William Elliott and Thomas Gavin discuss strategies to preserve wealth that remains “at risk” in the marketplace. Included in their discussion is life insurance, investments, trusts and the traditional private annuity.

Introduction

With respect to the marketplace, John Maynard Keynes wrote, “Markets can remain irrational longer than you can remain solvent.” By extension, Lynn Lopucki similarly describes the current state of our American liability system. He wrote:

Think of the liability system as a poker game. Each person, corporation, or other entity in the economy is a player. Players risk their chips that are their wealth, by tossing them into the pot that is, investing them in liability-generating economic activity. Chips contributed to the pot are at risk of loss; the system can take them to satisfy liability. Chips withheld are not at risk. ... [P]layers who don’t put any chips in the pot—that is, players who are judgment proof—can keep playing the game and are eligible to win. Why do players put chips in the pot? No rules require them to do so.1

Looking through the lens of our own discipline as tax and financial advisors, let’s apply the thoughts of Keynes and Lopucki to the preservation of individuals’ wealth that remains “at risk” in the marketplace. It is the more routine asset protection techniques that have fueled the growth of domestic offshore financial centers in recent years. Given the litigious times in which we live, we should be more aggressive in advising individuals and companies with legally defensible yet innovative means to protecting and preserving their wealth.

Three Scenarios

As practitioners, our responsibility is to work within ethical and legal frameworks to both protect and preserve our clients’ wealth. We must think creatively, outside of the box, and develop and employ novel planning techniques.
One such multi-faceted approach involves pooling the theory and techniques associated with income, estate and asset protection planning and using the “legally-structured” compartments that exist within each. The following three situations illustrate our case.

**Scenario 1.** Three discrete elements are brought together here. First, a U.S. domestic “mainland” or foreign “offshore” irrevocable trust arrangement is properly structured. Second, a custom-tailored privately-placed life insurance arrangement is created, which qualifies under the Code, and serves as the “wrapper” for holding a diversified portfolio of investments, selected by the trustee of the irrevocable trust. Finally, the latter is paired with the simplicity and predictability of a traditional “private-annuity” transaction that has been infused with new sophistication. These elements comprise the core of a multiple-entity plan that affords both domestic as well as offshore asset protection, the deferral and/or elimination of income tax, and material estate tax mitigation and liquidity. In sum, these represent a comprehensive and conservative approach to deal creatively with a client’s overall estate, income and asset protection plan.

Moving beyond the initially complex nature of the integrated structure proposed here, tax and financial service professionals can make appropriate use of domestic and offshore trusts to provide clients with an innovative yet reliable approach to wealth preservation and asset protection.

**Scenario 2.** To both protect income and provide for transfer tax efficiency, one of the best holding entities for a domestic or offshore asset diversification vehicle is a strategically custom-tailored irrevocable trust arrangement that serves as insulation for its sole or principal asset, an offshore or domestic variable life insurance policy. Asset diversification includes investing in traditional portfolio investments as well as private equity or hedge fund investments, all within the relatively secure environment of a variable universal life insurance policy. A trust arrangement should be drafted so that it can be adapted to prospective needs to further protect assets.

**Scenario 3.** Combining Scenarios 1 and 2 produces, in effect, a tax-free exchange of appreciated property to a taxpayer’s “self-settled” asset protection trust (APT), the optimal form being a “dynasty”-type trust “wrapper” within the APT. This scenario serves future generations in a tax-efficient manner by sparing them from onerous and tax-inclusive (i.e., in addition to the federal estate tax) federal generation-skipping transfer (GST) tax. The appreciating property can take the form of marketable equity securities or a closely held business or investment interest. The gain on the sale of the trust’s appreciated property can be rendered permanently nontaxable (i.e., unrealized appreciation disappears at the death of the insured in the form of nontaxable life insurance proceeds), as opposed to merely deferred. The entire proceeds are reinvested in a life insurance policy “wrapper” within the APT, filled with either traditional portfolio assets or private equity and hedge funds assets. The goal achieved is insulating the principal and upside potential for long-term appreciation from further income, estate or gift taxation as well as prospective known and unknown creditors and judgments. Please refer to Illustration 1.

**The Elements**

We begin by reviewing each of the three broad elements that comprise the “infrastructure” of our plan to construct a sophisticated private annuity transaction. The elements to be reviewed include life insurance, investments and trusts. As one progresses through the insurance arrangements, the distinction between insurance and investments becomes increasingly blurred. The following specific life insurance arrangements are discussed: variable universal life insurance (VUL), private (family)
split-dollar insurance, offshore private placement life insurance (OPPLI) arrangements and variable (deferred) annuities (VDAs).

