OFFSHORE VARIABLE LIFE INSURANCE

This is one of a series of informational articles to introduce the reader to the concepts of Asset Protection, Estate Planning and related topics.

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GENERAL ASPECTS OF OFFSHORE LIFE INSURANCE

Life insurance is frequently used for the liquidity needs of wealthy individuals and families as a part of estate planning. Estate planning with life insurance is generally accomplished through an irrevocable life insurance trust established by the grantor or, sometimes, through the establishment of a limited partnership to own the insurance policy. Through proper structuring, offshore variable life insurance can also be used as part of a wealthy individual's or family's estate planning. Offshore life insurance, in combination with offshore trusts, may achieve the goals of combining serious estate, gift and generation-skipping transfer tax planning along with income tax planning and wealth preservation/wealth protection (asset protection) planning. In addition to tax planning benefits, cost and other distinct advantages are available to those who include the use of offshore life insurance in their planning.

ADVANTAGES

Lower Premium and Internal Costs

Insurance companies operating outside the U. S. generally have lower overhead costs than U. S. life insurance carriers. U. S. carriers, in general, have a larger distribution system, commissions to agents, and are subject to higher and more costly governmental regulation. The result is that many foreign carriers have lower premium charges and lower internal operating costs.

World's Leading Investment Managers

Foreign carriers provide flexibility with respect to the location and type, as well as compensation arrangements, for investment managers across the world. Flexible Investment Opportunities subject to meeting the diversification requirements and wrap rules, both discussed below, the type of investments that can be held in the separate segregated account under the policy is unlimited. The policyowner, however, is prohibited from exercising

control over the selection of the securities of such separate segregated account. A specialized investment manager (or managers) is thus available, as opposed to having only the investment options offered by U. S. insurance companies.

Choice of Currencies

Policy investments of U. S. carriers are held in U. S. dollars. Foreign carriers frequently offer premium payments, withdrawals, borrowings and death benefits in several currencies.

Larger Face Values

Larger face amount policies are generally available from foreign carriers. The foreign marketplace is often used for underwriting very large policies on U. S. lives due to the location of the world's largest reinsurers outside the U. S.

Favorable Governing Law

A life insurance policy is a contract that generally allows the contracting parties to designate a governing law that is respected by other jurisdictions. The application, signing, delivery or payments of the first premium in the chosen jurisdiction increases the respectability of the governing law.

Avoid Entity-Level Taxation

U. S. carriers are subject to entity-level taxation (federal, state or local). Carriers from low-tax or no-tax jurisdictions are not subject to this high taxation. In addition, U. S. carriers are subject to the deferred acquisition cost tax.

Avoid State Premium Tax

The state premium tax is avoided through the sale of offshore life insurance to a non-U.S. person such as a trustee of an offshore trust.

Wealth Preservation and Protection

The separate segregated account formed to fund an insurance policy by an insurance company in some jurisdictions is available solely to satisfy the insurance company's obligation to the owner of the policy. Such legislation provides that assets in the separate segregated account of the policy formed by the insurance company are not subject to the claims of creditors or claims against other policyowners of the insurance company.

Increased Confidentiality

Many of the foreign jurisdictions provide that insurance policies must be held in strict confidence. Exceptions may apply with respect to disclosure of tax information, including provisions under tax treaties with the U. S.

Avoidance of Registration Requirements Under the 1933 Act

The purchase of securities by the insurance company in the separate segregated account is not subject to the registration requirements under 1933 Securities Act (hereinafter referred to as "1933 Act") if the necessary requirements are met.

Avoiding of Rule Against Perpetuities

By forming a foreign life insurance trust in a jurisdiction that has either abolished or extended the Rule Against Perpetuities, the trust may be continued offshore for a long period of time after the death of the insured, thereby continuing asset protection benefits, investment diversification, and other benefits for the trust and its beneficiaries.

Avoiding Registration Under Securities Laws

Variable life insurance policies issued by foreign insurance carriers may be issued onshore or offshore in accordance with Regulation D ("Reg D") of the 1933 Act as a private placement of a security. This requires an individual policyowner to be (i) an "accredited investor" who is defined as one having a net worth in excess of $1 million; or (ii) one who had individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

Classification of a Variable Life Insurance Policy as a Security

A variable life insurance policy is classified as a security and must comply with U. S. securities laws. In accordance with Reg D, securities offered and sold outside the U. S. are not required to be registered under the 1933 Securities Act and Reg S may be relied upon for such offers and sales, even if coincident offers and sales are made in accordance with Reg D inside the U. S. SEC Release No. 33-6863.

