

Private Placement Life Insurance

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Private placement life insurance (PPLI) is an increasingly popular type of variable universal life insurance which can provide investors with a tax-efficient means of investing in private equity, hedge funds, and other managed strategies to pass wealth to future generations and potentially supplement lifetime cash flow.

PPLI is similar to other types of variable universal life insurance in many ways:

- The premium payment schedule and death benefit are flexible.
- The insurance carrier offers a number of investment choices to policy owners, which are made in an account that is segregated from the carrier's general accounts.¹ The cash value of the policy and a sizeable portion of its death benefit will ebb and grow with the value of the investment account, shifting much of the investment risk from the carrier to the policy owner.
- The growth of the policy and its death benefit are income tax free. Withdrawals and loans from the policy may also receive an income tax preference.
- The death benefit can be transferred free of federal and state transfer taxes if ownership of the policy is structured properly.
- Unlike qualified plans and retirement accounts, there are no contribution limits or caps on the amount invested in the policy.
- Obtaining a policy still requires underwriting, including a medical examination.
- Both have surrender charge periods.

¹ Investment diversification and control requirements must be satisfied in order for the investments in an insurance policy to grow income tax free. Insurance carriers are generally responsible for making certain these requirements are met.

PPLI also has several key differences from other types of variable universal life insurance:

- PPLI is not available to all investors; most investors must satisfy minimum net worth requirements (i.e. must meet certain “accredited investor” and “qualified purchaser” requirements).
- Insurance carriers offer alternative investment choices to PPLI owners, including private equity, hedge funds, and managed accounts. Despite these offerings, there are no additional complexities, like K-1s, since the insurance company has a separate account that owns the underlying funds for income tax purposes.
- The fees and expenses of a PPLI policy are smaller but can still be material, especially early in the policy’s term.
- The portion of the death benefit paid by the insurance carrier is generally kept as small as possible, which helps reduce costs.
- PPLI may offer creditor protection, privacy, and additional cost savings, particularly offshore PPLI policies.

Many insurance carriers that offer PPLI also offer **private placement variable annuities (PPVAs)**. PPVAs provide a tax deferred vehicle for investing only until distributions are received, when the income becomes taxable. However, for investors who have concerns over insurability because of health issues, want to designate a qualified charity as the beneficiary of the policy, or are seeking regular lifetime distributions at a lower cost, PPVAs can be a better option than PPLI.

Eligible Investors

While other types of variable universal life insurance are securities registered with the SEC, PPLI is not (i.e. it is a private placement security, hence its name). Therefore, while any investor can purchase other types of variable universal life insurance, only accredited investors and qualified purchasers typically have access to PPLI.

The requirements to qualify as an accredited investor and qualified purchaser will depend on the type of investor:²

	Accredited Investor	Qualified Purchaser
Individuals	<p>Generally, any person with either:</p> <ol style="list-style-type: none"> 1. A net worth of \$1 million, excluding the value of his or her primary residence; or 2. Income in excess of \$200,000 (\$300,000 for a married couple) in each of the two most recent years and a reasonable expectation of the same level of income in the current year. 	<p>Generally, any person who:</p> <ol style="list-style-type: none"> 1. Owns at least \$5 million in investments; or 2. Owns and invests on a discretionary basis in at least \$25 million in investments, for his or her own account or the accounts of other qualified purchasers.
Trust	<p>Generally, any trust that:</p> <ol style="list-style-type: none"> 1. Has over \$5 million in total assets; 2. Was not formed specifically to acquire the private placement investment; and 3. Is directed by a sophisticated person to purchase the private placement investment (i.e. someone who has the knowledge and experience to evaluate its merits and risks). 	<p>Generally, any trust that was not formed specifically to acquire the private placement investment and whose trustee(s) or person(s) authorized to make investment decisions, as well as its settlor(s), are qualified purchasers.</p>

Satisfying these minimum income or asset requirements does not necessarily mean an investor is a good candidate for PPLI. Some advisors only recommend PPLI to investors looking to invest a minimum of \$3 million to \$5 million over a long time horizon in order for the income tax benefits of investing through PPLI to justify the initial and ongoing costs of the policy.

Income Tax Benefits of Investing through PPLI

PPLI can provide a tax-efficient means of investing in private equity, hedge funds, managed strategies, and other investments.

Tax-Free Growth of the Investments

Income and gains from investments owned in a life insurance policy receive a federal income tax preference—the income is not taxable during the policy’s term, allowing the investments to grow tax free. That is not the case when the investments are owned directly by an individual in a taxable account—the income is taxable as it is received.

² Entities, like LLCs, can also purchase PPLI policies, subject to unique accredited investor and qualified purchaser requirements.

Eliminating the added costs of paying taxes as income is realized during a PPLI policy's term can materially increase the returns of investments relative to a taxable account, and this benefit increases the longer the investments are held in the policy.

The types of investments offered through a PPLI policy—private equity, hedge funds, and managed accounts—can further accentuate this benefit of tax-free growth, as these investments can generate significant amounts of ordinary income and short-term capital gains which would otherwise be taxed at higher, ordinary income rates in a taxable account. Investing through a PPLI policy also comes with the added benefit that the policy owner will not receive any K-1s, reducing the income tax compliance complexities often associated with these types of investments.

Tax Preferences for Withdrawals and Loans

A policy owner may also be able to supplement his or her cash flow during the PPLI policy's term, without jeopardizing the tax-free growth of the remaining investments in the policy. Withdrawals and loans from an insurance policy generally receive favorable income tax treatment.

