Hot Topics In Insurance Planning: Private Placement Insurance

By Jonathan M. Forster, Michael B. Liebeskind, and Jennifer M. Smith

As tax rates increase and investment returns decline, high-net-worth clients will want guidance from their advisors regarding investment vehicles that can provide non-correlated hedges in today's market. For the right client, private placement annuities and life insurance products can offer such options by providing unique access to competitive investment returns in a tax-efficient environment. When properly structured, private placement annuities and life insurance can provide the client with tax management, investment flexibility, asset protection and financial privacy.

OVERVIEW

Private placement variable annuities ("**PPVA**") and private placement variable life insurance ("**PPVUL**"), are similar to traditional retail deferred variable annuity and variable universal life insurance contracts issued by an insurance company, where the contract owner's premium payments are held in a separate, segregated asset account ("**Separate Account**"). The contract owner selects among various investment funds (referred to as **"Insurance Dedicated Funds"** or "**IDFs**") offered by the insurance carrier on its Separate Account platform. The contract owner's Seperate Account value varies over time with the investment performance of the selected funds.

In the past, PPVA and PPVUL faced several issues that limited their appeal, including lack of IRS guidance regarding tax compliant structures, limited investment alternatives available on insurance company Separate Account platforms, and wide ranging expense charges. Recent developments in the PPVA and PPVUL market, including the issuance of IRS guidance on compliant structures[1] and the availability of relatively turn-key IDF platforms, however, have minimized the complexity and costs associated with PPVA and PPVUL, thereby increasing both their accessibility and potential desirability for the investment portfolios of high-net-worth clients.

Appreciating the potential planning opportunities associated with PPVA and PPVUL requires a general understanding of the investment considerations and expenses specifically associated with these products, as well as the favorable income tax rules applicable to annuity and life insurance products.

INVESTMENT CONSIDERATIONS

Requirements

Securities Regulation
Purchasers of PPVA and PPVUL must meet the accredited investor or qualified purchaser requirements as provided under Securities and Exchange Commission regulations.[2]

Separate Account
With PPVA and PPVUL, the insurance carrier must segregate the Separate Account assets from its general account, which protects these assets from the carrier's creditors. This creditor protection is particularly important given the current environment of credit downgrades and institutional risk for even the largest financial services companies.

Investment Restrictions
To preserve the income tax-deferral of PPVA and PPVUL investment gains (as discussed below), the IDFs offered by an insurance company within the Separate Account must satisfy the following requirements. Otherwise, the contract holder will be taxed as the direct owner of the Separate Account.

- Access. Carriers must limit access to their IDFs to investors who purchase an annuity or life insurance contract – these investment vehicles can be acquired only through annuities and life insurance and cannot be acquired directly by the general public.

- Control. The product must satisfy the "investor control doctrine," which limits the amount of control the contract owner can exert over the IDF. The contract holder cannot (1) select or identify any underlying investments, (2) set or revise an IDF's specific investment strategy, or (3) enter into any direct or indirect arrangement, plan, or agreement with the carrier or fund manager regarding specific investments objective or investments.

- Diversification The Separate Account of any variable contract must be adequately diversified within the meaning of Internal Revenue Code ("**Code**") §817(h).

Flexibility

Unlike traditional retail products, the owner of a PPVA or PPVUL investment account can allocate among IDFs that mirror publicly available retail mutual and index funds as well as more sophisticated alternative asset class options, such as hedge funds, hedge funds of funds, derivatives, etc. Interest in these alternative asset investment options will continue to increase as more highly regarded investment managers enter the private placement market. Thus, despite the restrictions noted above, PPVA and PPVUL investment accounts will provide access to a wide-range of investment alternatives on an income tax-advantaged basis.[3]

INCOME TAXATION

PPVA and PPVUL products benefit from highly favorable tax rules, as summarized below. In order to receive the tax benefits associated with life insurance policies, a PPVUL contract must qualify as life insurance pursuant to the requirements of Code §7702. Similarly, in order to receive the tax benefits associated with deferred annuities, a PPVA contract must meet the requirements of Code §72, including ownership by a "natural person" or an agent of a natural person, with certain limited exceptions.[3]

Income Tax Deferred Growth

Investment earnings within a life insurance or annuity contract are not subject to income tax as earned or realized.

