



INVESTORS PREFERRED ACADEMY



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Section 1:

Private Placement Life Insurance

Lesson #1

What is Private Placement Life Insurance?

Private Placement Life Insurance ("PPLI") is a type of life insurance policy that is typically offered only to policyholders who meet the Internal Revenue Code's definition of an accredited investor and/or qualified purchaser or are an institutional investor.[1] PPLI policies are customized, flexible, and tailored to the unique needs of each policyholder. It is typically used as part of an overall wealth management strategy to help preserve and transfer wealth to future generations.

One of the main features of PPLI is that it allows policyholders to invest their premiums in a variety of investment options, including hedge funds, private equity funds, and other alternative investments that are usually highly tax inefficient and not typically available in traditional life insurance policies. This allows policyholders to potentially generate higher returns on their investments, although it also carries the risk of investment losses. PPLI policies offer a range of tax benefits that can make them an attractive option for certain investors. For example, policyholders may be able to defer taxes on investment gains until they withdraw funds from the policy, or they may be able to escape taxation altogether if the policy is structured at the onset to do so or if the policy is held until the death of the insured.[2][3]

Because PPLI policies are highly customizable and complex, they are typically sold through private placements, meaning they are only available to a limited number of investors who meet certain criteria. As a result, PPLI policies are not regulated by the same laws and regulations that

[1] Private placement products offered by U.S. carriers to U.S. persons are subject to SEC regulations. Each purchaser generally must be a "qualified purchaser" under §2(a)(51) of the Investment Company Act of 1940, 15 USC §80a-2(a)(51), and/or an "accredited investor" under §501(a) of Regulation D of the 1933 Act, 17 CFR §230.501(a). A "qualified purchaser" is an individual or a family-owned business that owns \$5 million or more in investments. An "accredited investor" is anyone who meets one of the below criteria: Individuals who have an income greater than \$200,000 in each of the past two years or whose joint income with a spouse is greater than \$300,000 for those years, and a reasonable expectation of the same income level in the current year.

[2] Income tax-free loans available if policy is structured as a non-Modified Endowment Contract. Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

[3] IRC §101(a)(1)

govern traditional life insurance policies, and they may involve higher fees and costs than other insurance products.

PPLI differs from traditional life insurance in several ways. First, with PPLI, each party to the transaction functions in the role to which they are best suited instead of the life insurance company handling most, or all, functions. For instance, with most retail policies, the insurer accepts and holds the premium in its general account. The retail insurer then makes all the investment decisions about how to invest the premium and how much of the yield to share with the policyholder. All policy assets held in the insurer's general account are subject to the claims of any creditors.

On the other hand, with PPLI, the insurer holds a policy's premium separate from its general account where it is segregated and not reachable by the insurer's creditors. This layer of creditor protection and the knowledge that the financial fortune of their investments is not dependent upon the financial fortune of the insurer is a top reason why PPLI is so attractive to affluent individuals.

Another difference between PPLI and retail insurance is the PPLI insurer's ability to accept the policyholder's choice of investment manager and custodian to choose how to invest and hold the premium, which becomes the policy's cash value. [4] The PPLI insurer continues to provide the life insurance policy structure but, unlike a retail insurer which retains much of the death benefit risk, a PPLI insurer reinsures most of the death benefit risk with major, highly rated reinsurance companies. In other words, because there is a sophisticated policyholder who has access to professional investment management, most of the risk of making sure the policy performs is shifted from the insurer to the policyholder.

Perhaps one of the most recognized benefits and advantages PPLI has over retail life insurance is its lower, institutional pricing. Where retail insurance products such as whole life and universal life have higher expense loads and a lack of transparency, PPLI is priced and bundled like an investment. Fees and costs are clearly listed and, unlike most retail insurance products which carry surrender charges for as long as twenty years, PPLI policies generally do not carry surrender charges and can be surrendered without a penalty.

[4] IRC §817(c). A "separate account" is a separate set of financial statements held by a life insurance company, maintained to report assets and liabilities for particular products that are separated from the insurer's general account. Detailed statutory financial statement data and disclosures regarding the products and assets captured in a separate account can be found in SSAP No. 56—Separate Accounts

Lesson #2

Who is Private Placement Life Insurance For?

PPLI is reserved solely for an accredited investor and/or qualified purchaser^[5] - an individual or entity who is allowed to deal, trade and invest in financial securities and satisfy one or more requirements regarding income, net worth, asset size or professional experience.

PPLI enables policyholders to take advantage of investment products not available in retail insurance, like private equity funds or hedge funds, and defer or escape all income taxation that would otherwise have been paid on the realized gains on those assets. In effect, policyholders have the ability to invest in a completely tax-free environment.

PPLI policyholders are interested in the range of benefits offered, including tax-deferred growth, asset protection, and enhanced privacy. These benefits are often helpful in meeting a policyholder's unique planning needs and goals, such as providing for family members, funding charitable gifts, or supporting a business succession plan.

