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TEN TREMONT STREET, SUITE 600 – BOSTON, MASSACHUSETTS 02108  
Telephone: 617.720.6040 – Facsimile: 617.720.1919  
www.bovelanga.com

**Combining a Private Annuity  
With  
A Variable Universal Life Policy**

**By Alexander A. Bove, Jr., Esq.**

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**Introduction**

Few areas are more demanding on advisors than those of financial, insurance, and estate planning. In our current environment it is nowhere near enough to have an excellent knowledge of the products themselves, particularly the insurance products; rather, a successful planner must also have a comfortable knowledge of the specialized uses of such products and the laws impacting on such uses. For example, implementing ideas such as split dollar arrangements, irrevocable life insurance trusts, private placement life insurance (onshore and offshore), and annuities, both commercial and private, all require considerable knowledge not only of the products involved, but also of trust law, estate planning issues, federal income, gift, and estate tax law, even perhaps contract law. And in recent years we have added to this list the challenging issues associated with asset protection, always being admonished by the client to “keep it simple”.

Asset protection over recent years has developed into a subspecialty in planning, and affects or is affected by many different areas of the law as well as a new array of financial products, including insurance products, and some of the special laws relating to those products. The idea proposed in this article illustrates how a selected application of insurance products and the laws related to them can combine with asset protection and estate tax laws to protect assets and build wealth within a family.

### **Overview of State Laws Protecting Life Insurance**

Every state has laws protecting to some extent the cash value and proceeds of life insurance policies from creditors of the insured/owner, or in many cases, the beneficiary. Some states restrict protection to policies where the insured's spouse and/or dependants are the named beneficiaries (e.g., Hawaii, Illinois, Ohio, Tennessee), while others extend total creditor protection regardless of the beneficiary's dependence on the insured (e.g., Florida, Kansas, Michigan, Texas), and still others limit protection of cash value to a specified amount (e.g., Alaska, \$10,000, Connecticut \$4,000, Arizona \$25,000). Thus, the laws vary considerably from state to state, and one desiring to protect assets through the purchase of life insurance must carefully select the state law he wishes to apply before he goes to the trouble of moving to the state in order to avail himself of the applicable protection.<sup>1</sup> Even at that, a move for the sole purpose of availing oneself of increased protection on the purchase of a policy could backfire. In one case, for instance, where it was apparent that a debtor had moved to a state for the primary purpose of obtaining creditor protection under the state's insurance exemptions, the bankruptcy court held that the debtor's exemptions should be limited to those which would have applied in his former state of residence.<sup>2</sup>

### **Overview of State Laws Protecting Annuities<sup>3</sup>**

Annuity protection through state law is not quite as universal as it is with life insurance. There are a number of states, for instance, which offer no protection at all for annuities outside of an ERISA-qualified retirement plan (e.g., Connecticut, Massachusetts, New Hampshire, Virginia). Interestingly, some of these very same states (e.g., Connecticut and New Hampshire) offer

unlimited protection to a beneficiary's interest in a life insurance policy. In many states, protection of annuity proceeds or cash value is limited to amounts determined by the state to be reasonably necessary for the support of the owner or his dependants, but then there are several states which offer unlimited protection of amounts placed in annuities (e.g. Florida, Texas, Colorado, Michigan), regardless of dependants and even though the annuitant/owner could liquidate the contract and access the cash.

### **Asset Protection Where an Annuity is Annuitized**

For asset protection purposes, the annuity (private or commercial) offers a benefit that is not available with life insurance policies, which could be very valuable in those same states which otherwise offer limited or no protection for annuities. This occurs where the annuity is annuitized. To illustrate, assume that cash or property is used to acquire an annuity. In those states where the liquid annuity is not exempt by statute, the proceeds of the annuity are fully reachable by a creditor, regardless of whether the purchase was a fraudulent transfer, because the proceeds remain available to the annuitant/owner, no differently than a bank account or the cash value of a life insurance policy. But if the annuitant/owner irrevocably exercises her option to annuitize the contract, there is no liquid resource for a creditor to reach.

