PART II

UNDERSTANDING UL AND VUL POLICIES, IN ORDER TO UNDERSTAND PPLI/VUL POLICIES*

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UNDERSTANDING UL, VUL AND PPLI/VUL POLICIES

1. Life Insurance Policy Management

Life insurance (perhaps other than term, non-participating whole life, or no-lapse guarantee universal life), should be viewed by clients and their advisors not as a "buy and hold" asset, but a "buy and manage" asset. Those clients and advisors should also understand that, while there are plenty of folks who will help a client "buy" insurance, there are few, if any, who will help them "manage" it, once it is bought.

The only way to effectively manage such a policy is to have its performance re-illustrated periodically, at current values, so that the premium funding level can be re-evaluated and, if necessary, adjusted upwards.

Finally, as noted below, in universal type policies, costs of insurance are illustrated at current (lower) rates, but are subject to adjustment by the carrier to the (higher) guaranteed rates, perhaps (as discussed below) having nothing to do with its actual mortality experience. Any such adjustment would, however, have to be on a uniform basis for all insureds in a rate class.

One suggested basic policy management technique is as follows:

For Universal Life policies, where the interest crediting rate is declared by the carrier (subject to the guaranteed "floor"):

a) Review the "typical" in-force illustration with the current funding premium, current expenses, and currently declared crediting rate. If the policy is 8 - 10 years or older, the crediting rate is likely to be the guaranteed rate (4% prior to ~ 2003, 2% or 3% thereafter), and there should be no expectation that the crediting rate will ever be higher.

b) If the policy does not illustrate to "last" to an acceptable age (life expectancy plus 5 years), then request a recalculation of sufficient funding premium to life expectancy plus 5 years at current rate/current expenses.

c) Most carriers cannot illustrate anything between the current expenses and guaranteed expenses. Unless or until it's apparent that the carrier is starting to exceed its originally projected expenses, generally don't use the guaranteed expenses in an illustration request, unless the owner/trustee wants to review a "worst case."

For Variable Universal Life policies, where the crediting rate is determined solely by the investment returns in sub-accounts:

a) Follow the process described above for Universal Life, but request an in-force illustration with the current funding, current expenses, and no more than 7% assumed gross crediting rate (6% to be safely conservative).

b) If the policy doesn't illustrate to "last" to life expectancy plus 5 years at a minimum, then request a recalculation of a sufficient funding premium with no more than 7% assumed gross crediting rate (6% to be safely conservative).

Note the emphasis in each of these suggestions on determining a "**sufficient funding premium**" at lower crediting/rates of return and higher mortality costs. **This is the critical issue in policy management – will the policy sustain itself to life expectancy and beyond, at the premium originally "suggested" by the carrier?**

2. <u>Universal Life (Flexible Premium) Insurance Policies (UL Policies)</u>.

These are unitary policies, mostly issued by stock companies (some of which are subsidiaries of mutual companies), composed of two elements – a risk element (the death benefit) and an accumulation element (the cash value).

The risk element provides the policy owner with two choices: (a) Option A – provides for a level death benefit (the death benefit includes the cash value); this option is the only death benefit arrangement provided under traditional whole life policies. (b) Option B – provides for a so-called indeterminate death benefit (the death benefit is the sum of the accumulation element <u>plus</u> the face amount). Here, since the death benefit will be higher than under Option A, the mortality costs will be higher (which will mean that, unless higher premiums are paid, less will be in the accumulation account to earn interest). Electing this option after policy issuance will require evidence of insurability, unless the election is effective only prospectively.

The accumulation element is credited with interest, as it is earned by the insurer and added to the accounts of its policyholders. In many policies, the interest credited was initially a so-called "new-money" rate, based on short-term obligations, where changes – up or down – were passed through to the policyholder more quickly than in whole life portfolio rate structures.

The investment risk in these policies is effectively passed through to the policyholder – whatever interest is earned (after expenses) is credited to policy accounts, except to the extent of the guaranteed minimum crediting rate, initially usually 4 or 4.5% - currently, more like 2.5% or 3%.

Note that, except for the guaranteed minimum interest, policy illustrations for universal life policies are merely projections of anticipated interest rates that can (or may) be earned in the future and expenses that are projected (but not guaranteed) to be charged in the future. It is critical that clients and their advisers understand this concept and not rely on initially illustrated amounts, without having them both initially illustrated at lower returns as well as having them periodically re-illustrated, using actual performance. Given the general decline in rates since many of these policies were issued, the re-illustrated results may be startling – especially if higher rates were projected to "quick pay" the policy or to support premiums for term riders.

These policies were designed to respond to consumer complaints about low yields in traditional whole life products. They became popular in the 1970s – an era of high short-term interest rates, because they were then based on new-money rates. Most universal life policies now use a portfolio rate to credit interest to the accumulation account, because of the long-term downtrend in short-term rates. The decline in their popularity in an era of declining current rates lead, at least in part, to the development of variable policies, described below, offering the possibility of higher returns, keyed to the long-term performance of equities (rather than interest earned in the fixed income market) – and we all know how that worked out.

The trade-off here at the time was a "better" (i.e., current, new-money, market rates of interest credited to policy values) return, but fewer guarantees. In these policies, insurance carriers have shifted most of the investment risk to the policyholder (except to the extent of any minimum guaranteed rate), in response to consumers' requests for better investment returns in insurance products. In an era of lower interest rates, these policies may not project as well as traditional whole life policies.

The accumulation element in these policies is described as an "open architecture" structure, in which all policy charges and credits are separately stated. The so-called "black box" of the traditional whole life policy has been (at least partially) opened up. However, in many universal policies, the carrier determines the interest rate credited on the policy, based on its average returns. In some universal policies, however, the rate is tied to an outside index.

Because of the disclosure of mortality charges and other expenses, in these policies, no carrier can afford to let either get out of line for long; if they do, their healthy, well advised insureds would presumably exchange their policies for other, more competitive policies issued by other carriers, which would leave them with less healthy, possibly uninsurable, insureds.

Note that universal life products levy back-end loads, for 10 or 15 years (on a decreasing basis), accounting for the difference between the accumulation and cash surrender value amounts. These loads are designed to discourage use of the accumulation element in the policy as a money market fund.

Also note that the policy will lapse if the accumulation value won't cover the current expense and mortality charges, unless the insured/owner pays an added premium. Most policies show maximum mortality charges; actual mortality charges may be (and generally are) lower.

These are general account products; as such, the policy accumulation account values are subject to the claims of the carrier's creditors.

One of the defining feature of universal life policies is the flexibility the policyholder has to determine the frequency and magnitude of premium payments, subject to minimum policy maintenance (being sure there is always enough in the accumulation account to pay mortality charges and other expenses) and the maximum TEFRA policy guidelines to keep the contract within the definition of life insurance under Section 7702.

Most carriers suggest (not require) payment of the "planned" or "target" premium. Agent commissions are generally based on this amount; paying more than these amounts into the contract may therefore produce a higher return, since these extra amounts aren't reduced by commissions. These premium descriptions are another way of saying: "pay what you want, but this amount should (not will), based on current assumptions (which can and will change), keep the policy in force to life expectancy." When UL policies were being developed, there was a push to call these suggested amounts something other than "premiums", which, it was argued, had the connotation of required payments, but state regulators insisted on use of the word "premium" with a qualifier (like "planned").

Premium payments can be changed from time to time (increased, decreased, or even skipped), within those broad guidelines, without prior notice to or the approval of the carrier. The policy thus can be adjusted to mimic a level premium term product, a single premium product, or anything in-between, again, within the very broad guidelines of policy maintenance and the Section 7702 guidelines.

In addition to the ability to borrow against policy values, the owner may also withdraw amounts from the policy, by making partial surrenders – tax-free up to basis (assuming the policy is not a Modified Endowment Contract). Withdrawals are not loans; therefore, they don't require repayment, and no interest is charged on them (but, of course, there is less in the accumulation account to earn interest). Note that there are surrender charges in early years in many such policies, to prevent the accumulation account from being used like a savings or money market account; also note that withdrawals may reduce the death benefit.

With universal life, in addition to changes in the non-guaranteed part of the crediting rate, changes can also occur in the non-guaranteed expense and mortality charges. For example, a universal life product might not perform as initially expected, even though interest rates remain constant, because the carrier raises the non-guaranteed expense and/or mortality charges assessed against cash values (but not in excess of the guaranteed mortality charge).

In this era of continually declining interest rates, some carriers have apparently been increasing the cost of insurance charges in their universal life policies, even though their mortality experiences has been improving, not deteriorating, as a way of making up for the loss of earnings they have been experiencing, especially in policies where the guaranteed rates exceed their current earnings. See, however, In re Conseco Life Ins. Co., C10-02124 SI (2013), a Federal District Court case, approving settlement of cases where the plaintiffs argued Conseco could not raise its cost of insurance without proof its mortality costs had increased. The ability of an insurer to do so may depend on the contractual language dealing with this issue. One carrier describes in its policies that the cost of insurance will be determined based on its expectations as to earnings, mortality experience, persistence (lapse rates), expenses and taxes.

