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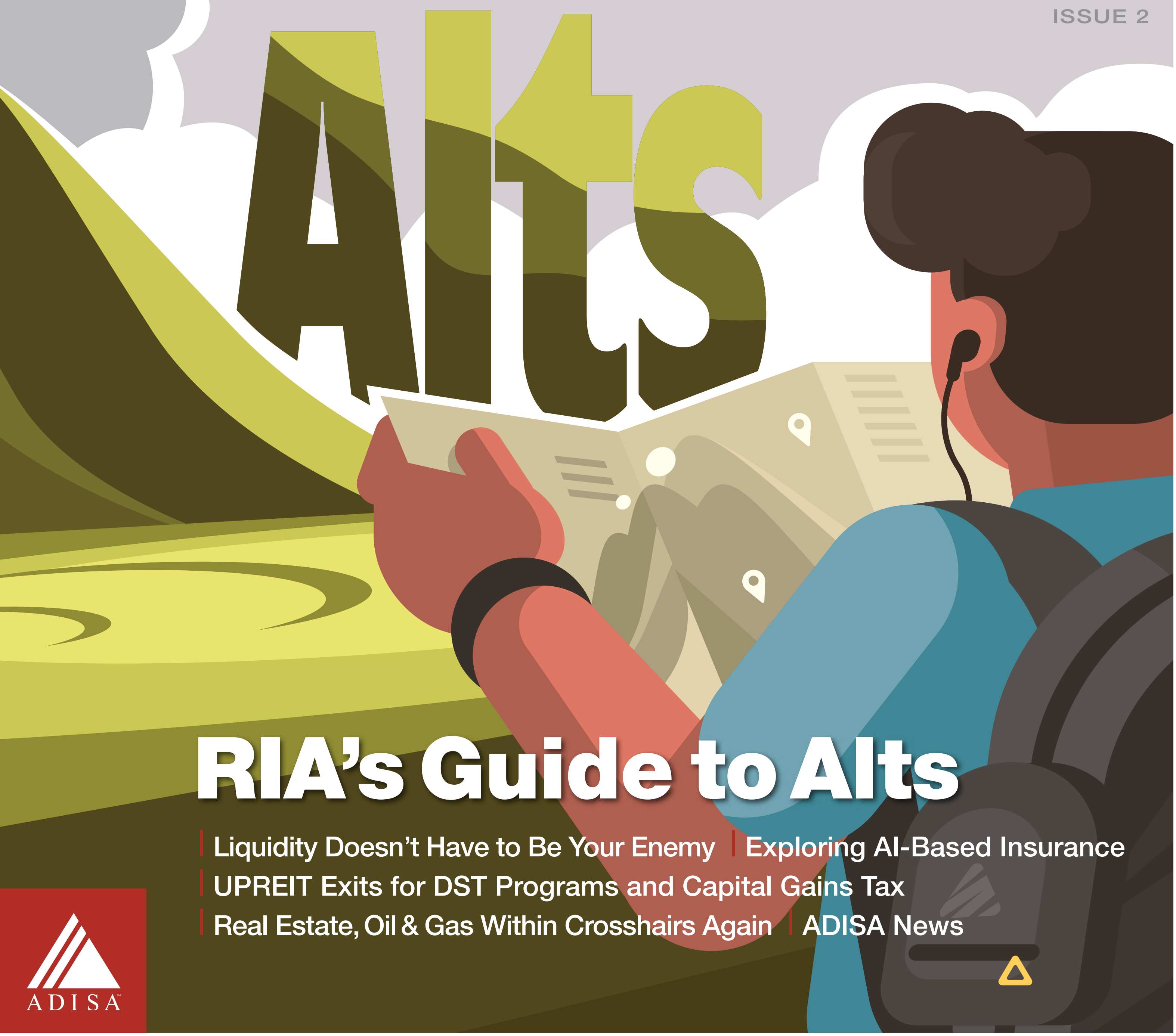

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ADISA

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Executive Director's Letter

By John Harrison, *DBA*

Executive Director, ADISA

What You Don't Know

If you knew more about what's going on at ADISA right now, you'd know more about what's going on in the world. We've long been known as the gold standard for networking in the industry—indeed I've heard, "if you only have one event you can go to per year, the ADISA Annual Conference is the one." But do you know about the knowledge component of your association?

First, if you were at our recent Spring Conference, and in between the great networking happened to catch the general session on "Investment Fallout from the Current Crisis in Eastern Europe." you could predict some economic upheavals currently happening. Dr. Ben Steil, perhaps the nation's top researcher on war/post-war economic effects marched us through compelling charts and graphs to arrive at some conclusions affecting the investment space:

"Equity markets and corporate fixed income broadly stand to perform poorly if current oil and commodity pressures continue. Sectors likely to outperform are: Oil exploration, Multifamily real estate, and Shipping. Sectors likely to underperform: Automobiles (especially electric vehicles), Semiconductors; and the risk of faster-than-expected tightening could compound these trends, driving further declines in equity markets."

If you weren't there, check out the slides from his presentation on the ADISA website. In fact, while you're on the website, we post all the available session presentation slides in the Members Only section (just log into the website in the upper right Sign In corner). And, hey, while you're there for the presentations, there's something else for you on the Members Only section of the website: a full directory of all the investment products and services in our retail alts space. All our sponsor and supplier members are listed there with contact info and the types of products/funds, services they offer. Sort and search for the category you want.

But wait, there's more. While you're on the website, notice there are over 120 (and growing) short, instructional videos available about topics in the industry, all sorted by category, not to mention recordings of our past webinars. Pick a few topics, grab some popcorn and watch the show. If you'd rather read the book than see the movie (and yes, there are those of us like that), there are so far 118 industry articles and white papers neatly sorted and ready for reading and downloading.

More on that front: our Standards, Education, and Publication Committee and subcommittees' leadership of Greg Mausz (Preferred Capital Securities), Lilian Morvay (IBDC Consulting), Mike Underhill (Capital Innovations), and Angela Barbera (NexPoint Securities) are designing an even more robust industry article library which features vetted materials to keep you in the know. And last, but certainly not least, all the issues of our industry magazine, Alternative Investment Quarterly, edited by Brad Updike (Mick Law) are there ready for searching, reading and downloading.

That's just the quick tour. The more you know about ADISA, the more you'll know about a lot! ▲

RIA's Guide to Alternative Investments

By *ADISA's RIA Advisory Council*

As investment advisors, you strive to help your clients reach their investment objectives by designing portfolios that are commensurate with your clients' time horizon and risk tolerance. The pursuit of an appropriate portfolio is not unique in the RIA space. However, what is very different is how we source and allocate to investments, achieve a proper balance and produce what we hope to be a winning formula for our clients.

When it comes to investment solutions, many advisors use mutual funds, ETFs, SMA managers, UMA programs, and UITs; perhaps you build your own models with stocks and bonds. What may be missing from your opportunity set of investment solutions are alternative investments. The term "alternative investment" is a broad definition that includes multiple asset classes, spanning multiple structures and strategies. The purpose of this document is to be an initial guide to assist you in incorporating alternative investments into your practice.

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What are Alternative Investments?

One way to define Alternative investments is to define what they are not. A general definition for alternative strategies is an investment in assets other than long-only stocks, bonds, and cash. Some primary examples of alternative strategies are Real Estate, Private Equity, Private Credit, Oil & Gas, and Hedge Funds.

Why allocate to alternatives?

Alternatives in clients' accounts can be very effective in reaching investors' objectives. The use of alternative investments can bring added alpha, income, and diversification to the traditional asset portfolio. *JP Morgan, Jamie Kramer, Pulkit Sharma*. The unique risk-return qualities of alternative investments can address gaps and vulnerabilities in traditional portfolios. In addition to these portfolio

benefits, certain alternative investments such as DST 1031s and Oil & Gas programs may provide significant tax benefits.

Sourcing Alternative Investments

The private nature of some alternative investments can be an obstacle to your selection process. Information about these investments tends to be decentralized and not readily available within advisors' commonly used research tools and platforms. However, industry conferences such as ADISA can be a valuable resource to sourcing offerings. Multiple 3rd party due diligence firms also hold events that offer RIAs access to senior management teams and provide a forum to learn more about each strategy. Many of these events are free for RIAs and Family Offices. The ADISA website provides a list of the 3rd party due diligence firms and other service providers within the *Products & Services Directory*. Relatively new to the marketplace, alternative investment turnkey investment platforms, such as iCapital and CAIS, offer access to alternative investment managers along with education and due diligence support.

Due Diligence

Due diligence means conducting a reasonable investigation of the issuer and the offered security (FINRA, 2010). In 2019, the SEC clarified the fiduciary duty that an investment adviser owes to its clients under the Investment Advisers Act of 1940. The Duty of Care requires an adviser to conduct a reasonable investigation into a product or strategy as a prerequisite for investment advice to be considered in the best interest of a client. Some of the factors an adviser should consider before recommending an alternative investment are cost, investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon, and cost of exit.