Although no cases could be found as to whether making the election to annuitize an annuity contract would itself be a fraudulent transfer, an argument could be made both ways. The argument against the fraudulent transfer is that there was in fact no transfer at all; the obligor was already holding the funds when the annuitant simply made a permissible election under the contract. Further, even if a transfer was deemed to take place, it was a transfer for full and fair consideration, since the present value of the projected annuity payments would be equal to the amount "transferred". On the other hand, a creditor could argue that even though the transfer was for fair consideration, the effect and intent of the election was to "hinder, delay, and defraud" the creditor, thus making it a fraudulent transfer.<sup>4</sup>

Once the annuity is annuitized, the cash or property that could otherwise be recovered by the annuitant/owner (or her creditor) if she liquidated the contract is no longer an asset of the

transferor; she is only entitled to a “stream of income” (the annuity payments). And as to the stream of payments, since the annuitant/owner cannot accelerate these, neither could a judgment creditor or a trustee in bankruptcy.<sup>5</sup> Depending on the amount of the payments and the annuitant/owner’s life expectancy, the required wait may motivate the creditor to reach a settlement, or if not, the creditor may simply give up on the effort to collect each payment as it comes due over the years.

### **The Private Annuity**

An interesting possibility in planning with annuities, whether in states with unlimited protection or otherwise, is the opportunity to utilize a private annuity. The typical state law allowing protection of non-Erisa annuities does not limit the protection to commercial annuities. In *In re Mart*,<sup>6</sup> for instance, as part of his estate protection plan, an individual entered into a \$350,000 private annuity agreement with his daughter-in-law, as trustee of an irrevocable trust for other family members. At the time of the private annuity agreement the individual was solvent and no suits were pending. Thirteen months later the individual filed for bankruptcy, claiming an exemption for the annuity as provided under Florida law. The creditors objected that the private agreement is not what was contemplated by the Florida statute; that the debtor exercised total control over the construction and implementation of the entire arrangement; and that if this qualified as an annuity, “any debtor can go to his cousin and give him all of his property in return for a promised stream of income,” and protect the funds. The court agreed that the exemption could invite abuse, but noted, in overruling the creditor’s exemptions, that on all the facts it found no intent to defraud creditors, that the annuity was purchased 13 months prior to bankruptcy and at a time when the debtor was solvent, that the debtor’s financial downfall was due to defalcations of another and not of his own business ventures, and that he did not anticipate insolvency or contemplate bankruptcy when the annuity was established.

### **A Strategy to Consider: The Private Annuity/Variable Life Combination Plan**

The result illustrated in *Mart*, if taken just a step further, offers a unique opportunity for planning, which can give the solvent client not only asset protection but also provide

considerable asset growth within the family, and with impressive tax results as well. The idea would be to follow up the private annuity with the purchase of a variable universal life insurance contract. Here is how it might work:

Dr. Kane, a 63 year old pediatric brain surgeon, is concerned over her exposure to claims for medical malpractice, though none are pending or expected at the moment. She has substantial assets, a portion of which she wishes to protect, including a portfolio of low basis publicly traded securities. She transfers \$5 million of such securities to her daughter in return for a private annuity, with payments to begin in 15 years (a deferred annuity). Because the daughter's basis in the securities will be \$5 million (the value of her promise), she can immediately sell the securities without realizing any gain<sup>7</sup>. Daughter can then use the \$5 million to purchase a variable universal life insurance (VUL) policy on her life.<sup>8</sup> The purchase of the policy could be by a single premium of \$5 million, in which case the policy would be classified as a "modified endowment contract" (MEC) with the attendant tax issues on withdrawals,<sup>9</sup> or preferably, the premiums could be structured over a period of years (generally, seven years) sufficient to avoid the MEC rules. Either way, the investment managers of the VUL policy funds would have fifteen years to build up a pool of assets, which daughter could then use as a source for the annuity payments to Dr. Kane when (and if) they must begin.

Two of the considerable financial benefits produced by this arrangement are 1) the arbitrage between the interest rate required to be applied to the private annuity versus the investment/return rates on the VUL investments, and 2) the tax deferral of growth and gains on the VUL policy investments. Again, the arbitrage results from the historical difference between the rate of return required by the Internal Revenue Service to be applied to the calculation of the private annuity payments (the "7520 rate")<sup>10</sup> and the probable return on the investments held within the variable universal life insurance policy compounding tax deferred over the deferral period (in this example, fifteen years).

To illustrate, say that the applicable 7520 rate is 5.6 percent and the rate of return on the VUL investments is 12 %.<sup>11</sup> A fifteen year deferred private annuity funded with \$5 million for a 63 year old will call for payments of about \$1,700,000 per year beginning at age 78 for the duration

of the annuitant's life.<sup>12</sup> The investment of \$5 million tax deferred for 15 years at 12 % will result in a sum of over \$27 million, assuming the \$5 million was invested in full in the policy at the outset. If instead the premiums were paid in at the rate of \$715,000 per year over 7 years, the investment result (with the same return) would be about \$20 million.