Withdrawals, Surrenders, and Loans

Life Insurance
Assuming a life insurance policy is not a modified endowment contract ("**MEC**"):[4]

- Owners may withdraw from policy cash value, income tax-free, up to their investment in the contract.[5]

- Withdrawals and a complete policy surrender will generate ordinary income to the extent the amount received exceeds the owner's investment in the contract.
- Owners may take policy loans, income tax-free.

Annuities
Withdrawals, loans, or surrenders are taxed first as ordinary income up to any untaxed gain in the contract, and then treated as a return of the owner's investment in the contract. A 10% penalty may apply to amounts includible in income, with certain exceptions (e.g., the annuitant has attained age 59 ½). If systematic distributions are taken in a form that qualifies them as "annuity payments", each payment is treated partially as (1) a return of the owner's investment in the contract (which is excluded from gross income) and (2) as taxable income.

Amounts Payable at Death

For annuities, amounts paid after the death of an annuitant are deemed income in respect of a decedent. Thus, any deferred gains will eventually be taxed as ordinary income after death. The death benefits payable under a life insurance policy, however, are generally exempt from income tax.[6]

FEES AND EXPENSES

PPVA and PPVUL products provide the client with the opportunity to negotiate certain costs. Thus, in some circumstances, they may cost less than traditional annuity and life insurance products. The typical fees and expenses associated with PPVA and PPVUL include the following:

PPVUL
- Agent Commissions. Typically based on a percentage of premiums as well as a trail commission based on the policy's assets under management. Depending on the size of the client's investment and the complexity of the transaction, the premium commission may range from 1.00% to 4.00%, and the trail commission on the policy's assets under management may range from 0.15% to 0.50%. This commission structure allows agents to participate in the contract's asset value growth

over time. As states, like New York, contemplate or implement agent compensation disclosure requirements, this compensation structure may become more appealing in the years ahead.

- Investment Management Fees Charged at market rates and paid at the IDF level of the Separate Account. The investment returns are reported to the Separate Account net of these fees, which effectively makes the entire fee tax-deductible, without regard to the deduction limitations typically imposed on taxable accounts for itemized deductions or alternative minimum tax purposes.

- Mortality and expense charges ("**M&E Fee**"). Provides a revenue stream to the insurance company. Asset-based agent commissions are typically paid from the M&E fee charged by the insurance company.

- Federal Deferred Acquisition Costs Tax ("**DAC Tax**"). Imposed at the carrier level and passed through to the contract owner. May average 1% to 1.5% of premiums paid.

- State Premium Tax. Charged by the state where the contract is issued. Varies greatly from state to state and may range from less than 1% to as much as 3.5% of premiums paid.

- Cost of Insurance Protection. Varies from year to year based on the net amount at risk (i.e., the difference between the death benefit and policy's cash value), and the age, gender, and health status of the insured at time of underwriting.

PPVA

PPVA contracts are subject to similar fees and expenses, except they typically do not incur charges for DAC Taxes, state premium taxes (other than in a small number of states), or cost of insurance. Thus, PPVA will have a much simpler and less expensive investment account structure than PPVUL but will receive less favorable tax treatment on distributions during lifetime or upon death.

PLANNING CONSIDERATIONS

Potential Benefits

For the right clients, PPVA and PPVUL investment accounts offer numerous investment and tax planning benefits, including:

- Long-term, income tax-deferred investment growth.

- Wealth creation through the tax-deferred compounding of investment assets.

- Availability of a wide range of investment options, including alternative asset classes.

- Flexibility in product design and implementation (e.g., costs, timing and amount of premium payments, death benefit options, and, (for PPVUL only availability of tax-free withdrawals).

- Financial privacy and asset protection from future creditors for Separate Account assets.

- Simplification of tax reporting, including elimination of K-1s for alternative investments.

- Opportunities for significant income and transfer tax-efficient wealth transfer planning (particularly for PPVUL).

- Supplemental tool for charitable planning (particularly for PPVA).

