Investment Tax Issues for Insurance Companies

ABA Tax Section
2019 Midyear Tax Meeting
Insurance Companies Committee

Jean M. Baxley; Deloitte LLP
Graham R. Green; Eversheds Sutherland (US) LLP
Michael A. Mingolelli, Jr.; Winged Keel Group
Roger Wise; Willkie, Farr & Gallagher LLP
Topics

• Industry Overview Address
• Recent Guidance – Rev. Proc. 2015-54
• Qualified Opportunity Zone Funds
• Amended Section 451(b)
• Qualified Business Income
• PFICs – Next Steps
Industry Overview Address

Agenda

• Effect of New Tax Law
• Growth in AUM
• Insurance-Dedicated Fund (IDF) Landscape and Line Up
• Growing Number of RIA Participation
• Growing Number of Brokers Participating in The Market
• Product Innovations
• Applications of PPVA and PPLI
• Where the Growth Has Occurred to Date
• Where Future IDF Growth Opportunities May Exist
Effect of New Tax Law

• Loss of deductibility of State and Local taxes has significant impact on investment returns. In many jurisdictions this results in an additional 40 - 50 bps of annual drag

• Examples assuming 75% STCG / Ordinary Income; 25% LTCG in San Francisco:

<table>
<thead>
<tr>
<th></th>
<th>New Tax Rates</th>
<th>PPLI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return After Investment Management Fees</td>
<td>7.00%</td>
<td>Return After Investment Management Fees</td>
</tr>
<tr>
<td>Federal Tax Rate at 36.55%</td>
<td>-3.11%</td>
<td>Impact of PPLI Fees and Charges at Life Expectancy</td>
</tr>
<tr>
<td>State and Local Tax</td>
<td>-1.13%</td>
<td></td>
</tr>
<tr>
<td>Deduction for State and Local Tax</td>
<td>0.00%</td>
<td></td>
</tr>
<tr>
<td>Net After-Tax Return</td>
<td>2.76%</td>
<td>Net After-Tax Return</td>
</tr>
</tbody>
</table>

Notes:
1. Assumes the net level annual rates of return shown above after a 1.50% investment management fee and before insurance-related charges on a $10 million investment in a PPLI Account and a Taxable Investment Account, 75.00% of realized gains are taxed at the Short Term Capital Gains (STCG) / Ordinary Income rate, and 25.00% of realized gains are taxed at the Long Term Capital Gains (LTCG) rate.
2. Assumes that investment management fees are not tax-deductible in the Taxable Investment Account.
3. Assumes a Federal Short Term Capital Gains (STCG) / Ordinary Income tax rate of 40.80% and Long Term Capital Gains (LTCG) tax rate of 23.80%. Assumes the tax rates shown will be applicable for all years.
4. Assumes 13.30% combined State and Local tax rates for San Francisco, CA.
5. Assumes State and Local taxes are effectively non-deductible under New Tax Rates due to the $10,000 limitation.
6. Assumes insured, a male age 50, will be classified as a Preferred non-smoker life insurance risk. The life expectancy of a male age 50 classified as a Preferred non-smoker life insurance risk is 40 years. Life expectancy is defined herein as the year in which the probability of the insured still being alive is 50%, based on Society of Actuaries' 2008 VBT Select mortality table.
7. In the Taxable Investment Account, an additional annual outlay of approximately $39,606 is required in years 1 – 10 for the annual premium for a $36,271,519 term life insurance policy for a male age 50 classified as a Preferred non-smoker life insurance risk at a 7.00% level annual rate of return net of investment management fees. Due to rounding, this additional annual outlay is not readily apparent in the illustrated results.
8. Assumes the PPLI policy is issued in the state of South Dakota and is structured to qualify as a non-Modified Endowment Contract (non-MEC). Under current tax law, if the policy lapses or is surrendered, all investment gains in excess of the policyowner's cost basis are taxed to the policyowner as Ordinary income in the year the policy lapses or is surrendered.
Industry Growth

