



**INTERNATIONAL  
PRIVATE PLACEMENT VARIABLE LIFE INSURANCE**

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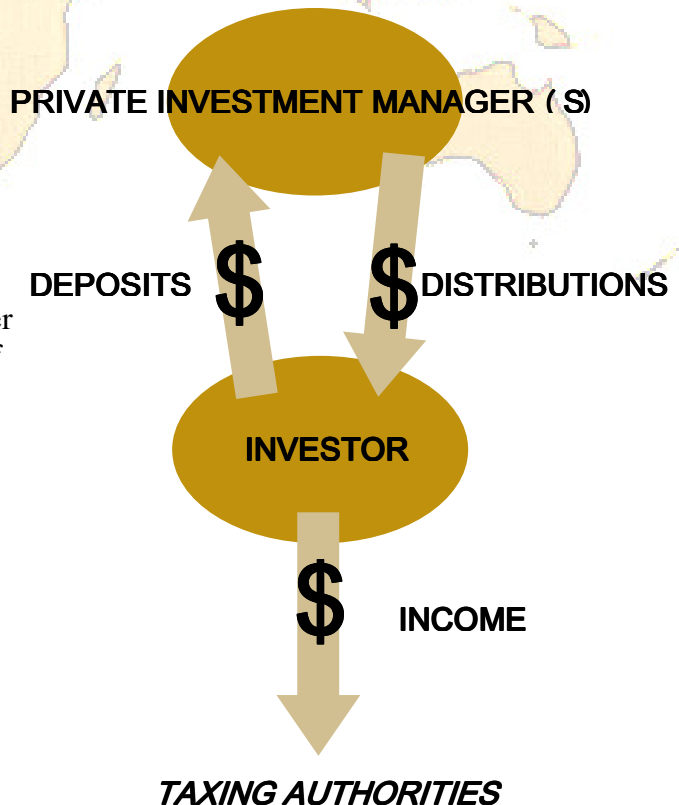
**A Fountainhead Forum Fact Sheet**

# INTERNATIONAL PRIVATE PLACEMENT VARIABLE LIFE INSURANCE

**Many high net worth clients have superior investment managers, but their returns are offset by the high taxes the investments generate. Is there any way these clients can defer (or even avoid) the taxes and get the benefit of compounding the deferral?**

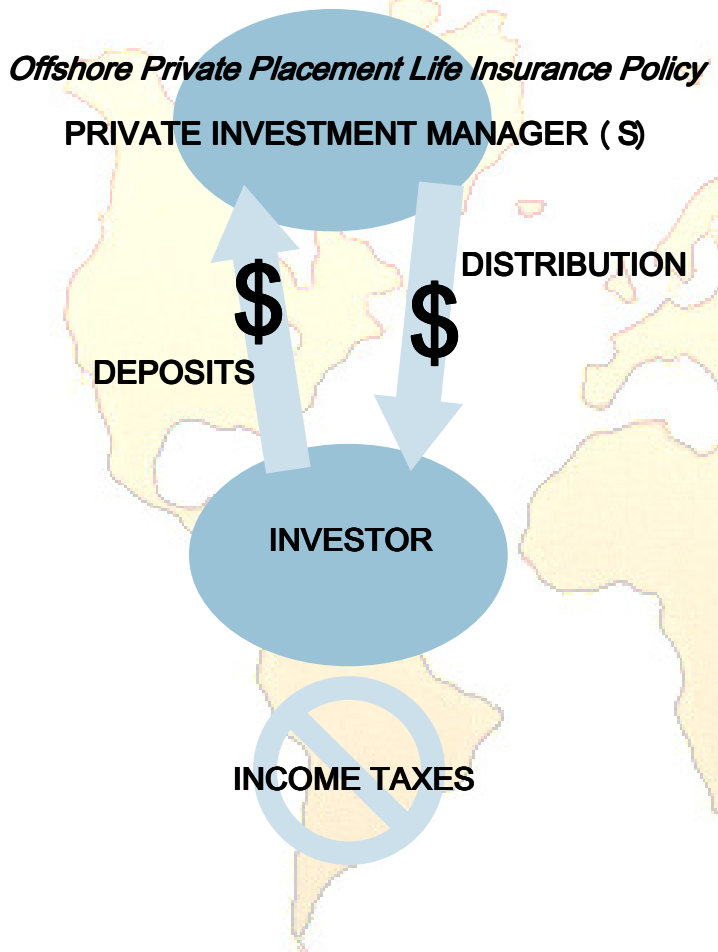
Income tax headaches created by successful investing are, of course, an age-old problem. Not only does active account management give rise to tax issues, but asset liquidations to satisfy cash needs are also often taxable events.