These benefits provide a valuable opportunity to high-net-worth clients with substantial exposure to tax-inefficient investments, such as hedge funds, commodity funds, or high-yield taxable bonds. These clients may see returns consistently taxed at the highest income tax rates and yet not receive distributions to offset the tax liability. Holding similar investments through a PPVA or PPVUL investment account defers the gain recognition and also avoids the potential for phantom income. In addition, tax-deferred growth allows Separate Account investments to compound at a faster rate, which generally results in better overall returns when compared to a taxable account. This feature is particularly attractive given the potential for a future rise in income tax rates at both the federal and state level. Many clients also will appreciate the simplified and reduced tax reporting requirements.

Considerations

PPVA and PPVUL are unique and complex insurance products that require a financially sophisticated client with a significant net-worth and a long-term investment horizon. There also are numerous considerations in selecting the appropriate product, insurance carrier, and jurisdiction. The following summarizes only a few of the potential issues that clients and their advisors must consider.

PPVA vs. PPVUL
From an income tax planning perspective, PPVUL will be more attractive than a PPVA, due to the potential for income-tax-free investment growth and payment of policy death benefits and the availability of tax-free withdrawals during the insured's lifetime. Of course, some of these income tax benefits depend on whether the PPVUL is a MEC. The need to avoid MEC status will depend on a client's particular circumstances and desire for lifetime access to policy cash value.

Holding the PPVUL contract through a properly structured irrevocable life insurance trust also can shelter the policy death benefit from estate taxation. PPVUL products, however, can generate substantial premiums, making it difficult to fund them into a trust on a gift tax efficient basis. Annual exclusion gifts alone likely will be inadequate, and full use of a client's federal gift tax exemption, even at the $5 million level, may not support required premiums. And proposed PPVUL financing, however, must be carefully analyzed and structured by the client's advisors.

PPVUL policies have higher expenses than PPVAs. They also are subject to potential "force-outs" of cash value if investment gains are higher than initially anticipated and the policy requires an increase in the net amount at risk beyond the insurance company's retention or reinsurance treaty capacity. The amount forced out will be taxable to the contract owner at ordinary income rates and may, in certain states, become immediately subject to creditor claims. Finally, PPVUL will require the client to complete financial and medical underwriting requirements. A client's age, prior health insurance acquisitions, and net -worth can all affect insurability and/or the PPVUL market capacity.

PPVAs avoid many of the costs and complexities associated with a PPVUL acquisition. PPVAs do not have any net amount at risk and therefore are not subject to requirements for medical underwriting, insurance capacity, insurability, or potential force outs. Also, as PPVAs generally are not used for estate planning, their acquisition does not involve the challenges of trust set-up and funding. Thus, many clients may prefer the simplicity of acquiring a PPVA investment account. The trade-off is that income tax will only be deferred, not eliminated, and the annuity may be subject to both estate and income taxes upon the annuitant's death. These considerations, however, make a PPVA an ideal vehicle for implementation of a client's charitable goals, as designating a charitable beneficiary of the PPVA, including a private foundation, can avoid many of the income and estate tax issues.

<u>Jurisdictional and Carrier Considerations</u>

Structuring a PPVUL acquisition involves a jurisdictional analysis, including consideration of whether to use a U.S. tax compliant onshore or offshore insurance carrier. Depending on the client's needs, PPVUL issued by offshore carriers may have lower costs, greater creditor protection, more investment options, and fewer securities and insurance regulations, although these differences are less pronounced in today's market than in the past. Further, many clients are reluctant to travel offshore to make their PPVUL acquisition or to invest in offshore accounts, given the recent scrutiny that such accounts have come under by federal tax authorities. For onshore products, a state-by-state analysis should consider applicable state regulations, creditor protections, and premium tax requirements.

Clients also must ensure that sufficient due diligence is performed with regard to the proposed insurance carrier. As the contract owner ultimately depends on the issuing carrier's ability to fulfill its contractual obligations, clients should purchase PPVUL only from financially solvent carriers with superior credit ratings (a key consideration in the wake of recent credit downgrades).

