

Private Placement Insurance Arrangements: Recent Developments Dictate a Fresh Look

By Robert D. Colvin

Private placement insurance planning has finally reached a level of maturity. Despite this coming of age, many structures remain haunted by the growing pains and foolish indiscretions of youth.

There was a time when these structures quietly cruised below the radar screen stealthily accomplishing their tax advantaged mission. Those days, however, are but a memory as the increased popularity of these vehicles combined with aggressive marketing by overzealous promoters has awakened the IRS to this useful planning vehicle.

The IRS recently issued two revenue rulings directed at these products and has additionally proposed certain changes to the critical diversification regulations that could have far reaching implications for existing as well as future plan designs. Taxpayers would be well advised to review their current structures to insure they were properly designed and have been appropriately monitored.

This article first provides an update on recent developments in this planning area and then addresses several common problems encountered as taxpayers review their existing structures. Our primary focus will be on issues relating to private placement variable life insurance and annuity contracts (collectively referred to as "PPLI" or "contracts") and management of their underlying investment portfolios.

Although not the subject of this article, a proper review should also include consideration of the holding structure and its contribution towards accomplishing the overall planning objectives.

THE IRS GUIDANCE

In late Summer 2003 the IRS issued its first official guidance in almost twenty years on the hotly debated "investor control" issue driving at the heart of PPLI planning. This came in the form of two revenue rulings and a proposal to amend the Section 817(h) diversification regulations by deleting the widely relied upon non-registered partnership exception discussed below. These actions directly target the popular wrapping of high-taxed hedge funds within tax-advantaged PPLI segregated asset accounts.

Revenue Ruling 2003-91,¹ a primarily positive ruling, confirms the generally accepted principle that owners of PPLI contracts are permitted to freely allocate investments among a limited menu of "insurance dedicated funds" ("IDF's") established exclusively for investment by insurance carriers or through insurance products. Although taxpayers are grateful for public acknowledgment that variable contracts offer the touted tax-sheltering advantages, the extremely limited number of IDF's available in the market attracted a fairly subdued applause.

A companion ruling² raised significantly more controversy in holding that contract owners are not permitted to direct that separate account funds be invested into “non-registered”³ partnerships that accept investments from persons other than insurance companies and pension funds (*i.e.*, “publicly available” investments). Violation of this rule will cause the contract holder, rather than the insurance company, to be treated as the owner of the underlying partnership investment and taxable on its income. In effect, this eliminates the tax-advantaged investment accumulation within those variable contracts. To many industry observers this announcement was not unexpected since it followed the IRS reasoning detailed in the “Keyport” private letter ruling issued the prior year.⁴

Nevertheless, Revenue Ruling 2003-92 was, at least for a brief moment, harshly criticized by practitioners as directly contrary to the long standing Section 817(h) diversification regulations expressly authorizing direct investment by variable contracts into non-registered partnerships. This criticism was extremely short lived, however, when the IRS announced the following week proposed changes to the diversification regulations removing the conflicting non-registered partnership exception.⁵

The notice of proposed regulatory changes warned that existing structures must be brought into compliance with this new regime by the end of the second calendar quarter following the effective date of the regulatory amendments. It may be very difficult and costly for certain taxpayers to meet this transition deadline due to restrictions on exit dates

and withdrawal penalties applicable to many private investment partnerships affected by these changes.

FIX IT OR JUNK IT?

Recent developments have prompted many taxpayers to review their existing structures for proper adjustment. For some this simply entails tightening a few bolts to get them back on the road. For many others, however, it could be bad news when they get the repair shop bill. Those who have neglected routine maintenance may require a complete overhaul to pass future inspection.

There is an endless list of things that can and do go wrong with these sensitive vehicles. The majority of issues arise from either an “economic” or “technical” failure in the contract. Economic failures are often based on dismal investment performance or an overly burdensome cost structure while a technical failure typically results from some potential breach of the applicable tax laws. The better strategy for many PPLI drivers may simply be to exchange that old clunker for a newer model.