In addition, FINRA has provided examples of what a reasonable investigation in Reg D offerings might consist of for each of the below topics in FINRA Regulatory Notice 10-22(2010). https://www.finra.org/rules-guidance/notices/10-22

- the issuer and its management;
- the business prospects of the issuer;
- the assets held by or to be acquired by the issuer;
- the claims being made: and
- Intended use of the offering proceeds.

To demonstrate that you have performed a reasonable investigation, you should document both the process and results of your due diligence.

Due Diligence Resources

The due diligence process can be overwhelming and time consuming. Many advisors leverage the services of 3rd party due diligence providers. These firms typically generate reports focused on the specific offering as well as the issuer. The primary reasons for outsourcing due diligence resources are examiner expertise, well-documented diligence, cost-effectiveness, and efficiency. As mentioned earlier in the "sourcing alternative investments" section, AI platforms such as iCapital and CAIS, provide due diligence resources for products available on their turnkey platforms. A thorough advisor review, understanding and consideration of any investment product is required prior to making a recommendation to a client, the documentation of that process is also vital. Therefore, ensure that you can easily retrieve evidence of your review and decision-making process.

To demonstrate that you have performed a reasonable investigation, you should document both the process and results of your due diligence.

Custodians

Before you decide to invest a client's assets in an alternative program, please check with your custodian and make sure the programs you intend to use are approved and accepted. Generally, custodians like Schwab, TD, and Fidelity have a list that they can provide to you. However, there are also trust companies that have less stringent policies and could also be much less expensive in this regard. ADISA conferences frequently hold sessions devoted to such subjects, and your attendance at these will provide an excellent education.

Holding alternative investments in a portfolio can be challenging because the alternative investment's market is not standardized. Advisory firms that use alternative investments often find they need to work with multiple custodians to effectively maintain their client portfolios. This makes reporting a key element in choosing a custodian. When picking a custodian, make sure to consider the following:

- Cost to Your Client: Custodians have different prices—some can be expensive.

- Reporting: You may need to be able to see your client's assets in a portfolio. Many custodians integrate with reporting software (e.g., Albridge, eMoney, Black Diamond, etc.). If you do not have automated reporting, you may have to manually track your client assets.

There are a variety of clearing platforms (like Charles Schwab, Fidelity, and TD Ameritrade) that custody alternative investments. While clearing firms are usually the first choice for custody client assets, they are generally selective and will only hold some alternative investments.

If a clearing platform does not hold an alternative asset, you can hold the asset directly at the issuer or the issuer's transfer agent. Make sure you understand what reporting an issuer or transfer agent provides before using them.

If you want to hold an asset in an IRA account, you may need to consider using a trust company. Trust companies can hold most alternative assets. Make sure to understand what reporting the trust company will provide before using them. The ADISA website provides a list of trust companies within the *Products & Services Directory*.

Fee Billing

RIAs should review their practices, policies, and procedures to ensure compliance with their advisor agreements and representations to clients. The SEC has reported fee billing practices as a frequent deficiency. Some of the reported issues identified were:

- Valued assets in a client's account using a different metric that that which was specified in the client's advisory agreement, such as using the asset's original cost to value and illiquid asset rather than valuing the asset based on its fair market value.
- Valued a client's account using a process that differed from the process specified in the client's advisory agreement.

https://www.sec.gov/ocie/announcement/ocie-risk-alert-advisory-fee-expense-compliance.pdf

Reporting

As an advisor, you most likely use a portfolio management system. If your system can allow for reporting alternatives and consolidated statements, great! If not, you may need to choose a system that allows for holding alternative investments and receiving feeds from your custodian that includes data for alternative investments. Platforms like Orion and Black Diamond have experience in this regard and the ability to organize alternatives for consolidated reporting as well as fee billing or the ability to suppress such products from the fee billing.

Compliance

You must also disclose in your ADV part 2 that you offer alternative programs. Your compliance staff should be aware of and properly disclose such investments and the fees you intend to charge. Since private investments require a subscription document and client signature, transactions in these investments usually fall outside the scope of advisor discretion, which also must be clearly stated in the ADV. In addition to disclosures within the ADV, most custodians require additional alternative investment disclosure documents if you are transacting the investment through their platform.

E&O Consideration

Professional Liability Insurance can extend coverage for claims arising out of the recommendation or sale of alternative products. Insurance carriers have specific underwriting criteria when it comes to considering whether, or not, to endorse an E&O policy with alternative investment coverage. RIAs will need to establish the following procedures to secure this endorsement.

- Established and well documented due diligence process along with any investment committee notes and formal approval
- Documented suitability analysis
- Concentration limit tracking
- Disclosure documentation signed by the client before the sale of the alternative products

Underwriters may request additional information before deciding whether to endorse the E&O policy.

Many carriers will be specific with respect to the alternative products they will cover. It is essential to read the policy carefully to confirm which products are covered.

A few carriers may impose concentration limits with respect to the sale of alternative products. For example, if your policy states that coverage is available provided that a client's alternative product concentration is no greater than a specific amount in any one product and in alternatives in total, it is essential that the firm pay close attention to concentration limits.

During the policy period an RIA may add alternative products to its approved product list. Confirm that the E & O policy will extend coverage for any new products added.

If the RIA recruits new advisors, a careful review of the advisor's client portfolios is critical to confirm that they do not contain products which are not covered under the E & O policy.

E & O policies are complicated contracts but are fluid documents that may be modified to fit the needs of the RIA. The key is to read the E & O policy carefully to fully understand the scope and the limitations to coverage, and to have an experienced insurance broker negotiate coverage terms on behalf of the RIA.

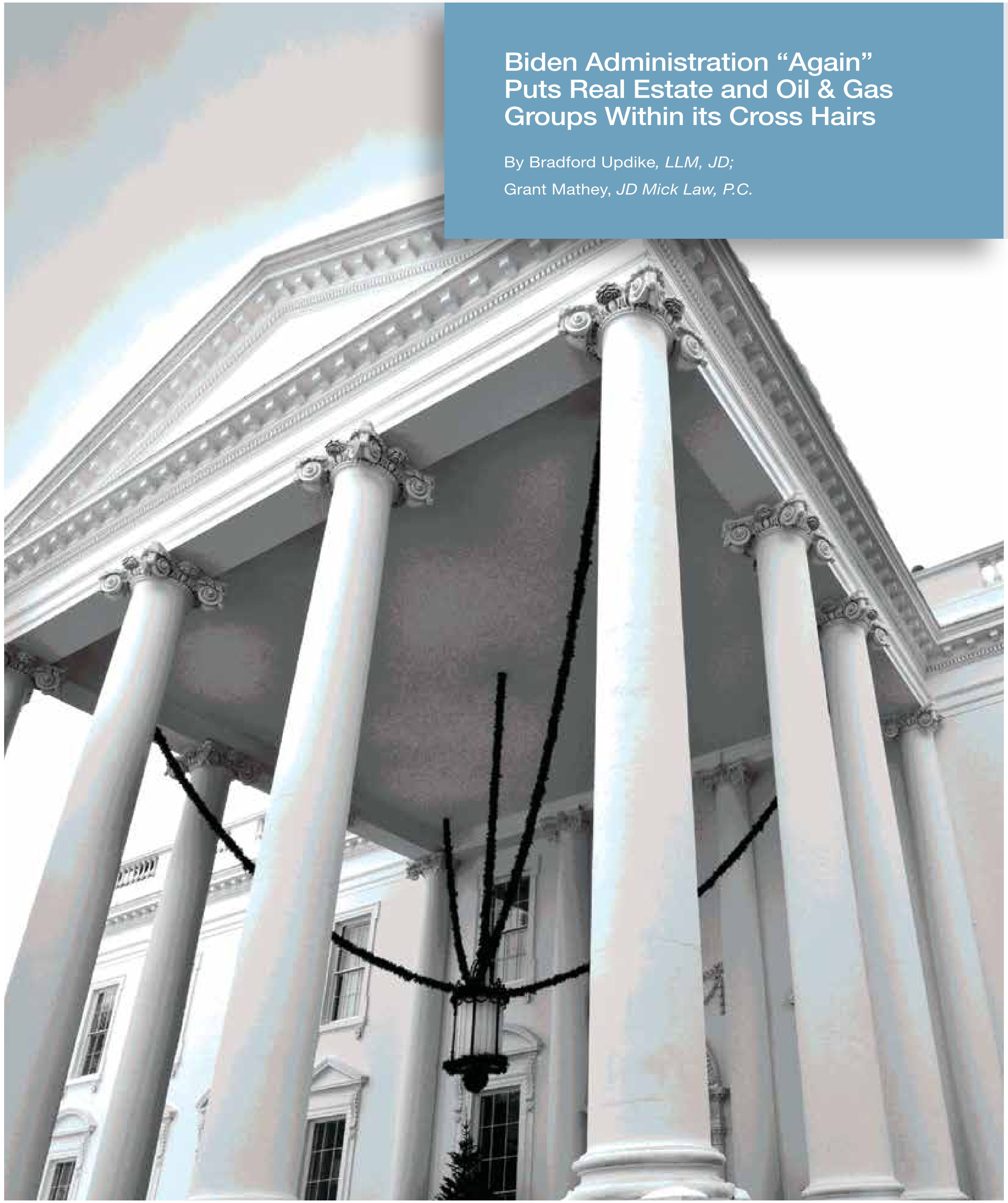
Education

These investments tend to be more complex and do require a level of due diligence that RIAs haven't been required to conduct on traditional assets and strategies in the past. While this document provides a high-level overview of what is needed in the alternative investment selection and diligence process, by no means is this meant to be comprehensive. To meet the duty of care standards, an investment advisor will also need to acquire the appropriate knowledge to demonstrate their capacity to make the recommendations. In addition to the industry leading events held by ADISA, members of ADISA also have access to the following educational resources;

