

DUE CARE BULLETIN

Private Placement Insurance Products: An Exclusive and Flexible Opportunity for High Net Worth Clients

Executive Summary

Private placement insurance products occupy a unique place in the spectrum of financial products. While having the same tax benefits, private placement insurance products offer policy structures and investment alternatives not found in traditional retail variable universal life (VUL) and variable annuity (VA) products. Because they can only be offered to individuals who are qualified purchasers and accredited investors, private placement variable universal life (PPVUL) and variable annuities (PPVA) offer high net worth clients access to both investment alternatives and customized product designs that are difficult or impossible to obtain in traditional retail or registered products. They are optimal in their use as a tool to address a multitude of financial, income, and estate tax planning objectives.

Because of its preferential treatment from an income tax perspective, insurance must be properly structured in order to assure it maintains its tax benefits. Clients should work with brokers experienced in structuring policies for high net worth clients and in working with multiple insurers to obtain the most favorable underwriting outcome.

This bulletin describes PPVUL and PPVA insurance products, outlines the advantages they offer both as financial products and over traditional insurance products, and addresses some important considerations for potential buyers.

Private Placement Overview

By law, all securities (which include variable insurance products) must be registered with the Securities and Exchange Commission (SEC). However, registration exemptions exist for securities (private placements) offered only to specific qualified purchasers (see Appendix).

In the case of investment funds, SEC registration stipulates that shares have sufficient liquidity so that they may be redeemed by shareholders at the current net asset value. This requires investment funds to be valued on a daily basis in order to fulfill redemption requests. Investment funds that do not seek to be registered (exempt funds) with the SEC often do so because they are difficult to value on a daily basis as a result of the types of assets they hold, such as options, derivative contracts, or other investment funds. In addition, exempt funds often engage in investment strategies that are illiquid and therefore require shareholders to remain invested for a certain period of time before they can redeem their shares.

Private Placement Variable Universal Life (PPVUL)

Overview - Life insurance enjoys favorable tax treatment as an asset that can be owned throughout its lifespan without incurring income taxes. The policy's account value accumulates free of recognition of income for tax purposes in the same way as

Life insurance due care requires an understanding of the factors that impact policy performance and drive product selection.

M Financial Group continues to lead the industry in life insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.

This material is for use with accredited investors and qualified purchasers.

Private Placement Insurance Products (continued)

an annuity. In addition, when the policy results in a death benefit, the beneficiary receives it without its inclusion as ordinary income. Furthermore, unlike an annuity, withdrawals from a life insurance policy are first treated as a return of basis before they are considered a receipt of taxable gains. Policyowners can also take loans against the policy's account value (at a low net interest expense) as a tax-free distribution. Typically, this is done after first withdrawing the policyowner's entire basis in the contract. As long as the policy remains in force until death, the policy loan balance is deducted from the death benefit and is not subject to income tax. If the policy is surrendered prior to a death claim, the amount received in excess of the policy's basis is taxed as ordinary income.

Because life insurance can be utilized in many ways that minimize taxable income, the IRS has prescribed several rules that must be adhered to in order to receive these tax benefits. First, policies must be issued as non-modified endowment contracts ("non-MECs") with minimum required death benefits depending on the amount of premiums paid into the policy within the first seven years [IRC Sec. 7702a]. Policies classified as MECs are treated similar to annuities with respect to distributions. Additionally, policies must always maintain a minimum amount of death benefit in relation to the policy's account value until age 95 or 100 (depending up the chosen Definition of Life Insurance test). Because of the consequences associated with violating these rules, insurance companies have administration systems designed to assure policy compliance.

Registered VUL products share a number of characteristics with PPVULs. Both have similar tax expenses generated for insurance companies, which are typically passed along to policies. In addition, both have similar mortality charges as well as similar types of policy charges (e.g., administration charges, asset-based charges, etc).

However, there are some differences. PPVULs are much more flexible in terms of both policy charges and structure. Since each policy is a private offering to a specific individual (rather than a general offering to the public) the policy can be customized to the client's needs. This can mean that factors that affect the insurer's expenses can be reflected in the pricing of the policy. For example, the cost of issuing a policy might be similar for an insurance company despite differences in the size of the policy. Economies of scale might result in the ability to have a policy issued with lower unit charges. In addition, the mortality risk for high net worth clients is historically lower than that of the general public. This lower risk can result in lower mortality charges over time.

Identical to PPVAs, policy assets are held in separate accounts not accessible by the insurer's creditors and can be reallocated between available investment choices without penalties or tax consequences.

