PRIVATE PLACEMENT INSURANCE PRODUCTS

Private placement insurance products occupy a unique place in the spectrum of financial products. While having the same tax benefits, they offer policy structures and investment alternatives not found in traditional retail variable universal life (VUL) and variable annuity (VA) products.

Because they can only be offered to individuals who are qualified purchasers and accredited investors, private placement variable universal life (PPVUL) and variable annuities (PPVA) offer high net worth clients access to both investment alternatives and customized product designs that are difficult or impossible to obtain in traditional retail or registered products.

Due to its treatment from an income tax perspective, insurance must be properly structured to ensure it maintains its tax benefits. Clients should work with brokers experienced in structuring policies for high net worth clients and experienced in working with multiple insurers to obtain favorable underwriting outcome.

PRIVATE PLACEMENT VARIABLE UNIVERSAL LIFE (PPVUL)

Life insurance enjoys favorable tax treatment as an asset that can be owned throughout its lifespan without incurring income taxes. The policy's account value accumulates free of recognition of income for tax purposes in the same way as an annuity. In addition, when a policy death benefit is paid, the beneficiary receives it without its inclusion as ordinary income or capital gains. Furthermore, unlike an annuity, withdrawals from a life insurance policy are first treated as a return of basis before they are considered a receipt of taxable gains.

Policyowners can also take loans against the policy's[1] account value (at a low net interest expense) as a tax-free distribution. Typically, this is done after first withdrawing the policyowner's entire basis in the contract. As long as the policy remains in force until death, the policy loan balance is deducted from the death benefit and is not subject to income tax. If the policy is surrendered prior to a death claim, the amount received in excess of the policy's basis, including policy loans, is taxed as ordinary income.

Registered VUL products share a number of characteristics with PPVULs. Both pass through premium taxes to policyholders. In addition, both have similar mortality charges as well as similar types of policy charges like administration charges or asset-based charges.

However, PPVULs are much more flexible in terms of both policy charges and structure. Because each policy is a private offering to a specific individual (rather than a general offering to the public), the policy can be customized to the client's needs. Factors that affect the insurer's expenses may be reflected in the pricing of the

[1] Non-Modified Endowment (Non-MEC) Contract

policy. For example, the cost of issuing a policy might be similar for an insurance company despite differences in the size of the policy. Economies of scale might result in the ability to have a policy issued with lower unit charges. Also, the mortality risk for high net worth clients is historically lower than that of the general public. This lower risk can result in lower mortality charges over time.

For all VULs, including PPVULs, policy assets are held in separate accounts not accessible by the insurer's creditors and can be reallocated between available investment choices without penalties or tax consequences.

Because of the consequences associated with violating these rules, insurance companies have administration systems designed to assure policy compliance.

TAX TREATMENT

- A properly structured PPVUL policy will not be taxed on the growth of its value until it is fully surrendered.
- Withdrawals (up to cost basis) and properly structured policy loans may be taken on a potentially tax-free basis.
- Death benefits are not taxed as ordinary income or capital gains to beneficiaries.

Policyowners invested in exempt investment funds do not receive K-1 statements.

IRS RULES FOR LIFE INSURANCE

- Policies classified as MECs are treated similar to annuities with respect to distributions.
- Policies must always maintain a minimum amount of death benefit in relation to the policy's account value until age 95 or 100 (depending upon the chosen Definition of Life Insurance test).

PRIVATE PLACEMENT VARIABLE ANNUITIES (PPVA)

An annuity is a contract with an insurance company that accumulates value on a tax deferred basis and allows the annuitant to annuitize the contract value for a guaranteed stream of income. During the accumulation phase, the contract's value can grow without recognition of income for tax purposes [IRC Sec. 72]. While annuities are required to begin paying income ("annuitize") by a certain point (usually age 90 or 100), they also allow policyowners to access account values either in partial installments or lump-sum withdrawals. Withdrawals are taxed as ordinary income to the extent that the policy's value exceeds basis, or the premium paid into the policy. In addition, a 10% penalty may be levied on the taxable amount if the withdrawal occurs before the annuitant's age of 59½.

Registered VAs are generally designed for buyers interested in accumulating assets by investing in investment accounts for the purpose of receiving a guaranteed stream of income in the future. In addition, many registered VAs also provide a minimum floor return on the investment values while the contract builds value or guarantees a return of principal. This makes registered VAs relatively expensive due to the benefits provided to buyers interested in guaranteed income.

