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An Analysis of Proposals Using Life Insurance: What Works, What May Not Be as Effective as Promoted, and What Does Not Work



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BACKGROUND

Why Use Life Insurance?

Some people don't believe in life insurance. They feel that they can invest the money that would otherwise be paid in life insurance premiums to accumulate an amount equal to a life insurance policy's death benefit throughout their lifetime. The primary flaw in this theory is that it assumes the individual investor will live a normal life expectancy. Unfortunately, bad things sometimes happen even to good people. No one knows what the future will bring. Although within a large sampling of people, most will live close to their average of life expectancy, many individuals within the sample will likely either significantly outlive their life expectancy or suffer an early demise.

Life insurance is a means of sharing the financial risk of an insured's early demise. Immediately upon issuance of a life insurance policy and the payment of the first premium, the full death benefit will be paid to the named beneficiary upon the insured's death. For an insured who dies prior to life expectancy, their investment in the policy (by way of policy premiums) likely will be less than they otherwise would have needed to invest to generate an equivalent amount of the death benefit.

On the other hand, for an insured that outlives life expectancy, the policy premium cost may prove to be more than the individual would have needed to invest to generate an amount equal to the death benefit. In other words, in general, the longer the individual insured lives, the lower the internal rate of return of the life insurance policy death

benefit when comparing this death benefit to the policy premiums. It is clear, therefore, that life insurance should be viewed, in part, as an investment within an insured's overall investment portfolio.

Further, life insurance is unique within the insurance industry. An individual may have many forms of insurance. For example, an individual may purchase home owner's insurance, auto insurance, health insurance, business interruption insurance, long-term care insurance, etc. Although premiums are paid for all of these forms of insurance, it is possible that an insured will never need the specific insurance protection so that a benefit claim may never be submitted. With life insurance, as long as the policy continues in-force during the individual's entire life, the individual will surely die at some point allowing his beneficiary to submit the death benefit claim. In addition, with many forms of insurance, the insurance company may dispute the benefit claim as falling outside the scope of the insurance coverage. However, with life insurance, there is no question when the claim exists as the insurance company will simply need to view the death certificate as proof of the benefit claim.

Life insurance is usually purchased to replace the income stream of the household income provider, to provide assets for the care of dependents, or to create wealth for beneficiaries. The receipt of a life insurance death benefit can be an economic savior for a significant portion of the population. (For example, according to the Federal Reserve's 2013 Survey of Consumer Finances, median 401(k)/IRA balances for households approaching retirement were only about \$110,000.) The use of life insurance and the receipt of an insurance death benefit by survivors, therefore, may reduce a family's need for various governmental benefits. As such, tax policy encourages the purchase of life insurance by providing consumers of life insurance with various income tax benefits.

Types of Life Insurance

Life insurance is generally one of two types (although these types can be blended): term insurance or permanent insurance. Term insurance generally has lower premiums that increase as the insured ages. Permanent insurance generally has higher initial premiums than term insurance. These higher premiums pay for the term cost of insurance and the remainder is set aside within the insurance policy for investment. The investment account (or cash value account) is used to defray the cost of the higher term costs of insurance in the later years of the policy.

Term Insurance

For term insurance, the premium for each specified term is paid to the insurance company only to cover the risk of the insured's death during that specific term. Because the risk associated with an insured's death will increase with their age, the related term insurance premiums also increase with an insured's age. The increasing premiums are projected at the inception of the policy without guarantees. Therefore, these *non-guaranteed* increasing premiums represent a significant risk. Term insurance is said to be renewable, typically annually, as the term rates increase. In general this renewable feature is at the carriers' sole discretion.

Insurance companies, however, will typically sell term policies for multiple years (like five, 10, or 20 year blocks) and spread the total premium for each year equally among all years within the block. For these multiple-year policies, the increasing premiums are determined for all of the years within the block of time. The average of the premiums for all years is then charged annually, and this premium amount is guaranteed for that block of years. In other words, the one-year premium for a \$100,000 policy death benefit for an individual age 50 may be only \$1,000. However, if that same individual were to price a 10-year block of term insurance, for the same death benefit, the individual may need to pay \$1,500 each year. The additional cost in the first year reflects the average cost of the insurance for all 10 years. The cost, however, will remain at that level, \$1,500 per year in the example, for all policy years for as long as the policy owner desires to keep that policy during that block of years. As long as the premium is paid when due, the contract remains valid.

Certain term policies also give the insured the right to convert the coverage into some form of permanent policy at expiration of the initial period of years. Because the conversion can be exercised without medical underwriting, it can be very valuable to an insured that has developed health issues during the initial term. However, the conversion is priced accordingly, and it will likely be a more expensive choice for an insured that remains in a favorable risk class.

Term insurance often becomes prohibitively expensive as an insured approaches life expectancy. Therefore, as people age, they tend to purchase less term insurance. In fact, many insurance companies will not sell term insurance to an individual once the individual reaches a certain age (like age 80). As a result, most term insurance expires without the death of the insured. Indeed, although statistics are not published, it is generally believed that only about 2% of term policies pay a death benefit.

Term policies do not include the savings feature of a cash value account within the policy and, therefore, do not have an associated cash surrender value. In fact, upon completion of the period of time associated with the premium paid (and assuming no conversion feature), the insured owns nothing of value. In this manner, term insurance can be viewed as analogous to renting an apartment.

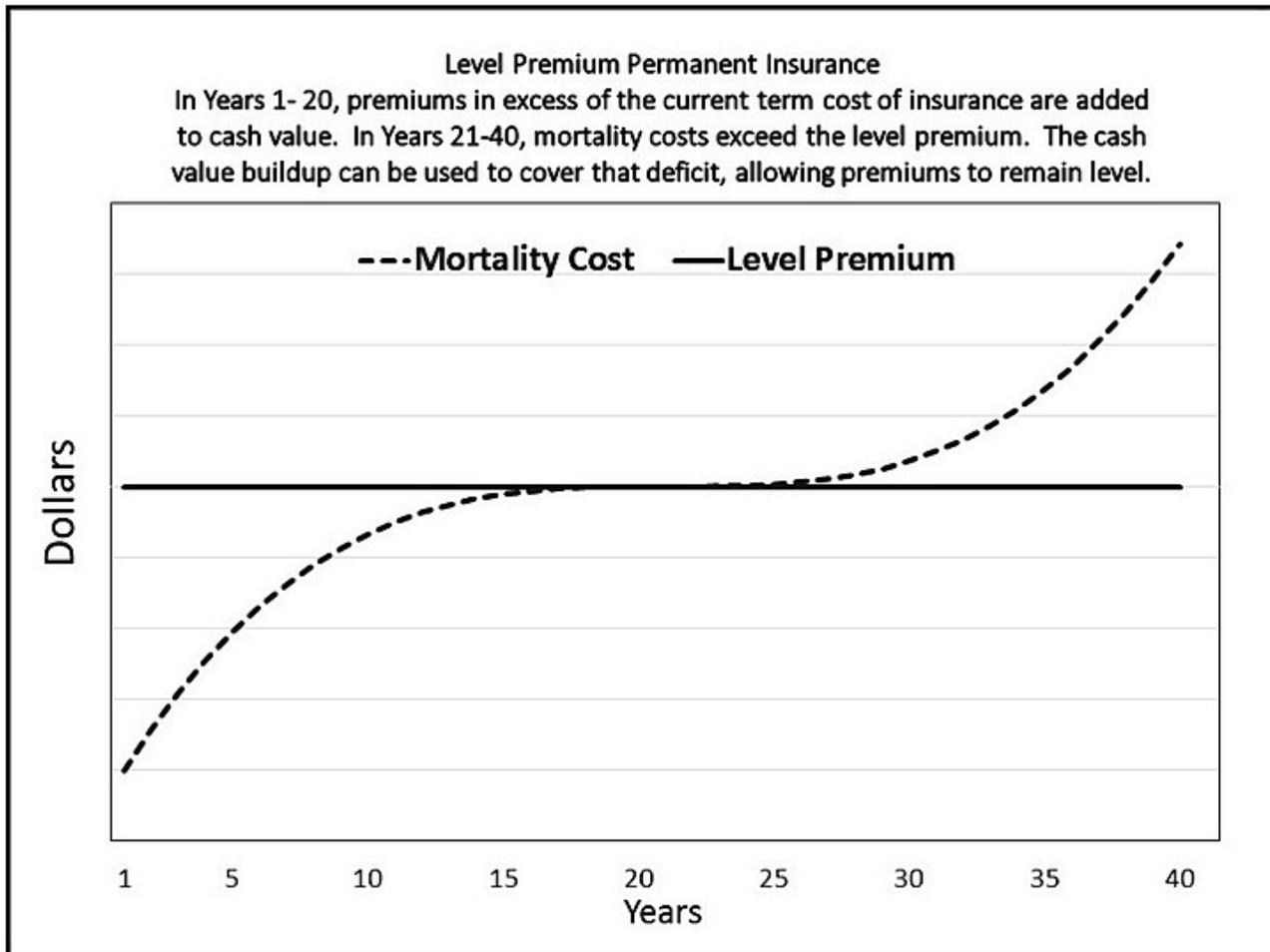
Term insurance may be best suited for someone with a short-term need for the insurance (for example to insure a debt is paid) or for people who have a need for the death benefit protection but cannot afford the higher premiums associated with permanent insurance.

Permanent Insurance

Permanent insurance is designed to provide a benefit through the insured's lifetime. As such, the idea is to spread the cost of this coverage over the life of the policy. Because of the duration risk not present with term insurance, permanent insurance typically has higher premiums. As mentioned above, these higher premiums pay for the

current term cost of insurance and the remainder is set aside within the insurance policy for investment. The investment account is used to defray the cost of the higher term costs of insurance in the later years of the policy. This investment account is typically referred to as the cash value account within the life insurance policy.

The cash value account buildup inside a permanent life insurance policy generates an associated cash value. Premiums paid in excess of the current term cost of insurance are added to this cash value. This cash value is invested and the earnings are reinvested within the cash value. This cash value buildup in later years may generate income that can be used to pay a portion of the policy premiums when the costs associated with the policy are in excess of the stated premium. Ultimately, the cash value itself also can be used to pay policy premiums. (See the example in the chart.) Premium payments made with the income and cash value may allow the owner of the policy to stop making cash premium payments at some point during his life. A policy with this feature is usually called a vanishing premium or limited pay policy.



Permanent insurance is available in three general types: *whole life*, *universal life*, and *variable life*. All three types are discussed in detail below. Most other names for insurance are not products themselves but describe the payment of the insurance premium. For example, single premium insurance is any insurance product where the premium is paid in one lump sum. Split-dollar life insurance is insurance that is typically paid for by two parties. With split-dollar, the bulk of the insurance premium is paid by a wealthy party (like an employer or parent), and a minimal amount of insurance premium is paid by the less wealthy insured (like an employee or adult child).

Structure of Permanent Life Insurance Policies

The structure of a permanent life insurance policy is divided into four main parts: mortality, lapse, administrative cost, and investment. An insurance company structures its products by considering its desired profits coupled with its current estimates, based on experience, of the four mentioned parts. The insurance company uses actuarial calculations to factor in the mortality issues (i.e., how much death benefit must be paid under its issued policies based on life expectancies of the insureds and the associated required statutory reserves). This actuarial calculation helps determine the amount of premium the insurance company needs to collect to ultimately pay death benefits. Because the insurance company needs to factor in future mortality rates in these calculations, it is constantly revising its assumptions based on experience and estimates of future mortality.

The mortality costs are typically divided into a number of rating classes from preferred or super preferred (for a very healthy individual) to various forms of "rated" classes depending upon the level of health of the insured. A hopeful insured with detrimental health issues will be quoted a higher premium for the same policy than someone

who is a standard health classification. The standard health insured will be quoted a higher premium for the same policy than someone who is in a preferred health status.

As discussed earlier, about 98% of term insurance never pays a death benefit. A policy that expires without paying a death benefit is said to lapse. Although a much lower percentage, a significant amount of permanent insurance also will lapse. This lapse experience helps an insurance company defray the cost related to those policies that do not lapse. The insurance company's experience with lapse, therefore, also factors into the cost of all policies.

The insurance company incurs administrative cost in the form of payroll, rent, and various other expenses. These administrative costs must also be allocated from the amount of premium the insurance company collects.

Finally, for whole life and universal (but not variable) policies (all described below), the insurance company invests the cash value of all of its policies in its general investment account. For these policies, the insurance company guarantees that the investment within each policy's cash value will earn a stated minimum rate of return — typically in the range of 3% to 4%. As the company will ideally generate a higher return from investing in its general account, it will use its discretion in deciding how much of the excess return to pass through to the policy owners while typically retaining a small amount of the excess for its profit margin spread on investment. The investment allocation in the general account is highly regulated and the carrier is required to maintain reserves in liquid vehicles to support projected death benefit claims. As such, the investment performance on the general account is constrained by the returns available on high quality liquid holdings available in the market at any given time.

Overriding all of these factors is the insurance company's desire to remain competitive in the market. Therefore, it must make decisions regarding mortality, lapse, investment, and administrative costs to allow it to competitively price its products. Insurance companies are required to provide a ceiling on costs associated with a given policy for the consumer. Carriers rarely if ever charge the guaranteed maximum allowable cost as specified within their insurance contracts. This ceiling allows a carrier to increase costs should they inaccurately price the contract at inception. To provide a normalized projection of costs associated with the policy carriers also illustrate a current cost scenario. The current cost structure projects the cash value assuming the current cost structure and current crediting rate of return (typically higher than the stated minimum rate of return). The two projections represent bookends: the guaranteed illustration being maximum charges and minimum credits illustrating the worst possible performance, and the current illustration that projects anticipated policy performance in the current return and cost environment. The carrier has the ability to run scenarios between these two bookends only.

