An Update of Utilization of Life Insurance and Annuity Products in the International Tax Arena

by James A. Walker, Esq.
J.A. Walker & Associates, P.C.

The use of retail or "private placement" life insurance and annuity policies issued by insurance companies located in a country outside of the home domicile of the insured has become a common international private banking and estate planning tool for high-wealth global clients. This presentation will focus on the two separate areas of primary focus in this arena: (1) the use of policies issued by U.S. or non-U.S. carriers that are U.S. tax compliant, meaning that they are structured and administered so as to meet the definitions and requirements for life insurance and annuities in the U.S. Internal Revenue Code; and (2) the use of policies issued by non-U.S. insurance companies to provide tax or insurance or investment planning benefits to persons with no connection to the U.S. or its taxation or insurance rules.

U.S. Compliant International Life Insurance and Annuities.

There are three typical planning scenarios wherein the use of a U.S. or non-U.S. private placement insurance policy arises as a planning tool option to be considered by the client and his or her advisors:

(a) High-wealth U.S. client needing significant life insurance coverage and wishing to use the investment advantages and flexibility of a variable life insurance policy. The international policy uses arise when the client has international investment and/or asset protection goals best afforded by a non-U.S. carrier;
(b) High-wealth non-U.S. client moving to the U.S. on temporary or permanent basis. In this "pre-immigration" planning

scenario, the options are a variable annuity or life policy from a non-U.S. carrier.

(c) High-wealth foreign client with U.S. intended beneficiaries, typically using international life policy coupled with international trust to provide for tax-efficient future distributions from the trust to U.S. beneficiaries.

In a typical United States variable life insurance purchase transaction, the sole concern of the attorney advising the purchaser client in such a situation typically revolves around structuring the ownership and funding of the policy such that the policy proceeds will not be subject to the United States federal estate tax upon the death of the insured.[1] In a private placement transaction, however, the ability of the insurance company to better customize the policy to better suit the specific needs of the high wealth client means that there are other tax issues the advisor must carefully consider. Primary amongst these issues are the diversification requirements and the investor control prohibition. These issues are at the heart of the controversy raised in the industry by the recent Rev. Rules 2003-91 and 2003-92, and the subsequent IRS proposal to delete regulation sections 1.817-5(f)(2)(ii) and –5(g)(ex.3).

1. DESIRED TAX BENEFITS

The Policyowner and the insurance company must meet certain restrictions under the Code, and all rules and regulations thereunder, if the variable life insurance policy is to qualify as a "life insurance policy" under Code Section 7702. If the variable life insurance policy so qualifies, the following benefits may be attained:

Unlimited tax deferral during the life of the Insured. The Policyowner is not taxed on the investment income or gains within the Separate Account. The domicile of the insurance company should impose no tax upon the insurance company or the segregated Separate Account. Note that U.S. or foreign withholding taxes could

[1] See Section 2042 of the Internal Revenue Code of 1986, as amended, for the rules governing whether the insured has retained an "incident of ownership" sufficient to cause inclusion of the death benefit proceeds upon the death of the insured.

be imposed on income earned from taxable jurisdictions by the insurance company on assets held in its Separate Accounts. Therefore, a Policyowner should consider the possible effect of U.S. and foreign taxes when selecting an investment philosophy strategy for a Separate Account.

Income Tax-Free Death Benefit. Upon the death of the insured, the Death Benefit under a variable life insurance policy is paid free from income tax to the designated beneficiaries under Code Section 101(a)(1) absent the application of the transfers-for-value rules.

Access to funds (Modified Endowment Contracts and non-Modified Endowment Contracts). The United States income tax consequences of lifetime distributions from a life insurance policy depend on whether the premium payments under the policy are structured to avoid the modified endowment contract rules of Code Section 7702A.

(1) Modified Endowment Contract. Basically, a Modified Endowment Contract (a "MEC") provides all of the tax benefits of a variable annuity or an Individual Retirement Account during the life of the insured plus offers a completely income tax free Death Benefit. MEC status does not affect the tax deferral on investments held in the insurance policy. Loans and withdrawals from a MEC, however, are generally taxable as ordinary income to the extent of "income in the contract" in the MEC, and such amounts are also generally subject to a 10% penalty tax if the Insured has not attained the age of 59½. Single premium and similarly designed policies will generally be a MEC.