Life Insurance

Life insurance is usually defined by reference to applicable state law or foreign jurisdiction. However, prior to the Tax Equity and Fiscal Responsibility Act (TEFRA), there was no statutory definition of insurance for income tax purposes in the Internal Revenue Code (“the Code”) or applicable regulations. The only insurance-related discussion concerned the general “risk shifting/risk sharing” analyses of older case law. In 1982, in response to a proliferation of “new” insurance products, among other things, TEFRA included temporary cash value accumulation and guideline premium/cash value corridor tests that were applicable only to so-called “flexible premium contracts,” also known as universal life contracts. This was the first attempt by the Code to distinguish between life insurance products and investment vehicles for income tax purposes, the latter having been disguised in many instances as life insurance in an attempt to avoid or defer tax on the increases in lifetime values in such vehicles.

Life insurance, probably the most versatile wealth transfer device available, plays a unique role in the estate and asset protection planning process. When used properly, it can maximize the benefits passed to succeeding generations because life insurance can accumulate income-tax-free. Therefore, it is more tax-cost-efficient than any other vehicle. As the integrated estate planner’s front line of defense, it can effectuate, at little financial and emotional cost, the irrevocable transfer of wealth from donor to beneficiaries.

Variable Universal Life (VUL) Insurance. VUL insurance arrangements, a recent genre of life insurance, is the fastest growing form of insurance and the one that we as practitioners will encounter when evaluating our clients’ needs. VUL is generally of a “universal life” variety, although it can take the form of whole life or a permanent insurance policy. Throughout the 1990s, as stock market returns substantially exceeded interest rates on public and corporate debt, it forced a redesign of the fundamental features of the straight universal life (UL) contract.

Innovative changes were made to elements of protection, expenses and the use of market-based mutual funds; these features dramatically enhanced the more traditional “cash values” plan. VUL premium payments increase over the term of the contract to reflect the increase in the mortality component of the contract. A larger portion of each premium payment, net of the insurance charge that covers administrative charges and the increasing mortality component of the policy, are placed in investments. The insurance company plays less of a role in the selection and management of the investments acquired within the life insurance policy while the policy owner (i.e., trustee of the irrevocable trust arrangement) has more control over investment selection.

VUL does have its risks. Since the primary difference between VUL and more traditional insurance is the investment element of the contract, the investment portion of an account operates like mutual funds. These funds are managed by the insurance company or by an outside investment firm. This gives the client the opportunity to achieve market-based returns. However, it is important to access the client’s tolerance for risk before deciding upon an appropriate asset allocation mix and then the specific mutual funds, etc. Clearly, a team of advisors is necessary to execute the desired plan.

Private (Family) Split-Dollar Insurance. Private (family) split-dollar insurance is a more recent and private application of a concept previously used in employer-employee, corporation-shareholder and corporation-third-party situa-
sions. It can be understood best by looking to LTR 9636033.

The ruling states that a private split-dollar arrangement between a trust and the insured’s spouse would be governed by principles laid out in Rev. Rul. 64-328, the seminal authority for split-dollar arrangement. In this revenue ruling, the taxpayer and spouse resided in a community property state. The taxpayer was the grantor of an irrevocable trust; his brother was trustee. The taxpayer retained no powers over the trust or its assets and made a gift of his separate funds to the trust. The trust entered into a collateral assignment (i.e., secured promise by the trust to reimburse grantor’s spouse at his death from the proceeds of the policy) nonequity (i.e., such repayment is limited to the premium outlay as opposed to receiving the cash value of the policy at the grantor’s death) split-dollar arrangement (i.e., at death, the monetary proceeds of the policy are “split” between the trust and the grantor’s spouse, as previously described).

Under the terms of the split-dollar agreement, the trust was both owner and beneficiary of the life insurance policy; it paid that portion of the annual premium equal to the lesser of the P.S.-58 cost (pure insurance cost per applicable IRS tables) or the insurance company’s one-year term rate. The wife paid the balance of the annual premium from her separate property. Upon termination of the agreement (i.e., at the death of the insured and the payment of the policy proceeds), the wife was entitled to the greater of the cash surrender value (CSV) or the premiums she “advanced.” The IRS held that premiums advanced by the wife were not gifts because she retained access to the CSV and would be reimbursed for her premium advances on termination of the arrangement. In addition, and more importantly, the IRS ruled that the proceeds on the life of the taxpayer were not includible in the taxpayer’s estate because he had no incidents of ownership under Code Sec. 2042.