Although there may be some complicated (and expensive) alternatives that a few investors have tried to solve these problems, the easiest and most efficient method is to allow the investment manager to manage the assets in the tax-free environment of a privately placed variable universal life insurance policy issued by an offshore international life insurance company. By doing this, the investments the manager makes with cash deposited into the policy accumulate on a tax-free basis. Further, the account values can be accessed tax-free through partial policy surrenders and policy loans. Investments can also be moved from one manager to another without tax consequences



## What is an offshore private placement variable universal life insurance policy?

### Income Tax-Free Investing



“Offshore” means that the insurance company is located outside of the United States and is probably not licensed to do business in the United States.

“Private Placement” refers to the fact that the offering is limited to accredited investors/qualified purchasers who must complete an investment suitability questionnaire.

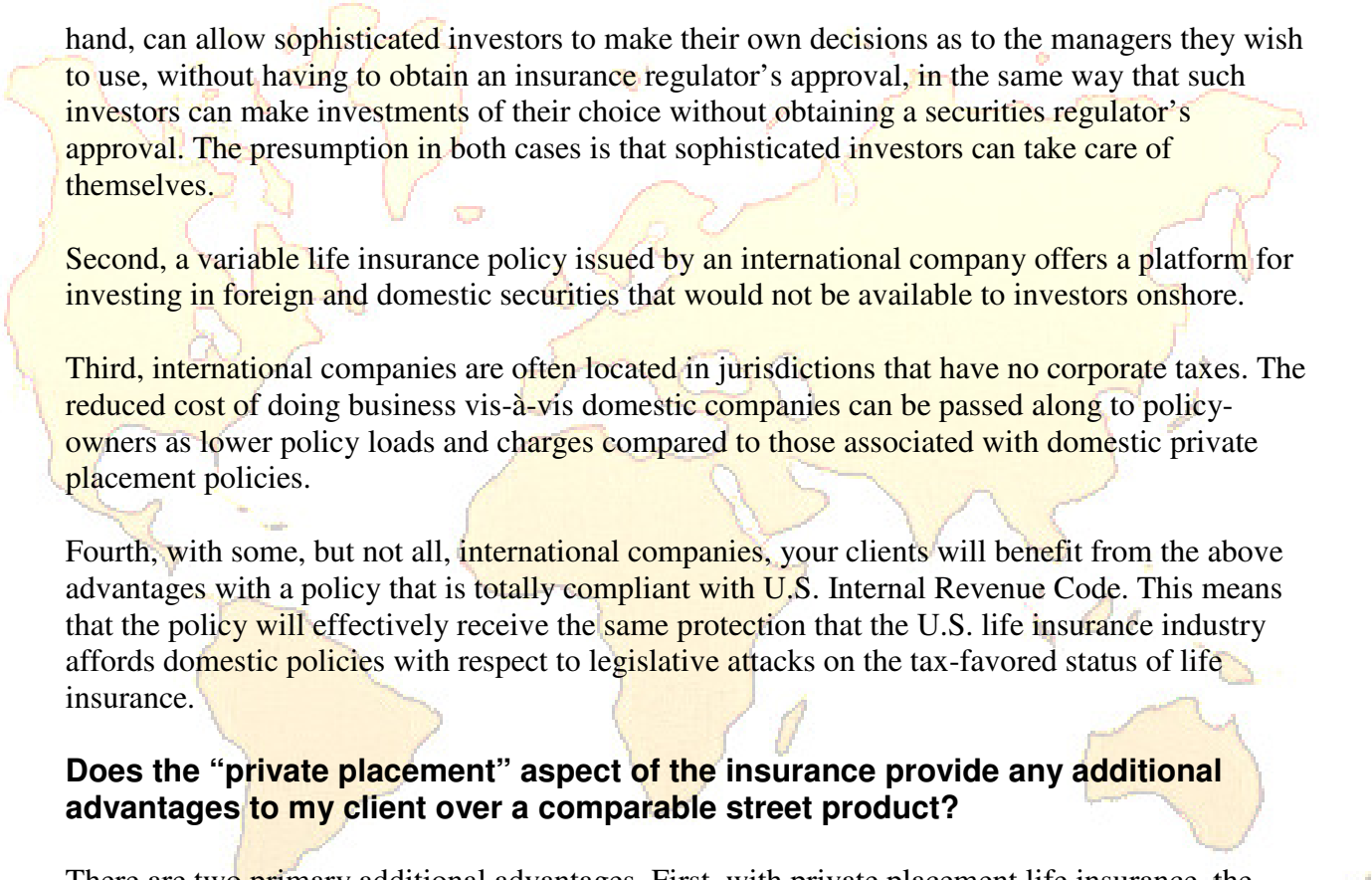
“Variable” refers to the fact that the assets in the policy are allocated by the policy owner to one or more of a stable of asset managers who have been appointed by the insurance company. Some (but not all) offshore life insurance companies allow the policy owner or insured to select the asset manager(s) to be appointed by the company.

