Contingencies, May/June 2000, a publication of the American Academy of Actuaries

Private Placement Variable Universal Life

A Primer on ppVUL

by Tom Bakos

It always frustrates me when other people talk about the newest insurance product concepts in front of me and I have to pretend to know what they're talking about. I've found that if you arm yourself with a little knowledge you'll be better prepared for the elevator chatter with the office know-it-all. The old saw says, "A little knowledge is a dangerous thing," but it isn't clear exactly who's in danger. There's no reason to sweat when your little bit of knowledge can make your inquisitor think he's happened upon the wrong guy, someone who may know more than he does!

So when the topic of private placement variable universal life (ppVUL) came up (so to speak) in the elevator the other day, I kept my handkerchief in my pocket. It was my turn to watch the other guy sweat because this time, I was the one who had the facts.

Basic Facts

A ppVUL product is, essentially, a variable universal life insurance contract that's not part of a general public offering (not distributed by prospectus to the general public). Instead, it's a private offering, available only to qualified purchasers. These qualified purchasers are people of substantial economic means (as defined by federal securities laws) and are presumed to have investment savvy. The term *private placement* has been commonly used to describe this type of offering.

In a ppVUL offering, a less formal private placement memorandum usually replaces the prospectus that's required in the sale of the more conventional VUL product, a registered security. In addition, insurance companies offering ppVUL products are careful to make sure that only qualified purchasers are involved in the sale.

A variable life insurance contract is affected by the regulatory authority of at least three bodies: the Securities and Exchange Commission (SEC), state insurance departments and the Internal Revenue Service (IRS).

The SEC is an independent, quasi-judicial regulatory agency that administers federal securities laws and issues rules and regulations to protect investors. Since variable life products are securities, they fall under the regulatory authority of the SEC. The SEC's aim is to ensure a fair and honest securities market.

Individual state insurance departments administer the insurance laws of their respective states with the primary objective of protecting the interests of policyholders. State regulation addresses three basic areas: the solvency of companies transacting insurance business in the state; product equity (including policy form approval and dividend payments); and market conduct including illustration regulation, agent licensing and (sometimes) compensation. Since variable life products are insurance, they fall under the regulatory authority of state insurance departments.

The federal taxes that fall under the jurisdiction of the IRS include personal and corporate income taxes, excise, estate and gift taxes. Life insurance receives special treatment under the Internal Revenue Code in that the internal interest accumulations (the inside buildup) within a life insurance contract are not subject to immediate taxation, unlike other forms of investment.

Because insurance is taxed differently and more favorably than a pure investment, the IRS takes a special interest in distinguishing insurance products from investment products. Since it's desirable for products sold as insurance to maintain their tax status as insurance, the tax code and the regulations and rules used to implement the tax code are important considerations.

Securities Laws, the SEC and ppVUL Products

The sale of securities such as variable life insurance are regulated, in part, by the Securities Act of 1933. The primary purpose of the 1933 act is to protect investors by requiring that they be provided with information material to the sale of publicly offered securities and to prevent misrepresentation, deceit or fraud in their sale. It accomplishes this objective by requiring registration of offers and sales of securities. With the information provided in the registration statements, potential investors in a security are supposed to be able to make a realistic appraisal of its merits and exercise informed judgment in deciding whether to purchase it.

Section 5 of the 1933 act prohibits the sale or transport of any unregistered security in interstate commerce or through the mails. There is, however, recognition of the fact that not all investors require the level of protection provided by the registration process. Therefore, the 1933 act provides for exemptions that would allow the sale of unregistered securities in specific circumstances.

Section 4(2) of the 1933 act provides an exemption from the registration requirements for any security "not involving any public offering." Section 3(b) of the 1933 act also provides the SEC with a basis to make additional exemptions. Regulation D under the 1933 act contains a set of six rules (Rules 501 - 506) pertaining to how such exempted securities can be distributed.

Private placement VUL products are securities exempt from registration by Section 4(2) of the 1933 act because they're securities designed and intended for sale in a private market to specifically qualified individuals or institutions. They cannot be involved in a general public offering because they're not registered. Since private placement VUL is a security exempt from registration under the 1933 act, it's also commonly referred to as a *nonregistered* variable product. On the other hand, VUL products offered by prospectus to the general public are often referred to as registered variable products.

