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Private Placement Life Insurance

A tax-efficient vehicle for tax-inefficient investments

www.skygemsolutions.com

PPLI Background

- Private Placement Life Insurance has been around for over 20 years.
- Hedge fund boom in late ‘90s propelled PPLI as a tool for sophisticated investors to implement tax planning into investment strategy.
- Aftermath of 9/11, Financial Crisis, and Bernie Madoff created headwinds for the widespread utilization of PPLI by HNW.
- In 2013, American Taxpayer Relief Act was passed and provided the necessary fuel to accelerate the usage and implementation of PPLI as a tax planning strategy.
- High-profile investment managers and companies have created IDFs in recent years adding to the legitimacy of the application.

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What is Private Placement Life Insurance?

- Private placement life insurance (PPLI) is a variable life policy which is not registered with SEC.

- PPLI includes unregistered investment subaccount options in addition to registered investment subaccounts typically available in registered variable life (VUL) policies.

Private Placement Investment Options

Registered variable life products (VUL) can only invest in registered subaccounts.

- Must have daily valuation
- Must offer daily liquidity

Private placement products can be invested in subaccounts that are unregistered.

- Can be valued on a monthly or quarterly basis
- Can have restricted liquidity and investment terms

Private Placement Qualifications

Policyowner must be Qualified Purchaser

- Individual or family trust with $5 million of qualified investments.
- Family-owned company with $5 million of qualified investments.
- A corporation, partnership, limited liability company, trust, or tax- exempt organization where each beneficial owner is a Qualified Purchaser.
- A corporation, partnership, or trust with at least $25 million in qualified investments.

Policyowner must also be an Accredited Investor

- Individuals: Net worth greater than $1 million, **or** reported annual income of $200,000 ($300,000 if joint) for the last two years.
- Institutional Investors: Assets in excess of $5 million.

What is a Qualified Investment?

Qualified Investments:

- Cash and cash equivalents
- Stocks, bonds, mutual funds
- Real estate, e.g., REITs, private, direct
- Hedge funds
- Private equity and private credit
- Physical commodities
- Financial contracts entered into for investment purposes
- Cash value of life insurance

Comparison of PPLI to Traditional VUL

	Traditional VUL	PPVUL
Surrender Charges	Generally, Yes	No
Distribution Costs	Commissions are usually higher, especially upfront	Commissions are usually lower but may include higher ongoing asset-based revenue
Mortality Costs	PPVUL does not usually have lower mortality charges than retail products	
Investment Options	Registered funds	Registered and unregistered ("exempt") funds

The primary advantage of PPLI is the ability to design a life insurance policy to look less like a traditional life insurance policy that is unattractive to HNW clients.

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Taxation of PPLI

PPLI enjoys the same tax treatment as traditional life insurance policies

- **Tax deferred growth** – Accumulated investment income credited under a life insurance contract is not subject to current taxation. [I.R.C. §7702(g)(1)(A)]
- **Income tax-free distributions from Non-MECs** – Withdrawals up to the policy owner's basis are income tax-free [I.R.C. §72(e)(3)] and policy loans provide income tax-free access to accumulated investment income. [I.R.C. §72(e)(5)]
- **Income tax-free death benefit proceeds** – Death benefits received from a life insurance contract, including any accumulated investment income, are generally received income tax free. [I.R.C. §101(a)(1)]
- **Estate tax-free proceeds** – If properly structured, the proceeds of a life insurance policy paid to an irrevocable trust may be excluded from the taxable estate of the insured.
- **Tax-free reallocations**– Policy account values may be transferred among the investment options available within the policy without creating taxable events.

Characteristics of an Ideal PPLI Candidate

- Not someone with traditional life insurance needs, e.g., income replacement, estate tax liquidity, conservative risk tolerance profile.
- Sizeable percentage of wealth in invested assets as opposed to illiquid assets or closely-held business interests.
- A portion of investment portfolio invested in tax-inefficient asset classes.
- Desire to invest in alternative or non-correlated (to equity markets) asset classes.
- Seeks to maximize growth of assets for transfer to next generation.

