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Private Placement Life Insurance

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What’s the Story?

- Private Placement Life Insurance has been around for over 20 years but often existed in the dark shadows of tax planning strategies
  - “This is great… why haven’t I heard of it? Why isn’t this more common?”
- 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
- Estimated sales of PPLI have grown by 50% CAGR since 2012.

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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
- Compensation to distributors is not fixed but incorporated into the design of the private placement policy offering ("institutional pricing")

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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

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Private Placement Qualifications

- Client must be pre-qualified before any information is discussed regarding Private Placement products
- 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

** Includes Corporations, Financial Institutions, Employee Benefit Organizations, Trusts

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What is a Qualified Investment?

- Qualified Investments:
  - Cash and cash equivalents
  - Securities as defined in section 2(a)(1) of the 1933 Act (no control issues)
  - Real estate held for investment purposes
  - Commodity interests held for investment purposes
  - Physical commodities held for investment purposes
  - Financial contracts entered into for investment purposes
  - Cash value of life insurance

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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

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State Premium Tax

- Some states have altered premium tax rates levied on insurance companies to attract large-premium trust-owned PPVUL policies
  - Typical state premium tax charge is 2.00% - 2.50%
  - Alaska, South Dakota, and Delaware charge a much lower rate (zero to 8 basis points) on annual premium in excess of $100,000
- PPVUL policies are generally the only products designed to pass this reduced charge to policyowners
  - A policy with a $1 million annual premium can realize a savings of up to $20,000 per year in premium tax charges

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Characteristics of PPLI Prospect

- 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

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Assumptions

- Male age 50, preferred nonsmoker 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%
- Affordable Care Act tax rate on investment income = 3.8%
- 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 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	1,306,600	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%

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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%

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

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			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%

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Unwinding the PPLI Policy

LIFE INSURANCE								
Year	Age	Annual Premium	EOY Annual Withdrawal	EOY Annual Loan	**Net EOY Account Value**	**Net AV IRR**	**Net EOY Death Benefit**	**Net DB IRR**
1	50	1,250,000	0	0	**1,275,185**	**2.01%**	**23,309,383**	**1764.75%**
2	51	1,250,000	0	0	**2,601,149**	**2.67%**	**23,309,383**	**284.71%**
3	52	1,250,000	0	0	**4,024,364**	**3.57%**	**23,309,383**	**124.73%**
4	53	1,250,000	0	0	**5,551,529**	**4.23%**	**23,309,383**	**72.38%**
5	54	0	0	0	**5,931,921**	**4.96%**	**23,309,383**	**50.75%**
6	55	0	0	0	**6,337,956**	**5.37%**	**23,309,383**	**38.74%**
7	56	0	0	0	**6,770,362**	**5.63%**	**23,309,383**	**31.21%**
8	57	0	0	0	**7,239,846**	**5.83%**	**20,070,000**	**23.32%**
9	58	0	0	0	**7,751,958**	**5.99%**	**16,310,000**	**16.84%**
10	59	0	0	0	**8,314,947**	**6.14%**	**11,142,029**	**9.81%**
11	60	0	0	0	**8,942,267**	**6.28%**	**11,624,947**	**9.23%**
12	61	0	0	0	**9,616,875**	**6.40%**	**12,309,600**	**8.91%**
13	62	0	0	0	**10,342,044**	**6.50%**	**13,030,975**	**8.65%**
14	63	0	0	0	**11,121,581**	**6.58%**	**13,790,761**	**8.42%**
15	64	0	0	0	**11,959,630**	**6.65%**	**14,590,749**	**8.22%**
16	65	0	5,000,000	6,250,000	**701,319**	**6.62%**	**2,141,623**	**7.46%**
17	66	0	0	0	**692,708**	**6.59%**	**2,108,802**	**7.36%**
18	67	0	0	0	**683,849**	**6.56%**	**2,072,530**	**7.27%**
19	68	0	0	0	**674,646**	**6.53%**	**2,032,464**	**7.18%**
20	69	0	0	0	**664,913**	**6.50%**	**1,988,139**	**7.10%**
30	79	0	0	0	**565,497**	**6.33%**	**1,156,653**	**6.48%**
40	89	0	0	0	**248,856**	**6.21%**	**1,094,501**	**6.34%**
50	99	0	0	0	**24,699**	**6.18%**	**24,699**	**6.18%**

- Assumes distribution from the policy in year 16, which is a combination of a withdrawal of basis and policy loan
- The policy loan is repaid at death from the gross policy death benefit
- Assumed investment rate of return after year 15 is 0%

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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

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

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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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Private Placement Investment Options

- "Can I put my investments into a life insurance policy?"
- Permissible investment options for insurance contracts should meet the following requirements:
  - Only accepts assets from insurance contracts; not available to the general public [*Revenue Ruling 2003-92*]
  - Policyowner should not have any control or direction over investment decisions made by fund manager [*Revenue Ruling 2003-91*]
  - Fund has minimum level of diversification [*IRC Section 817(h)*]
  - IRS has clearly stated that insurance-dedicated funds (IDFs) are approved for life insurance policies

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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