Withdrawals count first against the premiums paid for the policy, allowing tax-free withdrawals up to the policy owner's investment in the contract.³ Loans can also be taken from most life insurance policies income tax free, and any outstanding loans at the insured's death merely reduce the death benefit received by the beneficiaries rather than becoming taxable at that time. This can make a PPLI policy a tax-efficient vehicle to supplement a policy owner's income, including in retirement.

Withdrawals and loans from PPLI policies which are classified as **modified endowment contracts (MECs)** do not receive this same, favorable income tax treatment. Withdrawals and loans from MECs are treated as coming from the income of the policy first and are taxable as ordinary income to the policy owner. These distributions are also subject to an additional 10% tax if the owner is under 59 ½. An investor planning to use a PPLI policy to take lifetime distributions should avoid actions which can result in this MEC classification, as discussed later.

³ A policy owner's investment in the contract equals the amount of premiums paid less any earlier tax-free distributions.

Tax-Free Death Benefit for the Beneficiary

The benefits of PPLI policies can also extend to more traditional applications of life insurance. The lower costs and tax-free build-up of a wider array of investments can also result in a larger death benefit for a PPLI policy relative to other types of life insurance. This can make PPLI an attractive alternative for transferring wealth to future generations—the death benefit received by a beneficiary is income tax free, and it can also pass free of federal and state transfer taxes if the policy is owned by a properly structured trust or entity.

Surrender, Lapse, or Maturity may be Taxable

The income tax preferences afforded to most distributions are not extended to distributions received on the surrender, lapse, or maturity of a PPLI policy. A policy owner will have to recognize ordinary income to the extent amounts received, including the discharge of any outstanding loans, exceed the investment in the contract. PPLI is generally only an attractive alternative for investors planning to keep a policy in force until the death of the insured for this reason.

MEC vs. non-MEC

A PPLI policy will be classified as a MEC if its death benefit, relative to the premiums an owner has already paid for the policy, is too low, typically at any point during the first seven years of the policy. MECs are often created when an owner pays a single, upfront premium for the policy, but they can also arise in other situations, including when the death benefit is reduced during the first seven years.

Once a policy is classified as a MEC, it will retain that classification throughout its life and cannot be exchanged for a new, non-MEC policy in a tax-free exchange. Investors who wish to have the flexibility to take policy loans or distributions during their lifetime should avoid MEC classification accordingly, and this can be accomplished by ensuring that policy premiums aren't paid too quickly at the start of the policy and the initial death benefit is set at a sufficiently high amount. While this will increase the cost of the policy and slow the tax-free growth of its investments, it is the cost of being able to receive tax-free distributions during the policy's term.

While MEC classification can be undesirable when an owner plans on taking distributions, that is not the case with a PPLI policy acquired for the purpose of transferring wealth to future generations. The ultimate goal of these policies is to grow the largest death benefit possible. Paying premiums as soon as possible will allow the policy's investment account, on which the death benefit is largely based, more time to grow tax free. Creating a MEC will, therefore, typically be an unavoidable consequence of using PPLI to transfer wealth to future generations, but these harmful effects should be mitigated by the fact that the owner does not intend to take distributions during the policy's term.

To summarize the considerations for PPLI policies that are MECs and non-MECs:

	Non-MEC	MEC
Primary Use	Lifetime cash flow	Transfer wealth
Withdrawals	Non-taxable up to the investment in the contract	Taxable distribution of income first
Loans	Non-taxable	Taxable distribution of income first
Death Benefit	Non-taxable, but reduced by any outstanding loans	Non-taxable
Premium Payments	Must maintain a minimum death benefit relative to the amount of premiums paid; increases costs and slows the initial growth of the investment account	Can pay one large upfront premium; allows more time for the investment account, and corresponding death benefit, to grow tax free

Evaluating a PPLI Purchase

A potential PPLI investor may want to consider the following prior to purchasing a policy:

Eligibility. An insurance agent or carrier should be able to help an investor determine if they are an accredited investor and qualified purchaser eligible to invest in a PPLI policy.

Amount and time horizon of the investment. While PPLI policies generally have lower fees and expenses than other types of life insurance, the costs are still significant, particularly at the beginning of the policy's term. It can take some time for the benefits of tax-free growth to offset these added costs. Investors with longer investment horizons and large enough investments to justify these extra costs are generally the best candidates for PPLI.

Goal for the policy. It is important for an investor to determine how they intend to use the policy from the outset so that the premium payment schedule and death benefit can be set accordingly. An investor who would like to take distributions from the policy will likely have to spread premium payments over the first several years of the policy, or increase the initial death benefit of the policy, adding cost and slowing the growth of the investments (i.e. non-MEC). An investor who would like to use the policy primarily to transfer wealth to future generations can pay the entire premium at once, allowing more time for those investments to grow income tax free (i.e. MEC).

Ownership of the policy. A PPLI policy can be owned by an individual, trust, or entity. Policies owned by an individual may be subject to federal and state transfer taxes, while policies owned by a trust or entity may be able to avoid these added taxes if structured properly, but with some added complexity. An experienced estate planning advisor can help an investor understand which option works best for them.

Investment types. An investor has no say in the investments choices available to a PPLI policy, other than choosing from the menu offered by a carrier. Investment choices vary from carrier-to-carrier, so it is important for an investor to find a carrier offering the desired types of investments or managers.

Vetting carriers. Fees, creditworthiness, and the due diligence performed in selecting investment options can also vary from carrier-to-carrier.

Other alternatives. PPLI can offer an attractive means to invest in complex investments while minimizing income taxes. It is not, however, a one-size-fits-all solution for cash flow and estate planning needs. An investor considering PPLI should discuss how it fits into his or her existing financial and estate plan prior to purchasing a policy. Alternative vehicles and strategies may ultimately be a better fit depending on the investor.

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