Practitioners frequently use domestic and offshore life insurance policies as part of a private split-dollar arrangement so as to:

- leverage the gift tax annual exclusion of $11,000 per year per donee,
- get the GST exemption, and
- receive the lifetime estate tax unified credit amount.

So, where a client has already used or wishes to save its estate tax and/or GST lifetime exemptions, the planned premium payments in excess of the available annual exclusion amounts are treated as advances under the private split-dollar arrangements. These amounts are reimbursed to the donor at the termination of the arrangement.

Recently the IRS changed its view of split-dollar arrangements. Practitioners should be alert to the adverse income tax consequences associated with noncompliance of new guidelines. The guidelines essentially treat the taxpayer’s use of amounts accumulated within the policy as “interest-free” loans on which interest income is required to be “imputed” at the applicable federal rate. In addition, income is imputed on the “pure insurance cost” (i.e., P.S.-58 cost) that is derived from the mortality component of contract.

Offshore Private Placement Life Insurance (OPPLI) Arrangements. OPPLI arrangements, although somewhat complex, represented a sophisticated estate and asset protection strategy whose unique benefits are not easily obtained elsewhere. The advantages far outweigh the disadvantages, the latter being cured by practitioners’ familiarization with their features and workings. Benefits include lower life insurance premiums and lower internal overhead costs, greater investment choices, increased confidentiality, better asset protection and a decided tax advantage when assets are lodged within a variable life insurance policy “wrapper.”

Securing favorable tax treatment rests solely on the contract qualifying as a “life insurance policy” under Code Sec. 7702. Code Sec. 7702 defines a life insurance contract as one that meets applicable domestic or foreign law, but only if such contract satisfies either the cash value accumulation test (CVAT) or both the guideline premium test and the cash value corridor test (CVCT). The taxpayer is allowed to choose the methodology by which the contract qualifies. However, once selected, the methodology must be used for the duration of the contract.

While further elaboration of the mechanical requirements is beyond the scope of this article, practitioners should be alert to those requirements. Practitioners should advise their clients to get a written comfort letter from the insurer sufficient to shift the burden of liability that the contract remain qualified under Code Secs. 7702 and 817 (investment diversification requirements for investments within the policy) for the duration of the contract. Such annual compliance work potentially could evolve into a niche for the practitioner.

While life insurance is generally employed by high net-worth individuals to provide liquidity for the estate and to replace
wealth consumed by estate and inheritance taxes, OPPLI policies—typically those within the variable universal life family—primarily serve the policy owners as investment vehicles for lifetime wealth accumulation. Because of the favorable income tax benefits derived from OPPLI, these policies work exceptionally well for assets that might be incompatible and tax inefficient in a client’s investment portfolio, such as private equity and hedge funds. These investments typically generate ordinary income that is fully taxable at ordinary rates, unless residing as they do in this instance within the confines of a life insurance policy that qualifies as such under the Code. Life insurance qualifying under Code Sec. 7702, which receives favorable tax treatment, makes it suitable as a repository for passive investments. As such it can be employed to address a significant portion of the prospective client’s wealth accumulation. Properly structured, an OPPLI provides three benefits:

- Tax-deferred growth of the policy’s cash value
- Tax-free access to cash value, although caution should be exercised in this regard to avoid IRS assertion of “constructive receipt”
- Tax-free death benefits

OPPLIs asset protection features, when properly established and maintained, shelter the assets within the policy from claims and judgments while simultaneously permitting the policy holder access to such assets in difficult times. Practitioner should become familiar with the statutory and regulatory requirements necessary to obtain favorable tax benefits of OPPLI policies via Code Sec. 7702, which defines life insurance as well as the investment diversification rules contained in Code Sec. 817. Code Sec. 817 contains two relevant rules that must be satisfied for OPPLI to constitute life insurance: the “diversification requirements” and the “owner control” issues.

The IRS considers variable life insurance contracts as “diversified” if no one, two, three or four investments constitute 55 percent, 70 percent, 80 percent or 90 percent, respectively, of the investment portfolio’s (within the variable life policy) total assets. Please refer to Illustration 2.