- White Papers & Industry articles
- Videos & Webinar series
- AI Quarterly Magazine
- Products & Services Directory
- Industry Resources
- Third-party research and education platforms

Conclusion

As institutional managers become more readily available to individual investors along with the evolution of product structures, there will continue to be a democratization of alternative investments, which will allow RIAs to allocate more within their clients' portfolios. Alternative investments may benefit clients as a part of their overall portfolios, and with the resources, education, and access available, investment advisors will be armed to make appropriate recommendations. ▲



Biden Administration “Again” Puts Real Estate and Oil & Gas Groups Within its Cross Hairs

By Bradford Updike, *LLM, JD;*

Grant Mathey, *JD Mick Law, P.C.*

Grant Matthey, an Associate with Mick Law, focuses primarily on third-party due diligence analysis of private equity, hedge fund, real estate, and conservation option real estate offerings.

Bradford Updike, Director at Mick Law, manages the firm’s energy and tax-oriented practice. Other areas of practice include securities law, oil and gas, private equity, conservation real estate, DPP due diligence, taxation analysis relating to securitized financing, and securities advertising practices.

On March 28, 2022, the Biden Administration released its $5.8 trillion proposed budget for federal spending in 2023. This proposal serves as a fiscal blueprint for the Administration’s policy priorities, and the proposal signals to Congress on what the Administration endeavors to accomplish over the coming years. It also provides a look at how the proposed spending and revenue proposals would affect federal deficits and debt.

As was the case with respect to the President’s proposed budget last year, several of the President’s tax proposals appear again to take “dead aim” at multiple tax preferences that were intended to stimulate spending and investments within the real estate and oil/gas sectors. It also comes as no surprise that the IRS’ and Land Trust Alliance’s (“LTA”) movement to eradicate the usage of conservation easements within syndicated offerings has, once again, made its way back into the President’s proposed budget.

Without further ado, let’s look at what President Biden’s Administration has in store for the retail capital markets on a taxation front in 2023.

Once Again… IRC 1031 is on the block

As most of us know, owners of appreciated real property used in a trade or business or held for investment can defer capital gains on the exchange of the property for real property of a like-kind nature. As a result, the income tax on the capital gain is deferred until a later recognition event, provided that certain requirements set forth in Internal Revenue Code (“**IRC**”) §1031 are met. This provision of the federal tax code is arguably the most significant to us given its

On a comforting note, IRC §1031 has been a part of our tax code since 1921, and several prior efforts by past administrations to curb or eliminate its use have fallen short. In view of IRC §1031's overall popularity and usefulness within many circles of our economic system, the prospects for legislative change appear doubtful.

possible future impact upon retail product sales stemming from offerings of Delaware Statutory Trust interests (or "**DST**s," which accounted for over $7 billion in alternative product sales in 2021).

The President's proposal would allow the deferral of capital gains up to an aggregate amount of $500,000 for each taxpayer (or $1 million in the case of married individuals filing a joint return) each year for real property exchanges that are like-kind. Any gains from like-kind exchanges of more than $500,000 ($1 million for married individuals) would be recognized by the taxpayer in the year the taxpayer transfers the real property subject to the exchange. The proposal would be effective for exchanges completed in taxable years beginning after 2022.

On a somewhat comforting note, the proposal does not eliminate the use of like-kind exchanges for many accredited retail investors with capital gains not exceeding the above-mentioned gain deferral thresholds. As many DST product subscriptions fall within levels that are lower than the $500,000/$1 million limits, the proposal, if passed, would not eliminate the use of DSTs and other IRC §1031 eligible products by financial representatives and advisors (i.e., because the average DST subscription is around $300,000 to $400,000). Notwithstanding this observation, the President's proposal is curious to say the least, given its likely chilling effect upon (i) U.S. GDP (projected to fall $8.1 billion, if passed), (ii) investments (projected to fall $7 billion), and labor income (projected to fall $1.4 billion) (Source: Ernst & Young Report).

On a second comforting note, IRC §1031 has been a part of our tax code since 1921, and several prior efforts by past administrations to curb or eliminate its use have fallen short. In view of IRC §1031's overall popularity and usefulness within many circles of our economic system, the prospects for legislative change appear doubtful.

Elimination of tax breaks for the E&P sector

Currently, our federal tax code provides many tax preferences to accredited investors that place capital in drilling partnerships, mineral/royalty acquisition programs, and programs engaged in surface mining. Among these tax preferences include:

- Immediate expensing of intangible drilling costs ("**IDC**s") per IRC §263 (i.e., enabling some investors to write-off 60-80% of their subscriptions in the year of placing their program investments);
- Using the percentage depletion rules in IRC §613 to reduce gross income from oil gas production by 15% per annum (which can be taken even after the investor's basis has been reduced to zero);
- Two-year expensing of geological and geophysical costs per IRC §167(h);
- Procurement of active losses for IDCs, tangible equipment deductions, and other E&P capital costs per the working interest exception to the passive activity rules in IRC §469; and
- Immediate expensing of mining exploration and development costs.

The President's proposal eliminates each of these income tax preferences. While there would continue to be income tax rules in place to allow investors to recover their capital investments through cost recovery deductions (e.g., through 5-year IDC expensing and using cost depletion rules), these proposals, if passed, would probably become a game-changer in respect to how many of these retail programs are structured today.

Currently, our federal tax code provides many tax preferences to accredited investors that place capital in drilling partnerships, mineral/royalty acquisition programs, and programs engaged in surface mining.

This proposal also comes at a curious time, as press statements from the White House and the Department of Energy indicate a recognition, albeit begrudgingly, that more drilling is needed to balance the world's oil/gas supply and demand problems. As is the case with respect to IRC §1031, the E&P and mining sectors appear to be fairly positioned to defend the continuation of the above-mentioned income tax preferences.

Syndicated Easements

Conservation easements are a common type of qualified conservation contribution per IRC §170(h). Essentially, a conservation easement is a legal agreement placing a restriction (granted in perpetuity) upon the use that may be made of real property. Conservation purposes for such easements include, among other things, the protection of relatively natural habitats of fish, wildlife, or plants, and the preservation of certified historic structures. If the subject real estate is a long-term capital gain property (i.e., a capital asset held for more than one year), the taxpayer may deduct the fair market value of the donated easement, determined as of the time of the contribution. In determining the period for which the taxpayer has held property, if the taxpayer contributes the property to a partnership, current law adds to the partnership's holding period the period for which such property was held by the donor. Thus, if a landowner who owned land for more than one year contributes the land to a partnership in exchange for a partnership interest, the partnership **as a collective whole** is treated as if it held the land for more than one year (i.e., meaning that "all" investors of the partnership reap the benefit of the longer holding period).

Despite current law, the IRS' disdain for conservation easements used within syndicated real estate partnerships is well-established. This attitude is evidenced by, among other things, the issuance of IRS Notice 2017-10 which designates these transactions as listed transactions if the charitable deduction would exceed 250% of the taxpayer investor's relevant basis in the partnership.

As was the case with respect to last year's budget proposal, the Administration's 2023 proposal seeks to greatly reduce the use of conservation easements within most syndicated real estate partnerships.

As was the case with respect to last year's budget proposal, the Administration's 2023 proposal seeks to greatly reduce the use of conservation easements within most syndicated real estate partnerships. The proposal provides that a contribution by a partnership (whether directly or as a distributive share of a contribution of another partnership) is not treated as a qualified conservation contribution if the amount of such contribution exceeds 250% of each partner's relevant basis in such partnership. However, such disallowance would not apply if a ***three***-year holding period was satisfied. For purposes of this rule, the "relevant basis" refers to the portion of the taxpayer's basis that relates to the real estate that gives rise to the charitable deduction. The proposal would be effective for contributions made in tax years ending after December 23, 2016, or, in the case of contributions to preserve a certified historic structure, for contributions made in tax years beginning after December 31, 2018.

The Treasury and LTA began its collective effort to lobby Congress for the above-mentioned tax code change in 2017, which has garnered some support in Washington (See H.R. 4164 and S. 2256, which had 12 co-sponsors as of June 10, 2022). While the Treasury's and LTA's progress has been slow going through 2021, there appears to be a trend of support growing within some circles of the media for the IRS/LTA proposed tax law change (Source: Richard Rubin, Wall Street Journal, May 1, 2022).

