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A Closer Look

Private Placement Life Insurance: A Potential Tool for Tax Efficiency and Wealth Transfer

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In Brief

- **Because of its potentially significant tax advantages, private placement life insurance (PPLI) has gained increasing attention and popularity among investors, institutions, insurance brokers, and alternative investment managers.**
- **PPLI is most commonly used to improve the performance of tax-inefficient investments.**
- **PPLI may also be a solution for individuals and families of significant wealth seeking to transfer wealth as tax efficiently as possible.**
- **PPLI may help amplify some of the advantages of lifetime gifts by shielding assets from estate taxes while at the same time offering a death benefit that acts as a "de facto step-up in basis" to mitigate potential future capital gains taxes when the assets are sold.**
- **At the same time, PPLI has certain costs and other potential drawbacks, and is not an automatic choice. The potential benefits must be carefully weighed for each individual client and situation.**

What Is Private Placement Life Insurance?

Private placement life insurance is a type of variable universal life (VUL) insurance[1] that allows investments contained within the policy to grow with income and capital gains taxes deferred. Ultimately, these deferred gains can be received income-tax free at the passing of the insured in the form of a death benefit. Though it holds the same basic structure as traditional life insurance policies, PPLI differs in several key ways:

- There are no surrender charges, and the acquisition charges at inception are generally lower.
- Ongoing fees are typically lower than with traditional life insurance and are fully transparent.
- PPLI offers a wide and flexible array of investment opportunities not available through traditional life policies. These include hedge fund strategies, private equity, and other unique offerings by investment managers.
- As a private placement, it is only available to certain investors who qualify as "qualified purchasers" and "accredited investors" under SEC rules.[2]

As with traditional VUL insurance, PPLI builds cash value to support the policy's death benefit. Unlike some traditional life insurance that emphasizes the size of the death benefit, PPLI is designed to have a low death benefit relative to the cash value, to reduce policy fees and promote underlying asset growth.

PPLI offers the potential to protect assets, as part of a life insurance policy, from annual "tax friction." That includes income taxes related to dividends and other ordinary income produced by alternative assets classes, as well as gains taxes that might otherwise arise from the periodic buying and selling related to the investment management process.

- **PPLI cash value.** Cash value is composed of investments commonly invested in an **Insurance Dedicated Fund (IDF)**. IDFs are funds exclusively available to life insurance policyholders; they can contain a wide range of investment options.

[1] Variable universal life insurance is a form of permanent life insurance with flexible premiums, combining a death benefit with a cash value containing investments that can potentially appreciate (or decline) over time.

[2] Individual accredited investors must have a net worth in excess of $1 million or income above $200,000 in each of the past two years plus the current year. Individual qualified purchasers, on the other hand, aren't subject to a net worth or income requirement, but they must have at least $5 million in net investments. Trusts and business entities can also qualify as accredited investors and qualified purchasers under different standards.

- **Death benefit.** As with traditional life insurance, the beneficiary receives a tax-free death benefit. PPLI death benefits are designed to grow over time based on the appreciation of the policy's cash value, providing enhanced returns to beneficiaries. Most policies are structured with a minimal amount of life insurance.

- **Withdrawal and loans.** Another benefit of PPLI is the ability to take loans or withdraw money tax-free from the policy when it is structured appropriately. Policyholders are allowed to withdraw up to the policy's cost basis (the total premiums paid) tax-free. Any amount withdrawn above the cost basis must be recognized as ordinary income. However, policyholders may also borrow against the policy's value tax-free, but the carrier will charge interest based on a declared rate of interest. If a policy lapses with an outstanding loan, ordinary income taxes may apply to the extent that the total loan exceeds the policy's cost basis. Access to a portion of the policy's cash value is an attractive benefit when compared to liquidating other appreciated assets. However, loans or withdrawals may not always be optimal since both approaches are likely to slow the momentum of a key wealth transfer goal: tax-free growth of the underlying investments.

Underlying Investment Options

PPLI has become an increasingly popular way for qualified purchasers and accredited investors to protect certain alternative investments, such as hedge, credit, and direct lending funds, from income-tax friction. While the tax-deferred compound growth will have a material impact on an investor's net returns, investors may also be relieved of Schedule K-1 tax reporting requirements as they don't apply to PPLI investments.

