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Private Placement Life Insurance in Estate Planning and Income Tax Planning: Understanding and Utilizing a Misunderstood Asset Class and Financial Product

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Over the past 30 plus years the life insurance industry has evolved and planning with variable life insurance policies has displaced traditional whole life insurance policies for entire segments of the upper income and high net worth marketplace of consumers. The high net worth (HNW) and ultra-high net worth (UHNW) clients in their respective family offices are much more interested in acquiring policies to meet their estate planning and wealth preservation objectives which will enable them to take advantage of a unique life insurance strategy just further enhanced by §7702[1] which now allows a larger amount of accumulated cash value to grow and accumulate tax deferred indefinitely in a life insurance policy. This recent change in addition to the full-frontal onslaught that the UHNW client faces as a result of President Biden's proposed Tax Plan have made Private Placement Life Insurance (PPLI) even more efficient than it was just last year. Equally significant, PPLI offers better pricing, and lower costs due to participants having better health care access, which they in turn pass on to the insured. These factors, in addition to significantly reduced institutional rather than retail commissions, result in a larger cash value buildup, and unlike their retail counterparts, have no early withdrawal penalties.

Such a strategy also offers the insured access to institutional hedge funds rather than traditional retail mutual funds. The combination of hedge funds, venture capital, and equity markets in a tax deferred insurance company wrapper provides a significant benefit to the insured. What makes it even more meaningful is that the death benefit can pass from one generation to the next, on an income tax free, and estate tax free basis, if set up correctly, providing the most tax efficient and desirable investment returns.

When looking at life insurance as the true investment 'asset class' it is, it can provide the insured and their beneficiaries with significant cash flow on a tax-favored basis. For example, it can provide tax-free distributions, on a leveraged basis to pay for any long-

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[1] Unless otherwise noted, all Section references herein are to the Internal Revenue Code (''the Code''), as amended, or the Treasury regulations promulgated thereunder.

term care needs directly from the death benefit of a life insurance policy. You can think of this strategy as an enhanced version of the Roth IRA because it allows an unlimited amount of funds to be placed in a tax-deferred vehicle indefinitely. The Roth IRA, unlike its counterpart the traditional IRA which, once inherited, as a result of the recently enacted SECURE Act,[2] now requires that all funds must be distributed by the majority of beneficiaries at the end of the 10th year. Moreover, the PPLI policy provides for income tax deferral on growth during life, access to cash values via borrowing from the policy, and can provide for a rollover of the death benefit into an immediate or deferred annuity payment option with a near 100% exclusionary ratio on distributions over the lives of the beneficiaries.

Implementation of a PPLI strategy offers significant tax and other benefits to the insured, policyholder, and beneficiaries, it is costly to properly structure and customize to the needs of the clients (as it is deemed a security under U.S. federal securities law and requires a private placement memorandum and subscription documents), and requires the coordinated efforts of a tax attorney, a CPA, and an experienced life insurance professional. The strategy only makes sense from an economic perspective where policy premiums and/or assets transferred into the policy exceed certain thresholds. However, where the scale is sufficient, it will make sense to utilize a PPLI, whether from a boutique specialty insurer or one offered by any one of several of the major insurers, as they all will enable the insurance professional the opportunity to offer their clients life insurance on an institutional basis with lower fees, rather than on a traditional commissionable basis.

Either way, the newfound ability to acquire these types of investments inside a policy of life insurance or an annuity contract, and thereby meet the clients' goals and objectives, has facilitated the funding of large amounts of dollars into the policy investment. The burgeoning of the market for these types of policies and structures has led to the establishment of a variety of products and has energized the Private Placement Variable Life Insurance market (''PPVLI'' and ''PPLI'' interchangeably herein). When you consider the timing of §7702 and timing of the SECURE Act, it is clear that the government has sent a strong signal that it has favored life insurance over the traditional IRA. The growth of the PPLI market and the demand for new investment vehicles has fueled and facilitated a significant expansion in the offerings of these types of products and created what is now a distinct and oftentimes misunderstood asset class. Moreover, the growth of the PPLI industry segment and the creation of new products has mainstreamed and transformed PPLI into it into what is now a very legitimate and genuine life insurance marketplace with products designed to benefit HNW and UHNW clients and their families. The acceptance of these types of policies in the market has created a solid and very stable foundation for growth. What was once a segment of the life insurance industry focused solely on super affluent investors (individuals with $10 million or more in liquid net worth) has become an industry suitable for the lower-to middle-HNW market and the single-family and multi-family office marketplace. PPLI involves the utilization of a variable universal life (VUL) insurance chassis and a transaction that occurs within a private placement offering for securities law purposes. Private placement adds the flexibility to VUL product's construction, pricing, and asset-management offerings. Because the product is sold through a private placement memorandum (PPM), every transaction can be individually negotiated, and custom designed for the investor. The tax benefits it offers to policy owners are available from few other investment vehicles, particularly since they accrue without the need for complex trust structures.