A fair follow-up question to this proposed legislation is why the vagueness of conservation easement valuation rule is not being examined closer? The vagueness stems from the fact that the underlying donation involves the gift of an "easement placed into perpetuity" as opposed to the real estate itself (i.e., whose uses may evolve considerably over hundreds or perhaps thousands of years). Also, driving the unclarity is the reference within the Treasury Regulations to the conserved real estate's "highest and best use," which suggests that a discounted cash flow approach to the valuation might be justified in some cases where the property's commercial functionality is needed in the relevant local community (i.e., as a real estate development or mineral exploitation project). **Assuming the law stays as is, advisors and representatives can nonetheless continue to expect a high level of audit and enforcement activity coming out of the IRS in 2022 and future years.**

Other tax proposals of interest

The President's tax proposal also contains many other tax law changes that, if passed, will affect the income tax consequences of investors, sponsors, and the financial investment community at large. A summary of certain of these income tax proposals is provided below:

- Increasing the income tax for corporations from 21% to 28%;
- Increasing the highest marginal tax rate for individuals from 37% to 39.6% (for families with taxable incomes over $450,000 and single filers with taxable incomes above $400,000);
- Imposing a minimum income tax of 20% upon total income, inclusive of capital gains, for taxpayers with a net worth in excess of $100 million;
- Requiring 100% recapture of depreciation as ordinary income for certain depreciable property (i.e., IRC §1250 assets);
- Taxing the carried interest income of program sponsors and fund managers as ordinary income (i.e., such interests of which are referred to in the President's proposal as investment services partnership interests); and
- Extending the period for assessments of tax for certain qualified opportunity fund investors (i.e., which would enlarge the period in which the IRS may assess taxes pertaining to capital gain inclusion events occurring prior to December 31, 2026).

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Where will this all go?

While parts of the President's tax proposals are uncomforting to many, it's important to understand that, at the end of the day, "**Congress controls the purse strings**." The government is funded through 12 appropriations bills that need to be passed by both chambers and signed into law by the President. Those spending bills can be passed along party lines in the House, where Democrats control a majority. However, they need 60 votes in the Senate, which is split 50-50 at this time.

Time will tell where these proposed tax measures end up. ▲

Do UPREIT Exits for DST Programs Allow Investors To Avoid Capital Gains Tax Indefinitely?

By Gail Schneck, *CEO of FactRight, LLC*

Serving as FactRight's CEO, Gail has been a part of the team since 2012 and has been involved in alternative investments since 2005. She holds a master's degree in economics from Duke University, an MBA in finance from NYU, and a certification in financial planning. She provides leadership, direction and education to FactRight's staff and recommendations and perspective to its clients.

A growing number of non-traded real estate investment trusts are seeking to expand their funding sources by offering section 1031 exchange investment properties that may later be (re)acquired by the REIT through an umbrella partnership real estate investment trust (UPREIT) transaction.

Such transactions allow investors to diversify their holdings into the operating partnership (OP) of a REIT that is likely to own multiple properties. And if the ability to enter into section 1031 exchanges is substantially curtailed—as has been proposed several times in recent years—the UPREIT option may still provide investors who have already entered into an affiliated Delaware statutory trust (DST) with the ability to continue to defer taxes (at least until the property acquired is sold or refinanced) under section 721 of the Internal Revenue Code. This is why we are also seeing a number of REITs emerge, after the issuance of DSTs by the same sponsor, to provide an UPREIT exit. A DST with an UPREIT structure may provide a significant opportunity to the right investors, but they must understand the ramifications of such investments. Let's look at the main considerations for determining whether investing in a DST program with an UPREIT option is appropriate for your client.

What kind of investors should consider this kind of program?

Through an UPREIT option, investors would exchange their DST interests for units in a REIT's OP at the time the REIT or an affiliate exercises its option to purchase the DST property. Assessing whether your client has the right to receive cash proceeds to potentially pursue a subsequent 1031 exchange, if available, in lieu of OP units is a critical inquiry. Many REIT programs do not give the investors a cash-out option, or else they may limit the amount of sales proceeds that may be paid in cash. In those cases, an investor interested in a future section 1031 exchange might not be suitable. However, even those programs that do give investors an option to take cash a subsequent 1031 exchange may not be viable in the future depending on the fate of section 1031.

Thus, the DST/UPREIT arrangement is most appropriate for investors seeking diversification and easier liquidity for their heirs, who are also comfortable with a relatively large eventual investment in a non-traded REIT.

What exactly would your client be UPREITing into?

My father once told me that it is unwise to make investment decisions based on tax consequences alone. And he was a tax lawyer. It is one thing to diversify a portfolio. It is another to assess what you are diversifying into. Before investing in a DST program with an UPREIT option, you and your client should step back and ask whether an eventual investment in the REIT is sound absent the potential tax advantages. After all, these programs can materially vary in the level of diversification offered, risk/return profile, quality of the portfolio, and fee structure.

What happens if the UPREIT transaction doesn't occur?

The option is exercisable at the discretion of the REIT. Most programs intend to UPREIT the property and therefore expand the capital raise of the REIT by capturing the equity raised from the prior DST syndication. However, the REIT is under no obligation to do so, and may decide to pass on the repurchase if property performance deteriorates over the holding period. Therefore, investors may face taxes on capital gains when the DST exits, at potentially higher rates than prevail today, since 1031 may not an option in the future. Of course, this prospect faces investors in any DST program these days.

Ultimately, your client must have the resources to be prepared for various outcomes in the future, in addition to being suitable for the REIT investment.

What type of liquidity does the REIT provide?

If the UPREIT transaction does occur, usually investors are required to hold the OP units for at least a year before they can be converted into REIT shares and liquidated. Upon conversion, the investors can take advantage of the repurchase program included in the REIT structure. Repurchase program features vary among and between public and private REITs. But liquidity is not guaranteed—one common feature is that these programs can be suspended or terminated without investor consent.

Safeguards for affiliated transactions

The UPREIT structure presents affiliated transaction-related risk, often at the beginning and certainly at the end of the DST investment.

On the front-end, some programs acquire properties for the DST from third parties, which they then intend to UPREIT. Other programs have the OP acquire the property, or they take an existing OP property, and drop them down into the DST. Affiliated transactions, such as the latter scenarios, require additional safeguards surrounding determination of the DST purchase price such as independent appraisals.

At the DST exit, the same third-party appraisal considerations apply. How close in time to the UPREIT transaction must that appraisal be obtained? Also, note whether the sponsor might earn a disposition fee on the roll-up transaction (whether or not the affiliated REIT will be paying them an acquisition fee). Some DST sponsors are not entitled to transaction fees for an affiliated exit, which may help to mitigate conflicts of interest, while others are.

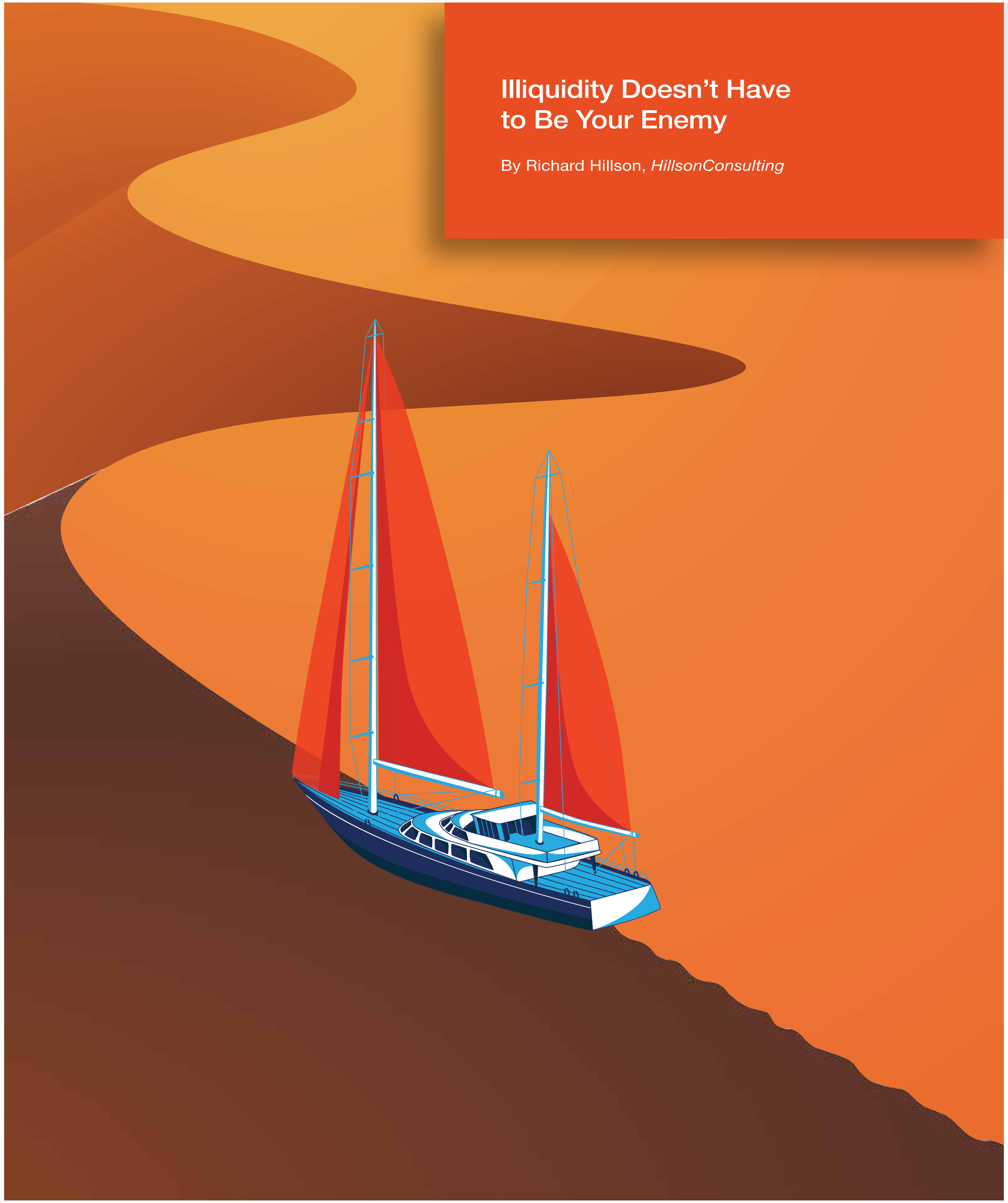
Tax deferral forever?