For qualified purchasers and accredited investors who prefer long-term equities-based appreciation, PPLI policies may also be structured to include a balanced portfolio of investments, such as stocks, bonds, private equity, and alternatives. Although a balanced portfolio may be more tax-efficient than a portfolio consisting of alternatives, the benefits of multiple asset classes and potential appreciation may be more attractive in the long run. Additionally, the tax-preferred treatment of PPLI account value may afford active managers the opportunity to be less concerned with tax ramifications and seek better returns, for example, by investing in corporate bonds in place of municipals, increasing the portfolio's turnover rate, or using a strategy that includes hedge funds or other alternative investments.

Case Study: PPLI and Tax-Efficient Wealth Transfer

The two primary means for transferring significant wealth from one generation to the next — giving during one's lifetime and giving after death as part of one's estate — both offer advantages and disadvantages from a tax perspective.

For clients whose estates exceed the federal gift and estate tax exemption (for 2019, $11.4 million for an individual), lifetime gifts hold the advantage that once the gift is made, those assets are no longer includable in their taxable estate. That's an important consideration when transferring assets with significant appreciation potential. If a gift valued at $10 million today doubles over the next decade, the gift still counts as $10 million from a gift- and estate-tax perspective. The disadvantage is that the tax basis of the assets is set at the time the gift is made. Thus, when the beneficiaries ultimately sell them, the appreciated assets may be subject to sizeable capital gains taxes.

By contrast, when assets are transferred at death, beneficiaries receive a step-up in basis to the full value of the appreciated asset at the time the estate is settled — eliminating or greatly reducing the capital gains exposure when the assets are sold. The disadvantage is that because the assets remain part of the estate at the time of death, the fully appreciated value of the assets may be subject to estate taxes.

Choosing the optimal approach becomes an exercise in comparing the difference between potential capital gains taxes (a lifetime gift) and estate taxes (a bequest).

For some taxpayers, however, private placement life insurance (PPLI) may hold another solution. As part of a life insurance policy, assets may grow tax deferred during the insured's lifetime. At the same time, PPLI offers a tax-free death benefit payout that creates a "de facto step-up in basis," eliminating the taxes on any gain.

If ownership is structured properly (e.g., in an irrevocable trust), life insurance proceeds may be free from estate taxes as well. Yet because PPLI comes with certain fees and other limitations, only a careful case-by-case analysis can determine whether PPLI is right for a given client and situation.

The following analysis (see Exhibit 1) compares two investments of $10 million by a 50-year-old male. Both investments assume 7.00% annualized returns for a balanced growth portfolio, one taxable and the other a nontaxable PPLI insurance dedicated fund.

PPLI with a grantor trust. A private placement life insurance contract can be an effective way to complement a grantor trust. Grantor trusts can be an excellent tool for estate tax purposes, since they enable an asset to grow outside of the grantor's estate, thus removing that appreciation from the estate. With a grantor trust alone, grantors can pay the trust's taxes out of their taxable estate. Thus, they lower their taxable estate, while allowing the assets within the trust to grow more efficiently. PPLI offers the added benefit of potentially eliminating those taxes altogether. Additionally, as previously mentioned, the PPLI policy's tax-free death benefit eliminates taxes on the investment portfolio's gain when liquidated for certain purposes, such as estate taxes.

