NEWTONONE

NEW YORK DELAWARE SAINT LOUIS

"You Can Go Your Own Way"
Taking Advantage of the Premium Tax Reduction/Elimination and Other Life Insurance Strategies

Holland & Knight

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Agenda

- Understanding the PPLI Opportunity
- PPLI Mechanics
  - Accredited investor
  - Qualified purchaser
  - Premium tax
- Safe Harbor Rules
  - Diversification
  - Investor control
- Case Study
- Closing thoughts

Introduction

- Wealth accumulation, tax efficiency, and asset protection are among the most critical financial concerns of ultra high net worth individuals.

- Private Placement Life Insurance (PPLI) and Private Placement Variable Annuities (PPVA) are inexpensive and flexible solutions to these fundamental wealth management objectives.

- Investment options such as hedge funds, private equity and managed accounts may be wrapped within a PPLI policy.

  - Makes tax inefficient assets tax efficient.

    - PPLI – Tax deferral/elimination

    - PPVA- Tax deferral

With PPLI, the Potential Exists to:

1. Develop a new story for:
   a) Existing clients
   b) Prospective clients
   c) Advisors referrals
2. Increase AUM (no taxation on investment earnings)
3. Increase Fee Income (no taxes, more assets, higher fees)
4. Create significant second and third generation “inflows” of AUM (payment of tax free death proceeds on multiple generations)
5. Tax deferred / tax free investing (makes tax management irrelevant and reallocations simple)
6. Potential for asset protection of AUM (each state laws differ on this subject)
7. Enhance charitable and estate tax planning objectives

The Environment

- **Taxpayer Relief Act of 2012**
  - Raises taxes on high income earners and trusts
  - Highest rates in over a decade

- **Unlike years past, limited planning options**
  - Including certain state rates overall levels may be over 50%
  - Deduction and Exemption limitations further increase taxes

	2013				
	Top Federal Tax	Medicare Surtax	Total	MO Tax	Total *
Earned Income	39.60%	2.35%	41.95%	6.00%	47.95%
Capital Gains	20.00%	3.80%	23.80%	6.00%	29.80%
Dividends	20.00%	3.80%	23.80%	6.00%	29.80%
Interest	39.60%	3.80%	43.40%	6.00%	49.40%

** Before phase-outs*

Why Use A PPLI Structure?

- Tax deferral/elimination
- Combine with wealth transfer strategies (GRATs, Defective Trusts, Dynasty Trusts)
- Exposure to variety of investment managers / strategies / asset classes
- Intergenerational planning to lower the COI charges
- Elimination of K-1s
- No surrender charges imposed by insurers
- Opportunities to exchange existing life products may be available
- Enhanced creditor protection may be available, depending on state of issue
- Transparent pricing structure

Competing Markets

Investment Market vs. Insurance Market

Investment-centric

Mutual Funds

Wrap Accounts

Hedge Funds

ETFs

Insurance-centric

Term, Whole Life, Universal Life & Variable Universal Life

Fixed Annuities & Variable Annuities

PPLI / PPVA: Combining the Best of Both

Investment-centric

PPLI
and
PPVA

Insurance-centric

- Access to Alternative Investments
- Manager/Fund selection
- Institutionally priced

