

**U.S. TAX COMPLIANT INTERNATIONAL
VARIABLE UNIVERSAL LIFE INSURANCE POLICIES
AN OVERVIEW**

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U.S. tax compliant variable universal life insurance policies (“VUL’s”) sold by international life insurance companies are a cost effective way to:

Enjoy the wealth accumulation benefits of income tax deferral;

Enjoy the ability to borrow against the cash value of the policy without an income tax impact if the policy is not a modified endowment contract;

Distribute the policy benefits to the beneficiaries free from U.S. income tax;

Enjoy the flexibility of investment choices that are available in an international environment;

Shield the appreciation of the cash value in the policy from estate tax depending upon the estate planning needs of the principals, through the use of a life insurance trust; and

Protect wealthy individuals’ assets from the claims of creditors in those states where VUL’s are exempt from creditors’ claims.

The purpose of this writing is to explain:

The taxation of VUL’s - investment income and distributions;

The U.S. income tax requirements that must be satisfied in order for an insurance policy to receive the tax benefits of a life insurance policy;

The benefits of an international VUL vs. a U.S. domestic policy;

The relative security of an investment in an international insurance company; and

The unique ways life insurance policies may be put to work to solve the problems of particular U.S. tax payers.

How Is VUL Investment Income Taxed

So long as the VUL satisfies the requirements of the U.S. tax code, the owner will not be taxed on the investment income inside the policy. Unless the policy is a modified endowment policy (discussed below) amounts borrowed against the cash value of the policy will not be subject to income tax, and distributions of the death benefit, including distributions of the income earned on the cash value, will not be taxed to the beneficiaries.

With few exceptions, international VUL's are taxed identically to U.S. domestic policies. One difference is the imposition by the United States of a one time 1% excise tax on the amount of premium paid.

The second difference is that certain investments inside the VUL will be subject to tax. A 30% withholding tax will be imposed on dividends paid with respect to stocks held for the benefit of the policy. Also, capital gains from the sale of U.S. real property interests (as defined by Internal Revenue Code §897) will be subject to tax as if the foreign insurance company were an ordinary domestic corporation against which 10% of the proceeds of sale will be withheld. For this reason, U.S. real property interests should never be part of the investment portfolio of an international VUL.

It is also worth pointing out that ownership of an international VUL does not give rise to an IRS reporting requirement. There is no box to be checked on the 1040 asking about ownership of such a policy.

Funding A VUL - Tax Consequences

The purchaser of a VUL will realize gain on the transaction if appreciated property is used to pay the premium. For example, a person considering purchasing a VUL might have an account with a stockbroker. He may want the securities within the account to become securities within the VUL. He would do this by establishing a VUL with an insurance company. The insurance company would establish an account with the stock broker, and the assets of the individual's account would be transferred to the insurance company's account. This will constitute the sale or exchange of all of the securities in the individual account in return for the VUL policy, and is a taxable event. The purchaser will recognize the gains and losses in his account at the time of the conversion. Therefore, the purchaser may want to plan the timing of taking gains and losses and roll into the VUL gradually over time rather than simply converting the portfolio in a single transaction.

U.S. Tax Requirements For Life Insurance Policies

To be respected as a life insurance policy for U.S. income tax purposes and have the associated tax benefits, the policy must satisfy certain requirements under the U.S. internal revenue code, most of which are set forth in §7702 of the Code (“IRC” or “Code”) and the associated regulations.

The VUL contract must be considered a life insurance policy under the laws of the jurisdiction of the issuing life insurance company. With most international jurisdictions, this shouldn’t present a problem.

There must be real insurance. That is there must be a shifting of the mortality risk from the policy purchaser to the life insurance company. The death benefit can not be funded with capital otherwise supplied to the life insurance company through another means, such as the simultaneous purchase of an annuity that expires at death.

The investments made for the benefit of the policy must satisfy the diversification requirements of Treasury Regulations §1.817-5. That is, as of the end of any calendar quarter, the policy assets must be invested in at least five investments, and not more than 55% of the value of the assets within the policy can be in one investment. Not more than 70% can be in two investments, not more than 80% can be in three investments, and not more than 90% can be in four investments. The portfolio will be considered adequately diversified if it is diversified as of the last day of the calendar quarter (or 30 days thereafter). According to IRS regulations, market fluctuations will not result in a violation of diversification requirements unless there has been an acquisition that is either wholly or partially responsible for the violation.

The policy must satisfy some tests that are intended to make sure the policy provides a meaningful death benefit in excess of the cash value accumulation within the policy. The policy must either satisfy the cash value accumulation test, or it must satisfy both the guideline premium limitation and the cash value corridor test. The cash value accumulation test is generally applicable to whole life policies rather than VUL’s. It requires that the cash value of the policy not be more than is required to fully fund the policy benefits.

