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Sophisticated planning for high net-worth United States citizens often includes the use of offshore variable life insurance. Such leading edge planning is accomplished through structures that provide income, gift, estate and generation-skipping transfer tax planning not available domestically. In addition to providing sophisticated tax and estate planning benefits, variable life insurance policies issued by foreign-based carriers have numerous economic advantages.

Advantages of Offshore Life Insurance

Many insurance carriers operating outside the United States have lower overhead costs when compared to their U.S. counterparts. U.S. carriers, in general, have larger distribution systems and commissioned agents. Moreover, they are subject to greater, and more costly, governmental regulation.[1] The result is that many foreign carriers are able to offer lower

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[1] U. S. insurance carriers are required to qualify to do business in, and comply with the State Department of Insurance rules for, each state in which insurance is sold to a resident of that state. U. S. insurance carriers have departments devoted to complying with the varying State Department of Insurance rules for each state in which insurance is sold to a resident.

premium charges while maintaining lower internal operating costs.

In addition, larger face amount policies are available from foreign carriers. In fact, the foreign marketplace is often used for underwriting very large policies on U.S. lives - this result is primarily due to the fact that the world's largest reinsurers are located outside the U.S. Moreover, while U.S. carriers require their policy investments to be held in U.S. dollars, foreign carriers frequently offer premium payments, withdrawals, borrowed funds, and death benefits in a number of currencies.

Foreign carriers also provide greater flexibility. For instance, foreign carriers offer investment managers across the world the opportunity to consider various insurance vehicles with respect to the location and type of policy, as well as the compensation arrangements.

Establishing offshore life insurance policies with foreign carriers also may have significant tax advantages. For instance, while U.S. carriers are subject to entity-level taxation (federal, state or local), carriers from low-tax or no-tax jurisdictions are not subject to such high taxation. In addition, while U.S. carriers are subject to the deferred acquisition cost tax,[2] foreign carriers are not. Nevertheless, establishing offshore life insurance policies may subject U.S. policyholders to other domestic tax burdens. For example, U.S. persons may be subject to state premium taxes.[3] Such taxes can be avoided, however, through the sale of offshore life insurance to a non-U.S. person (e.g., a trustee of an offshore trust).

Also, many regulatory rules in jurisdictions outside the U.S. require policies to be held in strict confidence. Exceptions may apply, however, with respect to disclosure of tax information, as may be required under certain tax treaties between a foreign jurisdiction and the U.S.[4]

Some foreign jurisdictions also have abolished or extended the Rule Against Perpetuities,[5] thereby allowing a trust to continue offshore for a

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[2] *See* I.R.C. § 848 (1999).

[3] *See, e.g.*, FLA. STAT. ch. 624.509 (1999), which assesses "an amount equal to 1.75% of the gross amount of such receipts on account of life and health insurance policies covering persons resident in this state . . ."

[4] U. S. tax treaties include a provision entitled "Exchange of Information" and the U. S. has Tax Information Exchange Agreements with other jurisdictions that provide law enforcement agencies with the mechanism to enforce investigations of criminal activity such as drug trafficking and money laundering (which includes tax fraud and tax evasion). In addition, another avenue for the exchange of information is the Convention on Mutual Administrative Assistance in Tax Matters, developed by the Counsel of Europe and the Organization for Economic Cooperation & Development, referred to as the Multilateral Mutual Assistance Convention.

[5] Generally, the common law Rule Against Perpetuities holds that interest must vest not later than twenty-one years after a life in being at the creation of the interest. *See* GRAY, RULE AGAINST PERPETUITIES 191 (4th ed. 1942).

longer period of time after the death of the insured. Such relaxed perpetuity laws enable a trust to provide continued asset protection benefits, investment diversification, and other benefits for the trust and its beneficiaries. On a related note, it is important to keep in mind that a life insurance policy is a contract and, in general, contracting parties may designate a governing law, the law under which the policy will be interpreted. Many jurisdictions, however, encourage more than a simple designation of governing law. For instance, if the application, signing, or delivery of the policy or payments of the first premium are conducted in the chosen jurisdiction, many jurisdictions will look more favorably upon, and thus honor, the designation. Therefore, it may be in the insured's best interests to establish greater "contacts" with the desired jurisdiction when making such a designation.

When considering investment possibilities, offshore life insurance policies additionally provide the insured with greater investment options. Subject to meeting the diversification requirements and wrap rules - both discussed below - the types of investments that can be held in the policy's separate, segregated account[6] are unlimited. Although a policyowner is prohibited from exercising control over the selection of the securities of such separate, segregated account,[7] a specialized investment manager (or managers) is available through the foreign carriers to assist the policyholder in making investment decisions. In the U.S., domestic insurance companies only offer investment options, without providing the policyholder with any comparable investment advice. As an additional benefit, the purchase of securities by the insurance company in the separate, segregated account is not subject to the registration requirements under the Securities Act of 1933 ("1933 Act") if the necessary requirements are met.[8]

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[6] Foreign insurance carriers may form separate, segregated accounts which are used to fund individual insurance policies. In some jurisdictions, insurance companies establish these accounts only to satisfy their obligations to the owner of the policy. Within these jurisdictions, legislation provides that assets in the separate, segregated account of the policy are not subject to the claims of creditors or claims against other policyowners of the insurance company.