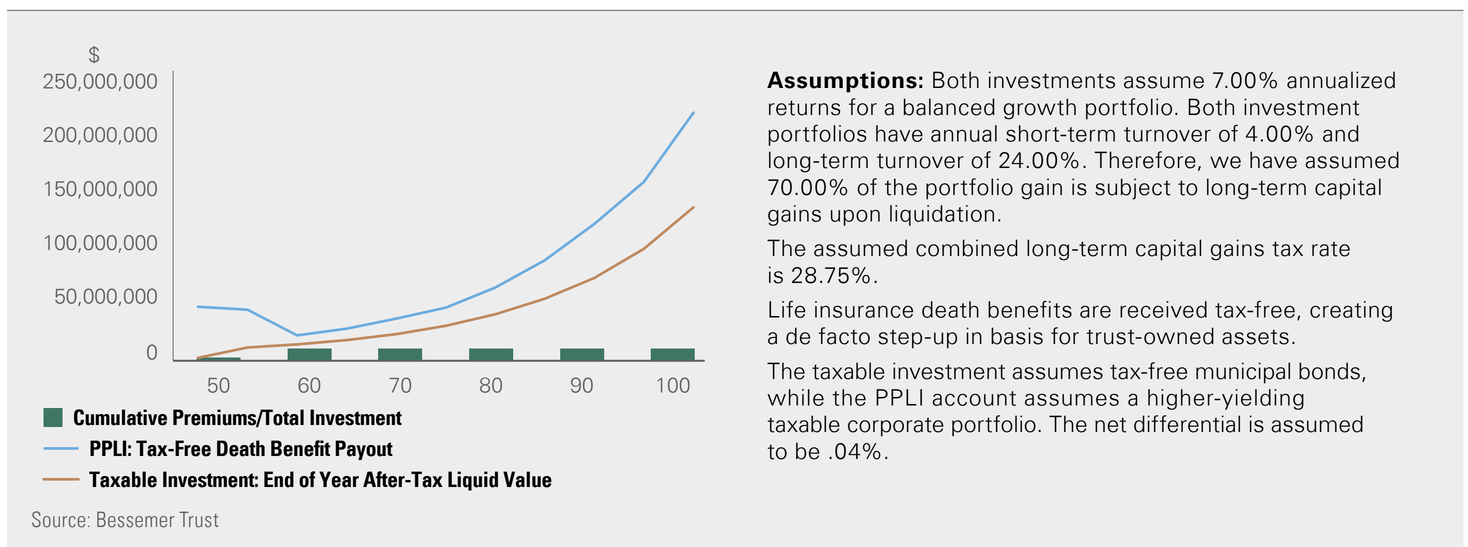
Private Placement Variable Annuities

Just as PPLI uses life insurance to pursue tax-advantaged investment growth, private placement variable annuities (PPVA) use the structure of annuities with similar goals in mind. Unlike traditional annuities, PPVAs don't come with income guarantees or principal protection; hence they tend to have lower fees. Because they are private placement contracts, they may contain a wide selection of investment options.

As with traditional annuities, investments in a PPVA can grow tax-deferred until the assets are withdrawn, at which point the gains are subject to ordinary income taxes. There's a 10% tax penalty on withdrawals taken before age 59½. Because PPVAs don't have tax-free death benefits, they may be an option to consider when charitable giving is a goal. If the designated beneficiary is a charity, the proceeds may be distributed tax-free at death, although the owner defers taxes and remains in control of the asset during life. In addition, foundations, endowments, and pension funds that are subject to unrelated business income tax (UBIT) due to investments in certain alternative classes may utilize PPVAs as a way to eliminate these taxes. Unlike PPLI, there are no underwriting requirements (including medical exams) for PPVA.

Exhibit 1: Private Placement Life Insurance vs. Taxable Investment ($10 million investment)

Key Takeaway: The longer PPLI is held, and the more the underlying assets appreciate, the more pronounced the benefits relative to a taxable investment may become. Early on, benefits may not outweigh the fees.



Source: Bessemer Trust

Assumptions: Both investments assume 7.00% annualized returns for a balanced growth portfolio. Both investment portfolios have annual short-term turnover of 4.00% and long-term turnover of 24.00%. Therefore, we have assumed 70.00% of the portfolio gain is subject to long-term capital gains upon liquidation.

The assumed combined long-term capital gains tax rate is 28.75%.

Life insurance death benefits are received tax-free, creating a de facto step-up in basis for trust-owned assets.

The taxable investment assumes tax-free municipal bonds, while the PPLI account assumes a higher-yielding taxable corporate portfolio. The net differential is assumed to be .04%.

Drawbacks of PPLI

Despite its potential advantages, PPLI is not a solution for every client or situation. Before making any decisions, it is important to consider potential drawbacks:

Underwriting. Obtaining a PPLI policy entails medical underwriting. Individuals must be relatively healthy and willing to allow a review of their medical records and take an insurance exam.

Lack of control. An IRS rule known as the investor control doctrine requires that the policy owners do not influence the selection of securities within the IDF either directly or indirectly. Policy owners can select specific funds that are managed on a discretionary basis. If they are deemed by the IRS to have too much control, policyholders could face significant penalties in addition to losing the tax advantages. This could be an issue for investors seeking maximum control over their investments. Yet for those seeking the long-term benefits of tax efficiency, the ability to help set the direction and select managers with guidance from an experienced advisory team may suffice.