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Comparison of PPLI to Taxable Account

Assumptions

- Male age 50, preferred nonsmoker rating class
- 8% rate of return, net of investment expenses
- Life insurance designed as non-Modified Endowment Contract (MEC)
- Federal ordinary income tax rate = 39.6%
- Long-term capital gains tax rate = 20%
- Not subject to state income taxes
- Estate tax rate = 40%
- Taxable investment is not held in trust and is subject to estate tax
- Life insurance is not includable in insured’s estate

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100% Ordinary Income

			ACCUMULATED VALUE				VALUE AT MATURITY			
			TAXABLE ACCT.		LIFE INSURANCE		TAXABLE ACCT.		LIFE INSURANCE	
Year	Age	Annual Premium	Net Account Value	Net Taxable IRR	Net EOY Account Value	Net AV IRR	Taxable Account Net of Estate Tax	Net DB IRR	Death Benefit Net of Estate Tax	Net DB IRR
1	50	1,250,000	1,306,600	4.53%	1,275,185	2.01%	783,960	-37.28%	23,309,383	1764.75%
2	51	1,250,000	2,672,363	4.53%	2,601,149	2.67%	1,603,418	-26.20%	23,309,383	284.71%
3	52	1,250,000	4,099,967	4.53%	4,024,364	3.57%	2,459,980	-19.65%	23,309,383	124.73%
4	53	1,250,000	5,592,214	4.53%	5,551,529	4.23%	3,355,328	-15.33%	23,309,383	72.38%
5	54	0	5,845,429	4.53%	5,931,921	4.96%	3,507,258	-9.81%	23,309,383	50.75%
6	55	0	6,110,110	4.53%	6,337,956	5.37%	3,666,066	-6.73%	23,309,383	38.74%
7	56	0	6,386,776	4.53%	6,770,362	5.63%	3,832,066	-4.75%	23,309,383	31.21%
8	57	0	6,675,969	4.53%	7,239,846	5.83%	4,005,582	-3.36%	20,070,000	23.32%
9	58	0	6,978,257	4.53%	7,751,958	5.99%	4,186,954	-2.34%	16,310,000	16.84%
10	59	0	7,294,233	4.53%	8,314,947	6.14%	4,376,540	-1.56%	11,142,029	9.81%
11	60	0	7,624,516	4.53%	8,942,267	6.28%	4,574,709	-0.93%	11,624,947	9.23%
12	61	0	7,969,754	4.53%	9,616,875	6.40%	4,781,852	-0.42%	12,309,600	8.91%
13	62	0	8,330,624	4.53%	10,342,044	6.50%	4,998,375	0.00%	13,030,975	8.65%
14	63	0	8,707,835	4.53%	11,121,581	6.58%	5,224,701	0.35%	13,790,761	8.42%
15	64	0	9,102,126	4.53%	11,959,630	6.65%	5,461,275	0.66%	14,590,749	8.22%
16	65	0	9,514,270	4.53%	12,860,717	6.71%	5,708,562	0.92%	15,432,861	8.05%
17	66	0	9,945,076	4.53%	13,829,416	6.77%	5,967,046	1.15%	16,457,005	7.96%
18	67	0	10,395,389	4.53%	14,870,954	6.81%	6,237,233	1.35%	17,547,726	7.88%
19	68	0	10,866,092	4.53%	15,990,632	6.85%	6,519,655	1.53%	18,709,039	7.81%
20	69	0	11,358,109	4.53%	17,193,927	6.89%	6,814,865	1.69%	19,944,955	7.75%
30	79	0	17,686,115	4.53%	35,771,397	7.14%	10,611,669	2.67%	37,559,967	7.32%
40	89	0	27,539,677	4.53%	73,499,899	7.22%	16,523,806	3.15%	77,174,894	7.36%
50	99	0	42,883,010	4.53%	152,287,643	7.29%	25,729,806	3.43%	152,287,643	7.29%