Burdensome Cost Structure

Competition in the PPLI markets has significantly reduced the costs of these products over the past few years. Any contract in place for more than five years should be reviewed to examine all of its annual charges.

Most legal practitioners mistakenly focus solely on the “mortality & expense” charges when comparing contracts. However, other recurring expenses such as the “cost of insurance” (*i.e.*, the “true” insurance element in the

contract) and distribution fees can vary considerably while significantly impacting the long term performance of a contract.

Taxpayers should periodically request an “in force illustration” detailing all of the charges to determine the competitiveness of their present vehicle. The best way to flush out hidden charges or other elements that make one contract perform better over another is to compare the long term projections of other products against your present contract.

So what can you do if you believe your contract is no longer competitively priced?

The first place to start is with your current carrier since there are substantial costs and challenges in transferring to another company. Certain carriers may be willing to reconsider their charges if circumstances have changed dramatically while other companies stand firm to the original agreement. One possibility may be an exchange for a more recent contract form issued by the same carrier which would be much less costly than switching to a new carrier.

Certain insurance contracts can be exchanged on a tax-free basis provided the annuitant or insured is the same under both the original and replacement contracts.⁶ The basic principle is to permit exchange for another contract with similar or less desirable tax attributes. For example, an annuity (which merely provides deferral) can only be exchanged for another annuity contract and not a life policy. In contrast, a life policy (which provides a permanent tax exemption) can be

exchanged for either a life policy or annuity contract.

The basis in the replacement contract is equal to the basis of the original contract, subject to adjustment for any gain or loss on the exchange (such as from boot),⁷ plus any additional contributions to the new contract.⁸ Note that acquisition of a replacement contract in a “tax-free” exchange may be treated as a new purchase for many purposes including state premium taxes, DAC charges, the 1% Federal excise tax on payments to foreign carriers, death benefit calculations, and certain other important contract attributes.

All factors should be considered, including pricing and non-financial elements, in evaluating whether to exchange contracts. Be aware that an exchange is not necessarily a simple or inexpensive matter, which means you could find yourself married (for better or worse) to your present arrangement. Exchange for a life policy will require an updated medical underwriting with the new carrier which could be problematic if the insured’s health has significantly deteriorated. Avoidance of these underwriting issues makes it much easier to exchange to an annuity contract than a life policy.

Poor Investment Performance

Take the situation of Joe M. who invested \$5 million into a contract that has precipitously declined to \$1 million in value. The first hard lesson Joe just learned is that carriers offer no minimum investment guarantees on PPLI contracts. The flip side of reaping big rewards on hefty investment returns is facing the reaper when those returns go

underground. Joe has many options, including:

1. Remove and replace the investment advisor.
2. Terminate the structure.
3. Add more premiums to boost critical mass.
4. Exchange a loser life policy for a new life policy.
5. Exchange a loser life policy for an annuity contract.

Remove and Replace the Investment Advisor. Joe's initial reaction may be to find a new investment advisor. Sounds simple enough since most PPLI contracts traditionally permit the owner, subject to the carrier's approval and certain limitations, to request replacement of the investment advisor. Although the majority of practitioners and carriers in an informal poll express confidence this privilege remains intact, the Summer 2003 rulings use certain language implicating renewed attention to the manner by which this heretofore common practice is exercised.

In addition to Joe's consideration of the successor fund's investment suitability, the insurance carrier must conduct appropriate due diligence on the new fund or manager. This process includes negotiating a participation or investment management agreement between the carrier and investment manager that could add further delays to the entry dates. Many insurance contracts limit the frequency in which funds can be moved in and out of investment alternatives so pick your next fund wisely.

In the gradual PPLI exodus away from "publicly available" hedge funds many taxpayers are finding lock-ups and early

withdrawal penalties significantly increasing their transition costs. Not only may the current fund extract a departure penalty on withdrawal but Joe could find his proceeds lingering in limbo awaiting the next entry dates of the successor fund.