- Income tax exempt or deferred
- Estate Tax solution
- Creditor protection

PPLI Mechanics

Contributions and Withdrawals

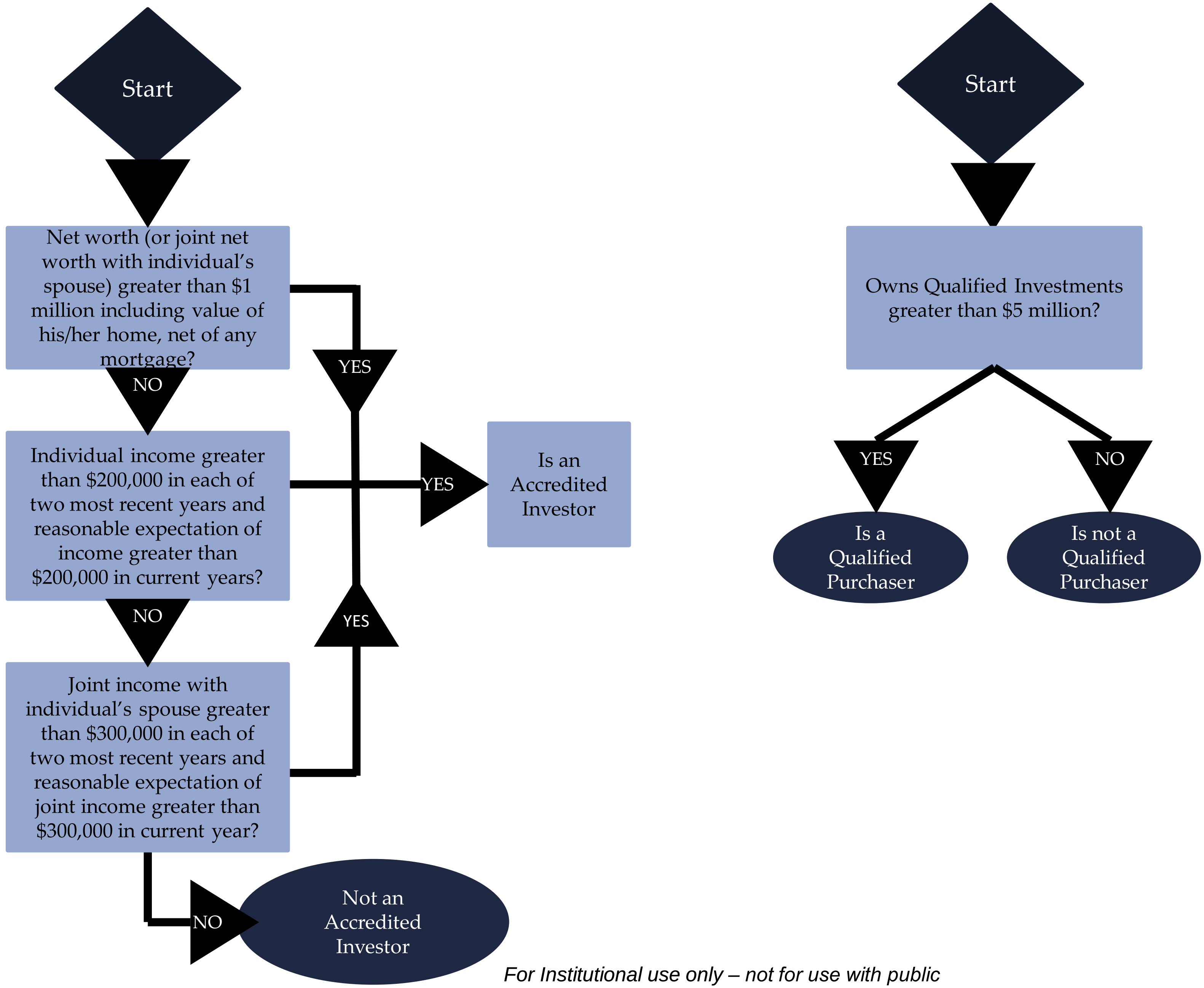
- Policy owner contributions are limited by applicable tax / insurance guidelines.
- Insurer imposes no charge on withdrawals from policy or on surrender of policy. (Withdrawals reduce account value, may cause early lapse and reduce death benefit).
- Tax on gains/returns on policy investments may be payable on contract withdrawals, and are payable on contract surrender.
- Withdrawals may be limited by illiquidity of contract investments.

