



Offshore Insurance and Annuities



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I. Using an international life insurance or annuity policy

The international life insurance and annuity market generally provides custom, cost efficient insurance solutions for high-wealth clients worldwide. As many countries in Europe, Latin America and the Far East do not have insurance capabilities sufficient to meet the needs of the mega wealthy global family or business enterprise, custom international insurance providers have arisen in domiciles like Bermuda and the Cayman Islands to service this special clientele.

In the United States there is a sophisticated life insurance industry offering a wide variety of retail and private placement products that generally meet the needs of most clients and planning situations.

In our experience, however, there are a number of circumstances where an international private placement policy might be of particular benefit to a client:

A. High-wealth U.S. client with international planning goals or needs

Regardless of their United States investment and insurance planning, many high-wealth U.S. taxpayers have international planning goals that can be best served by using a U.S. compliant international private placement variable life insurance or annuity policy. Examples might include: a U.S. client seeking to invest with non-U.S. managers and investment funds; a U.S. client with non-U.S. business activities or family members; a U.S. client seeking international asset protection; and a U.S. client needing a custom policy or investment structure not easily achieved within the regulatory confines of the U.S. insurance market.

B. Pre-U.S. immigration / Pre-expatriation planning

This client group reflects the increasing mobility of high-wealth executives, sporting personalities, entertainers and entrepreneurs. Insurance and annuity products might be particularly attractive to non-U.S. citizens or residents planning to move to the U.S. (either temporarily or permanently), or to individuals presently resident in the U.S. who plan to terminate their U.S. status in the future. If moving for a limited period, a single premium U.S. compliant variable life insurance policy (or even a properly structured deferred variable annuity) can present an ideal planning solution. It can act to isolate the non-U.S. assets that a client does not wish to expose to U.S. reporting and taxation during their U.S. residency.

C. Non-U.S. client with U.S. intended beneficiaries

For a high-wealth non-U.S. client with intended U.S. beneficiaries, a life insurance policy used in conjunction with an international 'dynasty' trust can avoid significant accumulated distribution tax penalties and income tax on future distributions to U.S. beneficiaries.

D. Clients with non-U.S. related planning needs

There is a rapidly increasing use of tax efficient and compliant international insurance and annuity policies in non-U.S. related situations. Some further information is contained at section VIII on page 16.



II. Structure and benefits of a U.S. compliant international policy

Before further exploring the use of an international policy, it is important to understand that in order to obtain the desired planning results, the policy must be tax compliant. Many non-professionals intuitively think that the international private placement insurance market exists because of 'tax savings' offered by the tax-free status of certain 'offshore' countries. This is simply not correct. To obtain a U.S. tax result, the policy must be U.S. tax compliant, regardless of where it is issued. In other words, for a U.S. taxpayer, it does not matter whether a policy is issued by an insurance company domiciled in a U.S. state, such as Nevada or New York, or in a foreign country. The tax outcome for a U.S. client will depend on the compliance of the policy with the applicable U.S. tax laws.

That said, the major benefits of a life or annuity policy issued by a non-U.S. life insurance company, include: (1) cost; (2) flexibility, (3) asset protection; (4) lack of U.S. withholding and reporting for non-U.S. clients; and (5) confidentiality.

The basic architecture of any variable life insurance or annuity policy is as follows:

	Premium paid
less	Sales charges
less	Administration charges
less	Mortality charges
less	Investment charges
plus	Investment return
less	Surrender charges
=	Cash value

In such an equation, the critical factors from a client's perspective are quite simply to reduce the charges and increase the investment return.

A variable life insurance or annuity policy issued by a non-U.S. insurance company may offer the following significant advantages:

A. Low cost

Insurance companies domiciled and operating outside the United States can provide a wealthy and sophisticated investor access to reasonably priced variable annuities and life insurance policies. These companies are not subject to many of the costs typically associated with U.S. domestic life insurance companies, such as layers of government regulation and significant capital costs. Lower costs make an international insurance policy an effective lifetime investment vehicle, rather than just a pure life insurance/death benefit product.