[7] *See generally* Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984); Rev. Rul. 77-85, 1977-1 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 81-225, 1981-1 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11; Priv. Ltr. Rul. 94-33-030 (August 19, 1994).

[8] *See* Securities Act of 1933 § 5, 15 U.S.C. § 77e (1997) (setting forth prohibitions relating to interstate commerce and the mails with respect to securities sold without registration). Section 77(3) requires all securities for sale, as well as any prospectus related thereto, to be registered with the United States Securities and Exchange Commission. Exceptions to this registration requirement exist, however. The relevant exceptions relating to insurance policy investments are discussed below.

Avoiding U.S. Securities Laws for Offshore Funds

Variable life insurance policies issued by foreign insurance carriers may be issued as a security in accordance with Regulation D ("Reg D") of the 1933 Act as a "private placement."[9] With few exceptions,[10] Reg D requires an individual policyowner to be an "accredited investor," or rather one who has a "net worth" in excess of $1 million.[11]

Regardless of whether Reg D is followed, a variable life insurance policy is classified as a "security" and therefore must comply with U.S. securities laws.[12] In accordance with Reg D, securities offered and sold outside the U. S. are not required to be registered under the 1933 Act, and Reg S may be relied upon for such offers and sales, even if coincident offers and sales are made in accordance with Reg D inside the U. S.[13] As a result, many foreign insurance carriers will not issue policies directly to U.S. individuals in an effort to avoid the reporting requirements of the U.S. securities laws, as well as the Reg D exemption. These foreign insurance

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[9] 17 C.F.R. §§ 230.501-230.508 (1999). Generally, the substantive provisions of Regulation D may be found therein at §§ 230.504, 230.505, and 230.506.

[10] Certain provisions, most notably Rule 505 and 506, allow a restricted number of persons to take part in such a "private placement" without qualifying as an "accredited investor." *See* 17 C.F.R. § 230.505, 230.506 (1999). Rule 504, on the other hand, allows for an unlimited number of persons to take part without first qualifying; however, Rule 504 is limited to an offering of $1,000,000 or less, a restrictive provision in itself. *See* 17 C.F.R. § 230.504 (1999).

[11] *See* 17 C.F.R. § 230.501(a) (1999). With respect to natural persons, the provision requires that a person have a net worth or joint net worth with that person's spouse of $1,000,000 at the time of the purchase. The provision also allows an individual to qualify as an "accredited investor" if the individual has had an income in excess of $200,000 in each of the two of the most recent years, or joint income with the individual's spouse of $300,000 in each of those years. The individual must also have a reasonable expectation of reaching the same income level in the present year. Furthermore, Regulation D places restrictions on the number of non-"accredited investors" allowed to participate, thus further limiting the scope of the offering.

[12] *See* Securities Act of 1933 § 2(a), 15 U.S.C. § 77(b) (1997) (defining the term "security").

[13] Regulation D–Preliminary Notes to Rules 501-508. Note 7 of Reg D–Preliminary Notes, which is added by SEC Release No. 33-6863 provides the following: "Securities offered and sold outside the United States in accordance with Regulation S need not be registered under the Act. See Release No. 33-6863. Regulation S may be relied upon for such offers and sales even if coincident offers and sales are made in accordance with Regulation D inside the United States. Thus, for example, person who are offered and sold securities in accordance with Regulation S would not be counted in the calculation of the number of purchasers under Regulation D. Similarly, proceeds from such sales would not be included in the aggregate offering price. The provisions of this note, however, do not apply if the issuer elects to rely solely on Regulation D for offers or sales to persons made outside the United States."

carriers rely on the Regulation S ("Reg S") exemption, rather than the "private placement" exemption under Reg D.[14]

In fact, most offshore funds conclude that "offers" and "sales"of shares of their funds are not subject to the registration requirements under the 1933 Act, and thus rely on Reg S. Their conclusions are based upon the fact that the registration requirements under section 5[15] of the 1933 Act do not apply to "offers" and "sales" of securities occurring outside the U.S.[16]

Principal Requirements for Reliance on Reg S and Avoiding Registration Requirements Under the 1933 Act.[17]

In general, two requirements are necessary to avoid registration under the 1933 Act in relying on the Reg S exemption: (i) offers of the offshore fund shares are made only to persons located outside the U.S., and buy-orders are accepted only from persons located outside the U.S.; and (ii) no activities are undertaken that have the purpose of, or that can reasonably be expected to have the result of, "conditioning" the market in the U.S. for the purchase the offshore fund shares.[18] If selling efforts "condition" the U.S. market to purchase offshore fund shares, such efforts are deemed to be "directed selling efforts" which requires registration under the 1933 Act.[19]

Under Reg S, any trust, of which the trustee is a U.S. person, is classified as a U.S. person. If the trustee is a professional fiduciary, however, a trust that includes a U.S. person as a co-trustee is not deemed to be a U.S. person where the other co-trustee is not a U.S. person and no beneficiary of the trust is a U.S. person. From this definition, it is recommended that a foreign irrevocable life insurance trust should include no U.S. person as a co-trustee. By including only a foreign trustee, the trust

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[14] *See* 17 C.F.R. §§ 230.901-230.905 (1999).