Owner control issues stem from policy owners retaining an “impermissible degree of control” over OPPLI investments contained within domestic or offshore variable life contracts. OPPLI policy owners may choose from a broad array of investment strategies; they are permitted to be informed of the general investment strategy to be followed; and they may possess a contractual claim for cash as a direct consequence of purchasing the life insurance contracts. However, they should not possess a legally binding right to acquire a particular investment, nor should they have an interest in any specific investment item held by the insurer or within the investment portfolio of the variable universal life contract. Generally, to qualify for favorable treatment under the Code, the investments selected should not be available to the general public, even via a private offering, as the IRS, in recent private letter rulings, has expressed its sensitivity to investor control issues and the use and abuse of such policies masquerading as structures analogous to personal holding companies or incorporated pocketbooks; such investments should be exclusively limited to the variable life policy at hand (i.e., a private equity or hedge fund offered exclusively to arrangements such as these).

**Variable (Deferred) Annuities (VDAs).** VDAs primarily serve as investment vehicles with life insurance features. VDAs typically permit the contract’s value to increase income tax-free during the “accumulation period,” and they also permit the owner various withdrawal options. The “staged withdrawal,” the most popular feature, permits one to avoid three things:

**Illustration 2**

**Variable Life Insurance Policy**

| INVESTMENT 1 | 55% ≤ ≤ ≤ | 90% 1,2,3,4 |
| INVESTMENT 2 | 70% 1,2 |
| INVESTMENT 3 | 80% 1,2,3 |
| INVESTMENT 4 | 90% 1,2,3,4 |

Diversification Requirements of Code Sec. 817

1. No single investment constitutes 55% of VUL portfolio.
2. No two investments constitute 70% of VUL portfolio.
3. No three investments constitute 80% of VUL portfolio.
4. No four investments constitute 90% of VUL portfolio.
Private Annuity Transactions

- The immediate tax incurred on a lump-sum distribution
- The mortality risk
- The lack of flexibility associated with “annuitization”

Investments—Protective Characteristics of Annuities

A variable annuity can be described as fixed income and equity mutual funds within an “annuity” wrapper. It is analogous to the variable life insurance wrapper referred to throughout this article, but care should be exercised to examine the agreement for multiple commissions, load charges and annual fees inherent in these products, which are more generous than in more traditional life insurance products, especially of the offshore variety. While established as an annuity contract for deferred income taxation purposes, the driving force behind this type of annuity contract is that the client gets deferral of income taxation on the “inside build-up” of appreciation of the investments within the annuity contract.

Insurance or similar companies issue common types of annuity. A number of these annuities are available for estate planning purposes; among them are those authorized under the “anti-freeze” statute—Code Sec. 2702. Here, a split-interest trust is created per an arrangement whereby the settlor retains an interest for a term of years, with the remainder transferred directly to descendants or held in trust for their benefit. State statute determines whether these types of interests qualify as annuities and qualify as being exempt from creditors’ claims. However, two things are clear: (1) the remainder interests are not subject to the claims of the settlor’s creditors as the settlor lacks a property interest in the remainder, and (2) a bankruptcy trustee can seize the debtor’s interest in a self-settled trust unless the trust is an asset-protected trust under applicable state law.

Code Sec. 817(g) governs the definition of a variable annuity contract. It provides that payment of an annuity be calculated on the basis of recognized mortality tables and either the investment experience of a segregated asset account or the company-wide investment experience of a company that issues such variable contracts. To qualify as a variable annuity contract for tax purposes, the segregated asset accounts must satisfy the diversification requirements of Code Sec. 817. The basis, or investment in the contract, offsets a portion of the income generated from annuity payments. That is, amounts received as an annuity are taxable to the extent they exceed an allocable portion of such basis.

Private Equity (Including “Hedge”) Funds. Private equity (including “hedge”) funds, hereafter called funds, typically engage in high-risk, high-return strategies such as leveraged buyouts, restructurings, merchant banking transactions, venture capital or real estate lending. These are distinguished from the typical hedge funds that generally finance their investment capital entirely through equity investments rather than leverage through borrowings. A hedge fund is a private investment portfolio, usually structured as limited partnership that is open to accredited investors, and charges an incentive based fee. The general partner invests in and manages the fund.

Given the decline in the stock market over the past three years, investors have increasingly moved monies out of traditional equity mutual funds and into the vehicles described in the previous paragraph. Generally speaking, these funds offer an effective and efficient way to pool funds for investment in nonpublic, i.e., non-SEC regulated transactions.