PPLI Mechanics

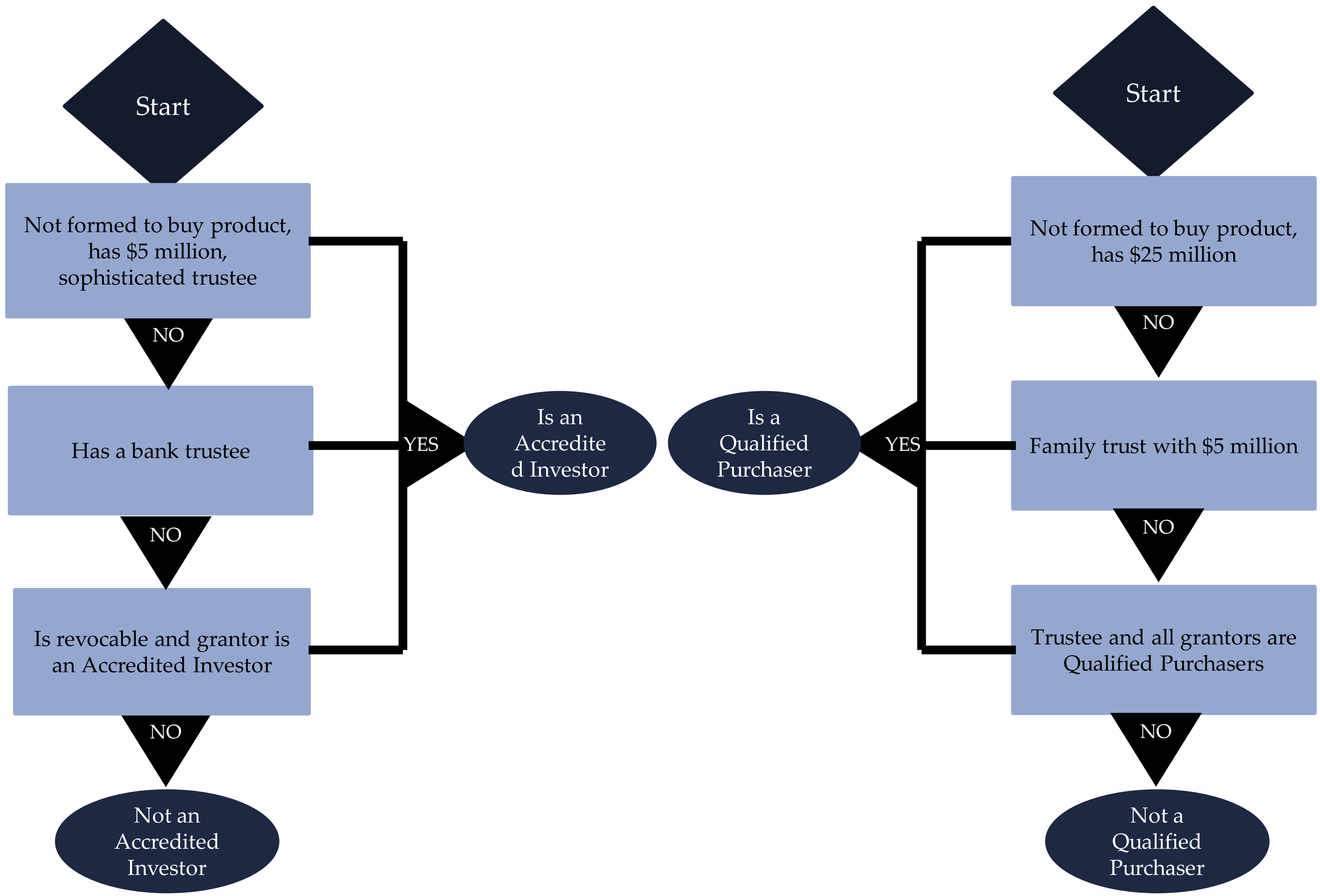
Variable Life Ownership Requirements

- Accredited Investor
- Qualified Purchaser
- Minimum $1 million contribution

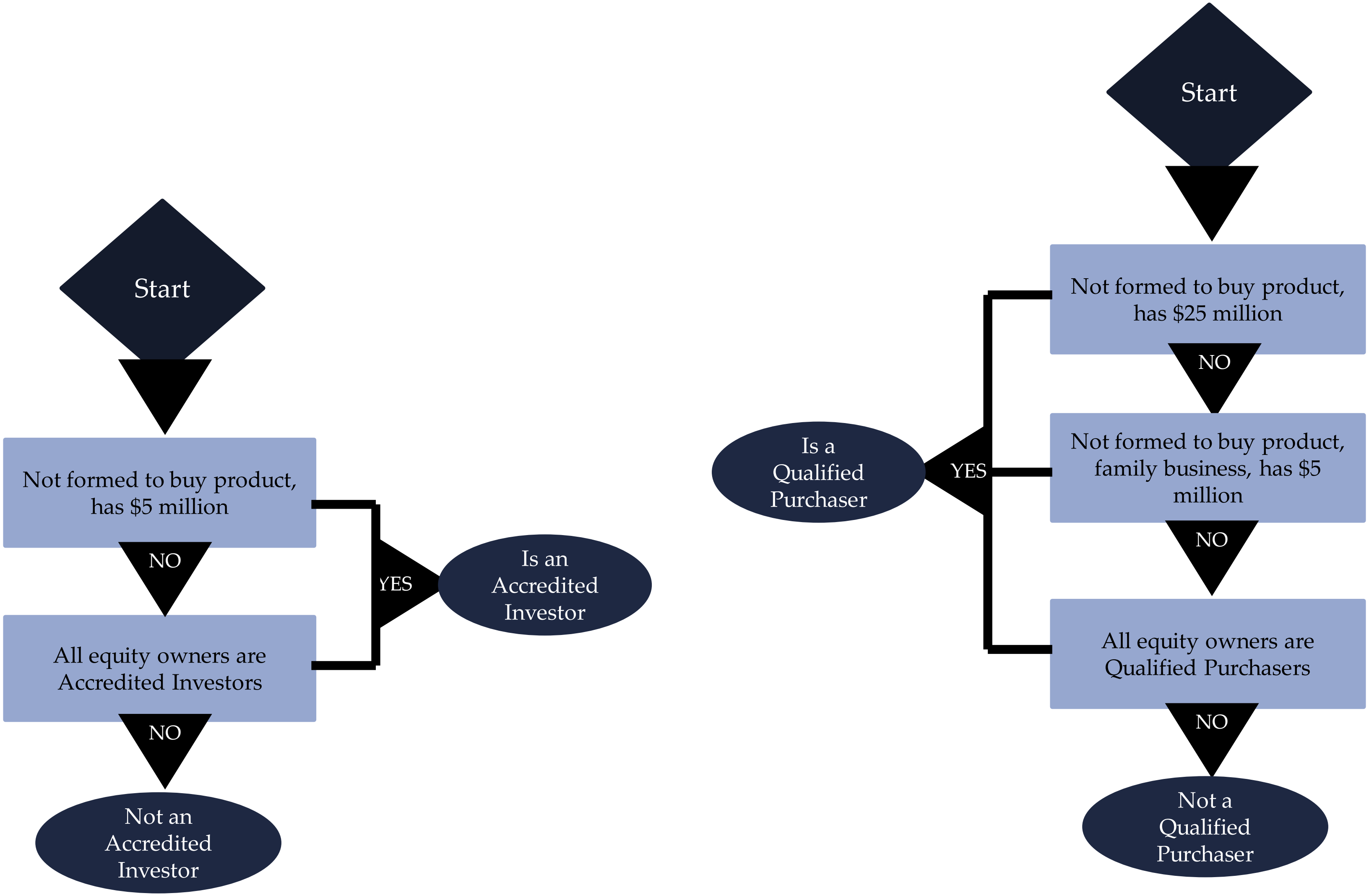
Individual (Natural Person) Analysis



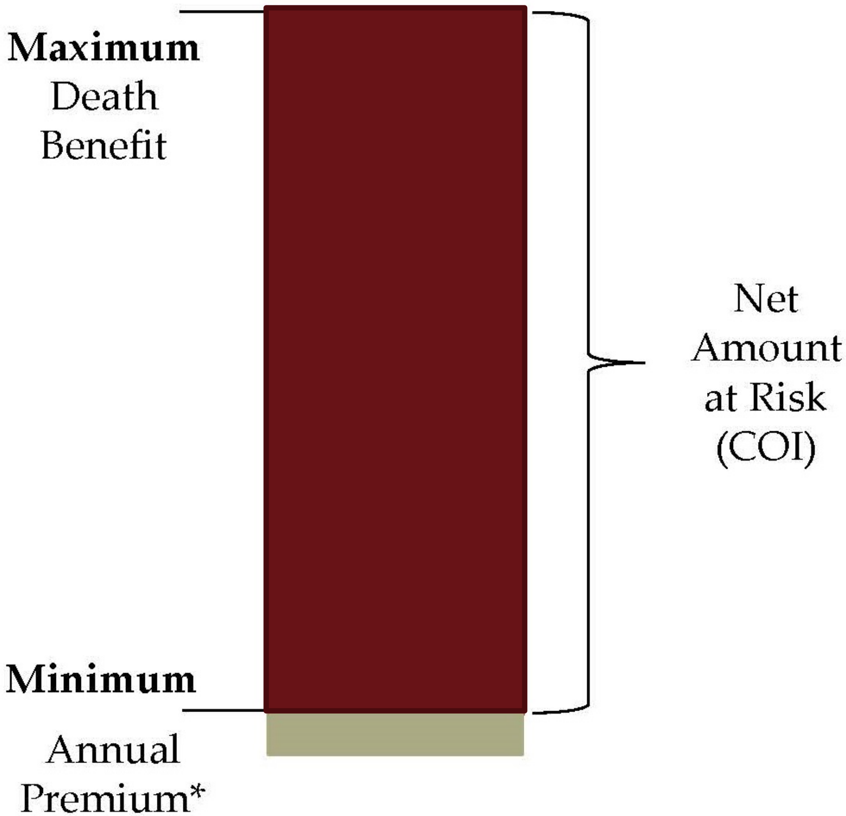
Trust Analysis



Business Entity Analysis

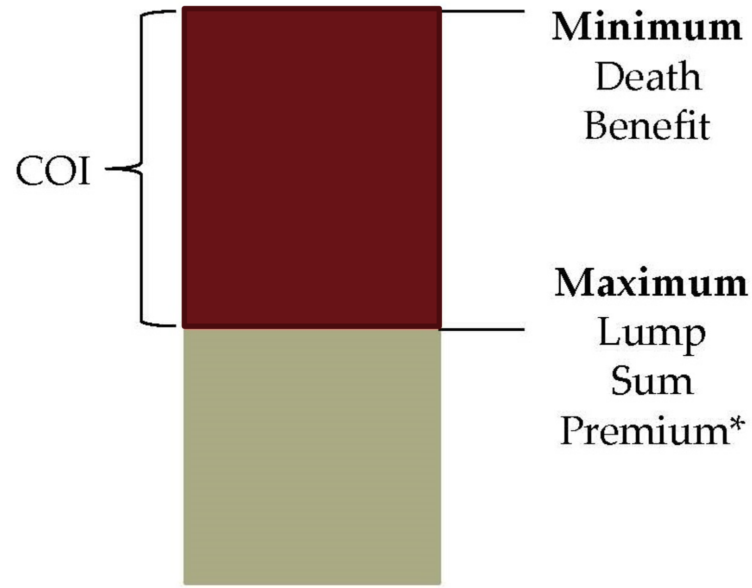


Traditional Life Insurance Policy Design



Customary to have long duration low premiums annually

Private Placement Life Insurance Design



Customary to have short duration (lump sum) premium (investment)

State Insurance Premium Tax Rates in the U.S.

Alaska*	**10 bpts.**
Arizona	200 bpts.
California	235 bpts.
Connecticut	175 bpts.
Delaware*	**0 bpts**.
Florida	**175 bpts.**
Georgia	225 bpts.
Hawaii	275 bpts.
Illinois	**50 bpts.**
Massachusetts	200 bpts.
Minnesota	22 bpts.
Missouri	**200 bpts.**
Nevada	350 bpts.
New Hampshire	100 bpts.
New Jersey	210 bpts.
New York	**200 bpts.**
Ohio	140 bpts.
Pennsylvania	200 bpts.
South Dakota*	**8 bpts.**
Washington	200 bpts.
Wyoming	75 bpts.