(2) Non-Modified Endowment Contract. Determination of whether a life insurance policy is a MEC is based on a complicated "seven-pay" test that applies a complex actuarial calculation to the policy. In general, a policy is considered to fail the seven-pay test (and, therefore, be characterized as a MEC) if the cumulative premiums paid at any time during the first seven years of the contract exceed the sum of the maximum net level premiums that could 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. In

effect, the seven-pay test generally requires the premiums to be paid into the policy over a period of several years (rather than in a single up-front payment) as a condition to avoid MEC status and its adverse consequences.

If the life insurance policy is not a MEC, then the policy loans are generally tax free and withdrawals are generally tax free to the extent of the Policyowner's basis in the policy. Policies where the premiums are paid in equally for five years or more rather than in a lump sum generally are non-MEC's. The lifetime income tax advantages of a non-MEC means the Policyowner can have tax-free access to Policy values during the lifetime of the insured.

2. DIVERSIFICATION REQUIREMENTS

The significant United States tax benefits of a variable life insurance policy noted above do not occur unless the policy complies with the diversification requirements. Section 817(h) of the Internal Revenue Code of 1986, as amended (the "Code") requires the segregated asset account of variable life policies to meet certain minimum "diversification" requirements. If the diversification requirements are not satisfied, then the variable contract is not treated as a life insurance contract for purposes of Subchapter L (life insurance company taxation) and Section 7702(a) (relating to the definition of a life insurance contract).

Regulation Section 1.817-5(d)(1) sets forth the general diversification requirement that no more than 55% of the aggregate value of the policy investment account can be invested in any single asset, nor more than 70% of the total value in any two investments, nor more than 80% in any three investments, nor more than 90% in any four investments. For purposes of this testing, all securities of the same issuer, all interests in the same real property project, and all interests in the same commodity are each treated as a single investment. In the case of government securities, however, each government agency or instrumentality is treated as a separate issuer.

This "diversification" requirement is tested at the end of each calendar quarter over the life of the policy, but does not apply during the first year the separate account is in effect. See Reg. 1.817-5(c)(2)(i). The diversification requirement must be satisfied on the last day of the calendar quarter or within thirty (30) days after such last day to be considered diversified for such quarter.

A segregated asset account that satisfies these diversification requirements at the end of any calendar quarter is considered diversified in a subsequent quarter even though a discrepancy exists between the value of its assets and the diversification requirements unless the discrepancy exists immediately after the acquisition of any asset and the discrepancy is wholly or partly the result of that acquisition. Specifically, Regulation Section 1.817-5(d) provides:

"A segregated asset account that satisfies the requirements of paragraph (b) of this section at the end of any calendar quarter (or within 30 days after the end of such calendar quarter) shall not be considered nondiversified in a subsequent quarter because of a discrepancy between the value of its assets and the diversification requirements unless such discrepancy exists immediately after the acquisition of any assets and such discrepancy is wholly or partly the result of such acquisition."

In effect, once a portfolio is adequately diversified then it generally continues to meet these requirements regardless of market fluctuations in value unless new assets are acquired that cause the account to become nondiversified.

In addition to the general "diversification" requirements described above, IRC Section 817(h)(2) provides a "safe harbor" in that a segregated account will be considered "diversified" without further showing if it satisfies the diversification requirements applicable to regulated investment companies under IRC Section 851(b). Also, an alternative diversification test can be used for variable life insurance contracts under Regulation Section 1.817-5(d)(3) that hold U.S. treasury securities as a major part of the overall account.

In determining compliance with the diversification requirements, a significant issue revolves around whether an investment in a collective investment vehicle is a single investment or whether there is a "look–through" to the underlying investments of the collective investment vehicle. The general rule is that there is no look through. However, as usual, there are some key exceptions to this general rule. Specifically, Regulation Section 1.817-5(f) provides that a beneficial interest in a regulated investment company, a real estate investment trust, a partnership, or a grantor trust is not treated as a single investment. Instead, a pro rata portion of each asset of the investment company, partnership or trust shall be treated as an asset of the separate account. However, the regulations go on to specify that this exception only applies if (1) all beneficial interests in the investment company, partnership or trust are held by one or more segregated insurance accounts (with certain permitted exceptions), and (2) public access to the company, partnership or trust is only available through the purchase of a variable contract.

