By Mike Cohn

Domestic Private Placement Life Insurance

Has its time finally come?

Private placement variable universal life insurance (PPVUL) products are available "onshore" through some of the largest insurance companies in the United States. For advisers who know PPVUL only as an offshore vehicle, it may be time to consider the planning opportunities with domestic PPVUL. Domestic PPVUL, properly designed, is complex, but can be extremely rewarding for the high-net-worth clients who seek new ideas from their advisers. Although clients can own PPVUL in their estates, those who do so don't take advantage of the many planning opportunities to enhance PPVUL's benefits.

With income and capital gains taxes likely to increase in the near future, the tax-free build up of cash values in life insurance may become an attractive option—whether for supplementing retirement income or as a wealth transfer vehicle for future generations. Most advisers don't think of life insurance as an efficient investment vehicle due to life insurance's traditionally high sales loads and policy charges, lack of transparency and inability to customize investment options. This is where PPVUL may be ideal with its low-cost structure, access to sophisticated investment strategies and managers, flexibility and transparency.

Furthermore, the experienced PPVUL broker can enhance product efficiency by minimizing death benefits and related mortality charges (subject to Internal Revenue Code Section 7702 limitations), assisting with state of issue (for state premium taxes) and by creating insurance-dedicated funds that align with a policy owner's investment objectives, without violating Internal Revenue Service rules about investor control and diversification.

The typical life insurance transaction is designed for maximum death benefits with premiums paid over multiple years or over the lifetime of the insured. Cash values in traditional products may be secondary to the goal of maximizing death benefits.

The PPVUL buyer's goal is typically to maximize the efficiency of cash value growth, with death benefits secondary. With PPVUL, large premiums (over $1 million) are usually funded over one to five years. The value of PPVUL as an investment vehicle is ideally for the most tax-inefficient assets in an investor's portfolio. Furthermore, investments in hedge funds owned inside PPVUL eliminate Schedule K-1s since there is no reportable income. PPVUL can be especially attractive for the highly liquid client who doesn't need traditional life insurance but is interested in tax-free compounding of investment earnings.

What is PPVUL?

PPVUL is a non-SEC-registered U.S. tax compliant (IRC Section 7702), flexible premium variable life insurance policy (single-life or survivorship) offered only to accredited investors (defined below). PPVUL provides the same income tax-exempt death benefits as other life insurance policies. Since 1963, the IRS and the courts have held that increases in cash values aren't taxed until a policy's surrender or maturity, and untaxed earnings can become income tax-free if paid as a death benefit.[1]

The policy owner allocates premiums, less charges and fees, to investment options inside the insurer's separate accounts.[2] Some highlights of PPVUL are:

- Investment flexibility—The PPVUL policy owner has access to non-registered investments (for example, hedge funds) and managers not available through traditional products.

- Flexible and lower charges—PPVUL charges and loads are fully disclosed and are significantly

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lower than traditional products, so cash values compound tax-free faster. Also, certain fees in PPVUL may be negotiable depending on the premium commitment.

- No surrender charges—Traditional policies generally have surrender charges that inhibit a policy owner's flexibility; there are no surrender charges with PPVUL.

- Lack of guarantees—PPVUL doesn't provide the guaranteed cash value that universal life or whole life products provide, or universal life's guaranteed minimum interest (unless the PPVUL policy owner allocates cash values to PPVUL's fixed account).[3]

The Corridor Factor

In 1984, the IRS promulgated IRC Section 7702, which established the definition of life insurance and specified the factors that determine the relationship between cash values and death benefits. This relationship is called the corridor factor and can be satisfied by either of two tests: a guideline premium test (GPT) or a cash value accumulation test (CVAT). However, to obtain the optimum PPVUL design for a client, both tests should be considered since they produce different outcomes.

PPVUL is often designed with minimum death benefits that create high early cash values. As cash values increase, the PPVUL death benefit automatically increases due to the policy's corridor factor. A GPT design typically produces higher cash values in later years, preferable if PPVUL is to be used for retirement funding.

A CVAT design pushes the corridor factor sooner than GPT, preferable when larger death benefits in later years is a primary goal—especially when the PPVUL policy is owned in an irrevocable grantor trust (IGT) and the objective is to transfer wealth to beneficiaries without income and estate tax. In fact, PPVUL that uses CVAT (and begins with a minimum death benefit) may produce a larger death benefit at normal life expectancy than a traditional level death benefit policy.