Increasingly, PPLI is being used by affluent families to transfer wealth more efficiently by combining an investment strategy with estate planning. By incorporating PPLI into a multi-generational trust structure, a family can enhance the tax efficiency of the investments underlying the policy. Upon the passing of the insured, the policy's income tax-free death benefit essentially provides a step-up-in-basis at death for the underlying investments.

Businesses and family offices use private placement to informally fund executive benefit programs, support business succession planning and key person retention programs and to invest institutional capital efficiently. ^[6] When incorporated into business planning, a PPLI policy's

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^[6] IRC §101(a)

death benefit can be utilized to recover the costs, including the time value of money, of employee benefit programs.

Those considering PPLI typically have one or more of these characteristics:

- Desire a long-term tax diversification strategy.
- Want to enhance tax efficiency on investments.
- Seeking to make tax efficient investments following a liquidity event.
- Interested in future, supplemental income.
- Have an established wealth transfer trust with liquidity.
- Seeking to make an investment in alternative assets.
- Have a need for life insurance for estate and wealth planning.
- Planning to gift to charity.

Lesson #3

How is Private Placement Life Insurance Used?

PPLI can be used in a variety of ways, depending on the policyholder's specific financial goals and objectives. Here are a few common uses of PPLI:

1

Estate Planning

PPLI can be used to transfer wealth to future generations while minimizing estate taxes. The policyholder can create an irrevocable life insurance trust ("ILIT") to own the policy and to receive the death benefit, which removes the policy's death benefit from their taxable estate. Investments held within a PPLI policy receive a step-up in basis at the death of the insured in the form of the income tax-free death benefit.

2

Asset Protection

PPLI can provide a high level of asset protection for policyholders, especially if they are concerned about lawsuits or creditor claims. Depending upon the state, the policy's cash value is generally protected from creditors and is not subject to attachment or garnishment.

3

Charitable Giving

PPLI can be used to fund charitable gifts or create a legacy for a favorite charity. The policyholder can name the charity as the policy's beneficiary or transfer ownership of the policy to the charity.

4

Business Succession Planning

PPLI can be used to fund a buy-sell agreement or other business succession plan. The policy's death benefit can provide liquidity to help facilitate a smooth transition of the business to the next generation.

5

Tax-Deferred Growth

PPLI policies offer tax-deferred growth on the policy's cash value, which can help policyholders accumulate more wealth over time.

6

Tax Diversification Strategies

PPLI policies can enhance the tax efficiency of highly tax inefficient investments such as hedge funds, private equity and other alternative assets. This allows a policyholder to reduce risk in an investment portfolio while still including these asset classes

These are just a few examples of how PPLI can be used. To determine whether PPLI is appropriate for a prospective policyholder's specific needs and goals, it's important to work with an insurance company and financial advisor or life insurance professional who specializes in these products.

Lesson #4

Types of Permitted Investments Underlying a Private Placement Life Insurance Policy

PPLI can permit a variety of investment types, depending on the insurance company offering the policy and the investment strategy chosen by the policyholder.

Some common types of investments that can be held within a PPLI policy include:

1. Equities: PPLI policyholders can invest in stocks of publicly traded companies or private equity funds.
2. Fixed Income Investments: These include bonds, fixed-income securities, and other debt instruments.
3. Alternative Investments: PPLI policies can allow investment in alternative assets such as hedge funds, private equity, real estate, and commodities.
4. Cash and cash equivalents: PPLI policies can hold cash and cash equivalents such as money market funds.

The Internal Revenue Code ("IRC") lays out the treatment of variable life insurance and annuity contracts in Section 817 and authorizes two types of investments by a variable policy, including a PPLI policy: an Insurance Dedicated Fund ("IDF") and/or a Separately Managed Account ("SMA"). Registered investment advisors ("RIAs") and fund managers typically engage fund administrators, such as industry leaders SALI Funds Services and Spearhead, LLC, to form IDFs and SMAs in order to attract PPLI policy investment.

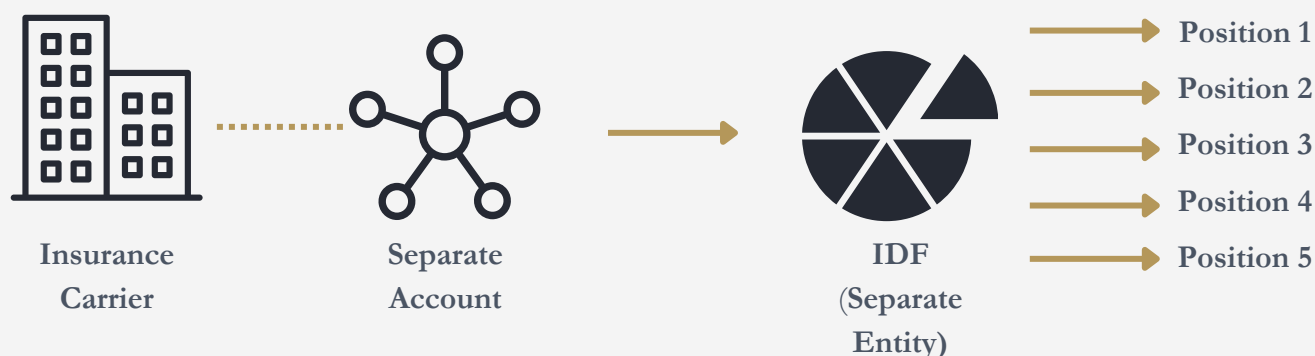
Historically, until the last decade, IDFs were utilized almost exclusively as PPLI policy investments. SMAs have emerged in popularity as RIAs and family offices have come to recognize the tax benefits of PPLI and seek to deploy customized portfolio strategies within policies.

