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**Recent PLR Favorable for Investment Options of Separate Account Products**
**December 13, 2012**
**Bulletin No. 12-54**

**Major References:** PLR 201240018
**Related Reports:** 11-19, 03-75, 03-74

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***MARKET TREND: A market of relatively low yields and potentially high taxes favors a proactive approach to tax and life insurance planning as it relates to a client's investment portfolio. Accordingly, we will continue to see increasing interest in annuity and life insurance products, including separate account and private placement products, as investment alternatives that can help manage income tax exposure and offer non-correlated returns in the current market. SYNOPSIS: Annuity and life insurance products, including separate account and private placement products, may facilitate tax management, investment flexibility, asset protection, and financial privacy. Over the past few years, the IRS has issued several revenue rulings and private letter rulings, like PLR 201240018, which provide guidance that can assist carriers in creating tax-compliant investment options for separate account products. TAKE AWAY: IRS guidance continues to offer insight into the crafting of tax-compliant investment options for separate account life insurance products, which may help carriers expand the selection of investment options for these products and increase their overall desirability for client investment portfolios. In particular, high net worth clients with the wherewithal to invest in more sophisticated life insurance structures may wish to explore private placement products, especially if they have concentrated positions in tax-inefficient investments, like hedge funds, private equity funds, etc. Given these product developments and the tax dynamics currently in play, insurance advisors must have (1) a working knowledge of the full array of available annuity and life insurance products, (2) a greater understanding of the economic and tax implications associated with life insurance investments, and (3) the ability to articulate clearly the role these products can play in a client's overall financial portfolio and tax plan***

The market for private placement products, like private placement variable annuities ("**PPVAs**") and private placement variable life insurance ("**PPVUL**") has developed over the past several years. These products, when properly structured, can offer income tax deferral, financial privacy, asset protection, and simplified tax reporting (*e.g.*, elimination of K-1s for alternative investments) for assets held through the separate accounts of PPVAs or PPVUL. Moreover, in the current market, clients are seeking investment options that can help manage their income tax exposure and provide non-correlated returns. This has led to increased interest in annuities and life insurance generally, including separate account and private placement products. In recent years, the IRS has issued several revenue rulings and private letter rulings, like PLR 201240018, which may assist carriers in creating and expanding tax-compliant investment options for separate account products.

**Why it Matters**

Life Insurance Products Generally. Assuming rising income tax rates and continued economic uncertainty, the tax-deferral benefits provided by annuity and life insurance products will grow in appeal. Investments in an annuity contract or life insurance policy grow free of exposure to income tax and the new Medicare Tax on net investment income.[1] Clients can further manage their tax exposure based on the type of product acquired. For example, a client who acquires a deferred annuity can control the timing of income recognition for income and Medicare tax purposes. Alternatively, the purchase of a life insurance policy that maximizes cash value can provide the client with access to tax-free funds, since the client can withdraw cash value, up to his or her investment in the contract, without triggering either income tax or the Medicare tax (assuming the policy is not a modified endowment contract ("**MEC**")). In addition, the death benefits payable under a life insurance policy can pass income tax-free (and estate tax-free with proper planning through an irrevocable life insurance trust ("**ILIT**")).

Private Placement Products.[2] In this environment, private placement products, , may particularly appeal to high net worth clients. PPVAs and PPVUL are similar to traditional, retail deferred variable annuity and variable universal life insurance contracts issued by a carrier, where the contract owner's premiums are held in a separate, segregated asset account and invested in various investment funds selected by the owner from the carrier's separate account platform.

*Tax Considerations*. Generally, properly structured PPVAs and PPVUL provide the same tax-deferral benefits as traditional retail products, but with more flexibility in product design and implementation (*e.g.*, cost negotiability, timing and amount of premium payments, death benefit options, etc.). This tax-deferred growth, over the long-term, can enhance returns in the PPVA or PPVUL investment account as compared to a taxable account, especially if income tax rates continue to increase. PPVUL also provides for the payment of death benefits on an income tax-free basis (and estate tax-free basis, if held through a property structured irrevocable trust). Philanthropic clients may find PPVAs a particularly attractive option, since leaving the account to a charitable beneficiary (like the client's private foundation) can eliminate the deferred income tax due after the client's death.

*Client Considerations*. Clients with substantial holdings in tax-inefficient investments (*e.g.*, private equity funds, hedge funds, commodity funds, high-yield taxable bonds, etc.) may particularly benefit from the use of PPVAs or PPVUL. Not only is income from these investments generally taxed at the highest income tax rates, it also will qualify as net investment income for purposes of the Medicare tax. Holding these or similar investments through the investment account of a properly structured PPVA or PPVUL can defer income recognition for purposes of both the income tax and Medicare tax.

Ex. Client, whose MAGI greatly exceeds the Medicare tax threshold, has $10 million invested in a tax-inefficient fund (*i.e.*, taxed at short-term capital gains or ordinary income rates). The fund generates a net taxable return of $1,000,000 in 2013 (10%). Client could owe up to $434,000 in combined income and Medicare taxes (43.4% x $1,000,000, assuming application of 39.6% top ordinary income tax rate). If the investment is through a PPVA, however, the client could defer the taxes until he receives an annuity payment or surrenders the annuity contract, which also allows for management of the timing of the client's tax exposure.

