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A Short, Practical Private Placement Life Insurance Primer: Or Why Estate Planners Need to Understand Things Like Facultative Reinsurance

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A. Introduction

In the more than forty years we have been helping create estate plans, Private Placement Life Insurance[1] ("PPLI") has become an increasingly important tool for clients prepared to invest $1 million or more in insurance premiums. With apologies to Barbra Streisand who made her Broadway debut in 1962 in the musical of the same name,[2] PPLI is the insurance industry's way of saying "*I Can Get It For You Wholesale*." Essentially PPLI is a *variable universal* life contract in which the *retail markups* have been eliminated and the policy owner is permitted to name one or more specific investment managers to manage the *separate investment accounts*, subject to insurer due diligence and *investor control issues*. The italicized terms are discussed below. The *underwriting process* tends to be somewhat more complex and challenging than with retail insurance. Although, most PPLI policies were initially offered by off-shore insurers, PPLI products are now offered by a number of major domestic insurers and this article focuses on the use of domestic PPLI in estate planning.

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1 For a detailed discussion of life insurance generally, the authors recommend the Insurance Counselor series published by the American Bar Association. Especially recommended are Louis A. Mezzulo, *An Estate Planner's Guide to Life Insurance*, A.B.A., Pub. No. 5430492, Insurance Counselor Series (2d ed. 2009); Harold D. Skipper & Wayne Tonning, *The Advisor's Guide to Life Insurance*, A.B.A., Pub. No. 5430547, Insurance Counselor Series (2011); and Richard A. Schwartz & Catherine R. Turner, *Life Insurance Due Care: Carriers, Products, and Illustrations*, A.B.A., Pub. No. 0897079736, Insurance Counselor Series (2d ed.1994). *See also* Jon J. Gallo, *The Use of Life Insurance In Estate Planning: A Guide To Planning And Drafting- Part 1*, 33 Real Prop. Prob. & Tr. J. No. 4, 685 (1999).

2 For a comprehensive biography of Barbra Streisand, see Barbara Streisand's Biography, The Official Barbara Streisand Site, http://www.barbrastreisand.com/us/biography (last visited Dec. 5, 2011).

In exchange for much higher premiums, PPLI offers two advantages that are not found in retail insurance products: investment flexibility and negotiated charges and fees. The following three examples of actual cases from the authors' files illustrate the ability of PPLI to combine tax-free investments in hedge funds providing high pre-tax rates of return with negotiated costs in order to produce death benefits or cash values that simply cannot be achieved through retail insurance. In all three examples, the client was prepared to invest $10 million, either in a lump sum or in equal installments of $2.5 million over four years. In all three examples the insurance company, after appropriate due diligence, retained the investment advisor recommended by the proposed insured to invest the policy's cash value.

Example One:

The client was a 64-year-old widow with a significant estate who wanted to create a minimum of $50 million of liquidity to pay estate tax at the lowest gift tax cost. An ILIT was established under South Dakota law to take advantage of South Dakota's liberal perpetuities law and low premium tax. The ILIT purchased $58 million of private placement variable universal life insurance. The client was rated preferred through the underwriting process and the total premium was $10 million. The insured entered into a private split-dollar plan with the ILIT using the loan regime and lent the ILIT $10 million, which was used to pay premiums over a three year period in order to avoid MEC status. The policy's cash value was invested in hedge funds producing short term gains. Assuming a 10.50% investment return over 20 years (a historically low figure for such hedge funds), the ILIT will repay the loan in full, together with accrued interest of $12,478,351. Using the same assumption, the death benefit will grow from $58 million to approximately $153 million by age 100.

Example Two

The client was a 32-year-old unmarried man in good health with no children who had inherited a substantial sum. He wanted to invest $10 million in a manner that would provide significant income for him starting at age 60. He did not want to pay gift taxes and was not interested in saving estate taxes. A revocable trust was established with a South Dakota trust company as a co-trustee in order to take advantage of South Dakota's low premium tax. The revocable trust applied for and obtained slightly in excess of $104 million of PPLI. Premiums of $2.5 million were paid annually for four years in order to avoid MEC status. The policy's cash value was invested in hedge funds producing short term gains. Assuming an 11% investment return over 22 years (a rea-

sonable figure for such hedge funds), the client could begin to withdraw $8,732,974 annually for 25 years beginning at age 60 and continuing through age 84, for a total of $218,324,350. The net death benefit remaining at age 84 would be approximately $54 million and at age 100 would still be approximately $13 million.

Example Three

This is, candidly, one of our favorites because of the client's unique goals. The client was a 58-year-old man with a large estate. He was unmarried, had no children and intended to leave his entire estate to his private foundation. He came from a very long-lived family in which reaching age 100 was not uncommon. He informed us that his net worth would probably support him "comfortably" to age 100 but he was prepared to invest $10 million to provide significant extra income if, at age 90, he did not have enough! He was rated preferred in the underwriting process. Since the client wants access to the cash value build up, an ILIT was not used. Assuming an 11% investment return between for the next 32 years, he could withdraw $10,000,000 per year starting at age 90 and still have over $135 million in death benefit for his foundation.

In examining the use of PPLI, this article will provide background information on life insurance products and their pricing, as well as the application/underwriting[3] process. Your authors assume that the reader is familiar with such basic insurance concepts as Irrevocable Life Insurance Trusts (ILTs) and the rules related to Modified Endowment Contracts (MECs).

B. Background

The factors affecting premium pricing are customarily lumped into two major categories: Mortality and Expense Risk (M&E) and Cost of Insurance (COI).[4] The M&E category consists of the risk factors that impact company profitability. Among these factors are (i) mortality experience (sometimes referred to as underwriting or claims experience), based on mortality tables that usually assume the insured dies at age

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[3] Modern life insurance can be traced back to 1688 when merchants and ships' captains would meet with investors at Edward Lloyd's coffee house in London and sell part of the "risk" of the voyage before setting sail. Investors buying part of the risk would write their names under each other, and hence the origin of the term "underwriting." *History of Life Insurance*, One Dollar Globe Insurance, http://www.onedollarglobeinsurance.com/article/History-of-Life-Insurance (last visited Dec. 5, 2011); *Underwriting*, Investopedia, http://www.investopedia.com/terms/u/underwriting.asp#axzz1VQxu1srt (last visited Dec. 5, 2011).

[4] *See* Gallo, *supra* note 1 at, 685-754 (discussing the factors considered in life insurance premium construction).