*After first $100,000 of annual premium.

Competitive Premium Tax By Jurisdiction for Trust-Owned Private Placement Life Insurance

State	$1M Premium	$3M Premium
Delaware	$2,000	$2,000
South Dakota	$3,625	$6,125
Alaska	$3,600	$5,600

Delaware: 2% tax on first $100,000 of premium; 0% thereafter per year.

South Dakota: 2.5% tax on first $100,000 of premium; 1/8 of 1% thereafter per year.

Alaska: 2.7% tax on first $100,000 of premium; 1/10 of 1% thereafter per year.

Know the "Rules of the Road" Regarding Insurance-Dedicated Funds (IDF)

Safe Harbor Rules for Insurance – Dedicated Funds (IDFs)

- Diversification; IRC §817(h)
  - In general, each asset account in a variable life policy must contain at least 5 investments with no one investment representing more than 55% of the account's value
- Investor control
  - Although free to choose the investment manager, the policy owner should not have control over specific investment selections
  - Rev. Ruling 2003-91
  - Rev. Ruling 2003-92
- Two approaches in the marketplace
  - Managed account: One fund per family, assets not commingled
  - Pooled account: Each IDF is a specific strategy; multiple investors in each IDF
- Failure to comply
  - Failure to comply with diversification and investor control rules has adverse tax consequences to the policy owner

Diversification

Treas. Reg. §1.817-5(a)(1); I.R.C. §7702(g). A segregated asset account is adequately diversified if such account contains at least five investments and:

(a) No single investment accounts for more than 55 percent of the value of the account;

(b) No two investments account for more than 70 percent of the value of the account;

(c) No three investments account for more than 80 percent of the value of the account; and

(d) No four investments account for more than 90 percent of the value of the account.

See Treas. Reg. §1.817-5(b)(1)(i). Note, however, a segregated asset account is not treated as failing the diversification requirements if such failure results solely from market fluctuations. Treas. Reg. §1.817-5(d).

Diversification

In determining whether a segregated account is adequately diversified, such account will be treated as holding a pro rata portion of the assets of any regulated investment company, partnership, or trust (instead of an interest in such entity) if:

1) all beneficial interests in such entity are held by one or more insurance company segregated asset accounts, and

2) public access to such entity is available exclusively through the purchase of a variable contract. *See* Treas. Reg. §1.817-5(f)(2).

This look-through rule permits segregated accounts to invest in a single entity so long as such entity is itself adequately diversified.

Investor Control

Investor control is based on the premise that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed – the actual benefit for which the tax is paid." *See Corliss v. Bowers,* 281 U.S. 376, 378 (1930).

Beginning in the late 1970s, the IRS issued a series of revenue rulings in an attempt to clarify the parameters under which a policy owner will be treated as the actual owner of the assets of a variable life insurance policy or a deferred variable annuity (virtually all of the rulings related initially to deferred variable annuities, but have now been extended to variable life insurance policies) on account of the level of the policy owner's control over investments within a segregated account. *See, e.g., See, e.g.,* Rev. Rul. 77-85, 1977-1 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 2003-91, 2003-2 C.B. 347; and Rev. Rul. 2003-92, 2003-2 C.B. 350.

Investor Control

- *Webber v. Commissioner,* 144 T.C. 17 (2015)
- Mr. Webber purchased PPLI through his grantor trust
- An “independent” fund manager was appointed
- Mr. Webber had no direct, legal authority to direct the PPLI investments
- Records showed that the “independent” manager took direct orders from Mr. Webber’s attorney, who in turn was receiving the instruction from Mr. Webber
- Court ruled this violated the Investor Control rules and the income of the fund was taxed to Mr. Webber personally

Case Studies

Typical PPLI Transaction Insuring Next-Generation Adult Child

Generation 1

1

$8 million
AFR Loan Arrangement,
Note due at Son's death
Interest accrues, Policy
not used as collateral

Promissory Note
For $8 million

Family
Grantor Trust
(or LLC)

2

$8 million
premium paid

Issues policy
(MEC)

Insurance company
issued PPLI policy
on Gen 2

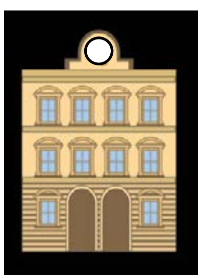
3

Premium
Allocated
By Policy
Owner

Insurance
Dedicated
Fund (IDF)