The exemption allowing a ppVUL product to escape registration recognizes that some purchasers already have or are presumed to have access to the kind of information registration would disclose. There's a provision in Regulation D that a certain category of purchaser, defined as an **accredited investor** in section 2(a)15 of the 1933 act and Rule 501(a) of Regulation D, can be presumed to have the necessary knowledge and experience to evaluate the merits and risks of a prospective investment. Therefore, such purchasers don't need the protection afforded by registration.

An accredited investor as defined in Regulation D of the 1933 act is a natural person whose individual or joint (with spouse) net worth exceeds $1,000,000 or has had an individual income of $200,000 (or joint income with spouse of $300,000) in each of the past two years and can reasonably expect this level of in-come in the current year. An accredited investor can also be any director, executive officer or general partner of the issuer of the securities being offered. The definition is broad enough to also include banks, private business development companies, 501(c)3 organizations and trusts that meet specified requirements.

Rule 506 of Regulation D (Exemption for Limited Offers and Sales without Regard to Dollar Amount of Offering) is the rule under which most ppVUL products would be offered (since there's no amount limit). Under this rule an insurance company can sell any number of ppVUL products to accredited investors.

A company can sell ppVUL products to purchasers who are not accredited investors if it reasonably believes their knowledge and experience makes them capable of evaluating the merits and risks of the product they're buying. But there's a limit of 35 on the number of investors who are not accredited investors a company can include in the offer and a requirement, under Rule 502(b), that information be furnished. Because of these requirements and limits, it seems likely that insurance companies will make their ppVUL products available only to an accredited investor.

Impact of the 1940 Act on ppVUL Products

The net premiums paid into a VUL contract are allocated by the policy owner to one or more subaccounts or divisions of a life insurance company's separate account. The assets in each subaccount or division of the separate account are invested in shares of an underlying mutual fund.

The separate account, with respect to a publicly offered VUL contract, is registered as an investment company (typically a unit investment trust) under the Investment Company Act of 1940 (the 1940 act). However, under Section 3(c)7 of the 1940 act, “any issuer, the outstanding shares of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which does not make … a public offering of such securities” is not an investment company within the meaning of the 1940 act. Since such a company is not an investment company, registration as an investment company and the associated reporting and disclosure requirements aren’t necessary An unregistered investment company is specifically prohibited by Section 7 of the 1940 act from directly or indirectly engaging in the public offering of securities.

A *qualified purchaser*, as defined in Section 2(a)51 of the 1940 act, is a natural person “who owns not less than $5,000,000 in investments.” Therefore, a sophisticated investor under the 1940 act is required to have greater means than under the 1933 act. But there’s no income requirement under the 1940 act. Companies, trusts and individuals who manage the investments of other qualified purchasers are also included in the definition if specified conditions are met.

In order to avoid the need to register their separate accounts as an investment company under the 1940 act, insurance companies need to require that people buying their ppVUL products be qualified purchasers as defined in the 1940 act. In order to avoid the need to register their ppVUL product as a security under the 1933 act, companies also have to require that prospective purchasers be accredited investors as defined in the 1933 act.

Initially, private placement VUL products emphasized low loads as their most significant marketing feature. The low loads (as a percentage of premium or accumulated value) were made practical by a significantly higher average size. In fact, loads were typically graded down by policy size. To qualify for these lower loads, companies required policy owners to commit to a high minimum premium level.

This approach, however, ignored the fact that purchasers who were not too particular about the available investment options could reduce the loads in a registered VUL product by replacing some of the permanent death benefit with a “target” term death benefit. This reduces the portion of the permanent premium that is fully commissionable target premium. Although the same total amount of the permanent premium is paid, most is commissioned at the lower excess premium commission rate. The cost of the target term is usually deducted directly from the accumulated value in the contract and is not commissionable at all.

By using a registered VUL product with a minimum amount of coverage and a target term filling in the rest of the required death benefit, policy owners can significantly reduce the loads in the contract and improve policy performance without having to commit to a high minimum premium level. Therefore, low loads as a selling feature are not much of an inducement to buy ppVUL.

Since the current ppVUL design is a nonregistered product under the 1933 act and its separate account is unregistered as an investment company under the I940 act, slow and expensive registration processes are avoided and reporting and disclosure requirements are reduced. This provides for greater flexibility to make changes in the investment options available within a nonregistered ppVUL contract. This greater flexibility allows companies to structure ppVUL investment options to more closely match the investment objectives of prospective purchasers without the need to refile a prospectus with the SEC.

