Private Placement Life Insurance:
Income and Estate Tax Planning for Wealthy Families

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The ABA Section of Real Property, Trust & Estate Law
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Biography – Leslie C. Giordani

Ms. Giordani is a partner in the Austin, Texas, law firm of Giordani Swanger, Ripp & Phillips, LLP (“GSRP”). Ms. Giordani primarily represents high net worth individuals and family offices in the design, implementation, and administration of domestic and international trust, investment, and life insurance structures. She also consults generally to major financial institutions and boutique financial service providers on matters of interest to the high net worth marketplace.

Ms. Giordani is Board Certified in Estate Planning and Probate Law (Texas Board of Legal Specialization), is listed in The Best Lawyers in America, and is a Fellow of the American College of Trust and Estate Counsel (ACTEC). A frequent writer and speaker in the areas of life insurance, asset protection, and foreign trust planning, Ms. Giordani recently co-authored, with Robert W. Chesner, Jr. (Director at GSRP), Bloomberg BNA’s Tax Management Portfolio 870, 1st, “Private Placement Life Insurance and Annuities.”

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Mr. Bounty is an attorney engaged in the practice of law in Connecticut. In 2013, he served as Vice President, Private Banking Solutions, Affluent Markets Group for Zurich American Life Insurance Company, leading Zurich’s sales and marketing efforts for private placement variable insurance products in the United States. Mr. Bounty has been engaged in the private placement life insurance and annuity business exclusively for the past twelve years. In 2002, he served as the in-house counsel and taxpayer representative with regard to PLR 200244001, which ultimately led to the issuance of Rev. Rul. 2003-91 and Rev. Rul. 2003-92. In these rulings, the IRS clarified the appropriate tax treatment of various investment structures used within private placement insurance products.

Mr. Bounty was the Managing Director of the Private Client Group at MassMutual from 2004-2012. Prior to joining MassMutual, he held various positions in the internal legal departments of Sun Life Assurance Company of Canada (U.S.) (2001 – 2004), Aetna (1995 – 2000), and Travelers (1986 – 1994). Mr. Bounty received his J.D. from the University of Connecticut, School of Law in 1982, served as a law clerk for the Chief Judge of the U.S. District Court in Hartford and spent three years as an associate with the Hartford law firm of Shipman & Goodwin.

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Biography – Amy P. Jetel

Ms. Jetel is a partner in the Austin, Texas, law firm of Beckett Tackett & Jetel, PLLC, where she focuses her practice on the design, implementation, and administration of outbound and inbound foreign trust and entity structures to meet the estate-planning and asset-protection goals of multi-jurisdictional clients. In this practice, she has gained a depth of experience in the U.S. tax and compliance aspects of non-U.S. trusts and entities, and she frequently addresses complex international tax and treaty issues faced by individuals with ties to multiple jurisdictions.

Ms. Jetel has developed a niche practice in planning around the throwback-tax regime that applies to foreign non-grantor trusts, and in representing clients before the Internal Revenue Service to bring previously unreported foreign structures into full compliance. Ms. Jetel also practices in the areas of traditional estate and disability planning, probate and estate administration, and entity formation and governance.

She is Board Certified in Estate Planning and Probate Law (Texas Board of Legal Specialization), she is a frequent author and speaker in the areas of estate planning, asset protection, and international taxation and compliance, and she is listed in The Best Lawyers in America. Ms. Jetel is a veteran of the U.S. Navy.

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## Federal Taxes on Investment Earnings and Wealth

<table>
<thead>
<tr>
<th>Tax Category</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary Income $^{2,4}$</td>
<td>43.4%</td>
</tr>
<tr>
<td>Short-Term Capital Gains $^{2,4}$</td>
<td>43.4%</td>
</tr>
<tr>
<td>Long-Term Capital Gains $^{3,4}$</td>
<td>23.8%</td>
</tr>
<tr>
<td>Dividends $^{3,4}$</td>
<td>23.8%</td>
</tr>
<tr>
<td>Estate Tax $^5$</td>
<td>40.0%</td>
</tr>
</tbody>
</table>

1. As a result of the American Taxpayer Relief Act of 2012 (“ATRA 2012”).
2. The top marginal income tax rate (for individuals with taxable income over $400,000/joint filers over $450,000) increased from 35% to 39.6% as a result of ATRA 2012.
3. The top marginal tax rate (over the $400,000/$450,000 income threshold) on long-term capital gains and dividends increased from 15% to 20% as a result of ATRA 2012.
4. A 3.8% tax imposed on net investment income by the Healthcare and Educational Reconciliation Act of 2010 (for individuals with taxable income over $200,000/joint filers over $250,000).
5. Subject to $5 million (indexed for inflation) individual estate and gift lifetime exclusion amount.
What is “Private Placement” Life Insurance?