Option:
Premium Financing
With Bank

Collateral = Gen 1's
other assets, not PPLI
Policy values



Bank

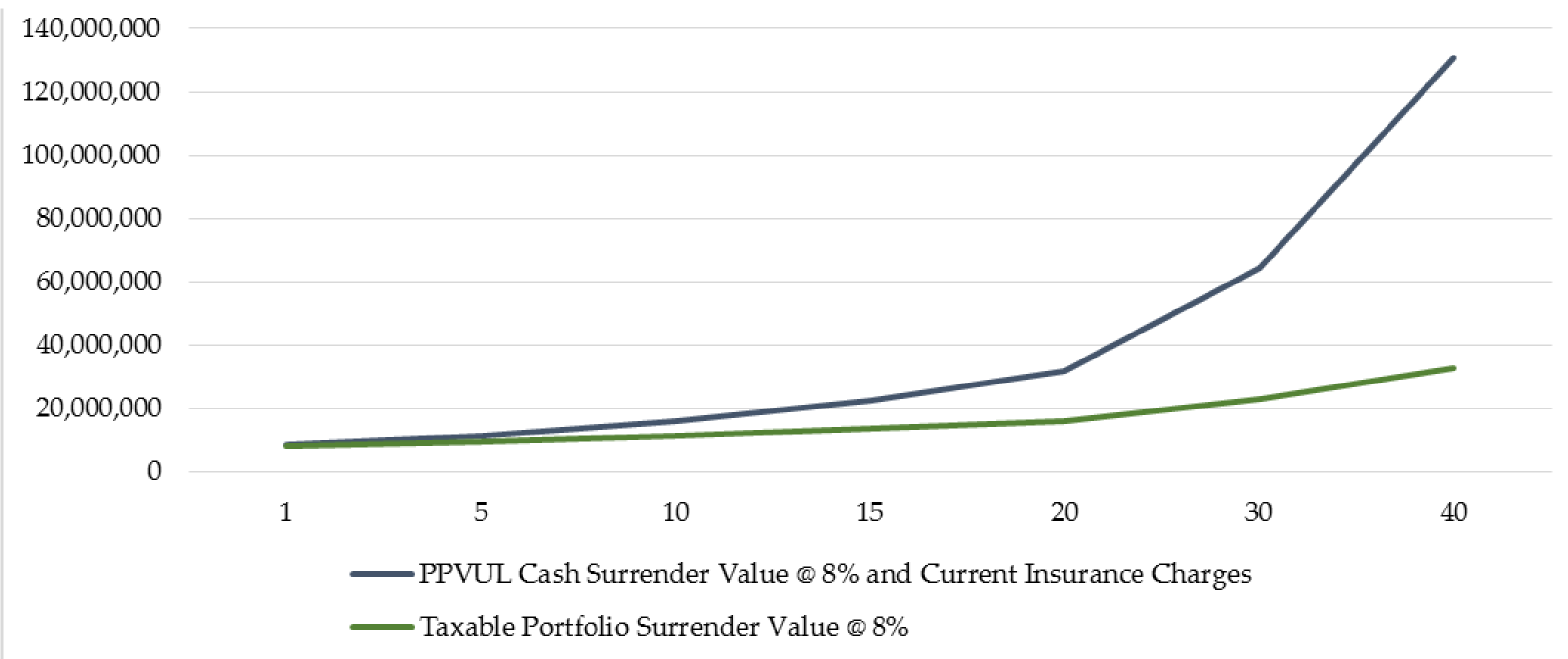
- **Would the value of the Note due Mom be discounted for transfer Tax purposes?**
  - **No collateral**
  - **No current payments**
  - **Cannot be called by Gen 1**
  - **Terminates at death of Gen 2**

PPLI Premium Financing: Three Forms

- Intra-Family Loan
  - Typically at AFR rates, term = death of insured
- Third-Party Loan
  - Typically at LIBOR + 50-100 bps, 5- to 15-year terms
- Private Split-Dollar
- Exit Strategies (unwinding the arrangement)
  - Termination of arrangement
    - Withdraw policy values
    - Intra-family loan to pay off a third –party loan
    - Third-party loan to pay off an intra-family loan
  - Creating a side fund with non-gift transfers (see Example)
    - Installment sales
      - Grantor trust status is generally advantageous and required for an effective installment sale
    - Zeroed-out GRATs with ILIT as beneficiary of GRAT (when PPLI is owned in ILIT and ILIT is not a GST trust)
    - Zeroed-out CLTs
  - Leveraged gifts to the trust (policy owner) using discounted entities

Summary of Values PPVUL MEC Structure vs. Taxable Account: Joint Life

Year	Total Allocation	PPVUL Death Benefit @ 8%, and Current Insurance Charges	PPVUL Cash Surrender Value @ 8%, and Current Insurance Charges	Taxable Portfolio Surrender Value @ 8%	Difference
1	**8,000,000**	**62,880,000**	8,395,123	8,281,472	113,651
2		62,880,000	9,001,795	8,576,001	425,794
3		62,880,000	9,650,688	8,881,827	768,861
4		62,880,000	10,348,397	9,198,774	1,149,623
5		62,880,000	11,100,898	9,527,087	1,573,811
10		62,880,000	15,781,159	11,353,114	4,428,045
15		62,880,000	22,442,730	13,529,139	8,913,591
20		62,880,000	31,832,203	16,122,239	15,709,964
30		67,595,838	64,376,989	22,894,738	41,482,251
40		137,182,298	130,649,808	32,512,175	98,137,633