Using Trusts to Preserve and Transfer Wealth

Irrevocable Life Insurance Trusts (ILITs). ILITs are a popular and tax-efficient vehicle for structuring an asset protection and tax planning arrangement. The owner and beneficiary of life insurance have wealth transferred from the grantor. If structured and funded properly, the insurance proceeds can be completely excluded from the grantor’s estate. However, if the grantor transfers a policy that he or she already owns to the ILIT and dies within three years of the transfer, the proceeds will be included under the three-year rule of Code Sec. 2035. The same rule would apply to an outright transfer of the policy, rather than going through a trust. Consequently, while the client will not be in a worse position than he would have been had he retained ownership of the policy, the transfer will accomplish nothing unless the transferor outlives the statutory three-year period.

The act of funding the ILIT generally will place the premiums and the policy beyond the reach of the settlor’s creditors; this assumes a
nonfraudulent transfer. Determining whether a transfer to an ILIT constitutes a fraudulent transfer depends on the intent of the settlor. Among other things, was the settlor insolvent at the time of the transfer? However, the continuation of established estate planning may demonstrate that a nonfraudulent transfer has taken place.20

The transfer of an OPPLI contract into a properly structured ILIT eliminates the following two things: (1) income tax to the policyowner when the policy matures, and (2) estate taxes when the owner dies. Neither the formation nor funding of an OPPLI has to be a taxable event. An ILIT provides effective asset protection, especially if it is presently in a favorable foreign (offshore) jurisdiction or if it is designed to “migrate” to such a venue, which can be accomplished by simply registering the domestic trust upon formation, in the jurisdiction of choice, if the jurisdiction so permits. An ILIT is a good vehicle within which to implement a private split-dollar arrangement; such an arrangement can significantly leverage the policy owner’s gift tax annual exclusions and lifetime exemption, while also exempting from estate tax, via exclusion, the taxation of the death benefit.

Generally, the practitioner will design the ILIT to be irrevocable and legally binding (i.e., “settled” or established properly). In addition, funding of the ILIT is generally treated as a completed gift for U.S. transfer tax purposes, although it can be drafted as an intentionally “retained life estate” under Code Secs. 2036 and 2038, fully taxable for estate tax purposes, but nevertheless providing some degree of asset protection. However, since the trust will simultaneously be “defective” for U.S. income tax purposes, this causes the ILIT to be a grantor trust. As such, the grantor, treated as the owner of the trust for all income tax purposes, is responsible for the taxation on trust items—income, deduction and credit, without the grantor being penalized by such payment of the trust’s taxes as constituting taxable gifts to the trust and its beneficiaries. Any installment sales to such a trust are nonincome taxable transactions. Likewise, any cross-border transfer of appreciated trust corpus will not trigger a gain on the unrealized appreciation.21

Rendering the ILIT defective for income tax purposes causes it to be taxed as a grantor trust under the Code. This is accomplished by drafting the trust so as to permit the grantor to retain certain impermissible powers for income tax purposes (i.e., the power to substitute property of an equivalent value or the ability to obtain loans on a favorable basis) which are not impermissible for U.S. transfer tax purpose under Code Secs. 2036 and 2038. Refer to Illustration 3.

Finally: Revisiting the Traditional Private Annuity

Traditional Private Annuities

A traditional private annuity transaction (PAT) involves the transfer of property by an “annuitant” in exchange for an unsecured promise to pay the annuity by an obligor. The initial transfer from annuitant to obligor is a nontaxable sale or exchange because an unsecured promise to pay an annuity has no value.22 A private annuity remains a staple in the tax planner’s arsenal because of the income, estate and asset protection benefits provided by this simple and effective technique.

We now describe a PAT and compare it to a self-cancelling installment note (SCIN). IRS General Counsel Memorandum

Illustration 3
(GCM) 39503\textsuperscript{23} describes a private annuity as:

... [G]enerally an arrangement whereby an individual transfers property, usually real estate, to a transferee who promises to make periodic payments to the transferor for the remaining life of the transferor. A private annuity may also include a transaction whereby the transferee agrees to make periodic payments until a specific monetary amount is reached or until the transferor’s death, which ever occurs first.