A funded IGT that meets the qualified purchaser rules discussed below may be an ideal buyer for PPVUL, since PPVUL can eliminate income taxes on that trust's investments and create opportunities to reposition the trust's investments to hedge funds or other tax-inefficient assets.

Who Can Purchase?

Prospective PPVUL buyers who wish to invest in PPVUL's unregistered securities must be "accredited investors" as defined in the Securities Act of 1933, who are also "qualified purchasers" as defined in the Investment Company Act of 1940:

- An accredited investor is a person with net worth exceeding $1 million or with annual income of at least $200,000 over the past two years.

Buyers who wish to invest in PPVUL's unregistered securities must be "accredited investors" who are "qualified purchasers" as defined by federal statutes.

- A qualified purchaser (QP) is a person with at least $5 million, or an entity with at least $20 million, in investments.

- Grantor trusts, partnerships and limited liability companies (LLCs) may meet QP requirements if the trustees and grantor, general partner, or LLC manager also meet QP standards. QP determination may be further subject to interpretation of the agent's broker-dealer.

- Irrevocable life insurance trusts (ILITs) without $5 million may qualify as a QP if a bank is trustee, or co-trustee, and makes investment decisions.

Prospective purchasers must be pre-qualified to verify that they meet the above requirements before sales presentations can be made.

Domestic PPVUL

Although PPVUL has been promoted as an offshore vehicle, the benefits of using PPVUL onshore with domestic life insurance companies may outweigh the offshore advantages. In the past, the primary advantages of going offshore were the ability to customize investment strategies, avoid state insurance premium taxes and achieve asset protection. However, offshore companies don't have financial surplus comparable to U.S. companies (even if they are a foreign subsidiary of a U.S. company). Most offshore insurance risk is reinsured, but sometimes at significantly higher mortality charges than domestic companies. In addition, regulations proposed in February 2010 would change the definitions of foreign accounts subject to Foreign Bank and Financial Accounts reporting to include offshore life insurance or annuity policies with cash values.

Domestic PPVUL policies are issued by major U.S. companies (for example, John Hancock, Prudential, Pacific Life, Sun Life, NY Life, Mass Mutual and American General) that are better capitalized than their offshore counterparts and subject to U.S. regulatory oversight. Mortality charges in domestic PPVUL may be lower than offshore products and underwriting categories (for example, for "preferred" risks) may be broader with domestic companies that can retain more of the mortality risk through internal capacity, avoiding more conservative (and expensive) reinsurance underwriting.

Policy owners who can satisfy the insurance company's requirements may be able to have policies issued in low premium tax states such as South Dakota with a state premium tax of 0.08 percent or Alaska with a state premium tax of 0.10 percent (versus Delaware's premium tax of 2.00 percent). (See "How States Compare," this page.) The properly designed PPVUL owned in a South Dakota LLC may also be an asset in a Delaware IGT, and therefore may have several layers of asset protection. In addition, PPVUL cash values are held in a segregated account of the life insurance company, so policy values aren't subject to the insurance company's creditors. And, in some states, cash values are protected from an insured's creditors.

How States Compare

Here's a sampling of premium taxes, measured in basis points (bps)

State	Tax	State	Tax	State	Tax	State	Tax
Alaska	10 bps	Florida	175 bps	Minnesota	200 bps	Ohio	140 bps
Arizona	200	Georgia	225	Nevada	350	Pennsylvania	200
California	235	Hawaii	275	New Hampshire	100	South Dakota	8
Connecticut	175	Illinois	50	New Jersey	210	Washington	200
Delaware	200	Massachusetts	200	New York	200	Wyoming	75

— 2009 CCH State Tax Handbook

An investment firm may form its own insurance-dedicated funds (IDFs), which can be added to a domestic insurance company's PPVUL platform. The investment firm must satisfy the insurance company's stringent due diligence requirements, demonstrate necessary administrative capabilities and comply with diversification requirements and investor control prohibitions. A customized IDF provides the investment firm an opportunity to better manage tax-inefficient assets for clients, for example, hedge funds, commodities, high-yield bonds and/or actively manage portfolios, without the income tax sensitivity that often influences portfolio construction.

Repatriating Offshore PPVUL Policies

For clients who want to bring their offshore policies onshore, the options outlined in IRC Section 1035 provide for tax-free exchanges of life insurance or annuities.

