## EXPLORING ALTERNATIVE INVESTMENT-BASED INSURANCE: PRIVATE PLACEMENT LIFE INSURANCE AND ANNUITIES

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The assets under management within U.S. issued variable life insurance policies are estimated to be in the trillions of dollars. An emerging yet obscure sub-market of the variable insurance product segment involves Private Placement Life Insurance ("**PPLI**"), which is an alternative investment-based form of variable universal life insurance that is tailored to meet the mortality and investment needs of affluent clients. These objectives are accomplished through the structuring of a specialized variable insurance product that offers indemnity in the event of death as well as a tax efficient investment that utilizes alternative investments to build income tax deferred cash values inside the policy. This article explores the features of PPLI and its companion product, the Private Placement Variable Annuity ("**PPVA**").

**What is PPLI?**

PPLI is a financial innovation developed over the past 25 years within the life insurance industry for highly affluent investors. It is a form of variable universal life ("**VUL**") policy that is sold through a private placement securities offering. Because the product is sold through a private placement memorandum ("**PPM**"), some transactions involving PPLI can be customized for the investor in terms of investments and other features.

In contrast to traditional VUL products, which have generalized investment alternatives such as mutual funds, PPLI provides access to alternative investments. This allows the policy's cash to be invested in non-traditional investments, such as hedge funds, private equity, funds of funds, real estate, commodities, and financial derivatives. These investments are made in many cases through insurance dedicated funds ("**IDF**"), which are investment funds marketed exclusively to insurance companies. Some insurers also offer customized contract provisions for death benefit amounts and duration, funding options, borrowing interest rates, crediting of interest charges, fees and loads, choices of insureds, ownership options, access to cash value alternatives, and use of professional asset managers.

PPLI is less expensive than traditional, publicly-offered life insurance because agent commissions on PPLI are lower. Additionally, while PPLI can be underwritten under the laws of the various U.S. states, non-U.S. PPLI is even less expensive due to lower tax-based costs imposed against the premiums. Given the flexible investment options and lower costs, PPLI can be an attractive option for clients that are looking for mortality protection and income tax planning benefits available through life insurance.

If the assets in the underlying separate accounts perform well, the PPLI's cash value may substantially exceed its minimum death benefit (**but with the opposite effect occurring if the investments do not perform well**). Upon the insured's death, the beneficiary receives the greater of the minimum death benefit or the value of the separate account, each of which is income tax free based upon Internal Revenue Code ("**IRC**") § 101(a). If owned by a properly designed

irrevocable life insurance trust, the death benefits and all of the earnings of the PPLI can likewise be estate tax free. Cash values of the PPLI can also be accessed on a tax preferred basis so long as the policies are not modified endowment contracts.

**What is a PPVA?**

A PPVA is a form of variable annuity that has investment features similar to that of a PPLI. In a variable annuity, the investment performance is based on the returns generated by the insurer's separate account funds. These funds are typically mutual fund clones or sub-accounts and are segregated from the insurer's general account assets. Similar to PPLI, the private placement version of the variable annuity is marketed to accredited investors and its performance is based upon the returns generated by alternative investments. Like PPLI, the companion annuity products are institutionally priced with no surrender charges, and the investment options include hedge fund, private equity and real estate options as well as traditional mutual fund-like options. Unlike a traditional annuity sold to retail investors, a PPVA doesn't have features such as income guarantees or principal protection. As a result, the PPVA generally has lower fees than a traditional retail annuity.

PPVA tax benefits and asset-protection issues are similar to the benefits of life insurance in that the investment amount grows free of current income taxation. At some point, assuming the contract has an investment gain, either the annuity contract owner or the beneficiary will be required to pay income taxes on the gain at the short-term capital gains rate. That makes this product an alternative for deferring current taxation, but it does not have the preferred lifetime access to cash value on a tax-deferred basis or an income tax-free death benefit as do life insurance contracts. For this reason, certain clients may prefer the PPLI when the ultimate goal is income tax deferral with tax efficient access to cash during the client's lifetime.