100; (ii) investment experience; e.g. the return on the savings component, (iii) lapse rates, and (iv) expenses, including sales commissions and administrative expenses. M&E is generally calculated as a percentage of the cash value (or equivalent) of the policy and is within the control of the insurer, since it effectively represents the amount of profit the company wishes to make, net of all expenses other than Cost of Insurance. M&E is non-negotiable in retail insurance but negotiable in PPLI.[5]

COI represents the insurer's cost of providing the insurance coverage and is calculated by multiplying the amount at risk by the COI rate determined by reference to the insured's attained age and rate class determined through the underwriting process. The combination of attained age and rate class to which the insured is assigned is often referred to as the "rate pool." Underwriting assigns each insured to a rate pool that hopefully reflects his or her life expectancy. The underwriting process and the role of the agent are discussed later in this article. COI is essentially non-negotiable in both retail and PPLI, but a well prepared agent may be able to convince the underwriter to assign the proposed insured to a rate pool with a higher life expectancy, thereby reducing the COI.

Until the late 1970s, insurance companies offered permanent insurance almost exclusively as a fixed premium, fixed return product commonly known as whole life. In whole life, the pledge to consumers is found on the very first page of the policy: "We promise to pay." That promise held and it is widely believed that all legitimate death claims under whole life policies were paid, despite the financial condition of the insurance company. Alliances were made between companies to guarantee death claim payments. For example, about 30 companies in New York informally guaranteed each other's death claims.[6] During the Great Depression, whole life policies were sold on a weekly basis known as "debit" insurance.[7] Agents would visit homes to collect

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5 *See, e.g.*, Charles L. Ratner, *PPLI Primer: even the savviest estate planners often fail to fully understand private placement life insurance and its recent developments*, 144 TR. & EST., 32, 36 (2005).

6 *See* SHARON A. MURPHY, INVESTING IN LIFE: INSURANCE IN ANTEBELLUM AMERICA (Cathy Matson ed., 2010).

7 *See* Sharon A. Murphy, *Life Insurance in the United States through World War I*, EH.NET ENCYCLOPEDIA (Feb. 1, 2010, 5:21PM) http://eh.net/encyclopedia/article/murphy.life.insurance.us (Robert Whaples ed. Aug. 14, 2002) (last visited Dec. 5, 2011); William C. Spaulding, *Life Insurance Fundamentals*, http://thismatter.com/money/insurance/types/life/life-insurance-fundamentals.htm (last visited Dec. 5, 2011).

weekly premiums of .50¢ for life insurance.[8] Two giant companies (MetLife and Prudential) were created by selling these weekly policies.[9]

In whole life insurance, the insurance company assumes all of the risks inherent in the M&E category and the resulting charges are non-negotiable. This provides the policy owner with guaranteed cash values and a consistent premium that is fixed, rather than increasing with age. As a general rule, premiums are payable for the life of the insured or until the policy endows (policy reserves equal face), usually at age 100.[10] In a traditional whole life policy, the premiums are structured so that the combination of the premium payments and the guaranteed crediting rate result in the policy reserves equaling the face amount of the policy at age 100. Once the policy endows, it effectively becomes a savings account and loses the tax favored treatment of life insurance. As mortality decreases with improved health care, whole life policies now often increase the death benefit in order to avoid endowment at age 100.

In traditional whole life, premium payments net of M&E charges are divided between the risk protection (COI) and a savings or investment account. The risk portion essentially represents the cost of term insurance for the amount at risk (which is the difference between the face amount of the policy and the investment portion) and the investment portion acts as a savings account inside the policy commonly known as cash value. As a general rule, the cash value in traditional whole life insurance is based on a portfolio rate of interest earned in the fixed income market. The policy's cash value is actually held in a sub-

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8 *See* Murphy, *supra* note 7.

9 *Prudential History*, PRUDENTIAL FIN. INC., http://www.prudential.com/view/page/public/11732?src=oc&name=oh (last visited Dec. 5, 2011).

> The Prudential Friendly Society was founded by insurance agent John Fairfield Dryden in a basement office in downtown Newark, N.J., in 1875. It was the first company in the U.S. to make life insurance available to the working class. The company sold Industrial Insurance, which provided funeral and burial expenses for low-income families, with some weekly premiums as low as three cents.

MetLife Begins, METROPOLITAN LIFE INS. CO., http://www.metlife.com/about/corporate-profile/metlife-history/metlife-begins/index.html (last visited Dec. 5, 2011).

> In 1879, MetLife President Joseph F. Knapp turned his attention to England, where "industrial" or "workingmen's" insurance programs were widely successful. American companies had not bothered to pursue industrial insurance up to that time because of the expense involved in building and sustaining an agency force to sell policies door to door and to make the weekly collection of five- or ten-cent premiums. By importing English agents to train an American agency force, MetLife quickly transferred successful British methods for use in the United States. By 1880, the company was signing up 700 new industrial policies a day. Rapidly increasing volume quickly drove down distribution costs, and the new program proved immediately successful.

10 Mortality tables generally assume that all insureds die in the year between age 99 and 100.

account that belongs to the insurance company and not to the policy owner and hence is subject to the claims of the insurance company's creditors. It is a liquid asset available to the owner of the policy through borrowing or surrendering the policy. The cash value is free from current income taxes because of tax favored treatment. When the policy is surrendered for its cash value, income taxes are due on the amount by which the cash value exceeds the total premium paid less dividends received. The level premium system results in the insurer collecting more in a policy's early years than the company needed to pay the COI in those years. In the policy's later years, increased mortality results in less being collected than needed to pay the COI, but the shortfall is covered by a combination of the earnings on the excess premiums and the earning on the excess premiums in earlier years.

The life insurance industry flourished offering essentially only whole life until the late 1970s and early 1980s when the prime rate began the climb from 6% to more than 20%.[11] As the prime rate gradually increased, insurance companies began to experience *disintermediation of insurance reserves*, a technical term used to describe what happens when the insurance industry is faced with a high interest rate environment and policy owners can take advantage of policy loan provisions with low interest rates.[12] Policy owners realized that they could arbitrage the difference between the policy loan interest rate and the rates being paid by banks and savings and loans. Since insurance companies invest the premium dollars and do not maintain large cash reserves, they found themselves in the uneconomic and unenviable position of borrowing at interest rates as high as 22% in order to lend money to policy owners at 4.5% to 6%, who would deposit the funds with the same lender and earn 20%![13]

Insurance companies responded to disintermediation by realizing that they needed to develop products that could compete favorably with

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[11] *Mortgage (ARM) Indexes, Prime Rate: Historical Data*, MORTGAGE-X, MORTGAGE INFORMATION SERVICE, http://mortgage-x.com/general/indexes/prime.asp (last visited Dec. 5, 2011).

[12] In economics, "disintermediation" refers to the removal of intermediaries in a supply chain, often exemplified today by consumers who deal directly with companies through the internet, forgoing distributors or wholesalers. *See* MARKETING TERMS: DISINTERMEDIATION, http://www.marketingterms.com/dictionary/disintermediation (last visited Dec. 5, 2011). By borrowing the cash surrender value of their policies and depositing the funds directly with the same savings and loan associations the insurance companies used for investment purposes, consumers effectively treated insurance companies as unnecessary intermediaries.

