Offshore Life Insurance: Wrapped In Controversy Amid Senate Probe

by Lauren Loricchio, Sarah Paez, Kiarra M. Strocko, and Chandra Wallace

Offshore life insurance policies are being promoted as a way to avoid taxes on the sale of closely held businesses, a practice some industry professionals think may stretch IRS rules to the breaking point.

Those types of structures are likely to face scrutiny from the Senate Finance Committee, which is now investigating the use of offshore private placement life insurance (PPLI) policies to dodge taxes.

"I am concerned that these insurance vehicles are being used, without a genuine insurance purpose, to invest in hedge funds and other investments while avoiding billions of dollars in federal taxes," Finance Committee Chair Ron Wyden, D-Ore., wrote in letters to major insurers and industry groups starting in August 2022.

Still, some advisers see nuance in the rules and think investors can put closely held businesses into PPLI policies in at least some cases. And others argue that the current rules are vague and in need of clarification.

PPLI Basics

Closely held businesses raise particular challenges for PPLI, stemming from how it works and the rules governing who controls investments placed in a policy.

PPLI, also called an "insurance wrapper," is a type of customized life insurance marketed to wealthy investors. A PPLI policy is structured as a private contract between the insurer and the investor and lets the investor "wrap" an investment portfolio within the life insurance. Industry professionals say the first PPLI policies were likely issued in the 1990s.

In a textbook PPLI policy, those investments are placed in separate accounts under the insurer's control, not the investor's. In return, the investments are shielded from gift, estate, and income taxes, and can grow tax free. Control by the insurer is necessary for the IRS to respect the arrangement as a life insurance contract under section 7702, the statute governing what qualifies as life insurance for U.S. federal income tax purposes. The assets an investor puts into the policy are considered premium paid for the insurance.

A PPLI policyholder must be an accredited investor, meaning they must have a net worth of more than $1 million, excluding their primary residence; or annual income of over $200,000 (or $300,000 for couples). The plans typically are available for people with enough wealth to contribute at least $2 million into a policy, but often policyholders invest millions more.

The rules governing life insurance vary depending on the country in which the insurer is based. PPLI offered by U.S. insurers faces relatively tight regulation. U.S.-based insurers typically accept only cash as premiums for PPLI and generally have high minimum premiums for investment.

But other countries have more flexible rules, with lower premium thresholds and the ability to put noncash assets into a policy, such as yachts, art, and even privately held businesses. Those features can make offshore insurance policies attractive options to some investors in the United States. If the foreign insurer follows U.S. laws for its policyholders subject to U.S. tax, then a sophisticated investor may find an offshore PPLI policy offers an appealing level of versatility.

'Tremendous Upside'

Whether the noncash assets in a PPLI policy can or should include closely held business interests is a point of contention in the field. Some advisers endorse the approach as a smart estate planning strategy, at least in some circumstances.

PPLI "has tremendous upside" for clients with a closely held business interest, said William D. Lipkind of Wilson Elser Moskowitz Edelman & Dicker LLP, who sets up the policies for high-net-worth individuals whom he counsels on wealth preservation.

"This is one of the things [the client] should think about. Whether he does it or not is secondary," Lipkind said.

Allan Rosenzweig of Evergreen Life Ltd., a Bermuda-based insurance firm that markets PPLI to U.S. customers, agreed that an individual can contribute closely held business assets — such as a passive minority interest in a start-up — to a

PPLI policy, so long as some conditions are satisfied.

All advisers who spoke with *Tax Notes* agreed that foremost among those conditions is the so-called investor control doctrine. Under that doctrine, if the investor exercises too much control over the assets in the policy, then the investor — not the insurance company — will be considered the owner of the policy assets for tax purposes, and the PPLI arrangement loses the life-insurance-related tax benefits.

The investor control doctrine doesn't appear in any statute but was developed beginning in 1977 through a series of IRS revenue rulings and court decisions. Some practitioners say the rule could benefit from more clarification.

"There's nothing really definitive out there about the parameters of investor control, which is both good and bad," Lawrence Brody of Harrison & Held LLP said. "You can play fast and loose and say that you're complying with the rules. But on the other hand, it also lets the IRS play fast and loose and say whatever you did violates investor control."