In either event, with the assumed rate of return the pool of funds left in the VUL would likely produce an annual cash flow in excess of the amount needed to make the required annual payments for the duration of Dr. Kane's life expectancy. (That is, a fund of \$20 million at 12% would return \$2.4 million per year, while the annuity payments would be about \$1.7 million per year.) Of course, if and as Dr. Kane exceeds her life expectancy, the "profits" realized by her daughter will diminish. If this is a concern, daughter could limit her exposure by having the annuity payments limited to a term of years, as discussed in greater detail below.

At the time the payments are to begin, the daughter could borrow an amount against the policy and use these funds to make the payments. If the policy is a MEC, the loan would be subject to income tax under the MEC rules,<sup>13</sup> in which case the daughter would have to withdraw an amount equal to the annuity payment plus her tax liability on the withdrawal. If the policy is not a MEC, as would be far preferable, daughter could simply borrow the amount of the annuity payment against the cash value of the policy on a tax-free basis.<sup>14</sup> Of course, the annuity payments to Dr. Kane would be subject to the usual tax treatment; that is, a proportional part of the payment would be return of capital, part capital gain, and part interest.<sup>15</sup> Note that the annuity contract cannot be secured by the cash value of the VUL, nor by any other asset, otherwise the exchange would be taxable to Dr. Kane at its inception.<sup>16</sup> Daughter's payments on the annuity, on the other hand, are not tax deductible to daughter.<sup>17</sup>

### **Death of Annuitant**

If Dr. Kane dies prior to daughter having paid fair value for the property exchanged, then daughter will have to recognize gain on the difference.<sup>18</sup> At the same time, Dr. Kane's estate would have a deductible loss (to the extent of her unrecovered basis in the securities), deductible

on her final income tax return.<sup>19</sup> Any unpaid balance of the original \$5 million, however, will be excluded from Dr. Kane's estate.

### **Death of Obligor**

If daughter should die before her mother, daughter's estate would be liable to continue making the payments. If her other assets are sufficient for this the policy proceeds could pass elsewhere. If not, daughter's estate plan should contemplate the use or set-aside of sufficient policy proceeds to fund the annuity payments. Of course, the obligation would constitute a deductible claim against daughter's estate.<sup>20</sup> Speaking of daughter's estate plan, it is likely that the \$5 million premiums plus the growth of that cash value in the VUL would produce a huge death benefit in daughter's estate. Numerous planning ideas may be explored to address this issue from an estate tax planning perspective, including, for example, a private split dollar plan with a family life insurance trust; a large loan to an irrevocable grantor trust with the note from the trust providing for deferred interest payments; charitable remainder trust(s); charitable lead trust(s); or a family foundation.

### **Limiting Obligor's Exposure**

One of the potential "problems" with a private annuity, for the obligor, that is, occurs where the annuitant lives well beyond her projected life expectancy. The present value of the annuity payments is based on the present value of the property exchanged for the annuity, based on the annuitant's life expectancy. That is to say, if the annuitant lives for a time just equal to her life expectancy, the total payments on the annuity will be equal to the value of the property exchanged, plus applicable interest on the declining balance (or increasing balance, for a time, where the annuity payments are deferred). But if the annuitant lives beyond her life expectancy, the obligor will have struck a bad bargain. To limit this exposure but still enjoy the tax and protection benefits offered by the annuity, the parties could limit the payments under the contract to the shorter of the annuitant's life or the annuitant's life expectancy under the IRS tables. This is sometimes called a private annuity for a term of years, and the Internal Revenue Service agrees that it will still be treated as an annuity for tax purposes.<sup>21</sup> Thus, the obligor would not be

obliged to make payments after the annuitant reached her life expectancy, thereby limiting her exposure.

If this option is used, however, the practitioner must be mindful of treasury regulations dealing with original issue discount (OID) rules, regarding “debt instruments”.<sup>22</sup> While an annuity in most cases are excepted from treatment as debt instruments,<sup>23</sup> recent treasury regulations provide that a private annuity will not qualify for the exception if the maximum payment provision (as in the case of an annuity for the lesser of a fixed term or the annuitant’s life) is for a period which is less than twice the annuitant’s life expectancy viewed from the time the payments begin.<sup>24</sup> Thus, in our illustration, for instance, in order to qualify for the exception and avoid the OID rules (which would cause Dr. Kane to be taxed on the interest portion during the deferral period), the maximum payout period would have to be about 18 years (twice Dr. Kane’s estimated life expectancy at age 78) from the time the payments begin.<sup>25</sup> The author believes this regulation could be successfully challenged, since it is clearly unreasonable overkill to the requirement under I.R.C. § 1275(a)(1)(B)(i), which merely requires that the annuity contract depend “in whole or in substantial part on the life expectancy of one or more individuals.”