Insurance Dedicated Funds

IDFs are private investment funds open to subscription to insurance carriers only for further allocation to PPLI policy accounts. IDF are stand-alone funds and must be separate legal entities from the life insurance carrier and its general account investments.

Structurally, IDFs have a number of important characteristics:

- An IDF is a private fund formed as an LLC that is only open to subscriptions from life insurance companies on behalf of their issued private placement policies.
- The number and asset value of an IDF's investment positions must meet the Diversification Test for variable contracts.
- Fund managers are permitted to create an IDF-equivalent of a taxable strategy they offer separately, as long as the investment decisions of the IDF are made by the advisor of such IDF in their sole and absolute discretion.
- In general, the carrier or independent investment advisor engaged by the carrier will select IDFs for subscription on behalf of the policy.
- Some carriers allow policy owners to influence the allocation of their policy's investment funds among a pre-determined set, or platform, of carrier-approved IDFs.
- Other carriers require IDFs to be selected by an independent investment adviser.
- In all cases, policyowners may not direct or control the investment activity of an IDF held in their policy, directly or indirectly as directed by the Internal Revenue Code's Prohibition Against Investor Control Doctrine.[7]



[7]Webber v. Commissioner (T.C., No. 14336-11, 144 T.C. No. 17, 6/30/15)

IDF Costs

The cost to establish an IDF varies depending on whether a fund utilizes internal or external legal support in developing the legal structure. The industry norm is to engage a cost-effective vendor where set-up fees can be as low as \$36,000.[8]

On-going administration fees for access to the vendor's platform are based on an IDF's assets under management ("AUM") and are commonly in this range:

AUM:

- < \$49,999,999 million is 0.15% per year
- \$50 million to \$149,999,999 million is 0.10% per year
- > \$150 million is 0.05% per year

subject to a minimum fee of \$2,500 per month.[9]

IDF costs do not include sub-advisor fees nor agent compensation. These additional fees are also deducted from a PPLI policy's cash value.

Separately Managed Accounts

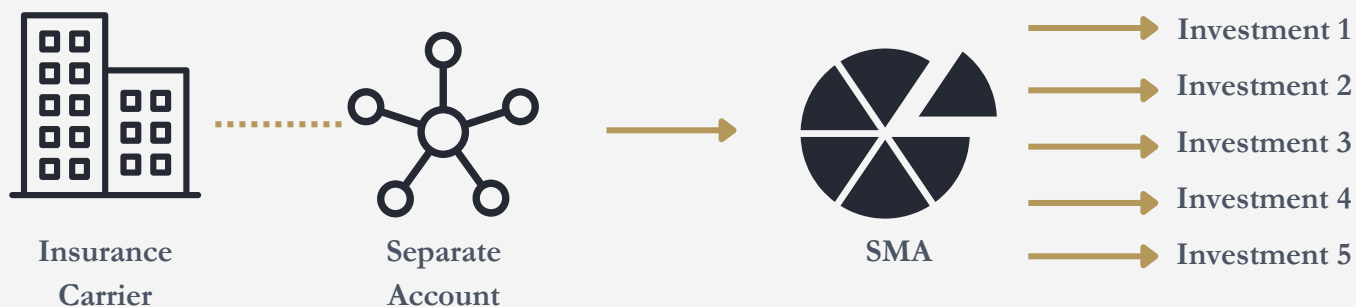
A SMA allows an independent investment advisor to access the broadest possible range of investments for the policy account, including marketable securities, structured notes, ETFs, hedge funds, private equity and other alternative investment strategies. Structurally, a SMA in a PPLI transaction is no different than a SMA an investor would purchase within their investment portfolio.

However, due to the tax benefits of a PPLI, a SMA comprised of highly tax-inefficient investments is commonly held under a policy.

SMAs are subject to the same diversification requirements and prohibition against investor control as IDFs.

[8] Judas, J. C., & Fontanini, M. (2022, January 20). PPLI Market Report. Retrieved February 19, 2023, from <https://www.lifeinsurancestrategiesgroup.com/post/u-s-ppli-market-report>

[9] Judas, J. C., & Fontanini, M. (2022, January 20). PPLI Market Report. Retrieved February 19, 2023, from <https://www.lifeinsurancestrategiesgroup.com/post/u-s-ppli-market-report>



SMA COSTS

On-going administration fees are based on an SMA's AUM and are commonly in this range:

AUM:

- < \$49,999,999 million is 0.10% per year
- \$50 million to \$149,999,999 million is 0.08% per year
- > \$150 million is 0.06% per year

subject to a minimum fee of \$2,500 per month.[10]

Pricing is generally “program-based” – based on a sub-advisor’s total assets across all policies. SMA costs do not include investment management or sub-advisor fees nor agent compensation. These fees are also deducted from a PPLI policy’s cash value.