Many insurers offer blends of a universal life policy into base and term components. In a well-designed policy, the term component will have lower loads and agent compensation than the base, as well as costs-of-insurance that are equal to or less than the costs-of-insurance in the base. Therefore, the strategy to consider with this product is minimize the base, maximize the term, and pay as much of the premium in as additional premium or "dump-in" as possible.

As noted above, for UL policies, where the crediting rate is declared by the carrier, on-going policy management is required. One technique suggested is to have the owner review the "typical" in-force illustration with the current funding premium, current expenses, and currently declared crediting rate. If the policy is 8 - 10 years or older, the crediting rate is likely to be the guaranteed rate (4% prior to ~ 2003, 2% or 3% thereafter), and there should be no expectation that the crediting rate will ever be higher. Then:

a) If the policy does not illustrate to "last" to an acceptable age (life expectancy plus 5 years), then request a recalculation of sufficient funding premium to life expectancy plus 5 years at current rate/current expenses.

b) Most carriers cannot illustrate anything between the current expenses and guaranteed expenses. Unless or until it's apparent that the carrier is starting to exceed its originally projected expenses, generally don't use the guaranteed expenses in an illustration request, unless the owner/trustee wants to review a "worst case."

Risk of Life Insurance Policies
Risk by Product Types – Universal Life

What's Guaranteed	What's Not Guaranteed - Risks
• First Year Death Benefit and Minimum Required Amount of Premium • Minimum Interest Crediting Rate • Maximum Cost of Insurance • Maximum Policy Expenses	• Premium Sufficiency • Policy Sustainability • Current Interest Crediting Rates • Current Costs of Insurance • Current Policy Expenses • Purchasing Power – Depends on Factors Such As Level or Increasing Death Benefit Option, Policy Performance, Funding Adequacy and Section 7702 Corridor

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3. Variable Universal Life Insurance Policies (VUL Policies).

These policies are a hybrid of universal and variable life insurance policies, combining – some would argue – the best features of both.

These policies provide the multiple investment accounts and separate account protection of variable life for the accumulation element, giving the policy owner access to the equity markets for policy values. They also provide the premium payment flexibility, death benefit options and withdrawal possibilities of universal life.

These are security-based policies. The policy itself is a security, because the lifetime values and (in some cases) the death benefit are determined by the "investment" choices made by the policy owner among the "funds" – actually separate investment accounts managed by the insurer (or an affiliate or an independent money manager) – offered under the policy.

These policies all offer a broad range of "funds", including money market, stock, bond, balanced, etc. which are only available as a part of a variable policy (although they may be "clones" of publicly available mutual funds).

These "funds" (except for the guaranteed interest account) are separate accounts, generally not subject to the claims of the carrier's creditors in the event of insolvency. While this protection depends on the state law applicable to the carrier, most states (and many foreign jurisdictions) have such a law. The general accounts of the insurer into which premiums are paid and out of which death benefits are paid are not such separate accounts, and, accordingly, are subject to claims of the carrier's creditors.

There are complex diversification rules under the Section 817 Regulations and investor control rules for variable policies, under an older Eighth Circuit Case, a series of published and private letter rulings and a recent Tax Court case, to assure that the policy owner doesn't directly control the investments within the funds offered under the policy. The owner can select among the funds offered under the policy, not individual securities or investments held within those funds; accordingly, in retail, off-the-shelf variable policies, investor control is not an issue. The investor control issue is especially an issue in private placement variable policies where, for example, the policy owner wants to add the funds of a favorite money manager to the fund mix offered under the policy.

The availability of one or more equity-based funds under the policy allows the policyholder access to the equity markets in which to invest policy values. On the theory that, over time, equity-based funds historically have out-performed interest-driven returns, these policies give the policy holder the <u>potential</u> for greater long-term returns on policy values, subject to the risks inherent in such investments. On that theory, investing inside a policy, as opposed to doing the same investing outside the policy is especially important, since the policy value growth is tax-free (or at least tax-deferred). This is especially true for tax-inefficient investments, such as hedge funds or strategies that generate short-term gains, etc.; in fact, the more tax inefficient the investment, the better a candidate it is for use inside a private placement variable policy.

The agent must meet NASD and state law licensing requirements, and a prospectus must accompany the proposal. The proposal format is dictated by SEC guidelines. Cash values <u>must</u> be projected at a gross rate of 0% <u>and</u> at one or more other gross rates of compounded growth, <u>none</u> of which may be more than 12%, even if the carrier has results for funds offered under the policy exceeding 12% (which some policies had provided, on a long-term basis). Maximum mortality charges must be shown; current charges can be show as well.

There will be SEC registration costs and ongoing asset management fees, and there may be surrender charges in early years in these policies. Because of these costs, variable policies probably won't make sense if the cash values are intended to be invested in money market or GIC accounts in the long-run, which may limit these policies to those clients whose risk tolerance matches the risks of the policy's equity-based funds. In addition, given those costs, for clients who want to do asset allocation for their policy values, it may make more sense for them to invest their variable policy amounts in one or more of the equity funds and to purchase a separate universal policy for asset allocation to fixed income returns – this has been described as Macro, rather than Micro, asset allocation.

Here, the black box of traditional whole life insurance policies has been opened completely, since the policy values are beyond the control of the insurer – the policy funds are worth what they are worth; this is WYSIWYG in the insurance industry. In addition, the prospectus describes the internal mechanics of the policy in more detail than anyone should care about. Finally, the policy statements show all debits and credits to the policy, on a monthly basis, and again, this disclosure should put pressure on the carriers to keep their costs (including mortality) and fees competitive (or run the risk of losing their healthy insureds).

The death benefit may vary with the policy's investment experience, but (at least in most policies) not below the guaranteed amount. A guaranteed death benefit – regardless of investment performance – can be an important feature in variable policies. The "cost" of that guarantee may be the payment of ongoing mortality costs, for life, reducing the investment accounts by what is essentially a term charge.

The investment risk here is <u>totally</u> assumed by the policyholder, except for any guaranteed minimum death benefit. The cash values are not only not guaranteed, and not only may not increase as quickly as has been projected, they may in fact decrease (or go to zero) – depending exclusively on the investment performance (or lack thereof) of the fund(s) chosen.

But again note the assumption about the long-term performance of equities versus fixed income securities. That long-run potential however must be weighed against the possible loss of some – or even all – of the principal value in any given period, especially when policy value at that point in time (the ability to stop making premium payments, for example) is critical to the plan. This will mean that these policies will, more than any other, require ongoing monitoring, which should be provided by the agent as a part of his or her policy service.

One way to compare variable policies to either whole life or universal life policies is to consider: the <u>potential</u> difference between portfolio yields and equity performance, over time (recognizing the inherent risk being taken for this potential) and the difference between general account and separate account status, for carrier insolvency protection.

As noted above, suggested basic management of VUL policies includes:

For Variable Universal Life policies, where the crediting rate is determined solely by the investment returns in sub-accounts:

a) Follow the process described above for Universal Life, but request an in-force illustration with the current funding, current expenses, and no more than 7% assumed gross crediting rate (6% to be safely conservative).

b) If the policy doesn't illustrate to "last" to life expectancy plus 5 years at a minimum, then request a recalculation of a sufficient funding premium with no more than 7% assumed gross crediting rate (6% to be safely conservative).

Risk of Life Insurance Policies

Risk by Product Types – Variable Universal Life

What's Guaranteed	What's Not Guaranteed - Risks
• First Year Death Benefit and Minimum Required Amount of Premium • Maximum Cost of Insurance • Maximum Policy Expenses	• Premium Sufficiency • Policy Sustainability • Earnings • Current Costs of Insurance • Current Policy Expenses • Purchasing Power – Depends on Factors Such As Level or Increasing Death Benefit Option, Policy Performance, Funding Adequacy and Section 7702 Corridor

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4. Private Placement Variable Universal Insurance Policies (PPLI or PPLI/VUL Policies).

These are large face amount, individually negotiated variable universal policies, issued by either U.S. or foreign carriers, which offer lower fees and expenses, negotiated commissions, additional investment choices (including more exotic choices, such as hedge funds, and, in the case of offshore policies, those which aren't otherwise available to U.S. investors) and which may allow the insured/owner to suggest that the insurer add, as one of the fund choices, a favorite investment manager(s). These policies generally require a substantial (e.g., $1 million) premium commitment, either initially or over a short period of time.

The investor control issues and, to a lesser extent, the diversification requirement, described above, are critical in these policies, especially where, as is often the case, the insured/owner can suggest managers to the carrier to be added to those offered under the policy. The other issue involved in these policies is: to whom (or what) can these policies be sold, under the accredited investor and qualified purchaser rules, described below?