B. Flexibility

Provided the policy investments meet certain diversification requirements and the policy owner does not exercise prohibited 'investor control' over the selection of those assets, there is no limit on the type of investments that may be held in the Separate Account supporting the policy. As part of the policy application process, investment manager(s) of the Separate Account are selected and the investment arrangements and fees are finalized. Accordingly, a policy owner can take advantage of the investment expertise of a specialized investment manager, instead of having to settle for the investment options offered by a traditional insurance company. This customized flexibility allows for international hedge



fund, private equity investments and the like, that simply do not fit well within a U.S. regulated policy. In addition, there is now a growing number of insurance dedicated investment funds, in which the entire (or a proportion of the) policy assets may be invested.

Furthermore, the insurance laws and regulatory regimes of many international insurance domiciles allow for the efficient customization of policy provisions and reserving structures in a manner that could not be achieved in the U.S.. This is not due to the U.S. tax requirements governing life policies, but rather to the myriad U.S. state insurance regulation laws that govern and restrict policies issued by insurance companies operating within their borders.

C. Asset protection

Separate Account legislation, in the jurisdiction where the insurance company is domiciled, should provide that the policy assets in a Separate Account are available only to the designated policy owner. These Separate Account assets should not be available to satisfy liabilities or creditors of the insurance company nor available to other Separate Accounts or policy owners. This segregation provides not only security, but also flexibility, in enabling each Separate Account to adopt an investment strategy best suited to the individual objectives of the policy owner. In addition to segregation legislation, many jurisdictions offer specific creditor protection laws directly exempting insurance and annuity policies from the claims of any creditor of the policy owner or a beneficiary of the policy. Finally, as part of an international annuity or insurance policy, spendthrift provisions may be utilized with the intention of contractually limiting the rights of the policy owner in a manner that may provide substantial asset protection as an ancillary benefit to holding a policy. The bottom-line is that a properly structured, U.S. tax compliant, international private placement life insurance or annuity policy can be an ideal asset protection investment vehicle for an appropriate U.S. investor.

D. U.S. withholding

The use of an international insurance company avoids a number of taxation and reporting requirements typically required with a domestic U.S. insurance company. In particular, for non-U.S. taxpayers, the use of a U.S. insurance company can mean substantial U.S. tax withholding on access to policy funds, as well as reporting information that may be shared with the home country of the non-U.S. client.

E. Confidentiality

Many high-wealth families wish to keep their financial affairs as private as possible, consequently, the relationship between an insurance company and a policy owner should as far as possible, be held in strict confidence under the laws governing the insurance company. In line with all financial products, substantial due diligence documentation will be required to effect an international private placement life insurance or annuity policy.



III. U.S. tax advantages of a variable life insurance policy

The policy owner and the insurance company must meet certain restrictions under the U.S. Tax Code, and all related rules and regulations, if the variable life insurance policy is to qualify as a 'life insurance policy' under Code § 7702. If the policy qualifies, the following benefits may be attained:

A. Unlimited tax deferral during the life of the insured

The policy owner is not taxed on the investment income or gains within the Separate Account, thus the jurisdiction where the insurance company is located should not impose tax on the insurance company or the segregated Separate Account. A policy owner, nevertheless, should consider the possible effect of U.S. and foreign taxes when selecting the investment strategy of a policy. This is because U.S. or foreign withholding taxes may be imposed on certain income arising to the insurance company on assets held in a Separate Account and it is rarely possible to recover the tax withheld.

B. 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 § 101(a)(1), subject to no application of the transfers-for-value rules.

C. Access to funds

(Modified Endowment Contracts and non-Modified Endowment Contracts)

The U.S. 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 § 7702A.

i. Modified Endowment Contract

Put simply, a Modified Endowment Contract ('MEC') provides all the tax benefits of a variable annuity or an Individual Retirement Account during the life of the insured, plus it offers a completely income tax free Death Benefit. MEC status does not affect the tax deferral on investments held within a policy, however, withdrawals and loans from a MEC are generally taxable as ordinary income to the extent of 'income in the contract' in the MEC. Such amounts are also generally subject to a 10% penalty tax, if the insured has not attained the age of 59½.