If offshore cash values aren't in IDFs, the domestic company may reject the 1035 exchange to avoid the "taint" of investor control from assets deemed to be "publicly available." Therefore, non-IDF assets must be disposed of before a Section 1035 exchange can occur. To accomplish this, the independent investment adviser (of the existing offshore policy) should issue a directive to the offshore company to liquidate or sell the assets in the policy (for fair market value).

Consider the state of issue for the new domestic PPVUL policy since the state premium tax will not have been previously paid and will be assessed against cash values when the new domestic PPVUL policy is issued.

Section 1035 Exchanges

Under the rules of Section 1035, a policy can be exchanged tax-free as long as the insured(s) and policy owner(s) are the same on both the surrendered and the to-be-acquired policy. Generally, a new medical exam and new underwriting will be needed. In some cases, the insurance company may transfer existing surrender charges from an older policy to PPVUL, when the Section 1035 exchange is within the same company.

Caution: An under-performing policy in a non-grantor ILIT may be a candidate for a Section 1035 exchange to PPVUL, but the non-grantor ILIT may not meet QP rules. In this case, an existing partnership, with the insured and the ILIT may be a solution (with the insured meeting the QP rules) and avoid transfer-for-value rules by meeting one of the exceptions in IRC Section 101(a)(2)(a).

MECs

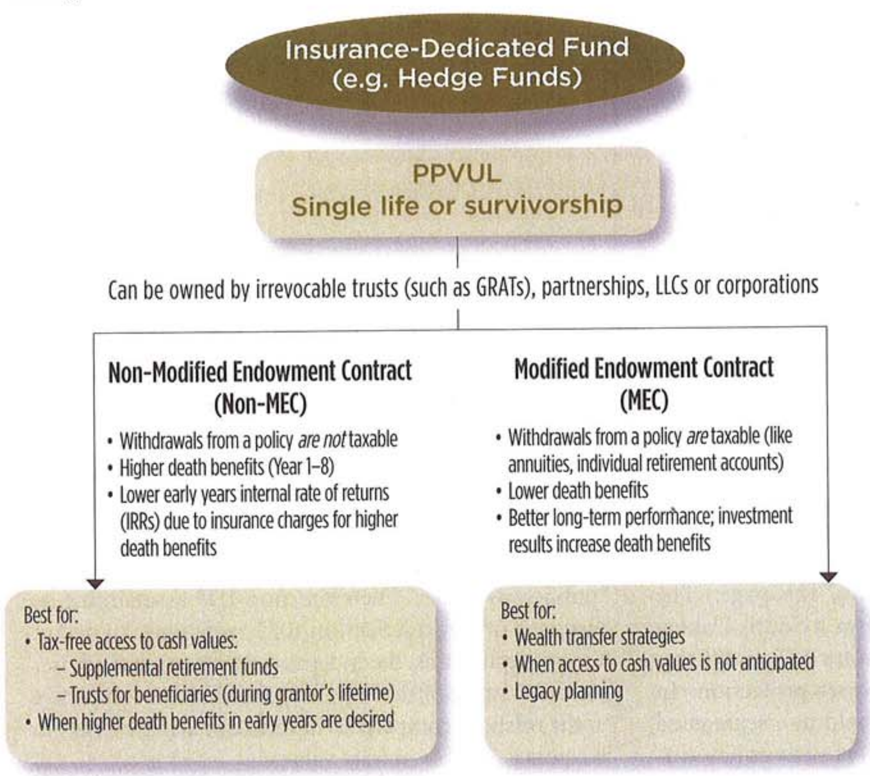
The IRS permits a life insurance policy to be designed in two ways: One permits tax-free withdrawals and the other causes withdrawals to be taxable. (See "Designing Your PPVUL," this page.) Both methods qualify under Section 7702 as life insurance policies and death benefits are not subject to income tax.

A modified endowment contract (MEC) is a policy that meets the Section 7702 definition of life insurance and is funded more rapidly than a paid-up policy based on seven statutorily defined level annual premiums. The basic difference between MECs and other life insurance contracts (non-MECs) is the federal income tax treatment of amounts withdrawn from the policy during the insured's life. Distributions from a non-MEC policy aren't subject to income tax. MEC policy distributions are subject to ordinary income tax and, when withdrawals are taken before age 59½, there's a 10 percent penalty, generally the same as annuities, IRAs and 401(k)s. The tax-free build up of cash values within an MEC and non-MEC and the tax treatment of death benefits are the same.