- From the start of 2014 to now the assets in Magnastar have more than doubled
- Lombard assets under administration grew by $4 billion in 2017
- Since the start of 2014, Zurich has experienced a 67% annualized growth rate in their High Net Worth Private Placement Business segment
- Crown Global had premium and future commitments of $820 million in 2017
- Pacific Life is adding 24 IDFss to their platform in 12 months
- SALI Fund Services AUM has doubled since the start of 2015
Insurance-Dedicated Fund (IDF) Landscape and Line Up

- Significant increase in number of investment options available in both registered and non-registered space
  - Increase in number of IDFs administered by SALI (data presented for 2018 in chart below includes both existing IDFs and IDFs currently under development)
Insurance-Dedicated Fund (IDF) Landscape and Line Up (continued)

- Single manager strategy IDFs administered by SALI, both existing and under development, increased from 19 in 2014 to 84 today
- **Non-registered IDFs increased from approximately 141 in 2014 to approximately 186 today**
  - Approximately 63% are single manager strategy IDFs
- AUM of IDFs continues to increase
- More and more IDFs are getting to scale
  - 35 IDFs administered by SALI have over $50 million of AUM
  - 22 IDFs administered by SALI have over $100 million of AUM
- **Registered IDFs increased from approximately 240 in 2014 to over 390 today**
Insurance-Dedicated Fund (IDF) Landscape and Line Up (continued)

• The environment for understanding the characteristics of the underlying investments is significantly more robust than just a few years ago. Key factors include:
  
  • Private Letter Rulings (PLRs) regarding the ability to improve transparency into underlying positions:
    
    • PLR 201323003: “The Contract Holders do not have, and will not have, any current knowledge of Insurance Fund’s specific assets or Insurance Fund’s specific allocation. Insurance Fund’s portfolio holdings, however, are made available on a delayed basis in monthly postings on the manager’s website, in quarterly filings with the SEC, and in annual and semi-annual reports to shareholders.”
    
    • PLR 201417007: “The asset holding of (the IDF)...will be publicly available on ADVISER’s website only on a delayed basis (about five days after the end of each month).”
  
  • PLR regarding the ability to create IDFs similar to taxable hedge funds:
    
    • PLR 201417007: “Each of the [IDFs] will have investment objectives and strategies identical to [the Manager’s publicly available] portfolios and will therefore invest in the same [underlying investments]. As [the Manager] manages the [IDFs] and [the Manager’s publicly available] portfolios, it will adjust their positions in the [underlying investments]. To the extent that [an IDF] and [the Manager’s publicly available] portfolio have the same investment objectives, the adjustments for each will be the same.”
  
  • Reaffirmation of Investor Control Doctrine through Webber v. Commissioner
Insurance-Dedicated Fund (IDF) Landscape and Line Up (cont’d)

IDFs by Strategy: Total Market
- Single Manager IDFs
- Multi-Manager IDFs

2014:
- Total IDFs: 141
- 69% Multi-Manager
- 31% Single Manager

2018:
- Total IDFs: 186
- 44% Multi-Manager
- 56% Single Manager

IDFs by Strategy: SALI 2018
- Multi-Manager (45%)
- Multi-Strategy (11%)
- Long-Only Equity (5%)
- Long/Short Equity (3%)
- Other (1%)
- Private Real Estate (1%)
- Market Neutral (1%)
- Credit (18%)
- Private Equity (6%)
- Event Driven (4%)
- Interest Rate (2%)
- MLP (1%)
- Global Macro (1%)
- CTA (1%)

Total IDFs:
- 2014: 141
- 2018: 186
Insurance-Dedicated Fund (IDF) Landscape and Line Up (continued)

• Growth in registered and non-registered IDFs has been important, but it is also important to have consistency in fund offerings across insurance companies
  • 72 IDFs are available through 3 or more insurance companies
  • Of the IDFs launched over the last five years, 42 are available through 3 insurance companies
  • Deutsche Bank, Dimensional Fund Advisors, Dreyfus, Fidelity, Goldman Sachs, PIMCO, and T. Rowe Price registered funds are available through at least 3 insurance companies
  • Vanguard registered funds are available through a number of insurance companies and more insurance companies are looking to add Vanguard registered funds

• Marketing incentive fees: 35 IDFs administered by SALI share a portion of the management fee with distributors
Insurance-Dedicated Fund (IDF) Landscape and Line Up (continued)