The tests more applicable to a VUL is the combination of the guideline premium limitation and the cash value corridor test. The guideline premium limitation requires the premium paid for the policy, either in a lump sum or in level payments, not to exceed the greater of the guideline single premium limitation or the guideline level premium limitation. The guideline single premium limitation is the single premium required to fully fund the policy benefits assuming a maturity no sooner than age 95 and not later than age 100. The guideline level premium limitation is the series of level premiums required to fully fund the benefits under the policy, again assuming a maturity no sooner than age 95 and no later than

age 100. The guideline premium limitation is generally applied at the time of the payment of the premium.

The cash value corridor test is applied to determine whether the cash value is excessive in relation to the death benefit of the policy. The amount of the cash value corridor that is permitted depends upon the age of the insured life. The older the insured life, the greater the cash value is permitted to be in relation to the death benefit.

Modified Endowment Contracts

If a policy qualifies as a life insurance policy under the requirements of IRS §7702, the accumulation of income inside the policy will tax deferred, and the death benefit will be distributed free of income tax. However, if the duly qualified life insurance policy is a modified endowment contract, any sums borrowed against the policy will be taxed up to the lesser of i) the amount of the loan or ii) the amount of income previously earned but untaxed inside the policy, and loans made prior to age 59½ will be subject to the 10% penalty on top of the tax otherwise assessed.

A policy is a modified endowment policy unless it satisfies the seven pay test established by IRC §7702A. The seven pay test requires that the aggregate of all premiums paid as of any given time during the first seven years of the policy be less than or equal to the aggregate of the payments that would have been made as of the same point in time if the policy provided for fully paid benefits after seven equal annual payments.

International VUL's Vs. Domestic VUL's – Flexible and Cost Effective

With two important exceptions noted above, international VUL's are taxed the same as domestic VUL's. The reason to select an international VUL over a domestic policy is flexibility and price.

Flexibility is achieved because state insurance regulators do not regulate these contracts.

Flexibility As To The Form Of Life Insurance Policy. The form is a matter of contract to be agreed upon between the insurance company and the policy purchaser;

Flexibility As To The Kinds Of Assets That Can Be Held For The Benefit Of The VUL. As assets can be distributed in kind (they do not need to be converted to cash prior to distribution) it is possible to invest in illiquid assets such as a minority interest in a closely held corporation; and

Flexibility As To The Investment Manager Hired To Direct The Investment Of The Capital Held For The Benefit Of The VUL. While the owner of the VUL cannot direct the investment and reinvestment of the assets of the VUL, generally an international insurance company will appoint a money manager or stock broker acceptable to the purchaser to have discretion with respect to investments. Further, as the owner of the VUL is free to do an IRC §1035 tax free exchange of a given VUL for a VUL issued by another company, foreign or domestic, the issuing insurance company is likely to be cooperative in replacing fund managers from time to time as requested by the policy owner.

Price. Mortality expense is generally more favorable because it is not loaded for commission. Further, there is usually no penalty (other than an income tax penalty) for an early withdrawal or a 1035 exchange for another life policy.

International Insurance Products – The Security of the Investment

Investors can take comfort in the security of the assets in their life insurance policy for a number of reasons. First, Cayman Islands law provides, “No one other than the policyholder can make a claim against the segregated account cash value of the life insurance policy or annuity.” That is, if the insurance company were to become financially troubled, the other creditors of the insurance company, including the other policyholders, can not make a claim against the assets of a given policy. Other foreign jurisdictions have similar provisions.

The investor may also take comfort in the fact that the assets are usually held in the U.S. by an investment advisor chosen by the policy holder. They are not usually held by the management of the international life insurance company.

Another important factor is the right of the policyholder to exchange a policy issued by the international insurance company for another VUL issued by either another international insurance company or a U.S. domestic company. This is tax free under the provisions of IRC §1035.

Putting VUL’S to Work

A variety of structures can be put together to take advantage of the characteristics of U.S. tax compliant VUL’s – a deferral on the imposition of U.S. income tax, asset protection and flexibility of investment.

Asset Rich Persons with High Liability Exposure. Certain people who have not only significant assets but significant exposure to liability from creditors

claims – such as doctors, attorneys, contractors, nursing home and other elder care facility operators may wish to avail themselves of the asset protection qualities of life insurance policies – perhaps in tandem with a self insurance program using an offshore rent-a-captive or captive insurance program.

Creative Structures. A number of advantageous and creative investment structures can be devised to take advantage of the particular qualities and characteristics of U.S. tax compliant international variable universal life insurance policies.

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