These policies are sold only to accredited investors in private placement transactions, so that the sales of these policies are exempt from SEC registration under the Securities Act of 1933. In addition, the issuer is exempt from regulation as a public investment company under the Investment Company Act of 1940, if the purchaser is a qualified purchaser under that Act, so many of these transactions also require the buyer be a qualified purchaser. Those exemptions should result in lower costs, which should be passed along to the purchaser.

The definitions of accredited investor under the 1933 Act and qualified purchaser under the 1940 Act are:

An Accredited Investor is:

- An individual with a net worth of $1 million or more, excluding home and automobile.
- An individual who has made $200,000 per year in income for the past two years and has a reasonable expectation of doing so in the future.
- An individual and spouse with aggregate income of $300,000 per year for the past two years and have a reasonable expectation of doing so in the future.
- A corporation, partnership, limited liability company, trust or tax exempt organization with assets exceeding $5 million, which was not formed for the purpose of investing in the product.

Under the SEC rules, an irrevocable trust can be an accredited investor only if it has total assets in excess of $5 million, it was not formed for the purpose of acquiring the securities, (determined under a facts and circumstances test, including how much of the trust's assets are made up of this security), and it is managed by a sophisticated person, under S.E.C. Rule 501(a)(7). Alternatively, it can qualify under S.E.C. Rule 33-6455, if a bank is a trustee or co-trustee which makes investment decisions, on the theory that the purchaser is a bank (which is an exempt purchaser).

In some cases, these policies are purchased by old trusts with substantial net worth. In other cases, the trust will be newly created, which will mean the trust will have to have a corporate trustee to be an accredited investor, unless the broker-dealer which is responsible for compliance with the 1933 Act accepts a new trust as an accredited investor because the grantor qualifies, even if it does not have a corporate trustee.

A Qualified Purchaser is:

- An individual who owns at least $5 million in qualified investments.
- A family business or a family trust that owns at least $5 million in qualified investments.
- A corporation, partnership, limited liability company, trust, or tax-exempt organization where each beneficial owner is a qualified purchaser.

- A trust that was not formed for the specific purpose of investing in the product, so long as both the persons with decision making power and each of the contributors to the trust is a qualified purchaser.

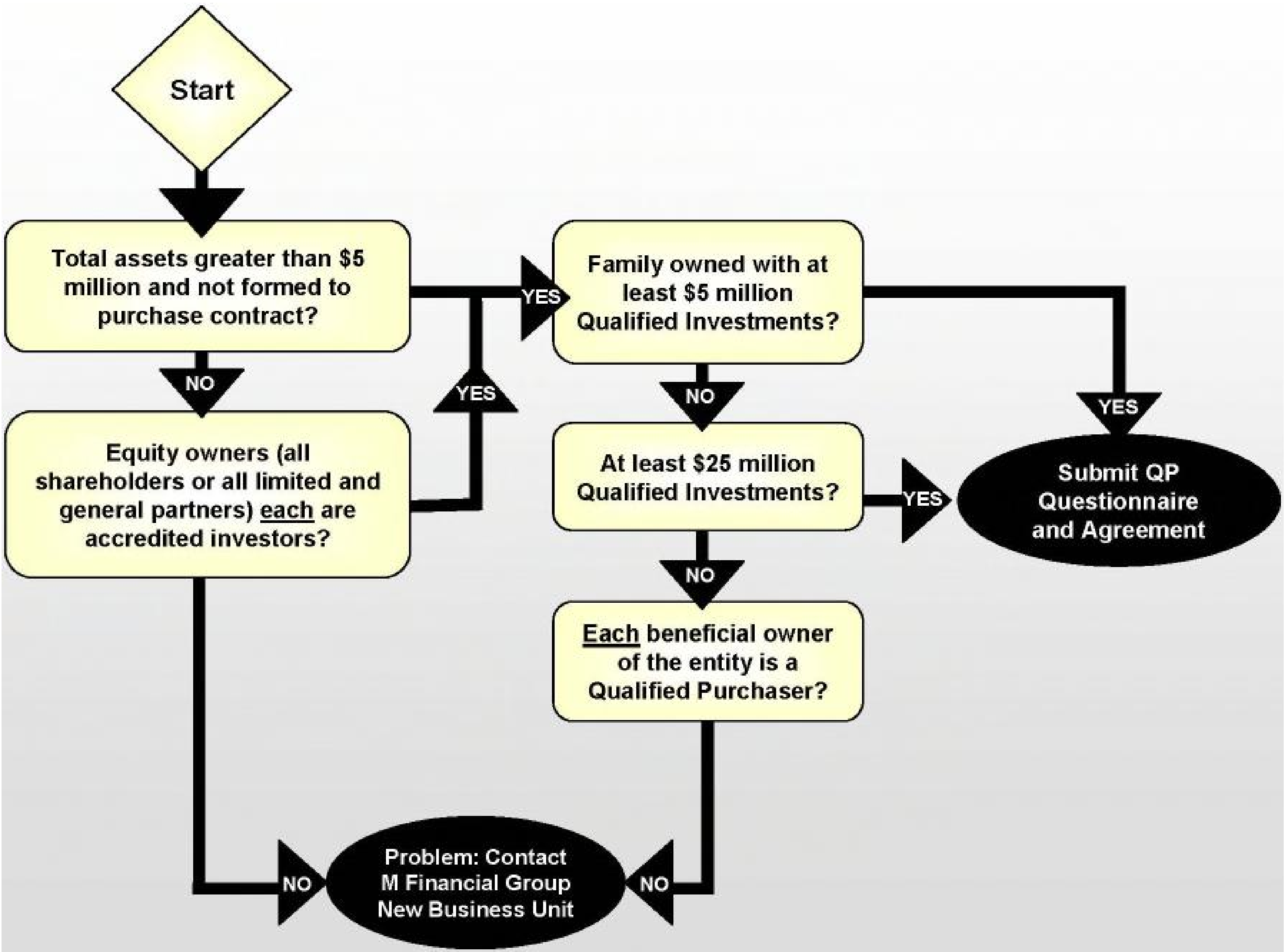
- A corporation, partnership, or trust with at least $25 million in qualified investments.

In this context, an irrevocable trust can technically be a qualified purchaser only if it wasn't formed for the purpose of acquiring the securities (under the same sort of test) and both the trustee and the settlor are qualified purchasers. In many cases, the trust will be newly created and can't qualify as a qualified purchaser, regardless of the identity of the trustee, again, unless the broker-dealer is willing to look through the trust to the grantor.

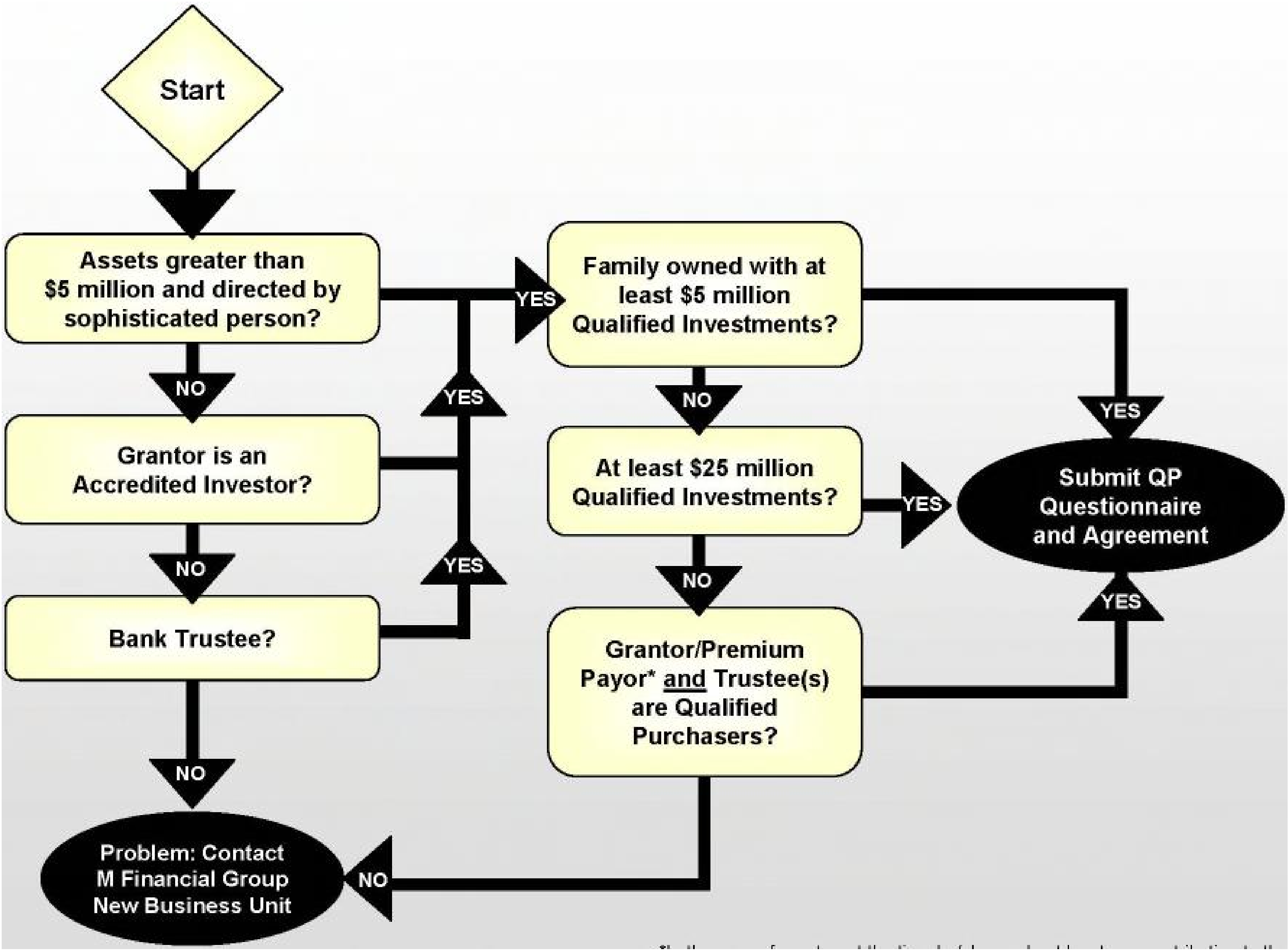
Whether the trust is a qualified purchaser or not isn't as important as whether it is an accredited investor, since that determines whether the sale is or is not exempt from registration under the Securities Act, which is the larger expense to be avoided, and many issuers will already be registered under the 1940 Act in any event.

