a limit as to the amount of premium that can be paid into the policy in relation to the death benefit. In addition, there is a minimum ratio of death benefit to cash value associated with this test.

The Internal Revenue Code describes a class of policies called Modified Endowment Contracts (MECs). Policies are classified as MECs if they violate tests defined in I.R.C. 7702A. Distributions during the insured's lifetime from MECs are taxed less favorably than policies that are non-MECs. If the distribution is taxable, it may also incur a 10% penalty tax unless you qualify under one of the exemption provisions of I.R.C. 72(v).

Based upon our understanding of the Internal Revenue Code and the assumptions in the illustration, this policy would become a MEC in year 1.

Consult your tax advisor for further details and advice about your personal circumstances.

Tax Effect columns include effects of taxable gains on amounts received from the policy. These include the effects of I.R.C. Section 7702 for treatment of gains received in excess of policyholder's basis, outstanding loans at lapse, or due to the contract being considered excessively funded and effects of I.R.C. Section 7702A for contracts considered Modified Endowments.

This is an illustration and not a contract. Although the information in this illustration is based on certain tax and legal assumptions, it is not intended to be tax or legal advice. Such advice should be obtained from the applicant's own counsel or other expert(s).

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00 05/09/2011 Page: 11 of 13

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

SUMMARY PAGE

The following is a list of policy features and assumptions. The assumptions are agreed to by the applicant and the applicant's advisors and are based upon information supplied by the applicant. Policy values being illustrated are dependent upon these assumptions. No representation is made by John Hancock regarding the accuracy of any assumptions.

Initial Face Amount:	$21,024,000
Scheduled Face Amount Increases:	None
Additional Coverage Segments:	None
Initial Premium:	$10,000,000
State:	Florida
Death Benefit Option:	Level
Assumed Gross Rate of Return:	7.00% From year 1 to 53
Assumed Net Rate of Return:	7.00% From year 1 to 53, Please refer to Investment Allocations page for explanation of gross and net rates.
Payment Mode:	Annual
Underwriting:	Full Underwriting
Class, Insured #1:	Standard Non Tobacco User
Class, Insured #2:	Standard Non Tobacco User
Ratings Insured #1:	No
Table Rating:	None
Permanent Flat Extra:	None
Temporary Flat Extra:	None
Ratings Insured #2:	No
Table Rating:	None
Permanent Flat Extra:	None
Temporary Flat Extra:	None
Insured Tax Rate:	40%
Annual Current Non-Guaranteed Mortality & Expense Risk Charge	
Current:	See Below
Guaranteed Maximum Charge:	See Below
Loan Interest Rate Charged on Policy Debt:	See Below
Rate Credited on Loan Account:	4.00%
1035 Exchange:	No
Initial 7-Pay Premium:	$1,613,802
Maximum Single Premium:	$10,000,000

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00 05/09/2011 Page: 12 of 13

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

SUMMARY PAGE

Annual Mortality & Expense Risk Charge

Year	Current	Guaranteed Maximum Charge	Year	Current	Guaranteed Maximum Charge	Year	Current	Guaranteed Maximum Charge
1	0.6517%	0.6517%	19	0.5571%	0.7571%	37	0.4877%	0.6877%
2	0.6517%	0.6517%	20	0.5571%	0.7571%	38	0.4877%	0.6877%
3	0.6517%	0.6517%	21	0.4877%	0.6877%	39	0.4877%	0.6877%
4	0.6517%	0.6517%	22	0.4877%	0.6877%	40	0.4877%	0.6877%
5	0.6517%	0.6517%	23	0.4877%	0.6877%	41	0.4877%	0.6877%
6	0.6517%	0.6517%	24	0.4877%	0.6877%	42	0.4877%	0.6877%
7	0.6517%	0.6517%	25	0.4877%	0.6877%	43	0.4877%	0.6877%
8	0.6517%	0.6517%	26	0.4877%	0.6877%	44	0.4877%	0.6877%
9	0.6517%	0.6517%	27	0.4877%	0.6877%	45	0.4877%	0.6877%
10	0.6517%	0.6517%	28	0.4877%	0.6877%	46	0.4877%	0.6877%
11	0.5571%	0.7571%	29	0.4877%	0.6877%	47	0.4877%	0.6877%
12	0.5571%	0.7571%	30	0.4877%	0.6877%	48	0.4877%	0.6877%
13	0.5571%	0.7571%	31	0.4877%	0.6877%	49	0.4877%	0.6877%
14	0.5571%	0.7571%	32	0.4877%	0.6877%	50	0.4877%	0.6877%
15	0.5571%	0.7571%	33	0.4877%	0.6877%	51	0.4877%	0.6877%
16	0.5571%	0.7571%	34	0.4877%	0.6877%	52	0.4877%	0.6877%
17	0.5571%	0.7571%	35	0.4877%	0.6877%	53	0.4877%	0.6877%
18	0.5571%	0.7571%	36	0.4877%	0.6877%			

