Private Placement Life Insurance and Annuities:

An Alternative Wealth Planning Strategy

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What are PPLI and PPVA?

Private Placement Life Insurance (PPLI) is a non-SEC registered flexible premium, variable life insurance policy. A Private Placement Variable Annuity (PPVA) is a non-SEC registered flexible premium, deferred variable annuity. If a US taxpayer is involved, the contract must be U.S. compliant under IRC §7702 regarding the definition of life insurance and IRC §72 for annuities. PPLI and PPVA policies are issued by both domestic (US) life insurance companies and offshore life insurance.

Not every domestic life company provides a private placement product, but many of the larger companies do. Some US life insurance companies have created offshore subsidiaries to offer offshore private placement products worldwide. Other offshore companies were created to target the US tax-compliant insurance market. Many of the offshore life companies are located in Bermuda and the Caribbean, but companies offering private placement life insurance and annuities may also be domiciled in international financial centers like Switzerland, Luxembourg or Singapore.

An offshore life company may apply for the IRC §953(d) election, which authorizes non-US-based life insurance companies to elect to be treated and taxed the same as US-based life insurance companies. Because of the historically high premiums dedicated to private placement products, the 953(d) election could result in significant savings for the US taxpayer client when compared with an offshore life company that has not chosen the election.

US taxpayers making premium payments to non-953(d) election life companies are obliged to pay a 1% federal excise tax (FET) on all new premiums. The minimum private placement premium is generally $1 million and several policies are issued in the hundreds of millions of dollars, so application of the 1% excise tax will be an important consideration. However, 953(d) companies may charge a Deferred Acquisition Charge (DAC) for PPLI premiums, but the DAC is generally less than 1% and not applicable at all on PPVA contract premiums. Other cost considerations are the life insurance company's Mortality & Expense Charge (M&E), Cost of Insurance Charges (COI) and broker fees. Since offshore policies are issued outside of the US, there is no US state premium tax. M&E and broker fees may be negotiated for larger premium commitments and your broker may even be able to deliver aggregate pricing for multiple family members investing in separate policies with the same insurer and owned by a common trustee.

In spite of the costs described, the tax advantages of offshore private placement products may outweigh the drag on the investment by policy charges, especially where domestic policies are concerned and with annuities that are issued without cost of insurance charges. As with any US domestic life insurance or annuity product, investment gains within PPLI and PPVA grow tax-deferred, whether the life company is onshore or offshore, and whether the issuing life company has elected 953(d) status or not. By staggering premiums over four to seven years, PPLI policies may be structured so that much of the policy cash values may be paid to the policyowner during the insured's lifetime through income tax-free withdrawals to basis and low cost, income tax free policy loans. Life insurance death benefits are paid income tax-free to the beneficiary and are generally free of probate, but additional planning is required if the life insurance death proceeds are to be removed from the taxable estate for federal estate tax purposes.

If no distributions are made, no Form 1099 will be issued by the life insurance company. It is important to note that if a US taxpayer buys a foreign life or annuity policy that is non-compliant with IRC §§7702/72, most of the US tax advantaged benefits will not be applicable and taxes and penalties may be applied for any investment gains on assets held within such contracts.

PPLI may be used within an irrevocable life insurance trust (ILIT) to settle federal estate taxes or other death duties. However, while death benefits are paid with PPLI and PPVA products, protection against financial loss due to the unforeseen death of the insured is generally not the primary motivation for their purchase. Clients may find traditional life insurance products more appropriate where a high level of death benefit is desired.

Offshore PPLI and PPVA products are used primarily as wealth accumulation tools for the high and ultra-high net worth individual client, which may include, but not necessarily be limited to the following scenarios:

US taxpayers who wish to invest in foreign hedge funds without incurring the reporting requirements, taxes and penalties associated with *Passive Foreign Investment Companies* (PFICs)

The client would make a premium payment to the offshore life company and the company would invest the premiums. Because the offshore life insurance company becomes the actual owner of the policy assets (the policyowner is issued a compliant life insurance or annuity policy representing and reflective of the values of the underlying assets within the policy), the investment manager's client is a Foreign Person, therefore not subject to PFIC reporting or restrictions. As long the investment manager respects Diversification under IRC §817(h) and the Investor Control Doctrine, worldwide investment opportunities may become available to the policyowner on a tax-advantaged basis. Diversification generally means that the investment manager must invest in at least five different investments structured so that no one investment exceeds more than 55 percent of the contract account value. Then, no two investments may represent more than 70 percent, no three more than 80 percent and no four investments can amount to more than 90 percent of the contract account value. Since policy charges are deducted directly from account values, the account must always maintain a certain amount of cash to allow for those deductions. Investor control basically means that the investment manager of the policy contract values must manage those assets at his complete and sole discretion without direction or interference by the policyowner or the measuring life (insured or annuitant). The United States Tax Court extensively discussed the Investor Control Doctrine in Webber v. Commissioner, T.C., No. 14336-11, 144 T.C. No. 17, 6/30/15