According to the GCM, if the specific monetary amount will be reached within the transferee’s life expectancy as determined under Reg. §1.72-9, Table V, the transaction will not be treated as an annuity but as an SCIN. Basic authority for taxing private annuities can be found in Rev. Rul. 69-74,\textsuperscript{24} pertaining to the transferor or seller, and Rev. Rul. 55-119,\textsuperscript{25} pertaining to the transferee or purchaser.

The income tax is about the same for a PAT and SCIN having the same sales price if the seller/transferor survives his/her initial life expectancy or if the specified monetary amount is reached. In structuring the transaction, one would first determine the present value of the annuity, using 120 percent of the federal mid-term rate at the time of sale, as required by Code Sec. 7520 and Table S of IRS Pub. 1457. If the fair market value of the property sold exceeds the present value of the annuity, the excess is a gift. The seller’s cost basis is subtracted from the present value of the annuity to determine potential gain on the sale. The amount of gain reported each year is determined by dividing the total gain by the seller’s life expectancy under Reg. §1.72-9, Table V.

The portion of each payment deemed a recovery of the seller’s cost is determined based on an “exclusion ratio.” This is the ratio of the seller’s cost to the product (i.e., result obtained by multiplication) of the annual annuity amount multiplied by the seller’s life expectancy. As a result, each year’s annuity payment is divided into the following parts:

- Tax-free recovery of basis
- Gain (usually capital gain)
- Ordinary income, the balance

For example, given a seller’s cost basis ($10,000), the product of the annual annuity amount ($2,000) multiplied by the seller’s life expectancy of 20 years equals $40,000. The ratio of the seller’s cost basis to the product of the annuity amount multiplied by the seller’s life expectancy (in this instance, $10,000 divided by $40,000) results in an exclusion ratio of 1/4 or 25 percent ($10,000/$40,000 = 25%).

If the purchaser resells the property in question after the seller’s death, the basis for calculating gain or loss is the sum of annuity payments made up to the time of the seller’s death. Rev. Rul. 55-119\textsuperscript{26} provides rules for determining depreciation during the seller’s lifetime, basis for the property and the gain or loss.

An SCIN and a PAT are similar in that the property sold and any remaining payments are excluded from the seller’s estate at death. However, in some situations a PAT has advantages over an SCIN. For example, gain recognition does not apply to a PAT; with a SCIN, a gain is recognized at the seller’s death for the difference between the adjusted basis of the property subject to the SCIN and its fair market value. Thus, an SCIN transaction requires a higher sales price, all other things being equal, to compensate for the cancellation feature (i.e., the fact that at the death of the obligee under the PAT, the note disappears and is legally cancelled or forgiven, such that there is nothing related to the transaction in the obligee’s estate for tax purposes).

A PAT, by way of contrast, can be designed based on annuity tables, unless, as set forth in Rev. Rul. 80-80,\textsuperscript{27} “the individual is known to have been afflicted, at the time of transfer, with an incurable physical condition that is in such an advanced stage that death is clearly imminent. Death is not clearly imminent if there is a reasonable possibility of survival for more than a very brief period,” which is defined in the ruling as a period longer than one year.

Code Sec. 453(e) calls for acceleration of the gain if property is resold via a private annuity; this is similar to an installment sale because it permits gain to be reported over a period of years. In this type of transaction, the buyer/transferee receives a basis in property in exchange for his/her agreement to make annuity payments. In general, the IRS views a private annuity transaction as a retained life estate with a gift of remainder interest if:

1. The payments are determined by the actual income of the transferred property.
2. The buyer is not personally liable.
3. The buyer or obligor has no resources—other than the transferred property—to make the payments.
4. The annuitant retains control over the property.\textsuperscript{28}

For income tax purposes, an annuity payment received by the seller consists of three parts: a tax-free recovery of basis, the gain portion
and ordinary income. The realized gain is a capital gain if the property transferred was a capital asset. The amount of each annuity payment excludable from the recipient’s income is based on the “exclusion ratio.” The exclusion ratio is the seller’s investment in the contract, the seller’s basis in the property transferred, divided by the expected return from the annuity. In turn, the expected return equals the annual annuity payments multiplied by the annuitant’s life expectancy. The capital gain is the excess of the present value of the annuity received over the adjusted basis (i.e., historical cost), divided by the life expectancy of the seller. The balance of the annuity payment is ordinary income.

**The “Transaction”**

The essence of this nonrecognition transaction follows. Although cast within the context of an offshore trust/offshore “drop-down” corporation holding structure that purchases a foreign life insurance policy (OPPLI), the effects are essentially equivalent to a U.S. domestic context that uses a domestic ILIT and a domestic life insurance contract. The context selected demonstrates the breadth and flexibility available to practitioners that structure these transactions.

