Insurance Company Separate Accounts

ABA Tax Section
2019 Midyear Tax Meeting
Investment Management Committee

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

• Key Trends & Growth
• Background on section 817(h)
• Recent Guidance
  • Rev. Proc. 2015-54
  • Notice 2016-32
• Investor Control Updates
  • Webber v. Commissioner
  • Recent Investor Control PLRs
Key Trends & Growth Agenda

• Effect of New Tax Law
• Private Placement Variable Annuity (PPVA)
• Private Placement Life Insurance (PPLI)
• Industry Growth
• Insurance-Dedicated Fund (IDF) Landscape and Line Up
• Growing Number of Registered Investment Advisor (RIA) Participation
• 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 may result in an additional 40 - 50 basis points (bps) of annual drag.

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

<table>
<thead>
<tr>
<th>New Tax Rates</th>
<th>Return After Investment Management Fees</th>
<th>7.00%</th>
<th>Return After Investment Management Fees</th>
<th>7.00%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Tax Rate at 36.55%</td>
<td>-3.11%</td>
<td>Impact of PPLI Fees and Charges at Life Expectancy</td>
<td>0.52%</td>
<td></td>
</tr>
<tr>
<td>State and Local Tax</td>
<td>-1.13%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deduction for State and Local Tax</td>
<td>0.00%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<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.
Private Placement Variable Annuity (PPVA) – Overview

Tax Characteristics

► Investment returns accumulate on an income tax-deferred basis
  
  IRC Section 72

► Assets within a PPVA Account may be reallocated without income tax
  
  Rev. Rul. 81-225 and Rev. Rul. 82-54

► When withdrawals are taken from a PPVA Account, deferred gains are subject to income tax at ordinary rates. There is a 10% excise tax on the gain element of withdrawals taken before age 59½
  
  IRC Section 72

► If distributions are taken in a systematic manner, a portion of each distribution is considered a return of cost basis and a portion is considered gain
  
  IRC Section 72

► If a private foundation or public charity is designated as the beneficiary of a PPVA Account, deferred gains become fully exempt from income and estate taxes at the death of the annuitant
  
  IRC Section 72

► Permits income tax-free exchanges from other annuities or life insurance policies
  
  IRC Section 1035

Attributes

► No limits on contributions

► No upfront loads or surrender charges

► No restrictions on withdrawals

► No distributions required until age 95 or older

► Not subject to life insurance company credit risk

► No K-1s
Private Placement Variable Annuity (PPVA) – Comparative Economic Results

$10 Million Investment
75% STCG / Ordinary Income; 25% LTCG
7.00% Return Net of Investment Management Fees

Notes:
1. Assumes a net level annual rate of return of 7.00% after a 1.50% investment management fee on a $10 million investment in a PPVA Account and a Taxable Account, 75% of realized gains are taxed at the Short Term Capital Gains (STCG) / Ordinary Income rate, 25% of realized gains are taxed at the Long Term Capital Gains (LTCG) rate, and no withdrawals are made before age 59½. There is a 10% excise tax on gains if withdrawals are made from a PPVA Account before age 59½.
2. Assumes that investment management fees are not tax-deductible in the Taxable Account. The PPVA Account enables all investment management fees and expenses to become effectively tax-deductible.
3. Assumes a STCG / Ordinary Income tax rate of 47.80% and LTCG tax rate of 30.80%. Assumes the tax rates shown will be applicable for all years.
4. The analysis above does not include any fees charged by professional advisors engaged by the client for tax and/or legal advice.
**Private Placement Life Insurance (PPLI) – Overview**

**Tax Characteristics**

- **Investment returns accumulate on an income tax-deferred basis**
  
  IRC Section 7702(g)(1)(A)

- **Assets within a PPLI Account may be reallocated without income tax**
  
  Rev. Rul. 81-225 and Rev. Rul. 82-54

- **Withdrawals up to cost basis and properly structured loans may be taken on an income tax-free basis. Approximately 80% - 85% of PPLI Account values can be accessed income tax-free during the insured’s lifetime**
  
  IRC Section 72(e)(3) and 72(e)(5)

- **If a PPLI Account is fully surrendered, deferred investment gains are subject to income tax at ordinary rates**
  
  IRC Section 72(e)(3)

- **Life insurance benefit proceeds received by a beneficiary, including any accumulated investment gains, are fully exempt from income tax**
  
  IRC Section 101(a)(1)

**Attributes**

- **Assets held in Separate Accounts are not subject to life insurance company credit risk. Life insurance benefit proceeds in excess of PPLI Account asset values are subject to life insurance company credit risk**

- ** Allows flexibility in amount and timing of deposits**

- **Can be syndicated among insurance companies to provide greater funding capacity and competitive pricing**

- **The costs include: federal Deferred Acquisition Cost (DAC) tax, state premium tax, a structuring fee, cost of insurance charges, and policy administration fees**

- **No K-1s**
## Private Placement Life Insurance (PPLI) – Comparative Economic Results

### Comparative Economic Results: $10 Million Investment

75% STCG / Ordinary Income; 25% LTCG

8.50% Gross Return (7.00% Return Net of Investment Management Fees)

