

# PRIVATE PLACEMENT INSURANCE PRODUCTS

## QUESTIONS & ANSWERS

### **What are Private Placement Insurance Products?**

Private Placement Insurance Products (PPIP) are non-registered Variable Universal Life Insurance (VUL) policies and Variable Annuity (VA) contracts that are offered exclusively to high net worth individuals. These products are filed with and approved by state insurance departments and are designed to comply with the current IRS tax code. During July 2003, the IRS issued clarifying guidelines for favorable tax treatment of private placement insurance products.

### **What is a Private Placement Variable Universal Life Insurance (PPVUL) Policy?**

PPVUL is a non-registered U.S. tax compliant (IRC 7702), flexible premium life insurance policy that provides the same income tax-exempt death benefits as other variable life insurance policies. Premiums less charges and fees are invested into the various investment options inside the insurer's separate account. PPVUL provides flexible investment options (with some non-registered investments within asset classes that are not available in other life insurance policies), flexible premium payments, and flexible compensation to brokers. PPVUL provides transparency to the buyer and the seller.

### **What are the U.S. tax advantages of life insurance, including PPVUL?**

#### **Under current U.S. law, the tax benefits include:**

- tax deferral of any current policy investment earnings and gains;
- tax-free exchanges between the underlying investment options;
- tax-free withdrawals (up to basis) and loans from the policy cash value free of income tax (provided the policy is a non-MEC under IRC 7702A);
- income tax-free death benefit to the policy's beneficiaries.

## **What is a Private Placement Variable Annuity (PPVA)?**

PPVA is a non-registered US tax compliant (IRC 72) asset accumulation vehicle issued by a life insurance company. Annuities are used for long-term investment, notably to accumulate retirement savings. PPVAs are designed to provide flexibility in connection with premium payments and the ability to reallocate and rebalance assets on a tax-deferred basis. It is a 'flexible premium' contract because it permits a great amount of flexibility in determining when and how much premium you pay. It is a 'variable' contract because the contract values vary according to the investment performance of the investment choices you have allocated premiums to.

## **What are the U.S. tax advantages of deferred annuities, including PPVA?**

The earnings within a deferred annuity are taxed only when the policyholder chooses to withdraw them, which he may do at any time without contractual penalty (subject to underlying investment liquidity). Withdrawals are deemed to come first from taxable earnings accumulated in the contract, and then from non-taxable principal. Any earnings withdrawn prior to age 59-½ are generally subject to a 10% penalty tax. A policyholder benefits from the deferral of tax on investment earnings; the value of this deferral can increase greatly the longer the contract is held. In essence, a deferred annuity has tax characteristics similar to those of a conventional (non-Roth) individual retirement account, except that purchase payments are non-deductible and there is no limit on the amount that may be invested.

## **Other than tax deferral and possibly tax exemption, are there other advantages to purchasing a PPIP?**

Yes. Alternative asset classes (including hedge funds) are generally available within a PPIP. Individuals who purchase a PPIP backed by investments in, say, hedge funds do not receive "K-1s"; hence they are not required to deal with tardy or incorrect forms or to report hedge fund earnings on their tax returns. It follows that investors need also not be concerned about fund liquidity restrictions preventing the withdrawal of funds in a timely manner to cover taxes due on fund earnings.

In addition, a PPIP corrects an investor's inability to deduct fund-of-fund management fees. An investor purchasing a fund-of-hedge-funds typically cannot deduct the management fees at the fund-of-fund level because a deduction is available only to the extent the fees exceed two percent of adjusted gross income. But where the fund is purchased through a PPIP, these fees may be

offset against investment gain, reducing taxes that ultimately will be owed upon later surrender of (or a partial withdrawal from) the PPIP contract.

Finally, under the laws of some states life insurance and annuity contracts may be shielded from the claims of the owner's creditors. (A purchaser should consult with counsel to determine the extent to which this protection applies in his particular circumstances and state of residence.)

## **Who can purchase Private Placement Insurance Products?**

Typically, Private Placement Insurance Products can only be sold to "Accredited Investors" that are "Qualified Purchasers." An Accredited Investor is a person with net worth exceeding \$1,000,000 or with an annual income of at least \$200,000 over the past two years. A Qualified Purchaser is a person with a minimum of \$5,000,000 of investments. However, AFM works with an insurance company that does offer a PPVA to "Qualified Clients" also. A Qualified Client is a person with a net worth exceeding \$1,500,000.

Prospective purchasers must be pre-qualified to verify they meet the above requirements before any sales presentations can be made. Trusts will meet the Qualified Purchaser standards as long as the trustees and the settlor meet the Qualified Purchaser standards.

## **Why are investors interested in PPIP?**

Investors acquire a PPVUL product to provide an income tax-free death benefit and provide a tax-deferred investment vehicle. Investors acquire a PPVA product to provide a tax deferred investment vehicle for retirement. Both products provide access to custom investment portfolios and alternative investment styles not found in other retail-oriented insurance products.

Selection of an alternative asset class such as hedge funds makes both investment and tax sense. Hedge funds complement a traditional portfolio of stocks and bonds. Since hedge fund returns are often independent of the overall direction of the stock and bond market, these funds can provide diversification of the total portfolio, and hence a better risk-return profile than just stocks and bonds alone.

Like retail insurance products, investment earnings within a PPIP accumulate on a tax-deferred basis until withdrawn; and there is no immediate tax due if changes in the portfolio are made (such as replacing one fund with another, or rebalancing the portfolio). And as is the case with retail life insurance products, death benefits are income tax-free.

Of course there is no assurance that any investment will have gains, and this risk must be recognized.