One of the biggest advantages of the UPREIT structure is that investors can create diversification by exchanging DST interests into the OP of the REIT, and if properly done through a section 721 exchange, continue to defer capital gains taxes. But this tax deferral may not be forever. Subsequent conversion of OP units into common shares is a taxable event. In addition, if the REIT sells or refinances the property originally acquired through the UPREIT transaction down the road, investors may also be hit with a tax liability, which is why many REIT programs offer tax protection agreements. However, these tax protections are often limited in duration to between five and ten years.

One of the strengths of section 1031 (as it now stands) is the ability for the investors to "swap 'til they drop," the latter part of that phrase a euphemism for an event that affords a stepped up basis for heirs, effectively eliminating capital gain liability at that time. While UPREIT programs can offer diversification and liquidity, at some point the tax liability may loom, in part because investors will no longer have the ability to enter into another 1031 exchange. From a liquidity standpoint though, after as little as one year, investors may exit the REIT by converting OP shares into common shares. Of course, this liquidity is dependent upon the repurchase feature provided by the REIT.

Overall, the UPREIT strategy probably makes the most sense for investors who have no need of funds and want to pass a more liquid, diversified holding to their heirs. If you're looking for more information on UPREIT transactions or due diligence services in the alternative investment space, please contact Gail Schneck or any member of the FactRight team for further assistance. ▲

One of the biggest advantages of the UPREIT structure is that investors can create diversification by exchanging DST interests into the OP of the REIT, and if properly done through a section 721 exchange, continue to defer capital gains taxes. But this tax deferral may not be forever.



Illiquidity Doesn't Have to Be Your Enemy

By Richard Hillson, *HillsonConsulting*

Hillson Consulting is a boutique investment consultancy founded by financial services entrepreneur Richard Hillson. The company helps independent advisors enhance and improve their offerings and drive revenue through alternative investments. HC also works with product sponsors to help them with education and access within the independent RIA channel.

With thanks to Ashlyn Burns, Spencer Mark, and Nick Pratico

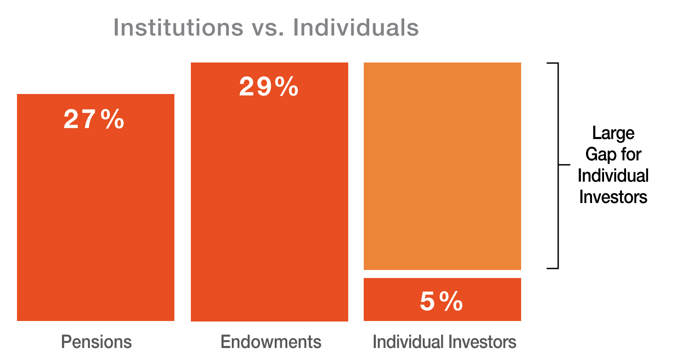
One of the most common conversations I have with advisors and clients is about liquidity… or more precisely, illiquidity. It might be the number one perceived "terror" in the alternative investment space. It is only a scary proposition if the advisor or client has not planned correctly. For the sake of brevity, for this discussion, illiquid also includes less liquid assets. By this we mean assets where capital is tied up for 3-5 years or more, or there are penalties for early redemption.

The table on the right shows average allocation to alternatives, comparing institutional investors vs individuals. I am not saying illiquidity is the only reason more individuals do not allocate more to alts, but it is a big part of the reason. Please note, as this is a few years old, I believe the individuals number has increased but still lagging far behind institutional investors.

Let's look at the pros of liquid assets. Flexibility. Pretty short list.

Now let's examine the argument for a percentage allocation to illiquid assets.

Average Allocation to Alternatives[1]



Stupid Decisions

Well planned allocations to illiquid investments prevent stupid, impulsive decisions. One of the most recent examples is the early Covid dip where many investors panicked; sold; mis-timed; and were left wishing they had not acted rashly. A strategic allocation to illiquid assets prevents this emotional reaction investing and avoids anyone trying to time the market, which even the smartest guys in the room do not always get right. It also takes away the day-to-day stress and panic which daily or even hourly position status checking creates.

Valuations

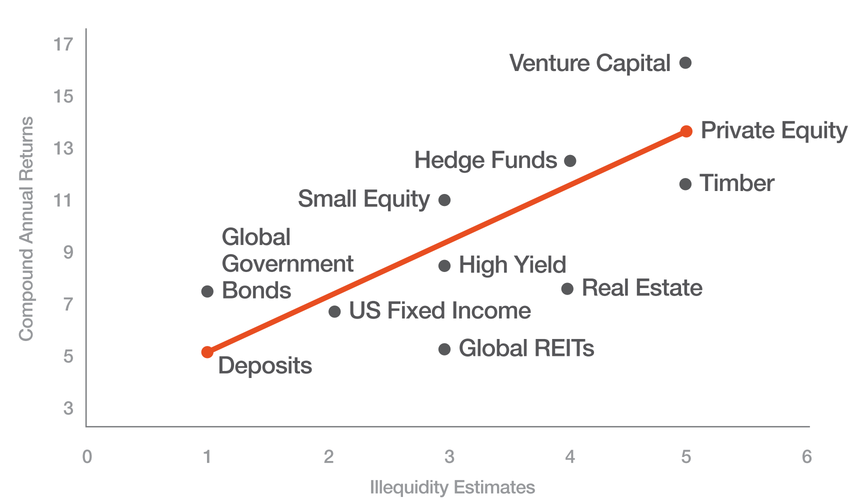
Illiquid assets are usually valued privately rather than publicly. Net Asset Value (NAV) is often used to value assets within a private fund or vehicle. Nothing is perfect in the valuation world, but a real asset-based calculation, rather than a public market sentiment overreaction/underreaction definitely has the potential to be more objective than subjective. This is particularly compelling if the appraisal is through a third party, not, sponsor management.

Illiquidity Premium

Let's take a basic hypothetical example. A public REIT and a private REIT are both offering 3% yield and are identical other than liquidity. Which one do you allocate to?! 99% of investors go for the public liquid REIT.

So how does a private and illiquid REIT compete? Offer a higher yield. How does 6% sound? This is the illiquidity premium.

Investment Returns Generally Increase With Degree of Illequidity[2]



If an advisor allocates client funds solely into liquid assets, they are leaving money on the table, fact! I am by no means advocating for tying up 80% of assets into less liquid products but a percentage of assets in securities with an illiquidity premium will raise the average return of the portfolio. If an advisor is doing their job correctly and planning time horizons; emergency funds; life events etc. then they know what percentage of capital can be tied up for a period of time and can capitalize on the higher returns available.

Retirement Accounts

I had this conversation with my friend Kyle Kadish, from AGES at a conference recently. His explanation was so eloquent that I asked to him summarize it for the purposes of this article.

"Investors and savers contribute to IRAs and 401k's to grow their net worth tax-efficiently; the tax-free or tax-deferred growth comes with the stipulation of reaching a certain age. A qualified account's inherent illiquidity structure neatly matches some illiquid investments' illiquidity nature. For investors with a longer time horizon, as they continue to accumulate wealth, or those seeking higher income due to the illiquidity premia with certain investments, a qualified account could be the right place to source funds for the illiquid investment.

- This should not change any suitability, net worth, or income requirements of an investment.
- Investors and advisors should always keep RMD age limits in mind when allocating to illiquid investments through a qualified account."