[13] The typical cash value life insurance policy provided for loan interest at between 4.5% and 6%. Savings and loan associations charge at least 200 basis points more interest on loans than they pay on deposits. Thus, at the peak, when S&Ls were paying 20% on deposits, insurance companies were paying at least 22% for loans.

other financial investments. As part of this development process, the risk factors in the M&E component of insurance pricing were gradually shifted from the insurance companies to the policy owners. Companies began by offering interest sensitive products in which current (i.e. new money) rates were used to determine interest or dividend crediting.[14] The new money rates used to illustrate the policy premium structure were always higher than the guaranteed crediting rate. If the new money rate subsequently dropped and policy performance was less than as illustrated in the *as sold illustration*, the policy owner had the choice of reducing the death benefit or increasing the premium.

The next step was the development of blended insurance, in which interest sensitive products were paired with term insurance in a "blend" which might, if all assumptions came true, offer insurance coverage for less than pure whole life or interest sensitive products. Blended insurance assumed that the cash value component of the interest sensitive policy would grow at a rate which would permit the purchase of additional paid up whole life insurance and the term component would be gradually replaced over time. Of course, if the assumptions proved to be overly optimistic, the death benefit offered by the whole life component could actually decrease over time, eventually leaving the policy owner with nothing but term insurance.

Then came the introduction of universal life insurance, which offered a revolutionary combination of interest being credited at the new money rate and flexibility in premium payments. Unlike all prior versions of cash value life insurance products which featured fixed, regularly reoccurring premiums, universal insurance permitted the policy owner to change the amount of premiums or even skip payments. A universal life policy remains in effect so long as the cash value (referred to in universal products as the accumulations account) is at least equal to the next month's COIs. This flexibility also means that a universal life product does not have a guaranteed cash value, since the amount and frequency of premium payments is determined by the policy owner and not fixed by the insurance company.

C. Variable Life Insurance

Variable insurance differs from all other forms of life insurance in two particulars. First, the policy owner controls the investment of the policy's cash value in one or more mutual funds made available by the insurer and the actual performance of the funds is credited to the policy, net of an administrative charge. Second, the policy's cash value is

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[14] See generally Schwartz & Turner, *supra* note 1, and Gallo, *supra* note 1, for a discussion of each type of insurance.

owned by the policy owner and not by the insurer. Although insurance companies began offering variable annuities as a hedge against inflation shortly after the end of World War II,[15] variable life insurance did not become commercially viable until after 1981 when Prudential acquired Bache.[16] Insurance illustrations using historical mutual fund performance values showed staggering IRRs compared to internal rates of return in traditional whole life policies and universal life policies. Variable life insurance gave the insurance companies access to Wall Street distribution systems and the carrot of transforming the old traditional and mutual life insurance companies to public companies. Prudential, Metropolitan, and Equitable are among the largest mutuals that became stock insurance companies.

All forms of cash value life insurance policies other than variable insurance are general account policies, i.e., the cash value of the policies is represented by sub-accounts which are part of the insurer's overall funds and hence subject to the claims of the insurer's creditors. In a variable policy, the cash value of the policy is represented by a separate investment sub-account administered by the insurer but selected by and owned by the policy owner. The sub-account is legally separate from the insurer's funds and is not subject to the claims of the insurer's creditors. The separate sub-accounts are securities within the meaning of the Securities Act of 1933, and may be offered only by a registered representative of a broker/dealer registered with the Financial Industry Regulatory Authority (FINRA).[17] The owner usually has the option to select various mutual fund-like investments, such as Stocks - Aggressive; Stocks - Conservative; Stocks - Long Term; Bonds - Intermediate Term; Bonds - Short Term; Government Securities; Total Return Accounts (stocks, bonds, cash, etc. .); Money Market Accounts; Guaranteed Fixed Interest Accounts and Real Estate Accounts. Because the policy owner controls the investments made by the sub-account, the investment risk is entirely shifted to the insured and cash values are not guaranteed. However, unlike general account policies in which the amount credited to cash value sub-accounts is determined periodically by the insurer, the actual performance of the investment sub-account in a variable policy passes through to the insured, less a fixed administrative charge.[18]

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15 For descriptions of the early days of variable life insurance contract, see Tamar Frankel, *Regulation of Variable Life Insurance,* 48 NOTRE DAME L. REV. 1017 (1973).

16 Sales of variable products did not reach 1% of the annualized new premium market until 1981. *See* U.S. SEC. & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION, 376 (1992), *available at* http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

17 *Registration,* FINRA, http://www.finra.org/Industry/Compliance/Registration (last visited Dec. 5, 2011).

18 *See* materials cited *supra* note 1.

A variable policy may be structured with fixed or (in the case of variable/universal) flexible premiums. The death benefit may fluctuate based on the performance of the underlying investments. Some companies offer a rider that provides that so long as a minimum annual premium is paid, the death benefit will not drop below a guaranteed minimum, which is usually the face amount. Some variable policies have higher than average administrative costs which tend to make them more expensive than general account policies. In theory, the extra cost is offset by the pass through of the increased earnings of the investment account.

D. Private Placement Variable Universal Life Insurance

PPLI is typically structured as a variable universal product which combines the separate investment sub-accounts of variable life with the premium and face amount flexibility of universal life. A purchaser must be an "accredited investor" under the Securities Act of 1933 or a "qualified purchaser" under the Investment Company Act of 1940, or both.[19] An individual is an accredited investor if he has a net worth in excess of $1 million or an income greater than $200,000.[20] An individual is a qualified purchaser if he owns $5 million in investments.[21] ILITs may qualify as either an accredited investor or as a qualified purchaser.[22]

1. PPLI Investment Sub-Accounts

For many clients, the greatest advantage of PPLI is the investment sub-account system available through a variable product. The investment sub-account provides substantially greater investment flexibility than would be found in a retail variable policy, in which the insurance company makes available a limited number of mutual funds in which investments may be made. Increased investment flexibility exists because the insured may "suggest" that the insurance company employ a specific investment manager who would be responsible for investing the sub-account. Although the investor control doctrine discussed below[23] prevents the insured from requiring the insurance company to engage a specific investment manager, it may reasonably be assumed that the in-

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19 *See* 15 U.S.C. § 80a-2(a)(51) (2006); 17 C.F.R. § 230.501(a) (2011).

20 *See* 17 C.F.R. § 230.501(a).

21 15 U.S.C. §80a-2 (51).