The big change for 2003 in this area deals with the second exception provided in the Regulations for "nonregistered partnerships." Specifically, Regulation Section 1.817-5(f)(2)(ii) provides that the look through exception "shall also apply to a partnership interest if the partnership interest is not registered under a Federal or State law regulating the offering or sale of securities." The IRS proposed in July of this year (2003) to delete this section of the Regulations and thus this "look-through" exception. The notice suggests no real grandfathering. The truncated diversification rules are to become immediately effective upon issuance of the final regs, including for investments made prior to the effective date. However, arrangements in existence on the effective date "will be considered adequately diversified if:

(i) those arrangements were adequately diversified within the meaning of section 817(h) prior to revocation of 1.817-5(f)(2)(ii) and

(ii) by the end of the last day of the second calendar quarter ending after the effective date of the regulation, the arrangements are brought into compliance with the final regulations."

In determining the respective values of the various investments of a separate account, Regulation Section 1.187-5(h)(9) provides that "value shall mean, with respect to investments for which market quotations are readily available, the market value of such investments; and with respect to other investments, fair value as determined in good faith by the managers of the segregated asset account."

It is important to note that it appears that the diversification testing begins at the level where the policyowner is able to select the investment options. Accordingly, if a single separate account is comprised of a portfolio managed by investment manager A and a portfolio managed by investment manager B, where both managers were selected from the available choices by the policyowner, the conservative position is that each of the portfolios managed by investment manager A and investment manager B would need to independently pass the diversification requirements. See PLR 9748035. This would not be the case for sub-managers and accounts under the selection and control of an "umbrella" investment manager (for example, a "fund of funds" type structure).

Satisfaction of the diversification requirements is a strict mathematical test applying the rules and percentage limitations. There is "no substance versus form" type analysis. For example, in PLR 9847017, the IRS addressed the situation of an insurance company that offered as separate account investment choices a series of investment company funds that were exclusive to separate accounts and thus qualified for the look-through treatment, and a series of nonpublically traded partnerships that were SEC registered and not exclusive to separate account investors and thus did not qualify for look-through treatment, even though the underlying investments and strategies and mangers were identical. Thus, it is possible to invest 100% in a mutual fund that does not satisfy the look-through requirements due to general public investors (Fidelity Magellan, for example) by creating an identical mirror "clone fund" that is only open to separate account investors. This seemingly ridiculous result is actually amplified in new Rev. Rul. 2003-92

(discussed below), to the dismay of many insurance companies and insurance advisors – the ultimate in form over substance.

Finally, it is important to note that it is unclear whether the Code Section 817 diversification rules apply at all to a variable policy issued by a non-US insurance company. Specifically, Code Section 817(d) defines a "variable contract" for purposes of Code Section 817 as being "a contract which provides for the allocation of all or part of the amounts received under the contract to an account which, *pursuant to State law or regulation*, is segregated from the general asset accounts of the company …." (Emphasis added). The term "State" is defined in Code Section 7701 and does not include any other non-U.S. country. Accordingly, by the very clear terms of the statute, the diversification restrictions and requirements do not seem to apply to a variable contract issued by a non-U.S. company where the contract does not rely on State law or regulation to establish the separate account funding the contract. This conclusion, which seems clear from the language of the Code, was implicitly confirmed recently in PLR 200246022, in which the Service address the applicability of the Sec. 817(h) diversification rules to non-U.S. insurance companies that have made the election under Sec. 953(d) to be taxed as domestic corporations. The ruling concludes that a non-U.S. life insurance company that has made a U.S. taxation domestic election is deemed to be within the "State" definition by virtue of the domestic election, and thus must maintain its variable policies in compliance with the Sec. 817(h) parameters. The clear implication from the ruling, however, is that absent the voluntary, compelling connection of the domestic election, Sec. 817(h) is simply not applicable to a non-U.S. carrier. Other than this PLR, however, there is no precedent confirming that the IRS or a U.S. court would agree with this conclusion. Thus, I strongly suggest that the more conservative and prudent course of action is to satisfy the diversification requirements for a variable life insurance policy that is intended to be US tax compliant. As a practical matter, all of the major international insurance companies offering policies that I have ever reviewed that are structured to be U.S. compliant do contractually mandate Sec. 817(h) diversification compliance, so the "State" issue is intellectually interesting but realistically not relevant.

3. INVESTOR CONTROL RESTRICTIONS

While the diversification requirements for a variable life policy are complicated, at least they are clearly set forth in the statue (the primary ambiguity being the non-US insurance company question noted above). The investor control restriction discussed below is more difficult to understand since it is not based on any cited Code section or Regulation.