- Variable universal life insurance product offered as a private placement
- Institutional pricing
- Customized and negotiated
- To purchase a U.S. private placement insurance product, investor typically must be an “accredited investor” who is a “qualified purchaser” under SEC rules
- Typically targeted toward $4-5M investment or greater, although smaller amounts are possible
- Offered by a number of “household name” carriers in the U.S. and Bermuda, but also by several large international companies; many small, thinly capitalized offshore carriers also participate in the PPLI marketplace
Benefits of Private Placement Life Insurance ("PPLI")

• Tax-free investment environment for policy cash value (especially good for hedge funds and other tax inefficient investments)

• Low cost structure (should be less than 1% of invested amount per annum on average over investment horizon)

• Flexible
  – Wider selection of investment management strategies
  – Easy to add/change asset managers
  – Can withdraw/borrow from policy at minimal cost (and tax free with proper structuring)

• Beneficiary receives death benefit income tax free, and if structured properly, free of estate tax

• Underlying investments may be afforded higher levels of creditor protection by statute or through effective use of trusts (domestic or international)
Retail Life Insurance vs. PPLI

**Retail Life Insurance Funding**
- Maximized Net Amount at Risk
  - Death Benefit
- Smaller Deposits
  - Made Over Long Time Period
- Death Benefit
  - Purchase Goal

**Private Placement Life Insurance Funding**
- Minimized Net Amount at Risk
  - Death Benefit
- Larger Deposits
  - Made Over Short Time Period
- Investment
  - Purchase Goal
Tax Compliance

• Definition of life insurance; IRC§7702
  – Policies must meet the definition of life insurance by passing one of two tests
    • CVAT (cash value accumulation test)
    • GPT/CVCT (guideline premium/cash value corridor test)

• Modified Endowment Contract (MEC); IRC§7702A
  – MEC policies are subject to additional taxation in the event of withdrawals or loans from policy cash values. MEC classification depends on premium funding levels and/or timing of premium payments
Investment Diversification and Investor Control

- Diversification; IRC § 817(h)
  - In general, each asset account in a variable life policy must contain at least 5 investments (issuers) with:
    - No more than 55% of the account value represented by any one investment
    - No more than 70% of the account value represented by any two investments
    - No more than 80% of the account value represented by any three investments
    - No more than 90% of the account value represented by any four investments
Tax Compliance (continued)

- **Investor control**
  - Although free to choose the investment manager (subject to insurance company approval), the policyowner may not have control over specific investment selections and there can be no “pre-arranged” plan with the investment manager
  - Rev. Rul. 2003-92
    - Non-insurance dedicated hedge fund is implied investor control
    - Insurance dedicated hedge funds are safe
    - Managed separate accounts not directly addressed; “facts and circumstances” test should continue to apply

- **Failure to comply**
  - Failure to comply with these rules results in loss of the tax benefits of life insurance
Investment Account Structures

• **Insurance Dedicated Funds**
  – Single Fund
  – Multi-Series Fund
  – With limited exception, must be available exclusively to insurance companies

• **Managed Separate Accounts**
  – Wholly discretionary
  – Greater potential for investor control
PPLI Clients

• Individual investors with large investment portfolios
  – Investments in highly-taxed asset classes such as hedge funds, actively managed portfolios, taxable bonds, commodities, etc.
  – Primary goal - improve portfolio’s overall tax efficiency
  – Secondary goals
    • Estate planning with death benefit purchase
    • Protection of policy from claims of future creditors (“asset protection”)

• Trustees seeking to optimize tax efficiency of trust assets
  – Exempt asset trusts (trusts outside investor’s estate)
  – Trusts established by foreign persons that benefit U.S. taxpayers
Investment Account Security

• Separate investment “sub-account(s)” are the account(s) in which insurance cash values are held and investments are fully protected from the insurance company’s creditors under U.S. state law (similar legislation exists in Bermuda, Cayman Islands, Bahamas, and Guernsey, etc.)

