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PRIVATE PLACEMENT LIFE INSURANCE (PPLI) HAS SLOWLY, QUIETLY GAINED ATTENTION OVER THE LAST COUPLE OF DECADES. WHY? WITH PPLI, A CUSTOMIZED WEALTH MANAGEMENT STRATEGY – INCLUDING HEDGE FUNDS, FUNDS OF FUNDS, REAL ESTATE, COMMODITIES AND MORE – CAN COMPOUND WITHIN THE TAX-PROTECTED COCOON OF A LIFE INSURANCE POLICY. MOREOVER, PPLI CAN BE PLACED WITHIN CERTAIN TRUST STRUCTURES THAT ENABLE THIS COMPOUNDING TO EXTEND ACROSS GENERATIONS, FREE NOT ONLY OF ORDINARY INCOME AND CAPITAL GAINS TAX, BUT OF ESTATE TAX, AS WELL.

Death ~~and~~ *of* Taxes

Private placement life insurance and the compounding power of 0% tax rates.

BY NICHOLAS J. BERTHA JD, *Director of Wealth and Trust Planning*

When we think of life insurance we think of a joyless, dutiful series of payments into a generic asset management pool to provide for our dependents in the event of premature death, or to pay off debt or estate taxes upon our demise. Personally, I think of perhaps the most oxymoronic phrase in finance – "death benefit."

But a different kind of life insurance strategy has slowly, quietly gained attention over the last couple of decades, one that is anything but joyless and is worthy of active consideration among successful families intent on growing wealth during their lifetimes or transferring it to children or charitable causes. It's known as private placement life insurance (PPLI).

PPLI is a form of variable universal life insurance, which means it builds cash value that can be allocated to various investments within the insurance company's portfolio. Like all cash-value life insurance, PPLI assets grow free of ordinary income and capital gains taxes, and the insured can borrow against it should liquidity be needed. And, like the traditional policy you are probably in today, death benefits pass to the beneficiary income-tax free, though the policy value counts toward the deceased's taxable estate.

However, while traditional, publicly offered policies place premiums in a generalized investment pool offered to all, PPLI is private. Its cash values are invested in separate accounts for each client, including custom accounts that can be managed by an independent investment manager, selected and monitored by the insurance carrier.

As a result, using PPLI, a customized wealth management strategy -- including hedge funds, funds of funds, real estate, commodities and more -- can be deployed within the tax-protected cocoon of a life insurance policy.

Additionally, placing PPLI within certain trust structures enables the death benefit to pass to succeeding generations free of all wealth transfer taxes. Taken together, this means no capital gains tax, no ordinary income tax, no estate tax. It's almost as if the IRS had never been born.

In my experience, apart from pure estate planning purposes few serious investors consider using traditional life insurance for substantial portions of their investable net worth. The investment pools are rather mundane and lack the customization that a thoughtful wealth

management strategy requires. This limitation is widely thought to outweigh the tax benefits. PPLI removes this limitation.

How PPLI Works

Private placement life insurance comes into play at wealth levels where the limits of IRA's and 401(k)s make taxable accounts a predominant part of the family's wealth management picture.

You purchase your PPLI contract at a level of, say, $10 million. Typically, you will pay in the $10 million over a period of years—this timing satisfies an IRS requirement that protects your ability to borrow from the policy in the future on a tax-free basis, should you wish.[1] You are immediately covered by $10 million in life insurance, which is typically a low-cost term policy. Though the insurance is statutorily necessary, it can be considered incidental to the broader purpose of capital appreciation supercharged by years (and perhaps decades) of tax-free compounding.

While tax efficiency inside the PPLI is a given, finding a tax-efficient way to fund the policy initially will be important. If the strategy makes sense for you from a wealth management standpoint, your Fieldpoint Private advisor can work with you to perform a portfolio analysis and recommend an approach that takes into account your cash, forthcoming liquidity events, gains/losses, and the time frame for funding.

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Though less expensive than traditional life insurance, the expenses associated with PPLI are high relative to taxable investment accounts. Regardless, these expenses will represent only a very small portion of the expected tax savings over the life of the contract. Costs include federal and state taxes paid on the premiums, the cost-of-insurance fee, and an insurance broker/carrier fee. They also include investment advisory and manager fees, which you would likely pay whether the assets were in an insurance contract or not.

Generally, the strategy works best if you can commit to remaining in the contract for at least ten years. Short of that, the economics become less advantageous.