See the following flowcharts from M Financial Corporation and its broker-dealer, illustrating these concepts.

Partnership or Corporation Analysis

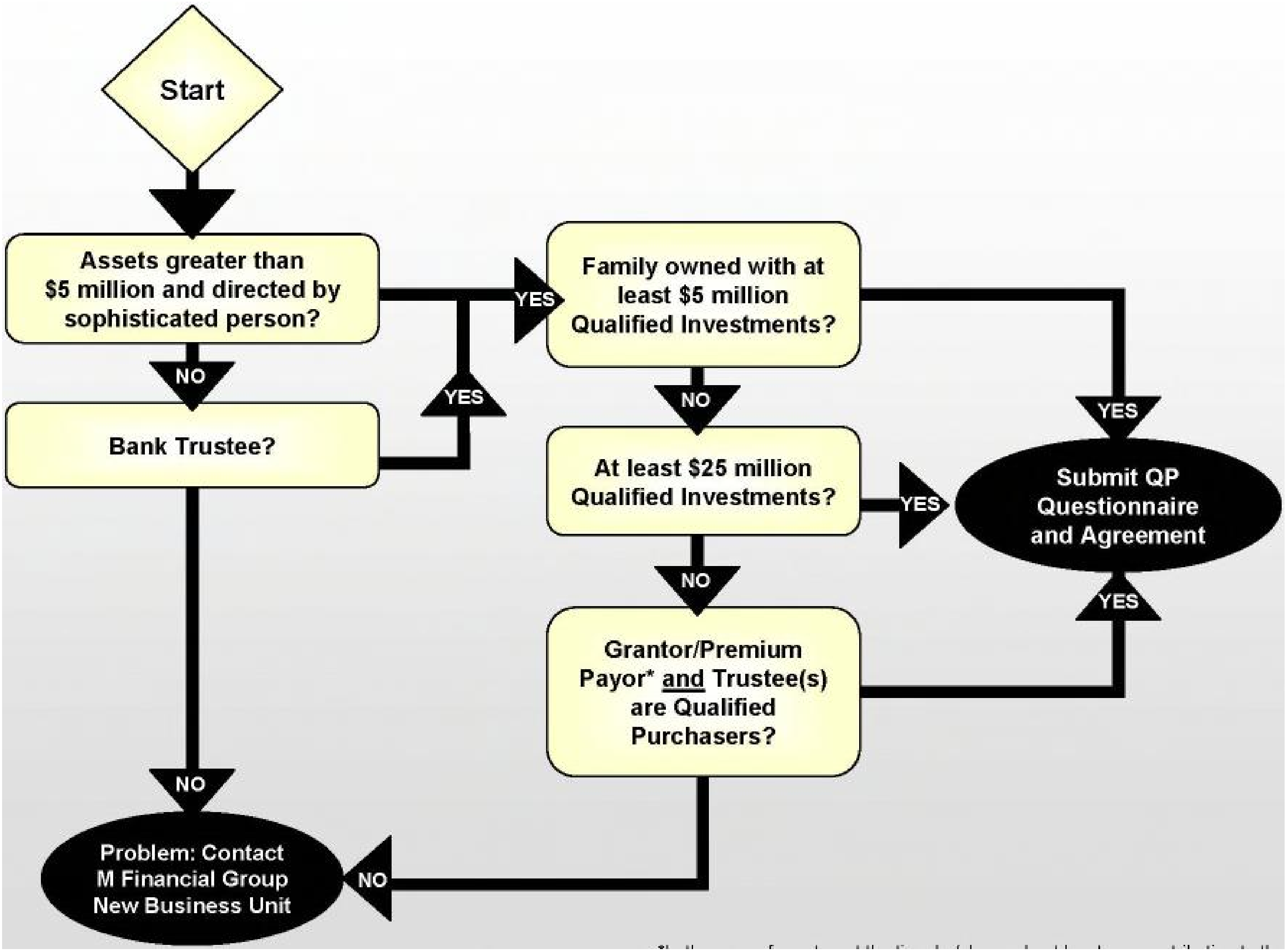


Revocable Trust Analysis



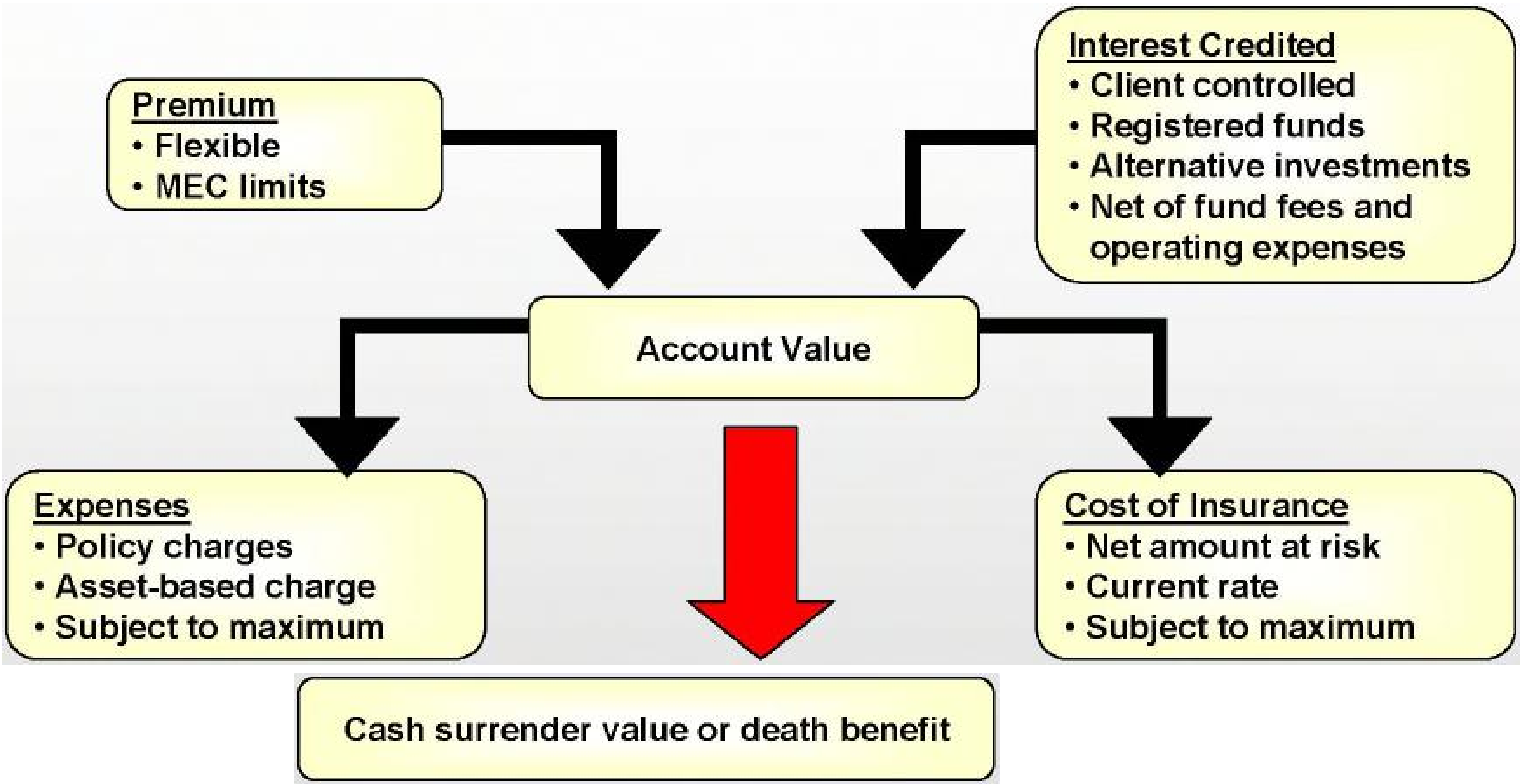
*In the case of grantor, at the time he/she made at least one contribution to the trust.