These illustrations must be included in the sales contract and be signed by the purchaser of the insurance. A comparison of these illustrations from different insurance companies is a tool to assist a potential insured in comparing carriers using the same assumptions regarding product, health status, death benefit amount, premiums expected to be paid, etc. It is universally agreed that illustrations are tools and not facts. The only fact in the illustration is that the policy will not perform below the guaranteed scenario, and even that fact assumes the timely and consistent payment of premiums.

As an example, assume a particular \$1 million death benefit life insurance policy contract for an insured age 60 includes a guaranteed maximum annual cost of \$1,000 (in addition to the term cost of insurance, which at age 60 is \$200 and will increase as the insured ages). The insurance company annually can charge the full \$1,000, but it currently elects to charge only \$600. In addition, assume the guaranteed rate of return is stated as 3% annually but the current earnings rate that the insurance company is paying to its policy owners is 5% annually. In this case, the insurance illustration will show one set of cash values and death benefits year by year with the \$1,000 guaranteed cost (plus the term cost of insurance as it may change annually and as stated in the insurance contract) and the 3% rate of return (a worst case or guaranteed scenario); and it will show a second set of cash values and death benefits year by year with the \$600 current cost (plus the term cost of insurance as it may change annually and as stated in the insurance contract) and the 5% rate of return (the current projection). With the lower costs and greater return of the current projection, the cash value and possibly the death benefit will grow much faster than the guaranteed or worst case cash value and death benefit. In fact, the policy illustration might show the policy lapsing at some point in the future under the worst case scenario while showing under the current projection excess cash value and a growing death benefit through age 100 of the insured.

In a permanent insurance contract, the insurance premium payment may have optionality. Policies can be structured to have premiums paid monthly, quarterly, or annually, and either over the entire lifetime of the insured or for a finite number of years. A potential advantage of paying over a finite number of years is the knowledge that after that time period, potentially no additional cash outlays will be required. (The short duration pay scenarios assume cash value buildup will support costs in future years. If the cash value does not grow as expected, there could be the need to pay additional "catch up" premiums.) However, this view may be short sighted. Whether or not the premium is paid over the insured's lifetime (assuming an average life expectancy) or a finite number of years, the present value of these payment streams should be equal. Therefore, if the purpose of the life insurance is to protect against a short life, paying over a finite period could make the death benefit more expensive than it otherwise needs to be. For example, assume that the premium under a \$100,000 death benefit policy can be paid either for 20 years at \$2,000 per year or for lifetime at \$1,500 per year. If that insured died prior to life expectancy after making the 18th of 20 payments, the insured would have paid into the policy \$36,000. Had the insured been paying the premium over life, the first 18 premium payments would have been only \$27,000. The payment of the extra \$9,000 was wasted premium due to the untimely death of the insured. If the insured lives close to life expectancy, there would be no economic advantage of paying the premium over the finite period.

On the other hand, if the primary goal of the life insurance policy is to create a lifetime tax-deferred investment (as discussed in more detail below), then paying the premium over a short, finite period makes sense so that the premium dollars are working toward that goal as fast as possible. Following this logic, it would be ideal to make one large premium payment at the inception of the policy. However, based on some potential negative income tax consequences when accessing the investment proceeds later in life (also discussed below), the policy owner will likely want to fund the policy over a longer but still short finite period. In this case, the policy should be designed to meet the owner's investment budget while solving to minimize the cost of insurance friction. (Again, this topic is discussed in more detail below.)

Types of Permanent Insurance

As previously noted, permanent insurance is available in three general types: *whole life*, *universal life*, and *variable life*. Universal life has several iterations — current assumption, guaranteed, and equity indexed. Variable life can be either standard variable or private placement variable. It is important to note that each product type is designed to solve for a fact pattern. This writer is not trying to promote one product over another, but merely help the consumer and their advisors understand what the products are intended to do, their associated benefits, and their constraints.

Whole life is the oldest form of permanent life insurance and, for a long time, was the only type of permanent life insurance. Both universal life and variable life and their derivative products are forms of permanent life insurance that were first created in the mid- to late 1970s, in part due to the quickly rising and high interest rates of the time. These products have been expanded to solve for client preference and market conditions.

The foundational distinction among permanent insurance policy types is the allocation of risk assumed by the insurance company and the policy owner. Whole life leaves more risk with the insurance company and less risk for the policy owner. Universal life shifts more risk to the policy owner in exchange for potentially lower cash premiums (at least in the early years of a policy) versus whole life. Variable life shifts even more risk to the policy owner, again, in exchange for potentially even lower cash premiums. No one type of insurance is appropriate for all clients. It is the responsibility of the insurance advisor to assist his or her client in matching the type of insurance with the client's objectives and risk profile.

Whole Life

Whole life generally guarantees a continued death benefit for the insured's entire life upon payment of fixed annual premiums. The required periodic premium payments are usually level for life and are based in part on the insured's age and health at policy issue. The whole life insurance contract specifies the maximum annual costs that can be charged against the policy annually as well as the minimum investment rate of return, which will be credited to the cash value account guaranteed by the insurance company. The required premium amounts are generally determined assuming these guaranteed cost levels and guaranteed minimum earnings per the insurance contract. However, if the carrier is able to achieve rates of return that are favorable as compared to its stated rate of return or manage expenses efficiently, they may show a more favorable illustration with a "vanishing" premium at some point in the future (if the current insurance company's costs and investment experience continues).

It is important to understand that any vanishing premium shown in a life insurance policy illustration is only a projection of future events that might not occur. In fact, any illustration that shows a vanishing premium will almost certainly not occur as shown. It is universally accepted that illustrations are tools that are only directionally accurate. The only guaranty is that the policy will not perform below the guaranteed projections as long as the premiums are paid on time as agreed. The insurance company has significant flexibility to change its costs charged from year to year within the parameters of the insurance contract. In addition, the investment return on the cash value account credited by the insurance company to the policy also will likely change from year to year. These factors will change the year, if any, during the policy life that the premiums may vanish. Further, the word vanish is also a misnomer. The premium does not really vanish, but, instead of payment with cash from the policy owner, the premium is projected to be paid within the policy by the earnings and/or principal of the cash value account. Regardless, the premium is paid in some manner.

With whole life insurance, the insurance company may pay annual "dividends" on the cash value of the policy as a result of actual lower costs charged and/or favorable investment performance in that insurance company's underlying investments within its general account. This dividend should not be equated with the dividend paid by many public companies in respect to their stock. It can be thought of, in some respects, as a refund of excess cash premiums paid in earlier years. As discussed in more depth below, this dividend, if retained within the policy, may not be subjected to income tax, but if distributed to the policy owner may be taxed as ordinary income.¹

¹ §72(e). All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

For their general account, insurance companies generally choose investments that are expected to generate steady returns like investment grade bonds, highly rated real estate mortgages, and other types of similar fixed income investments. They also use very little equity exposure to avoid volatility and to comply with statutory requirements. (These steady returns help toward favorable rating classes from the companies that rate the health of an insurance company.) Therefore, a whole life policy investment might be classified as a conservative investment risk and the dividends associated with whole life policies likely will be limited by the returns associated with these types of

investments. As mentioned, for whole life insurance policies, the insurance companies guarantee certain minimum investment results (for example, a guaranteed investment rate of return may be 4%).

The dividends paid by the insurance company can be paid directly to the owner of the policy. Alternatively, and more typically, the dividends can be used to further increase the cash value account. Upon reaching certain time periods, the dividend can be used to purchase additional insurance within the whole life policy called "paid-up additions" or PUAs. A PUA is a small amount of guaranteed single premium fully endowed life insurance on which no additional premiums will be necessary. PUAs increase the death benefit of a whole life policy.

As an additional alternative under a whole life policy, the dividend may be used toward the annual premium to reduce or eliminate the owner's cash contribution. If dividends had been used to purchase PUAs, these PUAs can also be "surrendered" in a future year to generate cash inside the policy to pay the premium. As described above, if the dividends or surrendered PUAs are sufficient to pay the premium that would otherwise be due in cash, the premium is said to "vanish."

The cash value account in a whole life policy may be accessed by the policy owner via loans from the policy or a complete surrender of the policy. It cannot otherwise be withdrawn from the policy. Policy loans or the complete surrender of the policy can have severe income tax consequences.

Certain whole life contracts, not typically used today, were designed to have the premiums paid in full prior to the death of an individual, for example, by the time the insured reached age 65. In these cases, upon completing the payment schedule, the policy is said to be "paid-up" and no additional premiums (cash or otherwise) are required to be paid. This is the only type of policy that truly can be deemed paid-up or fully paid. All other policies might appear to be fully paid, but depending on investment return and cost factors, additional cash premiums may be due at some future date.

Universal Life

Universal life policies were first developed in the mid-1970s. Until that time, whole life policies were the only type of permanent policies. Typically, with whole life policies, after favorable investment performance and/or efficient cost management during a year, the insurance company will declare a dividend to be paid at a later date. This time lag between the earnings and the dividends has a minimal effect on policy cash value investment performance in times of steady interest rates. However, when interest rates are rising quickly as they did in the 1970s, the delay in paying dividends can have a significant impact on a policy's cash value growth. As a result, the universal life insurance policy was developed to add earnings to the policy cash value more timely. With a universal life policy, typically favorable investment performance in an insurance company's general account is credited as interest to the cash value of the policy as earned on a monthly basis.

In addition, whole life can be looked at as a black box. In whole life policies, the operation of earnings, mortality, and expenses is all combined within the determination of guaranteed cash values and dividends. On the other hand, universal life is more easily understood due to its transparent architecture. The interest earned, cost of insurance, and expense elements can be separately identified and easily measured. The cash value account is determined by adding the net premiums (gross premiums paid less premium charges) and interest earned then subtracting mortality charges, administrative charges, and any withdrawals of policy cash value. The net amount reflects the policy cash value.

Unlike whole life, universal life policies also generally allow for flexibility in premium payments, options in cash accumulation, and optionality on death benefit. As a result, universal life is frequently referred to as flexible premium adjustable life. The cash premium paid can be changed by the policy owner periodically to any amount within a broad range. The policy face amount or death benefit also can be increased or decreased as needs change, although increases will generally require evidence of insurability. This added flexibility brings added risk to the policy owner.

Whole life policies contain guarantees along with their required premiums, which need to be paid in cash, via the use of dividends, or through surrender of PUAs as discussed above. As long as the premium is paid on time and as required by the contract, the cash value and death benefit within the policy will never fall below the minimum guaranteed level. Assuming no policy loans, the annual outlay required to maintain the death benefit will never be greater than the guaranteed annual premium.

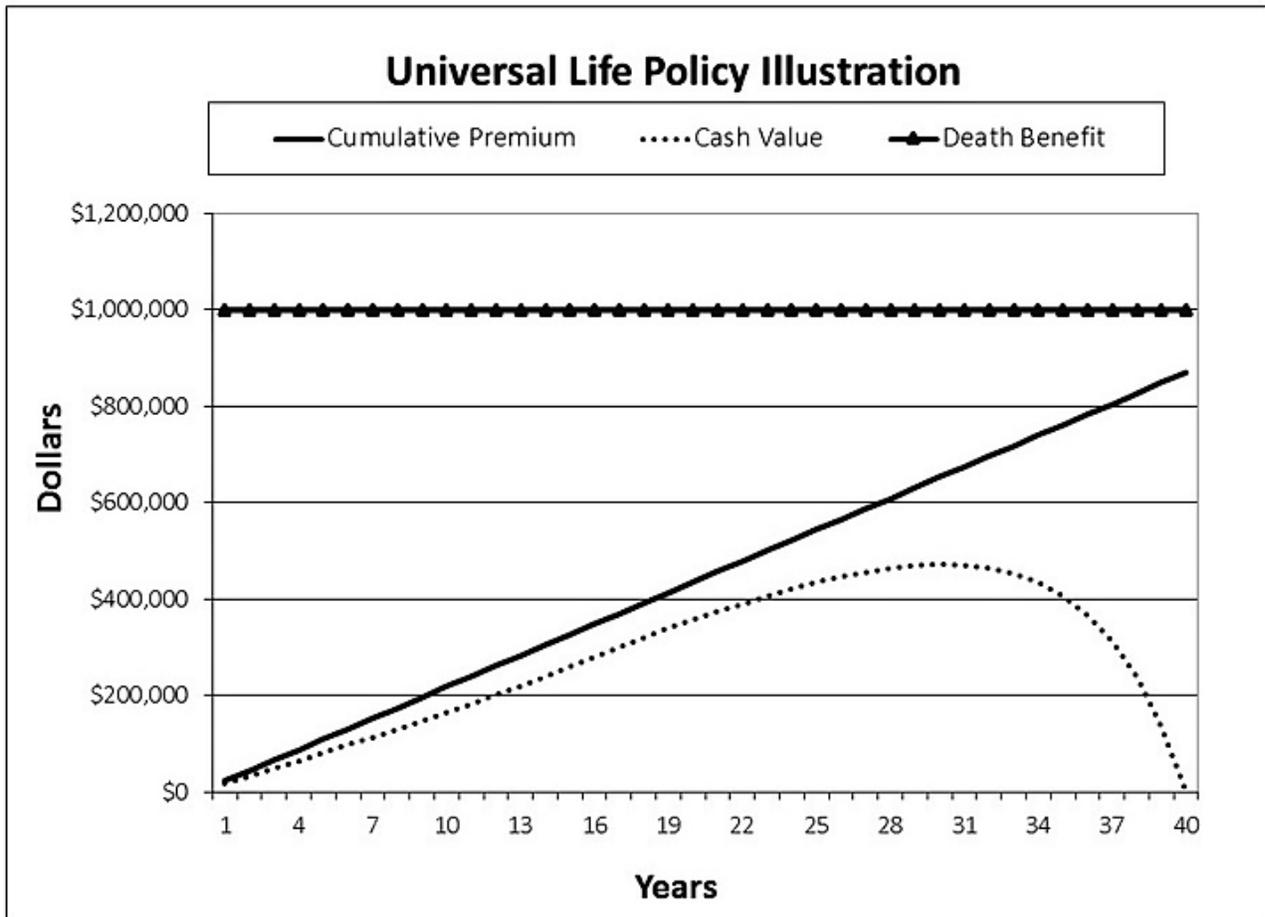
On the other hand, universal life policies will remain in force only as long as there is at least enough cash value to pay the coming month's cost of insurance and administrative charges. In this regard, universal life policies are typically designed with flexibility in the premium payment amounts in mind. Unlike whole life insurance, the universal life policy design solves for a premium stream for the desired death benefit outcome based on the expected current charges within the policy (lower than the contract maximum guaranteed amount) and current interest rates being credited to the cash value account (higher than the guaranteed minimum return) — all based on the insurance company's current experience. The idea of this design is to have a lower premium in the early years of the policy than within a comparable whole life policy to reflect something closer to the current real experience of the insurance company.