## **What is the “Break-Even” time period for a PPVA or PPVUL policy?**

The “break-even” period (when a tax-advantaged investment outperforms a taxable investment) will vary based on investment return, tax rates, and, in the case of PPVUL, the age and sex of the insured. Generally, this is between 2 — 4 years.

## **How much flexibility is there with investments inside of Private Placement Insurance Products?**

There is a great deal of investment flexibility with the investments inside a policy. However, since the insurance company is the owner of the assets, each investment manager managing assets for the insurance company must pass a rigorous due diligence test. Collectively, the insurance company, the adviser, and the policyholder must ensure that the policy meets the definition of life insurance under the Internal Revenue Code, and this places limits on the flexibility of the investments available within the contract. This is generally due to liquidity requirements upon surrender and death.

The insurance company will require the investment manager to comply with IRC §817 and associated rules with respect to “diversification requirements and investor control.” A prospective policy owner must relinquish direct control and ownership with respect to the investment options available within a policy.

The insurance company has administrative rules they apply to control their expenses and assure a quality offering. For example, the following are among typical requirements for adding investment options:

- Minimum deposit requirements of \$5 million within total life of the policy, and \$1million within a PPVA contract. (However, AFM has an insurance company that will accept a minimum deposit of \$1,000,000 or a minimum of five installments of \$500,000 on the PPVUL and a minimum deposit of \$500,000 on the PPVA.)
- Policy owner may not control the investment manager’s selection of specific investments.
- Investments must meet IRS diversification requirements.
- Adequate liquidity upon surrender and death.
- Satisfactory operational and risk management controls by the investment manager.

## **What are the main differences between private placement and retail insurance products?**

- Investment flexibility - The policy owner has access to alternative investment styles and manager(s).
- Flexible and lower Insurance company fees - Insurance Product Charges, Distribution Expenses, and Front End Loads, are generally more competitive than retail insurance products. In addition, certain fees may be negotiable depending on the premium commitment.
- No surrender charges - Retail life insurance policies generally have significant back-end surrender charges.

## **What are the requirements to sell it?**

An NASD Series 6 plus state insurance life and annuities licenses are required.

## **How much investment protection is afforded the insured?**

Insurance policies are not insured by the FDIC. The assets underlying variable insurance policies are deployed in a Separate Account, a separate and distinct legal entity inside the insurance company where the assets directly back specific policyholder liabilities. Assets are still subject to the same investment risks as other equity and/or fixed income investments. Typically, there are no guarantees relating to investment performance. A notable consequence of deploying a Separate Account is that the assets are protected from an insurance company's general creditors.

## **What are the cost components to PPIP?**

Generally there are five types of charges, each of which may have a current and guaranteed maximum level.

### **Insurance Company Charges**

#### **Asset Based Charges**

- Mortality and Expense (M & E) Fees – These are expressed as a percent of the invested funds and are deducted monthly. They are typically used to cover insurance company expenses, costs for any embedded guarantees, and profit.
- Admin / Distribution Charges – These are also expressed as a percentage of the invested funds and are typically deducted monthly. These fees are typically used for compensation or investment set-up expense recovery.

### **Risk Based Charges: (Not applicable to PPVAs)**

- Cost of Insurance Charge – This is designed to cover the cost of the true death benefit component. These charges are typically deducted monthly and vary with the age, gender, and general health of the insured.

### **Premium Based Charges**

- State Premium Tax – State Specific - charged on collected premiums.
- “DAC” Tax – Typically 1% of PPVUL collected premiums – currently not collected on PPVAs.
- Premium loads for distribution related expenses – charged on collected premiums.

**Surrender Charges - There are usually no surrender charges with PPIP.**

## **Investment Management Fees**

### **Investment Advisory and/or Management Fees**

- Independently set by third parties investment firms.

Note: Client(s) should carefully review the policy contract and all disclosure documents to make sure they have a thorough and complete understanding of applicable charges and fees.

## **What is the advisor compensation?**

Compensation is flexible and fully disclosed on premiums and assets. Fees are paid quarterly to the registered reps broker dealer.

## **How should investors acquire a PPIP?**

A PPIP should be part of an investor's overall financial plan. Generally there are four primary roles involved in the process:

1. The Attorney/Advisor
2. The Insurance Professional
3. The Investment Manager
4. The Insurance Carrier

Investors should engage legal counsel with estate planning expertise as well as a licensed and experienced insurance professional to facilitate the product acquisition process.

## **How much should an investor commit to PPIP?**

The total premium commitment should be at least \$1,000,000 minimum deposit for PPVUL and \$500,000 for a PPVA. In order to gain the maximum tax advantages in a PPVUL and avoid tax consequences associated with a MEC, total premium amount of \$2,500,000 should be paid in over a four or five years period.

## **What Death Benefit Protection does the policyholder have?**

For PPVUL policies, an issuing life insurance company typically utilizes its reinsurance facilities to spread the mortality risk. Viewed from the PPVUL policyholder perspective, this can be seen as enhancing the policyholder's death benefit protection. The issuing life insurance company only retains a portion of the Net

Amount of Risk (defined to be the Face Amount less the Account Value) and cedes the remainder to its reinsurers in reinsurance pool. Since the issuing life insurance company remains the sole "obligor" to the policyholder; reinsurers can only enhance the "credit worthiness" of the death benefit.

## **Are PPVAs eligible for 1035 Exchanges?**

Yes. Given the lower insurance company product fees (e.g. M&E) and customized investment options, PPVAs often make sense as a 1035 exchange vehicle. However, an annuity may not be exchanged into a life policy (and an exchange from one life policy to another will require new underwriting).