[15] Securities Act of 1933 § 5, 15 U.S.C. § 77(3) (1997) (requiring the filing of a registration statement if the offering falls under the provisions of the Act).

[16] Rule 901 of Reg. S, 17 C.F.R. § 230.901 (1999), specifically provides that, for purposes of Section 5 of the 1933 Act, the terms "offer", "offer to sell", "sell", "sale" and "offer to buy" are deemed not to include offers and sales which occur outside the U. S. The remaining provisions of Reg S describe safe harbors for offers and sales that are deemed to have occurred outside the U. S. If the jurisdictional requirements of the securities acts are met, there is no safe harbor, however, provided from the antifraud provisions or certain other aspects of federal securities laws.

[17] *See* John A. Sellers, "Regulation of Offshore Offers and Sales of Securities," *Offshore Finance U.S.A.*, March/April 1999, at 32.

[18] *See* 17 C.F.R. § 230.903(a) (1999). This provision requires that the offer or sale be made in an "offshore transaction," which is defined, among other things, as an offer not made to a person in the U.S. *See* 17 C.F.R. § 230.903(h) (1999).

[19] *See* 17 C.F.R. § 230.902(c) (1999).

is not classified as a U.S. person under Reg S. As a result, foreign funds can be sold to the trustee of that trust as a non-U. S. person in compliance with Reg S. Additionally, if the offshore life insurance carrier complies with Reg S, it generally is not subject to the state department of insurance rules of the state where the U.S. person (insured) resides.[20]

Tax Advantages of a Variable Life insurance Policy[21]

Investment income or gains under the separate, segregated account of a variable life policy are not taxed to the policyowner.[22] Moreover, some jurisdictions do not tax the insurance company or the separate, segregated account of the policy. However, U.S. or other foreign withholding taxes may be imposed on income earned in taxable jurisdictions from investments made by the insurance company with respect to assets held in the separate, segregated account.[23] In addition, a policy that complies with the rules for treatment as a non-Modified Endowment Contract permits borrowing without adverse income taxes.[24]

Requirements for Classification as a Variable Life Insurance Policy[25]

The Internal Revenue Code provides three distinct tax advantages to a qualifying life insurance policy: (i) the "inside build-up" that consists of the compounded investment gains of the reserves supporting the policy is not

[20] U. S. insurance carriers are required to qualify to do business in, and comply with the State Department of Insurance rules for, each state in which insurance is sold to a resident of that state. An offshore life insurance policy is issued by a foreign carrier to the trustee of a foreign trust as the applicant, owner and beneficiary. In such case, although the U. S. person is resident in a state in the U. S., the insurance is sold to a non-U. S. person (the foreign trustee) on behalf of an offshore trust.

[21] These advantages are mentioned aside from certain Code provisions that state that life insurance proceeds generally pass free of income tax at death, see I.R.C. § 101(a), and are excluded from estate taxation at the death of the insured, see I.R.C. § 101(a)(1).

[22] *See* I.R.C. §§ 72, 7702.

[23] I.R.C. §§ 871(a)(1) and 881 impose a flat 30% tax on certain types of U. S.-source income realized by a nonresident alien individual or a foreign corporation if the income is not effectively connected with the conduct of a U. S. trade or business. Several of these types of income fall within the category known as "fixed or determinable annual or periodical gains, profits and income."

[24] *See* I.R.C. §§ 72(e)(5)(A)(i), 7702A.

[25] *See generally* Alan R. Eber, "Creative Use of Foreign Entities for Asset Protection and Tax Planning: Part II," *Asset Protection Journal*, Summer 1999 (vol. 1, issue 2), at 1; James A. Walker, "Offshore Life Assurance and the Individual Taxpayer," Remarks at the International Tax Planning Association Conference (Nov. 9, 1998).

currently taxable to the policyowner;[26] (ii) upon the death of the insured, the proceeds paid as a death benefit to a designated beneficiary are exempt from federal income tax;[27] and (iii) if the insured retained no impermissible powers ("incidents of ownership"), the proceeds are not includable in the estate of the insured for federal estate tax purposes.[28] In general, Internal Revenue Code ("I.R.C.") section 7702 provides that the death benefit under a variable life insurance policy satisfies certain rules requiring that the insurance protection meet certain minimum requirements at the inception of the policy and during the years thereafter.[29] These minimum requirements are discussed below.