PPVA

A private placement contract can also take the form of a variable annuity, known as a PPVA. Like PPLI, these are invested in separate accounts rather than generalized pools. PPVA's, however, are geared toward income instead of wealth transfer, and their income and gains are tax-deferred rather than tax free. Moreover, due to rules governing the taxation of their distributions, they convert any long-term capital gains into ordinary income.

It's almost as if the IRS had never been born.

As a result, they are often compared to IRA's, over which they hold a couple of important advantages, including no contribution limit, and the ability to start taking withdrawals whenever you like (subject to the contract's terms), without IRA-style penalties, if structured properly. Unlike IRA's, however, there is no deduction for your contribution to the vehicle.

For wealthier families, PPVA's are often used for charitable giving. You may set up a PPVA and use it to fund any number of charities during your lifetime, or take income from the policy and assign any remaining annuity value to go to charity upon your passing. Unlike some tax-advantaged charitable strategies, which once established are irrevocable, a PPVA remains under your control (or that of your surviving spouse).

Investment Strategy

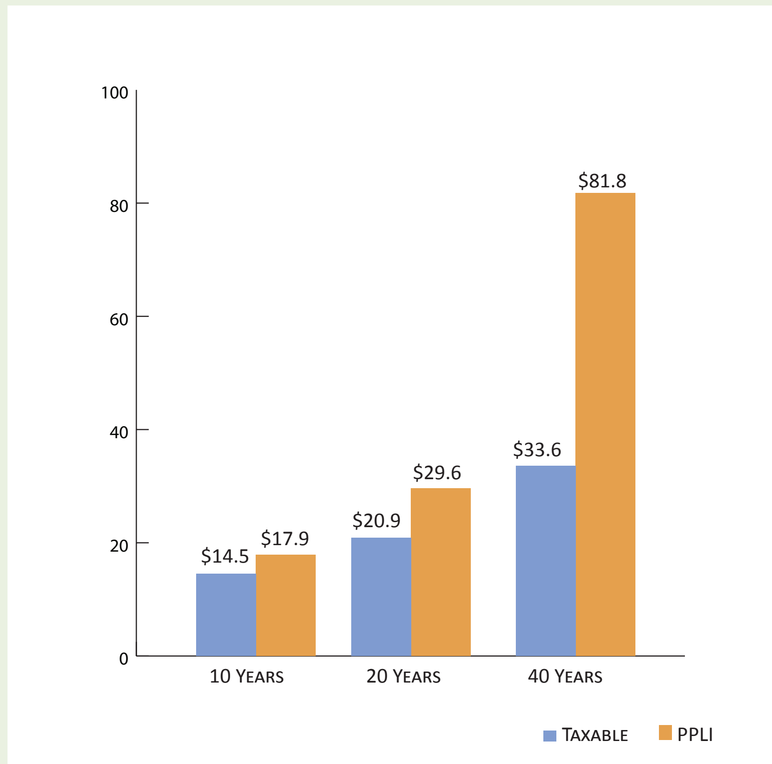
As the PPLI is established, your investments will reside in a vehicle called your "IDF" (insurance dedicated fund). With some important exceptions noted below, the process of working with your advisor to select your IDF is largely the same as for a taxable account.

From an investment strategy standpoint however, the absence of taxation removes consideration of tax

1. Front-loading your investment and thereby failing the "7-pay test" risks classifying your account as a "MEC," (modified endowment contract), under which any amount borrowed will be taxed at ordinary rates (up to 39.5%). Note also, there is a 10% penalty tax for withdrawals prior to age 59-1/2.

PPLI TAX BENEFITS VS. FEES AND EXPENSES
PER $10 MILLION INVESTED

Assuming identical gross return rates of 6.5% per year, assets in PPLI reach substantially higher levels over time because the income and capital gains generated are not taxed.



1. Assumes a 6.50% return net of investment management fees and advisor fee in the PPLI separate account.
2. Assumes a hypothetical combined tax rate of 52.2% on taxable earnings (39.6% federal, 8.82% NY state, and 3.8% net investment income) and 23.8% tax rate on dividends and long-term capital gains. Hypothetical split is 60% short-term gains (ordinary income) and 40% long-term gains and dividends. Actual results will vary.
3. The policy is designed as a modified endowment contract (MEC) under current tax law.
4. Under current tax law, if the policy is fully surrendered, all investment gains in excess of the policy owner's basis are taxed to the policy owner as ordinary income in the year the policy is fully surrendered. In addition, withdrawals or loans up to basis are taxed at ordinary income rates and there is a 10% penalty on withdrawals made before age 59 1/2.
5. Assumes one-time fees for premium load (160bps), state premium tax (10bps) and deferred acquisition costs (DAC = 100bps) in year one.
6. Assumes ongoing fees for policy load (5bps), COI (35bps), M&E (47bps) and IDF fees (25bps).
7. These calculations make assumptions as to future investment returns, mortality costs and administrative expenses that are not guaranteed. Actual results may be higher or lower. The contents of this report are provided strictly for informational purposes.
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efficiency from the investment decision-making process. The implications of this for long-term investing are difficult to overstate, as the policy's tax cocoon means that strategies that might be good for returns and risk management but bad for taxes (like an MLP or short-term-trading hedge fund) are back on the table.