Pre-immigration planning for non-US persons immigrating to the US

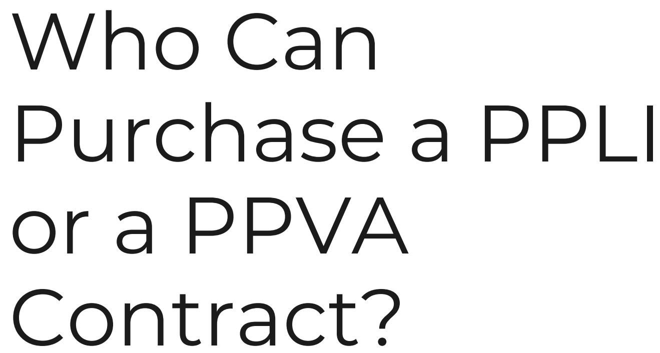
Many immigrants are very wealthy individuals with significant assets that most likely include foreign collective investments. Whether the immigrant is transferred by the employer to work in the US or they are entering the US or on any number of Visas, the immigrant will be subject to tax on worldwide income and investment gains when they become a full US taxpayer, including when a Green Card is obtained. Wrapping assets

beforehand in a PPLI or PPVA would shelter any undistributed investment gains while the client is a US resident taxpayer. When the client is no longer subject to US income taxes, the PPLI or PPVA policy may be collapsed without payment of US taxes or surrender charges. This is an ideal strategy for foreign athletes, entertainers or executives with significant assets who intend to spend a defined period in the US. These cases should be written through non-953(d) insurance companies to avoid US withholding and reporting upon surrender. The 1% federal excise tax would not apply if the applicant were not a US taxpayer when the contract was concluded.

Trustees of foreign non-guarantor trusts (non-US) with US beneficiaries

Foreign non-grantor trusts must make distributions of Distributable Net Income (DNI) to US beneficiaries. If the trust doesn't distribute or hasn't been distributing for some time, the trust will accumulate potentially severe tax consequences relating to Undistributed Net Income (UNI). PPLI and/or PPVA are ideal "wrappers" for the investments held by the trustee to deal with these issues. The tax-deferred status of the products allow the trustee to avoid mandatory distributions of DNI and a large death benefit PPLI policy could be used to pay UNI taxes and penalties that have already accumulated within the trust.

Investment flexibility, lower policy charges than US domestic life policies, no surrender charges and segregated account or protected cell legislation in select foreign jurisdiction (e.g. assets held within a Bermuda or Grand Cayman issued PPLI or PPVA contract are not part of the general account of the insurance company. If the life company fails, the policy's account values are not subject to the claims of the insurance company's creditors) are all reasons to consider offshore private placement products. However, no one should enter into a private placement contract without first securing competent legal and tax advice. It is essential as well that the client secure the services of a qualified, compliant international insurance broker and investment manager that understand these very complex issues, especially when a US taxpayer client is involved.



Who Can Purchase a PPLI or a PPVA Contract?

PPLI and PPVA are non-registered securities for federal and state securities law purposes. Therefore, the products are available to accredited investors and qualified purchasers as defined by federal securities law. The Securities Act of 1933 provides exemptions under §4(2) from securities registration for "accredited investors" as defined in Rule 501(a) of Regulation D under the Securities Act. An accredited investor is defined as an investor with a net worth of at least $1 million and joint income of at least $300,000 in each of the last two years, with the likelihood of continuation in the current year.

PPLI offerings are exempt from the Investment Company Act of 1940 under §3(c)(1) and § 3(c)(7) offerings. Under §3(c)(1) the number of beneficial owners is limited to 99 investors. Investors must be accredited investors or qualified purchasers. A qualified purchaser has investible assets of at least $5 million, excluding the value of an investor's principal residence from investable assets.. Under §3(c)(7) the number of beneficial owners is limited to 499 investors and theinvestors must be qualified purchasers.

If the client desires to purchase a PPLI or PPVA contract from an international/offshore carrier:

- The solicitation must occur outside the United States, and
- All underwriting, including the medical exam if needed, must occur outside the United States.

What are the Differences Between a Domestic Carrier and an Offshore Carrier?