I.R.C. section 7702(a) provides that, for purposes of state law, the policy must be classified as life insurance and meet one of the following: (i) the cash value accumulation test under I.R.C. section 7702(b); or (ii) the guideline premium test of I.R.C. section 7702(c) and the cash value corridor test of I.R.C. section 7702(d).[30] The guideline premium test is met for a variable life policy if the sum of the premiums paid does not at any time exceed the "guideline premium limitation," which is defined as the greater of the "guideline single premium" or the sum of the "guideline level premiums" paid to date for the policy.[31] The "guideline single premium" is further defined as the premium at issue for the death and endowment benefits under the policy such premium is generally determined at the time of issuance.[32] The "guideline level premium" is defined as the level amount payable over a period not ending before the insured attains age ninety-five (95).[33] Furthermore, for a variable life policy, as defined under I.R.C. § 817, the applicable tests are made when the death benefits under the policy change; however, such determination must occur not less than once during each twelve-month period.[34]

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[26] I.R.C. §§ 7702 and 72.
[27] I.R.C. § 101(a)(1).
[28] I.R.C. § 2042.
[29] *See* I.R.C. § 7702 (1999).
[30] Although both terms are defined, the guideline premium test and the cash value corridor tests are complex and require the use of an insurance actuary.
[31] *See* I.R.C. § 7702(c)(2) (1999).
[32] *See* I.R.C. § 7702(c)(3) (1999). The guideline single premium computation must take into account: (i) the mortality charges stated in the policy or used in determining the statutory reserves for the policy, if not stated in the policy; (ii) any other charges stated in the policy, either for expenses or for supplemental benefits and (iii) interest at the greater of a 6% annual effective rate or the minimum rates guaranteed on the issuance of the policy must also be taken into account. *See* I.R.C. § 7702(c)(3)(B) (1999).
[33] *See* I.R.C. § 7702(c)(4) (1999).
[34] *See* I.R.C. § 7702(f)(9) (1999).

The variable life policy meets the cash value corridor test if the death benefit under the policy is a specified percentage of the cash surrender value.[35] The specified percentage is set forth in a table under I.R.C. section 7702(d)(2). The death benefit is the amount payable by reason of the death of the insured. It is determined without regard to any qualified additional benefits.[36]

The variable insurance policies issued by offshore carriers are generally designed to satisfy the guideline premium test and the cash value corridor test - one of the tests referred to above. This minimizes reinsurance charges and maximizes the net growth of the segregated accounts. If excessive amounts of cash value are built up relative to the life insurance risk, the cash value corridor test disqualifies the variable life insurance policy as insurance.

Furthermore, the underlying separate, segregated account of a variable life insurance policy must be diversified in order to qualify as a life insurance policy. A variable life insurance policy is treated as life insurance for U.S. income tax purposes if it is based on a segregated asset account.[37] Thus, the segregated account is divided into separate, segregated accounts or investment accounts. At the end of the first policy year and on the last day of each quarter of each calendar year thereafter, no more than 55% of the value of a separate, segregated account may be placed in any one investment; no more than 70% of the value of a separate, segregated account can be placed in any two investments; no more than 80% of the value of a separate, segregated account can be placed in any three investments; and no more than 90% of the value of a separate, segregated account can be placed in any four investments.[38]

Separate, segregated accounts can be invested in shares of one fund; however, if such an investment is treated as one separate investment under I.R.C. section 817, the diversification requirement is not met. Under the "look-through" rules, a fund can be managed so that it qualifies under the diversification requirements. To qualify under the look-through rules, a fund may need to qualify as a partnership and be owned by one or more

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[35] *See* I.R.C. § 7702(d) (1999).

[36] *See* I.R.C. § 7702(f)(3) (1999). Qualified additional benefits include guaranteed insurability, accidental death or disability benefit, family term coverage, disability waiver of benefit, or other benefits prescribed by regulations. See I.R.C. § 7702(f)(5) (1999). "Policy loans are not qualified additional benefits." Priv. Ltr. Rul. 97-14-029 (April 4, 1997).

[37] *See* I.R.C. § 817(h)(1) (1999).