A single premium (and similarly designed) policy will generally be a MEC.

A life insurance policy intentionally structured as a MEC is often the perfect structure for a wealthy client concerned about income tax, asset protection, international diversification and estate planning, provided lifetime access to the policy assets is not a primary objective.



ii. Non-Modified Endowment Contract

The 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 a 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 premiums to be paid into a 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 a life insurance policy is not a MEC, then any policy loans are generally tax-free and withdrawals are normally tax-free to the extent of the policy owner's contributions to the policy.

Policies where the premiums are paid in equally for five years or more, rather than in a lump sum, are generally non-MEC's. The lifetime income tax advantages of a non-MEC mean the policy owner can have tax-free access to policy assets during the lifetime of the insured.

IV. U.S. tax advantages of a variable annuity policy

In the same way that a life insurance policy must fulfil certain restrictions under the United States Internal Revenue Code, so an annuity policy must also satisfy the Code to qualify as an 'annuity'. If the policy qualifies, the following benefits may be attained:

A. Tax deferral during the life of the policy owner

Income and gains earned by the insurance company on assets held in a Separate Account are not subject to income or capital gains taxes under the laws of the domicile of the insurance company. The policy owner of a variable annuity (as opposed to the insurance company itself) will generally not be subject to U.S. tax on investment gains in the Separate Account until such time as assets are withdrawn from the account through surrenders or until annuity payments are commenced under one of the Settlement Options offered by the insurance company.

Depending upon the kind of investments held, however, U.S. or foreign withholding taxes could be imposed on the income earned by the insurance company on assets held in its Separate Accounts. With U.S. investments, it is generally possible for the insurance company to recognize capital gains on stocks and bonds issued by U.S. corporations and to receive portfolio debt interest (such as government debt and deposits with U.S. banks) without imposition of U.S. taxes. Dividends paid to the insurance company on stock issued by a U.S. corporation and non-portfolio debt interest, however, would be subject to U.S. withholding tax equal to 30 percent of the dividend or interest. In addition, gains (including capital gains) derived from investing directly or indirectly in U.S. real property is generally subject to U.S. income taxes (and possibly branch profits taxes) as income effectively connected with a U.S. trade or business. Any U.S. taxes that are imposed on the insurance company's investments will be charged against the Separate Account holding the investment; therefore, a policy owner should consider the possible effect of U.S. and foreign taxes when selecting an investment strategy for a Separate Account.



B. Annuity policy surrenders

Partial or complete surrenders from an annuity policy are generally includable in the policy owner's gross income on an income-first basis as ordinary income under the Code. In addition, a 10% penalty tax may also be imposed on such distributions made before the annuitant attains age 59½, except in certain very limited circumstances. If the policy owner were not then a U.S. taxpayer there would be no U.S. tax or withholding. This makes a Lighthouse annuity a perfect tool for a non-U.S. citizen planning to reside in the U.S. as a taxable resident for a temporary period, and thereafter return to non-U.S. resident status.

C. Annuity payments

The United States income tax treatment of amounts received under an annuity contract are governed by Code §72. Amounts received under an annuity contract are includable in income except to the extent that they represent a return of the 'investment in the contract,' *i.e.*, premiums or other consideration paid for the contract, minus the aggregate amount previously received under the contract that was excludable from gross income. Annuity payments are generally treated for U.S. federal income tax purposes as having two elements: (1) an amount representing a partial recovery of the taxpayer's investment in the contract, which is excludable from gross income, and (2) the remaining amount representing earnings, which is currently includable in the taxpayer's gross income. Code § 72(b)(1) provides that the portion of each annuity payment that is excludable from gross income is to be determined by multiplying the amount of the annuity payment by the ratio of the investment in the contract to the 'expected return' under the contract (*i.e.*, the total amount of payments expected over the life of the annuitant), determined in accordance with the regulations (the 'exclusion ratio').

D. Other countries

Similar to the United States, other countries are increasingly following the United States model of worldwide taxation and punitive taxation and reporting of trusts and companies outside their borders. Insurance and annuity contracts are typically not governed by these problematic rules and can provide legitimate tax and investment/confidentiality advantages to persons who are citizens or residents of those countries.