Assuming the current experience of the universal life policy continues, this premium amount likely would need to be paid throughout the life of the policy without "vanishing." Vanishing still may occur if investment performance exceeds even the anticipated current performance, which likely is already above the guaranteed minimum of the policy. For example, assume a universal life policy contract guarantees investment performance of 4% and current experience of the insurance company's general investment account is allowing the company to credit its universal

life policies with an interest rate of 6.5%. In this example, the expected premium for a currently issued universal life insurance policy by the company is determined in part with the assumption that a 6.5% interest rate will continue to be credited to the policy cash value throughout the life of the policy. If after issuance the insurance company decides to credit greater than 6.5% to the policy cash value due to having a greater than 6.5% performance in its general account, the policy cash value will grow faster than originally anticipated. This extra cash value can be used to pay future premiums that would otherwise have been paid in cash.

On the other hand, if the carrier investment performance lags the projected rate after policy issuance, additional cash premiums may be required to maintain the policy death benefit throughout the insured's life. Under the same example, if the current interest credit to the policy is reduced to only 5%, reflecting lower earnings in the insurance company's general account, the cash value will grow slower than anticipated. Without greater cash premium payments, the cash value of the policy could deplete to zero before the death of the insured. If the cash value is allowed to decline to zero, the policy will lapse and the owner will either lose coverage or be required to make a "catch up" payment.

In some cases, universal policies are designed with premium payment expectations so that the minimum required premium is paid over time for the policy to accumulate just enough cash value to keep the policy in force long enough to pay a death benefit (say to age 90 with the assumption of the insured's death prior to age 90). Ideally, in this case, the insured would die with just \$1 remaining in cash value. (See chart of a universal life insurance policy illustration.) In this case, it becomes critically important for the policy owner to monitor the cash value account within the policy and to anticipate future additional cash premiums to maintain a sufficient cash value to protect the death benefit of the policy. This required monitoring of the policy as well as the possibility of additional cash premiums required over the anticipated cash premiums represents the trade-off between the lower potential premiums of universal life (at least in the early years of the policy) versus the guarantees provided by whole life insurance policies.



As a result of the fewer guarantees within universal life coupled with the flexible premiums and design of these policies, the policy owner assumes a greater portion of the risk. To compensate for this assumption of risk, most universal policies require lower cash premiums than a similar whole life policy in its early years. However, if the investment performance expected is not achieved, significant additional cash premiums may be needed to support the death benefit through the insured's lifetime. As a result, all universal policies should be monitored frequently to verify their performance is in accordance with the initial illustration.

As mentioned, the insurance company sets an interest rate from time to time to determine the earnings that are added to the policy cash value. These interest rates are based on the actual and projected investment performance in the company's underlying investments. The investments associated with a standard universal insurance are held in the insurance company's general account and, therefore, are the same fixed income type investments within whole life insurance. Therefore, the investment earnings are limited by the returns associated with these types of investments. Similar to whole life, because the insurance company makes the investment decisions regarding their general account, the insurance companies guarantee certain minimum results (for example, a guaranteed rate may be 4%).

In recent years, many insurance companies have expanded their universal life offerings to include something called equity indexed universal life. This product expands the policy's potential investment returns beyond the insurance company's general account of investments. It allows for adding in equity exposure by tying the cash value account to an equity index like the S&P 500 index. At the same time, similar to offering a guaranteed minimum return, the product offers principal protection from a decline in the indexed return in exchange for a cap, margin, or other upside participation modifier.

Another added flexible feature of universal life insurance allows the owner to access the cash value buildup in the policy via withdrawals of a portion of the cash value (categorized as cost recovery), leaving the policy in place. As with whole life, the cash value also can be accessed via loans or a complete surrender of the policy.

Variable Life

Variable life insurance was also developed in the 1970s. It was developed to allow a greater choice of investment within a life insurance policy — or, stated another way, additional shifting of risk from the carrier to the policy owner. With whole life and standard universal policies, the insurance company invests the cash value in its general account. The insurance company must maintain a steady investment return in order to assist in maintaining its ratings from insurance company rating services (described below). Therefore, the insurance company utilizes mostly investments that tend to maintain their principal value like bonds, mortgages, and the like. With variable life insurance, the policy owner decides what type of investment to make with the policy cash value. Because the investment choices are left to the policy owner, the insurance company does not offer guarantees with respect to investment performance.

Variable life insurance policies are generally structured as universal policies (allowing for flexible premiums and utilizing the current cost structure). The policy owner has the ability to direct the underlying policy investments among a group of investment options — typically within families of mutual funds on the carrier's platform. Carriers offer a wide range of investments such as domestic equities, international equities, investment grade and noninvestment grade bonds, as well as money market funds. The policyowner's ability to direct the investments into equity funds and other higher risk investment funds presents the opportunity for the policy owner to achieve greater long-term investment returns. However, along with the accompanying returns comes higher volatility and downside risk associated with many of the investment choices. Because there is an expectation of higher returns and relatively faster cash value accumulation, the supposition is that over time the variable product performance will result in a greater base to assist in the payment of the later year premiums. Therefore, the anticipated policy cash premiums associated with variable life policies are typically less than other permanent insurance products. In other words, the insurance company is shifting more risk related to continuing the insurance to the policy owner in exchange for potentially lower cash premiums.

With respect to variable life insurance policies, total policy expenses are higher than those associated with other permanent insurance products (with those costs passed to the policy owners) due to the cost of administration of these policies as well as money manager fees directing the investment funds. If the underlying investments chosen by the policy owner are only investment grade bond funds, the associated higher costs of administration will likely result in reduced performance compared to other permanent insurance products. Therefore, only persons expecting to invest primarily in the equity markets and willing to assume the associated risks of those markets should use variable insurance.

For variable life insurance, the costs within the policy may include the following, which should be listed in the policy illustration and/or the prospectus related to the mutual fund choices (and some of which are present in all universal based products):

- A sales charge (generally about 2% of the premium payments),
- A federal and state premium tax charge (also generally about 2% of the premium payments),
- Monthly insurance charges (a nominal administrative charge and a term cost of insurance charge or mortality charge based on age, sex, and rate class),
- A fee charged by the insurance company based on the cash value account for the administration of the investments (this fee is referred to as the "mortality and expense" or "M&E" risk charge even though it has nothing to do with mortality; it is typically in a range of 0.50% to 0.90% of the cash value account) and may change during the life of a policy (variable insurance only), and
- The mutual fund fees charged by the fund for management and operating expenses (similar to any mutual fund investment) (also variable insurance only).

A distinct and potentially valuable feature of variable insurance is the protection that is gained within a variable policy account. The accumulated cash values in each separate variable life policy are kept separate from the insurance company's general account and the insurance company's other assets and, therefore, are not subject to the claims of the insurance company's creditors (unlike whole life and universal life insurance). Therefore, if a particular insurance company goes bankrupt, the owner of a variable policy will be able to move their separate variable account to a new insurance company without loss of the cash value. Hopefully, if this became a reality, the insured will still be in good health to assist them in obtaining a new insurance policy.

Because variable life policies are typically structured as universal policies, the cash value buildup in the policy may be accessed via withdrawal of cash, loans, or a complete surrender of the policy. In the case of a variable whole life policy, cash withdrawals would not be permitted. However, the policy value can be accessed via loans or a total surrender of the policy.

Guaranteed Universal Life

A more recently developed product is known as guaranteed universal life or universal life with a no-lapse guarantee. Although a universal-based product, the product is designed to maintain its full death benefit without regard to the cash value of the policy through an age chosen by the insured. In order to obtain the guarantee, the policy owner must pay a set premium each year by the due date. (In some cases, the premium can be paid over a period of time rather than life and this shorter time frame is factored into the determination of an equivalent amount of the premium.)

Under the design of these policies, the insurance company credits the policy with a very limited investment return — keeping more of the investment return in exchange for the guarantee by the insurance company to pay the death benefit. It is expected that these policies will exhaust their cash value at some point well before the life expectancy of the insured. When the cash value is exhausted, the guaranteed or no-lapse feature will be applicable. The insurance company's guarantee to the policy owner then depends on their viability at the time the death benefit accrues. Usually the age chosen to maintain the death benefit is at least through age 100 and sometimes through age 120. The cost of the premium is in part determined with reference to this age although premiums are not typically due after age 100.

Some believe this product was developed in response to the public's desire for a policy with low guaranteed premiums. Others view the product as opportunistic by the insurance companies taking advantage of a low interest rate environment. As interest rates decreased in recent years, the interest rate being credited to universal policies was very close to the guaranteed rates. Therefore, the insurance companies were selling universal policies that did not look very attractive as compared to policies issued in the further past. Because they were already paying close to the minimum rate of return, the cost of the added guarantee was minimal. Further, insurance companies take a long view of investments and expect to earn higher rates of return on their general account over long periods of time. Therefore, even though a policy's cash value may exhaust in a policy illustration at a 4% interest rate, it will likely continue well past the illustrated year of exhaustion if investment returns over time are actually closer to historical averages.

If a guaranteed universal product is purchased, it will likely not build much cash value. Therefore, this product is almost like a term policy that will last until death. One who purchases this policy is stuck with the consequences for a long time. However, typically the premiums are lower than products that build cash value. In addition, for the policy owner to maintain the guarantee at the level of death benefit chosen, premiums must be paid precisely on time. Late payment of even one premium likely will reduce the guaranteed death benefit amount.

Second-to-Die or Survivorship Insurance

Life insurance either insures one life or two lives. Insurance on two lives rather than one is usually referred to as second-to-die or survivorship insurance and pays its death benefit at the second death of the two lives. It is most often used by a married couple to provide liquidity for federal estate taxes. Because survivorship insurance insures two lives, one of the lives typically being a female, survivorship insurance is usually much less expensive on an annual basis than insurance on a single life. However, survivorship insurance generally requires premiums to continue to be paid after the first death during the remaining life of the surviving insured.

TAX HISTORY

As mentioned earlier, tax policy encourages the purchase of life insurance. Section 101(a) provides that death benefit proceeds of a life insurance policy paid to a beneficiary by reason of the death of the insured is generally excluded from the gross income of the recipient beneficiary. Further, in general, the cash value build-up within a life insurance policy grows tax-deferred. Although this tax deferral is well accepted by the Internal Revenue Service,² it has not been expressly or directly codified in the Code. Section 72 generally controls the amounts paid from life insurance contracts to a taxpayer other than by reason of death (sometimes referred to as "living" proceeds). But so long as the cash remains inside the life insurance contract, it will not be taxed by §72 or any other Code section.

² See TAM 200213010.

³ See also *Cohen v. Commissioner*, 39 T.C. 1055 (1963), *acq.*, 1964-1 C.B. 4.

Definition of Life Insurance

When originally introduced, variable life insurance was offered by only a very limited universe of insurance companies. Most insurance companies did not believe the consumer would be willing to accept the higher risk of these policies even with the expectation of lower cash premiums. However, to the surprise of these companies, variable life became increasingly popular in a very short time.

Agents selling variable life began to focus on the tax-deferred investment growth of the policy and not the death benefit. They began selling so-called "single premium" policies that would grow tax-deferred and touted their use as a supplemental retirement account. In any one year, large amounts could be contributed to these accounts. An insurance policy account did not have a \$2,000 per year contribution limit like the individual retirement account of today. The death benefit became only a supplemental benefit to the use of the life insurance policy as a retirement plan.

The typical life insurance retirement plan was to fund the policy with an initial single payment that would grow in tax-deferred equity funds while the owner continued working. In retirement, based on the §72 rules, the policy owner would be able to first withdraw the premiums paid as a tax-free return of principal prior to a withdrawal of the tax-deferred earnings within the cash value account. Further, the policy owner would also be able to take a loan from the policy without withdrawing the investment earnings, further delaying any potential taxable income. If the policy ultimately paid its death benefit (reduced by any outstanding loan), none of the investment income would ever be taxed.

Due to its popularity among consumers, more and more insurance companies began offering variable life throughout the 1980s. Further, the investment choices within each company's policies grew from perhaps 10 mutual fund choices to more than 50 mutual fund choices. The expanded popularity of variable life even allowed for an entire new industry to grow — customized variable life insurance policies holding specific hedge fund and other tax inefficient investments. (The industry is called Private Placement Life Insurance and is discussed in more detail below.)

Codified Definition of Life Insurance

Prior to the early 1980s, there was no statutory definition of insurance in the Code. Instead, the principles and analysis used to determine what is or is not life insurance were developed in the case law. The cases used a "risk-shifting" analysis. This factual determination focused on whether there was a shifting of the risks of death to another. Because a risk-shifting analysis was a subjective factual determination, it did not adequately provide any objective criteria that could be used to determine whether the death benefit provided under the insurance contract was realistic in relation to the cash value of the policy. The purpose for codifying the tests to be used in defining what is life insurance was to provide objective, mechanical rules, eliminate the subjectivity of the risk shifting approach and ensure that an appropriate amount of the premiums are used to provide for a death benefit instead of cash value in the policy. The codification of the standards to be used has given the insurance industry certainty instead of the subjective factual approach used before the 1980s.