In evaluating future PPLI investments an "insurance dedicated fund" ("IDF") offers a considerably more conservative posture based on the Summer 2003 rulings. As a further incentive, these funds have been specifically designed for insurance investors and, therefore, often are more accommodating in terms of entry and exit dates as well as lock-ups and withdrawal penalties.

IDF's are now the industry rage because this is the only model expressly approved by the IRS. The hedge fund industry, which has been particularly favored by the PPLI market, until recently has been reluctant to fully embrace the IDF model.

A practical limitation for investors is that IDF's tend, at least initially, to be established on a specific insurance carrier's platform, which can make obtaining a list of industry-wide IDF's quite challenging. Although carriers freely share this information upon request, many brokers seasoned in the industry consider an expansive list of available IDF's across multiple carriers as a valuable marketing tool.

Terminate the Structure. At some point Joe may simply decide to take his marbles and go home. Calling it quits may, at first blush, appear particularly attractive if the ongoing structural costs exceed the projected tax and other benefits on a severely depleted portfolio.

One situation in which this may occur is a life policy where the substantial reinsurance charges drag down the investment return as compared to a less costly annuity contract.

Although typically no surrender charge is imposed on most PPLI contracts, several important factors should nevertheless be considered. Termination of a contract generally results in ordinary income to the extent the surrender proceeds exceed the investment in the contract.⁹ For this discussion we have assumed Joe's contract has lost substantial value due to poor investment performance. However, Joe should be reminded that forgiveness of those large policy loans withdrawn several years back will be added to the current proceeds in determining any gain or loss on surrender.

A loss on surrender of an investment annuity is generally deductible as an ordinary (rather than capital) loss.¹⁰ The amount of the loss is the excess of the taxpayer's basis in the contract less the surrender proceeds. Accordingly, termination of a loss annuity could provide an immediate benefit by offsetting other high-taxed ordinary income.

In contrast, typically no deduction is allowed for losses incurred on surrender of a life policy. In a few unique circumstances, however, certain courts have permitted a limited deduction if the policy has been purchased in a transaction entered into for profit.¹¹ It could possibly be argued that based on their significant investment orientation PPLI contracts should fall within this exception in appropriate circumstances.

Add more Premiums to Boost Critical Mass. Another alternative for a loss contract is to contribute additional funds to increase the contract's investment base. As a word of caution, there may be certain limitations on the ability to contribute additional premiums to a life policy without adversely affecting its tax status under the "modified endowment contract" ("MEC") rules or the more critical guideline premium test.¹² In contrast, an annuity contract generally permits unlimited premium contributions without affecting its tax qualification.

A rejuvenated contract with accumulated losses could serve a useful purpose if there is an expectation of significant investment earnings in the future. In particular, the owner's basis in the contract will be equal to the aggregate contributed premiums.

Example: In the hypothetical above, Joe M. initially invested \$5 million that had dwindled down to \$1 million. Suppose Joe invests another \$5 million into the contract bringing the current total value to \$6 million and his basis in the contract to \$10 million.

Continuing this scenario, assume Joe's luck turns and a few years later the contract investment account has increased to \$10 million. Joe could at that time terminate the contract with no taxable gain due to his aggregate \$10 million basis. In effect, this strategy permits Joe to apply his original loss to shelter \$4 million of future earnings. If working with an annuity contract, then the result is not surprising since he could have simply terminated the contract at any time and used the loss to offset other income.

But assume Joe's contract was a life policy characterized as a MEC. As noted above, surrender of the contract may not generate a deductible loss so Joe decides to invest another \$5 million (subject to contribution limitations). Withdrawals, loans or pledges from a MEC policy are taxable as ordinary income but only to the extent the cash value of the contract exceeds the investment in the contract.¹³ Until Joe's contract value rises above his total investment (now \$10 million), he should be permitted to take tax-free withdrawals and loans from the MEC policy.

Although this sounds good in theory, the practical problem with most PPLI contracts is that significant additional premiums will most likely disqualify its tax-free status. The next alternative may possibly avoid this limitation.