22 Certain irrevocable trusts are included in the definition of accredited investor and qualified purchaser. The definitions and qualification standards for trusts are neither identical to the qualification standards for individuals nor are they the same in both Acts. The reader is cautioned to read the definitions carefully in order to determine if a specific ILIT qualifies under either or both Acts.

23 *See infra* note 49 and accompanying text.

surer will retain the recommended manager provided he or she passes a due diligence review. Typically, the suggested investment manager has worked with the insured in the past and is familiar with the insured's other investments. Under the investor control doctrine, there may be no "arrangement, plan, contract, or agreement" between the insured and the investment manager regarding investment strategies, the insured may not "select or recommend particular investments or investment strategies" and may not communicate "directly or indirectly" with the investment manager concerning "the selection, quality, or rate of return of any specific investment or group of investments held in a" sub-account.[24] It would not be unreasonable to assume, however, that the insured's investment manager might independently determine to make tax efficient investments outside the variable policy sub-account and to make tax inefficient investments, such as hedge funds whose returns are based on short term trades, through the sub-account. As one insurance executive commented during an interview, "*The key thing is that if the clients bring enough cash, we will establish a separate sub-account managed by an investment manager of their suggestion, provided he passes our due diligence*."

Before recommending PPLI to clients, it is important to understand the investment limitations. Sub-accounts are regulated by both the diversification requirements of IRC § 817 and by four Revenue Rulings[25] that created the investor control doctrine.[26] The investor control doctrine permits the IRS to ignore a variable life policy or a variable annuity and treat the owner of the policy or annuity as the owner of the underlying investment.[27] The doctrine has two separate but inter-related arms: (i) the policy or annuity owner will be treated as the direct owner for income tax purposes of the assets in the segregated investment sub-accounts if the owner possesses significant incidents of control and ownership[28] and (ii) the policy or annuity owner will be treated as the direct owner for income tax purposes of any asset in which the segregated investment sub-account is invested if such asset is also available for investment by the general public.[29]

The Service provided examples of the investment control doctrine in Rev. Rul. 2003-91[30] and Rev. Rul. 2003-92.[31] In Rev. Rul 2003-91,

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24 *See* Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 2003-33, 2003-1 C.B. 642.

25 *See* Rev. Rul. 77-85, 1977-1 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11.

26 Christofferson v. U.S., 749 F.2d 513, 516 (8th Cir. 1984).

27 *Id.*

28 *See supra* notes 24-25.

29 *See supra* note 24 at 350. *See generally supra* note 25 and relevant discussion.

30 *See* Rev. Rul. 2003-91, 2003-2 C.B. 347.

31 Rev. Rul. 2003-92, 2003-2 C.B. 350.

the Service found that the investor control doctrine did not result in the sub-account being treated as owned directly by the policy owner.[32] The Ruling presented the following factual circumstance: Insurance company ("Company") offers a variable policy in which the assets are segregated from the assets that fund the Company's traditional life insurance products. Company maintains a separate account for the assets funding the policy, and the income and liabilities associated with the separate account are maintained separately from Company's other accounts. The separate account is divided into various sub-accounts. Each sub-account's assets and liabilities are maintained separately from the assets and liabilities of other sub-accounts. Investments made by the sub-accounts are not available for sale to the public. Rather, such investments are available solely through the purchase of a variable policy from the Company. The Company engages an independent investment advisor ("Advisor") to manage the investment activities of each sub-account. Each sub-account will at all times meet the asset diversification test set forth in IRC § 1.817-5(b)(1),[33] which is discussed below. Twelve sub-accounts are available for investment but the Company may increase or decrease this number at any time. However, there will never be more than 20 sub-accounts available. Each sub-account offers a different investment strategy. The currently available sub-accounts include a bond fund, a large company stock fund, an international stock fund, a small company stock fund, a mortgage backed securities fund, a health care industry fund, an emerging markets fund, a money market fund, a telecommunication fund, a financial services industry fund, a South American stock fund, an energy fund and an Asian markets fund.

According to the Ruling, an individual ("Holder") purchases a variable life insurance policy. At the time of purchase, Holder specifies the allocation of premium paid among the then- available sub-accounts. Holder may change the allocation of premiums at any time, and Holder may transfer funds from one sub-account to another. Holder is permitted one transfer between sub-accounts without charge per thirty-day period. Any additional transfers during this period are subject to a fee assessed against the cash value of the policy. There is no arrangement, plan, contract, or agreement between Holder and Company or between Holder and Advisor regarding the availability of a particular sub-account, the investment strategy of any sub-account, or the assets to be held by a particular sub-account. Other than Holder's right to allocate premiums and transfer funds among the available sub-accounts, all investment decisions concerning the sub-accounts are made by the Company or Advisor in their sole and absolute discretion. Specifically,

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32 Rev. Rul 2003-91, 2003-2 C.B. 347, 350.

33 *Id.* at 348.

Holder cannot select or recommend particular investments or investment strategies. Moreover, Holder cannot communicate directly or indirectly with any investment officer of the Company or its affiliates or with Advisor regarding the selection, quality, or rate of return of any specific investment or group of investments held in a sub-account. Holder has no legal, equitable, direct, or indirect interest in any of the assets held by a sub-account. Rather, Holder has only a contractual claim against Company to collect cash from Company in the form of death benefits, or cash surrender values under the policy.

All decisions concerning the choice of Advisor or the choice of any of the Company's investment officers that are involved in the investment activities of separate accounts or any of the sub-accounts, and any subsequent changes thereof, are made by Company in its sole and absolute discretion. Holder may not communicate directly or indirectly with Company concerning the selection or substitution of Advisor or the choice of any of Company's investment officers that are involved in the investment activities of Separate Account or any of the sub-accounts.[34]

In Rev. Rul. 2003-92, the Service applied the investor control doctrine and treated the sub-accounts as owned directly by the owner of the policy since the variable contract permitted investments in hedge funds that were open to all qualified investors and not restricted to investment through a variable contract.[35]

The second investment limitation on sub-accounts is found in IRC § 817(h), which requires the segregated investment sub-accounts to be "adequately diversified" in order for the policy to qualify as life insurance.[36] As of the last day of each quarter of a calendar year, each separate account must include at least five investments, with no one investment representing more than 55% of the value of the separate account's assets, no two investments representing more than 70%, no three investments representing more than 80% and no four investments representing more than 90% of the separate account's value.[37] Failure

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34 *See id.* at 347.

35 Rev. Rul. 2003-92, 2003-33 I.R.B. 350, 352.

36 I.R.C. § 871(h)(1) provides as follows:

> For purposes of subchapter L, section 72 (relating to annuities), and section 7702(a) (relating to definition of life insurance contract), a variable contract (other than a pension plan contract) which is otherwise described in this section and which is based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract for any period (and any subsequent period) for which the investments made by such account are not, in accordance with regulations prescribed by the Secretary, adequately diversified.