As a basic premise for a variable life insurance policy to qualify for tax deferral under the Code, the assets in the segregated asset account supporting the variable policy must be considered to be owned by the insurance company and not by the variable contract owner. Several rulings have been issued by the IRS that discuss control over the investments within the segregated account of variable contracts. Particularly in the context of variable annuities, the IRS has ruled that certain incidents of ownership by the contract owner, such as the ability to select and control specific investments in a segregated account, will cause the contract owner to be treated as the owner of the assets for tax purposes.

Specifically, the IRS has stated in published revenue rulings that a policyowner will be considered the owner of separate account assets if the owner possesses "incidents of ownership" in those assets. See, e.g., Rev. Rul. 77-85, 1977-1 C.B.12; Rev. Rul. 80-274, 1980-2 C.B.27; Rev. Rul. 81-225, 1981-2 C.B. 13. Generally, under these revenue rulings, in order for the insurance company to be considered the owner of the assets in a separate account, control over individual investment decisions must not be in the hands of the policyowners. Additional indications as to the general thinking of the Service can be found in private letter rulings involving these issues. See, e.g., PLR 9433030 (May 25, 1994), the Service's most recent private letter ruling on investor control.

In its private letter rulings, the Service has required certain representations regarding variable life insurance contracts as a precondition to issuing advance rulings concluding that the

insurance company, and not the policyowner, owned the assets of the separate account supporting the contract. The representations were intended to embody the Internal Revenue Service's views as to the permissible limits of a variable contract owner's control over separate account investments under which it will issue an advance ruling on the issue of investor control. The relevant representations required by the Service are in substance the following: No policyowner will have a legally binding right to require the insurance company or separate account to acquire any particular investment item with premiums or other amounts paid to, or earned by the insurance company and/or separate account. Furthermore, there will be no prearranged plan between any policyowner and the insurance company and/or the separate account for the insurance company and/or the separate account to invest any premiums or other amounts they receive in any particular investment item.

After years of functional silence on this subject matter other than occasional private letter rulings, the IRS was active in 2003, issuing two new Revenue Rulings. Rev. Rul 2003-91 is couched in more positive tones by concluding with the generally accepted principle that policyowners are permitted to freely allocate among a limited menu of insurance dedicated funds previously established exclusively for investment by insurance carriers or through insurance products. However, Rev. Rul. 2003-92 is much more difficult and restrictive, holding that policyowners are not permitted to direct that separate account funds be invested into "non-registered" partnerships which accept investments from persons other than insurance or annuity contracts. The basic holding of this ruling is directly contrary to the long standing regulations under section 817(h) with respect to the required diversification of variable contract separate accounts. Thus, the subsequent notice by the IRS discussed earlier that they would amend the 817(h) regulations to delete the conflicting guidance. Interestingly, to avoid this clear contradiction, Rev. Rule 2003-92 is not issued under Section 817(d), but rather under Section 61. Very strange at best.

Almost needless to say, these new Revenue Rulings have been widely criticized within the insurance industry and legal profession.

First, this author (and many other published commentators –see, for example, Robert Colvin's excellent published analysis of this and other related topic for the Steve Leimberg Estate Planning Newsletter) finds little solid legal support for the restrictions espoused in these rulings. The investor control position of the IRS is primarily based on the theory the Policyowner has "constructive receipt" of the earnings within the Policy segregated account. In Rev. Rul. 77-85, the IRS concluded in the variable annuity fact pattern presented in the ruling the policyowner had such "significant incidents of ownership" over the segregated account assets that the account was owned by the annuitant and thus the annuitant was taxable on its income. This position is not based on any statute or regulation, but rather reflects the IRS attempt to apply the common law doctrine of constructive receipt to variable annuity or insurance policies.

The validity of Rev. Rul. 77-85 was tested in *Investment Annuity, Inc. et. al. v. Blumenthal*, 442 F. Supp 681 (D.D.C. 1977), where the District Court held that Rev. Rul. 77-85 was unlawful and beyond the IRS' statutory authority, and further the court held that the reasoning of the ruling was incorrect. This decision was reversed on procedural grounds, but its analysis and reasoning remain persuasive.