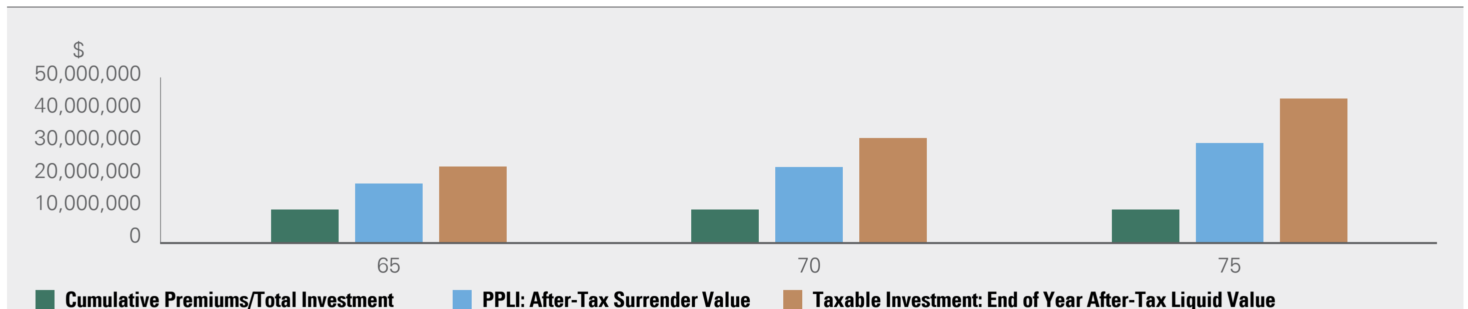
Considering the costs. While they do have tax advantages, PPLI contracts have a number of costs and fees, including a structuring fee — typically about 1% of the premium — plus federal deferred acquisition cost (DAC) tax, state premium tax, asset-based mortality and expense charges, and cost of insurance charges.

Some initial charges, such as the structuring fee and state and federal premium taxes, are deducted from the premium payment. Others, such as the asset-based mortality and expense charges, are typically deducted from the cash value (i.e., the investment component) of the PPLI policy — thus incrementally lowering the growth and compounding potential of the investment, compared with holding those same investments outside of a life insurance policy. Taken together, the total fees for PPLI could exceed any tax benefits to be reaped — especially early on, before the investment assets have time to appreciate. Thus, the benefits of PPLI will take years to develop. A tax-inefficient portfolio will benefit sooner than a tax-efficient portfolio.

The downside of surrendering. Another potential drawback for PPLI comes if a policyholder decides to surrender the policy early rather than holding it until death. While PPLI policies do not carry a charge for surrendering, there may be negative tax consequences for doing so. For example, when a PPLI policy is surrendered, any appreciation of the investments that has occurred will be taxed as ordinary income. That could leave policyholders in a worse position, from a tax perspective,

Exhibit 2: Surrender PPLI During Life vs. Net Liquid Value of a Taxable Portfolio ($10 million investment)

Key Takeaway: When a PPLI policy is surrendered, appreciation is taxed as ordinary income. For wealth transfer, PPLI is best suited to a "hold until death" strategy.



Assumptions: Both investments assume 7.00% annualized returns for a balanced growth portfolio. Both investment portfolios have annual short-term turnover of 4.00% and long-term turnover of 24.00%. Therefore, we have assumed 70.00% of the portfolio gain is subject to long-term capital gains upon liquidation.
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Source: Bessemer Trust

than if they had simply invested the assets in a taxable portfolio and paid capital gains on any appreciation (see Exhibit 2). Thus, PPLI as a wealth transfer tool is best suited to individuals who are specifically interested in long-term tax efficiency and a "hold until death" strategy. For clients who require access to the account value, a withdrawal of basis and a policy loan often yield a greater result than surrendering the policy.

Finding the "Crossover Point"

Depending on an individual's specific goals, determining the efficacy of a PPLI contract involves a detailed analysis of the expected performance of the investments, the tax savings compared to investing in a taxable environment, and the fees and costs related to insurance. PPLI will not always outperform taxable investments. In fact, unless long-term appreciation is significant, the benefits may be marginal. For example, the scenario below (see Exhibit 3) shows 5.00% annualized returns. The slight benefit of PPLI is almost certainly outweighed by other factors, such as increased liquidity for distributions and investment choices.

