

LIFE INSURANCE ADVISORY SERVICES



PRIVATE PLACEMENT LIFE INSURANCE ARRANGEMENTS &
“INSURANCE-FRIENDLY” HEDGE FUNDS

INVESTOR CONTROL DOCTRINE

IRS rules regarding investor control – that is, control by a policyholder over the investments supporting his or her private placement life insurance policy – are not set out in the tax code or regulations. Instead, guidance has been provided, piecemeal, through various IRS communications, including private letter rulings and revenue rulings.

In 2003, arriving shortly after the issuance of two private letter rulings released in 2002 for the purpose of establishing a formal position on the controversial “investor control doctrine” governing domestic and offshore private placement life insurance (PPLI/OPPLI), the IRS issued its first official instructions and guidance in a couple of decades in the form of two separate but related Revenue Rulings as well as the issuance of Proposed Regulations to amend the diversification regulations by deleting the widely relied on nonregistered partnership exception. Supplementing these first rounds of attack, the Service in 2003 issued a trilogy of private letter rulings directly affecting and providing safe harbors for variable life insurance contracts which choose to invest in certain mutual fund investments (popularly known as “insurance-friendly hedge funds”).

DECOSIMO is intimately familiar with the statutory and regulatory requirements necessary to obtain favorable tax benefits of PPLI and OPPLI policies as well as the myriad of rules governing the status of the arrangement for tax purposes of “life insurance” and the complex “diversification requirements” and “owner control” issues involved.

PRIVATE PLACEMENT LIFE INSURANCE – COMPONENT PARTS AND PLATFORMS

Variable Universal Life (VUL) Insurance– VUL premium payments increase over the term of the contract to reflect the increase in the mortality component of the contract. A larger portion of each premium payment, net of the insurance charge that covers administrative charges and the increasing mortality component of the policy are placed in investments.

Although the insurance company plays less of a role in the election and management of the investments acquired within the life insurance policy while the policy owner (i.e., trustee of the irrevocable trust arrangement) has more control over investment selection, VUL does have its risks.

Since the primary difference between VUL and more traditional insurance is the investment element of the contract, the investment portion of an account operates like mutual funds that are managed by the insurance company or by an outside investment firm. This gives the client the opportunity to achieve market-based returns. However, it is important to assess the client's tolerance for risk before deciding upon an appropriate asset allocation mix and then the specific mutual funds, etc. Clearly, a team of advisors is necessary to execute the desired plan.

Offshore Private Placement Life Insurance (OPPLI) Arrangements. OPPLI arrangements, although somewhat complex, represent a sophisticated estate and asset protection strategy whose unique benefits are not easily obtained elsewhere.

Benefits include lower life insurance premiums and lower internal overhead costs, greater investment choices, increased confidentiality, better asset protection and a decided tax advantage when assets are lodged within a variable life insurance policy "wrapper."

Securing favorable tax treatment rests solely on the contract qualifying as a "life insurance policy" under Code Sec. 7702.13 Code Sec. 7702 defines a life insurance contract as one that meets applicable domestic or foreign law, but only if such contract satisfies either the cash value accumulation test (CVAT) or both the guideline premium test and the cash value corridor test (CVCT).

The taxpayer is allowed to choose the methodology by which the contract qualifies. However, once selected, the methodology must be used for the duration of the contract.

OPPLIs asset protection features, when properly established and maintained, shelter the assets within the policy from claims and judgments while simultaneously permitting the policy holder access to such assets in difficult times.

The IRS considers variable life insurance contracts as "diversified" if no one, two, three or four investments constitute 55 percent, 70 percent, 80 percent or 90 percent. The segregated account of "variable contracts" must meet certain minimum "diversification" requirements to qualify as tax-free life insurance or annuity contracts. These general diversification provisions require that:

- No more than 55% of the aggregate value of the policy segregated account be invested in any single asset.
- No more than 70% of the total account value be composed of any two investments.
- No more than 80% of the total account value be concentrated in any three investments.
- No more than 90% of the total account value be concentrated in any four investments.

Essentially, the segregated account must at a minimum maintain at least five investments respectively, of the investment portfolio's (within the variable life policy) total assets.

Owner control issues stem from policy owners retaining an "impermissible degree of control" over OPPLI investments contained within domestic or offshore variable life contracts. OPPLI policy owners may choose from a broad array of investment strategies; they are permitted to be informed of the general investment strategy to be followed; and they may possess a contractual claim for cash as a direct consequence of purchasing the life insurance contracts. However, they should not possess a legally binding right to acquire a particular investment, nor should they have an interest in any specific investment item held by the insurer or within the investment portfolio of the variable universal life contract.

POLICY CONTRACT ISSUES

U.S. TAX COMPLIANT PRODUCT

More so than most other jurisdictions, the U.S. requires that a life insurance policy include a very significant death benefit element to qualify for "tax-free" treatment. In this context, "tax-free" generally means the segregated account investment income (i.e., inside build-up) is not taxable to the policy owner during the insured's lifetime.

The rules for determining U.S. compliancy are identical for domestic and offshore products. Section 7702 contains two alternative tests by which life insurance policies can qualify for tax-free treatment:

- The two-part guideline premium/cash value corridor test.
- The cash value accumulation test.

Cash Value Terms

The U.S. tax characterization of a life insurance policy is primarily determined by reference to the policy's "cash value," as indicated by the above tests for U.S. compliancy. In general terms, a policy's cash value is the greater of the maximum amount payable on lifetime surrender of the policy (excluding surrender charges), or the maximum amount the policy owner can borrow out of the policy prior to the insured's death. Within these parameters, the definition of "cash value" in a particular policy may vary considerably from insurer to insurer and even with respect to various policies issued by the same carrier.

International private placement variable life and annuity planning has been rediscovered as a wealth management tool for the high-net-worth world citizen. These strategies incorporate legitimate and well-regulated products into more traditional international wealth management structures. Like many advanced planning strategies, however, effective counsel and risk management represents a high-wire act for the competently informed and not just a simple stroll across the parking lot.

When there is a "U.S. connection" to the planning process, unique U.S. tax implications may occur in various ways. The more apparent is the direct or indirect acquisition of these products by U.S. citizens or residents, which may raise certain additional non-tax issues.

MEC vs. Non-MEC Status

The primary factor affecting U.S. taxation of policy distributions (including loans, withdrawals, and payments on lapse or surrender) is characterization of the policy under the "modified endowment contract" (MEC) rules. As an initial threshold, the policy must be "U.S. compliant" to exempt the policy owner from annual taxation on the inside build-up within the segregated account. Once so qualified, certain policies may be characterized as a MEC based on the timing and amount of premiums paid in relation to the death benefit provided under the policy (the "seven-pay test").

EFFECT OF RECENT IRS PRONOUNCEMENTS ON PLLI ARRANGEMENTS

The Service recently issued two Revenue Rulings directed at "currently available sub-accounts" and further proposed certain changes to the critical diversification regulations that could have far-reaching implications for existing as well as future plan designs. Taxpayers would be well advised to review their current structures to ensure they were properly designed and have been appropriately monitored.