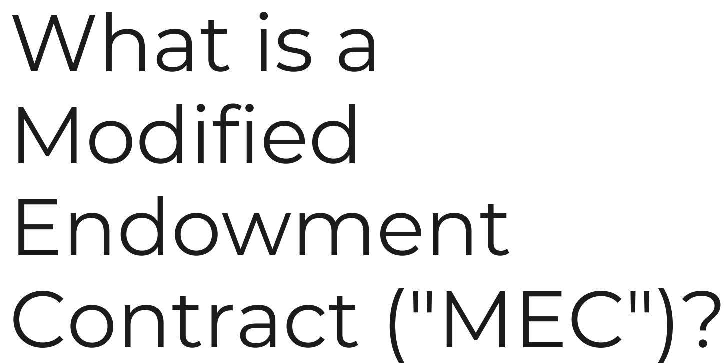
A PPLI policy or a PPVA contract may be purchased from either a domestic or offshore carrier. The table below will highlight some of these differences:

	Domestic Carrier	953(d) Carrier	Non-953(d) Carrier
Carrier subject to US federal corporate income tax	Yes	Yes	No
Subject to U.S. W/H on U.S. source investment income	No	No	Yes
Subject to U.S. Excise Tax on US Risks	No	No	Yes
Carrier Reporting to IRS on Policy Income Distribution	Yes	Yes	No
Carrier subject to W/H on Policy Income Distributions	Depends	Depends	No
PPLI considered a "security" for regulatory purposes?	Yes	No	No
Sell US Compliant Policies?	Yes	Yes	Yes
Is the Policy Filed with the Regulatory Authorities?	Yes	No	No
Use of U.S. IDFs?	Yes	Yes	No (Yes if solely for this carrier)
Use of Foreign IDFs?	Depends on PFIC View	Depends on PFIC View	Yes
Use of foreign hedge funds in managed accounts?	Depends on PFIC View	Depends on PFIC View	Yes
Separate Account Legislation	Yes	Depends	Depends

Below are some other differences between domestic and offshore transactions:

Domestic	Offshore
Policy written by a US compliant insurance carrier	Policy written by foreign carrier, located in your select offshore jurisdiction
Qualifies as life insurance under IRC §7702	Qualifies as life insurance under IRC §7702
Follows state insurance regulations	Not subject to state insurance regulations
Subject to state premium taxes	Not subject to state premium taxes
Transaction conducted in the US	Transaction must occur where offshore company is licensed or approved
Compensation flows through a broker/dealer	Compensation is paid to an offshore entity and offshore bank account
Distributor must be variable insurance licensed	Can provide additional creditor protection, if properly structured

What is a Modified Endowment Contract ("MEC")?



§7702A provides that a modified endowment contract (MEC) is a life insurance policy that is over-funded in the initial years of its existence based upon the timing and amount of premiums paid in relation to its death benefit. The MEC rules are essentially designed to discourage policy premium front-loading in the manner in which Congress believes too closely resembles the way an investor would make his or her investment in an annuity product.

The determination of whether a life insurance policy is an MEC is based on complex actuarial calculations and what is known as the "seven-pay" test.

Generally, a policy is a MEC where, for example, the cumulative premiums paid at any time during the first seven years of the contract exceed the sum of the maximum net level premiums that could have been paid on or before such time, if the contract provided for paid-up future benefits after the payment of seven level annual premiums.

Effectively, this test requires that the premiums paid into the policy be made over several years, as opposed to a single up-front payment. The seven-pay test, in most situations, can be passed for a premium payment period of only four years.

The following repercussions arise following characterization of a life insurance policy as an MEC:

- Loans taken from or secured by the policy are generally deemed to be distributions of earnings from the policy.
- All distributions, including payments upon the lapse or surrender of a MEC policy, are generally taxable as ordinary income up to the amount by which the cash surrender value of the policy exceeds the cumulative amount of premiums paid into the policy.
- A 10% additional income tax is imposed on all distributions made prior to the insured attaining age 591/2- provided, however, that this penalty shall not apply where the insured is disabled, or where such distributions are part of a series of substantially equal periodic payments extending over the life of the taxpayer.

Where an insurance policy is not characterized as a MEC, loans can generally be made from the policy on a "tax-free" basis. This result will ordinarily still be achieved in cases where the cumulative loans are in excess of the cumulative premiums paid into the policy.

The policy's cost basis is its cumulative premiums. Loans and partial surrender of the cash value are the primary mechanism whereby the policy owner is permitted to have access to a portion of the investment account during the insured's lifetime. As such, non-MEC status is critical importance in order to obtain the full benefits of this planning.

How Does PPLI and PPVA Provide Customized Investment Options Within the Policy or Contract?