PPVAs are often utilized by ultra-affluent individuals and families who intend to leave assets to a public charity or private foundation at their passing. If a charitable entity is named as the beneficiary of a PPVA, all the deferred investment gains pass incomer tax-free to the charity. However, unlike other charitable strategies that are irrevocable in nature, PPVAs provide flexibility for the individual or family if there is ever a desire to access the assets during the owner's lifetime. The PPVA's owner also retains control during its lifetime to change the beneficiary from one charitable entity to another.

**Eligible Purchasers and Suitability**

The offer of PPLI and PPVAs is limited to accredited investors and qualified purchasers. The Securities Act of 1933 provides an exemption under § 4(2) from securities registration for accredited investors as defined in Rule 501(a) of Regulation D under the Securities Act. An accredited investor is an investor with a net worth of at least $1 million and joint income of at least $300,000 in each of the last two years, with the likelihood of continuation in the current year. A qualified purchaser has investable assets of at least $5 million. Given the minimum premium requirements relating to such products, however, the target client will have a net worth that substantially exceeds the minimum accredited investor requirements mandated under Regulation D (i.e., $25 million or more in net worth).

Similar to other forms of life insurance, a medical underwriting is required for a PPLI that includes full health history disclosure and a medical exam that often involves a stress EKG. While the applicant's net worth and/or future estate tax liability may often justify the insurance coverage, the application process for a PPLI involves full financial disclosure. As such, PPVAs have been preferred by some to PPLI to date mainly because PPVAs are simpler to implement. They involve a shorter application and no financial related underwriting is required.

Clients with large long-term investments in income tax inefficient asset classes (i.e., investments subject to ordinary income taxes) may benefit from the acquisition of PPLIs and PPVAs. Depending on the product, the client should be ready to invest a minimum of $1 million in both forms of products ($5 million and higher required in some cases) and have an investment horizon of 10 to 15 years for PPLIs (to overcome the impact of up-front fees and expenses) or until age 59½ for PPVAs (to avoid the 10% federal excise tax upon gains). PPLI can benefit clients who are insurable and have a need for life insurance coverage and/or a desire to fund tax-efficient multigenerational estate planning structures (i.e., dynasty trusts). PPVAs can benefit clients who want to retain full ownership and access to their investment assets during their lifetimes but also are interested in long term charitable planned giving. In such cases, however, the client must accept some loss of investment control, since the tax benefits of both products require the investments to be under the management of an independent investment manager.

**Investments**

The ability of insurers to offer investment flexibility through alternative investments is one of the most important features of private placement products. Unlike traditional variable retail products, owners of PPLI and PPVAs can allocate among IDFs that mirror publicly available retail mutual and index funds, as well as alternative class options, such as hedge funds, private equity, funds of funds, derivatives, etc. Thus, the investment accounts of the private placement products will provide access to a range of alternative investments on an income tax-advantaged basis. If an investor wants to invest in an IDF that is not presently offered by a carrier, the manager of the fund can create a separate series that will qualify as an IDF. As there is often an additional cost for this process, it may be more cost efficient to select from existing IDFs. Investment in an IDF can only be made through the purchase of a PPLI or PPVA. Since the purchase of a PPLI or PPVA must be made with a cash payment, it is not possible to transfer existing investments into such policies.