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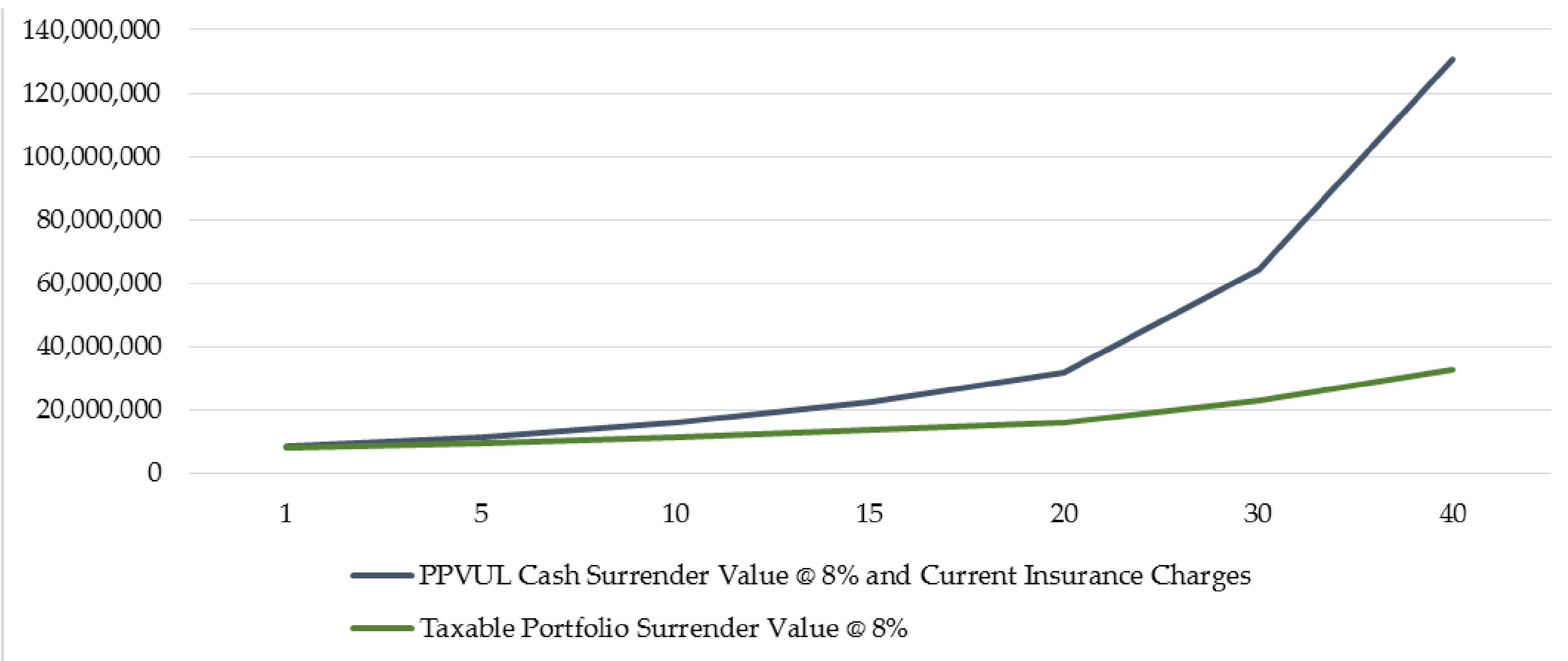

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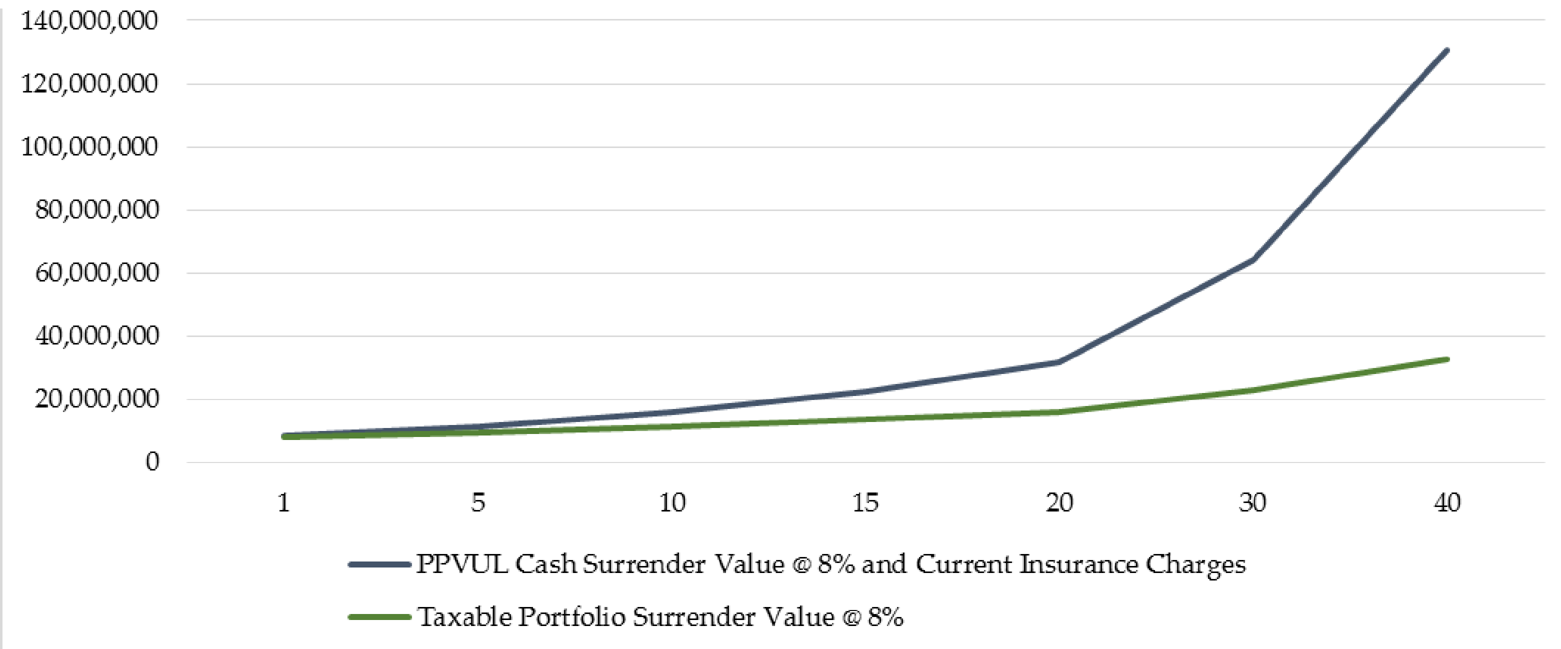