50% Ordinary Income / 50% LT Capital Gains

			ACCUMULATED VALUE				VALUE AT DEATH			
			TAXABLE ACCT.		LIFE INSURANCE		TAXABLE ACCT.		LIFE INSURANCE	
Year	Age	Annual Premium	Net Account Value	Net Taxable IRR	Net EOY Account Value	Net AV IRR	Taxable Account Net of Estate Tax	Net DB IRR	Death Benefit Net of Estate Tax	Net DB IRR
1	50	1,250,000	1,316,400	5.31%	1,275,185	2.01%	789,840	-36.81%	23,309,383	1764.75%
2	51	1,250,000	2,702,727	5.31%	2,601,149	2.67%	1,621,636	-25.61%	23,309,383	284.71%
3	52	1,250,000	4,162,696	5.31%	4,024,364	3.57%	2,497,618	-18.99%	23,309,383	124.73%
4	53	1,250,000	5,700,218	5.31%	5,551,529	4.23%	3,420,131	-14.63%	23,309,383	72.38%
5	54	0	6,003,014	5.31%	5,931,921	4.96%	3,601,808	-9.09%	23,309,383	50.75%
6	55	0	6,321,894	5.31%	6,337,956	5.37%	3,793,136	-6.00%	23,309,383	38.74%
7	56	0	6,657,713	5.31%	6,770,362	5.63%	3,994,628	-4.02%	23,309,383	31.21%
8	57	0	7,011,371	5.31%	7,239,846	5.83%	4,206,823	-2.63%	20,070,000	23.32%
9	58	0	7,383,815	5.31%	7,751,958	5.99%	4,430,289	-1.60%	16,310,000	16.84%
10	59	0	7,776,043	5.31%	8,314,947	6.14%	4,665,626	-0.81%	11,142,029	9.81%
11	60	0	8,189,107	5.31%	8,942,267	6.28%	4,913,464	-0.18%	11,624,947	9.23%
12	61	0	8,624,112	5.31%	9,616,875	6.40%	5,174,467	0.33%	12,309,600	8.91%
13	62	0	9,082,225	5.31%	10,342,044	6.50%	5,449,335	0.75%	13,030,975	8.65%
14	63	0	9,564,673	5.31%	11,121,581	6.58%	5,738,804	1.11%	13,790,761	8.42%
15	64	0	10,072,748	5.31%	11,959,630	6.65%	6,043,649	1.41%	14,590,749	8.22%
16	65	0	10,607,812	5.31%	12,860,717	6.71%	6,364,687	1.68%	15,432,861	8.05%
17	66	0	11,171,299	5.31%	13,829,416	6.77%	6,702,780	1.91%	16,457,005	7.96%
18	67	0	11,764,719	5.31%	14,870,954	6.81%	7,058,831	2.11%	17,547,726	7.88%
19	68	0	12,389,661	5.31%	15,990,632	6.85%	7,433,796	2.29%	18,709,039	7.81%
20	69	0	13,047,799	5.31%	17,193,927	6.89%	7,828,680	2.45%	19,944,955	7.75%
30	79	0	21,893,534	5.31%	35,771,397	7.14%	13,136,121	3.44%	37,559,967	7.32%
40	89	0	36,736,221	5.31%	73,499,899	7.22%	22,041,733	3.93%	77,174,894	7.36%
50	99	0	61,641,484	5.31%	152,287,643	7.29%	36,984,891	4.21%	152,287,643	7.29%

25% Ordinary Income / 25% LT Capital Gains / 50% Unrealized Gains

			ACCUMULATED VALUE				VALUE AT DEATH			
			TAXABLE ACCT.		LIFE INSURANCE		TAXABLE ACCT.		LIFE INSURANCE	
Year	Age	Annual Premium	Net Account Value	Net Taxable IRR	Net EOY Account Value	Net AV IRR	Taxable Account Net of Estate Tax	Net DB IRR	Death Benefit Net of Estate Tax	Net DB IRR
1	50	1,250,000	1,333,200	6.66%	1,275,185	2.01%	799,920	-36.01%	23,309,383	1764.75%
2	51	1,250,000	2,755,138	6.66%	2,601,149	2.67%	1,653,083	-24.60%	23,309,383	284.71%
3	52	1,250,000	4,271,720	6.66%	4,024,364	3.57%	2,563,032	-17.86%	23,309,383	124.73%
4	53	1,250,000	5,889,245	6.66%	5,551,529	4.23%	3,533,547	-13.41%	23,309,383	72.38%
5	54	0	6,281,234	6.66%	5,931,921	4.96%	3,768,740	-7.87%	23,309,383	50.75%
6	55	0	6,699,313	6.66%	6,337,956	5.37%	4,019,588	-4.77%	23,309,383	38.74%
7	56	0	7,145,219	6.66%	6,770,362	5.63%	4,287,131	-2.77%	23,309,383	31.21%
8	57	0	7,620,805	6.66%	7,239,846	5.83%	4,572,483	-1.37%	20,070,000	23.32%
9	58	0	8,128,045	6.66%	7,751,958	5.99%	4,876,827	-0.33%	16,310,000	16.84%
10	59	0	8,669,048	6.66%	8,314,947	6.14%	5,201,429	0.47%	11,142,029	9.81%
11	60	0	9,246,060	6.66%	8,942,267	6.28%	5,547,636	1.10%	11,624,947	9.23%
12	61	0	9,861,478	6.66%	9,616,875	6.40%	5,916,887	1.61%	12,309,600	8.91%
13	62	0	10,517,857	6.66%	10,342,044	6.50%	6,310,714	2.04%	13,030,975	8.65%
14	63	0	11,217,926	6.66%	11,121,581	6.58%	6,730,756	2.40%	13,790,761	8.42%
15	64	0	11,964,591	6.66%	11,959,630	6.65%	7,178,755	2.71%	14,590,749	8.22%
16	65	0	12,760,954	6.66%	12,860,717	6.71%	7,656,573	2.98%	15,432,861	8.05%
17	66	0	13,610,324	6.66%	13,829,416	6.77%	8,166,194	3.21%	16,457,005	7.96%
18	67	0	14,516,227	6.66%	14,870,954	6.81%	8,709,736	3.42%	17,547,726	7.88%
19	68	0	15,482,427	6.66%	15,990,632	6.85%	9,289,456	3.60%	18,709,039	7.81%
20	69	0	16,512,937	6.66%	17,193,927	6.89%	9,907,762	3.76%	19,944,955	7.75%
30	79	0	31,454,099	6.66%	35,771,397	7.14%	18,872,459	4.77%	37,559,967	7.32%
40	89	0	59,914,255	6.66%	73,499,899	7.22%	35,948,553	5.25%	77,174,894	7.36%
50	99	0	114,125,603	6.66%	152,287,643	7.29%	68,475,362	5.54%	152,287,643	7.29%