“Universal” means that, after the first deposit, there are no mandatory deposits to be paid so long as there are sufficient assets to pay the current insurance and other policy-related charges. Private placement policies require a minimum deposit commitment – typically two to several million dollars, which can, if appropriate, be paid over several years.

“Life Insurance Policy” in this context means that one qualifies as life insurance under section 7702 of the Code.

## Why should my high net worth clients prefer international private placement life insurance to similar private placement opportunities onshore?

For several reasons. First, high net worth clients likely have existing investment managers that they strongly prefer to manage their portfolios. Domestic companies, however, are reluctant to allow a client’s preferred investment manager(s) to manage assets inside their private placement policies, and will do so only with guarantees of very large deposits—typically \$20,000,000 or more (and even then, only a single investment manager may be allowed). This is primarily because the substantial reporting and due diligence requirements imposed on domestic insurers by state insurance regulators render smaller deposits cost prohibitive. Further, even if a domestic company is willing to include a client’s preferred investment manager, the company may be prevented from doing so by state imposed liquidity requirements (typically 30 days) that the investment manager cannot accommodate (e.g. hedge funds often have quarterly liquidity dates), or simply because the state insurance regulators frown on the type of investment or investment style (e.g. use of short-selling or leverage) and impose restrictions on investor flexibility that make that type of investing a practical impossibility. A foreign insurance company, on the other



hand, can allow sophisticated investors to make their own decisions as to the managers they wish to use, without having to obtain an insurance regulator's approval, in the same way that such investors can make investments of their choice without obtaining a securities regulator's approval. The presumption in both cases is that sophisticated investors can take care of themselves.

Second, a variable life insurance policy issued by an international company offers a platform for investing in foreign and domestic securities that would not be available to investors onshore.

Third, international companies are often located in jurisdictions that have no corporate taxes. The reduced cost of doing business vis-à-vis domestic companies can be passed along to policy-owners as lower policy loads and charges compared to those associated with domestic private placement policies.

Fourth, with some, but not all, international companies, your clients will benefit from the above advantages with a policy that is totally compliant with U.S. Internal Revenue Code. This means that the policy will effectively receive the same protection that the U.S. life insurance industry affords domestic policies with respect to legislative attacks on the tax-favored status of life insurance.

### **Does the “private placement” aspect of the insurance provide any additional advantages to my client over a comparable street product?**