However, an MEC can be designed with lower initial death benefits under Section 7702, so investment earnings are more efficiently re-invested to increase cash values instead of used to

Designing Your PPVUL

There's two ways to go but the goal is the same—maximize the efficiency of cash value growth



— *CFG Business Solutions, LLC*

support higher mortality costs (that is, lower death benefits equal lower mortality charges). As cash values increase, the death benefits in an MEC increase to comply with IRS corridor rules. MECs are best used when withdrawals aren't anticipated (for example, owned in an IGT as a wealth transfer vehicle).

A non-MEC requires higher death benefits for the first seven years and will be the preferred choice when withdrawals are anticipated or greater flexibility is desired. Tax-free withdrawals from a non-MEC typically take two forms: the basis is generally withdrawn first, then tax-free policy loans. A non-MEC will have lower early investment rates of return since earnings are used to fund mortality charges on the larger (than MEC) death benefits. The death benefits in a non-MEC can be reduced after the seventh year, without costs or penalties.

Using younger adult children as insureds can enhance returns: Their health may be superior to senior generation parents.

For example, when a non-MEC PPVUL is owned in an IGT, the trustee can withdraw cash values tax-free to provide income or support, during lifetime, for the trust's beneficiaries—ideal when parents want to assist adult children (or grandchildren) who are beneficiaries of the trust, and also want the trustee to invest in hedge funds and other tax-inefficient vehicles for higher returns.

PPVUL Policy Charges

PPVUL is not a "cheaper" form of life insurance. The mortality charges in PPVUL will be comparable to the issuing company's mortality charges for its other products. If the death benefit is minimized, the mortality charges will be lower, but only because the company's at-risk portion (that is, the amount in excess of cash value) is lower. PPVUL's low sales charges permit most of the premium to be allocated to cash values. PPVUL's charges are (1) premium-based, and (2) asset-based (cash value), similar to variable life. Typically the combined total of premium and asset-based charges will be approximately 1.0 percent to 1.5 percent (to earnings) in years one to 10, then 1 percent or less thereafter. A PPVUL illustration fully discloses all policy charges.

Premium-based charges include a federal deferred acquisition charge tax of 1.25 percent, state-specific premium tax and a placement fee, typically 1 percent to 2 percent, or separately negotiated. Some companies permit these charges to be amortized over 10 years and charged to investment earnings (for example, 20-30 basis points annually), instead of charged against the initial investment.

Asset-based charges are (1) mortality and expense risk charges, used to cover insurance company expenses, costs for any embedded guarantees and profit, expressed as a basis point charge against cash values, and (2) cost of insurance charges, for the life insurance feature which are age, gender and health specific.

Use in Family Offices

PPVUL can be ideal for family offices. Allocating the family's tax inefficient assets to PPVUL can improve after-tax results on the family's total portfolio. PPVUL charges are generally about one-half (or less) of the income tax drag on tax-inefficient investments. Therefore the family office can often realize an additional 150 to 300 basis points annually on an after-tax, after charges, basis with well-constructed PPVUL products. For example, $2 million invested in a PPVUL hedge fund can have a 6.06 percent internal rate of return (IRR) (assuming a 7 percent return net of management fees) in year five when both insureds are age 59. That same $2 million, invested in a taxable hedge fund (with the same net rate of return) will have an IRR of only 4.04 percent at current tax rates (3.30 percent if ordinary income tax rates increase to 45 percent and capital gains to 25 percent). So by allocating the assets to PPVUL, the family realizes an increase of approximately 275 basis points (one percentage point equals 100 basis points). (See "How Survivorship PPVUL Can Improve Returns," this page.)

Using younger adult children as insureds can enhance returns. Their health (and therefore medical underwriting) may be superior to senior generation parents. The lower cost of insurance charges on younger insureds will be attractive, although minimum death benefits required under Section 7702 will be higher at younger ages. Financial underwriting will also be a factor when attempting to use next generation insured's for PPVUL.

Family offices may want to collaborate with an independent investment firm to create an IDF adhering to the IRS' rules of the road[4] for diversification and avoiding investor control, as outlined below. The investment firm must also meet the insurance company's requirements for inclusion on that company's PPVUL platform.