37 Treas. Reg. § 1.817-5(b)(1)(i).

to meet the diversification requirements results in current taxation of the policy owner on gains in the sub-accounts under IRC § 7702(g).[38]

For a number of years, the Regulations to IRC § 817(h) contained a safe harbor exception to the diversification rules for hedge funds, which exception appeared to be in conflict with IRC § 817(h).[39] Notwithstanding the conflict, the exception made PPLI a preferred investment vehicle to invest in publicly traded hedge funds whose returns were tax inefficient, i.e., based on short-term trading.[40] IRC § 817(h)(4) and Treas. Reg. § 1.817-5(f) provide a look-through rule for assets held through certain investment companies, partnerships or trusts for purposes of testing the diversification rule.[41] Instead of the investment in a mutual fund being treated as a single investment for diversification purposes, the look-through rule meant that each of the individual holdings of the investment company could be counted.[42] The Treasury Regulations provided that such look-through treatment was available only if the investment met both prongs of the investor control rules: (i) all the beneficial interests in the investment company, partnership or trust must be held by one or more segregated investment accounts of one or more insurance companies and (ii) access to such investments is available exclusively through the purchase of a variable annuity or variable life contract.[43] However, as initially enacted, Treas. Reg. § 1.817-5(f)(2)(ii) provided that partnership interests that were not registered under a Federal or State law regulating the offering or sale of securities – in other words, hedge funds – were accorded look-through status and investments by those partnerships were counted for purposes of the diversification tests without regard to meeting the investor control rules.[44]

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38 I.R.C. § 871(h)(1).

39 *See* Treas. Reg. § 1.817-5(f)(2)(ii); *see* discussion *infra* notes 44-46 and accompanying text.

40 Such funds often produced impressive before-tax returns. However, the after-tax return was far less impressive for investors subject to income taxes as high 40% or more on the funds' returns depending on the investors' combined federal, state and local income tax rates. When the hedge fund was owned by a segregated sub-account inside a variable life insurance policy, the before-tax return became a truly impressive after-tax return!

41 Treas. Reg. § 1.817-5(f); I.R.C § 817(h)(4).

42 *See* Treas. Reg. § 1.817-5(f).

43 Treas. Reg. § 1.817-5(f)(2)(i).

44 *See* 2003-38 I.R.B. 595.

Under §1.817-5(f)(2)(ii), the look-through rule applies to a partnership interest that is not registered under a federal or state law regulating the offering or sale of securities. Unlike §1.817-5(f)(2)(i), satisfaction of the non-registered partnership look-through rule of §1.817-5(f)(2)(ii) is not explicitly conditioned on limiting the ownership of interests in the partnership to certain specified holders.

In 2002, the Service caused great confusion and consternation in the insurance industry by issuing PLR 200244001, which ignored the safe harbor exception of Treas. Reg. § 1.817-5(f)(2)(ii) and applied instead the requirements of IRC §817(h)(4) and Treas. Reg. §1.817-5(f) that the look-through rule applied only to investments which met the requirements of the investor control doctrine. PLR 200244001 treated the owner of the variable contract, and not the insurance company, as the owner of the hedge fund interest and hence made the owner taxable currently on the fund's undistributed income. The Service responded to the resulting uproar by revoking the safe harbor exception of Treas. Reg. § 1.817-5(f)(2)(ii) on the grounds that it was inconsistent with the public availability limitation of IRC § 817(h).[45] As a result, investment in hedge funds through PPLI is now legally permitted only so long as the hedge fund meets the diversification requirements of IRC § 817 and the investor control requirements of Rev. Rul. 2003-91 discussed above.[46]

In theory, PPLI sub-accounts may be invested exclusively in publicly traded hedge funds, just as they may be invested exclusively in publicly trades stocks, so long as investments are made in not less than five hedge funds and the percentage limitations of IRC § 817 are met.[47] However, it appears that out of an excess of caution, most if not all insurers restrict hedge fund investments to those which also meet the investor control requirements of Rev. Rul. 2003-91 and hence are not available to the public.

Nevertheless, hedge funds which meet the investor control requirements of Rev. Rul. 2003-91 offer possibilities that cannot be achieved with retail insurance, as illustrated in the examples of actual PPLI scenarios at the start of this article.

2. Transparency and the Ability to Negotiate Expenses

The second area in which PPLI differs from its retail cousins is increased transparency of expenses. Frankly, it is impossible for most people, including experienced insurance agents and estate planners, to understand all of the pricing components in a retail life insurance product. In a recent conversation with a pricing actuary at a major insurer, one of your authors was jokingly told that the actuary had 127 variables that could be adjusted in setting the premium for a policy! Even if all of the pricing components could be identified, it is equally impossible to negotiate the flat fees of a retail product. In a PPLI product, the M&E (Mortality and Expense Risk) costs are both revealed and negotiable.

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45 *Id.*

46 *Compare* Treas. Reg. § 1.817-5(f)(2)(ii) *with* I.R.C. § 817 *and* Rev. Rul. 2003-91.

47 *Compare* Treas. Reg. § 1.817-5(f)(2)(ii) *with* I.R.C. § 817 *and* Rev. Rul. 2003-91.

Retail insurance is designed to be distributed to the public through an agency system that sells large numbers of contracts with flat fees based on the insurer's M&E projections and premiums which tend to be in the hundreds or thousands of dollars. PPLI involves customized products in which premiums are in millions of dollars. As a result, PPLI products feature negotiable break-point fees for M&E costs rather than the non-negotiable flat fees in retail products.

The poster child in terms of negotiated fees in PPLI products is the transparency of insurance commissions. Typical commissions run in the vicinity of 55% of first year premiums and a cursory search on the internet discloses that commissions for retail products can be as high as 140% of the first year's premium after expense allowances and add-ons.[48] The commission in a PPLI product is negotiable and is typically structured as a combination of premium based commission (first year) and asset based compensation (trail compensation). Typical examples of commissions are a first year charge of 400 basis points (4% of the premium) plus trail compensation in subsequent years of 10 basis points (0.1%) or a first year charge of less than 400 basis points on the premium and 25 to 30 points year for trail compensation. The internal rate of return of the policy tends to be higher with a lower trail and higher premium based commission.[49]

Mortality and Expense charges are also negotiable. Retail products typically have an annual M&E charge of between 80 and 1110 basis points for the life of the policy. PPLI features break-point fees based on the premium. A typical M&E cost for a PPLI product might be 25 basis points on the first $10 million and zero thereafter.