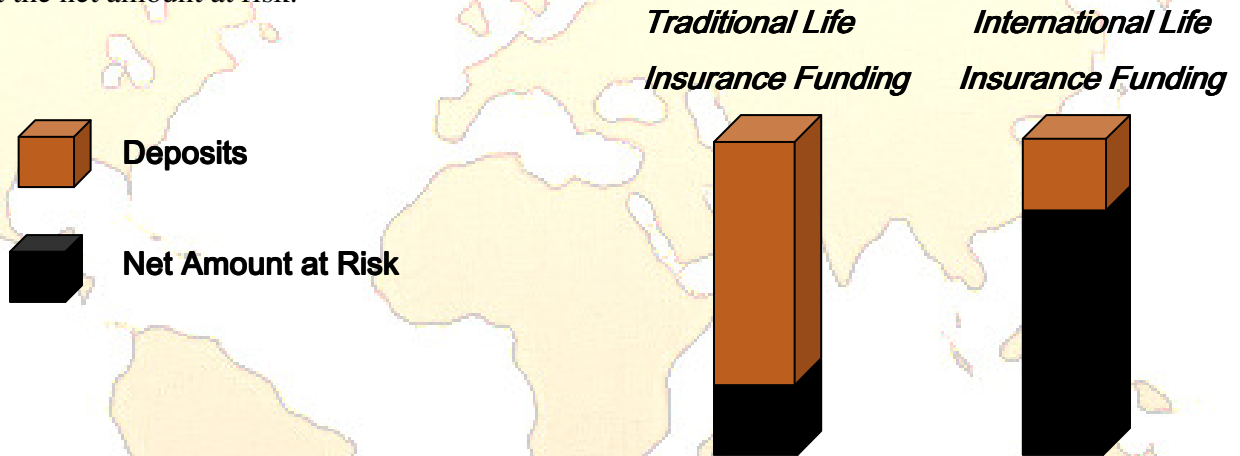
There are two primary additional advantages. First, with private placement life insurance, the insurance company has virtually no distribution costs (commissions, etc.) to be passed along as policy loads. For a street product, such policy loads can be 75-80% of the first year's deposit plus 5-10% of the next nine year's deposits. These loads represent a true impediment to excellent investment results due to their present value impact.

Second, the economies of scale provided by private placement products, and in the case of many international companies, a favorable tax environment, allow the insurance company to maintain adequate profit margins while assessing much lower mortality and expense (M&E) charges than those assessed street products. These M&E charges and reduced policy loads tend to provide on significantly improved rates of return over lengthy periods of time.

### **Is there any difference in how an international life insurance policy is funded for income tax planning purposes and how a domestic policy is funded for traditional life insurance purposes?**

Yes. With a traditional life insurance purchase, the objective is typically to purchase as desired level of death benefit protection for the minimum amount of premium dollars. In other words, the difference between the policy's investment account and the policy's face amount (the “net amount at risk”) is *maximized*. The primary purpose of the investment account is to support the death benefit, not to perform as an investment.

The funding of an international life insurance policy is the opposite of the above: the objective is to deposit as much cash into the policy as desired while maintaining the minimum policy face amount required by the Internal Revenue Code to be treated as life insurance under section 7702. In other words, the net amount at risk is *minimized*. Funding a policy in this manner enhances the performance of the policy's investment account since cost of insurance charges are assessed only against the net amount at risk.



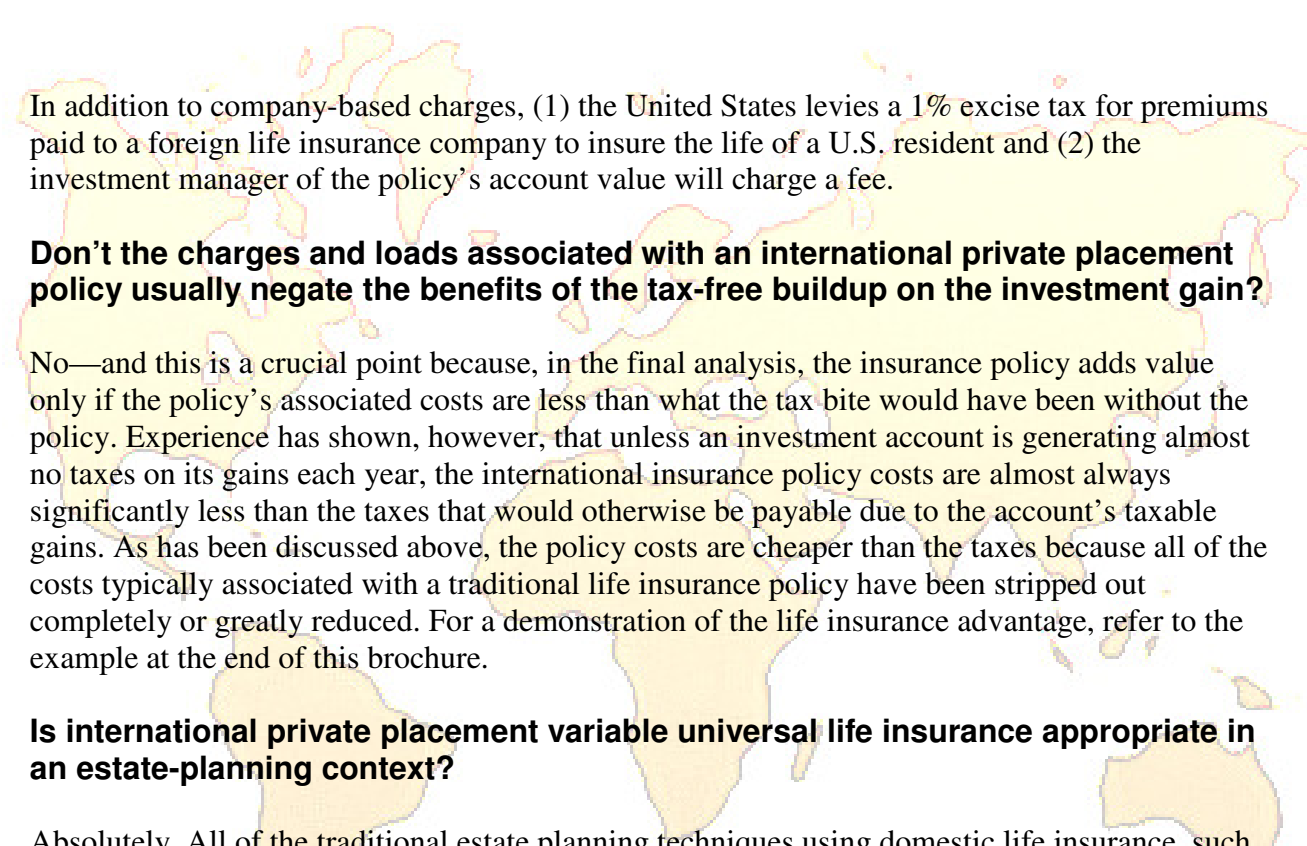
### What are the charges associated with international life insurance?