• Premium payments can and should be paid directly into carrier’s sub-account(s)

• Death benefit proceeds from reinsurance companies can be paid into and then out of sub-account(s) in the case of offshore policies
PPLI Economics

- **Cash Value**
  - Premiums paid less fees plus investment return
- **Death Benefit**
  - Cash Value plus Net Amount at Risk
- **Cash Surrender Value**
  - Cash Value less surrender charge (uncommon in PPLI)
- **Loanable Value**
  - Typically ~ 90% of Cash Value
# Taxable Investment vs. PPLI*

**Four Annual Investments of $2,500,000 – Non-MEC**  
**Male, Age 45, Preferred Non-Smoker**

<table>
<thead>
<tr>
<th>Year</th>
<th>Age</th>
<th>Deposit</th>
<th>Annual Return</th>
<th>Account Value</th>
<th>Internal Rate of Return</th>
<th>Account Value</th>
<th>Internal Rate of Return</th>
<th>Tax Cost</th>
<th>Subaccount Value</th>
<th>Internal Rate of Return</th>
<th>Death Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>45</td>
<td>$2,500,000</td>
<td>7.00%</td>
<td>$2,675,000</td>
<td>7.00%</td>
<td>$2,605,000</td>
<td>4.20%</td>
<td>2.80%</td>
<td>$2,604,845</td>
<td>4.19%</td>
<td>$54,696,143</td>
</tr>
<tr>
<td>2</td>
<td>46</td>
<td>2,500,000</td>
<td>7.00%</td>
<td>5,537,250</td>
<td>7.00%</td>
<td>5,319,410</td>
<td>4.20%</td>
<td>2.80%</td>
<td>5,371,561</td>
<td>4.88%</td>
<td>57,462,959</td>
</tr>
<tr>
<td>3</td>
<td>47</td>
<td>2,500,000</td>
<td>7.00%</td>
<td>8,599,868</td>
<td>7.00%</td>
<td>8,147,825</td>
<td>4.20%</td>
<td>2.80%</td>
<td>8,311,291</td>
<td>5.22%</td>
<td>60,402,589</td>
</tr>
<tr>
<td>4</td>
<td>48</td>
<td>2,500,000</td>
<td>7.00%</td>
<td>11,876,848</td>
<td>7.00%</td>
<td>11,095,034</td>
<td>4.20%</td>
<td>2.80%</td>
<td>11,440,581</td>
<td>5.46%</td>
<td>63,531,879</td>
</tr>
<tr>
<td>5</td>
<td>49</td>
<td>–</td>
<td>7.00%</td>
<td>12,708,227</td>
<td>7.00%</td>
<td>11,561,025</td>
<td>4.20%</td>
<td>2.80%</td>
<td>12,119,293</td>
<td>5.59%</td>
<td>63,531,879</td>
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<tr>
<td>10</td>
<td>54</td>
<td>–</td>
<td>7.00%</td>
<td>17,823,946</td>
<td>7.00%</td>
<td>14,201,524</td>
<td>4.20%</td>
<td>2.80%</td>
<td>16,331,334</td>
<td>5.91%</td>
<td>25,640,195</td>
</tr>
<tr>
<td>20</td>
<td>64</td>
<td>–</td>
<td>7.00%</td>
<td>35,062,399</td>
<td>7.00%</td>
<td>21,429,505</td>
<td>4.20%</td>
<td>2.80%</td>
<td>30,869,854</td>
<td>6.27%</td>
<td>37,660,978</td>
</tr>
<tr>
<td>30</td>
<td>74</td>
<td>–</td>
<td>7.00%</td>
<td>68,973,045</td>
<td>7.00%</td>
<td>32,336,226</td>
<td>4.20%</td>
<td>2.80%</td>
<td>59,061,824</td>
<td>6.42%</td>
<td>63,196,152</td>
</tr>
<tr>
<td>40</td>
<td>84</td>
<td>–</td>
<td>7.00%</td>
<td>135,680,420</td>
<td>7.00%</td>
<td>48,794,011</td>
<td>4.20%</td>
<td>2.80%</td>
<td>113,334,697</td>
<td>6.50%</td>
<td>119,001,431</td>
</tr>
</tbody>
</table>