The most significant recent court case addressing the doctrine, *Webber v. Commissioner*, 144 T.C. 17 (2015), involved a venture capitalist whom Lipkind had advised in setting up offshore PPLI policies. In the 2015 decision, the Tax Court held that Jeffrey T. Webber had exercised enough control over assets held in the policies — by issuing instructions to the insurance company's investment manager using Lipkind as an intermediary — to be considered the assets' owner for federal tax purposes. The court further held that Webber didn't have to pay the accuracy-related penalties because he had relied in good faith on Lipkind's tax advice.

Some in the field view *Webber* as a positive development that provides a roadmap for how to structure a transaction correctly.

In a post on its website from 2020, Private Risk Capital Development Advisors LLC — which advertises bespoke PPLI solutions — said *Webber* provided the planning community with guidance, including that "the degree of control and communication has to be somewhat constrained, although the facts of *Webber* are clearly quite egregious and unlikely to be repeated by anyone in the future."

Todd Steinberg of Loeb & Loeb LLP likewise said the decision set forth bright-line rules that shouldn't be crossed. "I would never want to be accused of participating in indirect control," he said.

Since *Webber*, Lipkind has changed his strategy with PPLI to reduce the risk of running afoul of the investor control doctrine. A non-grantor trust — a type of trust that affords no control or rights over the trust assets — is used to purchase the PPLI policy, and once the policy is set up, he said, his firm doesn't permit any further transactions between the owner and the policy. "We have a nonnegotiable practice to break the continuity of beneficial ownership," he explained.

Control in Closely Held Businesses

But if *Webber* shed some light on the limits of policyholder involvement in PPLI investment decisions, it was silent on the question of using closely held business interests as PPLI premiums.

Most practitioners who spoke with *Tax Notes* agreed that putting a closely held business into a PPLI wrapper when the investor owns a controlling share in the company or has a role in its management is all but guaranteed to violate the doctrine.

Marc Cadin of Finseca, a trade group representing financial securities professionals, has been troubled by some tax planning marketing that suggests people should take their closely held business and put it into an offshore life insurance policy.

"Saying that is dumb," Cadin said. "But *doing* it violates investor control."

Nevertheless, people are doing it. Steinberg said he knows of situations in which offshore PPLI carriers have acquired the policyholder's closely held business interests. He said he doesn't recommend that structure to his clients because he is unsure if it would withstand IRS scrutiny, but he reserved the right to defend it in case someone has figured out "how to thread that needle."

"Every structure, every technique is different in how it's implemented and how it is documented — what i's are dotted, t's crossed, all that stuff," Steinberg said, adding that, fundamentally, an appropriate investment in a

PPLI — certainly not domestically — wouldn't be a closely held business asset over which the insured has more than a de minimis control or ownership interest.

Rosenzweig said his company verifies a lack of investor control in a closely held business by examining the policy owner's shareholder rights, whether they have vetoes, and whether they can sell their shares at a future point. Evergreen Life wouldn't permit a policy owner to contribute shares in a private company that is still being run by the policyholder, he said.

Lipkind agreed that if the transferor retained beneficial interest in the PPLI assets and had control over how they are invested, then the investor control doctrine would apply and the client could face income tax liability, plus interest and penalties. But he said there is some element of risk in any case where the investor puts noncash assets into a life insurance policy.

"There are more moving parts" in those situations, Lipkind said, adding, "You should get an opinion of counsel from the law firm just so you know people will stand behind what they're recommending."

"Giving people options, spelling out the respective risk factors in each option, I think is part of our professional duty," Lipkind said.

Heightened Scrutiny

With Wyden's committee expected to release its report soon, investors and practitioners are likely to see even closer attention paid to offshore PPLI structures.

Authorities have already been subjecting offshore PPLI policies and other questionable life insurance arrangements to increasing scrutiny. In 2021 the Justice Department charged Swiss Life Holding AG and three of its subsidiaries with orchestrating a tax evasion scheme that included over 1,600 PPLI offshore policies and concealed over $1.4 billion from the IRS. Swiss Life agreed to pay $77.4 million as part of a deferred prosecution agreement.

In 2019 the Tax Court found in *Wegbreit v. Commissioner,* T.C. Memo. 2019-82, that a couple had underreported their income by almost $15 million from 2005 to 2009 because their PPLI structure failed to qualify as insurance. Ultimately, they were held liable for the unpaid taxes as well as civil fraud penalties. The Tax Court's 2019 decision was affirmed in 2021 by the Seventh Circuit. While not mentioned in court documents, the website of their insurance company (Acadia Life International Ltd.) advertises PPLI and annuities.