The charges will vary among the various life insurance companies; however, every company will assess cost of insurance charges (“COIs”) and most will assess mortality and expense (“M&E”) charges.

COIs compensate the insurance company for the pure insurance risk it assumes. COIs are assessed against the difference between the policy investment account value and the policy face amount (the “net amount of risk”) and are expressed as a cost per thousand dollars of coverage. For example, assume a policy has a face amount of \$15,000,000 and an investment account with a value of \$5,000,000 in a particular year. The net amount at risk is therefore \$10,000,000. If the COIs for that year are \$.50 per thousand dollars of coverage, the total charge would be \$5,000 ( $$.50 \times 10,000$ ).

M&E charges are asset-based charges expressed as a percentage of the policy's investment account value. These charges compensate the insurance company for accepting the risks that the insured may not live as long as anticipated and that the company's expenses of issuing and administering the policy may be more than the company estimated.

The insurance company may also charge a premium load, which would be expressed as a percentage of the deposits being paid into the policy. The company may also assess a one-time policy set-up fee, an annual administrative charge, and a surrender charge if the policy is surrendered in the first few years of the policy. The company will also likely pass through any brokerage fees and expenses incurred with respect to the policy investment account.



In addition to company-based charges, (1) the United States levies a 1% excise tax for premiums paid to a foreign life insurance company to insure the life of a U.S. resident and (2) the investment manager of the policy's account value will charge a fee.

**Don't the charges and loads associated with an international private placement policy usually negate the benefits of the tax-free buildup on the investment gain?**

No—and this is a crucial point because, in the final analysis, the insurance policy adds value only if the policy's associated costs are less than what the tax bite would have been without the policy. Experience has shown, however, that unless an investment account is generating almost no taxes on its gains each year, the international insurance policy costs are almost always significantly less than the taxes that would otherwise be payable due to the account's taxable gains. As has been discussed above, the policy costs are cheaper than the taxes because all of the costs typically associated with a traditional life insurance policy have been stripped out completely or greatly reduced. For a demonstration of the life insurance advantage, refer to the example at the end of this brochure.

**Is international private placement variable universal life insurance appropriate in an estate-planning context?**

Absolutely. All of the traditional estate planning techniques using domestic life insurance, such as irrevocable life insurance trusts, wealth replacement trusts and split dollar plans, are available using international private placement variable universal life insurance. Since this product is life insurance, it provides a substantial benefit upon the death of the insured, which can be a liquidity source for the tax liabilities of the estate. This product, therefore, provides two potent advantages for your high net worth clients: increased real returns on their preferred asset managers' investments and a sizable income tax-free death benefit with which to address their estate planning needs.