### **Transferor’s Estate Plan and Asset Protection**

As a further estate planning alternative to the overall plan, Dr. Kane could enter into the annuity agreement with more than one child, or with one or more generation-skipping or dynasty trusts. It is very important to note that if a trust should become the obligor under the annuity contract, the transferor must be careful to avoid having the arrangement viewed by the IRS as a transfer with a retained interest.<sup>26</sup> To accomplish this it is helpful that the trust has other funding and was not established solely to carry out the annuity contract.<sup>27</sup>

The private annuity contract must also be structured so that it is not transferable or revocable by Dr. Kane and that payments cannot be anticipated. If this is the case, and assuming that the original transfer would not be treated as a fraudulent transfer, then Dr. Kane’s creditors could not reach the transferred securities and could not force a liquidation of the contract, even in those states which do not offer special exemptions for annuities. Further, her creditors could not

anticipate any payments, but would have to wait until each payment became due, the first one not being due for 15 years.<sup>28</sup> As to daughter's creditors (with respect to the life insurance policy), it would depend in some respects on daughter's domicile. If daughter were domiciled in Florida, Texas, or Michigan, for example, the policy cash value and proceeds would be protected in full against daughter's creditors, absent a fraudulent conveyance.<sup>29</sup> If daughter were domiciled in a non-protective state, and if asset protection is a significant or controlling issue with daughter, the policy could be held by an offshore asset protection trust.<sup>30</sup>

### **Plan is Not Just for the Wealthy**

Although the illustration used above shows very dramatic results in the millions of dollars, it is important to note that the proposed plan could work just as well with more modest estate plans. For instance, assuming we begin with a potentially taxable estate, say \$1.25 million, and our Dr. Kane transfers not \$5 million but only \$250,000 of low basis securities to fund the annuity, using the same facts and assumptions, daughter would accumulate about \$1,000,000 cash value in the VUL policy, which would in turn be more than enough to fund annuity payments of \$85,000 per year to Dr. Kane. Accordingly, all of the same benefits, i.e., asset protection, estate tax savings, and family wealth enhancement would apply and no doubt would be just as meaningful to the family.

### **Conclusion**

As with any planning strategy, this one, combining a private annuity with the purchase of a variable universal life insurance policy by the obligor, may fit perfectly in some situations and not at all in others. In between, some modification of the idea may be indicated and useful. And of course, where the complicated interweaving of estate, tax, and asset protection planning issues is involved, the plan is definitely not for the uninitiated. Nevertheless, where it does fit, the plan can save estate taxes, protect assets, and produce significant financial profit for the family.

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<sup>1</sup> For an excellent and thorough review of the pertinent law of all states relating to insurance and annuities, including citations to the relevant statutes, see Gideon Rothschild & Daniel Rubin, *Creditor Protection for Life Insurance and Annuities*, Asset Protection Strategies: Planning with Domestic and Offshore Entities, Chapter 10 (Alexander A. Bove, Jr., ed., American Bar Association 2002).

<sup>2</sup> *In re Coplan*, 156 B.R. 88 (M.D. Florida 1993).

<sup>3</sup> Annuities that are held under an Erisa qualified plan are exempt from creditors' attack under federal law. This article deals with non-qualified annuities which do not enjoy such protection.

<sup>4</sup> Some states have a "fraudulent conversion" statute, subjecting to attack transfers that are for fair value but have the primary effect of prejudicing a creditor. Such statutes indicate that the fair value test may not always be an absolute defense. See e.g., Fla. Stat. Ann. §222.29 (West 2001); Tex. Prop. Code Ann. §42.004 (Vernon 2002).

<sup>5</sup> *In re Grossman*, 259 B.R. 708 (N.D. 2001).

<sup>6</sup> *In re Mart*, 88 B.R. 436 (S.D. Florida 1988), and see Fla. Stat. Ann. §222.14 (2001).

<sup>7</sup> Rev. Rul. 55-119, 1955-1 C.B. 352. Note, however, that gain may be recognized on the death of the annuitant. See note 19, *infra*.