Loan Interest Rate Charged on Policy Debt

Year	Loan Interest Charge	Year	Loan Interest Charge	Year	Loan Interest Charge
1	4.40%	19	4.31%	37	4.24%
2	4.40%	20	4.31%	38	4.24%
3	4.40%	21	4.24%	39	4.24%
4	4.40%	22	4.24%	40	4.24%
5	4.40%	23	4.24%	41	4.24%
6	4.40%	24	4.24%	42	4.24%
7	4.40%	25	4.24%	43	4.24%
8	4.40%	26	4.24%	44	4.24%
9	4.40%	27	4.24%	45	4.24%
10	4.40%	28	4.24%	46	4.24%
11	4.31%	29	4.24%	47	4.24%
12	4.31%	30	4.24%	48	4.24%
13	4.31%	31	4.24%	49	4.24%
14	4.31%	32	4.24%	50	4.24%
15	4.31%	33	4.24%	51	4.24%
16	4.31%	34	4.24%	52	4.24%
17	4.31%	35	4.24%	53	4.24%
18	4.31%	36	4.24%		

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00 05/09/2011 Page: 13 of 13

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

POLICY ACCOUNT VALUE DETAIL REPORT

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Non-Guaranteed Current Charges
Hypothetical Gross Rate of Return 7.00% (Net Rate 7.00%)
Values illustrated are as of end of policy year

Policy Year	Age	Annual Premium (1)	Premium Load - (2)	Admin. Charge - (3)	M&E Charge - (4)	Mortality Charge - (5)	Net Interest Credit + (6)	Asset Credit* + (7)	EOY Net Account Value = (8)	EOY Net Surrender Value = (9)
1	68/72	10,000,000	0	32,282	66,719	5,315	696,110	0	10,591,794	10,591,794
2	69/73	0	0	64,553	70,565	8,968	736,045	0	11,183,752	11,183,752
3	70/74	0	0	64,553	74,518	9,944	777,298	0	11,812,036	11,812,036
4	71/75	0	0	64,553	78,712	11,681	821,058	0	12,478,148	12,478,148
5	72/76	0	0	64,553	83,158	13,761	867,443	0	13,184,119	13,184,119
6	73/77	0	0	64,553	87,872	15,068	916,637	0	13,933,264	13,933,264
7	74/78	0	0	64,553	92,872	17,446	968,803	0	14,727,196	14,727,196
8	75/79	0	0	64,553	98,169	20,539	1,024,066	0	15,568,002	15,568,002
9	76/80	0	0	64,553	103,777	24,293	1,082,574	0	16,457,954	16,457,954
10	77/81	0	0	64,553	109,712	28,533	1,144,492	0	17,399,649	17,399,649
		10,000,000	0	613,256	866,074	155,547	9,034,526	0		
11	78/82	0	0	0	99,406	34,288	1,213,006	0	18,478,962	18,478,962
12	79/83	0	0	0	105,560	40,926	1,288,083	0	19,620,558	19,620,558
13	80/84	0	0	0	112,058	52,569	1,367,320	0	20,823,251	20,823,251
14	81/85	0	0	0	118,886	71,580	1,450,547	0	22,083,330	22,083,330
15	82/86	0	0	0	126,049	88,005	1,537,874	0	23,407,150	23,407,150
16	83/87	0	0	0	133,561	110,455	1,629,427	0	24,792,561	24,792,561
17	84/88	0	0	0	141,422	134,261	1,725,227	0	26,242,105	26,242,105
18	85/89	0	0	0	149,635	163,727	1,825,292	0	27,754,035	27,754,035
19	86/90	0	0	0	158,204	193,149	1,929,713	0	29,332,394	29,332,394
20	87/91	0	0	0	167,151	223,685	2,038,727	0	30,980,286	30,980,286
		10,000,000	0	613,256	2,178,006	1,268,192	25,039,741	0		

* Asset Credit is a credit for revenue sharing from the investment selections. The Asset Credit reflects investment options that have been chosen and will vary based on actual investment selection. Asset credits are non-guaranteed and will vary over time.