As a result of the growth of the industry touting the investment element of life insurance, Congress modified the tax rules around insurance that were designed to protect the death benefit from taxation so as to benefit widows and orphans (not the investment world). In 1984, Congress enacted §7702, which defines life insurance in the tax law.

Under §7702, a life insurance contract must meet either the cash value accumulation test (CVAT) or the two-pronged test comprised of the guideline premium test (GPT) and cash value corridor test (CVCT). The purpose of these tests is to disqualify policies created for their investment component without regard to the actual relationship between the cash value and the contractual death benefit. The two methods for testing under the tax law are understood in depth by the life insurance companies and contain various actuarial assumptions. Insurance companies generally design their policies to meet these tests. The carrier must disclose the fact that a policy does not meet the appropriate tests. Most often is it boldly disclosed at the top of each page of the illustration.

Under the CVAT, the cash surrender value of the policy may not at any time exceed the net single premium that would have to be paid at the time to fund the future death benefits under the policy, based on a maturity age between 95 and 100. This test is generally applied to traditional whole life policies. Under the GPT, the sum of the premium payments must not exceed at any time the greater of (1) the value of the guideline single premium payable at the time the policy is issued that would be necessary to fund the future death benefits provided by the policy, or (2) the sum of the guideline level premiums at any given date, based on an annual level amount necessary to fund future benefits until at least age 95. The CVCT is the easiest to understand. This test requires that the death benefit at all times must be no less than a specific percentage of the cash value. The percentage depends on the age of the insured. At age 40 the death benefit must be at least 250% of the cash value. This percentage decreases in increments to 100% at age 95.

Modified Endowment Contract

In further response to the single premium investment policies, in 1988 Congress introduced the modified endowment contract (MEC) rules under §7702A. Even if an insurance contract qualified as life insurance under §7702, Congress was concerned with the policy owner using life insurance policies to access earnings through the nontaxable loan route. Even if a MEC qualifies as life insurance under the general definition of §7702, any distributions from the MEC, including those labeled as loans, would be treated as if they were first out of the earnings from the cash value inside the policies. The MEC legislation was designed to reduce one's ability to pay large premiums for only the first few years the policy was in force and take out the earnings in a tax-free manner by

structuring the distributions as loans. Essentially, any distributions from a MEC are treated as distributions of income to the extent of the earnings in the cash value.

A MEC exists if it is determined that the policy owner paid too much in premiums in relation to the death benefit. The criteria used to test for MEC status is based on the first seven years the policy is in force. Although this is called the Seven Pay Test, the period over which the premiums can be paid can be as short as five years and, in limited situations, possibly four years. If one wants to pay in as much as possible in premiums as quickly as possible and still be a non-MEC, a pro rata amount can be paid each year over a five-year period. For example, assume a policy with a face amount of \$2 million will be paid up after seven years if the average annual premium paid during the first seven years is \$30,000. If in any given year more than the total average annual premiums to date have been paid, the policy will become a MEC. Therefore, if more than \$30,000 in premium is paid in the first year, the policy will be a MEC. If more than \$60,000 of premium is paid after two years, the policy will be a MEC, and so on.

It must be remembered that even though the policy is classified as a MEC, it is still life insurance under §7702 so that the income tax deferral on the build-up in the cash value can continue indefinitely. All that results from MEC classification is that the policy owner cannot take the distributions out as tax-free loans. Although it is better to have a policy that is not a MEC just in case a future cash withdrawal is desired, if it is anticipated that a withdrawal will never be made from the policy, and the policy will simply be held until it pays its death benefit, MEC status is not a factor. The tax treatment of the death benefit will be the same for a MEC or a non-MEC policy.

Diversification and Investor Control

In addition to the general rules of §7702, variable life policies must also comply with diversification tests under §817(h). This section requires, in general, that each "segregated asset account" must contain at least five investments. In addition, no one investment may represent more than 55% of the value of all of the assets, no two investments may represent more than 70% of the value of all of the assets, no three investments may represent more than 80% of the value of all of the assets, and no four investments may represent more than 90% of the value of all of the assets. Failure to meet this diversification test will result in taxation of the cash value accumulation within the policy. These diversification rules define what is deemed to be one investment. A mutual fund that is offered only through insurance products is considered a "look through" fund, i.e., the fund is not considered only one investment but the owner can look through the fund to its underlying investments for purposes of this diversification test. These funds are sometimes referred to as insurance dedicated funds or IDFs.⁴ An insurance dedicated hedge fund also can be considered a qualified IDF.⁵ If a policy fails the diversification test, the earnings accumulation will be currently taxable to the policy owner.

⁴ See Reg. §1.817-5(f)(2)(i)(B); PLR 200508002, PLR 200443029.

⁵ See PLR 200244001.

Another aspect of the diversification rules is the investor control doctrine. Although not found within the regulations, the IRS clearly takes the position that the policy owner/investor is free to choose an investment manager to manage the policy's separate account (and to change managers if desired), however, the owner must not have control over the actual selection of investments by the separate account manager. Again, if it is determined that the investor control doctrine is violated, the policy accumulation will be currently taxable.

The investor control doctrine has its roots in Revenue Rulings from the late 1970s and early 1980s, but can be explained best by two Revenue Rulings issued by the IRS in 2003. These Revenue Rulings are designed to curtail the abusive use of life insurance and annuity contracts to avoid current income taxation on investment income. The 2003 rulings, which from a glance at the headlines of the IRS's announcement threatened to be an entirely new and devastating approach designed to inhibit the use of insurance contracts, in reality are much less threatening than they appear. Essentially, they focus on the degree to which investor control should be limited so as to qualify as life insurance under the Code. Rather than looking at these administrative pronouncements as a warning shot, what the IRS has done is issue guidance establishing a safe harbor setting out specifically what the insured can and cannot do. For those who want no-risk situations, these rulings should be viewed as a welcome roadmap as to how to structure a product that will qualify as life insurance under the Code.

Rev. Rul. 2003-91 is a generally positive ruling that concludes with the generally accepted principle that individuals who own life insurance contracts are permitted to freely allocate the investments among a limited menu of IDFs previously established exclusively for investment by insurance carriers or through insurance products. Rev. Rul. 2003-92 sets forth what individuals are not permitted to do. This ruling states that an individual is not permitted to direct that the separate account funds be invested in nonregistered partnerships that accept investments from persons other than insurance contracts.

For those who wanted to know the limits on investor control, these rulings are welcome guidance. Essentially, the policy owner can tell the carrier how to allocate its investments among different types of investments. If there is available a selection of several mutual funds, the policy owner can tell the carrier which of these mutual funds to invest in and what the allocation among these funds should be. After picking the mutual funds and the amounts that should be allocated to each fund, the investor can no longer have any say related to those funds. In essence, the investor cannot tell the mutual fund managers which particular investments to make. However, the policy owner can reallocate to the various funds at its discretion.

Additional Income Tax Considerations of Life Insurance

Perhaps the most significant benefit regarding life insurance is the excludability of life insurance proceeds from federal taxable income (per §101). Although excludability is the general rule, it is possible to fall outside the general rule under the transfer-for-value rule. Under this rule, if a life insurance policy is sold or otherwise transferred to another person for consideration, the transferee will recognize taxable income upon receipt of the death benefit to the extent the death benefit received is in excess of the consideration paid plus any premiums paid by the transferee.

Example: Assume John Jones, the insured and owner of a \$500,000 death benefit policy, sells the policy to Jim Smith for \$100,000, and Jim Smith then pays five additional premium payments of \$5,000 each before John Jones dies. Upon Jones's death and the receipt of the \$500,000 death benefit, Smith will have \$375,000 of taxable income, which is the amount of the death benefit less Smith's purchase price of \$100,000 and the \$25,000 ($\$5,000 \times 5$) paid in premiums.

There are two main exceptions to the transfer-for-value rule under §101 that will allow the death benefit to maintain its tax-free status. The first exception applies if the transferee's income tax basis in the policy is determined in whole or in part by the transferor's income tax basis in the policy (the "carry-over basis exception"). For example, in the previous example, if Jones had given the policy to Smith instead of selling him the policy, Smith's tax basis in the policy after the gift would have been the same as Jones's tax basis. In this case, the transfer-for-value rule would not require Smith to recognize taxable income on receipt of the death benefit. This exception also applies in a transfer of a policy to a spouse or former spouse in a divorce situation as explained in §1041. In addition, the carry-over basis exception applies to corporate reorganizations. For example, if XYZ Corp. owns a key man life insurance policy and participates in a tax-free merger with ABC Corp., the life insurance policy will have the same basis in the hands of the newly merged corporation and the transfer-for-value rule will not apply.

The second exception to the transfer-for-value rule applies when the transferee is a permitted transferee. Permitted transferees include the insured, a partner of the insured, a partnership in which the insured is a partner, and a corporation in which the insured is an officer and/or a shareholder. However, if the policy has already been tainted by the transfer-for-value rule in the past, the transfer to a permitted transferee exception will not apply.

Note that if the transfer of the policy is a transfer from the grantor to his "wholly" owned grantor trust, because the grantor trust is ignored for income tax purposes, the transfer is deemed to be a transfer to the insured for purposes of this rule. This result was confirmed by the IRS in Rev. Rul. 2007-13, in which the IRS also ruled that a transfer from one grantor trust to another grantor trust created by the same grantor qualifies for this exception. For this reason, it is important to consider drafting all irrevocable life insurance trusts (ILITs) as grantor trusts. For years prior to this ruling, tax advisors and their clients have been faced with a problem. How can an individual unravel an ILIT without running afoul of the transfer for value rules in §101(a)(2)? In this ruling, the IRS provides an effective tool to cut through the "transfer for value" rules — the grantor trust.

Another important insurance-related income tax rule is the §1035 exchange rule. Generally an exchange of one property for another is a taxable event. The Code provides certain exceptions to this rule. One of the exceptions found in §1035 permits a life insurance policy to be exchanged for another life insurance policy provided that both policies apply to the same insured(s). The insurance company issuing the new policy does not have to be the same insurance company that issued the original policy. It is important to note that a single life policy cannot be exchanged for a second-to-die policy (unless it occurs after the death of one of the insureds).

ADDITIONAL LIFE INSURANCE CONSIDERATIONS

Understanding Life Insurance Policy Illustrations

Term insurance illustrations project premium payments and death benefits. There is no cash value to these policies. Premium costs are a function of the life insurance company's mortality experience and expenses (commissions, payroll, rent, etc.), and lapse rate. As mentioned earlier, about 98% of all term insurance lapses.

Permanent life insurance policy illustrations are projections of future cash value and death benefit based on certain assumptions regarding the expected premium payments, investment earnings of the cash value, as well as policy expenses and mortality charges. The lapse rate also factors into the illustrations. The company controls the company's expenses. Mortality charges (and lapse rates) are estimated based on the company's past experience and future expected experience. Investment performance by the various companies is typically similar. The life insurance industry is unique in its ability to illustrate to a customer what may happen in the future even though, in this writer's opinion, life insurance products should be viewed as investments. All other investments for sale come with the disclosure that past performance does not guarantee future results.

For whole life and universal life policies, initial illustrations reviewed should be based on the insurance company's current experience, in other words, their current charges and current earnings. Current earnings does not mean the same interest or dividend rate for all companies. If two policies have different rates of return, it may reflect the different type of investment mix that the particular insurance company chooses within its general account or the different spread it chooses to keep on the gross investment return (versus how much of the return it credits to the policy holders). Additional illustrations should also be reviewed showing a reduced earnings rate to determine the product's sensitivity to declines in investment earnings. For insurance company general account policies, the illustrations will never be able to show earnings in excess of the insurance company's current earnings rate.

However, the illustrations will always show the performance based on the guaranteed charges and guaranteed minimum investment return.

In times of unusual high interest rates and/or investment returns, these illustrations should be viewed with dividend or interest rates closer to long-term averages. It is likely that the consumer or their advisor will need to ask for illustrations showing reasonable investment return assumptions over the entire potential lifetime of the policy. Usually an illustration should be viewed that includes all years through the insured's age 100 or possibly longer as well. In these illustrations, it is important that with these reasonable assumptions, cash value remains available through the appropriate age so that the policy is not expected to lapse. Unless the policy is a guaranteed universal policy (as discussed above), if the cash value is depleted, the policy will lapse.

For variable life insurance policies, initial illustrations reviewed should be based on a reasonable return of the investments that are expected to be held in the policy separate account. For example, for an account that will be invested in a series of stock-based mutual funds, a reasonable long-term gross annual rate of return may be somewhere between 6% and 8%. Additional illustrations should also be reviewed showing a reduced expectation of the investment return to determine the product's sensitivity to declines in investment earnings. The Financial Industry Regulatory Authority (FINRA) requires that a variable illustration cannot be shown with an expected gross rate of return in excess of 12%, and requires the illustration to be shown with an expected gross rate of return of 0%. The illustrations generally will be based on the company's current charges, but must also be shown with the policy maximum or guaranteed charges.

Further, the variable policy illustration will show an average investment management fee expense based on all mutual fund choices allowed under the contract. Therefore, the illustration will state the gross investment return and this assumed investment expense fee as an annual percentage, or it may state the net investment return (after reduction for the investment expense fee) as well as this assumed investment expense fee as an annual percentage. Be aware the actual policy may incur higher or lower investment management fees based on the actual mutual fund choices included in the separate account. Because variable life insurance is treated as an investment product, the insurance company will provide a prospectus detailing all of the investment choices within the product. This prospectus will outline all fees associated with each investment choice.

Also be aware that if investment performance does not meet the illustrated projections, larger cash premium payments will be required in the later years than the cash premium payment that is projected. In addition, investment volatility will likely also cause the policy to perform differently than projected because projections are based on a constant earnings model.