*See next slide for Assumptions and Disclosures*
Assumptions and Disclosures

- Assumes a 7.00% return net of investment management fees in the PPLI separate account.
- Assumes a hypothetical combined state and federal income tax rate on taxable earnings of 40%.
- The policy is designed as a non-Modified Endowment Contract (non-MEC) under current tax law.
- Under current tax law, if the policy is fully surrendered, all investment gains in excess of the policy owner's basis are taxed to the policy owner as ordinary income in the year the policy is fully surrendered. Withdrawals or loans are tax-free to the policy owner.
- Assumes federal DAC taxes are charged against each premium deposit.
- These calculations make assumptions as to future investment returns, mortality costs, and administrative expenses that are not guaranteed. Actual results may be higher or lower. The contents of this report are provided strictly for informational purposes. It does not constitute an offer by Giordani, Swanger, Ripp & Phillips, LLP, or any other party to you or to any other person to acquire a life insurance policy.
# Typical Insurance Related Taxes and Fees

<table>
<thead>
<tr>
<th>Fee</th>
<th>Recipient</th>
<th>How Paid</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Domestic</strong></td>
</tr>
<tr>
<td>DAC Tax Charge</td>
<td>Insurance company</td>
<td>Assessed against each premium</td>
<td>1% - 1.5%</td>
</tr>
<tr>
<td>Premium Tax</td>
<td>Insurance company</td>
<td>Assessed against each premium</td>
<td>2%, on average</td>
</tr>
<tr>
<td>Mortality &amp; Expense (M&amp;E)</td>
<td>Insurance company and insurance advisor</td>
<td>Monthly assessment against cash value</td>
<td>Typically scaled by asset size and duration (i.e., 0.50% of cash value per year for first 10 years; 0.40% for second 10 years; 0.20% thereafter)</td>
</tr>
<tr>
<td>Cost of Insurance charge</td>
<td>Insurance company</td>
<td>Monthly assessment against cash value</td>
<td>Variable depending on net amount at risk, age, sex, and health of insured</td>
</tr>
</tbody>
</table>
| Compensation                 | Insurance advisor                | Outside the policy or from initial premium and/or cash value (part of M&E) | Front-end (if any) – 1% of premium or less  
Trail compensation – 0.10-0.50% of cash value per annum |

**Pricing Rule of Thumb:** The policy cash value’s internal rate of return (“IRR”) on investments should exceed the investor’s after-tax non-insurance equivalent in the first few policy years, and by the tenth to fifteenth policy year and beyond, the policy cash value’s IRR should be less than 125 basis points lower than the investment manager’s pre-tax return, net of fees.
Purchasing PPLI Internationally

- Premium tax savings *(no state premium tax and, in most cases, lower DAC tax CHARGE)*
- Superior asset protection
- Opportunity for “broker-less” transaction *(lower fees)*
- Foreign ownership structure required
- International underwriting and application required
- Sales, solicitation, or negotiation of international life insurance products in U.S. is prohibited
Uses of PPLI in Tax and Estate Planning

• Income tax protection of portfolio earnings
  – Individual, grantor trust, or single owner entity purchases policy

• Asset protection structure
  – Individual establishes foreign “asset protection” trust then trustee purchases policy as vehicle for trust’s liquid asset investments

• Transfer Tax Exempt Trust structure
  – Trustee of dynasty or similar exempt asset trust purchases policy as tax efficient vehicle for trust’s liquid asset investments

• FLP (or Family LLC) structure
  – Family limited partnership purchases policy as vehicle for partnership’s liquid asset investments
  – Income tax protection and leverage of discounted or potentially discountable assets’ earnings
Income Tax Protection

**Pros:**
- Simple and inexpensive
- Foreign company, if needed, can “check the box” and be disregarded for U.S. income tax purposes (Form 8832); minimal reporting (Form 8858 and FBAR)
- Easy access to cash value

**Cons:**
- Policy remains in estate for estate tax purposes
- Asset protection not as robust as trust ownership

**Administration:**
- Foreign company, if needed, requires offshore director or manager and offshore premium payment mechanism
- Entities need to follow corporate formalities (minutes, resolutions, etc.)
Asset Protection Trust ("APT")

Pros:
- Very robust asset protection
- Trust is looked through for income tax purposes (grantor trust)
- Simple reporting (Forms 3520 & 3520-A; FBAR)
- Easy access to cash value by Client
- Dovetails with Client’s estate plan

Cons:
- Policy remains in estate for estate tax purposes
- More expensive than company ownership (both up front and on-going)
- Ongoing trustee and protector fees