Exchange a Loser Life Policy for a New Life Policy. Suppose Joe exchanges his loser MEC life policy (basis \$5 million; FMV \$1 million) for a new MEC policy leveraged with an additional \$5 million premium contribution. The result should be a new contract with a \$10 million basis and \$6 million value, thus preserving the original \$4 million loss. It is also noteworthy that the death benefit calculation rules applicable to exchanges should permit Joe to obtain a more cost efficient replacement policy.

A MEC policy can only be exchanged tax-free for another MEC policy so the replacement contract will remain subject to the usual MEC restrictions on withdrawals, loans, and pledges.¹⁴ Nevertheless, tax is imposed on access to MEC values only to the extent of the "income on the contract".¹⁵ So long as

the contract's basis is in excess of its cash value there should be no income on the contract and, therefore, no tax on access to policy values within these limits.

Voila! Joe's old clunker policy has been morphed into an efficient investment accumulation vehicle.

Exchange a Loser Life Policy for an Annuity Contract. In most situations, the permanent exemption afforded life policies makes it undesirable to exchange such policies for the mere tax deferral available through annuities. However, if the life policy has a built-in loss (*i.e.*, basis in excess of fair market value) then such an exchange could be beneficial.

For example, the excess basis in a loser life policy may permit future tax-free withdrawals or loans from the replacement annuity contract despite the typical annuity limitations. This result is based on the same lack of "income on the contract" noted above in the MEC context.

Essentially, this alternative is a variation of the "Add More Premiums to Boost Critical Mass" strategy except (1) no additional premium contributions are required, and (2) conversion to an annuity eliminates the drag of life coverage costs on the investment accumulation. This may represent a more attractive option for many taxpayers.

Technical Failures

So far we have simply discussed situations in which disappointing economic results cause the taxpayer to

reflect on alternative courses of action. A significantly more difficult issue arises in the context of potential technical deficiencies that could affect the basic tax-free status of the contract.

The first task is to distinguish a clear fatal error from mere anxiety over a possible challenge. If the defect is beyond rehabilitation then the only course of action may be a “hat in hand” confession. However, if the taxpayer has simply become uncomfortable with the prior arrangement due to recent trends in this planning area, then there may be opportunities for conversion to a more conservative posture.

The objective in either situation is to make a clean break with the past towards a fresh start that will not taint the future benefits of the structure.

The Summer 2003 developments have shifted most practitioners, insurance companies and taxpayers towards less aggressive positions. It is widely anticipated the IRS will be considerably less sympathetic after expiration of the announced transition period.

To protect their preferred status, IDF managers must become more sensitive to the prior tax and financial history of their investors. The regulatory changes are still evolving but at present there is some risk that investment by a non-compliant contract could adversely affect the “insurance dedicated” nature of an IDF.¹⁶

In sum, all participants in a PPLI project should be concerned with insuring continued compliance with applicable requirements.

IMPACT OF THE ORDERING RULES

The order in which the investor control and diversification rules apply may have a significant impact on their final effect. The particular sequencing has never been explicitly addressed in any authority this author can identify. However, the IRS’ approach in the Summer 2003 rulings indicates the investor control principles must apply first followed by the diversification rules. This ordering is very important because violation of the investor control rule results in a fairly surgical extraction of the particular offending asset from the contract whereas, in contrast, a violation of the diversification provisions causes a total disqualification of the entire contract.

As viewed by the IRS, violation of the investor control doctrine causes the contract holder rather than the insurance company to be treated as the owner of the offending segregated account asset(s).¹⁷ The investor control rules essentially treat the offending asset as if it were no longer part of the contract and, therefore, the contract holder is taxable as if they owned that investment directly without benefit of the favorable insurance tax-free accumulation rules. This investor control analysis most logically applies on an asset by asset basis within the contract segregated account.

In contrast, the diversification rules apply only to assets of the “segregated asset account”. Therefore, any asset deemed owned directly by the contract holder by operation of the investor control rule should not thereafter be considered held within the contract’s

segregated account for purposes of applying the diversification rules.