Offshore Funds Generally Rely on Reg S

Reliance on Reg S is made by most offshore funds in concluding that offers and sales of shares of the funds are not subject to the registration requirements under the 1933 Act. In general, the registration requirements under Section 5 of the 1933 Act do not apply to offers and sales of securities occurring outside the U. S.

Principal Requirements for Avoiding Registration Requirements Under the 1933 Act

In general, two requirements are necessary to avoid registration under the 1933 Act in relying on the Reg S exemption: (i) offers of the offshore fund shares are made only to persons located outside the U. S. and buy-orders are accepted only from persons located outside the U. S.; and (ii) no activities are undertaken that have the purpose of, or that can reasonably be

expected to have the result of, "conditioning" the market in the U. S. to purchase the offshore fund shares. If the selling efforts condition the U. S. market to purchase offshore fund shares, this is deemed to be "directed selling efforts" which causes the necessity of registration under the 1933 Act.

Definition of a U.S. Person

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

State Department of Insurance Laws

If the offshore life insurance carrier complies with Reg S, it generally is not subject to the state department of insurance rules of the state where the insured U. S. person resides.

TAX ADVANTAGES OF A VARIABLE LIFE INSURANCE POLICY

Tax Deferral During the Insured's Life

Investment income or gains under the separate segregated account of a variable life policy is not taxed to the policyowner. Some jurisdictions do not tax the insurance company or the separate segregated account, also referred to as a subaccount, of the policy.

Insurance Proceeds Income Tax-Free

Life insurance proceeds generally pass free of income tax at death.

Insurance Proceeds Estate Tax-Free

Life insurance proceeds are excluded from estate taxation at the death of the insured.

Access to Insurance Policy Through Fund Borrowing

A policy that is not treated as a Modified Endowment Contract is referred to as a non-MEC, defined below, and permits borrowing without adverse income taxes.

REQUIREMENTS FOR CLASSIFICATION AS A VARIABLE LIFE INSURANCE POLICY

In general, I.R.C. § 7702 provides that the death benefit under a variable life insurance policy satisfies certain rules that guarantee that the insurance protection meets certain minimum requirements at the inception of the policy and for subsequent years.

Definition of Variable Life Insurance Policy

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

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

The variable insurance policies issued by offshore carriers are generally designed to satisfy the second test above-the guideline premium test and the cash value corridor test. This minimizes reinsurance charges and maximizes the net growth of the segregated accounts.

International Variable Life Policy

If excessive amounts of cash value are built up relative to the life insurance risk, the cash value corridor test disqualifies the variable life insurance policy as insurance. The cash value corridor test is met if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value. The guideline premium test and the cash value corridor tests are complex and require the use of an insurance actuary.

Diversification of Investments

The underlying separate segregated account of a variable life insurance policy must be diversified in order to qualify as a life insurance policy.

Diversification Rules

A variable life insurance policy is treated as a life insurance policy for U. S. income tax purposes if it is based on a segregated asset account. Thus, the segregated account is divided

into separate segregated accounts or investment accounts. At the end of the first policy year and on the last day of each quarter of each calendar year thereafter, no more than 55 percent of the value of a separate segregated account may be placed in any one investment; no more than 70 percent of the value of a separate segregated account can be placed in any two investments; no more than 80 percent of the value of a separate segregated account can be placed in any three investments; and no more than 90 percent of the value of a separate segregated account can be placed in any four investments.

Single Investments

A single investment includes all securities of the same issuer, all interest in the same real property project, and all interest in the same commodity.

Look-Through Rule

Separate segregated accounts can be invested in shares of one fund; however, if this is treated as one separate investment under I.R.C. § 817, the diversification requirement is not met. Under the look-through rules, a fund can be managed so that it qualifies under the diversification requirements. One method to qualify for the look-through rules is for the fund to qualify as a partnership and be owned by one or more segregated asset accounts of one or more insurance companies, so long as it is not registered under a federal state law regulating the offering or sale of securities.