V. Technical requirements

A. General

In the early 1980's, U.S. Congress became concerned that life insurance contracts were being designed where the investment element dominated the insurance protection element. Accordingly, Congress ultimately enacted Code §7702 to require that the death benefit provided under a life insurance contract satisfies technical rules designed to guarantee that the insurance protection provided under an insurance policy meets minimum requirements, both upon the issuance of the policy and during later years as the policy's cash value grows.

Code § 7702 provides a definition of a life insurance contract for all purposes of the Code, including the death benefit exclusion under Code §101(a). To qualify as a life insurance contract under this definition, Code §7702(a) provides that a policy must be a life insurance contract for purposes of state law and must satisfy one of two alternatives: either (1) it must meet the cash value accumulation test of Code §7702(b), or (2) it must satisfy both the guideline premium test of Code §7702(c) and the cash value corridor of Code §7702(d).

To minimize the long-term reinsurance charges and maximize the net growth of the Separate Account, most international variable insurance policies are designed to satisfy the second alternative, the 'guideline premium' and cash value corridor' tests.

In general, a contract meets the 'guideline premium' test set out in Code §7702(c) if the sum of the premiums paid under the policy does not at any time exceed the 'guideline premium limitation.' The guideline premium limitation is defined in Code §7702(c)(2) as the greater of the 'guideline single premium' or the sum of the 'guideline level premiums' paid to date for the contract. Section 7702(c)(3) defines the 'guideline single premium' as the premium at issue for the death benefits and endowment benefits under the contract, generally determined at the time of issuance. Section 7702(c)(4) generally defines the 'guideline level premium' as the level annual amount payable over a period not ending before the insured attains age 95. In the case of a variable policy, the determination whether the contract satisfies the applicable tests needs to be made only at the times when the death benefits under the contract change, although such a determination must occur not less frequently than once a year.

Section 7702(c)(3)(B), which specifies the mortality charges, the charges other than mortality charges, and the interest rate or rates that are to be taken into account in computing the guideline single premium, is designed to impose limitations on the amount of the guideline single premium. Thus, the mortality and other charges specified in that provision represent the maximum of such charges that may be taken into account, while the interest rate specified therein represents the minimum interest rate that may be taken into account. Under Code §7702(c)(4), the guideline level premiums are to be computed on the same basis as the guideline single premium, except that, as considered below, a different minimum interest rate may be used in certain circumstances. The guideline single premium is determined by using the greater of an annual effective rate of 6% or the rate specified in the contract, the mortality charges specified in the contract, or those used in calculating statutory reserves if none is specified, and any other charges specified in the contract. The guideline level premium is calculated on the same basis as the guideline single premium, except that the annual effective rate used is 4% instead of 6%.



A contract meets the cash value corridor requirement if the death benefit at any time is not less than the applicable percentage of the cash value specified in Code §7702(d).

Insured's Age	Applicable %	Insured's Age	Applicable %
40 or less	250	61	128
41	243	62	126
42	236	63	124
43	229	64	122
44	222	65	120
45	215	66	119
46	209	67	118
47	207	68	117
48	197	69	116
49	191	70	115
50	185	71	113
51	178	72	111
52	171	73	109
53	164	74	107
54	157	75-90	105
55	150	91	104
56	146	92	103
57	142	93	102
58	138	94	101
59	134	95 or more	100
60	130		

The application of the 'guideline premium' and 'cash value corridor test' is best understood by an example. The illustration below is based on a \$5,000,000 single premium for a 55 year old male, non-smoker with an assumed net annual investment return of 8%, no sales load, an annual administration charge of 1.25%, and standard cost of insurance ('COI') rates. The 'Fully Taxable Investments' column provides a comparison of the results. For the Fully Taxable Investments, there is no policy and therefore no policy charges; the same net investment return has been applied but it is assumed the account owner pays U.S. federal and state combined income tax of 40% annually on the portfolio's earnings:

Policy Year	Ending Cash Value	Ending Death Benefit	Fully Taxable Investments
1	\$5,309,914	\$14,440,550	\$5,240,000
5	\$6,670,882	\$14,440,550	\$6,320,864
10	\$8,822,586	\$14,440,550	\$7,990,663
15	\$11,692,979	\$14,440,550	\$10,101,579
20	\$15,777,835	\$16,566,726	\$12,770,140
25	\$21,433,018	\$22,504,669	\$16,143,663
30	\$28,883,780	\$30,327,969	\$20,408,378



In the preceding illustration, the guideline single premium required death benefit for the \$5,000,000 single premium is \$14,440,550. This amount stays fixed throughout the life of the policy (assuming there are no actuarial re-determinations arising from subsequent policy events). The second element of the two-part test, the cash value corridor test, is a fluid test that varies depending on the cash value at any particular time and the attained age of the insured at that time. These aspects determine the applicable corridor test factor to be applied (see the list above).

Accordingly, at the end of the first policy year, the cash value corridor factor for the next year (age 56, factor of 146%) produces a required death benefit of \$7,752,474 (being \$5,309,914 x 1.46). As this is less than the guideline premium death benefit of \$14,440,550, the higher of the two controls, and the initial death benefit for the next policy year remains at \$14,440,550. By the end of the 20th policy year, however, the situation has reversed, as the cash value corridor factor for the subsequent year (then age 75, factor of 105%) produces a required death benefit of \$16,566,726 (\$15,777,835 x 1.05). As this is higher than the guideline premium death benefit of \$14,440,550, and the higher of the two controls, then the initial death benefit for the next policy year is \$16,566,726.

Another key point about the interrelation of these two tests is the impact of the investment return of the Separate Account portfolio. At an assumed net investment return of 8% per annum, the crossover from the death benefit being determined by the guideline single premium test to the cash value corridor test occurs in policy year 17. If the assumed return increases to a net 12% per annum, then the crossover happens in policy year 10. Although the larger cash value, produced by the higher investment return, increases the death benefit more quickly, it materially lowers the policy's internal 'net amount at risk' (the difference between the death benefit and the separate account policy value). The reduction in the net amount at risk inevitably reduces the ongoing annual mortality charge in the policy, because it is calculated on the net amount at risk charged at the applicable COI rates applicable to the insured.

This clearly emphasises the point that the key to any variable life insurance policy is the investment performance, and why the investment flexibility of a private placement international policy is so attractive. By way of example, using an assumed net annual investment return of 8%, the cash value beginning at age 85 is \$28,883,780 and the death benefit is \$30,327,969. If an assumed net annual investment return is increased to 12%, however, then the cash value beginning age 85 is \$90,572,020, and the death benefit is \$95,100,621. Furthermore, when comparing these projected values to the Fully Taxable performance, the favourable impact of tax-free compounding within a policy is clear.

Finally, this in part also explains why variable policy illustrations are only as good as the internal assumptions supporting the illustrations (not just the investment return, which is the key factor, but also assumptions as to ongoing expenses and mortality charges and other factors). The point is that the projected results depicted in an illustration are entirely dependent on the assumptions underlying the illustration. If investment returns are less than assumed, or if mortality charges are higher than assumed, the illustrated cash values and death benefits will not be supported.

Internal Revenue Code mathematical rules governing life insurance are very technical and require the services of a competent life insurance actuary. It is a critical aspect of a policy that it meets the requirements of Code §7702, because if it fails, the result is that all the growth of the policy's cash value and the annual mortality charge within the policy are taxable each year to the policy owner.



B. Accredited investor

Variable annuities and variable life insurance policies issued by a non-U.S. insurance company should be issued as a private placement of a security in accordance with Regulation D of the Securities Act of 1933. Accordingly, the policy owner must be an 'accredited investor', generally meaning in the context of an individual policy owner that the individual policy owner has a net worth in excess of \$1,000,000.