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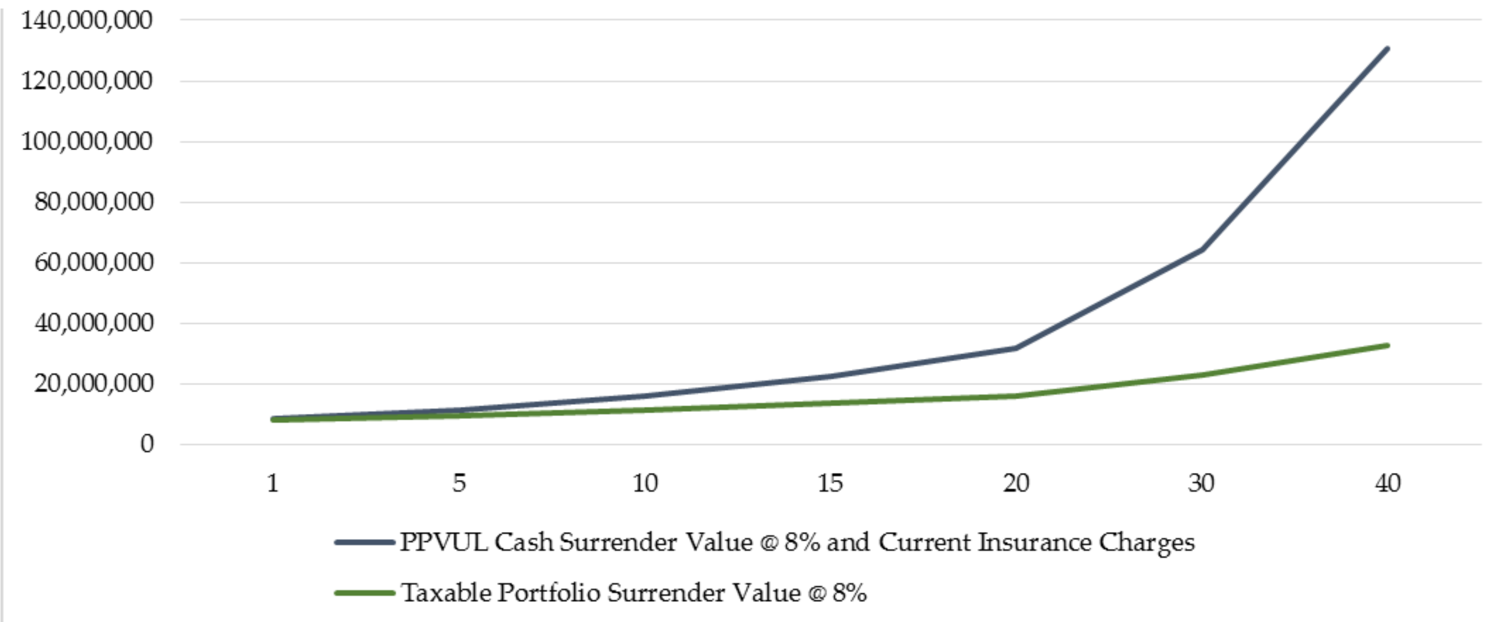

Top 10 Reasons for NOT doing a Private Placement Transaction

10 Never heard of it before

9 Loss of control

8 What if I need the money

7 Too complicated

6 I don't need insurance

5 Too expensive

4 Limited investment choices

3 I enjoy receiving K-1s in October

2 I don't want to go off-shore

1 My investment manager has a tax strategy – he harvests losses

Disclosure

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