[38] *See* Treas. Reg. §§ 1.817-5(b)(1), -5(c)(1) (1999). A single investment includes all securities of the same issuer, all interest in the same real property project, and all interest in the same commodity. *See* Treas. Reg. § 1.817-5(b)(1)(ii)(A) (1999).

segregated asset accounts of one or more insurance companies. The fund may not be one that is registered under any federal or state law regulating the offering or sale of securities.[39]

A Modified Endowment Contract

The income tax consequences of lifetime distributions, such as loans or withdrawals, from a life insurance policy is determined by whether the premium payments under the policy are structured to avoid the Modified Endowment Contract rules of I.R.C. section 7702A. A Modified Endowment Contract ("MEC") is any contract that meets the requirements of a life insurance contract and fails to meet the seven-pay test.[40] A single-premium contract is classified as a MEC since it is not paid with seven level premiums. Distributions from a MEC prior to death are subject to tax on the amount exceeding the investment in the policy.[41] In addition, such a distribution from a MEC results in a 10% penalty tax, unless the distribution is either made after the insured becomes disabled or attains age 591/2 or the distribution is a part of a series of substantially equal periodic payments based on the life expectancy of the distributee.[42]

Non-Modified Endowment Contract

Generally, the seven-pay test[43] requires premiums to be paid into the policy over a period of seven years in order to avoid MEC status and its adverse consequences. If a policy is a non-MEC, policy loans and withdrawals are generally tax-free to the extent of the policyowner's basis in the policy.[44]

Required Control of Insurance Company Over the Management of the Policy Assets

Individuals who acquire variable life insurance policies are generally more interested in the investment returns by the policy than the face value. These individuals are looking for the investment options and

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[39] *See* Treas. Reg. § 1.817-5(f) (1999). This provision permits the investments in hedge funds to qualify under the diversification of investment rules.
[40] *See* I.R.C. § 7702(g)(1)(C) (1999); Rev. Rul. 91-17, 1991-1C.B.190.
[41] *See* I.R.C. § 72(e)(2), (e)(10) (1999).
[42] *See* I.R.C. § 72(v) (1999).
[43] I.R.C. § 7702A(b).
[44] I.R.C. § 72(e)(5)(A)(i).

potential earnings of the variable life policy and want to "wrap around" the investments, without incurring income taxes, under a variable life insurance policy. The name "wrap around" comes from the fact that other investment assets such as stocks, bonds or mutual funds are wrapped into a variable life policy in the hope that earnings from such investments are not taxable to the policyowner as they might be had the policyowner purchased these assets directly.[45]

If the policyowner is treated as the owner of the separate, segregated account under a variable life insurance policy, income and gains from the separate, segregated account are taxable to the policyowner.[46] The policyowner is treated as the owner for tax purposes where the policyowner can select and control one or more investments in a separate, segregated account portfolio of investments of the life insurance carrier issuing the policy.[47] When ruling on such matters, the Internal Revenue Service determines whether the policyowner exerts actual command over the investments in the separate, segregated account.[48]

The insurance company is required to be the beneficial owner of the investments held in the separate, segregated accounts of the insured. If the policyowner may direct the investment of the funds placed in the separate, segregated accounts, the policyowner has surrendered few rights of ownership or control over the assets, thereby rendering the insurance company incapable of becoming the beneficial owner.[49] If funds are unique to the insurance company and available only through the purchase of its insurance product, are not available to the public, then the insurance company is considered the beneficial owner.[50] The Internal Revenue Service states that the insurance company is the owner of the funds, not the policyowner, where: (i) the insurance company funds annuity contracts through a variable annuity fund; (ii) the assets of the fund are invested in

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[45] *See* Christoffersen v. United States, 749 F.2d 513, 515 (8th Cir. 1984).

[46] *See* sources cited *supra* note 7.

[47] *See* Rev. Rul. 77-85, 1977-1 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27.

[48] A 1994 Private Letter Ruling by the Internal Revenue Service states: "We cannot too often reiterate that 'taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed - the actual benefit for which the tax is paid.' . . . And it makes no difference that such 'command' may be exercised through specific retention of legal title or the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency." Priv. Ltr. Rul. 94-33-030 (Aug. 19, 1994) (citations omitted).

[49] *See* Christoffersen, 749 F.2d at 515-516 (holding that where taxpayers maintained right to withdraw upon seven days' notice and right to choose another investment fund, taxpayers remained beneficial owners of the funds despite the fact that the fund company retained funds in its name).

[50] *See* Rev. Rul. 81-225, 1981-1 C.B. 12.

several mutual funds that are not available to the public; (iii) the policyowner is allowed to direct his payments for the annuity among the several funds; and (iv) control over the individual investment decisions is not in the hands of the policyowner.[51]

Moreover, an independent investment advisor may be appointed by the insurance company to manage the assets in the separate, segregated accounts of a variable life insurance policy. The policyowner is not allowed to appoint or control the advisor, however.[52]

Excise Tax

Absent a treaty, an excise tax of 1% is due on each premium payment made to a foreign life insurance company[53] for a policy of life insurance issued to a citizen or resident of the U.S. as the insured.[54] Each U.S. policyowner is required to deposit the excise tax in a timely manner with an authorized depository bank and file Internal Revenue Service Form 720 (Quarterly Federal Excise Tax Return), reporting each such payment.[55] This excise tax is payable by "any person who makes, signs, issues or sells any of the documents and instruments subject to the tax, or for whose use or benefit the same are made, signed, issued or sold."[56] The tax is payable by "the person who makes the payment of the premium to a foreign insurer . . . ."[57] This excise tax may be paid by the foreign insurance carrier on behalf of the policyowner, without disclosing the identity of the policyowner, which permits client confidentiality.