In addition to estate planning, private placement life insurance should also be ideal for many executive compensation plans where life insurance has traditionally served as the funding vehicle. Such executive compensation plans would include deferred compensation plans where life insurance has traditionally served as the funding vehicle. Such executive compensation plans would include deferred compensation plans, section 162 bonus plans, equity split dollar and SERP and stock option swaps.

Due to the superior efficiency of international private placement life insurance over domestic products, the effectiveness of all of these techniques should be enhanced by the use of an international private placement product.

**Does my client have to be insurable?**

Because international private placement life insurance is life insurance, someone does have to be insurable. Often, however, for age, health and/or planning reasons, the insured and the source of the funds are different.

## **Is my client's money safe with a foreign insurance company? What about the death benefit?**

As with all financial matters, foreign or domestic, you and your client should do your own due diligence to determine the financial strength and integrity of the company you intend to deal with and its principals. An insurance company located in a jurisdiction that has, as a part of its general insurance law, a "separate account" statute can provide as much, if not more, legal protection for your investments as any domestic insurance company.

A separate account statute provides that when a variable life insurance policy is issued, the investment assets are maintained in a separate segregated account and those assets can only be used to satisfy the life insurance policy obligation. They cannot be used to satisfy any other obligations of the insurance company, even in the event of the company's bankruptcy. Note also that, in most cases, the investment manager or another financial institution, not the international company, would have custodianship of the account assets.

Although separate account laws are common in the U.S., not all international jurisdictions have these laws. It pays to do your homework to ensure the safety of your client's investment assets.

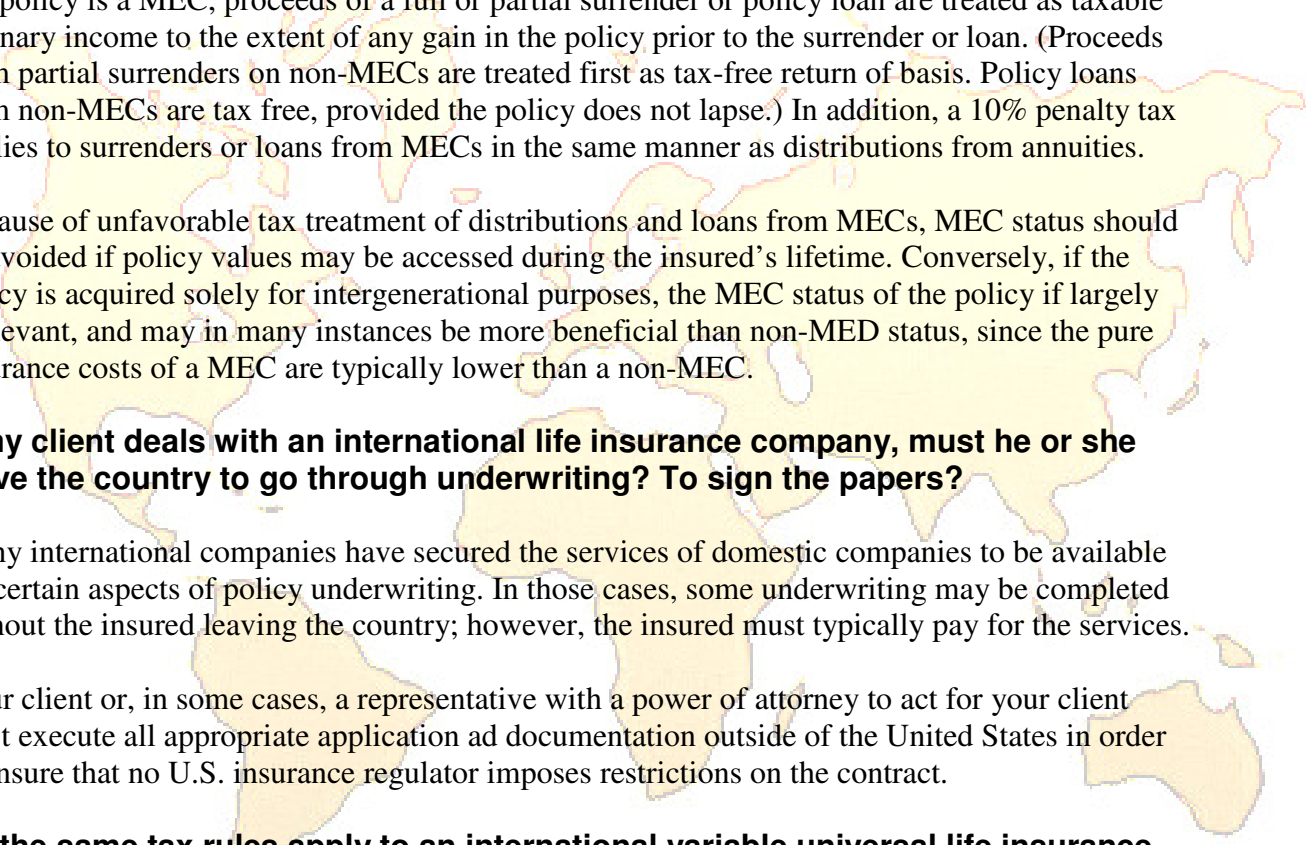
A separate account statute does not, however, provide the policy owner with any protection for the amount of death benefit in excess of the value of the policy's underlying investment accounts. This amount, called the net amount at risk, is a general liability of the insurance company. Foreign Insurance companies mitigate this risk by reinsuring almost all of the risk with other life insurance companies, which are often large, well-known domestic or multi-national institutions. By doing so, a foreign life insurance company's de facto liability for a policy it issues is only a small fraction of the face amount time.