(1) **Diversification (IRC Section 817(h)).** In general, each asset account in a variable life policy must contain at least five investments with no one investment representing more than 55 percent of the account's value. No two investments can constitute more than 70 percent of total assets, no three investments can constitute more than 80 percent, and no four investments can constitute more than 90 percent. The "look-through" rules of Section 817 are complex; regulations finalized in 2003 gave look-through treatment to a hedge fund if it's organized as an IDF.

How Survivorship PPVUL Can Improve Returns

The internal rate of return on a $2 million MEC PPVUL invested in a hedge fund insurance fund is greater than the internal rate of return on a $2 million investment in a taxable hedge fund portfolio

MEC PPVUL: HEDGE FUND INSURANCE FUND*						NON-INSURANCE TAXABLE FUND OF HEDGE FUNDS* (Current tax rates[5])				NON-INSURANCE TAXABLE FUND OF HEDGE FUNDS* (Higher tax rates[6])			
Year/ Age[1]	Earnings[2] (EOY) 7.00%**	Insurance Charges	Surrender Value	IRR[3]	Death Benefit	Earnings[2] (EOY) 7.00%**	Tax on Earnings (includes tax on investment fee)	Account Value[4]	IRR[3]	Earnings[2] (EOY) 7.00%**	Tax on Earnings (includes tax on investment fee)	Account Value[4]	IRR[3]
1/55	$139,393	($16,306)	$2,123,086	6.15%	$7,249,913	$140,000	($59,200)	$2,080,800	4.04%	$140,000	($74,000)	$2,066,000	3.30%
5/59	176,332	(23,875)	2,684,197	6.06	7,846,175	164,032	(69,362)	2,437,989	4.04	159,415	(84,262)	2,352,511	3.30
10/64	236,169	(30,877)	3,595,553	6.04	8,703,755	199,954	(84,552)	2,971,895	4.04	187,513	(99,114)	2,767,153	3.30
20/74	437,458	(39,663)	6,668,242	6.21	11,468,710	297,122	(125,640)	4,416,079	4.04	259,438	(137,132)	3,828,569	3.30
30/84	818,161	(73,695)	12,471,604	6.29	16,528,617	441,507	(186,695)	6,562,062	4.04	358,953	(189,732)	5,297,118	3.30

Notes:
* 7% investment return net of management fees
** Net of investment fee

1. Both insureds are this age
2. Insurance charges are deducted monthly, reflected in end-of-year (EOY) earnings
3. Internal rate of return (IRR) is a measurement of the hypothetical rate of return on premiums/investment vs. account values
4. Excludes the cost of survivorship term insurance—approximately $8,975 for years 1–5 required to equal PPVUL's death benefit in years 1–5
5. 85% ordinary income at 40% rate; 15% capital gains at 20% rate
6. 85% ordinary income at 45% rate; 15 % capital gains at 25% rate

— *CFG Business Solutions, LLC*

For example, a fund-of-funds organized as an IDF can realize diversification under Section 817(h) if it invests in at least five underlying hedge funds.

(2) **Prohibitions against investor control.** Other than the policy owner's right to allocate premiums and transfer funds among available investment options, all investment decisions must be made by the investment adviser (hired by the insurance company) in its sole and absolute discretion. The policy owner can choose investment managers from PPVUL account options, but can't control investment selections. Specifically, there can be no arrangement, plan or agreement between the policy owner and investment adviser regarding specific assets to be held in the policy. The policy owner can choose among available strategies (for example, balanced, growth, etc.) but can't influence the execution. The policy owner can't select or recommend particular investments. The policy owner can't communicate directly or indirectly with the investment adviser regarding selection, quantity or rate of return of any investment or group of investments held in the policy, and the policy owner has no legal interest in any of the assets—all assets are owned by the insurance carrier in segregated accounts.

(3) **Investments not publicly available.** The assets in the IDF can be available only through the purchase of an insurance or annuity contract. The IDFs may be clones of strategies (for example, actively managed) or funds (for example, hedge funds or commodity funds), which the adviser offers its non-insurance clients. IDFs are pooled accounts and may be available to other PPVUL policyholders although the investment adviser can restrict investors to their IDF. Each IDF is a specific strategy and there are typically multiple investors in each IDF.