Tax-Inefficient Investments

- PPLI should be considered as a placeholder for the portion of the client's investment portfolio that is considered to be "tax-inefficient"
- Generate a significant amount of taxable income as a result of:
  - High asset turnover
  - Use of short-term instruments such as options
  - High yield assets
- "Tax Drag" – Loss of income from taxation

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Tax Drag by Asset Class

Asset Class	Expected Annual Return (Including Yield)	Expected Annual Yield	Expected Turnover	Tax Drag
Emerging Market Equities	12.20%	1.40%	60%	3.59%
Pacific Ex-Japan Equities	11.84%	0.50%	60%	3.52%
European Equities	11.60%	1.25%	70%	3.69%
U.S. Small-Cap Equities	10.58%	0.40%	60%	3.15%
U.S. Mid-Cap Equities	10.35%	0.80%	40%	2.86%
U.S. Large-Cap Equities	10.12%	1.20%	40%	2.86%
Japanese Equities	9.43%	0.90%	60%	2.78%
Commodities	8.51%	1.70%	60%	2.70%
High-Yield Bonds	7.71%	6.50%	80%	2.91%
Directional Hedge Funds	7.90%	0.00%	80%	2.46%
Emerging Market Bonds	6.72%	3.70%	150%	2.52%
Real Estate Investment Trusts	6.75%	2.50%	20%	2.14%
Non-Directional Hedge Funds	5.60%	0.00%	80%	1.75%
International Bonds	4.32%	3.00%	150%	1.64%
Treasury Inflation Protected Securities	4.07%	3.50%	100%	1.55%
Taxable Bonds	3.43%	3.43%	75%	1.34%
Cash	1.43%	1.40%	0%	0.56%

Source: Deutsche Asset & Wealth Management; "Building Portfolios Inside PPVAs and PPLI", Trusts & Estates, June 2014

Insurance-Dedicated Funds (IDFs)

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"Hedge" Funds in Private Placement

- Alternative "unregistered" investment funds generally have some tax-adverse features, despite what may be an attractive investment strategy
  - Actively managed unregistered investment partnerships are usually less tax efficient and report a large amount of ordinary income
  - Investment partnerships typically issue K-1s to investors for tax reporting purposes
- Investments within life insurance contracts do not incur taxable income and do not require K-1s to be distributed to policyowners

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Considerations for Creating an IDF

- Investor Control
  - Policyowner cannot control investments in segregated account.
  - Disqualifies policy for treatment as life insurance.
- Diversification
  - No more than 55% of fund assets can be invested in a single fund or security; 70% in two securities; 80% in three securities; and 90% in four securities.
- Liquidity
  - Funds may be needed to meet policy distributions, policy charges, and/or death claims.
  - Funds with favorable liquidity and lock-up provisions will be more acceptable to insurance companies.
- Asset Valuation
  - Insurance companies require periodic valuation of shares to process policy charges and distributions.

Conclusion

- PPLI is attractive as an instrument to shield invested wealth from the drag caused by income and other current taxes.
  - Rather than let the tail (tax) wag the dog (investment strategy), PPLI allows clients to access the desired investment strategy without the unpleasant tax consequences.
- Over time, tax on investment returns can deplete assets for transfer to heirs more than the impact of estate tax.
- PPLI enables access to a substantial percentage of invested assets without incurring taxable income to the policyowner.
- Properly structured, PPLI can transfer invested wealth without income or estate taxes at the death of the insured.
- Biggest challenge to the implementation of a PPLI structure is the client's tolerance for complexity and nuisance with an investment- focused solution.
  - Many HNW clients are willing to tolerate complexity of estate planning solutions.

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