<sup>8</sup> The insured may also be someone other than the daughter. Although the implications of using other insureds for estate planning purposes are not relevant to the main object of the private annuity/VUL combination plan discussed here, there could be cost implications which would have a bearing on selection of the insured as pointed out in note 11, *infra*.

<sup>9</sup> I.R.C. §7702A(a)(1). Withdrawals or distributions from modified endowment contracts are generally taxable as income to the extent there is any growth on the policy in excess of the owner's investment in the policy. I.R.C. §72(e).

<sup>10</sup> I.R.C. §7520(a).

<sup>11</sup> The average rate of return for common stocks over the past 45 years has been over 12%; more than 300 mutual funds have produced a rate of return in excess of 12% over the past 15 years; thus an assumed return of 12% is not unreasonable. However, if the VUL funds should earn substantially less than the projected amount or, however unlikely, should actually result in a loss, daughter would nevertheless have the obligation to make the annuity payments. If daughter defaulted, Dr. Kane could sue for the payments, and it would not be impossible that a negotiated settlement could be reached, but not without tax consequences. This scenario, however, is quite remote.

Another factor that may affect the net investment return produced in the VUL policy are the internal administrative and mortality costs of the insurance company. Because of the somewhat younger age of the daughter and substantial amount of the premiums, it is likely that the face value of the daughter's VUL policy would be huge, say \$60 million to \$100 million. Further, it is unlikely that a policy with a face amount of this size would be available from one insurance company, so a portion would have to be re-insured, possibly increasing costs. It may also be worthwhile to consider an even younger insured, say a grandchild, or to purchase a second to die policy on the daughter and a grandchild. This would substantially reduce the mortality costs and provide a larger net return.

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Further, this article does not necessarily suggest that the VUL must be domestic. A foreign VUL could also be considered, as could a private placement policy, foreign or domestic. In the case of private placement or foreign policies, the insured/owner would typically have more investment flexibility, administrative costs are often lower, and may be able to produce an even greater return.

<sup>12</sup> The figures used here are reasonable approximations based on standard calculation programs. It may be that actual actuarial calculations and moving expectancy assumptions would result in a slightly different result, but not one which would change the complexion of the illustration.

<sup>13</sup> I.R.C. §72(e).

<sup>14</sup> Although withdrawals from a non-MEC policy are income tax-free, they are treated as loans from the policy and will be subject to interest charges by the insurer. Such charges, however, are likely to be far less than the return, and so should not upset the plan.

<sup>15</sup> Rev. Rul. 69-74, 1969-1 C.B. 43.

<sup>16</sup> *Estate of Bell v. Commissioner*, 60 T.C. 469 (1973).

<sup>17</sup> *See supra*, note 7.

<sup>18</sup> Rev. Rul. 55-119, 1955-1 C.B. 352, and note that in this case, daughter's gain, if any, would be short term gain as she did not hold the securities for more than 12 months. I.R.C. §1223(1).

<sup>19</sup> I.R.C. §72(b)(3).

<sup>20</sup> I.R.C. §2053.

<sup>21</sup> Gen. Couns. Mem. 39,503 (May 7, 1986).

<sup>22</sup> I.R.C. §1275.

<sup>23</sup> I.R.C. §1275(a)(1)(B).

<sup>24</sup> Treas. Reg. §1.1275-1(j)(6)(iii).

<sup>25</sup> Treas. Reg. §1.1275-1(j)(6)(iii) requires that the life expectancy must be determined under the "applicable mortality table prescribed under §417(e)(3)(A)(ii)(I)."

<sup>26</sup> *LaFargue v. Commissioner*, 689 F.2d 845 (9<sup>th</sup> Cir., 1982); Rev. Rul. 79-94, 1971-1, C.B. 296.

<sup>27</sup> *Weigl v. Commissioner*, 84 T.C. 1192 (1985), setting forth six factors in determining whether a private annuity with a family trust constitutes an independent transaction or a transfer with a retained interest.

<sup>28</sup> *See In re Grossman*, 259 B.R. 708 (N.D. 2001).

<sup>29</sup> Gideon Rothschild, *Establishing and Drafting Offshore Asset Protection Trusts*, Asset Protection Strategies: Planning with Domestic and Offshore Entities, Chapter 4 (Alexander A. Bove, Jr., ed., American Bar Association 2002).

<sup>30</sup> Alexander A. Bove, Jr., *The Mechanics of Establishing an Offshore Trust*, Asset Protection Strategies: Planning with Domestic and Offshore Entities, Chapter 5 (Alexander A. Bove, Jr., ed., American Bar Association 2002).