<table>
<thead>
<tr>
<th>Year</th>
<th>Taxable Account Value (after-tax)</th>
<th>PPLI Account Value (before-tax)</th>
<th>PPLI Liquidity Value (after-tax)</th>
<th>PPLI Insurance Benefit (tax-free)</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>$13.8</td>
<td>$15.8</td>
<td>$21.2</td>
<td>$34.4</td>
</tr>
<tr>
<td>20</td>
<td>$19.1</td>
<td>$29.7</td>
<td>$34.4</td>
<td>$49.8</td>
</tr>
<tr>
<td>30</td>
<td>$26.5</td>
<td>$49.8</td>
<td>$56.4</td>
<td>$59.2</td>
</tr>
<tr>
<td>40</td>
<td>$36.6</td>
<td>$95.4</td>
<td>$105.8</td>
<td>$111.1</td>
</tr>
</tbody>
</table>

### Notes:

1. Assumes a net level annual rate of return of 7.00% after a 1.50% investment management fee and before insurance-related charges on a $10 million investment in a PPLI Account and a Taxable Account. 75% of realized gains are taxed at the Short Term Capital Gains (STCG) / Ordinary Income rate, and 25% 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 Account.

3. Assumes a STCG / Ordinary Income tax rate of 47.80% and LTCG tax rate of 30.80%. Assumes the tax rates shown will be applicable for all years.

4. Assumes insured, a male age 50, will be classified as a Standard non-smoker life insurance risk. The life expectancy of a male age 50 classified as a Standard 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.

5. In the Taxable Account, an additional annual outlay of approximately $66,263 is required in years 1 - 10 for the annual premium for a $36,268,785 term life insurance policy for a male age 50 classified as a Standard non-smoker life insurance risk. Due to rounding, this additional annual outlay is not readily apparent in the illustrated results.

6. Assumes the 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 policy owner’s cost basis are taxed to the policyowner as Ordinary Income in the year the policy lapses or is surrendered.

7. The analysis above does not include any fees charged by professional advisors engaged by the client for tax and/or legal advice.
The number of attractive investment options available through PPVA and PPLI is increasing dramatically, which in turn has exponentially increased the adoption rate among the wealthiest US families.
Insurance-Dedicated Fund (IDF) Landscape and Line Up

Significant increase in number of investment options available in both registered and non-registered space

• **Non-registered IDFs increased from approximately 141 in 2014 to approximately 186 today**
  • Approximately 57% are single manager strategy IDFs

• **Registered IDFs increased from approximately 240 in 2014 to over 390 today**

• Assets Under Management (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
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 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
The number of single-manager IDFs is steadily increasing, with a greater diversity in investment strategies available.
There are over 390 Registered IDFs available, with many brand-name investment managers including, but not limited to:

- Deutsche Bank
- Dimensional Fund Advisors
- Dreyfus
- Fidelity
- Goldman Sachs
- JPMorgan
- Oppenheimer
- PIMCO
- T. Rowe Price
- Vanguard

Marketing incentive fees: 35 IDFs administered by SALI share a portion of the management fee with distributors
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 Separately Managed Accounts (SMAs)
  • More carriers are building the infrastructure to support SMAs
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

• Improved technology allows investors to do analytical sorts and get fund data more easily
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.

- **UNI / DNI Blocker** - Under certain circumstances, a foreign non-grantor trust can utilize a PPVA or PPLI Account to eliminate the accumulation of income on investment returns, thereby mitigating the potential impact of both Undistributed Net Income (UNI) and Distributed Net Income (DNI), along with the corresponding U.S income taxes and penalties.
Applications of PPVA and PPLI – Institutional Investors

• PPVA
  
  • **UBTI Blocker** - Foundations and endowments utilize PPVA 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 Accounts to simplify Foreign Investment in Real Property Tax Act (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
  - UNI / DNI Elimination
  - Asset protection / diversification
  - Pre-immigration planning
- Insurance companies are being flexible in accommodating transfers from legacy platforms to new platforms
  - Concessions on underwriting and pricing
  - 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
  • 50% of SALI IDF’s were launched with I-COLI in 2018

• UBTI elimination
  • Master Limited Partnership (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

• COLI: Potential to add higher-yielding investment offerings to traditional COLI
Background on section 817(h)

• Issue – investment-oriented contracts
• Consequence – failing to satisfy either the section 817(h) diversification requirement or the Investor Control Doctrine results in treatment of contract owner, and not issuer, as owner of the underlying investment assets in SAA
• Diversification Requirement – section 817(h)
  • 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 or 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)
Recent Guidance — Notice 2016-32

• Government Money Market Funds
  • Invest at least 99.5% of total assets in cash, government securities, or fully collateralized repurchase agreements

• Demand problem
  • Increase in demand for Government Money Market Funds, but limited number of issuers
  • How to meet five investment minimum and percentage limitations?

