Understanding Private Placement Life Insurance

A policy with an investment component that addresses both income and estate tax goals

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KEY POINTS

• PPLI is a type of variable universal life insurance that provides the same death benefits as other life insurance policies while allowing for the possibility for significant growth in cash surrender value

• With changes to the premium tax on trust-owned PPLI policies delivered in Delaware, trusts formed in Delaware that hold PPLI offer several advantages
With the federal transfer tax exemptions greater than $5,000,000 and the federal income tax rates as high as 43%, many taxpayers are more focused on the income tax consequences of potential investments than estate tax concerns. Private Placement Life Insurance (PPLI) may provide a very attractive solution that addresses both income and estate tax goals. With changes to the premium tax on trust owned PPLI policies delivered in Delaware, trusts formed in Delaware that hold PPLI offer many advantages.

PPLI

PPLI is a type of variable universal life insurance. It provides the same death benefits as other life insurance policies while allowing for the possibility of significant growth in cash surrender value. The policies are issued by insurance companies, both U.S. and foreign. The premiums, which generally range from $3 million to $5 million, are split into two parts. One part funds the life insurance on an insured and the other is invested in a segregated asset account of the insurance company. The owner of the life insurance policy is able to choose among various investment options within the segregated account and, unlike other variable insurance policies, has the flexibility to change the investment fund managers. The owner of the policy must be limited in the amount of investment control he or she has so that the policy owner is not deemed to be the owner of the underlying assets. Because of the sophisticated nature of investments held within the segregated accounts, PPLI may be offered only to qualified purchasers and accredited investors.

Insurance Dedicated Funds

The investment options must be a type of investment that is known as an Insurance Dedicated Fund (IDF). Different insurance carriers offer different IDFs, so the selection of a carrier is often driven by the investment opportunities offered by the carrier. If an investor wants to invest in a fund that is not presently offered by a carrier, the manager of the fund can create a separate series that will qualify as an IDF. There is an additional cost for this process, so it is best to select from existing IDFs. Investment in an IDF can only be made through the purchase of a PPLI policy. Since the purchase of a PPLI policy must be made with a cash payment, it is not possible to transfer existing investments into a PPLI policy.

Tax advantages

There are numerous tax advantages to most forms of life insurance:

- **Tax deferred increase in cash surrender value:** The increase in the cash value of the policy is not taxed during the existence of the policy.

- **Non-recognition of capital gains:** Changes to underlying investments in the policy do not create taxable gains.

- **Income tax benefit:** Death benefits are free from income tax.

- **Estate tax benefit:** If the policy is held in an irrevocable trust, the death benefits are generally free from estate tax.

PPLI provides these same tax benefits. PPLI’s greatest asset is its ability to allow the cash value to grow tax free during the life of the policy. Because the costs of providing insurance through PPLI are generally lower than those of regular insurance, more of the premiums are allocated to the cash value of the policy and are able to be invested. Any income earned on the assets in the segregated account is not subject to income tax, so the income yield is enhanced when the investments held in the policy
are tax-inefficient assets such as mutual funds, stocks, and bonds. And, PPLI might be more beneficial when the investments include hedge funds and alternatives. All of these investments pass through taxable income annually to their owners. If held outside PPLI, the taxes can be quite significant. But when held inside PPLI, the income is not taxed and the cash value grows unencumbered by taxes, producing a much larger return on investment than when held outside.

The total fees for purchasing PPLI are generally about 1% to 4% of the premium. These costs are often more than offset by the potential taxes saved on the income earned within a private placement policy. Since the income taxes on income earned by investments outside a PPLI policy can be as high as 40% or greater, the potential for tax savings and increased growth could be quite significant.

PPLI offers the policy owner the opportunity to make changes to the choice of investment and there is no tax for liquidating an investment in order to change investment managers, since any gain on the liquidation is not taxable. Some mutual fund companies do offer IDFs, so the proceeds of an investment can be “parked” in a mutual fund until a desired new investment is available. Thus, there is even more opportunity for growth through the ability to access new investments in the changing investment universe.

**Delaware trust advantages**

Although PPLI can be owned individually, it is often held in a trust structure where it can provide estate planning opportunities. When held in a dynasty trust, the assets may grow income tax-free until the death of the insured, and then can continue in trust for the beneficiaries. The income earned after the death of the insured would be subject to tax, however.