**A Five-Step Process**

**Step 1.** The settlor/grantor [(hereinafter, “Taxpayer” or “Annuitant”)](say, marketable equity securities, real estate, etc.) at fair market value in exchange for an unsecured promise by the corporation to pay a life annuity. Since an “unsecured promise to pay an annuity” has no value, this initial transfer of property from the taxpayer/annuitant is not a taxable sale or exchange. The insurance company should provide a written agreement to the ILIT trustee stating that it will maintain the insurance policy so that, at all times, it meets the requirements of Code Sec. 7702. Once the sale of the property is consummated, the proceeds will be invested such that the “diversification” and “owner control” requirements of Code Sec. 817 will be met continually. Now, the proceeds are made suitable for investing in a private equity or hedge fund that is not otherwise available or offered to the general public and that is designed exclusively or primarily for these types of arrangements. Alternately, the proceeds could be placed in deferred annuities; here, the underlying investments must meet the diversification and investor control requirements of Code Sec. 817.

**Step 3.** Contained within the offshore irrevocable trust arrangement is its sole asset, a so-called “drop-down corporation” or IBC, situated in a favorable jurisdiction and possessing a sophisticated financial structure. The IBC is controlled by the taxpayer’s family members since they are the ones who can comprise the board of directors. The drop-down entity enters into an “arm’s-length” private annuity transaction in which the settlor sells substantially appreciated property (say, marketable equity securities, real estate, etc.) at fair market value in exchange for an unsecured promise by the corporation to pay a life annuity. Since an “unsecured promise to pay an annuity” has no value, this initial transfer of property from the taxpayer/annuitant is not a taxable sale or exchange. The drop-down corporation, the recipient of the appreciated property via the irrevocable trust owning it, receives a step-up in basis for the property acquired from the taxpayer/annuitant that
is equal to the sum of (1) the total of the annuity payments made under the private annuity contract up to the date of disposition, and (2) the value of the prospective payments remaining to be paid at the date of such disposition.\textsuperscript{32} If we assume the drop-down corporation/obligor sells the appreciated property immediately after the exchange for the private annuity, the corporation/obligor would recognize no gain.

**Step 4.** The proceeds from the sale of the taxpayer/annuitant’s appreciated property that had been exchanged for the private annuity are now invested in a private equity or hedge fund, or a more traditional investment; the investments are generally designed for these arrangements, within the statutory confines of a variable universal life insurance policy “wrapper.” Prospectively, the earnings from the reinvested proceeds, coming from the sale of the appreciated property, accumulate on a tax-free or tax-deferred basis as a result of Code Sec. 7702 treatment accorded such earnings within a “life insurance policy.” It is extremely important that both Code Sec. 7702 and Code Sec. 817, dealing with the “diversification” and “owner control” requirements, be continuously complied with; this necessitates a review by the advisor on an annual basis.

**Step 5.** The corporation/obligor makes the annuity payments as stipulated in the previously executed exchange agreement to the taxpayer/annuitant for life from the earnings generated by the investments that reside in the drop-down corporation. Each payment is made up of three elements: recovery of basis, long-term capital gain and ordinary income.

**Three Favorable Outcomes**

**One.** Upon the death of the taxpayer/annuitant, the accumulated earnings within the trust/corporation arrangement can be distributed tax-free.\textsuperscript{33} These distributions, along with trust corpus, can provide liquidity to the estate of the taxpayer for the purchase of assets from the probate estate. Alternatively, depending on the trust’s provisions, these resources can be used for the benefit of or distributed to the taxpayer’s descendants.

**Two.** For federal estate tax purposes, the policy proceeds and accumulated earnings are excluded from the taxpayer/annuitant/insured’s gross estate. In a private annuity transaction, the annuity has no further value upon the death of the annuitant because payments cease at the annuitant’s death; the ILIT is designed to exclude policy proceeds paid at death from the estate of the insured because the insured never possess any “incidents of ownership” over the life insurance policy.

**Three.** Superb asset protection has been achieved for the life of the insured, the taxpayer/annuitant and the trust beneficiaries, for the duration of the ILIT.\textsuperscript{34} Please refer to Illustration 4.