<u>Target Clients</u>

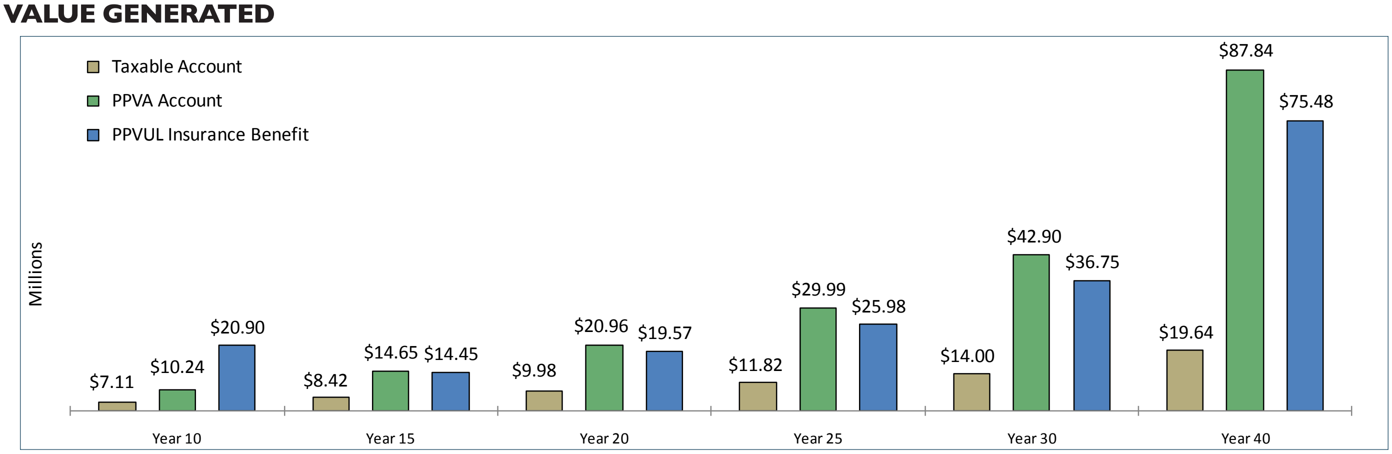
Clients with large, long-term investments in tax-inefficient asset classes may benefit substantially from the acquisition of PPVA and PPVUL investment accounts. Depending on the product, the client should be ready to invest at least $1 million in the PPVA or PPVUL investment account and have an investment time horizon of 10 to 15 years for PPVUL (in order to overcome the impact of up-front fees and expenses) or until age 59½ for PPVAs (in order to avoid the 10% excise tax).

PPVUL products will benefit clients who are insurable and have a need for significant life insurance coverage, a desire to fund tax-efficient, multi-generational (i.e., dynasty trust) planning structures, or an interest in planning for their long-term retirement income. PPVAs will work best for clients who want to retain full ownership and access to their investment assets during their lifetimes but also are interested in long-term charitable planned giving. In either case, however, the client must accept some loss of investment control, since the tax benefits of both PPVA and PPVUL require IDF investments to be under the full discretionary management (within the parameters of a defined investment mandate) of an independent investment manager.

CASE STUDY

To illustrate the potential benefits to a client of a PPVA or PPVUL assume that a 50 year old client acquires a PPVA or PPVUL product from an onshore life insurance company and invests a total of $5 million. Assume further that the acquisition is completed in a state that has a 2.00% premium tax (PPVUL only), and that the insurance carrier charges and agent commissions are consistent with market norms for an investment of this size. Finally, assume that the IDFs to which the client has allocated their PPVA or PPVUL seperate account assets generate an annual return of 8.00% after investment management fees, and that those investments would be fully tax-inefficient (i.e., subject to tax at short-term capital gains or ordinary income rates) if accessed through a taxable account. The graphic image and table below illustrate the values generated over time in a "Taxable Account", a "PPVA Account", and a "PPVUL Account". While the investment gain element of the PPVA Account would be subject to income tax upon distribution, a corresponding deduction would be available in most cases if the PPVA Account values are contributed to one or more private foundations or public charities.