- Greater awareness in investment management community of the role IDFs play for high net worth and institutional investors
- Greater understanding of turnkey IDF solutions for entering the market quickly and cost efficiently
- Greater and easier access to IDF performance information in user friendly format
Growing Number of RIA Participation

• Allocating among existing IDFs
  • Utilization of the Lombard allocator model

• Creating custom IDFs of one that enable one custom vehicle to be available across multiple carriers

• Creating co-mingled IDFs

• Use of SMAs
Growing Number of Brokers Participating in the Market

• Number of brokers: Over the last few years, over 50 brokerage firms who have placed a Private Placement policy allocated to IDFs administered by SALI

• Growing number of educational forums
  • Lombard Alpha Alliance Conference
  • Private Placement Life Insurance & Variable Annuities Forum (IIR)
  • Context Summit Conferences
  • Fall Private Placement Conference, Hosted by SALI Fund Services
  • MAGNASTAR® Regional Advisors Meetings
  • AICPA and other Estate Planning Conferences
  • IIG Conference
  • Ad-hoc Advisor Seminars and Roundtable Forums

• Embracement of broker collaboration

• Insurance company support in training and implementation has been helpful in expanding the number of brokers entering Private Placement space

• Growth in I-COLI and GVA to eliminate UBTI, ECI, and FIRPTA has created opportunities for institutional brokers to spend more time in this market
Product Innovations

• Ability for RIAs to be paid from product for allocating to IDFs and VITs
• New structures and reinsurance treaties that enable larger portfolios to be structured
• Availability of private market IDFs for institutional and high net worth vehicles
• Openness to draw-down IDF structures under the right circumstances
• Ability to do analytical sorts and download tear sheets from SALI Portal
Please see Disclosures page for important information.

Notes:
1. Chalkstream Capital Group, LP was retained as “Investment Subadvisor” as of 2/1/09. The fund was managed by another Investment Subadvisor prior to this date. Historical performance data for periods prior to the retention of Chalkstream Capital Group, LP as Investment Subadvisor has been omitted but is available upon request to the General Partner.
2. Results exclude uninvested cash that is wired to portfolio managers the following month.
3. Millennium Global Estate Series launched on 10/1/2013 and invests substantially all of its assets in Millennium Global Estate LP. As such, performance results presented from July 2015 through February 2013 are representative of returns achieved by Millennium Global Estate LP rather than Millennium Global Estate Series. Returns as of March 2015 are representative of what a Class A investor in the Millennium Global Estate Series would have attained. For historical performance prior to January 1, 2008, the incentive allocation was included as a monthly expense despite generally being reallocated at the end of a fiscal year. As of January 1, 2008, the incentive allocation was replaced with an asset-based management fee which is reflected as a monthly expense in returns subsequent to such date.
4. Performance results for this fund are only published quarterly. As such, any MTD return presented is actually a quarterly return, and any YTD return presented is as of the last quarter end.
5. The risk free rate applied to the Sharpe Ratio calculation is calculated based on methodologies employed by the Investment Subadvisor.
Applications of PPVA and PPLI – High Net Worth Individual Investors

• PPVA
  • Tax-deferred investing – Ideal for alternative asset class investments where a significant portion of the gains are subject to ordinary income or short-term capital gain rates, and for clients that may relocate to a state with low state income tax rates (Florida, Nevada, Texas, etc.).
  • Charitable Legacy planning – Ideal for tax-efficient investing of capital that clients want to maintain ownership of, but may leave to a private foundation or public charity at death.
  • Restructuring high-fee retail variable annuities – IRC Section 1035 Tax-Free Exchange allows for asset values within high-cost retail variable annuities to be transferred, free of income tax, into a PPVA Account with lower fees and more robust investment options.