## **Are the gains accumulated within a life insurance policy ever subject to income tax?**

If the gains are not distributed from the policy until the death of the insured, they will escape income taxation completely. In addition, gains can be effectively accessed tax-free during the life of the insured through policy loans, provided the policy does not lapse or is not surrendered during the insured's life and provided the policy is not a modified endowment contract ("MECs" are discussed below). If a non-MEC policy is surrendered in whole or in part prior to the insured's death, however, distributions upon surrender in excess of the policy owner's basis are taxed at the federal level at ordinary income rates. For MECs, whole or partial surrenders immediately create taxable income up to the extent of the gain in the policy.

## **What is a modified endowment contract ("MEC")?**

The rules governing MECs are complex, but, in general, a MEC is a life insurance policy that qualifies as life insurance under section 7702 of the IRC but the deposits to the policy exceed that allowable for non-MEC status.



If a policy is a MEC, proceeds of a full or partial surrender or policy loan are treated as taxable ordinary income to the extent of any gain in the policy prior to the surrender or loan. (Proceeds from partial surrenders on non-MECs are treated first as tax-free return of basis. Policy loans from non-MECs are tax free, provided the policy does not lapse.) In addition, a 10% penalty tax applies to surrenders or loans from MECs in the same manner as distributions from annuities.

Because of unfavorable tax treatment of distributions and loans from MECs, MEC status should be avoided if policy values may be accessed during the insured's lifetime. Conversely, if the policy is acquired solely for intergenerational purposes, the MEC status of the policy is largely irrelevant, and may in many instances be more beneficial than non-MEC status, since the pure insurance costs of a MEC are typically lower than a non-MEC.

### **If my client deals with an international life insurance company, must he or she leave the country to go through underwriting? To sign the papers?**

Many international companies have secured the services of domestic companies to be available for certain aspects of policy underwriting. In those cases, some underwriting may be completed without the insured leaving the country; however, the insured must typically pay for the services.

Your client or, in some cases, a representative with a power of attorney to act for your client must execute all appropriate application and documentation outside of the United States in order to ensure that no U.S. insurance regulator imposes restrictions on the contract.

### **Do the same tax rules apply to an international variable universal life insurance policy as they do to a domestic variable universal life policy?**

Yes, and these include the requirements that the policy owner/insured not have the ability to direct the investments of the account and that the investment account meets the diversification requirements of section 817 and the regulations there under. Provided an international variable universal life policy (1) is treated as life insurance under applicable local law and (2) complies with the same Internal Revenue Code requirements of a domestic variable universal life policy, the accumulations would be tax-deferred and policy distributions and loans would receive the same tax treatment as domestic policies.

Any investor considering an international variable universal life policy should review a copy of the legal opinions that the international insurance company has obtained regarding both the U.S. tax treatment of life insurance policies issued by the company and the treatment of the policy as life insurance under applicable local law. In addition, as with all matters involving U.S. taxation, investors should consult with and rely on their own tax advisors as to the specific tax issues that could be involved in using any variable universal life insurance policy to provide tax deferral for investments.