This flexibility, however, is tempered by IRS code, regulations and rulings, which, if not followed, would move the ppVUL outside the IRS definition of “insurance” and subject it to taxation as an “investment.”

Insurance companies that allow funds to be added as investment options under ppVUL products are particular about the kind of fund and how it’s selected. They prefer to deal with experienced investment managers who have some insurance experience and establish selection procedures to avoid any question of investor control. In addition, they have a minimum premium requirement to justify the developmental costs of adding a fund. The insurance company usually requires a fee for administrative services.

Since a ppVUL contract is a private offering, it cannot be offered or sold by any form of general solicitation or general advertising including newspapers, magazines, television or radio. Seminars or meetings whose attendees have been invited by any general solicitation or general advertising are also not allowed.

State Insurance Department and Federal Tax Regulation

The nonregistered ppVUL product is structurally similar to a registered VUL product available by prospectus in a general public offering. The policy forms require appropriate state insurance department approval prior to use, and there's no difference in valuation requirements. Insurance companies must be licensed in the states where they intend to sell insurance products. Their agents must also be licensed. There's a wide variance in the extent to which individual states exercise their authority.

The federal income tax consequences to the policy owner are no different for a nonregistered ppVUL than they are for a registered VUL product as long as the appropriate federal tax laws, regulations and rulings are complied with. Compliance is necessary for the ppVUL product to maintain its status as life insurance in the eyes of the IRS. Because of the unique features of ppVUL products, maintaining an appropriate tax status will require greater attention to federal laws, regulations and rulings.

In general, the federal tax laws that affect life insurance products (and variable life insurance products, in particular) are:

IRC §7702, which provides a definition of life insurance for federal income tax purposes.

The rules that apply to a ppVUL contract are the same as the an appropriate tax status rules that apply to any other type of life insurance contract. In order for a contract to remain qualified as life insurance, there must be a specified relationship between the death benefit and the policy's cash value. Two tests for demonstrating this are provided in the code: the Cash Value Accumulation Test and the Guideline Premium / Cash Value Corridor Test. Either test may be applied, but the method chosen must be fixed for the duration of the contract. There are subtle differences between the two tests that ought to be considered before a choice is made. Current product designs provide for the applicant to choose the method for demonstrating compliance at the time the policy is issued.

Since it's essential that a contract issued as life insurance continue to qualify as life insurance under §7702, insurance companies reserve the right to take unilateral action (e.g., returning excess premiums) to maintain that status. A ppVUL contract is usually a very large policy. It's more likely that the need to maintain the minimum corridor death benefit required by §7702 could put a significant strain on an insurance company's reinsurance outlets or its own ability to prudently absorb mortality risk. Therefore, companies are beginning to insert "force out" provisions in their policy forms. If specified conditions are met, these provisions allow the company to require the policy owner to surrender a portion of his policy (with no reduction in face amount) in order to bring the contract back within the death benefit corridor and remain life insurance according to the IRS. Of course, cash values forced out of the contract in this way could create a tax liability for the policy owner.

The interest accumulated on the cash values within a policy that qualifies as life insurance are not subject to current federa1 taxation as ordinary income. Instead, federal income taxes are due only if and when the contract is surrendered and the policy owner actually receives those values. When a policy owner does receive cash from his policy through a partial surrender, the cash received is considered to come first from his investment in the contract and is not taxable income. Only value received in excess of this investment in the contract is taxable income. Death benefits are paid income-tax free.

The Internal Revenue Code (in §7702A) defines a Modified Endowment Contract (MEC) as any contract that fails the "seven-pay test." The "seven-pay test" requires a specific relation- ship between the death benefit and the premium paid into the policy. The test is failed if the accumulated premiums actually paid during the first seven policy years exceed the seven-pay net level premiums that would have been accumulated through that time if the contract had provided for paid-up future benefits after the payment of seven level annual premiums. It applies to ppVUL contracts in the same way it's applied to regular VUL.

MECs don't fully qualify as life insurance under the Internal Revenue Code and are essentially taxed like annuities. That is:

- surrenders are subject to ordinary income tax like life insurance except that distributions are considered to come from investment earnings first and the investment in the contract is withdrawn last (and not subject to tax)
- policy loans are treated as distributions and subject to income tax as if surrendered
- an additional 10 percent tax is imposed on any distribution (surrender or loan) made prior to the insured's age 59 ½.