The most important issue when comparing illustrations is to make sure that the different company illustrations are based on the same assumptions. In other words, compare apples to apples. Therefore, for whole life and universal, make sure each company's illustrations are based on their particular current earnings rate and, perhaps, 1% or 100 basis points less than that rate. For variable insurance, make sure each company is illustrating the same gross annual rate of return and, perhaps, a rate that is 1% or 100 basis points less.

A good illustration will demonstrate how the product works by showing the expected growth of cash value (and, possibly, death benefit) based on the anticipated premiums. A good set of insurance illustrations will demonstrate how the product reacts to changes in interest rates and/or other nonguaranteed factors. Please remember, however, illustrations are tools, not facts. Illustrations also are limited — as they can only be run on a linear basis and cannot provide dynamic modeling.

When comparing illustrations, make sure all relevant facts match each other. These facts include:

- Appropriate risk class of the insured(s);
- Correct age of the insured(s) (note that some companies show the age on the illustration based on last birthday and some show it based on nearest birthday);
- Same timing assumptions in the year shown (some show the values as of the end of the year and some show the values as of the beginning of the year);
- Same duration of the illustrations (i.e., through the same relevant age; for permanent policies typically past life expectancy such as to age 95 or 100);
- Same optional benefits, if any; and
- Same smoker status.

When comparing permanent policies, it is easiest to compare when both premiums and death benefits are the same. If the other factors match as discussed above, the performance differences appear in the cash values. If the comparison is not for universal level death benefit policies, it is difficult to obtain this type of comparison. Whole life insurance is structured (within the black box) to determine the premium and death benefit for a desired face amount of insurance and the death benefit will typically be somewhat different from the face amount due to favorable performance purchasing PUAs and the possible surrender of a portion of PUAs in the later years of a

policy. Comparing increasing death benefit policies will have their death benefit change with the cash value, which will affect the future changes in cash value. As a result, other measures are sometimes used for comparison, such as the internal rate of return on the death benefit or cash value as compared to premium payments.

For universal level death benefit policies (which represent a large percentage of the permanent insurance market), the easiest comparison is effective. The comparison is simply a year by year analysis of the cash value where the death benefit and premium payments are the same in all years. A comparison of two illustrations may sometimes reflect a higher cash value in one or the other illustration at any future date. This discrepancy results from the insurance companies charging different amounts related to expenses or mortality charges in different policy years. Alternatively, for these policies, the comparison can focus on the lowest premium by having the illustrations solve for the minimum premiums necessary to achieve a cash value of \$1 at a certain age like age 100. In this case, be sure that the premiums are paid in over the same years — for example, for all years or for the first 10 years of the policy.

With respect to health risk or status, preferred status usually means excellent health, normal blood pressure, normal cholesterol levels, no family history of heart disease or cancer before age 60, no tobacco use for three years, no hazardous activities like sky diving, no regular foreign travel to riskier locations, and a clean driving record for three years. Preferred status only occurs in about 20% to 25% of issued policies and is, therefore, often an unrealistic expectation for those age 55 or older because of medical issues by that age. Standard status usually means the individual has no significant or serious medical problems. For example, a standard status is likely for an individual with high blood pressure if it is well controlled with medications and no other complications exist.

Life Insurance Company Due Diligence

Insurance companies are rated by independent third parties that provide information regarding financial stability and claims-paying ability. This information should be reviewed for all companies under consideration. The operating statistics provided by ratings firms show the historical performance of investment yield, mortality experience, expenses, and lapse ratios. The most highly regarded rating services include A.M. Best, Fitch, Moody's, and Standard & Poor's.

An insurance company's ratings can likely be found on the internet. Each of the ratings services rates insurers for financial strength as an indicator of the company's ability to pay claims under its policies and contracts as they become due. All of the ratings services evaluate the same key elements of financial strength: surplus adequacy, asset quality, liquidity, asset liability matching, profitability, management quality, and effectiveness of the carrier's distribution system. Regardless of the rating, however, any particular company's situation can change at any time. Therefore, be careful of the amount of reliance on these ratings.

To confuse matters, each company uses a different rating system. For example, A.M. Best has 15 different categories, and Fitch has 24. The fourth A.M. Best category is labeled A- (after A++, A+, and A), but the seventh S&P category is A- (after AAA, AA+, AA, AA-, A+, and A).

Bottom line, with respect to ratings, it only makes sense to purchase insurance from insurance companies that consistently appear near the top of each service's ratings list. To purchase insurance from other companies presents too high a risk of not being paid the death benefit many years down the road. (I often wonder who does buy insurance from these lower rated companies.)

Finally, make sure that you are reviewing the right company's information. Because there are so many companies, some have similar names and parent company relationships. Therefore, be sure to know the full name of the company and if the parent company stands behind the issuing company. For example, Northwestern Mutual may be confused with Northwestern National; and Mass. Mutual (the short hand name for Massachusetts Mutual Life Insurance Company) may be confused with Mass. General (the shorthand name for Massachusetts General Life Insurance Company). To further identify a company, obtain its state of domicile.

Term Riders or Term Blends

An insurance agent makes a very small commission on a term policy premium. However, the commission on a permanent policy premium is rather significant. Most of the commission is paid to the agent in the first few years of the policy. In a permanent policy, the more of the premium amount that is paid to the agent in the form of a commission, the less of the premium that is credited to the cash value account. Therefore, any reduction in insurance agent commission will increase the cash value account. This increase will then allow for lower future premium amounts to sustain the policy.

As discussed earlier, the great advantage of a permanent policy over a term policy is that a term policy will likely lapse and never pay a death benefit. It is much more likely that a permanent product will be held until death because the early year higher premium payments will be invested to defray the cost of the late year premiums. So wouldn't it be great to be able to buy a permanent product with a commission structure priced like a term insurance product? The answer, of course, is yes; and it is almost available.

Many insurance companies will allow the policy owner to blend into a permanent insurance product a term rider or term blend. The term blend or term rider may be allowed for up to 90% or more of the total face amount of the policy. For example, a universal product may have a \$1 million face amount with \$100,000 of base universal insurance and \$900,000 of term rider or term blend. This term insurance cannot be cancelled or otherwise separated from the universal base and, thus, can be maintained throughout the insured's lifetime like any other universal product. Therefore, to keep the full \$1 million death benefit in force, the policy owner would simply need

to maintain its cash value. Because the agent's commission will be a much smaller percentage on 90% of the policy, much more of the first year premium will be reflected in the cash value. The insurance company receives virtually the same fees, only the agent's commission is reduced which, in turn, lowers the overall premiums for the policy.

It may be pointed out that the term blend will add risk to the policy. As noted earlier, the risk, if any, will not include a potential lapse of the term part of the policy. As long as the permanent base insurance is maintained and the term premiums are paid, the term part will remain a part of the blended policy. It is possible that the term part may have a different guaranteed cost structure. But as discussed above, these guarantees are unlikely to occur, and the current charges will likely be the same for policies with or without term blends. Therefore, it is unlikely that this risk will ever be realized.

Term blends can be used with whole life policies as well. However, because of the "black box," when using term blends with whole life, the dividends need to be at a level that will allow the term insurance to be replaced by paid-up additions within the cost structure of the policy. For this reason, a lesser amount of term blend may be required for whole life. Because variable life is typically structured as a universal policy, large term blends can also significantly reduce the cost of variable insurance as well. Some insurance companies do not offer term blends or limit term blends to certain products. Some insurance companies limit the amount of term blend, and the limit may vary with its various products.

PLANNING: WHAT WORKS

Efficient Replacement of Existing Policies and the Life Insurance Checkup

In today's world of information overload, some investors review their stock portfolios and other investments many times a day! These same people will buy a life insurance policy and put it in their drawer or safety deposit box and never look at it again. Most people don't realize that a life insurance policy is an investment. As with any investment, it needs to be monitored on a regular basis to make sure the investment is performing as expected. If it is not performing as expected, the policy may need to be replaced with a new policy just as an underperforming stock might be sold and replaced with another stock.

Further, it is important to review the details related to life insurance policies on a regular basis. Life events occur on a regular basis. Therefore, a simple review of the beneficiary information may reveal an unintended beneficiary, such as an ex-wife or a parent named prior to the insured getting married or having children. Further, the ownership may need to be changed for estate planning. Perhaps the policy was purchased when the insured's net worth did not warrant the use of an ILIT.

In many cases, if a life insurance product was purchased in a period of relatively high interest rates, the insured may have been shown an illustration prepared with the unrealistic expectation that the high interest rates will continue for the life of the policy. When interest rates normalize, the policy cash value will not build as quickly as anticipated, and without additional premiums, the policy will likely lapse prior to the insured's life expectancy. A similar result could occur if reasonable interest rate assumptions were used prior to an extended period of low interest rates (such as currently). Likewise, if a variable policy was expecting to generate unrealistic returns, or happened to be purchased just prior to a bad stretch in the stock market, it too may likely lapse prior to its original expectation.

Even if a life insurance policy is performing as expected, replacement may be warranted. Insurance companies are always looking to become more competitive in the current insurance market. As such, insurance companies constantly introduce new products. Today's universal product from an insurance company may be much different in cost structure than their product of two years ago, which may be much different than their product of five years ago. When an insurance company introduces a new product, they do not inform their existing policy holders of the new product. Therefore, it behooves the policy owner to compare their existing product to a potential replacement product. This process may be analogous to refinancing a mortgage to benefit from lower interest rates. The difference is that the mortgagee has public information regarding mortgage rates.

In order to determine if existing policies are efficient, the following steps should be completed:

1. Locate all policies in which the individual is listed as the insured. Be sure to include corporate owned policies (possibly used for a buy/sell agreement), insurance held in retirement plans, group term policies, association policies like the AICPA or ABA, policies owned by a trust, and individually owned policies.
2. Create a policy inventory. The inventory should include for each policy:
 - Name of the insured
 - Name, address, and telephone number of the insurance company
 - Policy number
 - Owner of the policy
 - Beneficiary(ies) of the policy
 - Policy type (term, whole life, universal life, etc.)

- Policy issue date
- Annual premium (and term of premium if a limited pay policy)
- Term of coverage if not a permanent policy
- Death benefit
- Face amount if different from the current death benefit
- Death benefit option (level or increasing)
- Current cash value
- Amount of any outstanding loans

3. Most of this information, if not all, can be obtained from the original policy and from the most recent "Statement of the Policy." Each year on the anniversary date of the policy issuance, the insurance company will send to the owner this statement of the policy. In addition, because it will be current, it will highlight any change of owner or beneficiary since the policy was issued.

4. Review the financial strength of the current insurance company or companies (as discussed above).

5. Determine if the current coverage for the insurance need is adequate. Because insurance is acquired at a point in time, it is common that purpose and death benefit need changes over time.

6. Obtain and review an "in-force" illustration for the policy in question. This in-force illustration can be obtained from the original insurance agent or directly from the insurance company. The in-force illustration should show the original premium expectation, with cash value and death benefit through age 100. One or more additional in-force illustrations should be obtained to determine the sensitivity of the policy to lower dividend/interest rates for whole life or universal policies (like a 1% or 2% reduction from the current rate) or to solve for premium payments required to support the policy through age 100 (if it would otherwise lapse). For variable policies, the in-force illustration should be at a reasonable gross return rate based on the investments in the policy as well as a reduced assume rate of 1% or 2% less.

7. Confirm the payment history of the policy — as a missed or delayed prior premium payment may have a significant impact on policy performance.

The above information will be a foundation to determine if it will be necessary to adjust the premium to a new schedule compared to the original expectation of premiums in order to maintain the policy to the appropriate age of the insured. In addition, the information can be used to compare a potential new policy to that of the existing policy. The insurance agent can determine how much additional death benefit, if any, can be obtained assuming a transfer of the existing net cash value (after any surrender charge) into the new policy with the same new premium schedule. Alternatively, the insurance agent can determine if a policy can be obtained at the same death benefit level with the existing net cash value and obtain a reduction in the new premium schedule. In many cases, it will make sense to revisit the type of policy. For example, the low premiums of guaranteed universal insurance may not have been available when the original policy was purchased and currently may be an attractive option for the insured.

If it is desirable to replace a policy because of the poor financial strength of the current insurance company or to potentially reduce premiums, the following points are important to consider:

- The client must be insurable (in relatively good health) to qualify for the new policy at reasonable rates.
- The surrender charges of the old policy and the sales commission of the new policy may make an exchange expensive. However, because of product efficiencies, even if these costs are significant, replacement may still be economical.
- The tax consequences need to be considered. Many times the exchange will qualify as a tax-free exchange under §1035. Regardless, even a surrender of a policy may produce little or no taxable income depending on the structure of the old policy and its investment performance.
- Buying a new policy begins a new two-year period for suicide and contestability. These provisions may allow an insurance company to void a policy if the insured dies within two years of the policy issuance and the cause of death is either suicide or if the policy application contained a material omission or misstatement of facts.

- Replacing a policy with a new policy with the same company may produce certain efficiencies. For example, the insurance company may be willing to reduce a surrender charge or, for coverage in the same or lesser amounts, may be willing to waive medical tests (since they are already at risk for the current death benefit).

Life Insurance as an Investment or Retirement Plan Substitute

As mentioned earlier, life insurance enjoys many income tax advantages including the tax-deferred increase in cash surrender value. As such, many taxpayers look to accumulate investments inside life insurance policies exploiting the tax-deferred compounding of investment returns. If a life insurance policy is structured properly, the benefits of tax-deferred compounding will outweigh the costs associated with the insurance elements of the policy, especially when the investments would otherwise be tax inefficient.

Typically a policy structured for investment purposes will be structured as a variable universal policy; thus, allowing for the taxpayer to choose an investment vehicle that can achieve equity-like returns and allows for flexibility in the payment of premiums. Further, because the goal is investment, it is likely that the cash value of the policy will be distributed in the future, at least in part, and, therefore, the policy should be structured as a non-MEC. To maximize the tax-deferred investment, however, the investment assets in the form of the policy premiums should be funded into the policy as quickly as possible without triggering the MEC rules. Typically the funding can occur in about four or five equal premium payments.