An excise tax of 1% is due on each premium paid on a policy of reinsurance to a foreign insurance company for a policy of life insurance issued to a citizen or resident of the U. S. as the insured,[58] absent a tax treaty. If a foreign insurer, or reinsurer, reinsures a U. S. risk with an additional foreign insurer, a second excise tax may be imposed, causing multiple excise taxes.[59]

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[51] *See* Rev. Rul. 82-54, 1982-1 C.B. 11.
[52] *See* I.R.C. § 817(h)(5) (1999).
[53] *See* I.R.C. § 4372 (1999).
[54] *See* I.R.C. § 4371(2) (1999).
[55] *See* I.R.C. § 6501 (b)(4) (1999).
[56] *See* I.R.C. § 4374 (1999).
[57] *See* Treas. Reg. § 46.4374-1(a) (1999).
[58] I.R.C. § 4371(3).
[59] *See* Rev. Rul. 58-612, 1958-2 C.B. 850; Treasury Department Report to Congress on the Effect on U. S. Reinsurance Corporations of the Waiver by Treaty of the Excise Tax on Certain Reinsurance Premiums (Mar. 1990).

Use of an Offshore Trust to Acquire Variable Life Insurance Policy[60]

Foreign life insurance carriers generally will not market to, deal or negotiate with a U.S. person directly. Foreign carriers want to avoid the requirement of registering under the 1933 Securities Act and being subjected to the jurisdiction of State Department Insurance laws in the state in which the insured resides. The foreign carrier, however, will speak with the U.S. insured's professional advisors, such as lawyers, accountants and financial planners. The trustee of the offshore trust is the one who receives information regarding the policy from the insurance carrier and signs the application for insurance as owner and beneficiary.

An offshore variable life insurance policy may be acquired through several structures:

Structure 1.

The U.S. settlor may form and fund a foreign nongrantor trust; after which time, the trustee may then acquire a variable life insurance policy on the life of the U.S. person as the insured. The trust fund becomes the applicant, owner and beneficiary. Such a foreign nongrantor trust has no owner for U.S. income tax purposes under I.R.C. sections 671-679 and generally includes no U.S. beneficiaries until one taxable year after the death of the grantor and grantor's spouse.[61] Typically, a foreign charity is named as beneficiary during the lifetime of the grantor and until one taxable year after the death of the grantor and grantor's spouse. Furthermore, the "Crummey" withdrawal provisions are generally not included in this trust because such a withdrawal right may cause the trust to have a U.S. beneficiary, making it a foreign grantor trust as opposed to a foreign nongrantor trust.

Structure 2.

The U.S. person may also form and fund a domestic irrevocable life insurance trust. The trustee of the domestic irrevocable life insurance trust

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[60] *See generally* Eber, *supra* note 25; Craig Douglas Hampton, *International Life Insurance Presents Unique Planning Opportunities*, 24 TAX MGMT. EST. GIFTS & TR. J. 175 (July-August 1999); Gerald R. Nowotny, *Rastafarian Life: Creative Planning Opportunities Using Offshore Life Insurance*, J. ASSET PROTECTION, July/August 1999 (vol. 4, no. 6), at 10.

[61] *See* I.R.C. § 679(b) (1999).

then would form and fund a foreign grantor trust (i.e., an asset protection trust). The trustee of the offshore trust acquires a variable life insurance policy, as applicant, owner and beneficiary, on the life of the U.S. person. During the life of the insured, the offshore trust generally designates the trustee of the domestic irrevocable life insurance trust as the primary discretionary beneficiary - family members become secondary discretionary beneficiaries. Any income generated by the offshore trust (outside the variable life insurance policy) is taxed to the domestic irrevocable life insurance trust.[62] After the death of the insured, the offshore trust generally names the trustee of the domestic irrevocable life insurance trust as the primary beneficiary, and the offshore trust establishes trusts for the benefit of family members as secondary beneficiaries.

Structure 3.

Finally, the U.S. person may form and fund a domestic irrevocable life insurance trust. The trustee of the domestic irrevocable life insurance trust, in return, would form and fund a foreign nongrantor trust. The trustee of the foreign nongrantor trust would then acquire a variable life insurance policy, as applicant, owner and beneficiary, on the life of the U.S. person. During the life of the insured, and for one taxable year after the death of both the insured and the insured's spouse, the offshore trust specifically states that no income or principal may be distributed to, or accumulated for, the benefit of a U.S. person. During such time, the trust designates a foreign charity, or charities, as the beneficiary. After the death of the insured, the offshore trust may designate the trustee of the domestic irrevocable life insurance trust as the primary beneficiary, and the offshore trust establishes trusts for the benefit of family members as secondary beneficiaries.