Tax Treatment - A properly structured PPVUL policy will not be taxed on the growth of its value until it is fully surrendered. Withdrawals (up to cost basis) and properly structured policy loans may be taken on a potentially tax-free basis. In addition, death benefits are not taxed as income to beneficiaries. Policyowners invested in exempt investment funds do not receive K-1 statements.

Private Placement Variable Annuities (PPVA)

Overview - An annuity is a contract with an insurance company that accumulates value on a tax deferred basis and allows the annuitant to annuitize the contract value for a guaranteed stream of income. During the accumulation phase, the contract's value can grow without recognition of income for tax purposes [IRC Sec. 72]. While annuities are required to begin paying income ("annuitize") by a certain point (usually age 90 or 100), they also allow policyowners to access account values either in partial installments or lump-sum withdrawals. Withdrawals are taxed as ordinary income to the extent that the policy's value exceeds basis, or the premium paid into the policy. In addition, a 10% penalty can be levied on the taxable amount if the withdrawal occurs before the annuitant's age 59½.

Registered VAs are generally designed for buyers interested in accumulating assets by investing in investment accounts for the purpose of receiving a guaranteed stream of income in the future. In addition, many registered VAs also provide a minimum floor return on the investment values while the contract builds value or guarantees a return of principal. This makes registered VAs relatively expensive due to the benefits provided to buyers interested in guaranteed income.

Private Placement Insurance Products (continued)

Unlike registered VAs, PPVAs are designed primarily for buyers who are interested in accumulating assets without recognizing income for tax purposes. Due to the qualification threshold for private placement investments, PPVA holders generally are not looking for the guaranteed return benefits found in registered VAs. As a result, PPVAs are usually much less expensive than registered VAs. In addition, because growth in the value of an annuity is tax-deferred, PPVAs are especially attractive vehicles for investors who are interested in accumulating assets in investment funds that are tax-inefficient, or annually generate a high degree of ordinary income in their investment returns.

PPVAs are structured with no upfront charges on premium investments and no back-end charges on withdrawal or surrender. Policy assets are held in separate accounts that are not accessible by creditors of the insurance company. Policy account values can be reallocated between available investment choices without penalties or tax consequences. In addition, policyowners invested in exempt investment funds do not receive K-1 statements.

PPVAs must be owned by natural persons or a trust for the benefit of natural persons. In some states (e.g., Florida, Texas), annuity assets owned by natural persons are protected from creditors. Additionally, a tax-exempt charity can be designated as the beneficiary of the contract, allowing the policyowner to retain control of the assets during his or her lifetime without causing the policy assets to be subject to income or estate taxes.

Tax Treatment - A properly structured PPVA will not be taxed on the growth of its value until it is surrendered (redeemed) or has had withdrawals taken from it. Buyers may retain full ownership and control of their assets while enabling potential tax-free distributions at death to private foundations and/or charities. Again, policyowners invested in exempt investment funds do not receive K-1 statements.

Advantages of Private Placement Insurance

The appeal of private placement life insurance and annuities is derived from two aspects that differentiate it from traditional insurance products (i.e., whole life, registered variable products, etc.):

- the ability to customize policy charges
- the enhanced choice of investment options

Customization of Policy Charges - Sophisticated buyers of life insurance and annuities often have objections to the structure of policy charges in traditional retail products. Since carriers must manage the expenses and risks of an insurance product, despite the potential for it to be sold in a wide array of scenarios, products typically have premium loads (charges on premium payments) and surrender charges. In addition, other expenses, such as cost of insurance rates or administrative charges, can be relatively high depending upon the carrier's mortality experience (which may include groups of risks that are more expensive than the high net worth market) or distribution system.

PPVULs and PPVAs can be structured to be more attractive to their typically affluent buyer. Policies usually have low premium loads (or in some cases no premium loads) and surrender charges are almost non-existent. Due to the large size of the average PPVUL or PPVA case, policies can be designed with lower administrative charges (or other charges) than are usually found in traditional products.

Enhanced Choice of Investment Options - Registered VUL and VA products can only offer registered investment options (similar to retail mutual funds) due to the fact that registered securities must be valued on a daily basis and offer investors the ability to immediately redeem shares. However, PPVULs and PPVAs can offer investment alternatives that are not registered, such as hedge funds and other non-registered investment funds. These funds often employ strategies that require limitations on when investors can redeem shares in order to achieve their investment objectives, which include seeking to obtain returns not correlated to equity markets while also maintaining lower volatility on a periodic basis.

Investors interested in accessing these types of investment strategies, while minimizing the effects of current period income taxes, will naturally find themselves looking exclusively at private placement products.