Irrevocable Trust Analysis



*In the case of grantor, at the time he/she made at least one contribution to the trust.

Private Placement VUL Mechanics



5. Overview of the Benefits of PPLI

Unlike off-the-shelf variable life insurance products that are limited to investment in diversified mutual funds, PPLI buyers can invest in a range of assets, including hedge funds, private equity, stock portfolios and other alternative investments. Off-shore PPLI policies have an even greater range of permissible investments, based on the off-shore jurisdiction's regulatory requirements.

Investments held inside a life insurance policy versus investments held outside of a life insurance policy. As is the case with all insurance policies, the PPLI owner receives tax-free (or deferred) inside build-up of policy value, under Sections 7702(a) and 72(e) of the Code (subject to the "MEC" rules of Section 72).

These investment returns within the policy can be improved by lower costs that can exist in PPLI or that can be negotiated downward by the owner. The PPLI buyer may be able negotiate considerably lower agent commissions or negotiate commissions that are based on growth in the value of the policy, rather than a set commission. Since agent commissions are paid by the insurance company out of the premium, if these commissions are lowered, more of the premium is added to the VUL accounts. Gerald Nowotny noted in his 2012 article "Private Placement Life Insurance and Annuities 101-A Primer, (jdsupra.com, 8/28/2012) that traditional variable life insurance products have a commission structure that "pays the agent 55-95% of the target (commissionable) premiums in the first policy year" and commissions in subsequent years on premiums vary by carrier from 2-5% of the premium as well as .25-.35% of the policy's account value. Alternatively, it is possible to take the agent commission (the bulk of which is typically paid up-front in the first year) and pay it from each year premium on a ratable basis. Finally, it is possible at times to pay that cost directly to the insurance company rather than have it taken out of the premium, but the availability of this option is based on the jurisdiction's regulatory requirements and is more often found in off-shore PPLI.

Mortality and Expenses ("M & E") charges are fees that the insurance company charges within the premium for its administration of the policy and takes into account the risk that the insured may not live long enough for the company to make a profit from the policy, in light of the costs it expends to maintain the policy.

Cost of Insurance (COI) charges are fees paid to the insurance company within the premium for the pure investment risk is it taking on by issuing the policy and COI charges are based on the difference between the policy cash value and the policy's face amount.

PPLI typically has no surrender charges. PPLI has all the benefits of the more typical VUL policy as well. The assets held in the policy for investment are held in separate accounts, not the insurance companies' general account, thereby protect the assets from the claims against the insurance company and permitting greater flexibility of investment choices. Both on-shore PPLI and off-shore PPLI offer a death benefit that is not subject to income tax under Section 101(a) of the Code, subject to the transfer for value rules of Section 101 of the Code.

Managing PPLI under these Rules

The issuing carrier will grant the proposed policy owner the right to select among several investment options, each of which is designed so that all the investment decisions will be made by the investment manager in his sole and absolute discretion. The investment manager will be prohibited from initiating or responding to any direct or indirect communications with the policyholder. All decisions concerning the fund of funds have to be made by an investment adviser of the fund of funds in its sole discretion, including particular investments and or investment strategy.

A policyholder will only have a contractual claim against the insurance company to receive cash under the contract terms. Further, the contract owner can have no legal, equitable ownership interest in any of the assets in the fund;

How Does PPLI Work?

The general consensus among insurance professionals seems to be that the minimum initial premium for PPLI to make sense is five million dollars. There are some who believe it works with a one million premium, but that is usually for on-shore PPLI.

The life insurance company will create a multi-fund account that is not available to the general public and the insurance company holds the interests in the account, known as an Insurance Dedicated Fund (an "IDF"). The insurance company then enters into an agreement with an investment manager or managers to provide investment management services to the IDF.

How do IDFs work?

The investment manager manages the fund in the manager's sole discretion. The manager takes no investment recommendations from any policyholder (or anyone related to the policyholder). All decisions about the investment manager are made by the insurance company.

The investment manager may add additional managers to the separate funds. See Rev. Rul. 2003-91, 2003-02 CB 347, holding that since the separate account of the policy is broken into various sub-accounts, that were not available to the public, the investments would maintain their look-through treatment to the underlying securities for the purposes of the diversification requirements of Treasury Regulations Section 1.817-5.

The accounts are referred to as either "fund of funds", which are independently managed funds, or "clone funds", which are funds (usually hedge funds) also only available to insurance companies, but with investment objectives and strategies that mimic those of a fund managed by the same investment manager which are available to the general public. Importantly, the general public cannot invest in the clone fund, and the clone fund and the public fund share only similar investment objectives and strategies. See I.R.S. Priv. Ltr. Rul. 2002-44-001 (May 2, 3002), holding that even if an insurance company created a separate account for the fund, since the general public was able to invest in the same fund, the policyholder was deemed to be the owner of the fund and therefore any earnings and/or gains are includable in his or her gross income.

Domestic insurance companies may only want to add additional investment managers (or the investment manager may only want to add additional managers to manage an account) if the proposed investment manager already has several million dollars of assets under management. Many off-shore insurance companies may be more willing to utilize an investment manager with much lower amounts under management.

US Citizen Purchasing an Off-shore PPLI Policy.

Acquiring PPLI requires that the client to undergo medical and financial underwriting in a location where the major off-shore carriers do business or in an agreed country outside the U.S. The client's advisors must determine if a US trust or a foreign trust as the policyholder is appropriate, or another entity should be utilized. The IDF must be put into place, if a new investment manager is desired, a custodian chosen (if the insurance company does not already utilize a particular custodian), and the terms of the policy (and negotiation of costs) must be determined. A large initial premiums will then be invested, which requires moving money offshore.

Major Differences Between Off-Shore and Domestic PPLI

Regulations.

Off-shore PPLI has access to off-shore investments that do not require or have not obtained SEC regulatory approval. The access to a greater and more varied types of investments than what is available to on-shore PPLI is one of the primary reasons U.S. citizens consider off-shore PPLI.

Off-shore PPLI generally U.S. tax compliant. However, they benefit from looser regulatory regimes and may offer investments in foreign-registered securities that are not available to U.S. investors. Additionally, off-shore insurers do not have the compliance burden of domestic consumer laws, typically state laws, that were designed to protect the less-sophisticated consumer. See National Association of Insurance Commissioners (NAIC), *Model Laws, Regulations and Guidelines.*

Tax-Free Inside Build-up of Policy

On-shore PPLI that qualifies under Section 7702(a) receives the benefit of income tax free build-up of value inside the policy. Unless the policy is a MEC as determined under Section 72, that value can be accessed tax-free as well utilizing partial surrenders and loans.

Off-shore PPLI that qualifies under Section 7702(g) does not receive this benefit, thereby requiring different planning to ensure the increase in the cash value of the policy is not taxed on an on-going basis. Furthermore, off-shore PPLI will be subject to the tax laws of the jurisdiction where it is issued. For example, PPLI based in Switzerland, based on Swiss tax laws, are exempt from income and asset taxes as well as the Swiss and EU withholding taxes. "The True Cost of Swiss Private Placement Life Insurance and Deferred Variable Annuities", Martin Straub, Private Wealth Management, 2010 CFA Institute.

On-shore PPLI involves the following costs:

A state imposed premium tax, which typically vary from below 1 percent up to 3 percent. Alaska and South Dakota have implemented reduced state premium taxes to less than 1%. To take advantage of the tax advantages, one must have a contractual nexus to these states, the most common being either a trust, partnership or corporation domiciled in such states.

A federal regulatory fee or charge known as the Deferred Acquisition Cost Tax (the "DAC Tax"); see IRC § 848. The DAC Tax will vary from company to company, because it is based on an insurer calculation. The DAC Tax is usually in a range of .5% to 1.5%, which is deducted from the policy holder's initial premium.

Off-shore PPLI involves the following costs:

If the off-shore insurance company does not make the Section 953(d) election (which results in the company paying the DAC Tax), the policy owner will incur a 1% federal excise tax. See IRC § 4371.