PPLI products almost always provide a dramatically improved performance of the overall policy investment accounts when compared to traditional life insurance because there are significant reductions in the frictional costs which are present in traditional forms of life insurance. PPLI also provides the clients and their families with the very same benefits as any traditional life insurance product, an immediate income and estate tax free distribution of the death benefit. PPLI also provides privacy and asset protection features, as well as enhanced tax-deferred efficiency which results in better overall investment performance and returns.

What really differentiates PPLI from more traditional policies of life insurance, aside from the cost factors described above, is the ability to custom tailor the investment component of the contract. In this respect, PPLI is the hands down winner in comparison to other types of life insurance. Many of the carriers provide an open architecture philosophy which permits, subject to carrier approval, almost any qualified asset manager, asset allocator, separately managed account, or insurance dedicated fund (IDF) and IDF manager, or other bankable or non-bankable underlying asset, or investment position on the platform to be contained within the investment basket of the policy. As mentioned, PPLI policies provide access to sophisticated and alternative investment classes, such as hedge funds, funds of funds, commodities, real estate, and currency diversification. Clients, with the help of their attorney, CPA, or their family office managers,

[2] Pub. L. No. 116-94.

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are free to designate a traditional asset manager as long as certain additional requirements are met. Specifically, the manager must have full discretion (although policy investment guidelines may be implemented and modified from time to time).

TO UNDERSTAND PPLI POLICIES AND THE ADVANTAGES THEY MAKE POSSIBLE FOR CLIENTS, A STUDY OF THE BASICS OF LIFE INSURANCE IS ESSENTIAL

Of the two basic types of life insurance available — term and permanent coverage — term is considered the most cost-effective way to purchase a life insurance death benefit for a relatively short period. But it's the permanent contract that provides buyers with the unique tax benefits that have helped create the PPLI market. The key distinguishing factor of permanent coverage is that it has a cash value that accumulates on a tax-favored basis inside the product. The policy is funded over one or more years and is intended to last the entire lifetime of the insured. The premiums are typically much higher than they are for a term policy for the same death benefit, but the value of the product is to front load or level the premium amount so that the coverage lasts at least until the insured reaches age 100. This difference is important because it lays the foundation for the tax benefits that come with permanent life insurance products. These benefits help the policy owner grow the cash value that covers the higher costs of insurance charged as an insured party age, without a corresponding increase in premium payments.

Permanent life insurance has a long history in the United States as a tax-advantaged long-term wealth-creation, savings, and investment vehicle. The benefits of these insurance products have deep roots in long standing U.S. social policy which encouraged insurance protection and retirement savings on a private basis as opposed to the welfare role. These encouragements are reflected in a series of provisions of the Code. First, under §72, the cash value growth in a life insurance policy (or annuity contract) is sheltered from current income tax, and many distributions are taxed on an advantageous basis. Second, under §101(a), the death benefit under a life insurance contract is received by beneficiaries free of income tax (unless certain exceptions apply). Further, through appropriate estate planning techniques, life insurance proceeds can be received free of federal estate tax liabilities.

If a permanent contract complies with U.S. tax rules, it's entitled to preferential tax treatment. The Code sets forth the testing required for a permanent policy to ensure that it qualifies and remains compliant as a life insurance contract under U.S. tax law. With a properly designed and legally compliant contract, which is typically assumed as a given when working with the larger, more highly respected U.S. life insurance companies, a policy owner can accumulate tax-deferred investments by paying premiums into a policy. The growth will be tax free while in the policy and added to the death benefit component of the policy and the ultimate combined death benefit will pass to the beneficiary(ies). If the policy is owned in a properly designed irrevocable life insurance trust (ILIT), then the death benefits may likewise be free of estate and gift taxes. Thereby essentially accomplishing the equivalent of a ''triple-double'' (to borrow some sports vernacular) in the estate and tax planning world of the HNW and UHNW client.