Modified Endowment Contract

A Modified Endowment Contract ("MEC") is any contract that meets the requirements of a life insurance contract and fails to meet the seven-pay test. A policy fails the seven-pay test and is characterized as a MEC if the cumulative premiums paid at anytime during the first seven years of the contract exceed the sum of the maximum net level premiums that would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums. A single-premium contract is classified as a MEC since it is not paid with seven level premiums. Distributions from a MEC prior to death are subject to tax on the amount exceeding the investment in the policy. In addition, such a distribution from a MEC results in a 10 percent penalty tax, unless the distribution is made after disability of the insured or he attains age 59½, or the distribution is a part of a series of substantially equal periodic payments based on the life expectancy of the distributee.

Non-Modified Endowment Contract

Generally, the seven-pay test requires premiums to be paid into the policy over a period of seven years in order to avoid MEC status and its adverse consequences. If a policy is a non-MEC,

loans and withdrawals are generally tax-free to the extent of the policyowner's basis in the policy.

REQUIRED CONTROL OF INSURANCE COMPANY OVER THE MANAGEMENT OF THE POLICY ASSETS

Wrap Around Rules

The name "wrap around" comes from the fact that other investment assets such as stocks, bonds or mutual funds are wrapped in a variable life policy in the hope that the earnings from such investments are not taxable to the policyowner in the same manner as if the policyowner had purchased these assets directly.

Policyowner Control

If the policyowner is treated as the owner of the separate segregated account under a variable life insurance policy, income and gains from the separate segregated account are taxable to the policyowner. The policyowner is treated as the owner for tax purposes where the policyowner can select and control one or more investments in a separate segregated account portfolio of investments of the life insurance carrier issuing the policy. In making its rulings, the Internal Revenue Service determines whether there is actual command over the investments in the separate segregated account by the policyowner.

Control by Insurance Company

The insurance company is required to be the beneficial owner of the investments held in the separate segregated accounts for the insured. If the policyowner may direct the investment of the funds placed in the separate segregated accounts, the policyowner has surrendered few rights of ownership or control over the assets, thereby causing the insurance company not to be the beneficial owner. If funds are unique to the insurance company and available only through the purchase of its insurance product, and are not available to the public, then the insurance company is considered the beneficial owner. The Internal Revenue Service states that the insurance company is the owner of the funds, not the policyowner, where (i) the insurance company funds annuity contracts through a variable annuity fund; (ii) the assets of the fund are invested in several mutual funds that are not available to the public; (iii) the policyowner is are allowed to direct his payments for the annuity among the several funds; and (iv) control over the individual investment decisions is not in the hands of the policyowner.

Independent Investment Advisor

An independent investment advisor may be appointed by the insurance company to manage the assets in the separate segregated accounts of a variable life insurance policy. The policyowner may not appoint or control the advisor, however.

EXCISE TAX

Premium Payments

An excise tax of 1 percent is due on each premium payment made to a foreign life insurance company for a life insurance policy issued to a citizen or resident of the U. S. as the insured, absent a tax treaty. Each U. S. policyowner is required to deposit the excise tax in a timely manner with an authorized depository bank and file Internal Revenue Service Form 720 (Quarterly Federal Excise Tax Return) reporting each such payment. This excise tax is payable by "any person who makes, signs, issues or sells any of the documents and instruments subject to the tax, or for whose use or benefit the same are made, signed, issued or sold." The tax is payable by "the person who makes the payment of the premium to a foreign insurer …" Some practitioners take the position that no excise tax is payable where the premium is made by the trustee of an offshore life insurance trust since the offshore trust is a non-U. S. person. Other practitioners assert that the trustee of the offshore life insurance trust is acting as agent for the settlor (insured) of such trust causing the excise tax to be due.

Reinsurance Premium Payments

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

LEGAL STRUCTURES FOR ACQUIRING VARIABLE LIFE INSURANCE.