[10] Judas, J. C., & Fontanini, M. (2022, January 20). PPLI Market Report. Retrieved February 19, 2023, from <https://www.lifeinsurancestrategiesgroup.com/post/u-s-ppli-market-report>. Spearhead will charge the Sub-Advisor a one-time retainer of \$5,000 upon engagement to draft the SMA's legal documentation, complete Sub-Advisor due diligence and background checks, and to onboard the SMA Sub-Advisor onto the appropriate insurance carrier investment platform(s). This fee is credited back to the Sub-Advisor against Spearhead's monthly administration fee.

Lesson #5

The Diversification Rule

The Variable Life Insurance Diversification Requirement is a regulatory rule established by the U.S. Securities and Exchange Commission ("SEC") that requires variable life insurance policies to invest in a diversified pool of securities.[11]

Under the SEC's rule, variable life insurance policies must invest in a range of securities, which typically includes stocks, bonds, and other types of investments, to reduce the risk of loss to policyholders. The rule applies to PPLI and requires that no more than 55% of the value of the total assets of the account is represented by any one investment with increasing thresholds for additional investments: no more than 70% of the value for two investments; no more than 80% of the value for three investments; and, no more than 90% of the value for four investments.

Specific to each IDF, the Treasury Regulations contain a "look-through" rule for partnerships that allow a segregated account to look through an IDF to its underlying investments for purposes of satisfying the Test. This differs from the application of the test for a SMA where the Test is satisfied based on the number of assets and asset value held within the SMA. Given that most SMAs created by professional managers have dozens, if not hundreds of investments, the Test is easily met.

In other words, a policyholder may choose one IDF and meet the Test as long as the IDF itself has at least five different investments meeting the threshold asset value percentages. When a SMA is used, there is not a look-through and the policy must have at least five, individual investments and meet the threshold asset percentages.

Proper diversification must be met by the first anniversary of the policy (a longer period is permitted for investments made into specific classes of real estate). At the end of each quarter, diversification is tested and is confirmed by the investment manager to the insurer. If a policy fails a quarterly diversification test, there is a 30-day cure period.

[11] Treasury Regulations §1.817-5

If a failure of the diversification test is not cured, the policy may be deemed to not be life insurance and all the tax benefits of life insurance lost. This could result in the retroactive assessment of taxation at ordinary rates, plus fees and interest, on any investment growth in the separate account.

It is important to note that a policy does not fail the diversification test if individual investments gain or lose value without the actions of the policyholder or investment manager making investment purchases, sales or trades.

In addition to the diversification requirement, the SEC also requires that variable life insurance policies provide detailed information about the investment options available within the policy, as well as the risks and fees associated with each option.

By requiring variable life insurance policies to be diversified, the SEC aims to protect policyholders from the risks associated with investing in a single security or issuer. The rule also helps to ensure that variable life insurance policies provide a level of investment risk that is appropriate for the policyholder's investment objectives and risk tolerance.

Lesson #6

The Prohibition Against Investor Control Doctrine

The PPLI Investor Control Doctrine is a legal concept that defines the level of control a policyholder has over the investments held within a PPLI policy. The doctrine establishes that for a PPLI policy to qualify for favorable tax treatment, the policyholder must not have "investor control" over the policy's underlying assets.

The doctrine was established through a series of court cases and IRS rulings that established certain requirements for PPLI policies to qualify for tax-deferred treatment. Under the doctrine, the policyholder must not have control over the investment decisions made within the policy so as to not be considered the "real" owner of the underlying assets.

The investor control doctrine is designed to prevent PPLI policies from being used solely as a tax-avoidance strategy. By requiring the policyholder to not have control over the investments held within the policy, the Doctrine ensures that PPLI policies are used primarily for their intended purpose of long-term planning and not as an actively traded investment account.

Thirty years of Private Letter Rulings ("PLRs") issued by the IRS clarified what a policyholder could and could not do with respect to making policy investment decisions. A historical hide-and-seek game between the IRS and policyholders culminated in the U.S. Tax Court weighing in on the specifics of the Prohibition Against Investor Control Doctrine in *Webber v. Commissioner* (2015).[12]

In this case, the policyholder used premiums to purchase investments in start-up companies that the policyholder was closely aligned either via direct investments in the companies or through private equity funds that were managed by the policyholder. The Tax Court found the policyholder exercised his control over the policy's separate account through a not too elaborate "protocol" in which the policyholder's "investment advisor", accountant and lawyer acted as his intermediaries in the selection,

[12] *Webber v. Commissioner* (T.C., No. 14336-11, 144 T.C. No. 17, 6/30/15)

purchase and sale of the investments held in the policy account. As part of the evidence in the case, the IRS offered 70,000 emails to or from the taxpayer's investment manager, lawyer, accountant and insurance carrier containing his investment "recommendations", all of which were followed.