—Kyle Kadish, AGES Financial Services Ltd., Member FINRA/SIPC/MSRB Advisory services offered by Trust Advisory Group, Ltd., a Registered Investment Advisor, 444 Washington St, Suite 407, Woburn, MA 01801

Reinvestment Risk

"Reinvestment risk refers to the possibility that an investor will be unable to reinvest cash flows received from an investment, such as coupon payments or interest, at a rate comparable to their current rate of return. This new rate is called the reinvestment rate."[3]

Careful and successful financial planning requires predictability of cash flows, particularly if these cash flows are matched to liabilities. If I invest into a 5% 1-year bond-type structure and the interest environment changes, perhaps I should have invested into a 5-year product which may well have offered me a premium at 6%. We can all play the gambling game of what happens if interest rates increase but I will take predictability over speculation all day. Illiquid investments eliminate or at least mitigate this risk.

Redemptions

One additional point which deserves consideration is that of redemptions. This was addressed by Freddie Lait, managing partner of U.K.-based Latitude Investment Management LP.

"Illiquidity is a risk which has been mispriced over the past 10 years as quantitative easing programs have flooded financial systems with cash, and regulators have allowed funds to run liquidity mismatches in their portfolio."[4]

The problem arises with this mismatch when investors get skittish and a fund cannot meet their redemption demands. This is certainly a consideration for interval funds or other semi-liquid options but most of the sponsors in this space are illiquid until exit. It certainly makes sense to push this point in any due diligence conversations where limited liquidity is offered, the ability of the sponsor to meet a max redemption demand.

"There's price for liquidity, and that typically equates to lower returns. For many alternative sponsors providing liquidity essentially means money is sitting on the sideline not earning a premium or in other words there's a "dead money," component. I believe most investors given the option of having all of their money working for them or only a portion would choose the former if they are fully educated on the investment. While it's certainly nice to have liquidity available, illiquidity helps to remove emotions from the equation." — Todd Woodhead, EVP Capital Markets, Walton Global.

In summary, an allocation to illiquid investments HAS to be a consideration for advisors and their clients. Even at a 10-20% level, this leaves more than enough liquidity for unexpected events, emergencies etc. If an advisor is not making these allocations, they are not only leaving money on the table but are not delivering a high-level service to their clients. If a portfolio is 100% liquid, has the advisor really done their job properly in medium and long term planning and has understand the cash flow requirements for their client?! ▲

1 — Global Pension Assets Study 2016, Willis Towers Watson; National Association of College and University Business Officers 2016 Study (Equal-weighted Average); Money Management Institute, "Distribution of Alternative Investments through Wirehouses," 2016.

2 — "Expected Returns" by Antti Illmanen, 2011 as cited in "Private Capital, Private Opportunities" by Blackstone. © Michael Kitces, https://www.kitces.com/blog/capturing-an-excess-return-premium-for-illiquidity-is-a-privilege-not-a-right/.

3 — Jason Fernando, "Reinvestment Risk," Investopedia, March 30, 2021, https://www.investopedia.com/terms/r/reinvestmentrisk.

4 — Tom Bradley, "Why illiquid investments are all the rage and what you need to know about their risks," Financial Post, February 13, 2020, https://financialpost.com/investing/investing-pro/why-illiquid-investments-are-all-the-rage-and-what-you-need-to-know-about-their-risks.

Exploring Alternative Investment-Based Insurance: Private Placement Life Insurance and Annuities

By Brad Updike, *LLM, JD, Mick Law P.C.*

Matthew Zadorozny, *JD, Mick Law P.C.*

Bradford Updike, Director at Mick Law, manages the firm's energy and tax-oriented practice. Other areas of practice include securities law, oil and gas, private equity, conservation real estate, DPP due diligence, taxation analysis relating to securitized financing, and securities advertising practices.

Matthew Zadorozny primarily performs due diligence analysis for a wide variety of alternative investments presented to Mick Law. Matthew received his JD and MBA degrees from Creighton University in May 2020.

The assets under management within U.S. issued variable life insurance policies are estimated to be in the trillions of dollars[1]. An emerging yet obscure sub-market of the variable insurance product segment involves Private Placement Life Insurance ("**PPLI**"), which is an alternative investment-based form of variable universal life insurance that is tailored to meet the mortality and investment needs of affluent clients. These objectives are accomplished through the structuring of a specialized variable insurance product that offers indemnity in the event of death as well as a tax efficient investment that utilizes **alternative investments** to build income tax deferred cash values inside the policy. This article explores the features of PPLI and its companion product, the Private Placement Variable Annuity ("**PPVA**").

What is PPLI?

PPLI is a financial innovation developed over the past 30 years within the life insurance industry for highly affluent investors. It is a form of variable universal life ("**VUL**") policy that is sold through a private placement offering. Because the product is sold through a private placement memorandum ("**PPM**"), some transactions involving PPLI can be customized for the investor in terms of investments and other features.

In contrast to traditional VUL products, which have generalized investment alternatives such as mutual funds, PPLI provides access to alternative investments. This allows the policy's cash to be invested in non-traditional investments, such as hedge funds, private equity, funds of funds, real estate, commodities, and financial derivatives. These investments are made in many cases through insurance dedicated funds ("**IDF**"), which are investment funds marketed exclusively to insurance companies. Some insurers also offer customized contract provisions for death benefit amounts and duration, funding options, borrowing interest rates, crediting of interest charges, fees and loads, choices of insureds, ownership options, access to cash value alternatives, and use of professional asset managers.

Recently, independently managed separate accounts ("**SMA**s") are growing in popularity for PPLI investments. SMAs allow independent investment advisors to create customized portfolios that invest in a variety of alternative investments including limited partnership interests in private equity and hedge funds, among others. The key difference is SMAs allow investment advisors to customize the investment portfolio to fit their client's goals and risks. Traditionally with IDFs, the insurance carriers drive the portfolio investments and PPLI investors are subject to the specific IDF manager's objectives and strategy. Subject to tax requirements prohibiting control of investments, the PPLI investor can choose an investment advisor to manage an SMA, however, the investment advisor retains the sole authority over the SMA's investments.

PPLI is less expensive than traditional publicly offered life insurance because agent commissions on PPLI are lower. Additionally, while PPLI can be underwritten under the laws of the various U.S. states, non-U.S. PPLI is even less expensive due to lower tax-based costs imposed against the premiums. Given the flexible investment options and lower costs, PPLI can be an attractive option for clients that are looking for mortality protection and income tax planning benefits available through life insurance.

If the assets in the underlying separate accounts perform well, the PPLI's cash value may substantially exceed its minimum death benefit (**but with the opposite effect occurring if the investments do not perform well**). Upon the insured's death, the beneficiary receives the greater of the minimum death benefit or the value of the separate account, each of which is income tax free based upon Internal Revenue Code ("**I.R.C.**") § 101(a). If owned by a properly designed irrevocable life insurance trust, the death benefits and all the earnings of the PPLI can likewise be estate tax free. Cash values of the PPLI can also be accessed on a tax preferred basis so long as the policies are not modified endowment contracts.

What is a PPVA?

A PPVA is a form of variable annuity that has investment features like a PPLI. In a variable annuity, the investment performance is based on the returns generated by the insurer's separate account funds. These funds are typically mutual fund clones or sub-accounts and are segregated from the insurer's general account assets. Like PPLI, the private placement version of the variable annuity is marketed to accredited investors and its performance is based upon the returns generated by alternative investments. Like PPLI, the companion annuity products are institutionally priced with no surrender charges, and the investment options include hedge fund, private equity, and real estate options as well as traditional mutual fund-like options. Unlike a traditional annuity sold to retail investors, a PPVA doesn't have features such as income guarantees or principal protection. As a result, the PPVA generally has lower fees than a traditional retail annuity.

PPVA tax benefits and asset-protection issues are similar in some respects to the benefits of life insurance in that the investment amount grows free of current income taxation. At some point, assuming the contract has an investment gain, either the annuity contract owner or the beneficiary will be required to pay income taxes on the gain at the short-term capital gains rate. That makes this product an alternative for deferring current taxation, but it does not have the preferred lifetime access to cash value on a tax-deferred basis or an income tax-free death benefit as do life insurance contracts. For this reason, certain clients may prefer the PPLI when the goal is income tax deferral with tax efficient access to cash during the client's lifetime.

PPVAs are often utilized by ultra-affluent individuals and families who intend to leave assets to a public charity or private foundation at their passing. If a charitable entity is named as the beneficiary of a PPVA, all the deferred investment gains pass income tax-free to the charity. However, unlike other charitable strategies that are irrevocable in nature, PPVAs provide flexibility for the individual or family if there is ever a desire to access the assets during the owner's lifetime. The PPVA's owner also retains control during its lifetime to change the beneficiary from one charitable entity to another.