Foreign Trustee as Non-U. S. Person

Foreign life insurance carriers generally will not market to or directly deal with a U. S. person. Foreign carriers desire to avoid the requirement of registering under the 1933 Act and

avoid being subjected to the jurisdiction of State Department Insurance laws in the state in which the insured resides. Representatives of the foreign carrier, however, speak with the U. S. insured's professional advisors, such as lawyers, accountants and financial planners. The trustee of the offshore trust is the proper party to receive information regarding the policy from the insurance carrier and sign the application for insurance as applicant, owner and beneficiary.

Methods of Acquiring Offshore Variable Life Insurance Policy

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

Foreign Irrevocable Life Insurance Trust

A U. S. settlor forms and funds a foreign nongrantor trust, followed by the trustee acquiring a variable life insurance policy on the life of the U. S. person as the insured with the trustee as applicant, owner and beneficiary. A foreign nongrantor trust has no owner for U. S. income tax purposes under I.R.C. §§ 671-679 and generally includes no U. S. beneficiaries until one taxable year after the death of the grantor and grantor's spouse. Generally, a foreign charity is named as beneficiary during the lifetime of the grantor and until one taxable year after the death of the grantor and grantor's spouse. It is suggested that substantial and recurring distributions of income generated by the trust assets (other than the variable policy) be made to the foreign charity in order to avoid classification of the trust as a sham. The "Crummey" withdrawal provisions are generally not included in this trust since there is a potential that such a withdrawal right causes the trust to have a U. S. beneficiary making it a foreign grantor trust instead of a foreign nongrantor trust.

Domestic Irrevocable Trust and Foreign Asset Protection Trust

A U. S. person forms and funds a domestic irrevocable life insurance trust. The trustee of the domestic irrevocable life insurance trust forms and funds a foreign grantor trust (asset protection trust). The trustee of the offshore trust acquires a variable life insurance policy, as applicant, owner and beneficiary, on the life of the U. S. person as the insured. During the life of the insured, the offshore trust may designate the trustee of the domestic irrevocable life insurance trust as the primary discretionary beneficiary, and family members as secondary discretionary beneficiaries. Any income generated by the offshore trust (outside the variable life insurance policy) is taxed either to the domestic irrevocable life insurance trust or its grantor. After the death of the insured, the offshore trust generally designates the trustee of the domestic irrevocable life

Insurance trust as the primary beneficiary.

Domestic Irrevocable Trust and Foreign Nongrantor Trust

A U. S. person forms and funds a domestic irrevocable life insurance trust. The trustee of the domestic irrevocable life insurance trust forms and funds a foreign nongrantor trust. A foreign nongrantor trust is a trust, during the life of the insured and for one taxable year after the insured's death and the insured's spouse's death, that specifically states that no income or principal can be distributed to or accumulated for the benefit of a U. S. person, and generally designates during this period of time, a foreign charity or charities as the beneficiary. The trustee of the foreign nongrantor trust acquires a variable life insurance policy, as applicant, owner and beneficiary, on the life of the U. S. person as the insured. After the death of the insured, the offshore trust may designate the trustee of the domestic irrevocable life insurance trust as the primary beneficiary and the offshore trust establishes trusts for the benefit of family members as the secondary beneficiaries.

USE OF A PRIVATE ANNUITY ARRANGEMENT WITH THE VARIABLE LIFE POLICY

Implementing the Separate Segregated Account

Upon the premium payment or payments, the foreign life insurance carrier places a substantial portion of these funds in several diversified mutual funds. The remaining portion of the premium payment or payments may be placed in a separate segregated account that consists of an investment in one or more entities such as an international business corporation or a foreign limited liability company in a no-tax jurisdiction ("foreign entity"). The separate segregated account transfers assets in exchange for shares of stock or limited liability company interests in the foreign entity.

Private Annuity Arrangement

This foreign entity may acquire property from a U. S. person, as an investment of the policy, generally accomplished through a private annuity arrangement. The foreign entity often acquires appreciated assets from a U. S. person who is the insured party under the policy.

No Restrictions on Source of Assets in Segregated Account

The segregated asset requirements of a variable life policy include no restrictions or

guidelines on the source of assets. The diversification rules restrict the percentage of the segregated account assets that rules restrict the percentage of the segregated account assets that can be invested into a single investment; no restrictions are placed on the percentage of any one investment that the segregated asset account may hold. Use of a limited liability company as the entity, however, avoids any diversification issue. A disregarded entity, such as a limited liability company, is looked-through to its diversified assets; whereas, the stock in a corporation is the single investment, not the assets of the corporation.