To protect its tax-advantaged status, the account must be diversified with at least five different investments that do not exceed certain concentrations. It is a low hurdle that would be satisfied, for example, with a hedge fund of funds.

That said, while you can determine the IDF in which your assets are invested, tax rules stipulate that you cannot control decision making on the IDF's underlying investments (similar to most third-party money managers). However, if performance becomes an issue you can request the insurance company switch to a different IDF, which you can identify in collaboration with your advisor.

Wealth Transfer on steroids

The most common use of PPLI is to transfer assets to the next generation. Your purpose here could be to gift liquidity that your children can use while you are still here to watch them enjoy it, an inheritance after your death, or to create liquidity for your estate to pay death taxes (or any debts) and to avoid selling off things you wish to protect to third parties.[2]

These wealth transfer applications are best accomplished by placing the PPLI in a trust structure - one that will be very familiar to your estate attorney, the ILIT (Irrevocable Life Insurance Trust).[3]

When you die, the entire value cash value in the policy becomes an asset of the trust, free of estate tax, and subject to whatever stipulations you placed upon it when it was established.

If your wealth transfer ambitions extend over multiple generations, you place PPLI inside a dynasty trust. Without PPLI even this famously tax-efficient structure (which passes wealth across an unlimited number of generations without Generation Skipping Transfer tax[4]) would leak ordinary income and capital gains tax, which not only undercuts growth, but compromises the ability to use tax-inefficient strategies.

If you are planning to create liquidity to go to children (or others) while you are still alive, you may stipulate in the ILIT how and when the trustee may borrow against the cash value for this purpose. Upon your death, the life insurance pays back the loan and the remainder is paid to the trust for distribution as directed.

For assets you wish to give for charitable purposes upon your death, you can include the charity as a beneficiary on the PPLI being set up for family members. Alternatively, if family and charity might require different investment strategies, you can establish separate PPLI's for each. Charitable beneficiaries can include a donor-advised fund (DAF), private foundation, or any 501(C)(3) organization. With PPLI, in these situations, there is no need to establish a trust.

Offshoring

PPLI can also be purchased through non-U.S. carriers, which means they will generally not be subject to U.S. state premium taxes, (which can range from 1-3% of premium), and the U.S. "DAC" tax (approximately another 1% to 1.5%) is sometimes lower offshore.[5] Moreover, if structured through an off-shore entity, like a foreign trust, your PPLI can be afforded an added layer of protection from creditors, possibly divorce lawyers or others who might want to sue you or your beneficiary.

Miracle Drug?

Do all of these benefits make PPLI the miracle drug of tax-efficient wealth planning? Not exactly – it depends on your objectives and – pun intended – your health.

This is because you will be subject to underwriting, which like any life insurance, will require a medical exam. You also must be an accredited investor, as with any hedge fund, and should have an investment time horizon of ten years or more. The investments are not restriction-free — you cannot place the investment in the hedge fund you happen to run, nor place homes, private equity or artwork within your IDF.

2. If the policy is in an ILIT, that trust cannot just pay the estate taxes, but could buy assets from the estate for cash, or lend to it.
3. Caution, gift tax is payable here if you exceed your lifetime gift tax exclusion ($5,430,000 per person, or $10,860,000 per couple).
4. Subject to the Generation-Skipping Tax (GST) exemption, ($5,430,000 per person, or $10,860,000 per couple).
5. In some cases, your offshore savings will be partially offset by a U.S. federal excise tax of 1% on policy premiums on U.S. lives that are paid to foreign life insurance companies that are not taxed as U.S. corporations.

But in the end, if you seek tax-free investment accounts for wealth that is – or has the potential to be – multigenerational, this is worth your attention. PPLI is like a tax-free parallel universe, where the constrictions of IRA's and 401(k) s don't apply, and where growth is free to compound without being kneecapped year after year by ordinary income and capital gains taxes that can take 50% or more out of your growth -- and that's before you get to possible estate tax savings.

Your Fieldpoint Private advisor stands ready to discuss the pro's and con's with you, in light of your family's wealth planning objectives. ■

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