The Court in *Webber* highlighted three principles in determining whether a policyholder rather than the insurance company is the owner of the investment assets (and taxed as such):

1. Who has the power to select investment assets by directing the purchase, sale and exchange of particular securities?
2. Who has the power to vote the securities or exercise rights pertaining to the securities?
3. Who has the power to extract money from the account by a withdrawal or by other means?

Specifically, the owner of a variable policy, including a PPLI policy, cannot have an arrangement, contract, plan or agreement with the investment advisor to select or direct investments. The investment advisor must be permitted to make independent investment decisions, though, these decisions may be based upon the knowledge of a policyholder's general investment philosophy and risk tolerances.

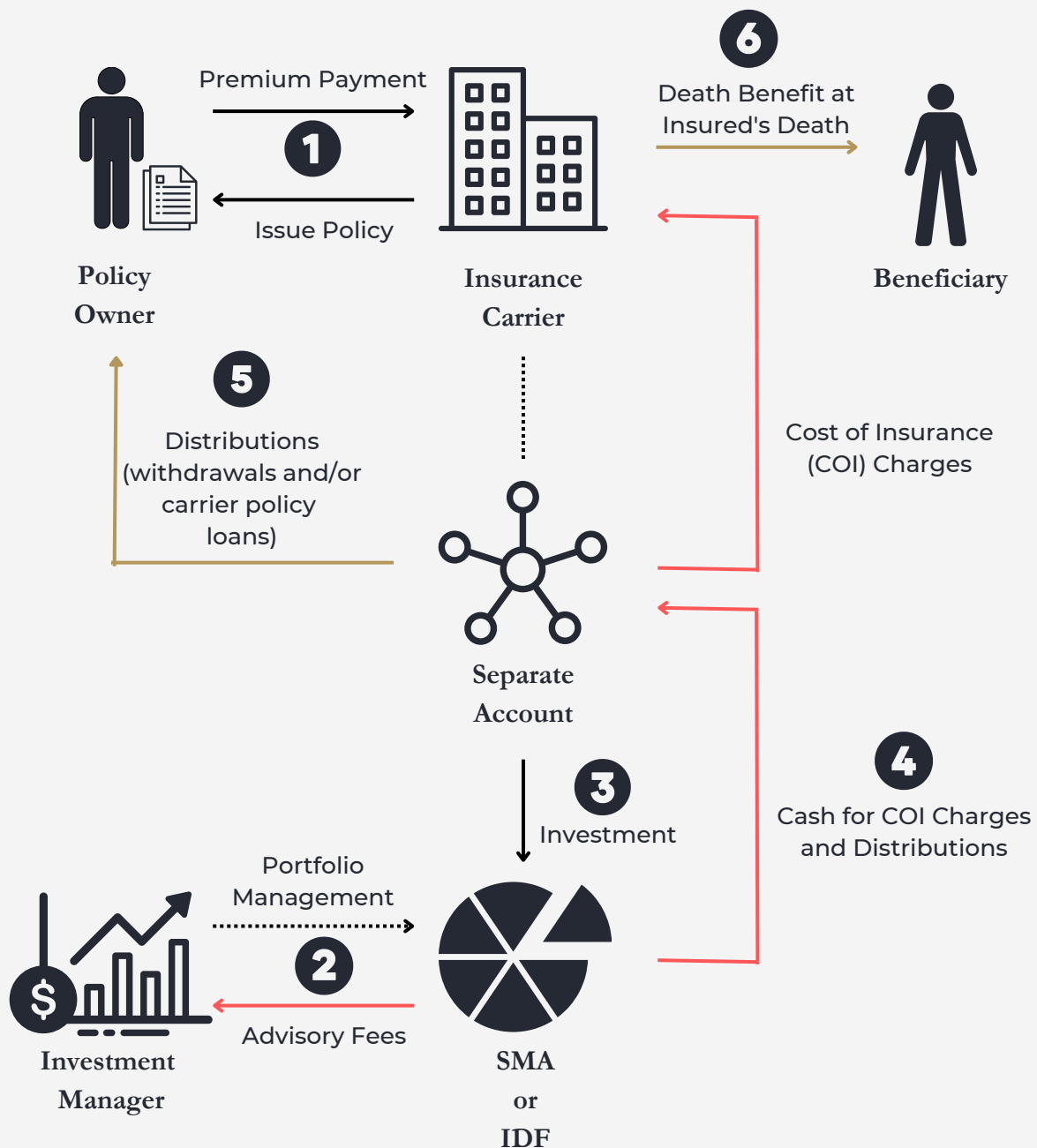
For instance, a policyowner may request a specific IDF or SMA but a policy's owner, insured or beneficiaries may not play a role in the selection of the IDF's investment positions nor the SMA's individual investments. Similarly, a policyowner may request a particular RIA and asset custodian, but the ultimate selection and ongoing retention of the RIA and custodian is fully discretionary for the carrier.