PPLI is often put to work with only a portion of an HNW or UHNW investor's assets, to wit: the excess portion of their investable wealth which will not likely be required for the family's day-to-day and year-to-year existence or living needs prior to the death of the insured party.

Most wealthy investors have a diversified portfolio of investments consisting of different investment strategies. In deciding the investment strategy for PPLI, the policy owner's overall investment mix should be considered. Diversifying a portfolio with high-yield, short-term trading, or other tax-inefficient strategies is often considered beneficial for minimizing risk as well as for increasing the client and family after-tax rates of return. PPLI often allows high-yield and short-term trading strategies to be added to one's investment mix without adding tax inefficiency. Imagine the benefits of being able to harvest both short- and long-term gains, high yielding hard-money loan portfolio interest rates with zero tax cost as opposed to the tax rates charged on ordinary income and short-term capital gain, plus a leveraged death benefit. The PPLI policy strategy allows for the super-charging of the portfolio based upon the elimination of the income tax drag or co-efficient of tax friction, plus the creation of additional tax-favored leveraged asset, as only a life insurance death benefit can do.

The downside to PPLI is that losses within the policy are not utilizable by the policyholder, and as such, assets which are expected to produce high, and consistent, total returns are the best candidates for PPLI policy investing. By and large, investments which are already highly tax-efficient (such as tax-managed offset funds) are generally not the best candidates for PPLI policy investments. Likewise, highly speculative investments which stand a high probability of losing value and where large losses are contemplated are generally not PPLI investment candidates, unless the investments produce large and wildly dis-

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proportional returns. That means PPLI is an attractive option even at 15%-24% capital gains tax rate, including the net investment income surtax. These benefits will be even more pronounced in the President Biden's plan if the potential for increases in the capital gains tax rate becomes a reality. Generally, the policy owner can choose the type of investment strategy for the PPLI policy.

The architecture of a permanent life policy, often referred to as the chassis, typically takes one of two forms. The first is a whole life contract; the second is a universal life contract. The whole life chassis is the older of the two and is somewhat antiquated for today's market. It has a fixed death benefit, a fixed premium amount that must be paid each year, and stated guarantees with respect to the coverage and a portion of the cash value. With whole life, if the stated premium is paid every year, the policy owner is guaranteed to have the stated death benefit available to contract maturity.

Giving transparency provides the buyer clarity regarding the amount the company is charging, as well as full disclosure regarding the guaranteed maximum the company can charge at any future time. The sophisticated investor's advisors gain the ability to analyze all elements in the contract and make informed cost comparisons. Although universal life products do offer many levels of guarantees, they are not the rigid guarantees that whole life products provide. Therefore, the product is more flexible and requires more knowledge to understand, transact, and service after the purchase. Despite the increased complexity, most clients quickly understand the economics of a universal life product, whereas they never understood the black box associated with a whole life policy.

SUMMARY AND PLANNING STRATEGY EXAMPLE

Multi-family office (MFO) enterprises which provide both investing, asset management, alternative investment selection, and administration services for several family offices, will be well served in their quest to generate higher overall returns for their constituent families via the use of PPLI. If the MFOs can decrease the "drag" or the "co-efficient of friction" due to income taxes on the returns which are generated on those investments, by employing the tax mitigation elements of well-designed PPLI strategy, they create serious additional value-add as part of this process. For example, if we assume a portfolio of two hundred million dollars with a diversified portfolio managed by the MFO and an 8% total return, the simple act of creating a PPLI policy within which the assets are going to be managed, will create an immediate pre-tax equivalent yield of 12% to 14% after fees and costs of insurance. When we consider the ability to use life insurance trusts and partnerships to save estate taxes as well, then the value add may be compounded exponentially.

Single family offices can likewise leverage the benefits to their constituents with proper design. A good general rule to follow would be to review any current retail premium in excess of $500,000 to make certain they are receiving the most tax efficient and cost-effective dollar in exchange for the premium they are expending.

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