Net Asset Value of Segregated Account

At the time that the foreign entity acquires the appreciated asset and enters into a private annuity arrangement, the value of the asset received and the liability due from the entity to the transferor causes the net asset value to equal zero.

Advantages of the Private Annuity

Numerous advantages may result from the use of the private annuity arrangement in selling appreciated property to the foreign entity formed by the separate segregated account. These advantages include: (i) capital gains taxes are reported ratably over the period of the transferor's life expectancy; (ii) the value of the unpaid portion of a private annuity obligation can be excluded from the transferor's gross estate; (iii) the non-resident alien foreign entity can sell the acquired appreciated property, which does not produce U. S. source income, without U. S. income taxation; (iv) since the foreign entity is located in a no-tax jurisdiction, no gain is recognized by it under the annuity contract; and (v) a deduction is available to the annuitant or the annuitant's estate for the unrecovered investment in the private annuity contract if the private annuity contract ceases by reason of the death of the transferor (annuitant).

DEATH OF THE INSURED

Estate and Generation-Skipping Tax Avoidance

At the death of the U. S. person, as the insured of the variable life policy, all of the investments, including the mutual funds and the investments in the foreign entity established by the policy, collapse and pass to the foreign trustee as beneficiary of the policy. These insurance proceeds pass to the foreign trustee without estate tax inclusion to the insured's estate.

Generation-skipping transfer taxes are avoided through several levels of generations due to the earlier filing of a gift tax return by the settlor/insured for any funding of the trust in order to pay the insurance premium or premiums and to elect to allocate his generation-skipping transfer tax exemption to the gift.

Filing the Gift Tax Return

Upon transferring cash to the trust in order to acquire a variable life insurance policy or to pay premiums, a gift tax return is filed. The applicable exemption amount against any taxable gift and the election to apply the exclusion against the generation-skipping transfer tax are reported on the gift tax return. The insurance proceeds pass to the trustee of the foreign trust that is governed by trust law that has either substantially extended or abolished the Rule against Perpetuities. Thus, the insurance proceeds pass through several levels of beneficiaries without estate tax or generation-skipping transfer taxation.

Payment of Premium

The payment of premium or premiums is generally made by cash transfers to a domestic irrevocable life insurance trust whose trustee, in turn, transfers cash to a foreign trust that acquires life insurance, or directly to the trustee of a foreign nongrantor trust that acquires the insurance. There are no tax consequences upon the transfer of cash. The transfer of appreciated property by a U. S. person to a foreign grantor trust is not subject to any recognition of gain since the U. S. person is treated as the owner. However, if a U. S. person transfers appreciated property to a foreign nongrantor trust, the transfer is treated as a sale or exchange and gain is recognized equal to the excess of the fair market value over the adjusted base of the property. Gain is recognized because the grantor of a foreign nongrantor trust is not treated as the owner.

CONCLUSION

Due to international and global information available in the communications and information age wealthy individuals are thinking globally and internationally. Wealthy individuals are concerned with the litigious society in the U. S. and are continuing to place some of their assets outside the U. S. Wealthy individuals are learning that foreign trusts and other structures provide access to some of the world’s leading investment managers and investments that are otherwise closed to U.S. persons.

High transfer taxes, including estate, gift and generation-skipping transfer taxes, are of concern to wealthy individuals and families. As a result, wealthy individuals and families are often seeking alternatives to domestic planning structures. Wealthy individuals are finding that implementing foreign structures that include various types of foreign trusts and the acquisition of foreign variable life insurance may result in reducing transfer taxes as wealth passes from one generation to another within the family.

This article is designed to introduce you to the importance of asset planning and the need to protect your wealth. It is published as part of general information series for visitors to our web site, our clients and prospective clients. If you need to pursue an asset protection strategy, make sure you do it with the assistance of a professional. This informational article is published by Law Offices of Daniel Greenberg, LLC, 35 Corporate Drive, Suite 1155, Trumbull, CT 06611, USA (203) 459-8900, www.offshorelaw.com, or email us at learnmore@offshorelaw.com. Any request for permission to distribute, reprint, or publish this copyrighted material must be submitted to the above address in writing.