There are two up front taxes that must be dealt with when obtaining domestic life insurance, namely the federal deferred acquisition cost (DAC) tax and the state premium tax.[50] It is not possible to avoid

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48 *See, e.g.,* U.S. Dep't of Labor, Bureau of Labor Statistics, *Insurance Sales Agents*, OCCUPATIONAL OUTLOOK HANDBOOK, 2010-11 EDITION *available at* http://www.bls.gov/oco/ocos118.htm (last visited Dec. 5, 2011); Bobbie Sage, *How Much Money Does My Agent Make from My Life Insurance Purchase?,* ABOUT.COM, http://personalinsure.about.com/od/life/f/lifefaq3.htm (last visited Dec. 5, 2011); *see also How do insurance agents make money?* YAHOO! ANSWERS, http://answers.yahoo.com/question/index?qid=20071115110443AABSAu0 (last visited Dec. 5, 2011), *How much commision [sic] does an insurance agent earn?* INSURANCEYAK.COM (Jan. 14, 2009), http://www.insuranceyak.com/how-much-commision-does-an-insurance-agent-earn/ (last visited Dec. 5, 2011).

49 These numbers are based on the authors' personal experience. One of the reasons we wrote the article is that these numbers never seem to appear in print and our goal is to provide guidelines based on our experiences.

50 The DAC tax is imposed by I.R.C. §848; for an industry critique of this tax see NAT'L ALLIANCE OF LIFE CO., DEFERRED ACQUISITION COST (SECTION 848), *available at* http://members.nalc.net/PDF/dac.pdf. For a discussion of state premium taxes, see Al

the DAC tax, although with some companies it is possible to negotiate amortizing the DAC tax rather than treating it as part of the sales load of the M&E costs. Amortizing the DAC tax will probably result in a slightly higher internal rate of return for the policy. The state premium tax varies widely from state to state. For example, Nevada charges 350 basis points, California charges 235 basis points while Alaska charges 10 basis points on premiums in excess of $100,000 and South Dakota charges only 8 basis points.[51] The difference is significant when dealing with multi-million-dollar premiums.

E. Due Diligence and the Role of the Life Agent

The acquisition of PPLI requires the assistance of a knowledgeable agent to explain the illustration and handle the application process.

By the early 1980s, the illustrated premium structure which forms the basis on which most policies are sold – known as the *as sold illustration* – had become nothing more than a hypothetical based on various assumptions, most of which were not guaranteed by the insurance company. The first assumption was that during the life of the policy (which is presumably the life of the insured) the insurer would not increase the expense component of the policy in excess of current charges. In fact, the contract of insurance permits the insurer to increase the charges to a maximum guaranteed level set forth in the policy. The second assumption is that, in the case of a non-variable product, the insurer will credit the cash value of the policy with annual dividends or interest at the illustrated rate, or in the case of a variable product, the investment choices made by the policy owner would result in fund values increasing as illustrated. In a non-variable product, the illustrated rate is usually the current crediting rate, although in some instances, a crediting rate in excess of the current rate may be illustrated. In almost all cases involving non-variable products, the illustrated crediting rate is higher than the minimum guaranteed crediting rate. In variable products, the insurer does not guarantee any investment return and the entire risk of underperforming the as sold illustration is with the policy owner.

W. King III & Pierce H. McDowell III, *State Premium Tax Planning: Strategize with clients to minimize costs incurred with large domestic insurance policies*, 150 Tr. & Est. 25 (2011).

51 Nev. Rev. Stat. § 680B.025 (2010); Cal. Ins. Code § 12976.5 (West 2011), Cal. Rev. & Tax. Code § 12602 (West 2011); Alaska Stat. § 21.09.210 (2011) (the 10 basis point tax is imposed on premiums in excess of $100,000; the tax on the first $100,000 of premiums is 270 basis points); S.D. Codified Laws § 10-44-2 (2011) (the 8 basis point tax is imposed on premiums in excess of $100,000; the tax on the first $100,000 of premiums is 250 basis points).

The agent needs to make certain that the client understands that if the assumptions on which the illustration is based prove to be correct over time, the policy will perform as illustrated. This means that the amount of premium which must be paid each year is correct and will not have to be increased during the life of the policy. If the policy has been sold based on a "vanishing premium," performance as illustrated means that the number of years the premium must be paid will be less than the lifetime of the insured, in which case the premiums are said to "vanish." However, neither the adequacy of the illustrated premium nor the vanish date are guaranteed by the insurer. In a non-variable product, the company may reduce the amount of dividends or interest credited to the policy to a minimum guaranteed level if it is unable to attain the illustrated investment yield. In both a variable and non-variable product, the insurer may increase costs to a maximum guaranteed level if expenses increase or it experiences increased mortality. In either event, it would be necessary to increase the amount of premiums to keep the policy in effect or the number of years that the premium must be paid would increase substantially over that illustrated.

The underwriting process in PPLI is potentially fraught with more difficulties than are typically encountered when applying for retail insurance. Underwriting is the process by which the insurer assesses and prices risk. In automobile insurance, the underwriting process looks to the driving history and safety record of the driver. Drivers with no tickets or accidents pay lower premiums than drivers with multiple speeding tickets or traffic accidents on their record. In fact, someone who has been convicted of drunk driving or vehicular manslaughter will likely be viewed as uninsurable at any price. Similarly, life insurance underwriting looks to the proposed insured's life expectancy. Factors affecting life expectancy are identified and the proposed insured is placed in a risk pool with others of similar life expectancies. The mortality charges in a PPLI policy are a function of the risk pool to which the proposed insured is assigned through the underwriting process.[52]

Since the amount of insurance and hence the amount at risk for the insurer tends to be substantially higher in PPLI than in retail contracts, underwriting is more detailed. Moreover, PPLI typically involves *facultative reinsurance,* which increases the number of underwriters scrutinizing the application. Insurance companies only retain (the company's *retention level*) a portion of the risk they incur when issuing a policy.[53]

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[52] This is true of all insurance and not just PPLI. Potential insureds are assigned to risk pools (sometimes referred to as "rating" or "being rated") based on assumptions made by the underwriter concerning life expectancy.

[53] The National Association of Insurance Commissioners uses the term "retention limit" to describe "a specified maximum amount of insurance that a life insurer is willing

In general, state laws prohibit domestic insurers from issuing insurance in excess of specified percentages of their surplus unless the excess is reinsured.[54] Retention limits are typically described in terms of dollar amounts, such as $10,000,000. If a life insurance policy exceeds the company's retention limits, the company *reinsures* by purchasing reinsurance from a company in the business of reinsurance. The reinsurance company agrees to pay some or all of the original insurer's losses in excess of retention. There are two basic types of reinsurance agreements: reinsurance treaties and facultative reinsurance. The fundamental difference between these two is that reinsurance treaties bind the reinsurance company to reinsure automatically all policies described in the treaty while facultative reinsurance involves individual negotiations between the insurer and the reinsurer for reinsurance of a specific policy.[55] Facultative reinsurance is involved whenever the amount of insurance exceeds both the retention level of the insurer and the amount of automatic coverage under the reinsurance treaty between the insurer and reinsurer. An important consequence is that the insured must meet the underwriting criteria of both the insurer and the reinsurer and those criteria may differ. When purchasing retail life insurance, it is possible to avoid facultative reinsurance by acquiring policies from several companies, with the amount of each policy being limited to not more than the retention limit of each insurer. This process is often referred to as "stacking" insurance policies.[56] PPLI will almost always involve facultative reinsurance since, because of the limited number of companies of-

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to carry at its own risk on any one life without transferring some of the risk to a reinsurer." *Glossary of Insurance Terms*, NAT'L ASS'N OF INS. COMM'R & THE CTR. FOR INS. POLICY & RESEARCH, http://www.naic.org/consumer_glossary.htm#R (last visited Dec. 5, 2011).

