Private Placement Life Insurance
Can Provide Investment and Tax Benefits

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Q: ***Life insurance as an investment?***

A: ***Yes. The more advanced policy designs available today can allow insurance to play an important role as an alternative asset class for high net worth clients seeking tax efficiency.***

When most people think of life insurance, they think "death benefit." They consider it solely as a hedge against mortality risk – a duty to their dependants to provide financial security in the event of a premature death or to provide liquidity to pay debts or estate taxes.

Such narrow thinking is outdated. Innovations in policy design have transformed the industry. Life insurance can now function as a tax-favored investment vehicle and used by many wealthy families in tandem with other traditional and alternative asset classes as an important part of an overall wealth management strategy.

One relatively recent innovation, private placement life insurance ("PPLI"), can provide an exceptionally wide range of benefits for the well-heeled investor. PPLI combines the advantages of professional money management with the tax-favored treatment of life insurance.

***Q:* What type of insurance products are available?**

***A*: There are many possible product designs, depending on the insured's objectives.**

In general, all life insurance products feature an income tax-free cash payout to the beneficiary at the death of the insured. There are three general choices of policies available.

Term insurance, the simplest and most common form of life insurance, pays the death benefit only if the insured dies within the specified time the policy covers, such as 5, 10, or 20 years. This pure death benefit type policy is what most people think of when they hear the words "life insurance". If the insured doesn't die within that specified term, the policy expires worthless.

Whole life insurance provides permanent coverage while requiring a fixed premium payment. It also introduces a savings – or cash value – element to the policy. This cash value portion of the policy is similar to a savings account where the insurance company sets the interest rate. Generally, the policy cash values are invested in ultra-safe, highly liquid asset classes, such as U.S. Treasury bonds, that will not fluctuate greatly in value and will ensure that the policy will perform as illustrated.

A more recent twist on whole life – ***universal life*** – allows you to make ongoing adjustments to the structure of the policy, such as the premium payment and policy face amount.

The costs of any given policy rise as the experts, actuaries and advanced underwriters employed by the issuing carrier, engineer the product by blending features, etc. The range and flexibility of the underlying investment options can increase as well. "Variable" life policies fall into this greater sophistication/higher cost category.

***Q:* What are variable life policies?**

***A*: An increasingly innovative structure that can offer a broader range of options for the investment of cash values.**

With ***variable life insurance***, the owner of the policy, rather than the insurance company, elects how the cash value portion is invested. A variable policy's cash value is held in separate accounts of the insurance company is not subject to general claims of the company's creditors and policy owners. Unlike traditional whole life policies that invest their cash value in such safe asset classes, the insurance company usually offers a selection of bond, money market and stock mutual funds for the investment portion of the cash value. This higher risk/higher potential return investment orientation also means that the cash value of the policy and the death benefit may decrease, depending on the performance of the investments the owner chooses. This is why there is generally no guarantees built-into the issuing companies' policy performance projections. There is, therefore, a chance of investment losses with variable life that does not exist with traditional whole life products. This is why unlike whole life policies, variable life products are registered with the Securities and Exchange Commission and must also meet strict requirements established by the IRS to be considered life insurance and retain that tax-favored status.

***Q:* What is "variable universal life" ("VUL")?**

***A*: VUL is among the most sophisticated insurance products with investment attributes.**

VUL extends the flexibility of a variable policy even further. The insured under a VUL contract will generally retain control over premiums and death benefits. As policy owner, the insured chooses the funds into which his or her premiums will be allocated. The policy owner can switch between fund selections without charge or tax consequences. The death benefit will increase with good investment performance. In addition, some of the cash value build-up is accessible through non-income taxable loans or income taxable withdrawals. As with all other forms of life insurance, the beneficiaries receive the death benefit income tax-free upon the death of the named insured. If the policy is held until "maturity", the accumulated cash value can build and never be subject to income taxation, exceeding the income tax-shelter benefits of IRAs and other tax deferred retirement accounts, the assets of which will be taxed as "ordinary income" when they are distributed.

***Q:* How does PPLI differ from a VUL policy?**

***A*: PPLI is a custom-designed policy with greater investment flexibility than VUL.**

Non-taxable death benefits and wider investment choices, such as plain vanilla mutual funds, may still not be compelling enough for a sophisticated investor to consider life insurance as part of his or her investment strategy. This may be particularly true in light of the expense ratios, sales "loads", mortality charges and other costs associated with many life insurance purchases. Innovators in the industry have taken the investment attributes of VUL to the next level with PPLI.

PPLI has all the benefits of VUL products. In addition, because the SEC restricts the availability of PPLI to "accredited investors" and "qualified purchasers", the investment alternatives for the investment portion of the policy's cash values are often broader than with traditional VUL products. The choices may include a wide range of alternative investments such as hedge funds. PPLI increases the desirability of some of these alternative investments classes by leveraging their potential for outsize returns with the income tax-favored status of life insurance.

Your investment manager may tell you that he or she is constrained on trading in your "taxable" (i.e., non IRA or 401(k)) account out of a desire to avoid taxable capital gains. When you hold private placement investments within an insurance wrapper, you can restructure your investments without incurring tax consequences within a given portfolio, giving the asset manager flexibility similar to that enjoyed by the managers of tax-deferred or tax-exempt accounts such as IRAs, 401(k)s and large pension or endowment funds.

