Managing Investments for an Insurance Company

By Raymond L. Britt Jr., JD, MLT, CFA, TEP

Overview

Private Placement Variable Insurance policies ("PPVI"), which includes both Private Placement Variable Universal Life policies ("PPVUL") and Private Placement Variable Annuity policies ("PPVA"), are fast growing products that combine the tax efficiency and access to cash (for PPVUL) offered by most "retail" oriented variable insurance products -- but with added flexibility for investment choices -- and in a much more cost effective structure. Properly structured, PPVUL may allow the policyholder the ability to eliminate U.S. federal and state income taxes on investment gains, provide tax- and interest-free loans and withdrawals, and provide the payment of an income tax-free death benefit. A PPVA may allow the policyholder the ability to defer U.S. federal and state income taxes on investment gains until distributions are taken from the policy for retirement purposes.

Investment managers that utilize retail variable insurance as an option for their clients will find that PPVI provides (a) the client greater access to flexibility for investment choices and (b) the investment manager the ability to manage assets for a client inside a PPVI. With PPVI, the investment choices and investment managers offered are almost unlimited, subject to normal due diligence on the investment managers (while with typical retail variable insurance, the policyholder is restricted to a limited menu of funds and investment managers).The assets managed under a PPVI are less likely to be permanently withdrawn/redeemed (when compared to non-insurance assets) and may attract new inflows of assets because of the unparalleled tax advantages of these products. However, in order to qualify for and preserve these tax advantages, the PPVI and their underlying investment accounts ("Series") must comply with certain sections of the Internal Revenue Service Code of 1986, as amended (the "Code"), most notably §7702, §72 and §817(h), and the "investor control" doctrine.

§7702 Requirements

Under §7702 of the Code, the term "life insurance contract" is a contract "which is a life insurance contract under the applicable state law" and which meets one of two tests: the "cash value accumulation test" or the "guideline premium and cash value corridor" test. Provided a life insurance policy (including a PPVUL) is properly structured, earnings on policy cash values, including investment dividends, interest, and capital gains are not taxable to the policy owner as they accumulate within the policy. In addition, if the policy is structured as a "non-modified endowment contract" ("non-MEC") (generally, with premiums paid over four or five years and death benefits a certain percentage of the cash surrender value of the policy), proceeds from loans or withdrawals in excess of cost basis may provide tax-free income to the policy owner.

§72 Requirements

There is no similar statutory definition of an "annuity contact". However, applicable regulations under §72 provide that an annuity contract is generally a contract issued by an insurance company that is "considered to be an annuity contract in accordance with the customary practice of life insurance companies." Provided an annuity (including a PPVA) is properly issued, under §72(b), an "exclusion ratio" is used to determine how much of an "amount received as an annuity" is included in gross income. The exclusion ration is a fraction, the numerator of which is the policyholder's investment in the policy, and the denominator of which is the expected return. While income inherent in an annuity policy is taxed ratably over the period that it is received (as chosen by the policyholder), income on a deferred annuity policy is not taxed as it is earned.

In addition to meeting the requirements of §72 and §7702, all variable policies must comply with the investment diversification and "investor control" provisions of IRC Section 817(h).

Diversification under §817(h) Requirements

Generally, 817(h) requires that each insurance policy investment account hold at least five different securities and that:

- No one investment constitutes more than 55% of the value of the total assets of the account;
- No two investments constitute more than 70% of the value of the total assets of the account;
- No three investments constitute more than 80% of the value of the total assets of the account; and
- No four investments constitute more than 90% of the value of the total assets of the account.

Any investment manager managing a Series will be required to ensure that each Series complies with diversification requirements under §817(h).

Investor Control

"Investor control" involves limitations on the policyholder's right to control the investments within the Series. It is very important that:

- There was no arrangement, plan, contract, or agreement between the policyholder and the insurer, or between the policyholder and the investment manager, regarding the availability of specific assets to be held by a particular Series. The policyholder can choose a particular strategy for a particular Series;
- Other than the policyholder's right to allocate premiums and transfer funds among available Series, all investment decisions concerning the Series is made by the insurer or the investment manager hired by the insurer, in their sole and absolute discretion. Specifically, the policyholder cannot select or recommend particular investments or investment strategies;
- The policyholder cannot communicate directly or indirectly with any investment manager of the insurer regarding selection, quantity or rate of return of any specific investment or group of investments held in a Series;
- All decision concerning the choice of an investment manager or the choice of any of the insurer's investment officers are made by the insurer company in its sole and absolute discretion;
- The policyholder may not communicate directly or indirectly with the insurer concerning the selection or substitution of an investment manager or the choice of any of the insurer's investment officers;
- The policy holder has no legal, equitable, direct or indirect interest in any of the assets in the Series, and all assets in a Series are owned by the insurer; and
- The investment strategies of the Series are sufficiently broad to prevent the policyholder from making particular investment decisions by choosing a particular Series.

Nonetheless:

- Potential policyholders should be able to recommend to the carrier what they consider to be good investment managers;
- The carrier is under no obligation to use the investment manager recommended by the policyholder. The Carrier may or may not add the investment manager after completing its own due diligence review, which the Carrier does under all circumstances;

- If a recommended investment manager is approved by the Carrier, its name will be added to a list of approved investment managers approved by the carrier and will be listed in Appendix A of the carrier's private placement memorandum (the "PPM");
- The policy holder may select the recommended investment manager from those listed in Appendix A of the PPM;
- The carrier in its sole discretion will determine whether an approved investment manager should be removed from Appendix A. The policyholder does have the right to allocate premiums to any of the investment managers listed in Appendix A of the PPM**.**

Failure to comply with diversification and "investor control" guidelines will jeopardize the tax status of the insurance policy and could lead to termination of the insurer's relationship with the investment manager. As part of the agreements with the insurer, all investment managers will be required to comply with §817(h) and the "investor control" rules.

Raymond L. Britt Jr., JD, MLT, CFA, TEP

Mr. Britt is legal consultant to Accel Fund Services and a partner in the Virginia law firm of Hubbard, Terry and Britt. His practice areas are insurance law, international taxation, trust and estates and elder law. From 2009 through 2012, Mr. Britt was responsible for the offshore private placement insurance product offered by Pramerica of Bermuda Life Assurance Company, a subsidiary of Prudential Financial, Inc. From 2003 through 2009, Mr. Britt was a legal, tax and investment consultant to Sun Life Assurance Company of Canada (U.S.) for its individual private placement insurance and COLI/BOLI products. Mr. Britt was also responsible for the individual private placement insurance products in Asia and Europe. From 1982 through 2002, Mr. Britt held various positions with Manufacturers Life Insurance Company in the areas of law, taxation, and investments. Mr. Britt is a graduate of The University of Virginia, with a B.S. in Nuclear Engineering, a graduate of the University of Western Ontario, with a LL.B degree and a graduate of the Marshall-Wythe School of Law, The College of William and Mary, with a M.L.T degree. Mr. Britt also holds the C.F.A. designation.