**With higher investment return potential, however, comes greater market exposure and greater investment risk**. A chart that compares private placement insurance compares to other forms of permanent life insurance is provided in the following table:

**Table I - Life Insurance Risk Spectrum**

| **High Investment Risk and Full Market Exposure**<br><br>*< High Product Risk* | **Hedged Investment Risk and Limited Market Exposure** | **Reduced Investment Risk and Carrier Portfolio Exposure** | **No Investment Risk and Guaranteed Results**<br><br>*Low Product Risk >* |
|---|---|---|---|
| Variable Universal Life & Private Placement Life Insurance | Indexed Universal Life | Universal Life and Whole Life | Guaranteed Universal Life |

| | | | |
|---|---|---|---|
| Cash values are invested in a basket of mutual funds, hedge funds, private equity, or combination of the same<br><br>Cash values maintained in separate accounts and are not subject to carrier's creditors<br><br>Policy owner takes investment risk and policy performance is based upon investment performance<br><br>Some carriers offer guaranteed riders that allow for both cash value growth and guaranteed premiums | Cash values grow based upon a specific market index return<br><br>Cash values are not invested in the market, rather a small portion buys call options on a specific index<br><br>Carriers set cap and floor and offer guaranteed caps and floors<br><br>Some carriers offer guaranteed riders that allow for both cash value growth and guaranteed premiums | Cash values are subject to carrier's creditor claims<br><br>Credit ratings reflect new money rates<br><br>Carriers offer contractually guaranteed minimum credit rates | Premium amounts and durations are guaranteed and are not interest sensitive<br><br>Essentially term life to age 100 with carrier taking more performance risk<br><br>Policies designed to have less cash value<br>Non-correlated to other assets<br><br>Market is shrinking |

**Modified Endowment Contracts ("MEC")**

According to IRC § 7702A, an MEC is a life insurance policy overfunded in the initial years of its existence based upon the timing and premiums paid in relation to its death benefit. The determination of whether a life insurance policy is an MEC is based on actuarial calculations that are referred to as the "seven-pay" test. A policy is an MEC where the cumulative premiums paid at any time during the first seven years exceed the sum of the maximum net level premiums that could have been paid on or before such time, if the contract provided for paid-up future benefits after the payment of seven level annual premiums. The test requires that the premiums be made over a period of years, as opposed to a single up-front payment. The following are consequences of a life policy characterized as an MEC:

- Loans taken from or secured by the policy are deemed to be distributions of earnings from the policy;[1]
- Distributions, including payments upon the lapse or surrender of an MEC policy, are taxable as ordinary income up to the amount by which the cash surrender value of the policy exceeds the cumulative amount of premiums paid into the policy;
- A 10% excise tax is imposed on distributions made prior to the insured attaining age 59 1/2 (but the penalty shall not apply where the insured is disabled or where the distributions are part of a series of substantially equal periodic payments extending over the life of the taxpayer).

[1] I.R.C. §72(e).

Avoiding MEC classification may be of concern where the goal is to invest as much in the PPLI as quickly as possible so that the return can begin accumulating on a tax efficient basis. If, however, the PPLI owner has no intentions of accessing policy cash values, MEC classification may be beneficial because the overall cost of insurance will be less.

**What are the Costs?**

A potential factor in the conservative growth in popularity of PPLIs relates to the disparity in their compensation when compared to the sales compensation of retail products. Retail VULs, in general, have a commission structure that pays selling agents 55-95% of the target premium in the first policy year. Commissions in subsequent years on VUL premiums vary by carrier from 2-5% of the premium. Additionally, the agent receives 25-35 basis points (0.25-0.35%) of the VUL's account value each year. The policies usually have declining surrender charges of 10-12 years. Traditional variable annuities have a commission structure that pays the selling agent 4-5% in the first year and on any subsequent premium payments. Additionally, the agent receives 25-35 basis points of the account value each year. Traditional variable annuities also have declining surrender charges over 5-8 years.

In contrast, PPVI and PPVAs generally have no surrender charges and compensate the selling agent with premium based commissions equal to 1-4% and asset based commissions based on the account value of .10-.50 basis points. Note that PPVAs typically do not incur charges for DAC taxes, state premium taxes (other than in a small number of states), or costs of insurance. Thus, PPVAs will have a somewhat simpler fee structure. A summary of the sales costs and other fees commonly associated with PPVIs is provided below.