Death benefits aren't affected if a life insurance contract is classified as an MEC. The death proceeds from an MEC are treated in the same way as the death proceeds from a nonMEC. They're received income-tax free.

While the testing under §7702A for MEC status is usually applicable only during the first seven policy years, material changes in the contract after seven years can trigger a new round of MEC testing. This and other important elements contained in §7702A must be considered in order to properly determine an insurance contract's status as a MEC.

IRC §817(h) (enacted as part of Tax Reform Act of 1984) and Treasury Regulation **1.817-5** (issued 3/l/89) specify *diversification requirements* for investments made by the separate accounts of variable insurance contracts.

IRC §817(h) provides that a variable life insurance contract that's not adequately diversified won't receive the favorable tax treatment afforded the inside cash value buildup of a life insurance contract.

Regulation 1.817-5 addresses these issues and in (b)(l) provides that the investments of a segregated asset account are considered adequately diversified if: No more than 55 percent of the value of the total assets of a segregated account can be represented by any one investment; no more than 70 percent by two; no more than 80 percent by three; and no more than 90 percent by four. Therefore, a segregated asset account used within a variable life contract must contain at least five independent investments.

The look-through rule defined in 1.817-5(f) provides that investments in a regulated investment company "shall not be treated as a single investment of a segregated asset account." Rather, a pro rata portion of each asset in the investment company will be treated as an asset of the segregated asset account. Therefore, if the investment company is adequately diversified, then the segregated asset account investing in it is also considered adequately diversified. Without this look-through rule the separate accounts (or their subaccounts) that VUL products invest in would have a difficult time satisfying the diversification test.

A further requirement of the look-through rule is that all of the beneficial interest in the investment company is held by one or more segregated asset accounts of one or more insurance companies. Public access to the investment company is available exclusively through the purchase of a variable contract. Some exceptions to this are allowed in 1.817-5(f)(3), but in general, this requires that the investment company cannot be publicly traded.

Other IRS administrative positions also have an impact on ppVUL contracts when trying to create a special investment option structure.

How much control policy owners have over the investment decisions made under their variable life contracts can threaten the status of the policy as "life insurance" for federal income tax purposes. This is the investor control issue and a good point to raise in any elevator discussion of ppVUL.

The deferral of tax on the investment earnings within a VUL or ppVUL insurance contract depends on the belief that the insurance company owns the assets in the separate account. If the IRS determines that the policy owner's position is substantially identical to direct ownership of the assets in the separate ac-count, the policy owner will be regarded as the owner of the assets and taxed on the investment income the assets generate. In making its determination, the IRS will consider the influence the policy owner has on the investment decisions of the investment company in which the VUL or ppVUL separate account invests.

Another consideration is that the variable account of a VUL or ppVUL contract can't invest in funds available to the general public without jeopardizing its favorable tax treatment. The IRS maintains that if the funds were available to the general public the investor would be in substantially the same position he would have been in had he purchased the funds directly (i.e., outside of the variable life insurance contract). Therefore, the fund choices included in a variable life insurance contract must be available only through a variable contract.

Offshore or Foreign Insurers

Offshore insurance companies are organized to avoid U.S. federal and state taxation. By meticulously complying with solicitation rules, an offshore company can substantially avoid being taxed as a U.S. corporation. And by requiring that applications be signed and premiums be paid at their offshore location, companies avoid state premium taxes. These tax savings can be reflected in the contract values through lower charges and loads. It's quite common to find these companies headquartered in Bermuda; making the trip to sign the application not entirely unpleasant.

The ppVUL (or VUL) contracts offered by offshore companies are, structurally, no different from ppVUL (or VUL) contracts offered by domestic insurers. When they are owned by U.S. citizens, they are subject to IRS rules and regulations. Therefore, ppVUL contracts offered by offshore companies are careful to satisfy the appropriate U.S. federal tax law and regulation to maintain the contract's status as life insurance.

The foreign insurance company offering offshore ppVUL products is not licensed with or regulated by any state insurance department. Rather, it need comply only with the rules and regulations established by the regulatory authority of the country in which it was organized.

These are the facts. Use them prudently and wisely. ●

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