54 State and federal laws, plus international treaties, effectively impose various capital to risk requirements for insurance companies. Many of these requirements are currently being reviewed and tightened. For example, the Solvency II program is a fundamental review of the capital adequacy regime for the European insurance industry. It aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current solvency requirements. Reinsurance plays an important and effective means of risk management, by shifting a portion of the insured risk to the reinsurer. For a detailed discussion of reinsurance, the reader is referred to David M. Raim & Joy L. Langford, *Understanding Reinsurance*, NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE § 40 (Matthew Bender & Co. 2007)*; See also* Gary S. Patrik, *Reinsurance*, *in* CAS. ACTUARIAL SOC'Y, FOUNDATIONS OF CASUALTY ACTUARIAL SCIENCES, Ch. 7 (4th ed. 2001) *available at* http://www.casact.org/admissions/syllabus/ch7.pdf.

55 Raim & Langford, *supra* note 54, §40.04(1), 40-16.

56 *See* California v. Continental Ins. Co., 88 Cal. Rptr. 3d 288, 302 (Cal. Ct. App. 2009) (explaning " [S]tacking means treating multiple policies that apply to a single loss as cumulative—as a 'stack' of coverage—rather than as mutually exclusive. Hence, stacking issues can arise almost any time multiple policies cover a single loss."). *See also* Barry

fering such products, the amount of insurance will almost always exceed the retention limit of any one insurer.

Underwriting a PPLI contract is not negotiable but a knowledgeable insurance agent will make certain that it is individualized for the proposed insured. The agent should know in advance of submitting the application what the underwriters for both the insurer and the reinsurer will look for. In extremely large PPLI policies, more than one reinsurance company may be involved, in which case the agent needs to be aware of the underwriting requirements of all reinsurers.

The underwriting process needs to be approached in much the same way that litigators engage in trial reparation, where it is an axiom that all information must be assembled before trial and one should never ask a question when the answer is not known in advance. All of the information relating to the proposed insured's risk profile should be known before the application is submitted. The proposed insured's entire medical history needs to be assembled and copies of all documents need to accompany the application. Doctors' records need to be reviewed, with particular care given to making certain that cross referenced tests and reports are obtained. For example, if the notes from last year's annual physical mention that the proposed insured said that he had a hearing examination that year which turned out normal, the agent needs to obtain and read a copy of the audiologist's report and include it in the package submitted to the insurer. A proactive and pre-emptive approach is necessary. If the records identify an area of concern, such as a heart condition or high cholesterol, which has subsequently improved, the agent should arrange for a new physical examination which shows that improvement.

Although it may seem obvious, every question on the application needs to be addressed. While there is no way to predict whether the IRS will audit a gift tax return reporting a discounted gift of a fractional interest in real estate, estate planners typically tell their clients that submitting a gift tax return without supporting appraisals for both the underlying real property and the claimed discount practically guarantees an audit. The same principles apply to PPLI applications. Applications submitted with unanswered questions or without the requested backup data simply raise the curiosity level of the underwriter and focus his or her attention on the omitted information.

Lifestyle issues also need to be addressed in advance of submitting the application. Does the proposed insured engage in activities that the underwriter will view as hazardous, such as scuba diving, mountain

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Zalma, *Stacking Insurance Limits* (2003), http://www.zalma.com/stacking.htm (last visited Dec. 5, 2011).

climbing, flying in private airplanes or traveling to areas experiencing civil unrest? Since it is not uncommon for clients purchasing PPLI to own yachts, it is actually necessary in light of today's geo-political realities to ask whether they sail in the Indian Ocean, where they may encounter Somali pirates.

Complete financial information justifying the amount of insurance being sought is also necessary. If the applicant and owner of the PPLI will be an insurance trust, it is also necessary to provide evidence of insurable interest. In the absence of both, some underwriters will treat the proposed insured as uninsurable. A knowledgeable agent will provide the underwriter with a written explanation of the estate plan, the facts justifying the amount of life insurance being applied for and the applicant's insurable interest in the life of the proposed insured.

F. Valuation of Private Placement Life Insurance

If PPLI is to be acquired and owned by an irrevocable life insurance trust, is it preferable to purchase the policy and transfer it to the ILIT or to transfer the funds to the ILIT and allow the ILIT to be the original owner? Ignoring the three year rule of IRC § 2035,[57] the issue turns on the valuation of the policy for gift tax purposes. And if the client initially acquires a PPLI individually and subsequently wishes to transfer it to an ILIT, how is the policy valued for gift tax purposes?

The transfer of all ownership rights in a life insurance policy is a taxable gift measured by the replacement value of the policy.[58] If the policy has been in force "for some time," its value "may be approximated" by adding together the interpolated terminal reserve ("ITR") of the policy and the unused portion of the last premium and dividend accumulations, less outstanding policy loans at the time of the gift.[59] The Service does not explain what is meant by "some time." However, for gift tax purposes the value of a newly purchased policy is its cost, e.g., the premiums actually paid.[60] Although there is no definition of a "new" policy, Example 1 presumably applies to any policy less than one

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[57] [I]f — (1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

I.R.C. § 2035(a).

[58] Treas. Reg. § 25.2512-6(a).

[59] Treas. Reg. § 25.2512-6(a).

[60] Treas. Reg. § 25.2512-6(a), Ex. 1.

year old. Thus, the transfer of the PPLI to the ILIT within the first year results in the same valuation as the transfer of the cash to the ILIT.

What if the policy is more than one year old?

In that case, value may be "approximated" as set forth above. The only problem with Treas. Reg. § 25.2512-6 is that PPLI is typically structured as a variable universal policy and the central valuation criterion, the policy's ITR, cannot be calculated! In fact, the insurance industry cannot even agree on what should be calculated in place of the policy's ITR!