An investor control violation can result in the retroactive assessment of taxation at ordinary rates, plus fees and interest, on any investment growth in the segregated account.

Lesson #7

Elements of a Private Placement Life Insurance Transaction

PPLI Policy Structure



- 1 A policy is issued to the owner from the insurer after underwriting approval of the insured and acceptance by the owner, who then remits premiums to the carrier. Premium payments can be in the form of cash or in-kind (in-kind premiums such as property or securities in kind are subject to taxation on any gain in value at the transfer from the policyowner to the insurer's separate policy account).
- 2 Owner selects a SMA or IDF in which the cash value will be invested and managed by a desired RIA or similarly permitted Investment Manager. The cash value is held in a separate account, segregated from the carrier's general account assets, dedicated exclusively to the owner's PPLI policy, and not subject to the reach of the carrier's general creditors.
- 3 The separate account invests the existing cash value and new premium amounts into the SMA or IDF.
- 4 Cash is disbursed from the SMA or IDF to the separate account as needed where it may be held in a money market fund for payment of upcoming cost of insurance ("COI") charges and other contractually listed policy fees, disbursed to the policy owner if a withdrawal is elected or invested in a fixed account to be held as collateral if a policy loan has been advanced by the insurer to the policy owner.[13]
- 5 Owner has the choice to receive distributions from the separate account cash value in the form of withdrawals and policy loans which, if properly structured, can be income tax free.[14]
- 6 Upon the insured's death, the insurer will pay the death benefit proceeds, reduced by any prior withdrawals and outstanding policy loans, to the beneficiary designated by the owner which, if properly structured, can be income tax free.[15]

[13] PPLI carriers typically hold enough value upfront in the money market fund within the separate account to support the deductions for the anticipated policy charges over 12-month periods thereby necessitating a distribution from the SMA or IDF to cover policy charges only once per policy year. If a policy loan is made to the owner, policy assets may need to be sold in order to provide the insurer with the requisite liquidity to make the loan.

[14] Income tax-free loans available if policy is structured as a non-Modified Endowment Contract. Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

[15] IRC §101(a)(1)

Tax Attributes of a Private Placement Life Insurance (PPLI) Policy

Under current law, if properly structured, PPLI policies are treated like a traditional policy for tax purposes:

- Annual income on the policy (excess of the cash surrender value increase plus the cost of life insurance protection over the premiums paid for the taxable year) is not taxable to the owner if the policy meets the definition of life insurance.[16]
- Cash value can be distributed to, and without recognition of taxable income by, the policy owner if in the form of withdrawals up to cost basis and/or policy loans, the policy is held in force to the insured's death, and never becomes a Modified Endowment Contract ("MEC"). [17]
- Death benefit proceeds received by reason of the insured's death are not includible in the recipient's gross income if the policy has not been previously transferred for valuable consideration or involved in a transaction that was treated as a reportable policy sale.[18]

[16] IRC § 7702.

[17] IRC §§ 72, 7702A.

[18] IRC § 101, Treas. Reg. § 1.101-1.

Lesson #8

What Does a Private Placement Life Insurance Policy Cost?

PPLI is institutionally priced and typically has a lower cost structure than traditional life insurance products. A policyholder may expect the following policy fees:

Cost of Insurance: The pure cost of the death benefit required for the policy to meet the definition of life insurance. This cost is roughly the equivalent of the cost of obtaining a term insurance contract for one year, each year of the policy and at the age of the insured that year.

Set-Up or Establishment Fee: A premium-based fee charged each time a premium contribution is made to the policy. This fee can range from between 40 to 150 basis points, depending upon the total amount of premium paid.

Mortality & Expense ("M&E") Fee: An asset-based fee which is based upon the account value of the PPLI policy. M&E is an annual fee which an insurer may collect quarterly and ranges from between 40 to 150 basis points, depending upon the size of the policy contribution and estimated growth in the policies underlying investments.

Investment Management Fee: Charged at market rates and paid at the IDF and/or SMA 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.

Deferred Acquisition Charge ("DAC"): The amount of an insurer's acquisition costs incurred as premium is written but earned and expensed over the term of the policy. DAC for PPLI varies widely with the charge ranging from 70 to 100 basis points.

State Premium Tax: South Dakota enjoys one of the lowest state premium taxes in the country. On an annual basis, the first \$100,000 of premium paid is taxed at 2.5%. Premium paid above \$100,000 is taxed at just 8 basis points, or 8/100 of 1%.

Section 2:

Private Placement Variable Annuities

Lesson #9

What is a Private Placement Variable Annuity (PPVA)?

A Private Placement Variable Annuity ("PPVA") is the use of an annuity structure by an accredited investor and/or qualified purchaser to apply the tax benefits of an annuity to one or more single investments or to a customized portfolio.[19] A PPVA recharacterizes a highly tax-inefficient investment as an annuity so that the investments underlying the policy can grow tax-deferred until the investments are accessed as annuity income in the future.