The IRS renewed its positions in Rev. Rul. 80-274 and 81-274, again both variable annuity situations. Taxpayers challenged Rev. Rul. 81-225 in *Christopherson v. U.S.*, 749 F.2d 513 (8th Cir. 1984) where the court, citing Treas. Reg. 1.451-2(a)[2], used a constructive receipt analysis to hold the policyowner taxable on separate account income invested under the control of the policyowner. In analysing the deferred variable annuity purchased by the Christoffersens, the court explained:

"the Christoffersens have surrendered few of the rights of ownership or control over the assets of the sub-account. The payment of annuity

[2] Treas. Reg. 1.451-2(a) provides that "income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."

premiums, management fees and the limitation of withdrawals to cash, rather than shares, do not reflect a lack of ownership or control. Similar requirements may be placed on traditional brokerage or management accounts. In addition, the possibility that the assets may be converted into an annuity in 2021 does not significantly impair the Christoffersens' ownership since all, or any portion, of the assets may be withdrawn before that time. Upon examination of the Contract as a whole, we must conclude that the Christoffersens, and not Pacific Mutual, own the assets of the sub-account."

Accordingly, the court concluded that "under the long recognised doctrine of *constructive receipt* (emphasis added), the income generated by the account assets should be taxed to the (Christoffersens) in the year earned, not at some later time when the Christoffersens chose to receive it. This is the essence of Rev. Rul. 81-225, which we find persuasive."

Given the *Christoffersen* court's constructive receipt analysis (which the court in *Blumenthal* refused to apply due to its conclusion that the statutory framework of Section 72 provides the clear rules under which annuities are to be taxed), consider the attached Cohen v. Commissioner, 39 T.C. 1055 (1963) and Nesbit v. Commissioner, 43 T.C. 629 (1965) cases. In both cases, the court considered IRS constructive receipt arguments in the context of variable life insurance policies with very little death benefit element, and in both cases the court squarely rejected the IRS' argument that via the doctrine of constructive receipt, the policyowners at issue should have been taxable on the inside build-up in the insurance policies at issue. The court in *Nesbit* succinctly explained that "there is no constructive receipt of income where one must surrender a valuable right in order to realize it." Under the facts presented in *Nesbit*, while the policyowner could access cash values by partial surrenders (unlike in *Cohen*), the ongoing economics of the policy would be affected by the partial surrender (*i.e.* the higher resulting insurance spread would by paid out of the accumulated dividend additions reserves in the policy). Basically, the court realized that in the context of any life insurance policy a policyowner must surrender the insurance protection and death benefit rights to fully realize the policy's cash

surrender value, and that upon surrender the amount received by the policyowners would be less than that growing in the policies for them to ultimately be paid out as part of the death benefit. Similarly, the *Cohen* opinion specifically recognized the special status of life insurance contracts in that by enacting IRC Section 72(e) Congress expressly permits the cash surrender value to accumulate untaxed unless and until the policyowner accesses those earnings through surrender of the policy.

The *Cohen* analysis continues to be respected in the life insurance industry and, in fact, has been cited in two significant IRS General Counsel Memorandums[3] to support the IRS' own conclusion the "constructive receipt" theory does not apply to life insurance and annuity products, which are generally governed by IRC Section 72. In GCM 38934 (Dec. 8, 1982) the IRS clearly states:

...the comprehensive rules of section 72 preclude the application of the doctrine of constructive receipt to the cash values, including the interest increments thereon, under such Policy prior to surrender. Specifically, the operation of section 72(e)(1)(B) prevents the current taxation of amounts credited annually to the cash surrender value of an annuity contract even if the doctrine of constructive receipt were to apply.

At 67. GCM 38934 cites *Cohen* as authority for this position and builds additional support for this conclusion through its analysis of the legislative history of IRC Section 264 disallows interest deductions on indebtedness incurred or continued to purchase or carry various types of annuities. The legislative history states the annual increase in the cash value of insurance policies is generally not taxable either currently or otherwise.[4]

This analysis continues to be respected in the life insurance industry. In the famous and often cited 1984 CLU Journal article "The New

3 A GCM is similar to a TAM in that it is an internal memorandum from the General Counsel's Office of the IRS addressing a particular technical issue with respect to a particular taxpayer. A GCM does not have the force of law and merely represents the interpretation of that issue in the context of that taxpayer by the in-house attorneys at the IRS.