For example, assume an investor wants to invest \$500,000 into a non-MEC life insurance policy. The investor will likely be able to contribute \$100,000 into the policy in each of the first five policy years without causing the policy to be classified as a MEC.

In addition, in order to minimize the costs of the insurance (that will reduce the investment performance), the investor should obtain a life insurance policy with the lowest death benefit permissible under the law. This death benefit must not violate the CVCT (discussed above) at any time. The CVCT will determine the minimum death benefit for the expected investment amount. By minimizing the death benefit, the costs of insurance will be reduced, and the cash value will grow faster. As the cash value grows, even for a level death benefit policy, the tax law (based on the CVCT) may require the insurance company to increase the death benefit during the life of the insured.

Ideally, the cash value will be allocated to tax-inefficient investments. Some of the most tax-inefficient investments are hedge funds that produce taxable interest and short-term capital gain. As mentioned above, the investments within the policy cannot violate the diversification and investor control rules. Therefore, the insured can choose a portfolio manager or particular mutual fund or hedge fund, but cannot choose the specific investments. In addition, if a fund is used, it must be an IDF (as mentioned earlier, an insurance dedicated fund that is only sold through insurance products and not to the general public outside of insurance products to allow for the "look through" rule to apply). Many mutual fund companies and hedge fund companies will create "clone" funds for their insurance-only products. These clone funds will invest in the same investments as the similar fund that is generally available to the public outside of an insurance product.

To determine if it might make sense to make a particular investment inside a life insurance policy, simply have the insurance company/agent prepare an illustration for the variable universal policy specifying the expected gross return of the investment based on the desired investment (premium) minimizing the death benefit without causing the policy to be a MEC. Once the illustration is prepared, compare the cash value growth in the illustration to the same investment outlay outside of a policy reducing the annual returns by the expected applicable taxes.

Premium Financing

Premium financing is simply a way to pay for insurance once the client has identified the policy of choice and coverage amount. Premium financing should be considered at the end of the planning process where a client has already worked with legal, insurance, and tax advisors to establish a plan, has either completed or is in the process of implementing the plan, and is in the process to determine the most efficient way to pay for the chosen coverage.

Too often the finance is used to promote "free" insurance or to buy more insurance because the policy can be financed. As described above, policy illustrations are imperfect and a static projection from a point in time. If the illustration of the policy is solid, a financing modifier may make it look better. Alternatively, if the illustration is overly optimistic, a financing will likely accelerate a decline in policy performance and may have unintended tax consequences. It is important to monitor a policy over time. If a policy is financed, the need to monitor the strategy and benchmark against the original plan is even more critical.

Premium financing is most appropriate when a wealthy individual is acquiring a policy to provide estate liquidity. To avoid having the policy proceeds included in the insured's taxable estate, the policy is most typically owned by an ILIT. As such, any dollars given from the insured to the owner/ILIT are a gift. For an individual that wants to acquire a significant death benefit, the premiums tend to be large, often exceeding an amount available under the annual exclusion. In these cases, more creative methods may be desired to move money into the ILIT for the premium payments.

To solve the above problem, until the very early part of this century, a funding technique known as split dollar was typically used. Split dollar funding was based on a favorable Revenue Ruling issued about 60 years ago. In essence, it allowed for interest-free loans to be made to the policy owner by a wealthy party, and the loans would ultimately

be paid back without interest from the death benefit. In the context of an ILIT, split dollar allowed the wealthy insured to pay most of the premium, and therefore, make gifts of a very small fraction of the premiums to the ILIT so that the ILIT trustee could then contribute toward the policy premium. These small gifts would typically fall within the annual exclusion amounts. Upon the insured's death, the ILIT would retain a large majority of the death benefit (estate tax free) and would repay the estate the amount of the "loans" without interest.

In 2002, the Treasury significantly modified the rules around split dollar arrangements and all but eliminated the use of split dollar funding. The rules were modified to require the imputation of interest for these arrangements, or worse, require the insured/benefiting party to recognize income in the amount of the benefit received. As a result, premium financing became an attractive alternative.

Because split dollar would now require the imputation of interest anyway (and possibly the recognition of income), the preferred method of funding large amounts into ILITs seems to be a loan documented by a promissory note and the actual payment of interest. (In some cases, annual exclusion gifts are still used to help the ILIT fund the interest payments.)

Example: Assume that a wealthy individual has five children. ILIT needs to make eight annual premium payments of \$250,000 each to fund a \$10 million death benefit life insurance policy being acquired by the ILIT. Wealthy insured lends \$250,000 each year to the ILIT documented by promissory notes stating that interest will be charged at the relevant Applicable Federal Rate (AFR). Assume the AFR is 3%. Wealthy individual also makes gifts to the ILIT within the annual exclusion amounts each year so that the ILIT can pay him back the annual interest. After the eighth premium payment, the loan principal amount will be \$2 million. The annual interest will then be \$60,000 (or an amount equal to less than five annual exclusion amounts).

Because insurance premiums need to be made in cash, the above loan scenario works for the wealthy individual that is flush with cash. However, most wealthy individuals have their wealth invested in various ways. In order to help sell more of these large policies, some insurance companies have arranged for an ILIT to obtain loans to fund the premiums from third-party lenders. See the further discussion of this form of premium financing below.

Life Settlements

Another recent development within the life insurance industry is the life settlement business. Life settlements developed out of the viatical settlement market. A viatical settlement is a financial transaction in which a company buys a life insurance policy from someone who is terminally ill at less than its face value (but typically much greater than its cash value). Viatical settlements began about 30 years ago. The origins are from AIDS patients who needed large sums of money for medication in the final years of their lives but could not afford the medicine. Opportunistic investors realized these patients' life expectancy had changed significantly since policy issuance and there was quite probably value beyond the stated cash value in their life insurance contracts. They began a secondary market in these life insurance policies. The purchasers would keep the policies, minimally fund the policies, and ultimately collect the death benefits.

Life settlements are similar to viatical settlements, but the insured is typically not terminally ill. In order to participate in a life settlement, however, the insured will normally be of a certain age (at least age 60) and generally must have some health impairment. The purchaser then analyzes the life expectancy of the insured to determine what the purchaser is willing to pay for the policy. In many cases, the offer will be significantly greater than the current cash value.

Because of the flexibility of a universal policy, universal is more desirable than a whole life policy in the life settlement market. The purchaser can more easily modify the premium structure (and possibly the death benefit) with a universal policy to minimize the investors out of pocket contribution to sustain the policy throughout the insured's life.

One of the significant issues with the life settlement business is the ownership of the policy by someone who does not have an insurable interest in the life of the insured. In fact, just the opposite, the purchaser will make a greater profit if the insured dies sooner. In addition, many life settlement purchasers will resell the policies, perhaps in a package, to various investors. Many of these companies that either purchase policies or purchase packages of policies in the insurance secondary market are foreign companies. Therefore, an insured who participates in a life settlement may never know who will ultimately profit from their early demise. This fact makes many insureds too uncomfortable to participate in a life settlement.

Because the life settlement business is relatively new and deals with many unknowns about the future, the market for any particular policy may vary widely by purchaser. Therefore, if looking to participate in a life settlement, the policy owner should not only obtain bids from a broker that may represent several purchasers, but should likely seek bids from several brokers.

It remains unclear exactly how the life settlement business will change the life insurance industry, but it seems likely that more change is ahead. What is clear is that it will be very unlikely for a purchaser of a policy via a life settlement to allow the policy to lapse. Because insurance companies expect a certain amount of policies held by consumers to lapse, these companies will need to change their pricing models to reflect the changing industry.

An insured who originally purchased a life insurance policy for a need that no longer exists should consider a life settlement rather than allowing the policy to lapse. The insured may find that the value of the policy is significant enough to decide to get comfortable with the life settlement.

Example: Insured, age 75, had a stroke five years ago. He owns a \$2 million death benefit universal life insurance policy with cash value of \$150,000. He purchased the policy because he owned a significant amount of real estate investment property and did not want his estate to potentially go through a fire sale of the real estate to pay estate taxes at his death. He has since sold all of the real estate and no longer needs the life insurance. A life settlement company may offer to buy his policy for significantly more than \$150,000.

Private Placement Variable Life Insurance

When a high net worth individual is looking for ways to invest with tax deferral, the use of private placement life insurance (PPLI) is a great way to supplement other qualified tax-deferred investments (like IRAs and pension plans).

PPLI is usually structured as variable universal life insurance. As mentioned above, with variable life insurance, unlike other forms of permanent insurance, the insurance policy owner chooses the investments for the cash value account within the life insurance policy. With an ordinary variable policy, however, the investment decision is limited to choices among a number of mutual funds designated by the insurance company.

PPLI offers several added benefits over ordinary variable insurance. These benefits include lower costs and a customized design. In order to reap these benefits, the insured must be willing to invest significant value within the policy in the form of large policy premiums (usually at least several million dollars). Compared to the more typical insurance policy, PPLI enjoys extremely low distribution costs per premium dollar. In addition, due to its purposeful design, the insurance company reduces annual costs on the cash value account (in the form of the M&E percentage) because of the significant premium dollars as well as the expectation that the policy will likely remain with the insurer for many years. The PPLI contract is also custom designed for each policy within the bounds of tax and insurance laws. The most significant custom feature is the ability for the policy owner to choose his own investment manager to manage the cash value within the policy. The insurance company does not limit the choice to only a few mutual funds as with the ordinary variable policy. Within the PPLI policy, the insurance company contracts with the chosen investment manager to manage the policy's cash value. The investment manager fees are then paid from the cash value of the policy. Many insurance companies have also created their own PPLI products with various otherwise tax-inefficient hedge funds as the IDF investment choices within the product. As hedge funds typically generate taxable interest and short-term capital gain, placing these hedge funds within PPLI will add tremendous tax efficiency to these investments. Of course, the investments must meet both the diversification and the investor control tests.

Individuals interested in a significant life insurance death benefit should strongly consider private placement life insurance. Its lower cost alone compared to other types of insurance will provide a strong incentive to choose this life insurance. The individual will be able to obtain a greater death benefit for the same insurance premiums. In addition, the individual can choose the investment manager as discussed above.

More often, individuals are interested in tax-deferred investing when using PPLI. To maximize the investment return, typically the death benefit of the insurance is structured to be the lowest amount allowed under the CVCT test for the dollar value invested. This strategy minimizes the insurance costs that are deducted from the tax-deferred return. In addition, the investment is typically paid into the insurance policy (as premium payments) over as few years as possible while still avoiding MEC classification. In this regard, the individual can withdraw these premiums from the policy (for example, at retirement) tax free prior to withdrawing the taxable investment return. An added benefit is the insurance protection of the life insurance policy. As the cash value of the policy increases, the CVCT test may require the death benefit to also increase.

Example: Individual, age 50, enters into a PPLI contract with an initial death benefit of \$20,000,000. He expects to contribute \$1,000,000 as premium payments initially and in each of the next three years (to avoid MEC status) for an aggregate investment of \$4,000,000. The \$4,000,000 is invested tax-deferred and grows to \$30,000,000 by the individual's age 70. At that time, the individual withdraws the first \$4,000,000 without paying tax. Any additional amounts withdrawn will be taxed at individual's ordinary income tax rates. Instead of making additional withdrawals, however, the individual borrows additional amounts from the policy cash value to avoid taxation. As an added benefit prior to the withdrawal, the individual's insurance death benefit has grown to \$34,500,000. The same \$4,000,000 investment made within a taxable account may have only grown to \$20,000,000 due to the annual income tax payments on the investment income and recognized capital gain.

Some insurance companies offer PPLI through their domestic affiliates. Sometimes these affiliates are located in a state that charges a very low life insurance premium tax. Many other PPLI offerings are from offshore life insurance companies. In many cases, these offshore companies can further reduce the cost of the policy. However, other costs incurred to structure the policy or by doing business offshore may outweigh this life insurance policy cost reduction.

PLANNING: WHAT MAY NOT BE AS EFFECTIVE AS PROMOTED

Frozen Cash Value Life Insurance Policies

Another form of PPLI also is being touted to the high net worth individual. This form of PPLI is exclusively offered by offshore life insurance companies and is called Frozen Cash Value (FCV) PPLI. FCV PPLI is designed to limit the cash value of the policy that is available during life for either withdrawals or loans. Those earnings that would otherwise be included in the ordinary PPLI cash value account annually only are included as part of the death benefit.

FCV PPLI relies on the literal wording of §7702. Section 7702(a), in defining life insurance, states in part, “the term ‘life insurance contract’ means any contract which is a life insurance contract under *the applicable law*.” [Emphasis added.] Section 7702(a) then provides that life insurance under the applicable law only meets the definition of life insurance if the contract also meets the CVAT or the GPT and CVCT, as discussed above.

Section 7702(g)(1)(A) states:

[i]f at any time any contract which is a life insurance contract under *the applicable law* does not meet the definition of life insurance contract under subsection (a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year. [Emphasis added.]

Section 7702(g)(1)(B) states:

[f]or purposes of this paragraph, the term “income on the contract” means, with respect to any taxable year of the policyholder, the excess of the sum of the increase in the net surrender value of the contract during the taxable year, and the cost of life insurance protection provided under the contract during the taxable year, over the premiums paid [...] under the contract during the taxable year.

Literalists have focused on the meaning of “the applicable law” and the wording within both §7702(a) and §7702(g). They have interpreted these sections to provide that life insurance policies issued under the laws of other countries are still life insurance contracts even if they do not meet the various tests mentioned in the second part of §7702 (a).