VALUE GENERATED



Reprinted with the permission of The Association for Advanced Life Underwriting

VALUE GENERATED-ANNUAL BREAKDOWN

	Taxable Account				PPVA Account				PPVUL Account				
Year	Capital Commitment (BOY)	Earnings (Net of Fund Management Fees)	Fed/State Income Taxes	After-Tax Value (EOY)	Earnings (Net of Fund Management Fees)	Less PPVA Fees	Account Value (Net of PPVA Fees)	Surrender Value (Net of PPVA Fees & Taxes)	Capital Commitment (BOY)	Earnings (Net of Fund Management Fees)	Less PPVUL Fees	Account Value (Net of PPVUL Fees)	Death Benefit
1	5,000,000	400,000	(195,264)	5,204,736	400,000	(28,600)	5,371,400	5,219,869	1,250,000	94,569	(83,355)	1,261,214	22,587,999
2	-	416,379	(196,784)	5,424,331	429,712	(30,724)	5,770,388	5,466,084	1,250,000	194,933	(95,869)	2,610,278	22,587,999
3	-	433,946	(247,142)	5,611,135	461,631	(33,007)	6,199,012	5,628,282	1,250,000	303,652	(88,221)	4,075,709	22,587,999
4	-	448,891	(255,653)	5,804,373	495,921	(35,458)	6,659,475	5,869,565	1,250,000	420,594	(95,130)	5,651,173	22,587,999
5	-	464,350	(264,457)	6,004,266	532,758	(38,092)	7,154,140	6,128,770	-	449,338	(64,570)	6,035,941	22,587,999
6	-	480,341	(273,565)	6,211,043	572,331	(40,922)	7,685,550	6,407,228	-	479,835	(71,204)	6,444,572	22,587,999
7	-	496,883	(282,986)	6,424,940	614,844	(43,961)	8,256,433	6,706,371	-	512,192	(78,977)	6,877,788	22,587,999
8	-	513,995	(292,731)	6,646,204	660,515	(47,227)	8,869,720	7,027,733	-	546,807	(79,967)	7,344,627	20,899,624
9	-	531,696	(302,812)	6,875,088	709,578	(50,735)	9,528,563	7,372,967	-	583,798	(88,256)	7,840,169	20,899,624
10	-	550,007	(313,241)	7,111,854	762,285	(54,503)	10,236,345	7,743,845	-	623,029	(97,818)	8,365,380	20,899,624
11	-	568,948	(324,028)	7,356,774	818,908	(58,552)	10,996,701	8,142,271	-	664,834	(102,612)	8,927,601	20,899,624
12	-	588,542	(335,187)	7,610,129	879,736	(62,901)	11,813,535	8,570,293	-	711,766	(57,672)	9,581,695	12,264,570
13	-	608,810	(346,731)	7,872,209	945,083	(67,573)	12,691,045	9,030,108	-	763,844	(63,555)	10,281,984	12,955,301
14	-	629,777	(358,671)	8,143,314	1,015,284	(72,593)	13,633,736	9,524,078	-	819,713	(67,193)	11,034,504	13,682,786
15	-	651,465	(371,023)	8,423,756	1,090,699	(77,985)	14,646,450	10,054,740	-	879,746	(71,185)	11,843,065	14,448,539
16	-	673,900	(383,801)	8,713,856	1,171,716	(83,778)	15,734,388	10,624,819	-	944,284	(74,649)	12,712,700	15,255,240
17	-	697,108	(397,018)	9,013,946	1,258,751	(90,001)	16,903,138	11,237,244	-	1,013,604	(80,578)	13,645,726	16,238,414
18	-	721,116	(410,691)	9,324,371	1,352,251	(96,686)	18,158,703	11,895,161	-	1,087,955	(87,443)	14,646,238	17,282,561
19	-	745,950	(424,834)	9,645,486	1,452,696	(103,868)	19,507,532	12,601,947	-	1,167,680	(94,886)	15,719,032	18,391,268
20	-	771,639	(439,465)	9,977,660	1,560,603	(111,583)	20,956,551	13,361,233	-	1,253,124	(103,851)	16,868,306	19,567,235
25	-	913,981	(520,532)	11,818,209	2,232,954	(159,656)	29,985,222	18,092,256	-	1,801,400	(89,531)	24,276,750	25,976,122
30	-	1,082,580	(616,552)	13,998,277	3,194,973	(228,441)	42,903,697	24,861,537	-	2,597,640	(135,047)	35,004,566	36,754,794
35	-	1,282,280	(730,286)	16,580,496	4,571,457	(326,859)	61,387,814	34,547,215	-	3,733,547	(233,888)	50,292,792	52,807,432
40	-	1,518,818	(865,000)	19,639,049	6,540,969	(467,679)	87,835,408	48,405,754	-	5,339,175	(418,179)	71,882,075	75,476,179

The graphic image below illustrates the after-tax distributions that can be taken from a Taxable Account, from a PPVA Account, and from a PPVUL Account during the client's lifetime. For this purpose, we assume that the distributions would be taken over a 20-year period after the investment had compounded on a tax-deferred basis for 10 years, for 20 years, or for 30 years.