PPVAs share many of the same attributes and are covered by much of the same legislation and regulations as PPLI but differs in structure and some applications. As an annuity, PPVA does not contain a life insurance death benefit component, and this means there is no medical underwriting and there are no premium limitations resulting from how much death benefit risk the insurance company can provide for each policy. Therefore, a PPVA contract holder can make unlimited contributions.

A PPVA differs from a traditional annuity in much the same way a PPLI policy differs from traditional life insurance. The insurer is responsible for arranging the annuity structure, leaving the choice of investment manager and custodian to the contract holder. The investment manager then instructs the insurance company on what underlying investments to make for the annuity. As with PPLI, the investments in a form of an IDF or SMA underlying a PPVA are held separate from the general account of the insurer and not subject to the insurer's creditors.[20]

Unlike a traditional annuity, a PPVA does not have features such as income guarantees or principal protection. As a result, PPVAs generally have substantially lower fees.

[19] Private placement products offered by U.S. carriers to U.S. persons are subject to SEC regulations. Each purchaser generally must be a "qualified purchaser" under §2(a)(51) of the Investment Company Act of 1940, 15 USC §80a-2(a)(51), and/or an "accredited investor" under §501(a) of Regulation D of the 1933 Act, 17 CFR §230.501(a). A "qualified purchaser" is an individual or a family-owned business that owns \$5 million or more in investments. An "accredited investor" is anyone who meets one of the below criteria: Individuals who have an income greater than \$200,000 in each of the past two years or whose joint income with a spouse is greater than \$300,000 for those years, and a reasonable expectation of the same income level in the current year.

[20] IRC §817(c). A "separate account" is a separate set of financial statements held by a life insurance company, maintained to report assets and liabilities for particular products that are separated from the insurer's general account. Detailed statutory financial statement data and disclosures regarding the products and assets captured in a separate account can be found in SSAP No. 56—Separate Accounts.

Lesson #10

Who is a Private Placement Variable Annuity For?

A PPVA is for affluent individuals and families who are interested in making tax-inefficient investments in a tax-efficient environment. PPVA is most often viewed as a wealth management structure and a savings tool to allow a contract holder to reduce taxation on funds earmarked for the future.

By investing in asset classes that typically result in mostly short-term capital gains and ordinary income tax treatment, a PPVA contract holder can defer taxation until the investments underlying the PPVA are accessed as annuity income in the future.

Like a MEC life insurance contract, distributions from an annuity before the owner is age 59 ½ faces a federal 10% excise tax.[21] Beyond this age, when distributions are made, only the earnings are taxed at ordinary income tax rates.

[21] IRC §72(q)

Lesson #11

Applications of Private Placement Variable Annuities

PPVAs are popular for those high-income individuals who intend to retire to a lower tax jurisdiction. For example, a New York State resident who plans to move to Florida can defer the income tax on their investment gains until they have relocated to a lower-tax jurisdiction, at which time they would take distributions and pay a lower effective tax rate.

Another application of PPVAs is for those who are interested in investing into hedge funds and other alternative asset classes. Many of these investments are highly tax-inefficient. Under a PPVA, taxes on these investments can be deferred.

PPVAs are also favored by individuals and families who intend to leave assets to a public charity or a private foundation at their death. If a charitable entity is named as the beneficiary of a PPVA, all of the deferred investment gains can be distributed tax-free to the charity. Unlike other charitable strategies that are irrevocable in nature, a PPVA remains under the full ownership and control of the contract owner and of the contract owner's surviving spouse throughout their lifetimes.