Most states charge a tax on the premiums paid for the insurance policy. The rates range from .08% to 3.0%. Until June of 2016, Delaware’s premium tax rate was 2%, which did not compare favorably with other states. The situs of the trust generally determines the state in which the premium tax is paid. Effective with legislation passed in June of 2016, the premium tax for Delaware is 2% of the first $100,000 and 0% for any premiums in excess of $100,000 for trust-owned life insurance policies that participate in private placement. The maximum premium tax in Delaware is $2,000 for each trust-owned private placement life insurance policy. Delaware’s premium tax on premiums above $100,000 is now lower than the tax in any other U.S. state.

Delaware offers many other advantages for holding PPLI in a trust situated in the state. A key advantage is the ability of the settlor to create a directed trust, which allows an investment advisor or investment committee to make decisions concerning the assets held in the trust. Because an insurance trust holds just one asset—the policy—the directed trust structure removes any pressure for the trustee to diversify and liquidate the policy. Delaware law also has additional rules applicable to life insurance on the life of the trust settlor that enhance the benefits of having the insurance trust located in Delaware.

Another important advantage of a Delaware trust is that Delaware does not impose any state income tax on income earned by Delaware resident trusts that have no Delaware resident beneficiaries. After the policy has ended and the trust holds the life insurance benefits, a Delaware resident trust can often be in the position of not paying income tax in any state. At a minimum, there would not be any additional state income tax paid to Delaware if there are no Delaware residents as current beneficiaries.

PPLI can be offered by both U.S. (onshore) and foreign (offshore) insurance companies. Policies offered by offshore companies are not subject to state premium taxes, which have made them more attractive than onshore policies. With the reduction in Delaware’s premium taxes, PPLI held in Delaware resident trusts will be more
Delaware’s premium tax on premiums above $100,000 is now lower than the tax in any other U.S. state competitive against the offshore policies. In addition, owning an offshore policy will require the policy owner to report the value of the assets held in the policy’s segregated investment accounts under FINCEN 114 (Report of Foreign Bank Accounts), known as the FBAR, and the filing of Form 8938 under the FATCA rules. PPLI issued by a U.S. carrier is not subject to either of these reporting requirements.

**Potential PPLI investors**

PPLI may be a good choice for both individuals and trusts. However, PPLI policies must be purchased through a trust situated in Delaware in order to be eligible for the new, reduced Delaware premium tax. PPLI should not only be considered for new trusts but also for existing trusts. Any gain recognized on the liquidation of existing assets would be taxable but any income from investments held in the PPLI policy would be free from tax throughout the life of the policy. PPLI can be purchased as a second to die policy, which has the advantage of significantly reducing the cost of the insurance policy and increasing the funds available for investment. Another option, if the goal is to provide maximum insurance benefits for future generations, is to insure the lives of younger family members. This will reduce the cost of the insurance as well as extend the time period for the investments to grow tax free.

If the goal is to provide growth and allow tax-free withdrawals of the cash value, this can be accomplished with PPLI. The insurance must be a Non-Modified Endowment Contract. This type of contract does not allow the front-loading of premiums as a Modified Endowment Contract does, so the cash value does not build up as quickly. But, it does allow tax-free withdrawals of the cash value. Seeking these types of withdrawals may trigger estate inclusion if the trust and the withdrawals are not structured in the appropriate manner. PPLI requires significant payment of premiums in the first years, which may present funding issues if held in a trust. Since the typical premiums are $3 million to $5 million, it may be difficult to use the settlor’s exclusion amounts to fund the trust. An option is to use a split-dollar insurance policy.

Although PPLI has been around for some time, it is rapidly growing in popularity. For investors who are looking for a way to increase returns from their investments while reducing the tax consequences of those returns, PPLI, with its investment component, could be a powerful option. By placing PPLI in a trust situated in Delaware, the administrative costs related to the premium tax can be reduced and the income and estate tax benefits of a Delaware trust can be harnessed to produce a favorable result.
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Note that a few states, including Delaware, have special trust advantages that may not be available under the laws of your state of residence, including asset protection trusts and directed trusts.

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