• PPLI
  • Tax-exempt investing – Investment returns accumulate on a tax-deferred basis and are eventually received by a beneficiary on an income tax-free basis. If structured as a non-Modified Endowment Contract (non-MEC), approximately 80% – 85% of the PPLI Account values can be accessed income tax-free during the insured’s lifetime.
  • Dynasty Trust investment management – Generation Skipping Trust assets grow tax-deferred within PPLI Investment Accounts, potentially eliminating the annual tax bill for Grantors.
  • 457A mitigation for investment manager offshore deferral accounts – Investment managers repatriating assets in accordance with 457A can mitigate their income-tax exposure by combining the tax attributes of a PPLI Investment Account and a Charitable Lead Annuity Trust (CLAT).
Applications of PPVA and PPLI – Institutional Investors

• PPVA
  • UBTI Blocker – Foundations and endowments utilize PPVA Investment Accounts to eliminate Unrelated Business Taxable Income (UBTI), which is generated by many of the investments they make.
  • FIRPTA / ECI – Sovereign wealth funds and foreign investors utilize PPVA Investment Accounts to simplify FIRPTA reporting and eliminate Effectively Connected Income (ECI).

• PPLI
  • Insurance-Company Owned Life Insurance (I-COLI) – Insurance company general accounts can invest in alternative asset class investments on an income tax-efficient basis, while also mitigating Risk Based Capital (RBC) charges. Given the persistence of a low interest rate environment, insurance companies seeking to achieve their investment portfolio target will continue to seek alternative asset classes.
Where the Growth has Occurred to Date – High Net Worth Individual Investors

• Family offices
  • Wealthiest US tax paying families eliminating income tax on intergenerational trust assets

• Restructuring high-fee variable annuities

• High net worth individual investors
  • Shielding or deferring tax-inefficient asset classes from income tax

• International families
  • Pre-immigration planning
  • Asset protection / diversification
  • UNI / DNI Elimination

• Insurance companies are being flexible in accommodating transfers from legacy platforms to new platforms
  • Concessions on underwriting and pricing
  • Importance of SALI in facilitating in-kind transfers
  • Opportunity to get money to new managers launching IDFs
Where the Growth has Occurred to Date – Institutional Investors

• Institutional
  • I-COLI: significant deals have closed and many others are in various stages of implementation
  • 1 in 4 SALI IDFs were launched with I-COLI in 2017

• UBTI elimination
  • MLP managers
  • Direct lending managers
Where Future IDF Growth Opportunities May Exist

• There are six major bank platforms that have launched Private Placement initiatives
  • They have begun to get asset flows but have yet to get to critical mass
  • We believe the approach of embracing third-party managers will allow these initiatives to experience growing success
  • 5 - 10 other platforms are looking to launch initiatives in the next 24 months

• BOLI: Potential to build Stable Value Wraps into IDFs to allow BOLI buyers to have a broader range of bank eligible investment options

• Sovereign wealth funds and systemically important government organizations using GVA to eliminate ECI, FIRPTA, etc. under Section 892 using IDFs

• Other non-US investors using GVA to eliminate various tax and regulatory elements through SMA accounts
  • SALI has developed businesses to support these SMA applications

• COLI: Potential to add higher-yielding investment offerings to traditional COLI
Recent Guidance — Rev. Proc. 2018-54

• Background on section 817(h) Diversification Requirement
• Five investment test (55%/70%/80%/90%)
• Look through rule for insurance dedicated funds
• Each government agency or instrumentality treated as a separate issuer
• 30-day period to cure
• Remediation
Recent Guidance — Rev. Proc. 2018-54

• Single Security Initiative of Federal Housing Finance Agency
  • Uniform MBS (UMBS) to be issued by both Fannie Mae and Freddie Mac starting June 2019
  • Conform terms, increase liquidity

• To-be-announced (TBA) market
  • Current practice includes specifying issuer
  • Changes for future TBA orders for UMBS

• Diversification problem
  • Without knowing identity of issuer until shortly before settlement, potential to exceed limits of five investment test
  • 30-day period to cure or seek remediation
Recent Guidance — Rev. Proc. 2018-54

• Solution in Guidance
  • Make deemed-issuance-ratio election to treat each UMBS as issued pro rata by each of Fannie Mae and Freddie Mac
    • Deemed ratio continues to apply even after ultimate actual issuer known
    • Fannie-to-Freddie proportion set annually
  • Applies to UMBS purchased without advance knowledge of issuer of UMBS to be delivered
    • Election irrevocable without IRS consent

• Open Questions
  • Treatment of TBA
  • Election mechanics/scope (issuer v. IDF)