



LAW OFFICE OF GERALD R. NOWOTNY, PLLC

Dark Side of the Moon

The Peculiarities of the Alternate Investment Diversification Testing Method for Variable Universal Life Insurance

Overview

I was never a Pink Floyd fan growing up. My older brother Willy liked Pink Floyd along with Jimi Hendrix, Led Zeppelin. I liked all of the horn bands – Chicago, Blood, Sweat and Tears and Tower of Power. The one thing that we agreed on, and the rest of the Canal Zone was the band Rare Earth. He bought me the albums that he liked as Christmas gifts and I did the same. These days we both agree on Salsa even though neither of us is a great dancer. It's a Zonian thing, Spanish after the fact!

In later years I was even less of a fan of Pink Floyd after hearing that Roger Waters, the front man, was very anti-Semitic. For the record, I am very Philo-Semitic. I too had to look that up the first time to see if that was a good thing or a bad thing. Nevertheless, I think that the title of an album, "*Dark Side of the Moon*", is pretty catchy.

I have previously written about the two sides or philosophies of PPLI. One side of the industry sees the PPLI industry as an extension of the retail variable life insurance and corporate owned life insurance industry but with institutional pricing and customized investment funds managed by large institutional money managers. The other side of the industry sees PPLI as tax advantaged, institutionally priced policy with investment options designed to migrate tax-sensitive investment and low basis capital assets. The traditionalists see the latter as the dark side of the moon laden with investor control tax risks. The investor control doctrine essentially says that if the policyholder retains too much direct and indirect control over policy investments, the tax-free inside build up is forfeited and immediately taxable.

The traditionalists say that the PPLI business was never meant to be the latter, i.e. the Wild West of the life insurance industry. Who has the correct view of the World? The answer to this question may not be as straight-forward when you look through the lens of the Treasury Regulations and the alternate investment diversification testing for life insurance. Viewed through this lens, a discussion of the investor control doctrine and congressional intent does not seem as straight-forward as it might otherwise seem.

The investor control doctrine is a tax rule that effectively says that if a “policyholder” retains too much control directly or indirectly of the policy’s investments, the policyholder forfeits the tax benefits of treatment as life insurance. The inside buildup of the cash value is immediately taxable. In the Webber Case, the taxpayer was not assessed tax penalties for the determination that the policyholder had violated the investor control doctrine. Nevertheless, the alternate diversification testing method stands in direct contrast to the proposition that the only “good” and viable insurance policies are ones that feature large commingled funds managed by institutional quality money managers.

This article makes the case that the non-traditionalists were wrong in thinking that Congress never intended for alternative assets and asset classes to be owned within life insurance, let alone large concentrated holdings.

The Investment Diversification Rules

The basic rules dealing with investment diversification in variable life insurance and annuities can be found in IRC Sec 817(h) and Treas. Reg. 1-817-5. Generally, the rules provide that no single investment can represent 55% of a fund; two investments 70 percent; three investments 80 percent; four investments 90 percent; resulting in a portfolio of at least five investments.

The general start up rule to meet these diversification rules is a year. Real estate has a “rolling” five-year start up period. The treasury regulations contemplate an explanation of an odd assortment of asset classes that do not exist at all, ever, in retail variable insurance products. Why are these asset classes mentioned at all?

The reason is that life insurers have used these products to prevent unrelated business taxable income (UBTI) tax treatment for fund offerings from investment advisory subsidiaries to tax-exempt investors. These offerings range from hotels to senior housing, and timber as well as agriculture. In my own travels (33 years now. Ouch!) around the life insurance industry, I have only seen one real estate fund within retail variable insurance products that made direct investment into real estate. This fund was available on the TIAA-CREF product platform.

The alternate investment diversification testing method found in the Treasury regulations, Treas. Reg. 1.817-(b)(3), is limited to life insurance contracts. Oddly enough, like the dark side of the moon, the provision contemplates a significant concentration in a single or limited number of concentrated investment holdings along with U.S. treasury securities. These rules seem to fly in the face of traditionalists who envision their better world for PPLI product space as a replica or the retail and COLI and BOLI space. Traditionalists do not want the PPLI terrain to be littered with investment transactions that challenge the investor control doctrine through the purchase of a single or portfolio of concentrated investment positions.

My question is if Congress did not contemplate these transactions, why is the alternate method for investment diversification in the Treasury regulations? A few examples show how the rules work.

Example 1

Bob Smith owns shares in a pre-IPO company, Acme, Inc. (still in business after so many years!). He believes that after a pre-IPO, the company's shares may appreciate by 1000 percent. The policy is owned within an irrevocable trust that is taxed as a non-grantor trust for tax purposes. The policy offers a separately managed account managed by Good Investments, LLC.

At the end of a calendar quarter, the account value of a PPLI contract has a total value of \$1 million. The treasury securities represent 90 percent of the account or \$900,000. The value of shares in Company Acme are worth \$100,000.

Based on the alternative testing method, the 55% limit for a single investment is increased by 45% ($.5 \times 90\%$ in T-Securities = 45%) to 100% and can be applied to assets of the account other than Treasury securities. In other words, The PPLI policy could purchase and own \$1 million of shares of Acme in addition to the treasury securities and meet the diversification requirements.

Example 2

John Smith's PPLI policy has an account value of \$1 million. Treasury securities represent 60 percent of the account value or \$600,000. The policy owns a two pre-IPO shares. Good Investments, LLC, the manager of the separately managed account would like to purchase more the shares in the two pre-IPO companies. Company A currently has a value of \$300,000 and Company B has a value of \$100,000.

Under the alternate method of testing, the 55% and 70% threshold in investment diversification testing is increased by 30% - ($.5 \text{ percent} \times 60 \text{ percent} = 30\%$). As a result, Good Investments can purchase additional shares in both companies so that the single holding threshold is increased to 85% and two holdings to 100% of the account value.

Summary

This is a complicated and little-known area of variable insurance product taxation, which stands for the proposition that Congress apparently contemplated the possibility of large concentrated holdings within variable life insurance contracts. These rarely used rules create a window of opportunity to use this rule to purchase a concentrated investment position within a PPLI contract. Contrary to popular belief that PPLI only considers large institutional commingled funds as acceptable investment options, the treasury regulations point to a different story; not only has it not been told but has been forgotten.