Eligible Purchasers and Suitability

The offer of PPLI and PPVAs is limited to accredited investors and qualified purchasers. The Securities Act of 1933 provides an exemption under § 4(2) from securities registration for accredited investors as defined in Rule 501(a) of Regulation D under the Securities Act. An accredited investor is an investor with a net worth of at least $1 million and joint income of at least $300,000 in each of the last two years, with the likelihood of continuation in the current year. A qualified purchaser has investable assets of at least $5 million. Given the minimum premium requirements relating to such products, however, the target client will have a net worth that substantially exceeds the minimum accredited investor requirements mandated under Regulation D (i.e., probably $25-50 million or more in net worth).

Like other forms of life insurance, a medical underwriting is required for a PPLI that includes full health history disclosure and a medical exam that often involves a stress EKG. While the applicant's net worth and/or future estate tax liability may often justify the insurance coverage, the application process for a PPLI involves full financial disclosure. As such, PPVAs have been preferred by some to PPLI mainly because PPVAs are simpler to implement. They involve a shorter application, and no financial related underwriting is required.

Clients with large long-term investments in income tax inefficient asset classes (i.e., investments subject to ordinary income taxes) may benefit from the acquisition of PPLIs and PPVAs. Depending on the product, the client should be ready to invest a minimum of $1 million in both forms of products ($5 million and higher required in some cases) and have an investment horizon of 10 to 15 years for PPLIs (to overcome the impact of up-front fees and expenses) or until age 59½ for PPVAs (to avoid the 10% federal excise tax upon gains). PPLI can benefit clients who are insurable and have a need for life insurance coverage and/or a desire to fund tax-efficient multigenerational estate planning structures (i.e., dynasty trusts). PPVAs can benefit clients who want to retain full ownership and access to their investment assets during their lifetimes but also are interested in long term charitable planned giving. In such cases, however, the client must accept some loss of investment control since the tax benefits of both products require the investments to be under the management of an independent investment manager.

Investments

The ability of insurers to offer investment flexibility through alternative investments is one of the most important features of private placement products. Unlike traditional variable retail products, owners of PPLI and PPVAs can allocate among IDFs that mirror publicly available retail mutual and index funds, as well as alternative class options, such as hedge funds, private equity, funds of funds, derivatives, etc. Thus, the investment accounts of the private placement products will provide access to a range of alternative investments on an income tax-advantaged basis. If an investor wants to invest in an IDF that is not presently offered by a carrier, the manager of the fund can create a separate series that will qualify as an IDF. As there is often an additional cost for this process, it may be more cost efficient to select from existing IDFs. Investment in an IDF can only be made through the purchase of a PPLI or PPVA. Since the purchase of a PPLI or PPVA must be made with a cash payment, it is not possible to transfer existing investments into such policies.

The increase in popularity with SMAs now adds an additional way for PPLIs and PPVAs to invest. SMAs offer more options to owners of PPLIs and PPVAs by allowing investment advisors the ability to create a custom portfolio that matches a client's individual goals or strategies that they may not be able to find with an existing IDF.

With higher investment return potential, however, comes greater market exposure and greater investment risk. **A chart that compares private placement insurance compares to other forms of permanent life insurance is provided in the table on the opposite page.**

Modified Endowment Contracts ("MEC")

According to I.R.C. § 7702A, an MEC is a life insurance policy overfunded in the initial years of its existence based upon the timing and premiums paid in relation to its death benefit. The determination of whether a life insurance policy is an MEC is based on actuarial calculations that are referred to as the "seven-pay" test. A policy is a MEC if the cumulative premiums paid at any time during the first seven years exceed the sum of the maximum net level premiums that could have been paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums. The test requires that the premiums be made over a period of years, as opposed to a single up-front payment. The following are consequences of a life policy characterized as an MEC:

- Loans taken from or secured by the policy are deemed to be distributions of earnings from the policy;[2] Distributions, including payments upon the lapse or surrender of a MEC policy, are taxable as ordinary income up to the amount by which the cash surrender value of the policy exceeds the cumulative amount of premiums paid into the policy;
- A 10% excise tax is imposed on distributions made prior to the insured attaining age 59 1/2 (but the penalty shall not apply where the insured is disabled or where the distributions are part of a series of substantially equal periodic payments extending over the life of the taxpayer).

Avoiding MEC classification may be of concern where the goal is to invest as much in the PPLI as quickly as possible so that the return can begin accumulating on a tax efficient basis. If, however, the PPLI owner has no intentions of accessing policy cash values, MEC classification may be beneficial because the overall cost of insurance will be less.

Table I - Life Insurance Risk Spectrum

HIGHEST RISK ← → LOWEST RISK

High Investment Risk and Full Market Exposure	Hedged Investment Risk and Limited Market Exposure	Reduced Investment Risk and Carrier Portfolio Exposure	No Investment Risk and Guaranteed Results
Variable Universal Life & Private Placement Life Insurance Cash values are invested in a basket of mutual funds, hedge funds, private equity, or combination of the same Cash values maintained in separate accounts and a re not subject to carrier's creditors Policy owner takes investment risk and policy performance is based upon investment performance Some carriers offer guaranteed riders that allow for both cash value growth and guaranteed premiums	Indexed Universal Life Cash values grow based upon a specific market index return Cash values are not invested in the market, rather a small portion buys call options on a specific index Carriers set cap and floor and offer guaranteed caps and floors Some carriers offer guaranteed riders that allow for both cash value growth and guaranteed premiums	Universal Life and Whole Life Cash values are subject to carrier's creditor claims Credit ratings reflect new money rates Carriers offer contractually guaranteed minimum credit rates	Guaranteed Universal Life Premium amounts and durations are guaranteed and are not interest sensitive Essentially term life to age 100 with carrier taking more performance risk Policies designed to have less cash value Non-correlated to other assets Market is shrinking

What are the Costs?

A potential factor in the conservative growth in popularity of PPLIs relates to the disparity in their compensation when compared to the sales compensation of retail products. Retail VULs, in general, have a commission structure that pays selling agents 55-100% of the target premium in the first policy year. Commissions in subsequent years on VUL premiums vary by carrier from

2-5% of the premium. Additionally, the agent receives 25-35 basis points (0.25-0.35%) of the VUL's account value each year. The policies usually have declining surrender charges of 10-12 years. Traditional variable annuities have a commission structure that pays the selling agent 4-5% in the first year and on any subsequent premium payments. Additionally, the agent receives 25-35 basis points of the account value each year. Traditional variable annuities also have declining surrender charges over 5-8 years.

In contrast, PPLI and PPVAs generally have no surrender charges and compensate the selling agent with premium based commissions equal to 0-4% and asset-based commissions based on the account value of .10-.50 basis points. Note that PPVAs typically do not incur charges for DAC taxes, state premium taxes (other than in a small number of states), or costs of insurance. Thus, PPVAs will have a somewhat simpler fee structure. **A summary of the sales costs and other fees commonly associated with PPLIs is provided below.**

Table II - PPL Common Costs

Fee	Recipient	How Paid	Amount
Fed. Deferred Aquistion Cost Tax	Fed. Govt.	Premium	0-1% Foreign 1-1.5% Domestic
State Premium Tax	State Govt.	Premium	0% International 2% avg. but varies by state (0.075% to 3.0%)
Mortality & Admin. Exp. Charge	Ins. Co./Ins. Advisor	Mo. Assess. Cash Value	Often scaled by asset size and duration (i.e., 0.20% to 1.50% of cash value per year for first 10 years, but scaled down after that). Includes cost of insurance.
Insurance Cost	Insurance Cost	Cash Value Assess	Variable depending on net amount at risk, age, sex, and health of insured. Typical annual COI charges for PPLI policies range between approx. 25 basis points (0.25%) and 50 basis points (0.50%) of the cash value for a single life product (sometimes slightly less for a second-to-die contract) once all premiums have been paid.
Sales Comp.	Ins. Advisor	Premium/Cash Value	1-3% of premium Trail compensation — 0.15 - 0.50% of cash value per annum

For PPLI and PPVAs, at the investment level, asset management fees are charged at market rates and paid at the IDF level of the separate account. The investment returns are reported to the separate account net of these fees, which effectively makes the entire fee tax-deductible, without regard to the deduction limitations typically imposed on taxable accounts for itemized deductions or alternative minimum tax purposes.

Risks of PPLI and PPVA

PPLI and PPVAs have special risks that must be discussed with clients prior to investing, and the offering materials of the products will generally contain an explanation of such risks. PPLI and PPVAs are unregistered securities that are not subject to the same regulatory requirements as registered variable products that include financial reporting obligations to the SEC. Similar to most forms of alternative investments, and due in part to their sales costs, insurance costs and other charges, PPLI and PPVAs should also be viewed as investments that require a long-term investment horizon to effectuate the client's financial objectives.

The value of the investment options of the separate accounts will be subject to economic and market risks that affect the portfolio investments of the segregated accounts. As such, cash values associated with these products will fluctuate, and when redeemed or annuitized, may be worth more or less than the invested cost. While the investments of the separate accounts may be diversified for federal tax code compliance purposes, it is possible that the investments covered within the fund investments can be concentrated within a limited number of industries.