When the IRS published Treas. Reg. § 25.2512-6, there were only two types of insurance policies available for purchase: whole life and annual renewable term. As discussed earlier in this article, all aspects of a whole life policy, including cash values, are fixed and guaranteed by the insurer. Under regulations promulgated in part by NAIC (the National Association of Insurance Commissioners) and in part by the individual Insurance Commissioners and legislatures of each state, carriers offering whole life policies were required to set aside a reserve each year to meet their contractual obligations to the owners of the insurance policies.[61] The amount of that reserve at the start of the year was known as the "initial reserve" and the reserve at the end of the year was known as the "terminal reserve." Thus the "terminal reserve" at the end of Year One becomes the "initial reserve" at the start of Year Two and so on, ad infinitum. Since all aspects of a whole life policy were fixed, the amount of the terminal reserve at the end of any year one was actuarially determinable. Moreover, if we needed to calculate the terminal reserve at a point between the start and end of the policy year, that amount could also be actuarially determined – it could be *interpolated* in the language of the Treasury Regulations – by reference to the year's initial reserve and the actuarially calculated terminal reserve for the end of the year. For example, if the initial reserve of a whole life policy at the start of Year Two was $5,000 and the terminal reserve of that same policy at the end of Year Two would be $8,000, the policy would have an interpolated terminal reserve of $6,500 eighteen months after issuance. Annual renewable term policies did not have a terminal reserve because the policy matured at the end of each year and had to be renewed or they lapsed.

In the years since Treas. Reg. § 25.2512-6 was published, life insurance companies have introduced Universal Life, Variable Universal

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61 The NAIC Accounting Practices and Procedures Manual (APPM) sets forth basic accounting guidelines, including surplus calculations. Each state also establishes guidelines, either by incorporating the NAIC guidelines or publishing its own. *See* NAT'L ASS'N OF INS. COMM'R, ACCOUNTING PRACTICES AND PROCEDURES MANUAL (2010); *see, e.g.* N.Y. INS. LAW § 4219 (McKinney 2011).

Life, Indexed Universal Life and Guaranteed No Lapse Universal Life. All of these products have reserves. However, since all of these products are current assumption products – both M&E and COI are passed through to the policy owner – the "terminal reserve" as of the year cannot be calculated until that date, which makes it impossible to "interpolate" a terminal reserve for purposes of the Treasury Regulations.

In addition, the proliferation of insurance products since the 1960s has resulted in actuaries developing various types of reserve calculations, which include the following:

- The Tax Reserve, which is the amount used by the insurance company for purposes of calculating federal income tax.[62]
- The Statutory Reserve, which is the amount used by the insurance company to comply with the reserve requirements of various states.[63]
- The AG 38 Reserve (Actuarial Guidance 38), which is the amount used for current assumption products with no lapse secondary guarantees.[64] The AG 38 Reserve is generally higher than either the Tax Reserve or the Statutory Reserve and it generally results in a higher reserve than for policies that do not offer secondary guarantees.
- The Deficiency Reserve, which is employed for certain current assumption policies for which a "Minimum Reserve" calculation is required by Regulation XXX of the National Association of Insurance Commissioners. An AG 38 Reserve which includes a Deficiency Reserve will be higher than an AG 38 Reserve without a Deficiency Reserve.

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62 I.R.C. § 807(d).

63 The difference between the Tax Reserve and the Statutory Reserve is primarily attributable to the interest factor that must be used. Usually, these two reserves are close together in a low interest environment and begin to differ as the interest rate environment increases.

64 For a discussion of the controversy surrounding AG 38, see Fran Matso Lysiak, *Reserving clash: the life industry is divided over reserve requirements for certain UL policies with secondary guarantees*, BEST'S REVIEW (Mar. 1, 2005), *available at* http://www.thefreelibrary.com/Reserving+clash%3A+the+life+industry+is+divided+over+reserve. . .-a0132746973.

A no lapse secondary guarantee provides that the death benefit will be payable notwithstanding the cash value of the policy so long as designated premiums are paid for the life of the policy. For a discussion of no lapse secondary guarantees, see John T. Bannen, *No Lapse/Secondary Guarantee Life Insurance Policies: What Are They, And Are They Appropriate For Estate Planning?,* 12 ALI-ABA EST. PLAN. COURSE MATERIALS J., 5 (June 2006), *available at* http://files.ali-aba.org/thumbs/datastorage/lacidoirep/articles/EPCMJ_EPCMJ0606_bannen_thumb.pdf.

Unfortunately, there is no guidance for gift tax purposes as to which reserve is to be used when attempting to comply with the ITR requirement of Treas. Reg. § 25.2512-6 when valuing a current assumption product such as PPLI. Moreover, the life insurance industry itself is not in agreement as to which reserve is to be used when attempting to comply with the Treasury Regulations. Some insurance companies do not even bother with using the reserves for calculation purposes. A few companies use the cash surrender value/cash accumulation value of a current assumption policy as the ITR and an even smaller minority use the California Method – a calculation methodology permitted by the California Department of Insurance – which treats the ITR as the mean between the cash surrender value and the cash accumulation value.[65]

A study presented at the 2009 Annual Meeting of the AALU entitled *Life Insurance Valuation: Navigating Uncharted Waters*,[66] reported on a valuation survey of fourteen carriers which offered current assumption products. Most of the carriers based their ITR calculation on either the Tax Reserve or the Statutory Reserve. A "couple" of carriers used the California Method and one carrier used the "cash surrender value" when calculating ITR.[67] When valuing Universal Life policies with no lapse guarantees, five of the carriers used the Tax Reserve, eight used the Statutory Reserve and eight included a Deficiency Reserve.[68]

Although the Service has provided guidance in Revenue Procedure 2005-25 for valuing a life insurance policy for income tax purposes, this Procedure does not apply to the valuation of life insurance policies for gift tax purposes.[69]

If you shudder a bit to realize that we are relying on Treasury Regulations that require us to use a concept (ITR) that does not apply to most contemporary insurance products in order to obtain an "approximation" of the value of PPLI for gift tax purposes, welcome to the group.

G. Conclusion

PPLI is certainly not for the product of choice for – or even available to – many of our clients. However, for the high net worth client, it

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65 State of Cal. Dept. of Ins., Bulletin No. 2000-2 (2000), *available at* http://www.insurance.ca.gov/0250-insurers/0300-insurers/0200-bulletins/bulletin-notices-commiss-opinion/upload/Bulletin-2000-02.pdf.

66 Slides from the panel discussion are available from the Association for Advanced Life Underwriting at http://www.morganlewis.com/pubs/PersonalLaw_LifeInsuranceValuation_04may09.pdf.

67 *Id.* at 21.

68 *Id.* at 22.

69 It is limited by its terms to I.R.C. §§ 79, 83, & 402.

represents another financial planning/estate planning opportunity. The authors hope that this primer will help estate planners evaluate the suitability of PPLI for appropriate clients.