**Conclusion**

The essence of the “private annuity transaction” described here is that it is true to its statutory safe harbor. It is intentionally cast within a more preferred holding structure made up of an offshore irrevocable trust that owns as its sole asset a drop-down corporation. In turn, the drop-down corporation purchases a foreign life insurance policy through a reputable offshore insurance company in a suitable offshore jurisdiction; the policy must be designed to meet the minimum requirements of a “life insurance contract” under Code Sec. 7702.
In turn, the policy serves as a “wrapper” to shield the proceeds from the “sale” of the appreciated property transferred by the settlor (as the annuitant) from taxation via a private annuity transaction.

Once the sale of appreciated property is consummated, the proceeds will be invested in such a manner so as to be sure that the “diversification” and “owner control” requirements of Code Sec. 817 are continually met. A suitable investment would be a private equity or hedge fund (i.e., a “fund of funds” is a family of various hedge funds that provides further diversification options and mitigates the risks). Alternately, the proceeds could be placed in deferred annuities; however, the underlying investments would have to meet these same diversification and investor control requirements. The drop-down corporation receives a step-up in basis for the property acquired from the taxpayer/annuitant. And, if the corporation/obligor sells the appreciated property immediately after the private annuity exchange, the corporation/obligor would recognize no gain. The drop-down corporation makes stipulated annuity payments to the taxpayer/annuitant from the earnings generated by the investments that reside in the corporation. These annuity payments comprise the following elements: recovery of basis, long-term capital gain and ordinary income.

When the taxpayer/annuitant dies, the trust/corporation’s corpus, along with accumulated tax-exempt earnings, can be distributed. This provides liquidity to the taxpayer’s estate to purchasing assets from the probate estate or to distribute benefits to descendents. Proceeds from the policy and accumulated earnings are excluded, for federal estate tax purposes, from the gross estate insured (taxpayer/annuitant). This affords superior asset protection during his or her life as well as the trust’s beneficiaries for the duration of the ILIT. If carefully established and properly maintained, OPPLI’s asset protection features shelter the assets within the policy from claims and judgments, while simultaneously allowing the insured policy holder access to such assets when most needed.

Finally, it is important that the practitioner realize that although we have revisited the traditional private annuity transaction in the context of an offshore arrangement, the same tax results (but without the same degree of enhanced asset protection) can be achieved in a strictly domestic U.S. context with solely domestic components.

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ENDNOTES


3 Tax Equity and Fiscal Responsibility Act (P.L. 97-248) enacted Code Sec. 7702.

4 See generally Helvering v. Le Gierse, 301 U.S. 619 (1937).

5 Lawrence Brody, Life Insurance is like a box of chocolates: You never know what you’re going to get until you open it up: A perspective on contemporary Life Insurance products and their uses, 30 U. Miami Inst. On Est. Plan. 7 (2000).


7 Id.


9 LTR 9636033 (Mar. 12, 1996).


12 Notice 2002-8, 2002-4 IRB 398.


14 Id.; see note 12.

15 Code Secs. 7702 and 817.

16 Id.; see note 7.


18 11 USC §§544(a), 541(c)(2) and 363(f).


23 GCM 39503 (May 7, 1986).


26 Id.


28 See S.M. Lazarus, CA-9, 75-1 ustc §13,065; 75-1 ustc 19387, 513 F2d 824; J.S. Greene, CA-7, 56-2 ustc §11,645, 237 F2d 848; Rev. Rul. 79-94, 1979-1 CB 296. See also Rev. Rul. 68-183, 1968-1 CB 308 (relating to the grantor trust rules of Code Sec. 671, but equally applicable to Code Sec. 2036).


30 Rev. Rul. 69-74, 1969-1 CB 43; Code Sec. 72(b); and Reg. §1.72-4(a)(4).

31 Because it is jurisdictionally severed from the United States, an offshore trust arrangement is less likely than a domestic trust to be targeted as a source for satisfying a future judgment or claim, with the inherent difficulty in accessing the trust, both physically and legally, potentially
influencing a potential future claimant’s decision to pursue an action, or at least incline the claimant to perhaps settle in ways more favorable to the defendant.

31 See SPERO, supra note 17.

32 Rev. Rul. 55-119, supra note 25; see generally note 30.

33 This is based on the general rule that proceeds of a life insurance policy are not subject to income tax.

34 Which, if all or part depending on the amount of the exemption available and the amount of trust corpus, is established as a “dynasty”-type GST trust, can be of a multi-generational duration.