Timeframe is an important consideration. It typically takes time for the assets in a private placement contract to mature. Thus, initially at least, the fees are likely to be considerably higher than the tax exposure of those investments would be.

For the same reasons, the economics of PPLI will generally look more attractive for younger clients, as there will be more time for assets to appreciate through life expectancy.

Over time, the benefits of the growth in the value are more likely to outweigh the fees and costs of having the insurance. Thus, a key consideration is determining at what point the compound tax-free growth and the income-tax-free death benefit create a more favorable outcome than simply investing in a taxable account. Finding that crossover point is central to determining whether PPLI may be the right choice for a given individual or situation.

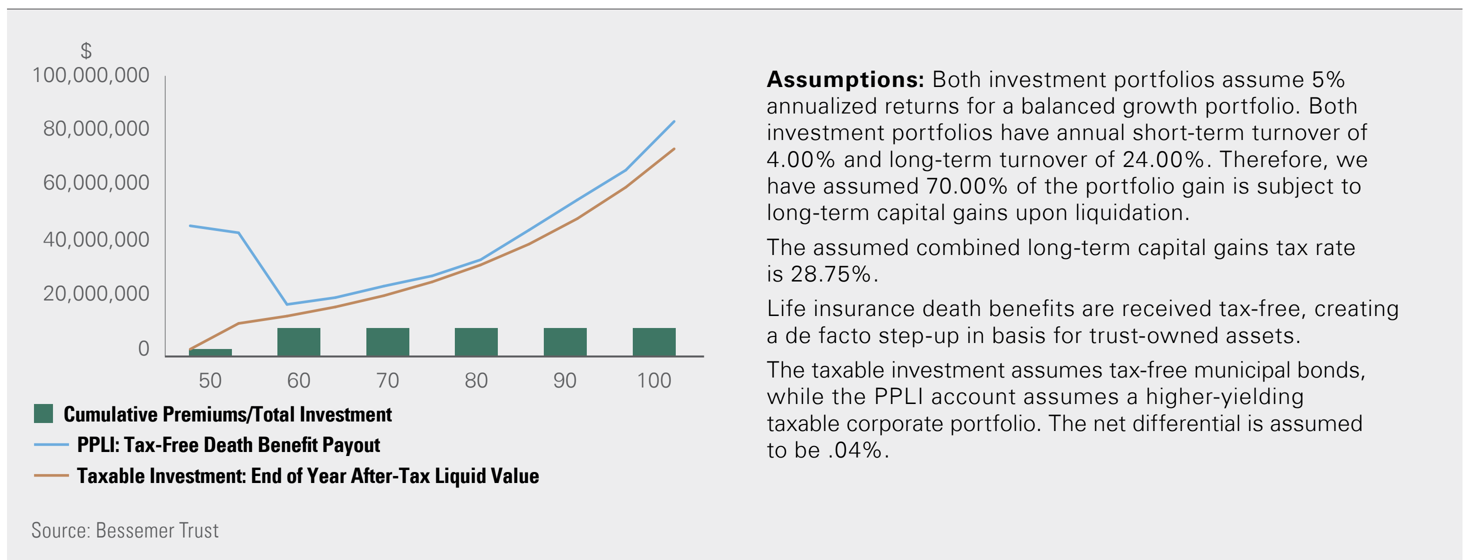
Is Private Placement Life Insurance the Right Choice?

For some individuals of significant wealth, private placement life insurance may offer an effective way to transfer wealth in a tax-efficient manner. Yet that determination requires a thorough review of your specific situation and needs, in the context of your overall financial strategy.

If you have any questions or would like to learn more about this subject, Bessemer's insurance advisors are happy to speak with you. Please contact your client service team or your local Bessemer Trust office.

Exhibit 3: Low Growth Assumptions: Private Placement Life Insurance vs. Taxable Investment ($10 million investment)

Key Takeaway: When long-term appreciation is only modest (5%), the benefits of taxable investments may be more attractive than the slightly higher returns offered by PPLI.



Source: Bessemer Trust

Assumptions: Both investment portfolios assume 5% annualized returns for a balanced growth portfolio. Both investment portfolios have annual short-term turnover of 4.00% and long-term turnover of 24.00%. Therefore, we have assumed 70.00% of the portfolio gain is subject to long-term capital gains upon liquidation.

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