Unlike registered VAs, PPVAs are designed primarily for buyers who are interested in accumulating assets without recognizing income for tax purposes. Due to the qualification threshold for private placement investments, PPVA holders generally are not looking for the guaranteed return benefits found in registered VAs. As a result, PPVAs are usually less expensive than registered VAs. In addition, because growth in the value of an annuity is tax-deferred, PPVAs are especially attractive vehicles for investors who are interested in accumulating assets in investment funds that are tax-inefficient or annually generate a high degree of ordinary income in their investment returns.

PPVAs are structured with no upfront charges on premium investments and no back-end charges on withdrawal or surrender. Policy assets are held in separate accounts that are not accessible by creditors of the insurance company. Policy account values can be reallocated between available investment choices without penalties or tax consequences.

TAX TREATMENT

- PPVA is not taxed on the growth of its value until it is surrendered (redeemed) or has had withdrawals taken from it.
- Buyers may retain full ownership and control of their assets while enabling potential tax-free distributions at death to private foundations and/or charities.
- Policyowners invested in exempt investment funds do not receive K-1 statements.

IRS RULES FOR ANNUITIES

- PPVAs must be owned by natural persons or a trust for the benefit of natural persons.
- In some states (for example, Florida and Texas), annuity assets owned by natural persons are protected from creditors.
- A tax-exempt charity can be designated as the beneficiary of the contract, allowing the policyowner to retain control of the assets during his or her lifetime without causing the policy assets to be subject to income or estate taxes.

ADVANTAGES OF PRIVATE PLACEMENT INSURANCE

The appeal of private placement life insurance and annuities derives from two aspects that differentiate them from traditional insurance products like whole life or registered variable products.

Customization of Policy Charges

Sophisticated buyers of life insurance and annuities often have objections to the structure of policy charges in traditional retail products. Since carriers must manage the expenses and risks of an insurance product, despite the potential for it to be utilized in a wide array of scenarios, products typically have premium loads (charges on premium payments) and surrender charges. In addition, other expenses, such as cost of insurance rates or administrative charges, can be relatively high depending upon the carrier's mortality experience (which may include groups of risks that are more expensive than the high net worth market) or distribution system.

PPVULs and PPVAs can be structured to be more attractive to their typically affluent buyer. Policies usually have low premium loads and surrender charges are almost non-existent. Due to the large size of the average PPVUL or PPVA case, policies can be designed with lower administrative or other charges than those usually found in traditional products.

Enhanced Choice of Investment Options

Registered VUL and VA products can only offer registered investment options (similar to retail mutual funds) due to the fact that registered securities must be valued on a daily basis and offer investors the ability to immediately redeem shares. However, PPVULs and PPVAs can offer investment alternatives that are not registered, such as hedge funds and other non-registered investment funds. These funds often employ strategies that require limitations on when investors can redeem shares in order to achieve their investment objectives, which include seeking to obtain returns not

correlated to equity markets while also maintaining lower volatility on a periodic basis.

Investors interested in accessing these types of investment strategies, while minimizing the effects of current period income taxes, will naturally find themselves looking exclusively at private placement products.

IMPORTANT CONSIDERATIONS

Investment Options

Variable insurance contracts are permitted to invest in segregated asset accounts [IRC Sec. 817(h)]. These accounts are required to be diversified such that no single asset may comprise more than 55 percent of the value of the account. Furthermore, the investment accounts available to a variable insurance contract should only be open to investments from insurance contracts and not be co-mingled with non-insurance investments [Revenue Ruling 2003-92].

In addition, the "investor control" doctrine [Rev. Rul. 2003-91] requires that holders of variable insurance contracts not have control over segregated account assets sufficient to be deemed the owner of the assets. If the policyowner is deemed by the IRS to exercise control of the segregated account, the policy will be disqualified as insurance for tax purposes.

POLICY ADMINISTRATION AND SERVICE

While private placement insurance products are often described as transactions executed "directly" with the insurance company, it should be noted that these products require a level of service and administration aligned with the complexities and requirements of the product. Buyers of private placement products should conduct the transaction with an experienced broker who can provide the following:

- Advanced policy design
- Knowledge of definition of life insurance tests and TAMRA [IRC Sec. 7702 & 7702a] rules
- Recommendations for policy ownership structures to minimize estate, income, and gift taxes
- Expertise in medical and financial underwriting
- Access to multiple insurance carriers and expertise in coordinating reinsurance to maximize capacity
- Inforce projections
- Custom reporting
- Assistance with post-issue policy changes (for example, face amount, death benefit option, beneficiary)

SECURITIES AND EXCHANGE COMMISSION REGULATIONS

By law, all securities (including variable insurance products) must be registered with the Securities and Exchange Commission (SEC). There are registration exemptions for securities (private placements) that are offered only to specific qualified purchasers.