As a threshold, clients interested in private placement products should have, in our view, at least $1 million available to invest in the product and an investment timeframe of 10 to 15 years for PPVUL (to overcome initial fees and expenses) or until age 59½ for PPVAs (to avoid the 10% excise tax that applies to withdrawals prior to that age). The determination to invest in a PPVA or PPVUL will depend on the client's tax, estate, and retirement planning goals and will involve review of numerous factors, including:

| | PPVA | PPVUL |
|---|---|---|
| Insurability Required | No | Yes |
| Tax-Free Lifetime Distributions / Withdrawals | No (and 10% penalty on distributions prior to age 59½ )[3] | Yes (up to investment in contract, if non-MEC) |
| Taxation at Death | Yes, as income in respect of decedent | No income tax (or estate tax if in ILIT) |
| Estate Planning Goals | Charitably inclined | Multigenerational (dynasty trust) planning /maximizing wealth transfer |

Regardless of the product, clients investing in either PPVAs or PPVUL must perform sufficient due diligence with regard to the proposed insurance carrier (since the owner ultimately depends on the issuing carrier's ability to fulfill its contractual obligations) and ensure the product acquired complies as an annuity or life insurance contract (as applicable) for tax purposes. In addition, clients must accept some loss of investment control. The tax-deferral features of private placement products depends, in part, on not running afoul of the "investor control doctrine," which provides that contract holders controlling the investment of an annuity or insurance contract's separate account assets are the owners of those assets for federal income tax purposes (even if the carrier has possession of and legal title to the assets). Generally, the IRS has found investor control when (1) the contract holder exercises sufficient control over the assets to be deemed the owner (*e.g.*, ability to direct or control investment of the assets); or (2) the assets are not available exclusively through the purchase of a life insurance or annuity contract (*e.g.*, are available for investment to the general public).

Thus, clients investing in PPVAs or PPVUL can only select among the general investment options provided on the carrier's platform and cannot identify specific underlying investments or set specific investment strategies. Fortunately, with the growth of the PPVA and PPVUL market, expanded investment options are being offered through carriers' separate account platforms, including access to highly sophisticated money managers and alternative asset classes. Further, IRS guidance through revenue rulings and private letter rulings (like PLR 20124008) continues to offer insight into the crafting of additional, tax-compliant investment options for separate account products.[4]

**PLR 201240018**

In PLR 201240018, a life insurance carrier offered a non-qualified deferred variable annuity that allowed contract owners to allocate contributions and transfers among both variable and indexed-linked investment options ("**ILIOs**"). The ILIOs were linked to specific indices and provided returns based on set formulas, rather than on actual market returns. If the assets supporting the ILIOs outperformed the formula, the carrier kept the excess; if they underperformed, the carrier made up the difference. The carrier held the assets supporting the ILIOs in its general account and a separate account. The annuity contract owners had no input regarding the underlying investments. The carrier requested a private ruling that it, and not the contract owners, owned the assets held in support of the carrier's contractual obligations under the ILIOs.

Based on its prior rulings on the investor control doctrine, the IRS specifically found that the contract owners purchasing ILIOs would **not** have any control over the purchase or disposition of the investments the carrier bought to support its contract obligations. Further, the indexed returns received by the contract holders were (1) formula-based, making them independent of the carrier's investment returns and (2) only available by purchasing ILIOs, and not outside the contract. Accordingly, the IRS held that, for federal income tax purposes, the contract owners did not have investment control over the ILIO assets, and thus the carrier, and not the contract owners, owned these assets. This favorable ruling was critical to preserving the tax-deferral benefits of these contracts for the contract owners. If the IRS held otherwise, the contract owners would be currently taxed on the income earned by the underlying investments, in the year earned.

**Take-Aways**

· IRS guidance continues to offer insight into the crafting of tax-compliant investment options for separate account life insurance products, which may help carriers expand the selection of investment options for these products and increase their overall desirability for client investment portfolios.

· In particular, high net worth clients with the wherewithal to invest in more sophisticated life insurance structures may wish to explore private placement products, especially if they have concentrated positions in tax-inefficient investments, like hedge funds, private equity funds, etc.

· Given these product developments and the tax dynamics currently in play, insurance advisors must have (1) a working knowledge of the full array of available annuity and life insurance products, (2) a greater understanding of the economic and tax implications associated with life insurance investments, and (3) the ability to articulate clearly the role these products can play in a client's overall financial portfolio and tax plan.

**NOTES**

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[1] Beginning January 1, 2012, a Medicare Tax of 3.8% will apply to the lesser of (1) net investment income (*e.g.*, dividends, interest, rents, capital gains, passive activity income) or (2) the excess of modified adjusted gross income over specified thresholds (e.g., $250,000 - joint filers; $200,000 - single filers).

[2] For a more in-depth discussion of private placement planning, see Jonathan M. Forster, Michael B. Liebeskind, Jennifer M. Smith "Hot Topics in Insurance Planning: Private Placement Insurance," *The AALU Quarterly*, Fall 2011.

[3] Subject to certain limited exceptions (*e.g.,* disability). See Code §72(q)(2)

[4] *See, e.g.,* Rev. Rul. 81-225, Rev. Rul. 2003-91, Rev. Rul. 2003-92, Rev. Rul. 2007-7, PLR 20115012 and PLR 201235001.

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