The ability to include high-yield and short-term trading strategies in your overall portfolio without tax inefficiencies may also lower the overall investment risk of a portfolio is another important feature of PPLI.

***Q:* What will PPLI cost me in structuring costs and ongoing fees? Can the costs outweigh the benefits?**

***A*: Whether you consider PPLI to be cost-prohibitive depends on your choice of vendors and your frame of reference, i.e., your experience with other alternative investments.**

Not only is PPLI income tax-efficient, it is often priced relatively attractively. With the high minimum size of commitment required (often $5 million or more), companies structuring PPLI can offer institutional, rather than retail, price structures. The proportion of premium amounts dedicated to the death benefit is lower than off-the-shelf policies. This allows more of the premium to remain as investable assets, giving the policy owner greater latitude to borrow tax-free from the cash value if needed.

<u>Q:</u> What pitfalls should I be aware of before I go shopping?

<u>A</u>: There are some potential traps, particularly, in the off-shore market.

PPLI has only been available through domestic (U.S.) insurance companies since the mid-1990s. It could be obtained before then through providers in offshore financial centers like Bermuda and the Cayman Islands. Policies sold in foreign jurisdictions may appear to be advantageous at first blush. Sometimes they can be, but there may be an added element of risk because offshore insurance companies are generally not as closely regulated as domestic insurance companies. The risks increase with the possibility of offshore companies violating U.S. securities or insurance laws. Such violations could disqualify the policy and disallow the beneficial tax treatment if the arrangement does not fall within the tax laws' strict and unforgiving guidelines and definitions for life insurance products. It is critically important to vet your issuer and perhaps secure a second opinion on the policy design before you commit the significant funds required to purchase their products.

<u>Q:</u> Can I insulate the PPLI's cash build-up and death benefit from estate taxation?

<u>A</u>: Yes – by owning the PPLI policy in an irrevocable life insurance trust ("ILIT").

As with a traditional policy, a PPLI policy can be purchased initially in an ILIT that can be designed as a "generation-skipping" trust. The generation-skipping ILIT's purchase of the policy will insulate the tax-free build-up (ultimately realized as the death benefit) from federal transfer taxes for several future generations of your family, making ILIT-owned PPLI a potentially complete income and wealth transfer tax shelter. If you establish the ILIT in certain US and foreign jurisdictions that allow for "self-settled trusts", you can retain some access to the cash value build-up during your life, even though the ILIT is technically irrevocable. The most tax-efficient trust vehicle in which to purchase PPLI is an existing trust that has significant liquid assets that can help pay the substantial premiums that will be due on the policy which in many cases will exceed your federal estate tax exclusion amount ($5.34 million in 2014, and $10.64 million if you are married).

If you are not fortunate enough to have such a trust, gift tax may apply to the initial funding of the ILIT, but the potential for accelerated growth in the PPLI could make the up-front gift tax far less than the potential taxes at the end if the PPLI was not ILIT-owned. There are several strategies, such as loans to ILITs designed as "intentional grantor trusts" and split-dollar and premium financing techniques, that can avoid the payment of gift taxes even when the cost of the policy will exceed the value of the gift tax exclusion amounts, but a detailed discussion of them is beyond the scope of this white paper. Anyone interested in funding the purchase of an ILIT-owned PPLI policy without paying gift taxes should inquire of their legal and tax counsel once the projected premium obligations are determined.

Q: Do the various states' laws vary on how PPLI is treated, and if so, which states' laws are best? How can I access them if I am a non-resident?

A: Yes. South Dakota is the preferred jurisdiction for PPLI purchases. You can take advantage of South Dakota's laws by "settling" a trust there to acquire the PPLI policy through a South Dakota resident ILIT.

South Dakota has enacted trust, tax and insurance laws that give it a leg up on all other jurisdictions for PPLI policies purchased and delivered there. Two noteworthy advantages available to a South Dakota-sitused ILIT purchasing a policy are the low (8 basis points) insurance premium taxes versus other states' (usually 100-200 basis points), and a broader range of asset classes that can be purchased in large VUL policies. Most states consumer protection laws limit investments in VUL policies to mutual funds holding domestic publicly-traded stocks and bonds that are highly liquid. South Dakota law permits PPLI investment accounts to make direct investments in illiquid and potentially more volatile assets such as hedge funds and private equity partnerships. There are several South Dakota-chartered trust companies that will serve as trustee of non-residents' ILITs holding PPLI for a relatively modest fee.

***Q:* Sounds like I need an expert to navigate me through this maze.**

***A:* True – probably more than one.**

As with all insurance policies, there are numerous variables in structure, benefit, pricing, and investment control, so you should review PPLI carefully with a properly registered licensed life insurance professional, as well as your investment, legal and tax advisors. Note that not all licensed life insurance professionals will have the resources, experience and network to source the best coverage (including addressing reinsurance issues) from the universe of potential underwriting carriers, deftly manage the process, and coordinate seamlessly with other advisors. Only the e-lite in the industry, usually affiliated with well-resourced producer groups, will be able to deliver in this niche market. So the "due diligence" process for a PPLI candidate can be much more involved than purchasing a garden-variety policy from a son-in-law who is "in the business". But given its broad range of benefits and onshore availability, PPLI will increasingly be considered seriously as a part of a comprehensive and diversified wealth management strategy for many wealthy families.

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