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

POLICY ACCOUNT VALUE DETAIL REPORT

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Policy Year	Age	Annual Premium (1)	Premium Load - (2)	Admin. Charge - (3)	M&E Charge - (4)	Mortality Charge - (5)	Net Interest Credit + (6)	Asset Credit* + (7)	EOY Net Account Value = (8)	EOY Net Surrender Value = (9)
21	88/92	0	0	0	154,552	278,242	2,152,517	0	32,700,009	32,700,009
22	89/93	0	0	0	163,079	317,002	2,271,136	0	34,491,064	34,491,064
23	90/94	0	0	0	171,961	356,333	2,394,714	0	36,357,484	36,357,484
24	91/95	0	0	0	181,221	395,825	2,523,547	0	38,303,986	38,303,986
25	92/96	0	0	0	190,885	433,654	2,658,033	0	40,337,480	40,337,480
26	93/97	0	0	0	201,021	455,811	2,799,176	0	42,479,823	42,479,823
27	94/98	0	0	0	211,713	472,941	2,948,105	0	44,743,274	44,743,274
28	95/99	0	0	0	223,030	482,398	3,105,775	0	47,143,621	47,143,621
29	96/100	0	0	0	235,044	486,310	3,273,208	0	49,695,475	49,695,475
30	97/101	0	0	0	247,907	450,992	3,452,679	0	52,449,256	52,449,256
		10,000,000	0	613,256	4,158,420	5,397,701	52,618,632	0		
31	98/102	0	0	0	261,847	386,485	3,647,332	0	55,448,256	55,448,256
32	99/103	0	0	0	277,191	243,743	3,862,010	0	58,789,331	58,789,331
33	100/104	0	0	0	294,477	0	4,104,314	0	62,599,168	62,599,168
34	101/105	0	0	0	313,561	0	4,370,293	0	66,655,900	66,655,900
35	102/106	0	0	0	333,881	0	4,653,510	0	70,975,529	70,975,529
36	103/107	0	0	0	355,518	0	4,955,080	0	75,575,090	75,575,090
37	104/108	0	0	0	378,558	0	5,276,194	0	80,472,726	80,472,726
38	105/109	0	0	0	403,090	0	5,618,117	0	85,687,753	85,687,753
39	106/110	0	0	0	429,212	0	5,982,198	0	91,240,738	91,240,738
40	107/111	0	0	0	457,027	0	6,369,874	0	97,153,585	97,153,585
		10,000,000	0	613,256	7,662,784	6,027,929	101,457,554	0		

* Asset Credit is a credit for revenue sharing from the investment selections. The Asset Credit reflects investment options that have been chosen and will vary based on actual investment selection. Asset credits are non-guaranteed and will vary over time.

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

POLICY ACCOUNT VALUE DETAIL REPORT

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Policy Year	Age	Annual Premium (1)	Premium Load - (2)	Admin. Charge - (3)	M&E Charge - (4)	Mortality Charge - (5)	Net Interest Credit + (6)	Asset Credit* + (7)	EOY Net Account Value = (8)	EOY Net Surrender Value = (9)
41	108/112	0	0	0	486,645	0	6,782,673	0	103,449,613	103,449,613
42	109/113	0	0	0	518,182	0	7,222,223	0	110,153,654	110,153,654
43	110/114	0	0	0	551,763	0	7,690,259	0	117,292,150	117,292,150
44	111/115	0	0	0	587,520	0	8,188,625	0	124,893,255	124,893,255
45	112/116	0	0	0	625,594	0	8,719,288	0	132,986,949	132,986,949
46	113/117	0	0	0	666,135	0	9,284,341	0	141,605,154	141,605,154
47	114/118	0	0	0	709,304	0	9,886,011	0	150,781,861	150,781,861
48	115/119	0	0	0	755,271	0	10,526,673	0	160,553,264	160,553,264
49	116/120	0	0	0	804,216	0	11,208,853	0	170,957,901	170,957,901
50	117/121	0	0	0	856,333	0	11,935,242	0	182,036,810	182,036,810
		10,000,000	0	613,256	14,223,747	6,027,929	192,901,742	0		
51	118/122	0	0	0	911,828	0	12,708,704	0	193,833,686	193,833,686
52	119/123	0	0	0	970,919	0	13,532,290	0	206,395,057	206,395,057
53	120/124	0	0	0	1,033,839	0	14,409,249	0	219,770,467	219,770,467
		10,000,000	0	613,256	17,140,332	6,027,929	233,551,985	0		

* Asset Credit is a credit for revenue sharing from the investment selections. The Asset Credit reflects investment options that have been chosen and will vary based on actual investment selection. Asset credits are non-guaranteed and will vary over time.