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Case Studies

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Case Study #1

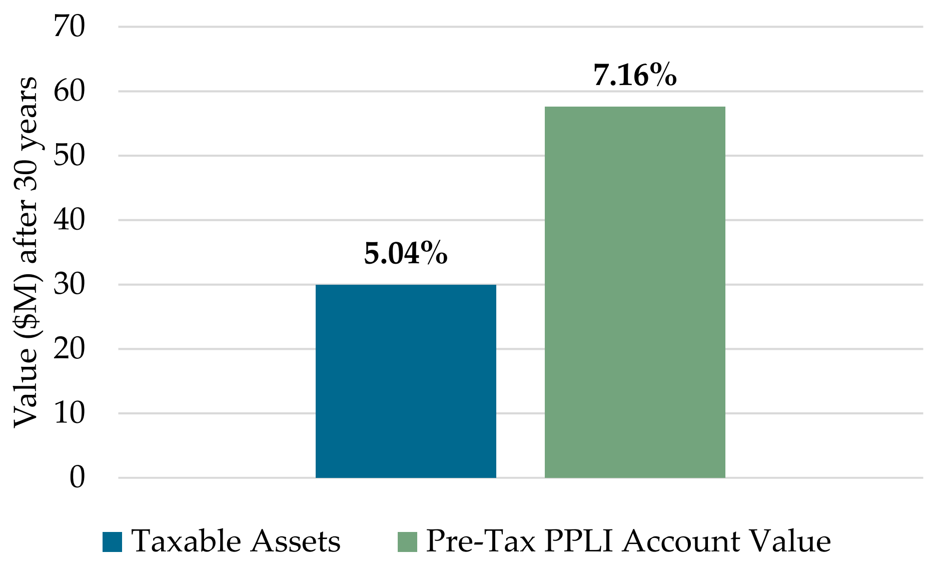
- 59 year-old Patriarch built wealth in real estate, net worth in excess of $240 million
- $65 million in liquid investment assets with some in trust; exposure to alternative investments
- Invested assets are creating a marginal income tax rate of 37%
- Aside from charitable intentions, client's goal is to maximize wealth transfer to heirs
- Plan involved moving $8 million into PPVUL
  - Assumed investment rate of return = 8% net of management fees
  - Four premiums into non-MEC policy
  - Allocation to multi-strategy fund of funds

Case Study #1

Year	Taxable Assets	Pre-Tax PPLI Account Value	Tax-Free PPLI Death Benefit
1	2,100,800	2,024,794	28,233,679
5	9,060,096	9,615,438	26,208,885
10	12,169,174	13,599,268	15,911,144
20	19,897,945	27,982,664	29,381,797
30	32,535,340	57,647,597	60,529,977

Plan involved moving $8 million into PPLI structured with four $2 million premiums into non-MEC policy

- Male age 59, preferred non-tobacco user
- Assumed net investment return of 8%
- Assumed tax rate on taxable assets of 37%
- Graph shows values after 30 year holding period
- Comparison would vary under different return assumptions; tax expense on taxable assets would be dramatically lower if returns are very minimal or zero



Case Study #2

- Male age 60 and Female age 54 had previously set up GST with $10 million exemption
  - Wife was in good health but husband had some history of medical issues, including high blood pressure which was being controlled with medication
- Trust is defective grantor trust so couple are paying taxes on investment returns
- Currently investing in tax-exempts and ETFs to minimize tax liability but would prefer to invest in equities and private partnership structures
- Marginal tax rate of 49.15% on investment income
- Assumed rate of investment return for comparison purposes was 7% net of management fees and expenses

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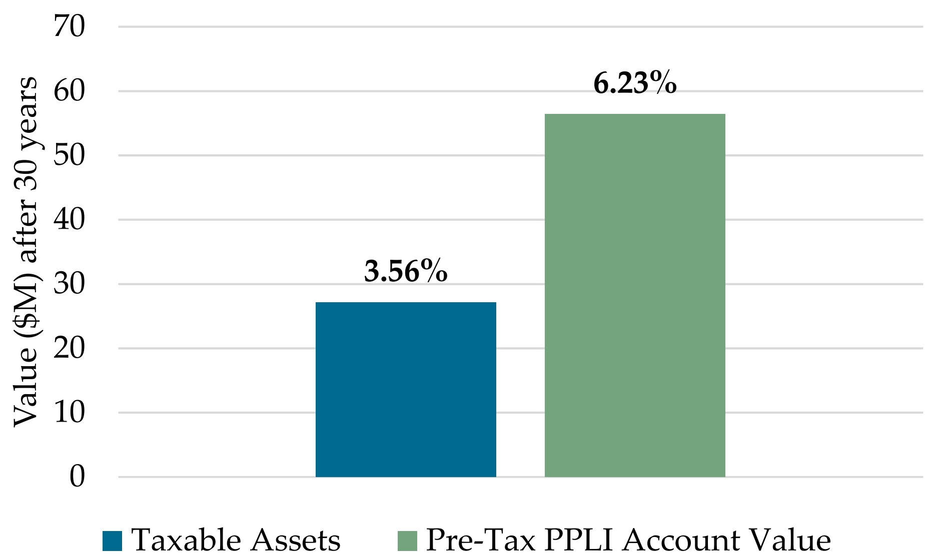
Case Study #2

Year	Taxable Assets	Pre-Tax PPLI Account Value	Tax-Free PPLI Death Benefit
1	2,588,988	2,545,765	50,989,191
5	10,922,118	11,870,379	50,989,191
10	13,472,448	16,069,862	50,989,191
20	19,113,753	29,839,680	50,989,191
30	27,117,236	56,126,305	58,932,620

Because of male's health and the efficiency of a joint-life design, client acquired joint-life survivorship PPVUL policy allocating $10 million from GST over four-year period into non-MEC

- Male age 60, standard non-tobacco user & Female age 54, preferred non-tobacco user
- Assumed net investment return of 7%
- Assumed tax rate on taxable assets of 49.15%
- Graph shows values after 30 year holding period
- Comparison would vary under different return assumptions; tax expense on taxable assets would be dramatically lower if returns are very minimal or zero



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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