But scrutinizing offshore life insurance arrangements poses a challenge for the IRS, according to a 2020 report from the Government Accountability Office.

The GAO report explains that "insurance is not defined in statute, and generally IRS and the courts have served as arbiters of what insurance products are considered genuine insurance for federal tax purposes, which requires significant resources."

According to the report, "IRS enforcement officials said some taxpayers abuse insurance tax shelters specifically because of the complexity of conducting enforcement actions against these schemes, including those held offshore." IRS officials told the GAO that it can be challenging to conduct enforcement actions against offshore insurance tax shelters because of bank secrecy laws.

Because IRS audit rates for PPLI appear low, the structures that skirt the rules are unlikely to be caught by the agency, according to Jay Adkisson of Adkisson Pitet LLP. "Your average [IRS] field agent has no idea about these things," he said.

When asked if the IRS has a program specifically targeting PPLI, Carissa Cuttrell, a spokeswoman for the IRS Criminal Investigation division, pointed to *Swiss Life*, saying that CI "targets abusive tax schemes and offshore tax evasion, as well as the professional enablers of those schemes."

Kevin F. Sweeney of Chamberlain, Hrdlicka, White, Williams & Aughtry said his firm hasn't seen many audits related to PPLI. "The only ones I'm aware of are ones that have made it to the Tax Court, and those cases are few and far between," he said.

Given the focus on the promotion of PPLI in *Swiss Life*, Sweeney said he would have expected to see more cases involving PPLI and a larger focus by the IRS on scrutinizing foreign insurance wrapper policies. "Quite honestly, I haven't seen the degree of focus that I thought I would," he said.

Regarding Wyden's investigation into PPLI, Jerry Vanderzanden of WSLV LLC said that there is a political aspect "when you're talking about people that are generally considered to be in the top 1 percent."

But Vanderzanden said that another reason for the investigation might be the reemergence of "past excesses that needed to be addressed with stricter controls around investor control."

More Rules? Or More Discipline?

Those stricter controls have been a long time coming. Treasury issued regulations in 1989 and again in 2005 addressing the diversification requirement under section 817. The 2005 regs (T.D. 9185) removed a look-through rule for assets of a nonregistered partnership held in a variable insurance policy, but the preamble explained that Treasury wasn't adopting any recommendations on investor control from the multiple comments received. Treasury stated that the letters "will receive careful attention in the event of further guidance on investor control," but it never wrote that guidance.

How or whether to close that guidance gap is an open question. Lipkind pointed out that the federal government could take steps to stop the use of PPLI but hasn't.

"All Congress has to do is modify section 7702(a) of the Internal Revenue Code," Lipkind said. The IRS could also put PPLI on its "Dirty Dozen" list of the worst tax scams, he said.

Some suggest that what's needed is better, more conservative professional advice, not new rules.

Cadin said that Finseca is "pretty outspoken on the need to strictly comply with the spirit and rule of the investor control doctrine, because if you don't do that the rest of this falls like a deck of cards."

In discussions with Wyden's staff, Cadin has said that if people are indeed violating the investor control doctrine, they should be found and audited by the IRS. But the possibility of these violations isn't a rationale for changing the law, he said.

"The notion that we're going to fix this through the tax code is something that we find very, very troubling," Cadin said.

Problems Ahead: Lingering Loopholes

Luís Carlos Calderón Gómez of Yeshiva University's Benjamin N. Cardozo School of Law said the use of PPLI "goes past what their tax treatment envisaged them as" and that the best solution would be a legislative fix.

Calderón Gómez said there are different things that could be done to curb abuse of PPLI. In an article in *Tax Notes*, he suggested that Congress could prevent policyholders from contributing noncash premiums, "determining that such payment is akin to selecting the policy's investments."

However, the biggest problem Calderón Gómez sees with those policies is their ability to shelter large amounts of income from taxation.

The most practical and possible way of addressing the issue would be to cap the amount of money that can be put inside a policy, like what Congress has done with IRAs, according to Calderón Gómez.

"Even if all these doctrines fail, and you're really able to stash a lot of money inside tax free, there's only so much you can do," he said.

But as Calderón Gómez explained, legislative fixes aren't expected to happen anytime soon with a divided Congress.

A spokesperson for Wyden didn't respond to a request for comment by press time. ■