PPLI and PPVAs often require a significant premium commitment (i.e., $1-3 million plus) funded over a period of years. Thus, a failure by the client to fund required premiums due to unforeseen financial difficulties could result in a substantial reduction of planned life insurance benefits and anticipated cash values supporting the client's retirement or estate planning objectives.

The continued financial stability of the insurer is also a necessary development to ensure that the life benefits and cash value objectives of the client are achieved. Thus, the benefit of the PPLI or PPVA will be substantially compromised if the underlying insurer or reinsurer fails to remain in business as a going concern.

While cash values from PPLI and PPVA are generally maintained in separate accounts of the insurer, the accounts contain the cash values of numerous variable policies accounts. Thus, while separate accounts, to the extent used by the insurer, will generally insulate the insurer's variable policy assets from the liabilities of its other business lines, it does not prevent claims from one policy from being paid with the assets of multiple insureds.

Change in Section 7702

In December of 2020, H.R. 133 was signed into law bringing a change in interest rates associated with I.R.C. § 7702. §7702 provides the definition for a life insurance contract, an important characterization in order to properly realize the benefits of PPLIs and PPVAs. Under I.R.C. § 7702, a life insurance policy will be given the life insurance contract treatment if it meets either the cash value accumulation test ("CVAT") under §7702(b); or the guideline premium test ("GPT") under

§7702(c). The interest rates originally installed with §7702 in the 1980s when interest rates were high remained unchanged until this update, meaning that insurance carriers needed to comply with the 4% interest rate assumption for the CVAT and 6% for the GPT.

To broadly summarize the changes to I.R.C. § 7702, the Insurance Interest Rates are now calculated based on two formulas: (i) §7702 valuation interest rate; or (ii) the §7702 applicable federal interest rate. For determining a net single premium or a guideline level premium under §7702, and the 7-pay premium under §7702A, the interest rate will be the lesser of (i) the Insurance Interest Rate in effect when the life insurance policy was entered, or (ii) an annual effective rate of 4%, but not less than the rate(s) guaranteed at issue. For calculating guideline single premiums, the computation of interest is the lesser of (i) 2% plus the Insurance Interest Rate in effect at the time the life insurance policy is issued, or (ii) an annual effective rate of 6%, but not less than the rate(s) guaranteed at issue. For reference, in 2021, the guideline level premium rate was reduced to 2% and the guideline single premium rate was reduced to 4%.

Effectively what the update to I.R.C. § 7702 does is it allows policyowners the ability pay more premiums and grow the cash value of a PPLI policy without an increase in the death benefit. More importantly, the change to §7702 allows policyholders to pump more into the policies without violating the existing tests in §7702 and §7702(A). The update to §7702 appears to be a favorable one and with potential looming tax rate increases, could make investments in PPLIs even more beneficial for investors' tax treatment.

PPLI Providers

Below is a list of some of the most prominent providers of PPLI and IDFs:

- BlackRock
- Wells Fargo Private Banking
- Zurich
- Crown Global
- Pacific Life, and
- John Hancock

1 — Insurance Information Institute website (visited June 7, 2022).

2 — I.R.C. §72(e).

Conclusion

The only two things that will continue to remain forever constant for all U.S. Citizens, including affluent ones, are death and taxes. While income tax related expenses are perhaps the single biggest expense any person has from a financial planning standpoint, we operate in an environment where (i) few investors and their advisors truly understand the need to manage their taxes, and (ii) few alternative investments address this planning need in a meaningful way. Acknowledging that private placement insurance products are niche products that will not appeal to everyone, their features are noteworthy for affluent clients that desire mortality protection coupled with a tax efficient wealth accumulation strategy that utilizes alternative investments as the underlying assets. ▲

ADISA Advocacy

We advocate for you. ADISA proudly represents the non-traded alternative investment sector in Washington.

Whether in combination with other associations, as part of an issue coalition, or fighting on our own, ADISA's efforts protect the interests of our members. We also monitor rulemaking and legislation and relay important news to our members.

- ADISA Comments on FINRA Regulatory Notice 22-08 (Complex Products and Options) (May 11, 2022)
- ADISA Addresses Concerns to What the SEC is Proposing Under the Investment Advisors Act of 1940 (April 26, 2022)
- ADISA Issues Comment Letter to SEC Expressing Concerns on Share Repurchase Disclosure (March 31, 2022)
- ADISA Co-Signs Letter to the Employee Benefits Security Administration Requesting an Extension of Time to Comment on an NPRM (March 23, 2022) ▲

Save the Dates

ADISA 2022 Annual Conference & Trade Show

October 10-12, 2022

The Cosmopolitan of Las Vegas

ADISA 2023 Spring Conference

April 24-26, 2023

Marriott Marquis San Diego Marina

See You There!!

ADISA Board member Brad Updike, Mick Law, will be this year's chair of the AI Research & Due Diligence Forum, July 19-20, at the Renaissance Atlanta Waverly Hotel. With Atlanta's convenient location and concentration of broker-dealers and RIAs, this year's AI Research & Due Diligence Forum promises to deliver the drilldown educational event of the year.

- Network with more than 250 industry professionals
- Learn about today's issues and business opportunities
- Discover advanced due diligence techniques, processes, tools and resources to remain compliant and safe

Who Will Attend?

Retail Broker-Dealers

Registered Investment Advisors (RIAs)

Family Offices

Due Diligence Professionals

Compliance Officers

Sponsors

Affiliates

Agenda-to-Date *(As of 7/1/2022)*

Tuesday, July 19

7:45-8:30 am
Breakfast & Exhibition

8:30-8:45 am
Welcome & Introduction
Brad Updike, Mick Law
2022 Alts Research & Due Diligence Forum Chair

8:50-9:50 am
Keynote Speaker Bob Rice
"Big Picture Trends in Alternatives"
Explore where we are going with the industry's futurist and thought leader Bob Rice.

9:50-10:20 am
Break & Exhibition

10:20-11:20 am
Alternative Investments Sector Report
Views and data from around the alts world: 1031s, energy, REITs, BDCs, private placements, private equity.
Moderator: John Harrison, ADISA
Presenters: Mike Kell, iCapital Network; Taylor Garrett, Mountain Dell Consulting; Matthew Iak, U.S. Energy Development Corporation; Kevin Gannon, Robert A. Stanger & Co.

11:30 am-12:30 pm
Private Placement Blowups: What We Have Learned
Overview of recent past "mistakes" in our industry's offerings and lessons drawn.
Moderator: Bryan Mick, Mick Law
Presenters: Ann Moore, International Assets Advisory; Paula Miterko, Miterko & Associates; Karlton Kleis, Arete Wealth Management.

12:30-2:00 pm
Lunch & Exhibition

2:00-3:00 pm
E&O for Alts: You Think You're Covered But You're Not
Perspectives on current insurance topics regarding alts.
Moderator: Myra Nicholson, International Assets Advisory
Participants: Nick Duren, Crescent Securities Group; Lori Kamen, Aurora Securities; Dee Cordea, InterWeb Insurance

3:00-3:30 pm
Break & Exhibition

3:30-4:45 pm
Alts Marketing Best Practices: Reg 506 and Rule 2210 Compliance Tips and Common Mistakes
This session will discuss topics affecting sales of alternative investments from a marketing compliance perspective (to include discussions on general solicitation, FINRA/SEC marketing content rules, and the importance of tempering expectations during the due diligence period to ensure that the marketing side is well positioned to syndicate in a "securities compliant" manner).
Moderator: Greg Mausz, Preferred Capital Securities
Speakers: John Grady, ABR Dynamic Funds; Darryl Steinhause, DLA Piper; Brad Updike, Mick Law

5:00-6:30 pm
Welcome Reception & Exhibition

Wednesday, July 20

7:30-8:30 am
Breakfast & Exhibition

8:30-9:30 am
New DST Best Practices
Review and exploration of ADISA's new publication on DST Best Practices.
Moderator: Thomas Voekler, KVCF
Panelists: Darryl Steinhause, DLA Piper; Angela Barbera, NexPoint Securities; Craig Covington, DAI Securities

9:40-10:50 am
Town Hall Meeting on Due Diligence Topics, Ethics and What Keeps Us Up at Night
Join us for a discussion on the current ethical dilemmas facing our industry today. We will have both small group and open discussion and participation from all is encouraged. In particular, we will be focusing on conflicts of interest and discussing practical solutions and potential future methods to better the alternative investment space for all investors.
Coordinators: Brad Updike, Mick Law; Rick Chess, Crescent Securities

10:50-11:10 am
Break & Exhibition

11:15 am-12:05 pm
More on Due Diligence Practices: Advanced Perspectives and Sponsor Due Diligence
Assessment of program manager viability and execution potential and other advanced due diligence topics.
Panelists: Mike Underhill, Capital Innovations; Jacob Heidkamp, FactRight; Mark Atchity, JCC Capital Markets

12:05-12:15 pm
Closing Remarks
Brad Updike, Mick Law
2022 Alts Research & Due Diligence Forum

450 E. 96th Street, Suite 185
Indianapolis, IN 46240

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Renaissance
Atlanta Waverly Hotel