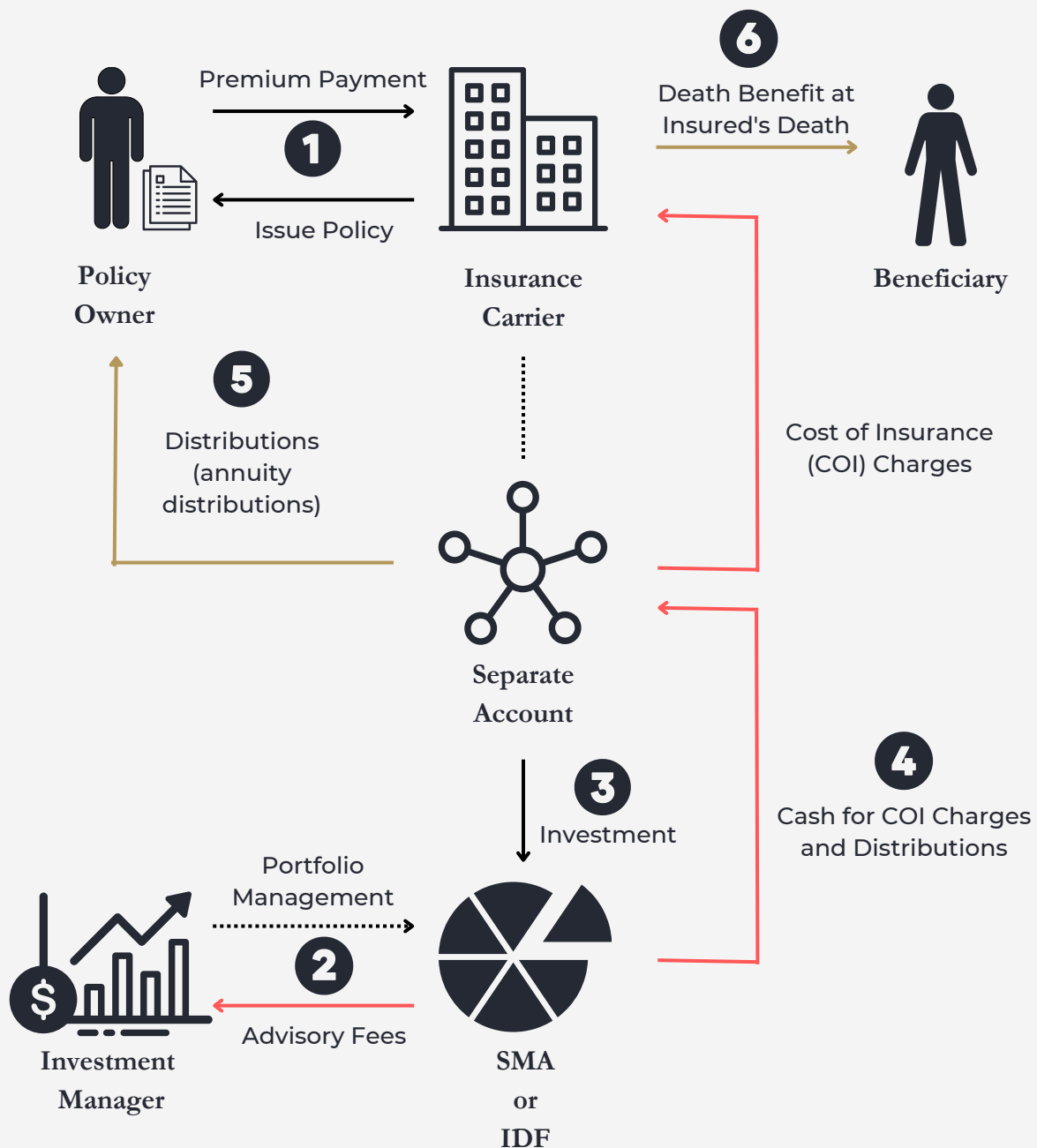
For tax-exempt institutional investors, a PPVA eliminates unrelated business taxable income ("UBTI").^[22] Taxed at corporate rates, UBTI can be somewhat lowered by the use of expensive and complex offshore corporate blockers. However, if a tax-exempt organization such as an endowment, pension, charity or foundation makes an investment into a UBTI generating asset through a PPVA, the investment and any distributions are recharacterized as an annuity and annuity income, respectively.

^[22]IRC §§1.512(b)-1(a) & 72(u) (Subchapter L). PLR 2002060047 & PLR 9708022

Lesson #12

Elements of a Private Placement Variable Annuity Transaction

PPVA Contract Structure



- 1 A PPVA contract is issued to the owner from the insurer after the insurer approves the application and the owner remits premiums to the carrier. Premium payments can be in the form of cash or in-kind (in-kind premiums such as property or securities in kind are subject to taxation on any gain in value at the transfer from the contract owner to the insurer's separate contract account).
- 2 Owner selects a SMA or IDF in which the contract's account value will be invested and managed by a desired RIA or similarly permitted Investment Manager. The cash value is held in a separate account, segregated from the carrier's general account assets, dedicated exclusively to the owner's PPVA contract, and not subject to the reach of the carrier's general creditors.[23]
- 3 The separate account invests the existing account value and new premium amounts into the SMA or IDF.
- 4 Cash is disbursed from the SMA or IDF to the separate account as needed where it may be held in a money market fund for payment of listed contract fees, disbursed to the contract owner if a distribution is elected. [24]
- 5 Owner has the choice to receive distributions from the separate account cash value in the form of withdrawals, subject to a 10% federal excise tax on distribution made before the contract owner is age 59 ½.[25]
- 6 Upon the annuitant's death, the insurer will pay the PPVA contract's proceeds to the beneficiary designated by the owner.

[23] IRC §817(c). A "separate account" is a separate set of financial statements held by a life insurance company, maintained to report assets and liabilities for particular products that are separated from the insurer's general account. Detailed statutory financial statement data and disclosures regarding the products and assets captured in a separate account can be found in SSAP No. 56—Separate Accounts.

[24] PPVA carriers typically hold enough value upfront in the money market fund within the separate account to support the deductions for the anticipated contract charges over 12-month periods thereby necessitating a distribution from the SMA or IDF to contract policy charges only once per policy year.

[25] IRC §72(q)

Disclosures

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