C. Diversification

Section 817(h) of the Code provides that the investments of each separate account underlying a variable annuity policy or variable life insurance contract must be 'adequately diversified' in accordance with Treasury regulations in order for the policy to qualify as an annuity or life insurance policy. The Treasury Department has issued regulations prescribing the diversification requirements in connection with variable policies. See Treas. Reg. 1.817-5. The regulations generally require that at the end of the first policy year and thereafter on the last day of each quarter of a calendar year no more than 55% of the value of a Separate Account's assets be represented by any one investment, no more than 70% be represented by any two investments, no more than 80% by any three investments, and no more than 90% by any four investments.

For purposes of the diversification regulations, 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. Treas. Reg. 1.817-5(b)(1)(ii)(A). In addition, in applying the diversification tests, the regulations provide a 'look-through' rule that permits a segregated asset account to treat the assets of certain entities as assets of its own. Amongst the several situations in which the 'look-through' is permitted is an investment in a partnership 'if the partnership interest is not registered under a Federal or State law regulating the offering or sale of securities'. Treas. Reg. 1.817-5(f). This exception is particularly important in the context of investment into international 'hedge' funds and similar commingled investment vehicles.

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 policy is in effect. Furthermore, a segregated asset account that satisfies these diversification requirements at the end of any calendar quarter is not considered non-diversified in a subsequent quarter because of a discrepancy 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. 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 non-diversified.

In addition to the general 'diversification' requirements described above, Code §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 Code §851(b).

It is interesting to note that it is unclear whether the Code §817 diversification rules apply at all to a variable policy issued by a non-U.S. insurance company. Specifically, Code §817(d) defines a 'variable contract' for purposes of Code §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 §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 in PLR 200246022, in which the Internal Revenue Service address the applicability of the §817(h) diversification rules to non-U.S. insurance companies that have made the election under §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 §817(h) parameters. The clear implication from the ruling, however, is that absent the voluntary, compelling connection of the domestic election, §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, it is clear 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 U.S. tax compliant. As a practical matter, our research suggests all of the major international insurance companies offering policies that are structured to be U.S. compliant, do contractually mandate §817(h) diversification compliance, so the 'State' issue is intellectually interesting but realistically not relevant.

Finally, the insurance company should require appointment of an independent investment advisor selected by the policy owner from the list of advisors acceptable to the insurance company to manage the Segregated Account. If more than one investment advisor is managing the account, then the portfolio managed by each investment advisor should independently be diversified in accordance with these requirements.

D. Investor control

Under current U.S. tax law, in certain circumstances, a policy owner may be considered the owner, for Federal tax purposes, of the assets of a Separate Account of a variable annuity or life insurance policy. If a policy owner were treated as the owner of the Separate Account assets, income and gains from the Separate Account would be included currently in the policy owner's gross income.

The IRS has stated in published revenue rulings that a policy owner 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 policy owners. Additional indications as to the general thinking of the IRS can be found in Private Letter Rulings involving these issues. See, e.g., PLR 9433030 (May 25, 1994), the IRS' most recent private letter ruling on investor control. The only judicial support for the IRS's investor control position is found in *Christoffersen v. Commissioner*, 749 F.2d 513 (8th Cir. 1984).

Many practitioners believe the diversification requirements of Code §817 were intended to provide a more objective measure of the investment characteristics of variable policies in contrast to the subjective factors asserted under the IRS' concept of 'investor control', particularly in the absence of any regulatory guidance on this point. Others point out that the *Christoffersen* court's constructive receipt analysis (which a prior decision, Investment Annuity, Inc. et. al. v. Blumenthal, 442 F. Supp 681 (D.D.C. 1977), refused to apply due to its conclusion that the statutory framework of §72 provides the clear rules under which annuities are to be taxed) only holds water in the context of a deferred annuity and has no



substantive application to a life insurance policy, where constructive receipt-based taxation does not apply. See Cohen v. Commissioner, 39 T.C. 1055 (1963); Nesbit v. Commissioner, 43 T.C. 629 (1965). However, 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 policy owners 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. Rev. Rul. 2003-92 is much more difficult and restrictive, holding that policy owners are not permitted to direct that separate account funds be invested into 'non-registered' partnerships that accept investments from persons other than insurance or annuity contracts. As the holding in Rev. Rul. 2003-92 seemed to directly contradict the long standing regulations under §817(h) with respect to the required diversification of variable contract separate accounts, the IRS announced one week after the publication of the ruling that they were further proposing to amend the §817(h) regulations to delete the conflicting guidance.