The Section 953(d) election permits an off-shore insurance company to be treated as a domestic corporation for US income tax purposes, even though it is not doing business in the United States. By doing so, the one percent Federal excise tax which is imposed on premiums paid to a Non-US insurance company (and on any reinsurance premium payments made by an insurance company to a non-US reinsurer) can be avoided.

The Section 953(d) election is also important because without it the insurance company's separate accounts in the policy can be treated as non-US accounts income tax purposes and certain categories of investment income would be subject to withholding taxation under Section 871(a) at a 30 percent rate.

Off-shore PPLI is usually structured by utilizing a custodian to hold the assets and an investment manager who handles the investments in the IDF. Both of these roles results in fees.

An estimate of the costs and returns of off-shore PPLI was provided in one article written in 2010 which stated that the median fees at the outset that a policyowner could expect over the first five years of the contract was approximately 6.75% in establishment and up-front loads and 14.59% in ongoing fees and charges which when deducted from median investment returns of 33.82% resulted in a net return over the five year period of 12.22%. "True Cost of Swiss Private Placement.." Martin Short, 2010 CFA Institute. The author of this article also reiterated, however, that these costs could be negotiated downward.

There ARE also the costs of travel to the foreign jurisdiction for underwriting and to meet with representatives of the custodian bank and insurance company.

The investments offered only by off-shore PPLI must be attractive enough to offset these costs.

Amount of Insurance

On-shore PPLI may support larger amounts of death benefit (and therefore larger policy investment) due to the greater availability of reinsurance, which has been claimed to be two to four times greater in the domestic market than the offshore market. See "Private Placement Life Insurance Overview", Gerald R. Nowotny, Long Gray Line Consulting, PPLI White Paper. Given the paucity of reinsurers in the off-shore market, understandably the costs of reinsurance are higher off-shore than for on-shore carriers.

Off-shore PPLI may support a larger premiums investment if the jurisdiction's regulatory requirements allow for a smaller amount at risk than US policies.

Weighing the Issues for US clients Considering Off-shore PPLI

Off-shore policies are not as constrained by the U.S. securities regulatory environment, therefor the policies are more easily tailored to the individual desires of the policy holders. The US client will be holding assets off-shore. The client will have to travel to the off-shore marketplace to undergo a physical examination and complete all required paperwork. The policy will receive the benefit of the US tax laws if the off-shore insurance company makes the Section 953 election. The client may utilize a US or a foreign trust; there are obviously different tax consequences based on this decision.

The separate accounts in the policy will be held by a custodian, usually a foreign bank, and it is the bank's financial strength the client is concerned about more than the off-shore insurance company's financial strength.

Additionally, U.S. citizen with off-shore holdings must comply with the Foreign Account Tax Compliance Act (FATCA) and file Report of Foreign Bank and Financial Accounts (FBAR). For example, A taxpayer with more than $10,000 in an off-shore account, must file a Report of Foreign Bank and Financial Accounts with the IRS and anyone with at least $50,000 in a foreign account will have to file a separate tax-compliance form, along with his or her annual return.

Puerto Rico enjoys the status of being both on-shore and off-shore. As a Commonwealth of the U.S., Puerto Rico is not subject to the FATCA and FBAR requirements. Several insurers were formed in Puerto Rico, offering PPLI products, based on Puerto Rico's tax-friendly corporate environment and the increased scrutiny and regulation of transactions off-shore.

Section 7702(g) and Frozen Cash Value Insurance

If a PPLI policy fails both tests of Section 7702(a), then the "income on the contract" will be treated as ordinary income received or accrued by the policy during such year.

The "income on the contract" is defined in the Section as the sum of the increase in net surrender value over the taxable year plus the cost of insurance protection provided under the contract for the taxable year over the premiums paid during the taxable year.

The "cost of insurance protection" is defined in the Section as the lesser of (i) cost of individual insurance on the life of the insured as determined on the basis of uniform premiums (computed on the basis of 5 year age brackets) prescribed by the Secretary by regulations, or (ii) the mortality charge (if any) stated in the contract.

Planning for Section 7702(g):

If the cash value never increases above the premiums paid, there will be no ordinary income. This is the concept of "frozen cash value".

The death benefit paid under this type of policy is a small amount of death benefit based on the foreign jurisdiction's requirements on the amount of risk required, which can sometimes be as low as 5% of the cash value, depending on the jurisdiction) plus the value of the separate accounts determined as of the date of the claim.

This planning restricts the policy owner from accessing the cash value in excess of the amount of premiums paid (through partial surrenders or loans of up to 90% of the premiums paid amount) during the insured's lifetime, which results in a PPLI policy that is acquired for its death benefit and not for lifetime access to the growth in cash value.

Section 7702(g) provides that although the policy fails the tests of Section 7702(a), the excess of the death benefit over the net surrender value of the contract will be treated as life insurance under Section 101, and that the policy will be treated as an insurance contract for tax purposes.

6. Investor Control/Diversification Issues in PPLI

Overview. The IRS and both the Eight Circuit Court of Appeals, see, e.g., Christoffersen v. United States, 749 F.2d 513, 515-16 (8th Cir. 1984), cert. denied, 473 U.S. 905 (1985), stating that "[u]nder the long recognized doctrine of constructive receipt, the income generated by the account assets should be taxed to the [annuity holders] in the year earned, not at some later time when the [annuity holders] choose to receive it. This is the essence of Rev. Rul. 81-225, [below] which we find persuasive."

The preamble to the Proposed and Temporary Treasury Regulations under Code Section 817(h) noted that "[t]he temporary regulations . . . do not provide guidance concerning the circumstances in which investor control of the investments of a segregated account the may cause the investor, rather than the insurance company to be treated as the owner of the assets in the account. . . . Guidance on this and other issues will be provided in regulations or revenue rulings under Code Section 817(d) relating to the definition of variable contracts."

The Final Regulations under Code Section 817, promulgated after the decision in Christoffersen, above, and the four early published revenue rulings, discussed below, do not address the extent to which a contract owner may direct the investment of assets in a segregated account without being treated as the owner of the assets. The Final Regulations do, however, incorporate by reference certain aspects of Rev. Ruls. 81-225 and 77-85, below. Treas. Reg. Secs. 1.817-5(f)(3)(iv) & -5(i)(2).

Nonetheless, as noted above and discussed below, the IRS has taken the enforcement position that the enactment of Code Sections 817 and 7702 did not supersede the investor control rulings nor the Eighth Circuit's decision in Christoffersen, and has continued to rely on those authorities in issuing private letter rulings. More recently, the Tax Court in Webber v. CIR, 144 T.C. No. 17 (2015), held that the IRS rulings imposing the investor control requirement were entitled to deference, since they "have reasonably applied well-settled principles of Supreme Court jurisprudence to a complex area of taxation"; the Tax Court found that, on the arguably extreme facts of the case, the taxpayer (rather than the insurer) was treated as the owner of the separate accounts held under the policy, for Federal income tax purposes, because of the control he exercised over those accounts.

The IRS victory on this issue in Webber, despite some commentators' position that the IRS had no authority to impose this requirement, as discussed below, means that this will continue to be an issue for private placement policies going forward. have taken the position that a variable life insurance policy owner who retains substantial control over the investment of assets underlying the policy may be treated as owner of the underlying assets for Federal income tax purposes and therefore would be subject to current taxation on income realized on the underlying assets, even if all of the statutory and regulatory requirements for non-recognition of current income on assets held under a variable life insurance policy were satisfied. See, Christoffersen v. United States, and Webber v. CIR, both above.

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Origins. In the 1970s, the IRS became concerned that taxpayers were avoiding recognition of income by "wrapping" their investments in "investment annuity contracts" which created "the possibility of major tax shelter abuse." See Investment Annuity, Inc. v. Blumenthal, 442 F. Supp. 681, 693 (D.D.C. 1977), rev'd on procedural grounds, 609 F.2d 1 (D.C. Cir. 1979), cert. denied, 446 U.S. 981 (1980). In these transactions, each "investment annuity contract" paid an annuity to the owner, based on the investment return and market value of the contract's segregated asset account. A third-party custodian held and invested the contract's assets in accordance with the annuity owner's directions.

In response to this perceived abuse, the IRS published four Revenue Rulings between 1977 and 1982, describing the circumstances under which the owner of a variable annuity or life insurance contract (rather than the insurer) would be treated as the owner of and would therefore be taxed on the income of the assets underlying the contract, due to the owner's control of the investment of those assets. Rev. Ruls. 77-85, 1977-1 C.B. 12; 80-274, 1980-2 C.B. 27; 81-225, 1981-2 C.B. 12; and 82-54, 1982-1 C.B. 11. The United States Court of Appeals for the Eighth Circuit also adopted the IRS's position, as has the Tax Court; Christoffersen and Webber, above.