The practical effect is that at least a portion of the contract may be salvageable in spite of a serious investor control violation unless, of course, that infraction specifically touches each account investment. Every situation should be closely reviewed to determine whether it's time to fall on the sword or there is a reasonable opportunity for a partial cure before a total meltdown.

In many ways the inflexibility of the rigidly defined diversification rules are more difficult to finesse than the subjective "facts and circumstances" investor control principles described in the rulings. The proposed changes to the diversification "look through" provisions as they have applied for many years to non-registered investment partnerships (such as hedge funds) have raised anxiety levels in both the insurance and hedge fund markets. As noted above, many fund managers are scrambling to quickly set up IDF's to accommodate their clients and prevent an outflow of capital.

CONCLUSION

The time has come to take a fresh look at PPLI contracts previously established in a less regulated environment to see if they measure up to the new more discriminating standards. The IRS has taken bold and necessary steps to curtail perceived abuses in this planning area, yet has kindly extended a small olive branch by indorsing the IDF model.

The good news is there's free cheese on the other side of the river. The bad news

is your old boat may need some critical repairs to get you safely to the picnic.

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¹ 2003-33 IRB 1.

² Rev. Rul. 2003-92, 2003-33 IRB 2.

³ The term "non-registered" for these purposes means the investment is not registered with any State or Federal securities laws. See Treas. Reg. Section 1.817-5(f)(2)(ii).

⁴ LTR 200244001 (May 2, 2002).

⁵ The announcement (REG-163974-02) proposes to delete the exception under the "look-through" provisions of Treas. Reg. Section 1.817-5(f)(2)(ii) and the supporting Example 3 of Treas. Reg. Section 1.817-5(g). It should be noted that this exception was never expressly authorized by the statute which means it is well within the IRS' discretion to remove these provisions without Congressional approval. Accordingly, it is very likely these or similar changes will come into effect.

⁶ Section 1035; Treas. Reg. Section 1.1035-1.

⁷ An often over-looked issue in an exchange transaction is that loans outstanding against the contract may constitute taxable "boot" unless the new contract is subject to the same (or higher) loan amount after the exchange. Therefore, any exchange involving a contract with outstanding loans must be carefully coordinated to avoid immediately triggering taxable income on the exchange. See Section 1035(d)(1) cross referencing Section 1031(b) & (c); Treas. Reg. Section 1.1031(b)-1(a) & (c).

⁸ Section 1035(c)(1) & (d); Rev. Rul. 85-159, 1985-2 C.B. 29; PLR 9442030.

⁹ Section 72(e)(10).

¹⁰ Section 162; Rev. Rul. 61-201, 1961-2 CB 46; *Cohan v. Commissioner*, 39 F.2d 540 (2nd Cir. 1930).

¹¹ *Cohen v. Commissioner*, 44 BTA 709 (1941); *Fleming v. Commissioner*, TC Memo 1945; *London Shoe Co., Inc. v. Commissioner*, 80 F.2d 230 (2nd Cir. 1935).

¹² Section 7702; Section 7702A.

¹³ Section 72(e)(10).

¹⁴ Section 72(e)(10); Section 1035(a)(2).

¹⁵ Section 72(e)(10).

¹⁶ Only insurance accounts and very limited other investors (such as the investment manager and certain pensions) are permitted investors in IDF's. *See* Treas. Reg. Section 1.1817-5(f)(3). If the fund has any disqualified investors then it could lose its "insurance dedicated" status and, thereby, adversely impact the qualification of each insurance contract invested therein. The primary concern is whether investment by a contract that has previously violated a diversification or investor control requirement could be characterized as a non-permitted investor. It is optimistically anticipated that upcoming changes to the diversification regulations will provide some relief for this or similar inadvertent discrepancies.

¹⁷ Rev. Rul. 2003-91, 2003-33 IRB 1; Rev. Rul. 2003-92, 2003-33 IRB 2; LTR 200244001 (May 2, 2002).