4 See H.R. Rept No. 749, 88th Cong., !st Session 61 (1963), 1963-1 c.B. 125, 185.

Federal Definition of 'Life Insurance Contract'" by Hahn and Adney, for example, the authors noted that the inside gains in an insurance policy are not taxable because "the constructive receipt doctrine has generally been found to preclude taxation because realization of a contract's cash value is 'subject to substantial limitations or restrictions,' e.g., the loss of insurance coverage." Journal of American Society of CLU, November 1984.

As a practical matter, the United States insurance industry has evolved to the point where policyowners are routinely given substantial practical control over the initial and ongoing investment choices amongst third-party managed funds within a variable annuity or life insurance policy. For example, the standard variable annuity presently offered by Fidelity, a nationally recognized investment firm, offers twenty-eight (28) investment choices, each of which is a regulated investment security. The owner of the Fidelity annuity can make an unlimited number of exchanges between these securities (although the policyowner is limited to only eighteen (18) changes annually via the telephone or web based service offered by Fidelity), in substance allowing the policyowner to substantially control the substantive investment of the annuity through sector and fund allocation amongst the twenty-eight (28) securities presently offered in the annuity. All of these choices are "clone accounts" of publicly available investment funds. The result of Rev. Rule 2003-91 seems not to well define or eliminate investor control, but rather seems to allow unlimited investor control as long as that control is the selection of various "clone" and other insurance only investment options offered within a policy.

Significant to the private placement variable life insurance niche marketplace, the IRS has ruled that a separate account investment portfolio may be custom established for a single customer without causing that customer to be the deemed owner of the account assets under the investor control prohibition. In PLR 9433030, the Service approved the establishment of a separate account existing solely for the benefit of a specific policyowner and in which the policyowner could allocate (no more than four times a year) the amounts in the account to various investment strategies (short-term bond, common

stock, intermediate bond, and money market). This remains the dominant private placement investment model for the high-wealth market, and does not appear to be eliminated by the new rulings as long as there remains an appropriate firewall between the policyowner and the selection of specific investments. .

A core difficulty with this subject is that it is hard to find the logic or compelling public policy underlying the Services' investor control restriction position (which must be common law based – the *Christopherson* constructive receipt analysis - since there is no Code or Regs providing for or defining this restriction). The fact is that there is, intentionally, a significant degree of "investor control" in every variable annuity and variable life insurance policy issued in the United States. It is the policy ower that selects from amongst the various investment choices available within that policy. The whole point of a variable policy is the policy owner makes the investment decisions and bears, for better or worse, the consequences of those decisions via the performance of his or her investment selections. The insurance company expressly does not make the investment decisions and is not responsible for investment performance of the policy. Investor control is the very essence of a variable annuity or insurance policy. If the policy owner is to bear the financial risk of the investment performance with the policy, then it would seem only logical and proper that the policy owner be given the maximum ability to control that risk via controlling the investment decisions within the policy. This author would note that this is similar to the situation in say an Individual Retirement Account, yet in that highly tax complex structure it is deemed perfectly o.k. for the U.S. taxpayer to have complete control over the investment decisions made within his or her retirement account. In short, this author sees no intellection or legal merit in the current Internal Revenue Service investor control position, which seems to allow some investor control but not too much, without statutory authority or clear definitions as to when a policy owner crosses the line. The imposition of an insurance only "clone" fund as the investment choice adds no substance, only a new additional procedural layer of expense.

As with the diversification requirements discussed earlier, I suggest that the arguable ambiguities presented by the investor control position should be addressed very conservatively by the practitioner until they are formally resolved in subsequent published court cases or tax legislation. In the international insurance context, this means insurance only funds and insurance only custom structured discretionary accounts by accredited third-party managers working for the insurance company, with a solid fire wall between the policyowner and the underlying investment decisions. For the major providers, this is basically how the business has always been done (the practical administrative costs and risks and hassles of "self directed" policy investment accounts have always made such policies not desirable to the insurance company and its administrators), so the new Revenue Rulings are really only of impact in the very narrow niche of client selected "hedge fund wrapper" policies. Ironically, the hedge fund wrapper business has been in rapid decline in any event over the last several years, as the negative market returns have cut the economic legs out under from many such plans. (I know several advisors who are wondering whether they can use the Rulings to allow their client to personally take the loss on the failed investments with such a policy).