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

COMMISSION REPORT

FOR BROKER-DEALER USE ONLY

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Commission Projection

Policy Year	Age	Annual Premium (1)	Premiums Allocated to Band 1 (2)	Premiums Allocated to Band 2 (3)	Premium Based Comm's Band 1 (4)	Premium Based Comm's Band 2 (5)	Total Trail Commission (6)	Annual Commission Payable (7)	Total Present Value @ 8.00 (8)
1	68/72	10,000,000	1,613,802	8,386,198	24,207	125,793	26,479	176,479	176,479
2	69/73	0	0	0	0	0	27,959	27,959	202,368
3	70/74	0	0	0	0	0	29,530	29,530	227,685
4	71/75	0	0	0	0	0	31,195	31,195	252,449
5	72/76	0	0	0	0	0	32,960	32,960	276,676
6	73/77	0	0	0	0	0	34,833	34,833	300,383
7	74/78	0	0	0	0	0	36,818	36,818	323,584
8	75/79	0	0	0	0	0	38,920	38,920	346,294
9	76/80	0	0	0	0	0	41,145	41,145	368,523
10	77/81	0	0	0	0	0	43,499	43,499	390,283
		10,000,000	1,613,802	8,386,198	24,207	125,793	343,340	493,340	
11	78/82	0	0	0	0	0	46,197	46,197	411,682
12	79/83	0	0	0	0	0	49,051	49,051	432,719
13	80/84	0	0	0	0	0	52,058	52,058	453,392
14	81/85	0	0	0	0	0	55,208	55,208	473,692
15	82/86	0	0	0	0	0	58,518	58,518	493,615
16	83/87	0	0	0	0	0	61,981	61,981	513,154
17	84/88	0	0	0	0	0	65,605	65,605	532,304
18	85/89	0	0	0	0	0	69,385	69,385	551,056
19	86/90	0	0	0	0	0	73,331	73,331	569,407
20	87/91	0	0	0	0	0	77,451	77,451	587,354
		10,000,000	1,613,802	8,386,198	24,207	125,793	952,126	1,102,126	

Band 1 Target Level: $1,613,802
Band 2 Target Level: $8,386,198

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

COMMISSION REPORT

FOR BROKER-DEALER USE ONLY

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Commission Projection

Policy Year	Age	Annual Premium (1)	Premiums Allocated to Band 1 (2)	Premiums Allocated to Band 2 (3)	Premium Based Comm's Band 1 (4)	Premium Based Comm's Band 2 (5)	Total Trail Commission (6)	Annual Commission Payable (7)	Total Present Value @ 8.00 (8)
21	88/92	0	0	0	0	0	81,750	81,750	604,893
22	89/93	0	0	0	0	0	86,228	86,228	622,023
23	90/94	0	0	0	0	0	90,894	90,894	638,742
24	91/95	0	0	0	0	0	95,760	95,760	655,051
25	92/96	0	0	0	0	0	100,844	100,844	670,954
26	93/97	0	0	0	0	0	106,200	106,200	686,461
27	94/98	0	0	0	0	0	111,858	111,858	701,584
28	95/99	0	0	0	0	0	117,859	117,859	716,339
29	96/100	0	0	0	0	0	124,239	124,239	730,740
30	97/101	0	0	0	0	0	131,123	131,123	744,813
		10,000,000	1,613,802	8,386,198	24,207	125,793	1,998,880	2,148,880	
31	98/102	0	0	0	0	0	138,621	138,621	758,589
32	99/103	0	0	0	0	0	146,973	146,973	772,113
33	100/104	0	0	0	0	0	156,498	156,498	785,446
34	101/105	0	0	0	0	0	166,640	166,640	798,592
35	102/106	0	0	0	0	0	177,439	177,439	811,553
36	103/107	0	0	0	0	0	188,938	188,938	824,332
37	104/108	0	0	0	0	0	201,182	201,182	836,931
38	105/109	0	0	0	0	0	214,219	214,219	849,353
39	106/110	0	0	0	0	0	228,102	228,102	861,600
40	107/111	0	0	0	0	0	242,884	242,884	873,674
		10,000,000	1,613,802	8,386,198	24,207	125,793	3,860,375	4,010,375	