The insurance laws of some other countries allow the face amount of the insurance contract to be less than its cash value or premiums paid. In fact, within these countries, a life insurance contract could exist with a current premium well in excess of the original face amount of the insurance policy. These policies would, therefore, not meet the definition of life insurance under the Code as they would not meet the CVCT test. For example, in such a jurisdiction, a one-time premium of \$5 million might be invested in a \$250,000 face amount FCV PPLI policy, or one-time premium of \$25 million might be invested in a \$1.25 million face amount FCV PPLI policy. A domestic PPLI policy for the same \$5 million premium might require a \$30 to \$40 million face amount to qualify as life insurance under the CVCT test. A domestic PPLI policy for the same \$25 million premium might require a \$150 to \$200 million face amount to qualify as life insurance under the CVCT test. With domestic PPLI, the cost of insurance on such a large face amount will be a significant drag on the cash value investment performance as compared to the FCV PPLI. Because the FCV PPLI will not meet the CVCT test, the FCV PPLI intentionally violates the Code definition of life insurance within §7702(a).

The trade-off within FCV PPLI is that the cash value account is not credited with the investment earnings during the life of the insured. Therefore, these investment earnings are not accessible by the policy owner during the life of the insured. The investment earnings related to the cash value account are instead held by the insurance company in a separate “mortality reserve” account. The cash value account under the FCV PPLI policy is defined to include only the premiums paid plus the cost of insurance (if paid separately) less any policy loans or withdrawals.

Because the FCV PPLI policy is designed to be treated as a life insurance contract under the applicable law of a foreign jurisdiction, the argument is that it is still a life insurance contract, but not a life insurance contract for domestic purposes. In fact, in the typical FCV PPLI offering, a foreign legal opinion is included as support that the life insurance policy issued qualifies as life insurance under the law of the foreign jurisdiction.

As mentioned above, §7702(g)(1) states that the income of a life insurance contract under the applicable law that is otherwise not life insurance as defined in §7702(g) is treated as ordinary income. Income under the contract is defined as the increase in cash surrender value. Because FCV PPLI cash value does not increase with the earnings related to the premium amounts that are invested, arguably there is no income within the FCV PPLI policy throughout the life of the insured. As mentioned, the increase in investment value is allocated during the life of the insured to a mortality reserve account. This mortality reserve account is not available for withdrawal during the insured's life but is included as part of the death benefit.

With respect to the death benefit, §101(a)(1) provides in general that gross income does not include amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured. Although not specifically stated, it is believed that this provision is designed to exclude only the pure death benefit related to an insurance contract (or the amount above the cash value account). It is the §7702(g) provisions that would exclude the investment increases in the cash value account for life insurance contracts that meet the definition of

life insurance within §7702. However, in FCV PPLI, there are theoretically no increases in the cash value account. The earnings on the cash value account are held within the mortality reserve account. This mortality reserve account, along with cash value account and the small face amount of the FCV PPLI policy, together form the death benefit of the policy. Therefore, if the policy owner can forgo access to the earnings on the cash value during the insured's lifetime, the earnings windfall will be paid to the beneficiary in a lump sum as part of the death benefit. And, arguably, because the FCV PPLI was a life insurance contract under *the applicable law*, the death benefit, even though it includes more than just the pure death benefit, will be fully excluded from taxable income under §101(a)(1). The expected result would be that all investment earnings within the policy are deemed to be tax-free.

In this regard, FCV PPLI may be interpreted by some technically to fall under the tax statutes to, in essence, allow the annual earnings as well as the death benefit to escape income taxation. It seems, however, that based on the tax history around the definition of life insurance and its use as a wrapper for a tax-deferred investment that FCV PPLI violates the spirit of these tax laws. It is the author's opinion that the use of FCV PPLI should be avoided under the "too good to be true" doctrine.

Stranger Owned or Investor Owned Life Insurance

Stranger owned life insurance (STOLI) or investor owned life insurance (IOLI) is usually a contrived transaction designed to sidestep state insurable interest and other laws and allow investors to use life insurance to profit from the deaths of people they do not know. In STOLI/IOLI, investors entice seniors to purchase life insurance policies, with the intent to transfer most of the benefit to the investors who then profit when the senior dies. The sooner the insured dies, the greater the investor's profit. Some believe that STOLI promotes wagering on human life. Also, STOLI may cause consumers unexpected taxes, loss of privacy, and the inability to obtain additional life insurance in the future.

STOLI typically works as follows:

- Investors, such as hedge funds, persuade senior citizens to purchase life insurance. The seniors purchase the policies in their own names but agree to an arrangement where the investors, after a period of time (usually the expiration of a two-year contestability period), obtain beneficial ownership of the policy. Some insurance agents will find the seniors on behalf of the investors.
- The senior typically receives some financial inducement to engage in the transaction. The inducement may be an upfront payment, a portion of the profit when the policy is sold, or a small continuing interest in the death benefit.
- Investors often agree to finance the premiums with a loan that is nonrecourse to the senior.
- The senior actually owns the death benefit during the initial time period. Therefore, the transaction is described to the senior as "free" insurance for this time period. If a death benefit is paid during that time, the lender is repaid from the death benefit. At the end of the time period, the senior is given the choice to pay back the loan to continue the insurance or to walk away. If they walk away, they are typically offered additional financial consideration.
- The investors typically profit by collecting the death benefits after the seniors die. The sooner the seniors die, the higher the profit.

Senior citizens participating in these arrangements may not be aware of the following:

- The income received from participating in STOLI, including the cost of insurance coverage during the "free period," is generally taxable income.
- The prevalence of STOLI may even increase costs of all insurance policies, because companies have to devote significant resources to detect STOLI, which both increases the cost and time that it takes to issue policies to legitimate purchasers. In addition, STOLI policies are unlikely to lapse (as discussed under Life Settlements above).
- Seniors participating in STOLI may use up their insurance capacity and be unable to purchase life insurance in the future for estate planning and other needs. (Insurance companies limit the amount of life insurance they will issue on any one individual based on the individual's net worth.)
- Through these transactions, seniors will be giving permission for someone to "check periodically" if they are still alive.
- Seniors need to be aware that any misstatements or lies on the insurance application, including those questions completed by an agent that they acknowledge with their signature, could have adverse consequences. The consequences might include the voiding of the insurance contract. because the investors will be looking for their death benefit, the senior's family may be stuck with a liability to the investors without an insurance death benefit to fund the liability. Indeed, STOLI applicants who mislead insurance companies on the policy applications could face legal liability or the risks of litigation.

In fact, on July 12, 2017, the U.S. District Court for the Eastern District of Tennessee, in the Memorandum Opinion of *Sun Life Assurance Co. v. Conestoga Tr. Servs., LLC*, declared a Sun Life insurance policy on the life of Erwin Collins void *ab initio* as a policy that lacked an insurable interest at its inception.⁶ In that regard, Sun Life did not have to pay the death benefit to the then policy holder. The court scrutinized the circumstances under which the Sun Life policy was issued and found the undisputed facts supported the conclusion that investors improperly used the insured as a conduit to acquire a policy that the investors could not have otherwise acquired. Because the policy holder was the sixth assignee owner of the policy and had paid premiums in good faith, the court ordered the repayment of the premiums this policy holder paid indicating that the policy was declared void only due to the misconduct of others.

⁶ 263 F. Supp. 3d 695 (E.D. Tenn. 2017).

Premium Financing with Unrealistic Assumptions

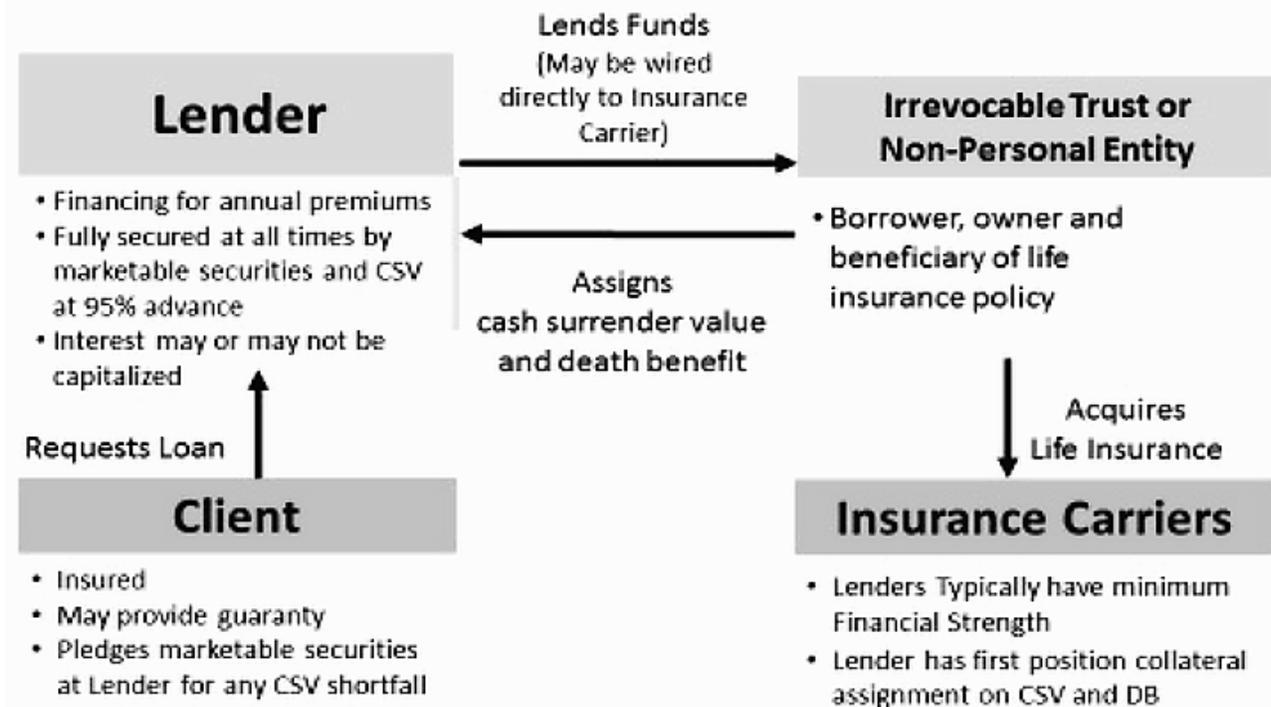
As discussed above, premium financing may be an attractive alternative for funding significant premiums into an ILIT. However, as also discussed above, with unrealistic assumptions regarding the financing and other aspects of an insurance policy, premium financing can accelerate a decline in policy performance and may have unintended tax consequence. As premium financing has become more popular, certain entrepreneurial producers and aggressive financiers have convinced lenders that making loans to ILITs with the loan being satisfied with a portion of the death benefit is a good credit risk.

With little to no regulation on how to model or illustrate these scenarios, promoters created models that illustrate unreasonably low borrowing rates (e.g., 2% fixed for the life of the loan of 30 plus years in some cases) and overlay this loan on carrier illustrations showing aggressive investment returns within the policy (e.g., a linear 8% investment crediting rate for the life of the policy). Because in these illustrations the cash value grows so much faster than the outstanding loan balance, the illustrations show interest accumulated into the loan principal with the insured still having sufficient collateral only using the cash value within the policy as support. In these illustrations, the policy owner does not pay even a penny into the policy. Further the loan is illustrated as non-recourse and only due at death to be repaid with the proceeds of the life insurance policy. Unfortunately, these illustrations do not always ring true, and these strategies have already often failed. The consequences have been that lenders lost money, carriers lost money, and insureds lost coverage and often realized taxable gains on these failed policies.

Premium financing of large policies can be successfully implemented. However, this success requires reasonable assumptions, coordinated partnerships with all parties, a clear objective, a disciplined monitoring system, and a planned repayment strategy — other than the death of the insured.

The typical premium finance structure is as follows:

Standard Loan Structure



The borrower is typically an ILIT. The lender lends the money directly to the ILIT to acquire the life insurance policy on the life of the "sponsor or insured." The lender takes a collateral assignment on the cash surrender value of the policy. This assigns all policy rights from the owner to the lender until it is released. The lender funds the premiums but, as described earlier, the cash value does not equal premiums paid. The lender will require the loan to be fully collateralized. The sponsor/insured or a related party typically will pledge marketable securities for any difference between the cash value of the policy at a discounted rate and the notional loan balance. The lender may or may not require personal guarantees. Interest may or may not be paid out of pocket depending on policy type, performance, collateral availability, and carrier requirements. After a period of positive arbitrage between the tax-deferred earnings on the policy and the borrowing rate on the loan, there is an anticipated crossover point where the cash value growth has outpaced the loan balance. (This crossover typically occurs between years seven and 10 depending on policy type and performance.) At some point thereafter, there should be sufficient build-up in the policy to repay the loan while retaining enough of the tax-deferred earnings in the policy to support the death benefit through at least age 100. See the illustration below.