Finally, I note that it is common for policies to be custom structured to provide limited or no lifetime cash values to the policyowner, but rather to be solely oriented to providing the largest possible ultimate death benefit upon the death of the insured. This type of policy would be difficult to structure domestically due to state insurance consumer protection regulations (non-forfeiture laws), but is viable and common in the more flexible international jurisdictions for large private placement policies. A variation of this design, for example, would be standard fare for an international policy designed to pay a death benefit to a Canadian beneficiary, or as part of the overall executive benefit package for a multi-domiciliary global executive. In the U.S. policyowner or beneficiary context, such a policy design should substantively eliminate any IRS concern that the policy is being "abusively" used as a no restriction on access or control tax-free brokerage account rather than to provide and generate a long-term death benefit, and should be completely sound and protected under

the *Christopherson* case. Thus, by using a more restrictive and conservative policy design available in the international context, it may be possible to mitigate the current investor control uncertainties.

International Life Insurance and Annuities with No U.S. Tax or Planning Connection.

All of the tax rules and concerns discussed above arise solely when it is important for a policy to be treated favourably under the U.S. income tax laws.

The most common use of international life insurance, however, is in the context of non-U.S. planning. Specifically, these policies are very actively used for planning for clients domiciled in Latin America, Canada, Europe and Asia. For each relevant country, of course, the policy must be structured to meet the planning needs and requirements of the client's domicile. That is the real advantage of an international insurance company, in that many are located in domiciles like Bermuda or the Cayman Islands that offer first class insurance companies and infrastructures but also allow those companies to custom tailor high-wealth private placement policies with little regulatory cost or interference.

As an example of the use of a private placement international policy in this context, Israel has been a very active client market in 2003. Specifically, three factors converged to make an international private placement policy very attractive for a high-wealth Israeli. First, due to the military/terrorist risk, it is very difficult to acquire significant life insurance on someone residing in Israel. Through the use of appropriate exclusion riders, however, international life companies can provide the desired coverage. Second, those same political/terrorist risks make it prudent for a high-wealth Israeli to have significant investments outside of Israel. The international private placement policy provides that infrastructure in a conservative, due diligence compliant manner, and does not require a trust or company that often causes administrative and reporting problems. Third, the tax rules in Israel changed to make the use of the international policy very advantageous.

Specifically, under the tax reform enacted in Israel and effective as of January 1st 2003, Israeli residents are taxed by Israel on their worldwide income. Under this law, capital gains, interest and dividends from "foreign securities" (generally securities traded on a market outside of Israel) are subject to a 35% tax rate. In certain cases interest income can be subject to a 50% tax rate (e.g. interest on loans granted to companies or individuals). However, major Israeli tax counsel and lawyers confirm that the tax on the savings component of an insurance policy (properly structured to be deemed insurance under the relevant Israeli laws) is only taxed at 15%, and only when and if profits are withdrawn from the policy in excess of the premium.

With this significant tax advantage coupled with the true insurance protection available via the international life policy (often at direct reinsurance pricing that is well less that the retain price for mortality coverage), it is little wonder that the use of an international life policy is increasingly a standard component of the global wealth planning for a well advised high-wealth Israeli client. This is similarly true for other jurisdictions like Mexico and the Latin America countries, where a properly structured international insurance policy can provide real insurance cost advantages and significant compliant tax savings, while also avoiding the problems clients from these countries typically have with trusts and companies in a "blacklist" international jurisdiction.

Finally, a growing use of international insurance is to structure policies that are tax compliant in multiple jurisdictions. This year I participated in a project with a major global bank and well-known international insurance company to structure an international variable life policy that is compliant with both the U.S. tax rules and the requirements of the European Union. In a world of increasing financial and personal mobility for senior executives and high-wealth families, such a tool provides tremendous flexibility and benefit.

WALKER BIO

James A. Walker, Jr. is the president of J.A. Walker & Associates, P.C., an Atlanta, Georgia law firm specializing in insurance and international tax and estate planning. Additionally, he is a member of Walker, Black & Co, LLC., an Atlanta, Georgia based insurance company consulting firm. Mr. Walker received his undergraduate degree in history with honors from the University of Virginia, and his law degree with honors from the University of Georgia, including serving on the Georgia Law Review. After graduating law school, Mr. Walker joined the firm Powell, Goldstein, Frazer & Murphy in Atlanta, Georgia, where he would make partner in the tax and estate planning department. Mr. Walker left the firm in 2001 to start J.A. Walker & Associated, P.C., a law firm specializing in international insurance and tax planning, and Walker, Black & Co, a consulting company to insurance companies. He is a frequent author and speaker on international insurance and international tax topics.