Band 1 Target Level: $1,613,802
Band 2 Target Level: $8,386,198

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

COMMISSION REPORT

FOR BROKER-DEALER USE ONLY

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Commission Projection

Policy Year	Age	Annual Premium (1)	Premiums Allocated to Band 1 (2)	Premiums Allocated to Band 2 (3)	Premium Based Comm's Band 1 (4)	Premium Based Comm's Band 2 (5)	Total Trail Commission (6)	Annual Commission Payable (7)	Total Present Value @ 8.00 (8)
41	108/112	0	0	0	0	0	258,624	258,624	885,579
42	109/113	0	0	0	0	0	275,384	275,384	897,316
43	110/114	0	0	0	0	0	293,230	293,230	908,888
44	111/115	0	0	0	0	0	312,233	312,233	920,297
45	112/116	0	0	0	0	0	332,467	332,467	931,546
46	113/117	0	0	0	0	0	354,013	354,013	942,637
47	114/118	0	0	0	0	0	376,955	376,955	953,571
48	115/119	0	0	0	0	0	401,383	401,383	964,352
49	116/120	0	0	0	0	0	427,395	427,395	974,981
50	117/121	0	0	0	0	0	455,092	455,092	985,460
		10,000,000	1,613,802	8,386,198	24,207	125,793	7,347,152	7,497,152	
51	118/122	0	0	0	0	0	484,584	484,584	995,792
52	119/123	0	0	0	0	0	515,988	515,988	1,005,978
53	120/124	0	0	0	0	0	549,426	549,426	1,016,022
		10,000,000	1,613,802	8,386,198	24,207	125,793	8,897,150	9,047,150	

Band 1 Target Level: $1,613,802
Band 2 Target Level: $8,386,198

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

COMMISSION REPORT

FOR BROKER-DEALER USE ONLY

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Commission Schedule

		Premium-based Commission Rates					Trail Commission Rates						
Policy Year	Age	Band 1 Module 1	Band 1 Module 2	Band 2 Module 1	Band 2 Module 2	Band 3	Asset Layer 1	Asset Layer 2	Asset Layer 3	Asset Layer 4	Asset Layer 5	Asset Layer 6	Service Commission Per 1000
1	68/72	0.00%	1.50%	0.00%	1.50%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
2	69/73	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
3	70/74	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
4	71/75	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
5	72/76	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
6	73/77	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
7	74/78	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
8	75/79	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
9	76/80	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
10	77/81	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
11	78/82	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
12	79/83	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
13	80/84	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
14	81/85	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
15	82/86	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
16	83/87	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
17	84/88	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
18	85/89	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
19	86/90	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
20	87/91	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
21	88/92	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
22	89/93	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
23	90/94	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
24	91/95	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
25	92/96	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
26	93/97	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

COMMISSION REPORT

FOR BROKER-DEALER USE ONLY

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Commission Schedule

		Premium-based Commission Rates					Trail Commission Rates						
Policy Year	Age	Band 1 Module 1	Band 1 Module 2	Band 2 Module 1	Band 2 Module 2	Band 3	Asset Layer 1	Asset Layer 2	Asset Layer 3	Asset Layer 4	Asset Layer 5	Asset Layer 6	Service Commission Per 1000
27	94/98	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
28	95/99	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
29	96/100	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
30	97/101	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
31	98/102	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
32	99/103	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
33	100/104	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
34	101/105	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
35	102/106	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
36	103/107	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
37	104/108	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
38	105/109	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
39	106/110	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
40	107/111	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
41	108/112	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
42	109/113	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
43	110/114	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
44	111/115	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
45	112/116	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
46	113/117	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
47	114/118	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
48	115/119	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
49	116/120	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
50	117/121	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
51	118/122	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0
52	119/123	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0

State Policy Form Number: MAG200 FL
Version 2011.01, Product Version 11.00

05/09/2011

JOHN HANCOCK MAGNASTAR PRIVATE PLACEMENT VARIABLE LIFE

COMMISSION REPORT

FOR BROKER-DEALER USE ONLY

Insured #1: Male Client
Male, Age 72, Standard Non Tobacco User
Insured #2: Female Client
Female, Age 68, Standard Non Tobacco User
Death Benefit Option: Level
Configuration Code:

Initial Face Amount: $21,024,000
Initial Annual Premium: $10,000,000.00
Tax Compliance Test: Cash Value Accumulation

Commission Schedule

		Premium-based Commission Rates					Trail Commission Rates						
Policy Year	Age	Band 1 Module 1	Band 1 Module 2	Band 2 Module 1	Band 2 Module 2	Band 3	Asset Layer 1	Asset Layer 2	Asset Layer 3	Asset Layer 4	Asset Layer 5	Asset Layer 6	Service Commission Per 1000
53	120/124	0.00%	0%	0.00%	0%	0%	0.2500%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	$0

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