Compliance with the investor control restriction is thus a factual question that in practice should be easy to satisfy. The policy owner may not self-direct the investment of the Separate Account policy reserves. Rather, the insurance company must hire and direct the investment with a third-party accredited investment manager or insurance qualified fund (typically a mirror 'clone' fund of an existing publicly available mutual or hedge fund). The policy owner may allocate and select from amongst the investment offerings of the insurance company.

VI. Transaction costs and fees of international life insurance and annuity policies

A. Internal life insurance policy charges

Variable life insurance policies offered by international insurance companies may have up-front 'sales charges' or back-end 'surrender charges', while others are 'no load' products, depending on the structure of the transaction and the agreed compensation for the professional insurance advisors working on the transaction for the client. The routine annual transactions costs should be (1) administration of the insurance policy, which should be a small basis point percentage of the annual Separate Account value (depending on premium size and policy complexity, generally less than 100 basis points), (2) the investment and custodian charge that will vary depending on the investment goals of the policy owner and the investment manager(s) and vehicle(s) selected by the policy owner, and (3) the mortality charge applied to the 'net amount at risk' under the policy, being the difference between the policy's Separate Account value and the Death Benefit that is guaranteed under the life insurance policy (which will depend on insurability but generally for a single premium MEC should be about 15-40 basis points based on the annual Separate Account value).

B. Federal Excise tax

In addition to the charges specified in the policy, a U.S. person will generally be subject to a 1% United States federal excise tax on premiums paid into the policy. This is the tax obligation of the policy owner and not the insurance company. However, at the request of the policy owner, this excise tax can be paid by the insurance company on behalf of the policy owner (without disclosing the identity of the policy owner) so as to maintain client confidentiality. Note that the international private placement policy should not be subject to any state premium tax or federal DAC tax.



VII. Illustration for a high-wealth U.S. taxpayer seeking to invest \$1,000,000 in hedge funds and actively managed custom equity portfolios

This is a typical U.S. scenario and it fits well with an international private placement life insurance policy. The goals of the transaction are: (1) access through an international vehicle to desired investment funds and managers; and (2) compliant tax savings.

The illustration is based on a 56 year-old male non-smoker, with standard mortality rating, and an assumed long-term average investment return of 10%. The 'Ending Cash Value' can be easily compared to the 'Fully Taxable Investments' option, which has the same criteria and investments, without using a life policy, and therefore subject to combined federal and state income taxation at an assumed combined rate of 40%.

Age	Beginning Net Death Benefit	Beginning Net Cash Value	Deposit	Ending Net Cash Value	Fully Taxable Investments
56	2,680,000	0	1,000,000	1,074,899	1,060,000
57	2,680,000	1,074,899	0	1,165,974	1,123,600
58	2,680,000	1,165,974	0	1,264,083	1,191,016
59	2,680,000	1,264,083	0	1,370,218	1,262,477
60	2,680,000	1,370,218	0	1,485,359	1,338,226
61	2,680,000	1,485,359	0	1,610,581	1,418,519
62	2,680,000	1,610,581	0	1,746,935	1,503,630
63	2,680,000	1,746,935	0	1,895,569	1,593,848
64	2,680,000	1,895,569	0	2,057,742	1,689,479
65	2,680,000	2,057,742	0	2,234,961	1,790,848
66	2,680,000	2,234,961	0	2,428,935	1,898,299
67	2,866,143	2,428,935	0	2,639,463	2,012,196
68	3,088,172	2,639,463	0	2,867,633	2,132,928
69	3,326,455	2,867,633	0	3,114,820	2,260,904
70	3,582,043	3,114,820	0	3,382,464	2,396,558
71	3,822,185	3,382,464	0	3,673,845	2,540,352
72	4,077,967	3,673,845	0	3,991,030	2,692,773
73	4,350,223	3,991,030	0	4,336,558	2,854,339
74	4,640,117	4,336,558	0	4,713,351	3,025,600
75	4,949,019	4,713,351	0	5,124,697	3,207,135
76	5,380,932	5,124,697	0	5,571,129	3,399,564
77	5,849,685	5,571,129	0	6,055,469	3,603,537
78	6,358,243	6,055,469	0	6,580,756	3,819,750
79	6,909,794	6,580,756	0	7,150,221	4,048,935
80	7,507,732	7,150,221	0	7,767,355	4,291,871
85	11,332,189	10,792,561	0	11,710,039	5,743,491
90	16,983,034	16,174,318	0	17,518,857	7,686,087
95	24,353,769	24,112,643	0	26,158,099	10,285,718