Use of a Private Annuity Arrangement with the Variable Life Policy

Upon payment of the premium,[63] the foreign life insurance carrier will place a substantial portion of these funds in several diversified mutual funds. The remaining portion of the premium payment may be placed in a separate, segregated account that consists of an investment in one or more entities such as an international business corporation or a foreign limited liability company ("foreign entity"). The segregated account transfers assets

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[62] The trustee of the domestic variable life insurance trust is treated as the owner. *See* I.R.C. § 679(a) (1999).

[63] In general, a single premium is made to the type of variable life insurance policy here discussed.

in exchange for shares of stock in the corporation or interests in the limited liability company.

This foreign entity may acquire property from a U.S. person, as an investment of the policy, generally through a private annuity arrangement. For instance, the foreign entity often acquires appreciated assets from a U.S. person who is the insured party under the policy. When the foreign entity acquires the appreciated asset and enters into a private annuity arrangement, the value of the asset received and the liability due from the entity to the transferor causes the net asset value of such assets to equal zero.[64]

Moreover, the transfer of appreciated property by a U.S. person to a foreign grantor trust is not subject to any recognition of gain since the U.S. person is treated as the owner.[65] However, if a U.S. person transfers appreciated property to a foreign nongrantor trust, the transfer is treated as a sale or exchange, and gain equal to the excess of the fair market value over the adjusted base of the property is recognized.[66] Gain is recognized because the grantor of a foreign nongrantor trust is not treated as the owner.[67]

Furthermore, the segregated asset requirements of a variable life policy do not include restrictions or guidelines on the source of assets.[68] The applicable diversification rules simply restrict the percentages of the segregated account assets that can be invested into a single investment; no restrictions are placed on the percentage of any one investment that the segregated asset account may hold. Use of a limited liability company as the entity, however, avoids any diversification issue.[69] An entity, such as a limited liability company, is "looked-through" to its diversified assets; whereas, the stock in a corporation is the single investment, not the assets of the corporation.[70]

Numerous advantages may result from the use of the private annuity

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[64] If the interests sold are discounted, pursuant to a qualified appraisal, for valuation purposes, the interests acquired and the liability are the same; however, the asset may potentially be sold by the entity for a value in excess of the discounted value.

[65] *See* I.R.C. §§ 671, 684(b), 679 (1999).

[66] *See* I.R.C. § 684(a) (1999).

[67] *See* I.R.C. § 684(b).

[68] *See generally* I.R.C. § 817 (1999); *see also* Treas. Reg. § 1.817 (1999).

[69] A limited liability company is a flow-through entity, whereas, a corporation is a separate taxable entity. Thus, if a limited liability company makes diversified investments, these investments are looked through to the policy. However, the investment by the policy is deemed to be the shares of a corporation, not the investments made by that corporation.

[70] *See* Treas. Reg. § 1.817-5(e), 1.817-5(g) (1999) (see especially Example 1 of reg. § 1.817-5(g)); *see also* Fidelity Philadelphia Trust Co. v. Smith, 356 U.S. 274 (1958); Helvering v. Rhodes' Estate, 117 F.2d 509 (8th Cir. 1941); Estate of Zeitz v. Commissioner, 34 T.C. 351 (1960); Estate of Milner v. Comm'r, 6 T.C. 874 (1946); Estate of Bergan v. Commissioner, 1 T.C. 543 (1943) (acq. 1943 C.B. 2); Rev. Rul. 55-438, 1955-2 C.B. 601.

arrangement when selling appreciated property to the foreign. These advantages include: (i) capital gains taxes are reported ratably over the period of the seller's life expectancy;[71] (ii) the value of the unpaid portion of a private annuity obligation can be excluded from the transferor's gross estate;[72] and (iii) the non-resident alien foreign entity can sell the acquired appreciated property, which does not produce U.S. source income, without U.S. income taxation.[73]

Death of the Insured

At the death of the insured, all of the investments, including the mutual funds and assets in the foreign entity established by the policy, collapse and pass to the foreign trustee as beneficiary. These insurance proceeds pass from the foreign trustee, without estate tax inclusion, to the insured's estate under I.R.C. section 2042.[74] Moreover, if the settlor/insured, in an effort to pay the insurance premium, funded the trust and filed a gift tax return in connection with such funds, generation-skipping transfer taxes and federal estate taxes may be avoided at several generation levels. Under such an approach, the trust law governing the foreign trust receiving the proceeds must adhere to relaxed perpetuity laws.

Gift Tax Returns

With respect to the generation-skipping tax issue stated above, it is important to remember that gift tax returns are filed when cash is transferred to the trust to acquire the variable life policy (or at a time when premiums are paid). The applicable exclusion amount against any taxable gift, as well as the election to allocate the generation-skipping transfer tax exemption to

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[71] Rev. Rul. 69-74, 1969-1 C.B. 43. If the transferor lives past the life expectancy period, subsequent payments are treated as ordinary income. During the life expectancy payment period, each payment is part return of basis, part capital gain and part interest.