A	B	C	D	F	Illustrated				
					L	M	N	O	P
Year	Premium	Interest Rate	Interest Expense	YE Loan Balance / (Cash From Policy)	"At Risk"	CSV @ 95%	Collateral Shortfall (M-F)	Death Benefit Illustrated	Net Cash to Trust (O-F)
1	2,983,696	2.10%	63,528	3,047,224	(1,555,637)	1,417,008	(1,630,216)	52,783,842	49,736,618
2	2,983,696	2.79%	170,600	6,201,520	(1,634,361)	4,338,801	(1,862,719)	55,781,058	49,579,538
3	2,983,696	3.27%	304,528	9,489,744	(1,618,882)	7,477,319	(2,012,425)	59,006,059	49,516,315
4	2,983,696	3.71%	469,192	12,942,632	(1,523,645)	10,848,038	(2,094,594)	62,475,540	49,532,908
5	2,983,696	4.04%	652,360	16,578,688	(1,346,996)	14,470,107	(2,108,581)	66,209,292	49,630,604
6	2,983,696	4.35%	862,783	20,425,167	(1,079,300)	18,378,573	(2,046,594)	70,241,901	49,816,734
7	2,983,696	4.55%	1,079,896	24,488,759	(575,762)	22,717,347	(1,771,412)	74,601,167	50,112,408
8	2,983,696	4.75%	1,323,066	28,795,521	54,207	27,407,241	(1,388,280)	73,429,857	44,634,336
9	2,983,696	4.93%	1,588,475	33,367,692	804,218	32,463,315	(904,377)	78,344,175	44,976,483
10	2,983,696	5.07%	1,868,613	38,220,001	1,692,040	37,916,438	(303,563)	83,476,265	45,256,264
11		4.00%	1,550,033	39,770,034	3,368,194	40,981,317	1,211,283	84,838,230	45,068,196
12		4.00%	1,612,896	41,382,930	5,173,881	44,228,970	2,846,040	86,956,811	45,573,881
13		4.00%	1,678,308	43,061,238	7,192,399	47,740,954	4,679,716	89,153,636	46,092,398
14		4.00%	1,746,372	44,807,610	9,444,754	51,539,746	6,732,136	91,522,364	46,714,754
15		4.00%	1,817,198	46,624,808	11,954,721	55,650,552	9,025,744	94,079,528	47,454,720
16		4.00%	1,890,895	48,515,703	14,744,462	60,097,156	11,581,453	97,160,164	48,644,461
17		4.00%	1,967,581	50,483,284	17,840,889	64,907,963	14,424,679	100,324,172	49,840,888
18		4.00%	2,047,378	52,530,662	21,274,997	70,115,375	17,584,713	103,705,658	51,174,996
19		4.00%	2,130,410	(54,661,072)	16,166,228	15,357,917	15,357,917	44,366,228	44,366,228
20					18,123,040	17,216,888	17,216,888	46,323,040	46,323,040

Given the limitations of policy illustrations and the ability to customize and modify projections, it is particularly important to review how the financed strategy has been designed. As previously stated, illustrations are linear and static. Some selling materials model fixed lending rates and positive arbitrage over long periods of time to produce attractive outcomes. By modifying the policy assumptions to include only the reduced guaranteed investment returns, the policy cash value builds slower and the premium financed policy fails to meet its objectives as shown below.

A	B	C	D	F	Guaranteed				
					G	H	I	J	K
Year	Premium	Interest Rate	Interest Expense	YE Loan Balance / (Cash From Policy)	"At Risk"	CSV @ 95%	Collateral Shortfall (H-F)	Death Benefit Illustrated	Net Cash To Trust (J-F)
1	2,983,696	2.10%	63,528	3,047,224	(1,861,391)	1,126,541	(1,920,683)	52,478,088	49,430,864
2	2,983,696	2.79%	170,600	6,201,520	(2,437,520)	3,575,800	(2,625,720)	54,977,899	48,776,379
3	2,983,696	3.27%	304,528	9,489,744	(3,130,953)	6,040,851	(3,448,893)	57,493,988	48,004,244
4	2,983,696	3.71%	469,192	12,942,632	(3,977,352)	8,517,016	(4,425,616)	60,021,833	47,079,201
5	2,983,696	4.04%	652,360	16,578,688	(4,995,414)	11,004,110	(5,574,578)	62,560,874	45,982,186
6	2,983,696	4.35%	862,783	20,425,167	(6,210,658)	13,503,783	(6,921,384)	65,110,543	44,685,376
7	2,983,696	4.55%	1,079,896	24,488,759	(7,503,372)	16,136,118	(8,352,641)	67,673,557	43,184,798
8	2,983,696	4.75%	1,323,066	28,795,521	(8,980,968)	18,823,824	(9,971,697)	64,394,682	35,599,161
9	2,983,696	4.93%	1,588,475	33,367,692	(10,715,058)	21,520,002	(11,847,690)	66,824,899	33,457,207
10	2,983,696	5.07%	1,868,613	38,220,001	(12,725,816)	24,219,475	(14,000,526)	69,058,309	30,838,308
11		4.00%	1,550,033	39,770,034	(14,330,266)	24,167,780	(15,602,254)	67,139,768	27,369,734
12		4.00%	1,612,896	41,382,930	(16,105,557)	24,013,504	(17,369,426)	65,677,373	24,294,443
13		4.00%	1,678,308	43,061,238	(17,986,965)	23,820,558	(19,240,680)	63,974,272	20,913,034
14		4.00%	1,746,372	44,807,610	(19,974,598)	23,591,361	(21,216,249)	62,133,012	17,325,402
15		4.00%	1,817,198	46,624,808	(22,064,169)	23,332,606	(23,292,202)	60,060,638	13,435,830
16		4.00%	1,890,895	48,515,703	(24,258,802)	23,044,055	(25,471,648)	58,156,900	9,641,197
17		4.00%	1,967,581	50,483,284	(26,553,990)	22,732,828	(27,750,456)	55,929,293	5,446,009
18		4.00%	2,047,378	52,530,662	(28,946,297)	22,405,146	(30,125,516)	53,484,364	953,702
19		4.00%	2,130,410	(54,661,072)					
20									

As shown in this illustration, if the policy underperforms or performs close to the guaranteed illustration, the ILIT could have a \$52 million loan (this loan balance assumes interest is accumulated), an additional \$30 million of needed collateral, and a death benefit of less than \$1 million in year 18. Even if interest is paid annually, there will still be a significant premium loan due, excess collateral required, and significant interest paid for a severely reduced death benefit.

In reviewing the above scenario, it is likely that the result will be in between the two illustrations as long as the strategy has been closely monitored and corrections and adjustments are made throughout the life of the policy. The key risks implicit in any financed strategy include interest rate fluctuations, carrier strength, lender longevity, policy design, policy performance, and initial and ongoing collateral requirements. Positive results can be achieved using leverage; however, the key component is to frequently monitor and correct.

The following is extracted and condensed from an actual sales illustration:

Year	Projected Lender Loan Interest	Cumulative Loans From Lender/ Premium Paid	Policy Cash Surrender Value @ Return of 6.5%	Policy Cash Surrender Value Net Of Lender Loans	Death Benefit	Net Cash to Trust	Policy Death Benefit
1	(59,313)	(4,500,000)	4,035,253	(464,747)	20,760,000	16,260,000	20,760,000
2	(59,313)	(4,500,000)	4,228,545	(271,455)	20,760,000	16,260,000	20,760,000
3	(59,475)	(4,500,000)	4,430,192	(69,808)	20,760,000	16,260,000	20,760,000
4	(59,313)	(4,500,000)	4,640,782	140,782	20,760,000	16,260,000	20,760,000
5	(59,313)	(4,500,000)	4,860,293	360,293	20,760,000	16,260,000	20,760,000
6	(59,313)	(4,500,000)	5,098,582	598,582	13,520,485	9,020,485	13,520,485
7	(59,475)	(4,500,000)	5,348,760	848,760	13,663,682	9,163,682	13,663,682

7	(55,475)	(4,500,000)	5,548,700	848,700	13,003,002	7,103,002	13,003,002
8	(59,313)	(4,500,000)	5,611,387	1,111,387	13,823,378	9,323,378	13,823,378
9	(59,313)	(4,500,000)	5,887,877	1,387,877	14,000,207	9,500,207	14,000,207
10	(59,313)	(4,500,000)	6,178,700	1,678,700	14,193,387	9,693,387	14,193,387
11	(59,475)	(4,500,000)	6,564,601	2,064,601	14,660,664	10,160,664	14,660,664
12	(59,313)	(4,500,000)	6,973,108	2,473,108	15,144,864	10,644,864	15,144,864
13	(59,313)	(4,500,000)	7,404,934	2,904,934	15,645,267	11,145,267	15,645,267
14	(59,313)	(4,500,000)	7,860,706	3,360,706	16,161,434	11,661,434	16,161,434
15	(59,475)	(4,500,000)	8,342,020	3,842,020	16,694,796	12,194,796	16,694,796
16	(59,313)	(4,500,000)	8,849,958	4,349,958	17,245,702	12,745,702	17,245,702
17	(59,313)	(4,500,000)	9,387,440	4,887,440	17,818,126	13,318,126	17,818,126
18	(59,313)	(4,500,000)	9,956,066	5,456,066	18,413,272	13,913,272	18,413,272
19	(59,475)	(4,500,000)	10,557,384	6,057,384	19,031,966	14,531,966	19,031,966
20	(59,313)	(4,500,000)	11,191,967	6,691,967	19,673,854	15,173,854	19,673,854
21	(59,313)	(4,500,000)	11,861,055	7,361,055	20,340,447	15,840,447	20,340,447
22	(59,313)	(4,500,000)	12,565,732	8,065,732	21,032,132	16,532,132	21,032,132
23	(59,475)	(4,500,000)	13,306,959	8,806,959	21,748,893	17,248,893	21,748,893
24	(59,313)	(4,500,000)	14,085,720	9,585,720	22,490,985	17,990,985	22,490,985
25	(59,313)	(4,500,000)	14,902,560	10,402,560	23,257,746	18,757,746	23,257,746
26	(59,313)	(4,500,000)	15,758,194	11,258,194	24,048,936	19,548,936	24,048,936
27	(59,475)	(4,500,000)	16,652,991	12,152,991	24,863,788	20,363,788	24,863,788
28	(59,313)	(4,500,000)	17,587,553	13,087,553	25,702,134	21,202,134	25,702,134
29	(59,313)	(4,500,000)	18,562,467	14,062,467	26,563,497	22,063,497	26,563,497
30	(59,313)	(4,500,000)	19,581,608	15,081,608	27,452,063	22,952,063	27,452,063
31	(59,475)	(4,500,000)	20,649,503	16,149,503	28,385,191	23,885,191	28,385,191
32	(59,313)	(4,500,000)	21,772,099	17,272,099	29,371,579	24,871,579	29,371,579
33	(59,313)	(4,500,000)	22,951,735	18,451,735	30,407,884	25,907,884	30,407,884
34	(59,313)	(4,500,000)	24,190,355	19,690,355	31,495,920	26,995,920	31,495,920
35	(59,475)	(4,500,000)	25,492,518	20,992,518	32,641,528	28,141,528	32,641,528
36	(59,313)	(4,500,000)	26,862,449	22,362,449	33,835,028	29,335,028	33,835,028
37	(59,313)	(4,500,000)	28,303,750	23,803,750	35,103,665	30,603,665	35,103,665
38	(59,313)	(4,500,000)	29,821,004	25,321,004	36,449,100	31,949,100	36,449,100
39	(59,475)	(4,500,000)	31,414,976	26,914,976	37,869,321	33,369,321	37,869,321
40	(59,313)	(4,500,000)	33,092,209	28,592,209	39,351,976	34,851,976	39,351,976

The aggressive assumptions within this actual sales illustration include an interest rate of 1.3% continuing for the life of the loan, repayment of the loan not being required until death, a positive 520 basis point investment arbitrage continuing for the life of the strategy, and the required payment of significant interest over the life of the loan. It is important to further note that the policy being illustrated is a MEC which could cause adverse taxation as mentioned above.

PLANNING: WHAT DOES NOT WORK

Private Placement Life Insurance with Indirect Investor Control

As mentioned earlier, the IRS clearly takes the position that within variable life insurance and PPLI, the policy owner/investor is free to choose an investment manager to manage the policy's separate account. The owner, however, must not have control over the actual selection of investments by the separate account manager. If it is determined that this investor control doctrine is violated, the policy accumulation will be currently taxable.

Investor control appears to apply whether it is actual investor control or indirect investor control. It was this indirect control that caused the investment income inside a PPLI policy to be taxed to the investor/policy owner in the Tax

Court case of *Webber v. Commissioner*.⁷ In *Webber*, the investor's grantor trust purchased two PPLI policies on the lives of two elderly relatives. The grantor trust beneficiaries were the investor and his descendants. The insurance company created a special purpose company to hold the investments for these two policies. This company invested in startups and other venture type investments in which the investor usually also owned a personal interest. Although there was an official investment manager designated for the insurance policy separate accounts, the investment manager always followed the investment requests given to him by the investor's lawyer or accountant. A special effort, however, was made to prevent the investor from directly and personally contacting the insurance company or the investment manager.

⁷ 144 T.C. 324 (2015).

Relying on the investor control doctrine, the Tax Court agreed with the IRS that the investor was taxable on the income within the PPLI policies because he had maintained substantial control over the separate accounts. The court noted that although the policies themselves denied the investor the power to direct investments, the investment manager always followed the investor's investment directions, albeit received via communications from the investor's agents. Nearly all the investments were non-publicly traded securities, and the investor admitted that the investment manager could not have had access to these investments except through the investor. Further, the investment manager maintained no compliance records, financial records, or other business documentation to establish that the insurer or the investment manager actually performed independent due diligence with respect to any of the requested investments. In many cases, the investor negotiated a deal directly with a third party, then recommended (indirectly through his agents) that the investment manager implement the deal that he had already negotiated.

The Tax Court also found that the investor dictated what actions the special company that held the policy's investments should take with respect to its ongoing investments. The investor required that the investment manager take no action without approval from the investor's lawyer or accountant, including how they should vote as shareholders, respond to capital calls, and participate in financing. Further, the court found that the investor arranged the investments in the separate accounts to mirror or complement his own personal investments. In the aggregate, the Tax Court concluded that the investor, through his agents, exerted excessive control over the separate account investments, and, therefore, was the deemed owner and taxable on the income from these investments.

CONCLUSION

Life insurance can be an important asset within an individual's financial life. Life insurance products, however, are complex and diverse. Advisors should assist their clients in choosing the appropriate product to match their need and risk appetite. Further, because financial projections of these products can be somewhat controlled to produce results desired, these projections need to be carefully scrutinized in the evaluation process. If used properly, the proper life insurance product can be used efficiently and effectively to accomplish various financial goals. If used for tax-efficient lifetime investing, however, it seems prudent to limit that use within the bounds of the law and to be very careful when the result being achieved sounds too good to be true.

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