### **What about deferred variable annuities?**

A deferred variable annuity ("DVA") is another tax deferral vehicle that is often offered by international insurance companies in addition to life insurance. As with international life

insurance, the two most attractive features of an international DVA are investment flexibility (many international companies allow a preferred investment manager to manage a DVAs underlying investments) and tax deferral.

Because DVAs typically have no life insurance component (and therefore no associated cost of life insurance charges), they are usually more efficient wealth accumulators than life insurance. Unlike life insurance, however, all of the gains in a DVA will be taxed at ordinary income tax rates when they are deemed distributed from the annuity. In addition, the gains could be subject to an additional 10% penalty tax if they are deemed distributed prior to the annuitant attaining age 59½. Gains accumulated in a life insurance policy, on the other hand, often escape income taxation completely, particularly if the policy is never surrendered or allowed to lapse.

Whether international life insurance or an international DVA is more appropriate for a client must be determined on a case-by-case basis. In many situations, however, the favorable tax treatment of life insurance is found to outweigh the accumulation efficiency of DVAs.

### **Can my client contribute appreciated assets into an international variable universal life policy on a tax-free basis?**

Yes, if the Wealth Preservation Strategy is Employed.

## **DEMONSTRATING THE POWER OF INTERNATIONAL LIFE INSURANCE**

Assume Bob, a 50 year-old non-smoking male, has \$2.5 million to invest each year for 4 years. He would prefer to invest with his chosen investment manager, because the investment manager has historically earned 12% per year. Unfortunately, the investment manager's investment style generates substantial taxable gains that decrease investor's actual returns by an average of 31%. While the investment manager's after-tax returns remain attractive to Bob, Bob would like to reduce or eliminate the "tax drag" on his investments. Domestic tax-deferral vehicles are not an option, however: contribution limitations eliminate qualified plans from consideration, and state regulatory concerns, among other issues, prevent domestic life insurance companies from allowing Bob's private investment manager to manage accounts within their variable life insurance and annuity products.

In this type of situation, international life insurance is the solution.

### **Assumptions**

Investor: 50 year old male non-smoker

Account Invested: \$2.5 million for four years

Investment Manager: Chosen by Investors

Gross Investment Return: 12% (after Investment Manager's Fees)

Taxable Investment Account Values: Net of Taxes

International Life Insurance Investment Account Values: Net of Policy Loads and Charges.

The charts below compare the growth of a taxable investment account to a tax-deferred investment account inside an international life insurance policy. Both accounts are managed identically by Bob's private investment manager and earn a 12% gross return (after investment manager's fees). The amounts shown for the taxable accounts are net of taxes. The amounts shown for the insurance policy account are net of policy loads and charges.

### Accumulation Only

Year	Investor Age	Offshore Life Insurance Account Value	Taxable Investment Value	Offshore Life Insurance Advantage
10	59	\$23,751,595	\$19,747,323.00	\$4,010,272.00
20	69	\$68,509,581	\$43,737,981.00	\$24,771,600.00
30	79	\$200,073,102	\$96,903,889.00	\$103,169,213.00
40	89	\$582,848,835	\$214,695,864.00	\$368,152,971.00
50	99	\$1,742,390,626	\$475,670,423.00	\$1,266,720,303.00

### Access Account Values During Life

**\$4.5MM tax-free annual income stream beginning at investors age 66**

Year	Investor Age	Income Stream from Life Insurance for 25 years	Income Stream from Taxable Investment for 9.5 years	Offshore Life Insurance Net Account Value*	Taxable Investment Account Value	Offshore Life Insurance Advantage
10	59	\$0	\$0	\$23,751,595	\$19,741,323	\$4,010,272
20	69	\$4,500,000	\$4,500,000	\$44,778,755	\$21,690,485	\$23,088,270
30	79	\$4,500,000	\$0	\$42,023,056	\$0	\$42,023,056
40	89	\$4,500,000	\$0	\$23,499,108	\$0	\$23,499,108
50	99	\$0	\$0	\$35,192,200	\$0	\$35,192,200
<b>Total Income Received</b>		<b>\$112,500,000</b>	<b>\$44,040,091</b>			