[72] The sale must not include a gift element (i.e., sale of the asset for less than its fair market value). The remaining obligation under a private annuity arrangement, at death, is excluded if the transferor is not deemed to have retained a life estate under I.R.C. § 2036(a) or to have made a transfer intended to take effect, in possession or in enjoyment, at the transferor's death under I.R.C. § 2037.

[73] If the foreign entity acquires real estate, however, and sells or exchanges that real property interest, any U. S. person who acquires such interest is required to withhold 10% of the sales price or consideration given in the transaction under the Foreign Investment Real Property Tax Act ("FIRPTA"). *See* I.R.C. § 1445(a) (1999).

[74] The insured must not have retained any incidents of ownership under I.R.C. § 2042 (1999).

the gift, are reported on the gift tax return.

Tax Reporting and Compliance Requirements

The transfer of cash or other assets by the settlor to a foreign trust requires the filing of Internal Revenue Service Form 3520. This return is to be filed with the federal income tax return, and a copy of the form is sent to the Philadelphia Service Center. If the foreign trust has a U.S. beneficiary during the settlor's (insured's) lifetime, or within one year before settlor's or settlor's spouse's death, Form 3520-A must also be filed.[75] Essentially, this form is the annual report that provides: (i) a full and complete accounting of all the trust activities and operations for the tax year; (ii) the name of the U.S. agent for the trust; and (iii) other information as prescribed by the Internal Revenue Service.[76] A complete Form 3520-A is filed with the Philadelphia Service Center, and is due on the 15th day of the third month after the end of the trust's tax year.

Form SS-4 is also filed with the Philadelphia Service Center in order to obtain a federal tax identification number. In addition, Form 56 is filed when a fiduciary relationship is created. This form serves to place the Internal Revenue Service on notice of the correct address and identity of the trustee of the foreign trust.

Treasury Regulation sections 25.2511-2(b) and (j) require the grantor to file a Form 709 - even where transfers are not completed gifts. Treasury Regulation section 25.2511-2(j)[77] addresses the situation where a donor contends that the retention of power over the gift asset at issue is of such a nature as to render a gift incomplete, and thus, not subject to gift tax. In such an instance, the tax return must adequately disclose the transaction, regardless of whether gift tax is due or a completed gift is made.[78] Treas.

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[75] *See* I.R.C. §§ 679(b), 672(e)(1).

[76] *See* I.R.C. § 6048(b)(1)(A) (1999). The information prescribed by the Internal Revenue Service is included with Form 3520A and the required attached statements. *See also* Notice 97-34.

[77] *See* Treas. Reg. § 25.2511-2(j) (1999).

[78] *See* Treas. Reg. § 25.2511-2(j) (1999) (referring to Treas. Reg. § 301.6501(c)-1). Treas. Reg. § 301.6501(c)-1 (2) specifically states:

A transfer of property . . . will be considered adequately shown . . . only if, with respect to the entire transaction or series of transactions (including any transaction that affected the transferred interest) of which the transfer (or taxable event) was a part, the return provides: (i) A description of the transactions, including a description of transferred and retained interests and the method (or methods) used to value each; (ii) The identity of, and relationship between, the transferor, transferee, all other persons participating in the transactions, and all parties related to the transferor holding an equity interest in any entity involved in the transaction; and (iii) A detailed description (including all actuarial factors

Reg. § 25.2511-2(b) provides:

> But, if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, . . . or partially incomplete . . . . For example, if a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or his heirs, the entire gift would be a completed gift . . .[79]

Where a foreign grantor (asset protection) trust includes the provision granting a testamentary (sometimes inter vivos) special power of appointment to change the disposition of assets after the death of the grantor, the gift is incomplete for gift tax purposes.[80] The transfer of assets to a foreign nongrantor trust, however, is a completed gift. With respect to filing, Form 709 is filed with the same service center as the grantor's federal income tax return, with additional filing due on April 15 following the year of any transfer.

Conclusion

The use of offshore variable life insurance, through proper structuring, is a method of achieving serious positive objectives of wealthy individuals. Those objectives include achieving the goals of combining serious estate, gift and generation-skipping transfer tax planning with income tax planning, wealth preservation and wealth protection (asset protection planning). In addition to tax planning benefits, numerous costs and other distinct advantages are available to U.S. persons who include the use of offshore life insurance in their planning.

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and discount rates used) of the method used to determine the amount of the gift arising from the transfer (or taxable event), including, in the case of an equity interest that is not actively traded, the financial and other data used in determining value. Financial data should generally include balance sheets and statements of net earnings, operating results, and dividends paid for each of the 5 years immediately before thevaluation date.

[79] Treas. Reg. § 25.2511-2(b) (1999).

[80] *See id.*