

IRS Clarifies the Structuring of Insurance-Dedicated Funds

New PLR has positive impact on the IDF market

By **Michael Liebeskind**

The Internal Revenue Service recently published Private Letter Ruling PLR 201417007 (released April 25, 2014), which provides some additional clarification with respect to the structuring of Insurance-Dedicated Funds (IDFs).

Tax-Compliant IDF

The rules for structuring a tax-compliant IDF are comprised of three basic elements:

1. The IDF must be structured as a separate legal entity attached to, but distinct from, the insurance company's segregated asset account;
2. The IDF must be broadly diversified with no more than 55 percent of its assets allocated to any one investment, no more than 70 percent of its assets allocated to any two investments, no more than 80 percent of its assets allocated to any three investments and no more than 90 percent of its assets allocated to any four investments, and
3. The IDF must be managed on a discretionary basis, meaning that no Private Placement Variable Annuity (PPVA) or Private Placement Variable Universal Life (PPVUL) Investment Account owner can directly or indirectly influence the IDF manager with respect to the selection of funds or securities to fulfill the IDF's investment mandate.

Investor Control Doctrine

The first two rules are straightforward. But the third rule, the Investor Control Doctrine, has been the subject of confusion and debate within the professional advisor community. We've seen a wide range of perspectives among professional tax advisors about what facts and

circumstances are likely to be deemed acceptable by the IRS (for example, degree of communication between the IDF investment manager and PPVA/PPVUL Investment Account owners, degree of transparency of underlying IDF positions, degree of similarity between an IDF and a taxable fund offered by an investment management firm and degree to which the IDF assets may be allocated to the IDF investment manager's existing taxable funds). To date, the IRS pronouncements haven't provided sufficient guidance on these matters, and there hasn't been enough enforcement action to enable a body of case law to have been developed.

PLR 201417007

In this context, we are expecting PLR 201417007 to have a positive impact on the IDF market, which already has a lot of momentum due to increased tax rates on investment portfolio gains. In this PLR, the IDF:

1. Is structured as a fund of the IDF investment advisor's existing, publicly available funds.
2. Is structured as a clone of one of the IDF investment advisor's existing publicly available funds.
3. Includes various share classes to differentiate specific terms offered to classes of policy owners.
4. Provides full transparency into its underlying holdings within five days of the end of a month.

The IRS ruled favorably, concluding that none of these facts "will cause the variable contract holders to be treated as the owners of the FUNDS shares for federal income tax purposes." In other words, these facts won't cause the gains within the IDF to be subject to current period taxation.

While a PLR doesn't create a precedent that taxpayers can rely on, (other than the taxpayer to whom the PLR applies), such rulings do provide a measure of comfort to professional advisors who are being called on to express their understanding of the IRS' view on the Investor Control Doctrine. It's worth noting that this is the second PLR in less than a year that gives a blessing to an IDF that provides transparency into its underlying holdings. PLR 201417007 goes further, however, both in terms of the degree of transparency and the timing of the reporting.

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Michael L. Liebeskind is a Principal of Winged Keel Group. Winged Keel specializes in the structuring and administration of large block life insurance portfolios for sophisticated business owners, private investors, executives, and ultra-affluent families. For more information, please visit www.wingedkeel.com.