These "investor control" authorities apply to variable annuity and life insurance contracts the well-established Federal income tax principle that a person is treated as the owner of an asset if that person possesses significant incidents of ownership over the asset, regardless of who holds legal title to the asset.

Early Published Rulings. The IRS's first response to the perceived abuse, Revenue Ruling 77-85, above. concluded that an annuity owner was, for federal income tax purposes, the owner of the separate account assets where the annuity owner controlled the investment of the separate account assets, had the power to vote any securities in the account, and could withdraw any or all of the assets at any time. The ruling held that the annuity owner's gross income under Code Section 61 includes interest, dividends and other income from the separate account assets in the year received by the custodian because the assets were not owned by the insurer for federal income tax purposes, and were not subject to exclusion under former Code Section 801(g)(1)(B) governing segregated accounts. The ruling analogized the investment annuity contract to a pledge arrangement in which assets are set aside in the separate account to purchase an annuity. The ruling emphasized that even though the annuity owner did not have title to the separate account assets under state law and the separate account assets constituted the insurer's assets for state insurance law purposes, the annuity owner was the owner of the assets for federal income tax purposes.

The second ruling, Revenue Ruling 80-274, above, similarly concluded that a savings and loan association depositor was, for federal income tax purposes, the owner of a certificate of deposit underlying a variable annuity contract, where the depositor transferred the CD to the life insurance company in exchange for the variable annuity contract and the insurance company was expected to hold the transferred CD for the depositor's benefit.

The third ruling, Revenue Ruling 81-225, above, applied the investor control principle to five different situations. In four of the situations, the annuity owner, rather than the insurance company, was considered the owner of mutual fund investments underlying the annuity contracts. In the final situation, the insurance company was considered the owner. In Situation 1, the segregated account underlying the annuity contracts held only shares of a single publicly available mutual fund managed by an independent investment adviser. Situation 2 was similar to Situation 1 except that the mutual fund was managed by the insurance company or one of its affiliates. Situation 3 also was similar to Situation 1 except that the segregated asset account underlying the annuity contracts consisted of five sub-accounts on which the performance of the annuity contract would depend. The annuity owner retained the right to allocate or reallocate funds among the five sub-accounts during the life of the annuity contract. Situation 4 was similar to Situation 2, except that the shares of the mutual fund were not sold directly to the public, but were available only through the purchase of an annuity contract or by participation in an investment plan account. Situation 5 also was similar to Situation 2, except that the shares in the mutual fund were available only through the purchase of an annuity contract.

The ruling concluded that the annuity owners in the first four situations had sufficient control and other incidents of ownership to be considered the owners of the underlying mutual fund shares for federal income tax purposes. The ruling concluded, however, that in Situation 5 the insurance company, rather than the annuity owner, was the owner of the mutual fund shares for federal income tax purposes. It reached that conclusion because the mutual fund's sole function was to provide an investment vehicle which allowed the insurance company to meet its obligations under its annuity contracts.

In the final ruling, Revenue Ruling 82-54, above, annuity owners directed the insurance company to invest in the shares of any or all of three mutual funds that were not available to the public. One mutual fund invested primarily in common stocks, another in bonds, and a third in money market instruments. Annuity owners allocated their premium payments among the three funds and had an unlimited right to reallocate contract values among the funds prior to the maturity date of the annuity contract. The ruling concluded that the annuity owners' ability to choose among general investment strategies (stocks, bonds, or money market instruments) did not constitute sufficient control to cause the annuity owners to be treated as the owners of the underlying mutual fund shares.

Required Representations in the Early Private Letter Ruling Requests. Although a private letter ruling only binds the Service with respect to the specific party receiving the ruling, and may not be cited as authority, under Code Section 6110(k)(3), it is indicative of the Service's position in an area. The IRS had issued several private letter rulings on the issue of investor control, setting forth, in each case, the various representations required to support a holding that the insurance company, and not the contract owner, would be treated as the owner of the assets of the segregated asset account supporting a variable life insurance contract, for Federal income tax purposes. See, e.g., PLR 8427091 (April 5, 1984); PLR 8335124 (May 27, 1983). The following representations were typically required to obtain the favorable rulings:

(a) A contract owner could not have a legally binding right to require the insurance company or separate account to purchase any particular investment.

(b) There could be no prearranged plan between the contract owner and the insurance company to invest premiums or other amounts in a particular investment.

(c) A contract owner could be informed of the general investment strategy that would be followed.

(d) The contract owner would be permitted to choose among broad investment strategies.

(e) No contract owner could have any interest in any specific investment held by the insurance company or the separate account.

(f) A contract owner could have only a contractual right against the insurance company or separate account for cash as a result of purchasing the life insurance contract.

Note that although these facts were required to be represented in these earlier ruling requests to get the desired ruling, they are not necessarily a statement of the law; they do, however, provide an insight into the Service's thinking on what factors it considers important in the investor control area. As discussed in detail below, the more recent rulings have expanded these representations, likely based on additional concerns raised by the IRS, in response to additional facts presented in the later requests.

<u>Subsequent Published Rulings</u>. In Rev. Rul. 2003-91, 2003-2 C.B. 347. an individual purchased variable life insurance contracts or variable annuity contracts from an insurance company. The assets that funded the contracts were separated from the insurance company's other assets and maintained in separate accounts that were divided into several sub-accounts which offered various investment strategies. Interests in the sub-accounts were available solely through the purchase of the contracts and not available for sale to the public. The insurance company engaged an independent investment adviser to manage the investments of each sub-account. The individual could allocate premiums and transfer funds among the sub-accounts, but could not select or recommend particular investments or investment strategies, nor communicate directly or indirectly with any investment officer of the insurance company regarding the selection or quality of any specific investment or group of investments held in a sub-account.

The ruling stated that whether the contract owner possessed sufficient indications of ownership over the sub-account assets to be deemed the owner of the assets depended on all of the facts and circumstances. The ruling held that the contract owner was not considered to be the owner, of the assets that funded the contracts for Federal income tax purposes, since other than the individual's right to allocate premiums and transfer funds among the available sub-accounts, all investment decisions were made by the insurance company in its sole and absolute discretion.

Significantly, the ruling noted that a contract owner did not have investment control with respect to a contract, based on the following facts and circumstances:

(a) The owner only had the right to choose among sub-accounts based on their general investment style and had no authority or control regarding decisions relating to investment of the account or appointment of the investment adviser or any investment officer of the insurance company, all such decisions being in the sole discretion of the insurance company or the investment adviser, and

(b) The owner could not communicate directly or indirectly with any investment officer of the insurance company or its affiliates or the investment adviser regarding selection, quality or rate of return of any specific investment or group of investments held in a sub-account, and

(c) The owner had no legal, equitable, direct or indirect interest in any asset held by a sub-account, but only a contractual claim against the insurance company to collect cash from the insurance company in the form of death benefits or cash surrender value under the contract, and

(d) There was no arrangement, plan, contract or agreement between the owner and the insurance company or between the owner and the investment adviser regarding availability of a particular sub-account, the investment strategy of any sub-account or the assets to be held by a particular sub-account.

In Rev. Rul. 2003-92, 2003-2 C.B. 350, which replicated the facts of Private Letter Ruling 200244001, an individual purchased variable life insurance contracts or variable annuity contracts from a life insurance company. These contracts were for sale outside of insurance policies, but only to individuals who were qualified purchasers and accredited investors under the federal securities laws. The assets supporting the contracts were held in separate accounts that were segregated from the insurance company's other accounts and each separate account was divided into sub-accounts. Individuals who owned policies could allocate premiums and transfer funds among the sub-accounts. Each sub-account invested in partnership interests which were sold in private placement offerings only to qualified purchasers that were accredited investors and to no more than one hundred individuals. Each partnership had an investment manager that selected the partnership's investments.

The ruling held that the individual was the owner of the interests in the partnerships for federal tax purposes, because interests in the partnerships were available for purchase other than by purchasers of contracts from insurance companies (even though the individual purchasers had to be accredited investors). In a separate variation of the facts, the interests in the partnerships were available only through the purchase of an annuity or life insurance contract from an insurance company. Under these facts, the ruling concluded that the contract holder did not own the interests in the partnerships. See also PLR 2007010016 (Oct. 5, 2006), dealing with variable annuities sold only to charities, to the same effect.

In Rev. Rul. 2007-7, 2007-1 C.B. 468. an individual purchased a variable annuity or life insurance contract from a life insurance company. The assets funding the contract were held in a segregated asset account that invested in a regulated investment company (RIC). The beneficial interests in the RIC were held by one or more segregated assets accounts of the insurance company or by investors described in Treas. Reg. Section 1.817-5(f)(3), which include the general account of a life insurance company or related corporation or a manager of an investment company partnership or trust or a related corporation, in both cases only if they received the same rate of return as the separate accounts held under the variable policies. This effectively precludes the practice of carried interest by hedge fund managers. The IRS held that these investors were not members of the general public for purposes of the investor control rules and that, therefore, the individual contract owner was not treated as the owner of an interest in the RIC.