Private Placement Insurance Products (continued)

Important Considerations

Investment Options - Variable insurance contracts are permitted to invest in segregated asset accounts [IRC Sec. 817(h)]. These accounts are required to be diversified such that no single asset may comprise more than 55 percent of the value of the account. Further, the investment accounts available to a variable insurance contract should only be open to investments from insurance contracts and not be co-mingled with non-insurance investments [Revenue Ruling 2003-92].

In addition, the “investor control” doctrine [Rev. Rul. 2003-91] requires that holders of variable insurance contracts not have control over segregated account assets sufficient to be deemed the owner of the assets. If the policyowner is deemed by the IRS to exercise control of the segregated account, the policy will be disqualified as insurance for tax purposes.

Some private placement insurance contracts have policy assets invested in a managed separate account where an advisor, or “allocator,” directs the investment of the account. The underlying investments are not “insurance-dedicated” funds but securities available to the general public. Each account usually manages assets for a single policy.

Unlike insurance-dedicated segregated asset accounts, these allocator accounts have not been approved by the IRS. In fact, an IRS Internal Legal Memorandum [ILM 200840043] advised an insurance company taxpayer seeking a private letter ruling that it intended to rule that the policyowner, and not the insurance company, would be deemed the owner of assets of the account. Such a determination would disqualify the policy for tax treatment as life insurance.

Policy Administration and Service

While private placement insurance products are often described as transactions executed “directly” with the insurance company, it should be noted that these products require a level of service and administration aligned with the complexities and requirements of the product. Buyers of private placement products should conduct the transaction with an experienced broker who can provide the following:

- Advanced policy design
- Knowledge of definition of life insurance tests and TAMRA [IRC Sec. 7702 & 7702a] rules
- Recommendations for policy ownership structures to minimize estate, income, and gift taxes
- Expertise in medical and financial underwriting
- Access to multiple insurance carriers and expertise in coordinating reinsurance to maximize capacity
- Inforce projections
- Custom reporting
- Assistance with post-issue policy changes (e.g., face amount, death benefit option, beneficiary, etc.)

The Obama Administration's Fiscal Year 2013 Revenue Proposals (“Green Book”) included a proposal to require life insurance companies to report information on private separate accounts. A private separate account is defined as any account in which 10 percent or more of the account's value is represented by policies owned by a related group of persons. The administration's reasoning for increasing the reporting requirements is to allow the IRS to identify more easily those variable insurance contracts that should be disregarded under the investor control doctrine.

These actions by the IRS and the administration indicate that variable insurance contract policyholders seeking the tax treatment of life insurance should allocate policy assets to insurance-dedicated accounts.

Private Placement Insurance Products (continued)

Buyers who do not fully recognize the value of these services, and choose to deal directly with an insurance company, may not receive the level of consultation and service needed to facilitate optimal results in the insurance transaction.

Conclusion

Private placement insurance products offer high net worth clients access to both investment alternatives and customized product designs that are difficult or impossible to obtain in traditional or registered products. They are optimal in their use as a tool to address a multitude of financial, estate, and income tax planning objectives and should be pursued with the assistance of brokers experienced in structuring policies for high net worth clients.

Variable life insurance products are long-term investments and may not be suitable for all investors. An investment in variable life insurance is subject to fluctuating values of the underlying investment options and it entails risk, including the possible loss of principal. Variable Universal Life insurance combines the protection and tax advantages of life insurance with the investment potential of a comprehensive selection of variable investment options. The insurance component provides death benefit coverage and the variable component gives you the flexibility to potentially increase the policy's cash value.

Variable annuities are long-term investments designed for retirement. The value of the investment options will fluctuate and, when redeemed, may be worth more or less than the original cost.

Loans and partial withdrawals will decrease the death benefit and cash value and may be subject to policy limitations and income tax.

When considering alternative investments, including hedge funds, you should consider various risks including the fact the some alternative investment products: often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, can be illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, are not subject to the same regulatory requirements as other registered products, often charge high fees, and in many cases the underlying investments are not transparent and are known only to the investment manager.

This material is intended for informational purposes only and should not be construed as legal or tax advice and is not intended to replace the advice of a qualified attorney, tax advisor or plan provider.

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Appendix

Accredited Investor [Regulation D of the Securities Act of 1933]

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

Qualified Purchaser [Section 2(a)(51) of the Investment Company Act of 1940]

- An individual who owns at least \$5 million in Qualified Investments;
- A family business or trust that owns at least \$5 million in Qualified Investments;
- A corporation, partnership, limited liability company, trust, or tax-exempt organization where each beneficial owner is a Qualified Purchaser;
- A trust that was not formed for the specific purpose of investing in the product, so long as both the persons with decision making power and each of the contributors to the trust is a Qualified Purchaser; or
- A corporation, partnership, or trust with at least \$25 million in Qualified Investments.