One of the principal advantages of PPLI and PPVA is the ability to customize investment options within the policy. This process begins when the life insurer performs an investment due diligence review of the proposed investment manager. Some life insurers outsource this task to consultants with special asset classes. This due diligence review will consider the personal and business background of the investment principals; investment track record; assets under management; and business history, as well as business model.

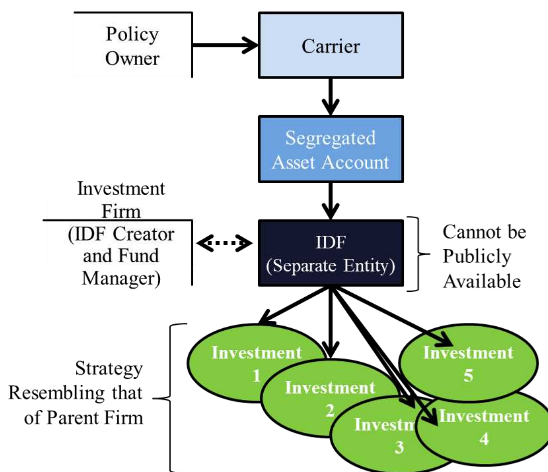
Following the creation of an insurance dedicated fund (IDF) by the investment firm, the life insurer will sign a participation agreement to subscribe to the fund.

The investment manager is responsible for certifying to the life insurer on a quarterly basis that it has met the investment diversification requirements of §817(h) and is in compliance with the investor control doctrine. The investment manager will normally report the net asset value of the policyholder's investment on a monthly or quarterly basis depending upon the underlying investment strategy.

The PPLI private placement memorandum (PPM) may be amended on an ongoing basis to add new investment options. These amendments normally do not require any advance filing with the department of insurance within the jurisdiction where the policy was issued or the insurer's domicile.

A second investment option underlying a PPLI or PPVA contract is a Separately Managed Account (SMA). Where a single IDF is permissible within a contract due to its legal structure and ability to meet proper diversification inside the fund, the investments within a SMA must meet the Diversification thresholds as previously described. The type of investments permitted in a SMA under a PPLI or PPVA vary greatly and may include direct investments into a fund, LP interest in a LLC or a third-party promissory note. Equally as important as meeting Diversification is the requirement for discretionary management to adhere to the Investor Control Doctrine.

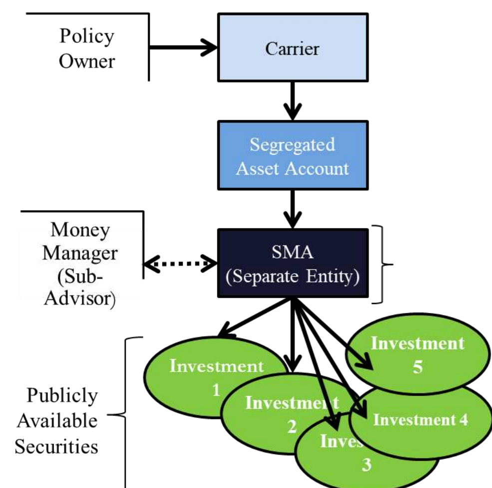
Investment Structure Using Insurance Dedicated Funds:



- The Separate Account only invests in Insurance Dedicated Funds
- Policy assets are owned by the insurance company's separate account
- Managers must pass carrier's due diligence
- Manager is responsible for diversification testing, compliance, and reporting
- IDF legal structure provides "look-through" to underlying assets
- Manager must not proactively discuss the investments with the insured
- Manager has "sticky" insurance assets and opportunity for new money

Investment Structure Using Managed Accounts

- Carrier hires manager to manage assets
- Money manager can create and manage a portfolio on a client by client basis
- Top Level Managers (allocators) and any underlying money managers must pass carrier's due diligence
- Policy assets are owned by the insurance company's separate account
- Manager is responsible for diversification testing, compliance, and reporting
- Manager has sticky insurance assets and opportunity for new money
- Post issue, client must not direct the investments nor the money manager



About the Author

Robert R. Hall is the President and Chief Operating Officer of Hall International Insurance Strategies LLC.

Hall International Insurance Strategies LLC is an international insurance brokerage group that delivers global insurance solutions to high and ultra-high net worth clients. Robert has 45 years of experience in the insurance and financial services industry with 43 of those spent in Europe.

Many of Robert's US insurance solutions are also applicable to non-US persons with US and non-US tax and estate planning issues.

Robert is a specialist in offshore and US domestic private placement life insurance and annuities. He has spoken about his private placement wealth and estate planning strategies at several international events, including the Society of Trusts and Estate Practitioners, The American Bar Association and life insurance company forums.

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