Some families have considered (or are using) PPVUL with an "allocator" or managed separate account structure—an independent adviser who manages investments, in lieu of the more cumbersome process of creating and maintaining an IDF. With an allocator model, the insurance company creates one account per family, and although assets aren't commingled with other families or funds, it isn't an IDF. Previously considered a "gray area," it is no longer. In a June 2008, Notification of Withdrawn Letter Ruling Request,[5] the IRS clearly stated that the policy owner (not the insurance company) was deemed to be in control of the investments since "the segregated asset account directly invests in assets available to the general public."

The Administration's Fiscal Year 2010 Revenue Proposals (Obama's "Green Book") further targets these accounts by requiring life insurance companies to report to the IRS information about "private separate accounts." This is any account for which a single person (or related group of persons) owns policies with cash value of at least 10 percent of the account's value. The purpose is to permit the IRS to identify variable contracts that should be disregarded as insurance contracts under the investor control doctrine. Knowledgeable industry insiders have commented that the allocator, or managed separate account, structure is no longer viable, evidenced by the fact that most of the insurance companies that offered this have discontinued doing so.

Options

The insured will normally be the policy owner if he wants flexibility to access cash values in the policy. This arrangement isn't consistent with traditional estate planning for life insurance. To avoid inclusion of the insurance proceeds in the insured's estate for estate tax purposes, the insured is generally not the policy owner and doesn't have incidents of ownership under IRC Section 2042.

Private split-dollar, governed by IRC Section 7872, may be an option for financing PPVUL, when the owner will be an IGT. The funder's interest in a non-equity split-dollar arrangement will be the higher of cash values or premiums paid. Therefore, with PPVUL and an investment strategy designed for growth, cash values will generally be in excess of premiums by the end of year one. Split-dollar therefore removes the "excess" death benefits from the insured's estate, if ownership of the policy is an IGT. When PPVUL is a survivorship policy, the economic benefit is measured by extremely low survivorship rates, derived from Table 2001 single life rates. Private split-dollar with survivorship PPVUL is worth considering while both insureds are living—with an option to convert to a potentially lower cost applicable federal rates (AFR) loan after the death of the first insured.

Loans with interest at AFR, paid or accrued, generally aren't governed by Section 7872 and should also be considered as a financing option. The insured (or lender) will have no interest in the PPVUL's cash values in excess of the loan, plus accrued interest. This limits the amount includible in the insured/lender's estate under IRC Section 2033, to the amount of the note (premiums advanced plus interest accrued). There will be no income tax consequence from the loan if the trust is a grantor trust under the income tax non-recognition rules.[6] The loan is generally unsecured, and the policy not assigned as collateral which avoids incidents of ownership under IRC Section 2042(2).[7] The principal amount of the note, if not repaid during lifetime, can be repaid from the PPVUL's death benefit.

With all financing arrangements, an exit strategy should be designed at the outset to repay the loan or terminate the split-dollar agreement. If the PPVUL is a non-MEC, funds can be withdrawn tax-free from the policy to repay principal and accrued interest. This isn't ideal since the withdrawal of funds from the PPVUL policy reduces the policy's death benefit and reduces the amount of PPVUL proceeds passing income and estate tax free to the trust. A PPVUL structured as an MEC may create the best scenario if the loan or split-dollar arrangement will not be repaid until death of the insured. TE

Endnotes

1. *See Theodore H. Cohen*, 39 T.C. 1055 (1963), *acq.* 1964-1 C.B. 4; *Abram Nesbitt, II*, 43 T.C. 629 (1965). Also, Internal Revenue Code Section 7702(g) enacted in 1984, confirmed that death benefits, as defined in IRC Section 7702, generally are not taxable to a beneficiary under IRC Section 101(a)(1).
2. For the basics of private placement variable universal life insurance (PPVUL), *see* Charles L. Ratner, "PPLI Primer," *Trusts & Estates*, September 2005 at p. 32.
3. PPVUL products may have a "fixed" account option with guarantees similar to universal life, but the PPVUL buyer is generally seeking different investment options than fixed accounts.
4. *Christoffersen v. U.S.*, 84-2 USTC 9990 (8th Cir 1984); Revenue Rulings 2003-91, 2003-92 (which amplified and clarified previous rulings first articulated in Private Letter Ruling 200244001); *see also* PLRs 8427085, 9433030, 200420017
5. Internal Legal Memorandum 200840043 (June 10, 2008).
6. Rev. Rul. 85-13, 1985-1, C.B. 184.
7. *See also* PLR 9809032 that held that an insured's loans to a trust to pay premiums did not, in and of themselves, create an incident of ownership.