Required Representations in the Recent Ruling Requests. The taxpayers requesting these recent rulings made substantially the same representations regarding the facts and circumstances relating to the investor control issue as were required under the previous private letter rulings and the facts and circumstances presented in Rev. Rul. 2003-91, above (see paragraphs (a) through (e) below), as well as additional representations based on facts and circumstances relating to the publicly available investment funds (see paragraphs (f) through (i) below). Note that the representations made in the more recent ruling requests were more extensive than those made in the prior requests, which may reflect further thought on this issue by the IRS, based on additional facts presented in the ruling requests. As noted above, these representations are the "price" of obtaining a favorable ruling, and provide an insight into the IRS' concerns about potential investor control, although they may not be a statement of the substantive law.

(a) Except as otherwise permitted by Section 1.817-5(f)(3) of the Regulations, all of the beneficial interests in the fund of funds and any sub-funds related to the fund of funds had to be held directly or indirectly by one or more segregated asset accounts of one or more insurance companies and public access to the fund was available exclusively through purchase of a variable contract.

(b) There could not be any arrangement, plan, contract or agreement between the investment adviser (or a sub-adviser) and a variable contract owner regarding the availability of the fund of funds under the contract or the specific assets to be held by the fund of funds or any fund it invested in.

(c) Other than a contract owner's ability to allocate premiums and transfer amounts to and from the fund of funds, all investment decisions concerning the fund of funds had to be made by the investment adviser (or sub-adviser) of the fund of funds in its sole and absolute discretion. In particular, the percentage of a fund of fund's assets invested in a particular publicly available fund could not be fixed in advance of any contract owner's investment and had to be subject to change by the adviser (or sub-adviser) at any time.

(d) A contract owner would not be able to direct a fund of fund's investment in any particular asset or recommend a particular investment or investment strategy and there could not be any agreement or plan between the investment adviser (or sub-adviser) and a contract owner regarding a particular investment of the fund of funds.

(e) A contract owner could only have a contractual claim against the insurance company to receive cash from the insurance company under the contract terms, amplified in some of the rulings by the statement that a contract owner could not have any legal, equitable direct or indirect ownership interest in any assets of the fund of funds.

(f) No contract owner could communicate directly or indirectly with the investment adviser (or any sub-adviser) concerning selection, quality or rate of return on any specific investment or group of investments held by the fund of funds, with an exception in some of the rulings for what was required to be presented in periodic reports to the fund of fund's shareholders.

(g) No contract owner could have any current knowledge of the fund's specific assets, with an exception in some of the rulings for what was required to be presented in periodic reports to the fund of funds shareholders. In one ruling, the contract owner was also expressly prohibited from knowing the specific investment techniques of the investment manager.

(h) In one ruling, the insurance company and the investment manager were expressly prohibited from soliciting contract owners or prospective contract owners or communicating about selection, quality or rate of return of any specific investment or group of investments held in any fund, and also from responding to unsolicited requests for such information from any contract owner or potential contract owner.

(i) In one ruling, the fund of fund's investments in any publicly available assets were limited to 30% of the assets of the fund of funds, and in another ruling they were potentially unlimited.

<u>The President's Fiscal Year 2012 Budget Proposal</u>. The President's 2012 budget proposal sought to require life insurance companies to report the owners of any contracts that invest in a separate account in which related persons hold annuity, endowment or life insurance contracts with aggregate cash values equal at least 10 percent of the value of the assets of the separate account to the Internal Revenue Service. Joint committee Report, 112th Cong., 1st Sess; JCS 3-11, notes 1206-1209 and accompanying text. The stated purpose for the proposal was to permit investigation of these contracts on the investor control issue; interestingly, the argument that Section 817(h) is the sole measure of investor control was also mentioned in the proposal.

<u>The IRS Authority to Impose Investor Control Requirements</u>. The IRS has developed and asserted the investor control rules over a period of nearly 35 years, but a number of commentators have argued that the IRS is acting beyond its authority in taking this position in addition to the diversification requirements contained in Treas. Reg. Sec. 1.817-5. These commentators point out that Code Section 817(h)(1), enacted in 1985, after the IRS had begun to develop both the investor control doctrine and the diversification requirement, required adequate diversification "in accordance with regulations prescribed by the Secretary," but was silent on the issue of investor control. The Conference Report on the statute explains the scope of that grant of authority and, to these commentators, makes clear that:

"[i]n authorizing Treasury to prescribe diversification standards"

> implementing Code Section 817, Congress intended Treasury and the Service to use the diversification requirements "to deny . . . life insurance treatment for investments that are publicly available to investors and investments which are made, in effect, at the direction of the investor." H.R. Conf. Rep. No. 98-861 at 1055 (1984).

Thus, it is argued, the Treasury's authority in this area is limited to development of the diversification requirement and does not extend to imposition of additional restrictions on investor control. Consistent with this position, the Final Section 817 Regulations, Treas. Reg. Secs. 1.817-5(i)(2) (effective date exceptions referencing Rev. Ruls. 81-225 and 77-85) and 1.817-5(f)(e)(iv) (application of the look-through rule not prevented by holdings that comply with Rev. Ruls. 81-225 and 82-55). which were issued on March 2, 1989, are limited to the diversification requirements, and do not address the extent to which a contract owner may direct the investment of assets in a segregated account without being treated as the owner of the assets for Federal income tax purposes. The Regulations do, however, incorporate by reference certain aspects of the earlier investor control revenue rulings and the preamble to the 2005 amendments to the Final Regulations expressly reserved the right to provide future guidance on this point. T.D. 9185, 70 F.R. 9869 at 9871, Mar. 1, 2005.

For a discussion of the authority of the IRS to add the factor of investor control to the diversification requirements of Section 817, see, e.g., Leslie C. Giordini, Recent Developments Affecting Hedge Fund Investing Through Private Placement Life Insurance, 25 Ins. Tax Rev. 579 (2003); David Neufeld. The "Keyport Ruling" and the Investor Control Rule: Might Makes Right?, 24 Ins. Tax Rev. 383 (2003); David Neufeld, New Guidance on Investor Control Rule; Road Map or Road Block?, Tax Notes, September 1, 2003 at 1191; see also, Investment Annuity, Inc. v. Blumenthal, above.

The IRS appears unconvinced by these arguments. It has stated that:

> "[s]atisfying the diversification requirements [of Treas. Reg. section 1.817-5] does not prevent a contract owner's control of the investments of a segregated asset account from causing the contract owner, rather than the insurance company, to be treated as the owner of the assets in the account."

Rev. Proc. 99-4, 1999-48 I.R.B. 598, setting forth the conditions under which the Service will treat a contract as an annuity contract described in Code Sections 403(a), 403(b) and 408(b), notwithstanding that the contract premiums are invested at the direction of the contract owner in publicly available securities. Rev. Proc. 99-4, 1999-48 IRB 598.

The IRS has consistently taken the enforcement position that the enactment of Code Section 817(h). and other Code provisions regulating the definition of life insurance for purposes of the Federal income tax purposes does not supersede the IRS's revenue rulings on investor control nor the Eighth Circuit's decision in Christoffersen, and it continues to assert the validity of the investor control doctrine in its guidance on other matters related to treatment of variable contracts under Code Section 817(h). See Notice 2008-92, 2008-43 I.R.B. 1001 (Oct. 27, 2008).

Given the Tax Court decision in Webber, above, approving the IRS position on the application of its investor control rules to private placement insurance, the IRS will undoubtedly feel its view of investor control has been justified and will continue to apply it in the future.

Conclusions. The IRS continues to assert in both published and private rulings that it has authority to impose the investor control rules on owners of variable life insurance contracts, and will continue to do so after the Tax Court's approval of its position in Webber, above.

In issuing its private rulings in this area, the IRS evaluates all of the facts and circumstances of the particular case in determining whether the contract owner has retained prohibited investor control. Moreover, the nature and extent of the factual representations relating to investor control required to obtain a favorable ruling with respect to investor control have increased over time, likely indicating an increased concern by the IRS about this issue. Note however, that one commentator has taken the position that the holding in Webber, above, only upheld the so-called "subjective" investor control doctrine, not the "objective" one which requires that funds offered under the policy not be available to the public. See the Neufeld articles above.

Contract owner communication to the issuer about selection of the fund manager or to the issuer or the fund manager about investment funds to be made available under the contract has been increasingly restricted. Based on the recent rulings, any evidence of communication from the contract owner to the issuer or fund manager on these topics could support the assertion that the contract is tainted by prohibited investor control. One way to demonstrate the absence of investor control would be to engage an independent expert to develop selection criteria and to assist with actual selection of the investment manager and the particular funds.