Administration:
- Needs foreign trustee and protector
- May need offshore bank account
Transfer Tax Exempt Trust

- **Pros:**
  - Assets already outside Client’s estate for estate tax purposes are used to fund PPLI (and then become income tax protected)
  - Easy access to cash value for trust beneficiaries
  - Simple and inexpensive to add foreign company, if offshore policy

- **Cons:**
  - Settlor does not have access to cash value

- **Administration:**
  - Follow corporate formalities (minutes, resolutions, etc.)
  - *If offshore policy:*
    - Need foreign company and director or manager
    - Need offshore premium payment mechanism
FLP or Family LLC

- **Pros:**
  - Use existing family entity
  - Leverages use of existing entity interest gifting plan
  - Simple and inexpensive to add foreign company, if offshore policy

- **Cons:**
  - Less robust asset protection than APT for Client’s retained interest in entity

- **Administration:**
  - Follow corporate formalities (minutes, resolutions, etc.)
  - *If offshore policy:*
    - Need foreign company and director or manager
    - Need offshore premium payment mechanism
Irrevocable Life Insurance Trust

**Pros:**
- Cash value and death benefit is outside Client’s estate for estate tax purposes
- Excellent asset protection because assets no longer belong to Client
- Easy access to cash value for beneficiaries
- Possible generation-skipping planning
- Can be a “grantor” trust so that any income is taxable to Client
- Simple and inexpensive to add foreign company, if offshore policy

**Cons:**
- Gift to trust is taxable so, to avoid gift tax, must use lifetime exclusion amount and/or annual exclusion gifts (however, see split-dollar discussion)
- Client does not have access to cash value, except via repayment of split-dollar loan, if applicable

**Administration:**
- Requires U.S. trustee
- Follow corporate formalities (minutes, resolutions, etc.)
  
  *If offshore policy:*
- Need foreign company and director or manager
- Need offshore premium payment mechanism

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Taxable gift or lifetime exclusion amount or loan

Settlor (Client)

U.S. Trustee

U.S. Trust ("ILIT")

Sets up and funds

Children are Beneficiaries (grandchildren too, if applicable)

Foreign Company (e.g., LLC) *if necessary*

PPLI
Offshore or Domestic Policy: Split-Dollar Loan Funding

• When is Split-Dollar loan funding appropriate?
  – When a Client desires to remove the PPLI policy from the estate AND
  – Does not have sufficient gift/estate exclusion to fund the policy OR
  – Does not want to use the lifetime exclusion OR
  – Wants a mechanism to return the premium plus interest to his balance sheet, gifting only the appreciation to future generations

• How does Split-Dollar loan funding work?
  – **Step 1:** Client lends PPLI premium to a trust that is outside his estate
  – **Step 2:** Client gets back a note from the trust; the interest rate is the long-term AFR; no payments are due until the death of the insured
  – **Step 3:** Client and Trust enter into a “Split-Dollar” Agreement that complies with IRS regulations
  – **Step 4:** Loan can be repaid from PPLI either before or at the death of the insured
Offshore or Domestic Policy: Split-Dollar Loan Funding

• What are the tax results of Split-Dollar funding?

  – *Income Tax*: because the client and the borrowing trust (a “grantor” trust) are the same taxpayer, there is no income or deduction for the loan interest

  – *Gift Tax*: there is no gift tax due; each year, the difference between the PPLI earnings rate and the split-dollar interest rate is a tax-free gift to the trust

  – *Estate Tax*: if the trust is structured properly, the PPLI will be outside the estate; however, the split-dollar note remains in the estate

  – *Generation-Skipping Tax*: assuming the initial gift (e.g. $10) to the trust received an allocation of GST exemption, the trust value (i.e. the PPLI policy value after repaying the split-dollar loan) will be exempt from GST
Irrevocable Life Insurance Trust
Purchase of PPLI with Borrowed Funds (Split-Dollar)

Parent or Grantor Trust
Created by Parent

creates trust

Irrevocable Trust f/b/o
Children and
Grandchildren
(grantor trust to parent)

note*

loan of premium

Foreign LLC
(if foreign policy)

PPLI Policy
(on the life of grantor
and/or grantor’s spouse)

Investments
(e.g., insurance dedicated funds)

*Follows guidelines of split-dollar regulations; long-term AFR (annual compounding) is 3.49% as of January 2014; term is life of insured