**Table II- PPVI Common Costs**

| Fee | Recipient | How Paid | Amount |
|---|---|---|---|
| Fed. Deferred Acquisition Cost Tax | Fed. Govt. | Premium | 0-1% Foreign<br>1-1.5% Domestic |
| State Premium Tax | State Govt. | Premium | 0% International<br>2% avg. but varies by state (0.10% to 3.0%) |
| Mortality & Admin. Exp. Charge | Ins. Co./Ins. Advisor | Mo. Assess. Cash Value | Often scaled by asset size and duration (i.e., 0.80% to 1.50% of cash value per year for first 10 years, but scaled down after that). Includes cost of insurance. |
| Insurance Cost | Insurance Cost | Cash Value Assess | Variable depending on net amount at risk, age, sex, and health of insured. Typical annual COI charges for PPLI policies range between approx. 25 basis points (0.25%) and 50 basis |

|  |  |  | points (0.50%) of the cash value for a single life product (sometimes slightly less for a second-to-die contract) once all premiums have been paid. |
|---|---|---|---|
| Sales Comp. | Ins. Advisor | Premium/Cash Value | 1-3% of premium<br>Trail compensation – 0.15-0.50% of cash value per annum |

For PPLI and PPVAs, at the investment level, asset management fees are charged at market rates and paid at the IDF level of the separate account. The investment returns are reported to the separate account net of these fees, which effectively makes the entire fee tax-deductible, without regard to the deduction limitations typically imposed on taxable accounts for itemized deductions or alternative minimum tax purposes.

**Risks of PPVI and PPVA**

PPLI and PPVAs have special risks that must be discussed with clients prior to investing, and the offering materials of the products will generally contain an explanation of such risks. PPVI and PPVAs are unregistered securities that are not subject to the same regulatory requirements as registered variable products that include financial reporting obligations to the SEC. Similar to most forms of alternative investments, and due in part to their sales costs, insurance costs and other charges, PPVI and PPVAs should also be viewed as investments that require a long-term investment horizon to effectuate the client's financial objectives.

The value of the investment options of the separate accounts will be subject to economic and market risks that affect the portfolio investments of the segregated accounts. As such, cash values associated with these products will fluctuate, and when redeemed or annuitized, may be worth more or less than the invested cost. While the investments of the separate accounts may be diversified for federal tax code compliance purposes, it is possible that the investments covered within the fund investments can be concentrated within a limited number of industries.

PPLI and PPVAs often require a significant premium commitment (i.e., $1 million plus) funded over a period of years. Thus, a failure by the client to fund required premiums due to unforeseen financial difficulties could result in a substantial reduction of planned life insurance benefits and anticipated cash values supporting the client's retirement or estate planning objectives.

The continued financial stability of the insurer is also a necessary development to ensure that the life benefits and cash value objectives of the client are achieved. Thus, the benefit of the PPLI or PPVA will be substantially compromised if the underlying insurer or reinsurer fails to remain in business as a going concern.

While cash values from PPLI and PPVA are generally maintained in separate accounts of the insurer, the accounts contain the cash values of numerous variable policies accounts. Thus, while separate accounts, to the extent used by the insurer, will generally insulate the insurer's variable policy assets from the liabilities of its other business lines, it does not prevent claims from one policy from being paid with the assets of multiple insureds.

**Conclusion**

Although taxpayer burdens on federal income tax obligations are likely to be eased to at least some extent through the transitioning of executive control to the GOP, the only two things that will continue to remain forever constant for all U.S. Citizens, including affluent ones, are death and taxes. While income tax related expenses are perhaps the single biggest expense any person has from a financial planning standpoint, we operate in an environment where (i) few investors and their advisors truly understand the need to manage their taxes, and (ii) few alternative investments address this planning need in a meaningful way. Acknowledging that private placement insurance products are niche products that will not appeal to everyone, their features are noteworthy for affluent clients that desire mortality protection coupled with a tax efficient wealth accumulation strategy that utilizes alternative investments as the underlying assets.