• Solution
  • Alternative diversification requirement to treat SAA as adequately diversified if:
    • No policyholder has investor control, and
    • Either (i) account itself is a government money market fund, or (ii) account invests all of its assets in an investment company, partnership, or trust that qualifies for treatment under the look through rule and qualifies as a government money market fund
  • Regulations or future administrative guidance to be issued
Investor Control Updates —
Webber v. Commissioner, 144 T.C. 324 (2015)

• First investor control case since Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984) – variable annuity contracts

• Private placement variable life insurance contracts

• Extensive factual record of control and active management by policyholder

• Tax Court found policyholder, not issuer, owned SAA assets
  • Acknowledges continued relevance of Investor Control Doctrine
  • Benefits and burdens of tax ownership analysis
  • Skidmore deference to IRS Revenue Rulings

• Accuracy-related penalties not imposed
Investor Control Updates

• Recent Investor Control PLRs
  • 201705003 – investments in publicly available RICs; adviser’s discretion and authority defeated ability to replicate
  • 201651012 – adviser’s discretion and authority defeated ability to replicate
  • 201651002 – adviser’s discretion and authority defeated ability to replicate
  • 201540004 – investments include ETFs affiliated with subadvisor
  • 201504005 – investments in publicly available RICs; adviser’s discretion and authority defeated ability to replicate
  • 201502003 – overlap in investments between IDF and public funds; IC protocols

• Open Questions
  • Maximum number of permissible funds?
  • Maximum number of permissible transfers?
  • Where is the line?
Disclosures

A Private Placement Life Insurance (PPLI) Account is an unregistered securities product and is not subject to the same regulatory requirements as registered products. As such, a PPLI Account should only be presented to accredited investors or qualified purchasers as described by the Securities Act of 1933.

This material is for educational purposes to illustrate the concept and effect of insurance charges when purchasing life insurance compared to investing in a taxable account. Educational material should not be construed as legal or tax advice and is not intended to replace the advice of a qualified attorney, tax advisor and plan provider.

The information presented here is not an offer to purchase, recommendation, or the solicitation of an offer to purchase an investment product as this strategy may not be suitable for your specific situation. Consider your personal investment horizon and income tax bracket, both current and anticipated, when making an investment decision as these may further impact the results of the comparison. Note that lower maximum tax rates on capital gains and dividends would make the investment return for the taxable investment more favorable, thereby reducing the difference in performance between the accounts shown. Please consult with a tax and/or legal advisor before entering into any sophisticated financial arrangement.

For specific facts about the policy or investment that may be recommended to you, please carefully read the (Prospectus) or (Private Offering Memorandum), as it will contain details regarding risks and characteristics that are not contained in this illustration, and should be used as your primary source of information. Under no circumstances should this illustration be construed as an offer to purchase a security.

Private placement life insurance is an unregistered securities product and is not subject to the same regulatory requirements as registered variable products. As such, private placement life insurance should only be presented to Accredited Investors or Qualified Purchasers as described by the Securities Act of 1933. Specific information must be obtained from careful review of the private offering memorandum for each policy that is recommended for purchase. The offering memorandum will contain specific and detailed risk and characteristic disclosures that are not contained in the illustrations. The disclosures in the offering memorandum should be the only source of information relating to any specific policy and there should be no reliance on educational materials in deciding whether to purchase any products.

The financial illustrations and other statements within this report, as well as comments made by any individuals, are not guaranteed and do not constitute a contract. Any contract entered into is between the PPLI Account owner and the insurance company, through its PPLI policy. You should read the PPLI Account contract and offering documents thoroughly.

Variable Universal Life insurance combines the protection and tax advantages of life insurance with the investment potential of a comprehensive selection of variable investment options. The insurance component provides death benefit coverage and the variable component gives you the flexibility to potentially increase the policy’s cash value.

Variable life insurance products are long-term investments and may not be suitable for all investors. An investment in variable life insurance is subject to fluctuating values of the underlying investment options and entails risk, including the possible loss of principal. Policy values will vary based on the actual performance of sub-account investments selected, actual insurance charges over the life of the plan and the timing of premium payments. The policyholder may receive more or less than the amount invested.

These calculations make assumptions as to future investment returns, mortality costs, and administrative expenses and are not guaranteed. Actual results may be higher or lower than illustrated. Loans and partial withdrawals will decrease the death benefit and cash value and may be subject to PPLI Account limitations and income tax.

If the life insurance policy is or will become a Modified Endowment Contract (MEC), any distribution from a MEC (including assignments, policy loans, withdrawals, and partial surrenders) is taxable as ordinary income on a Last In First Out (LIFO) basis to the extent of policy gain. In addition, a 10.00% penalty tax is imposed on the gain portion of any distribution made prior to the policy owner’s age 59 1/2.

Alternative investments, such as hedge funds within private placement life insurance, involve risks that may not be suitable for all investors. These risks include (but are not limited to) the possibility that the investment may not be liquid, principal return, and/or interest rate risk. Higher fees associated with alternative investments may offset any potential gains. Investors should consider the tax consequences, costs and fees associated with these products before investing by consulting with qualified professionals.

Investors should consider the investment objectives and horizons, income tax brackets, risks, charges, and expenses of any variable product carefully before investing. This and other important information about the investment company is contained in each fund’s offering memorandum, which can be obtained by calling 212.527.8000. Please read it carefully before you invest.

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