In the case of investment funds, SEC registration stipulates that shares have sufficient liquidity so that they may be redeemed by shareholders at the current net asset value. This requires investment funds to be valued on a daily basis in order to fulfill redemption requests.

Certain investment funds (exempt funds) may not seek to be registered with the SEC because they are difficult to value on a daily basis due to the types of assets they hold, such as options, derivative contracts, or other investment funds. In addition, exempt funds often engage in investment strategies that are illiquid and therefore require shareholders to remain invested for a certain period of time before they can redeem their shares.

Registration Exemptions

Accredited Investor
[**Regulation D of the Securities Act of 1933**]

- An individual with a net worth of $1 million or more, excluding home and automobile;
- An individual who has made $200,000 per year in income for the past two years and has a reasonable expectation of doing so in the future;
- An individual and spouse with aggregate income of $300,000 per year for the past two years who have a reasonable expectation of doing so in the future; or
- A corporation, partnership, limited liability company, trust, or tax-exempt organization with assets exceeding $5 million that was not formed for the purpose of investing in the product.

Qualified Purchaser

[**Section 2(a)(51) of the Investment Company Act of 1940**]

- An individual who owns at least $5 million in Qualified Investments;
- A family business or trust that owns at least $5 million in Qualified Investments;
- A corporation, partnership, limited liability company, trust, or tax-exempt organization where each beneficial owner is a Qualified Purchaser;
- A trust that was not formed for the specific purpose of investing in the product, so long as both the persons with decision-making power and each of the contributors to the trust is a Qualified Purchaser; or
- A corporation, partnership, or trust with at least $25 million in Qualified Investments.

ABOUT M FINANCIAL GROUP

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PRIVATE PLACEMENT PRIVATE CLIENT SOLUTIONS

Your M Team contacts for all Private Placement Life information regarding the sales process, access to up-to-date information for new and inforce MAGNASTAR® clients, and ongoing Member Firm training needs.

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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 (or Annuities) should only be presented to accredited investors or qualified purchasers as described by the Securities Act of 1933.

PPLI 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 investment component provides you the flexibility to potentially increase the PPVL account's surrender and loan value.

PPVA are long-term investments. The value of a PPVA account will fluctuate and, when redeemed, may be worth more or less than the original deposit. Withdrawals or other distributions, including death benefit payments, will be subject to ordinary income tax. If withdrawals or other distributions are taken prior to age 59½, a 10% excise tax may apply to the gain element. Maine, South Dakota, and Wyoming charge a premium tax for PPVA deposits. California, Nevada, and West Virginia charge a premium tax upon depositor annuitization of a PPVA account. A PPVA account may include additional fees, such as placement fees and performance fees.

The tax and legal references attached herein are designed to provide accurate and authoritative information with regard to the subject matter covered and are provided with the understanding that neither M Financial Group, nor its member firms are engaged in rendering tax, legal, or actuarial services. If tax, legal, or actuarial advice is required, you should consult your accountant, attorney, or actuary. Neither M Financial Group, nor its member firms, should replace those advisors.

Investments in securities involve risks, including the possible loss of principal. When redeemed, units may be worth more or less than their original value. Actual investment results and performance will vary and are not guaranteed.

Loans and partial withdrawals will decrease the death benefit and cash value and may be subject to policy limitations and income tax.

An insurance contract's financial guarantees are subject to the claims-paying ability of the issuing insurance company.

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. Please read it carefully before you invest.

If the life insurance policy is or will become a Modified Endowment Contract (MEC), be aware that the following considerations apply:

- Unlike non-MECs, which allow policy owners to first recover their non-taxable "investment in the contract" (i.e., policy basis) when making policy withdrawals, MECs follow a "last in, first out" ("LIFO") rule, which requires policy owners to first withdraw taxable income from the MEC.
- If the MEC has income accumulation, income taxation will be triggered on withdrawals, policy loans, pledges of the MEC as loan collateral, cash dividends, and dividends retained and applied by the insurance company to policy loans.
- An additional 10% tax also applies to the taxable portion of a MEC distribution, unless the distribution: (1) is made after the policy owner attains age 59½ or becomes disabled or (2) is part of a series of substantially equal periodic payments that are made at least annually for the life expectancy or joint life expectancies of the policy owner and his or her beneficiary (the "added 10% tax").

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

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