AFTER-TAX DISTRIBUTIONS

These illustrations demonstrate that both PPVA and PPVUL can provide substantial value relative to a Taxable Account for clients who have a long-term investment time horizon and/or an interest in earmarking specific assets for charitable planned giving without giving up ownership of those assets (as would be required with a direct contribution to a private foundation or public charity).

CONCLUSION

In the right situation, PPVA and PPVUL investment accounts can offer significant and unique investment and income tax planning opportunities, particularly in the face of concerns over rising income tax rates for high-net-worth clients in the years ahead. Due to the complexity of these products and their threshold requirements for feasibility, however, advisors must understand the economic, legal, and tax implications associated with these investments. The acquisition and ongoing administration of PPVA and PPVUL investment accounts will require the involvement of insurance advisors who are experienced with this market and who have the resources to provide guidance regarding jurisdiction, carrier selection, product design and compliance, and who have the infrastructure required to meet client expectations with respect to ongoing administration and reporting services. The ability to access attractive investment funds in a tax-efficient structure, however, may be well worth the costs and effort for many high-net-worth clients.

Financial Disclaimer. The projections and illustrations provided in the examples are hypothetical approximations only, based on various factual, actuarial, and tax assumptions. Actual results will vary and cannot be guaranteed. The authors are not providing investment advice.

Circular 230 Disclaimer. Pursuant to U.S. Treasury Department Circular 230, the tax advice contained in this communication was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties or (ii) promoting, marketing or recommending to another party any matter(s) addressed herein.

[1] See e.g., Rev.Rul 81-225, Rev. Rul. 2003-91, Rev. Rul. 2003-92, IRS Internal Legal Memorandum 200840043, and PLR 201105012.

[2] See 15 USC §80a-2(a)(51); 17 CFR § 230.501(a).

[3]Includes exceptions for annuities acquired by a decedent's estate, held under a Code §401(a) or §403(a) plan, an IRA, or a Code §403(b) program, and immediate annuities. See Code §72(u)(3). Note that certain trusts, such as grantor trusts and non-employment trusts that only benefit natural persons, may qualify as such agents for annuity taxation. See e.g., PLRs 9752035, 9639057, and 201124008.

[4]Defined by Code §7702A. Generally, non-MECs involve premiums paid for four or more years. If the policy is a MEC, withdrawals, surrenders and loans (including pledges of the MEC as loan collateral) are taxed as ordinary income until they exceed any gain in the MEC, and an additional 10% penalty tax may apply to the amount included in gross income (See Code §72(v)).

[5]Generally, for purposes of policy withdrawals and surrendering the aggregate amount of premiums or other consideration paid for the contract, less the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income.

[6]Assuming there has been no transfer for value pursuant to Code §101(a)(2).

About the Authors

Jonathan M. Forster, *Shareholder, National Chairman of Wealth Management Group, Co-Chair of the Insurance Regulatory and Transactions Group, Greenberg Traurig LLP*

Jonathan M. Forster, listed as one of the nation's top tax lawyers, focuses on business planning for privately held companies, business succession, executive compensation, and estate planning. Jon provides innovative, practical tax strategies to assist business owners in building and preserving the value of their companies and personal net worth.

Michael B. Liebeskind, *Principal, SALI Fund Services*

Michael B. Liebeskind is a Founding Principal of SALI Fund Services and has helped to develop the company's internal infrastructure and its market presence within the Private Placement Life Insurance and Annuity markets. SALI is an open-architecture insurance dedicated fund development and administration platform that works cooperatively with insurance carriers, insurance brokers, and investment managers to create funds targeted for distribution in the high-net-worth individual, COLI, I-COLI, and BOLI markets.

Jennifer M. Smith, *Associate, Wealth Management Group and Insurance Regulatory and Transactions Group, Greenberg Traurig LLP*

Jennifer M. Smith focuses her practice on developing tax-efficient structures for her clients' estate, charitable, and business succession planning needs. She also advises insurance clientele on issues of specific interest to the life insurance industry, including insurance policy taxation, split-dollar planning, premium financing, and charitable insurance structures.