The results clearly show the short and long-term tax advantages of using a policy as the desired international investment platform.



VIII. Using international life insurance and annuities with no U.S. connection

The most common use of international life insurance is in the context of non-U.S. planning and policies are actively used by clients in Latin America, Canada, Europe and Asia. For each case, of course, the policy must be structured to meet the planning needs and requirements of a client's domicile and residence. Therein lies the real advantage of an international insurance company located in a domicile such as the Cayman Islands. The insurance company can provide a first class insurance infrastructure with little regulatory cost or interference, and it is capable of allowing a reasonable degree of custom tailoring of a high-wealth private placement policy to ensure the specific needs and concerns of a client are satisfied.

As an example of the use of a private placement international policy without U.S. considerations, Israel is presently a very active planning market using international private placement insurance. Specifically, three factors converged to make an international private placement policy very attractive for a high-wealth Israeli. Firstly, due to the military/terrorist risk, it is very difficult to acquire significant life insurance for someone residing in Israel; however, using appropriate exclusion riders, international life companies can provide the desired coverage. Secondly, those same political/terrorist risks make it prudent for a high-wealth Israeli to have significant investments outside Israel. The international private placement policy can achieve that objective in a conservative and due diligence compliant manner that does not require using other structures, such as a trust or company, which may cause administrative and reporting problems. Finally, the changed tax rules in Israel make the use of the international policy very advantageous.

Important tax reforms were enacted in Israel from 2003, and further reforms came into effect from 1st January 2006. Israeli residents are taxed by Israel on their worldwide income, with interest, dividends and capital gains subject to a 20% tax rate; although in certain circumstances, interest income can be subject to a higher tax rate. Israeli tax counsel and lawyers confirm that the income from a life insurance policy is taxed at 20%, when, and if, profits are withdrawn from the policy in excess of the premium. A life insurance policy therefore allows for the significant deferral of Israeli tax while the profits remain within the life policy. Furthermore, if on the termination or withdrawal from the life policy, the proceeds are paid to a non-Israeli resident, it may be possible that some or all of those proceeds will not be subject to Israeli tax.

The 2006 tax reforms in Israel imposed a new regime with respect to the taxation of trusts, where generally, the trust is ignored for Israeli tax purposes and the income attributed to the Settlor. Not only would a trust not afford any tax deferral opportunities, but Israeli settlors, beneficiaries and the trustee are subject to extensive reporting requirements.

With this considerable tax advantage, coupled with the true insurance protection available through the international life policy, 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 an international insurance policy can provide real insurance cost advantages and significant compliant tax savings. It also avoids problems typically encountered when using trusts and companies in a 'blacklist' international jurisdiction.



In Canada, the international policy can provide an 'estate freeze' solution; in South Africa, it is recognised as a legitimate U.S. dollar denominated international financial tool being both tax and disclosure compliant; while for EU clients, depending on their tax domicile, there may be many potential tax advantages, including insulation from potential EU withholding tax and disclosure and reporting requirements.

Finally, a growing use of international insurance is to structure policies that are tax compliant in multiple jurisdictions. Lighthouse has clients, where the goal is to provide those clients with international variable life policies that are compliant with both the U.S. tax rules and the requirements of certain European Union countries. In a world of increasing financial and personal mobility for senior executives and high-wealth families, such a tool provides tremendous flexibility and benefit.

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