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Private Placement Life Insurance (PPLI) – The Triple Crown of Managing Wealth: Wealth Creation, Tax Efficiency and Asset Protection

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Private Placement Life Insurance (PPLI) is much more than an insurance policy. PPLI represents one of the most powerful vehicles available to the high net worth investor in the marketplace today.

PPLI enhances both wealth creation and wealth preservation. Wealth creation is the result of the tax-free growth of potentially high-performing alternative investments inside the insurance contract, and wealth preservation is a result of the death benefit paid from the insurance contract.

PPLI effectively augments an investor's wealth, creating long-term assets by providing the following benefits for these assets:

- Tax-deferral[1] of the investment portfolio's performance gains
- Tax-free[1] access to policy gains through loans and/or withdrawals for non modified endowment contracts ("MEC")
- Income tax-free death benefit
- Estate tax-free death benefit, provided the policy is properly owned in an irrevocable trust
- Asset protection from creditors (in many jurisdictions)
- Customized investments that have demonstrated some of the best opportunities to create wealth (based on historical information)
- Institutionally priced – very low initial and on-going insurance costs
- Well-capitalized and well-recognized U.S. and offshore insurance carriers with high quality credit ratings
- Separation of the investment portfolio from the insurance company's assets

PRIVATE PLACEMENT LIFE INSURANCE REPRESENTS ONE OF THE MOST POWERFUL VEHICLES AVAILABLE TO THE HIGH NET WORTH INVESTOR IN THE MARKETPLACE TODAY

PPLI's Role In An Investor's Portfolio

There are four primary PPLI applications that provide guidance for setting the investment goals:

1. **Wealth Creation**. PPLI contracts can offer an array of assets such as hedge funds and private equity that are unavailable through traditional insurance products.
   Key Goal: Help provide protection against inflation's erosive effects for current and future generations.
2. **Asset Protection**. PPLI, as a separate account product, can help protect the assets/investments held under the policy from creditors of the insurance company. There is also some individual protection available in certain jurisdictions through statutory exemption of life insurance cash values and death benefit proceeds.
   Key Goal: Provide protection from creditors and/or litigants arising from unforeseen, adverse events.
3. **Tax Management**. PPLI's protection of ordinary income and capital gains from taxation affords high net worth investors the ability to create tax efficiency within the policy. Such tax efficiency accelerates wealth creation as the tax savings are compounded on top of the investment portfolio's potential gains.[1]
   Key Goal: Achieve tax efficiency to drive accelerated wealth creation.
4. **Wealth Transfer**. By creating policies owned by downstream generations, PPLI provides a highly

efficient means to transfer wealth. Indeed, the longer a policy's horizon, the greater the wealth could accumulate. Depending on the legal structure, the wealth created inside the PPLI contract can also be accessed on behalf of the inter-generational beneficiaries through withdrawals and loans on a similarly tax-free basis, when the policy is structured as a non-MEC.

Key Goal: Establish a strong financial foundation for subsequent generations.

The actual application(s) employed on behalf of a high net worth investor or family is a customized process arising from the combined leadership of the investor's team of trust and estate attorneys, accountants, investment and insurance advisors.

Aligning PPLI with the Overall Portfolio

Various government and private sector studies have shown that approximately 70% of a high net worth investor's portfolio is devoted to supporting his/her working and retirement lifestyle needs, and 30% of the portfolio represents assets that are not targeted for any specific purpose. This latter asset pool offers a key resource for establishing the trust and estate plan. Moreover, as wealth increases, the greater this free-standing asset pool becomes relative to the total portfolio.

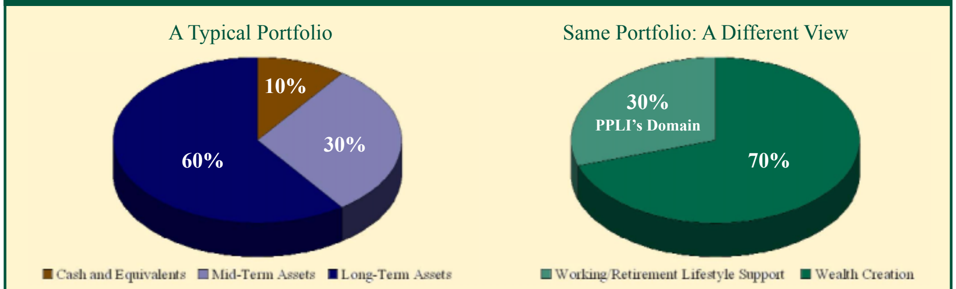
PPLI presents a simple question illustrated in Figure 1: If such long-term assets are not backing any particular lifestyle need, why subject them to taxes as well as to potential adverse situations?

The answer to this question resides in the tax management plan and the investor's investment policy document. Clearly, PPLI's tax efficiency can enhance the tax management plan.

However, what is missing from most PPLI implementations is the integration of a separate investment policy document that takes into consideration the investor's total portfolio. An important purpose of this document is to ensure that investments well suited to PPLI are effectively managed to meet the investor's various long-term needs.[2]

PPLI, structured in the most common form (a non-modified endowment contract), provides access to a significant portion of the policy cash values through withdrawals and very low cost loans. This access provides the comfort necessary for the investor to move forward and purchase the policy.

Figure 1.
Introduction of PPLI's Portfolio Role
Growing Long-Term Wealth vs. Lifestyle Support



Source: Spenser Trask Asset Management

Essentially, PPLI is best suited to hold many of the high-risk assets contained in the 30% wealth-creation slice from Figure 1 above, while the low-risk assets supporting the investor's lifestyle needs represent the remaining 70% of the portfolio.

PPLI is one of several tools at the disposal of the trust and estate planning team. Practically speaking, it is unrealistic to take all of the target portfolio's assets and immediately establish a PPLI policy of commensurate value. As well, these considerations must be part of the re-allocation process that funds the policy:

- Assets such as collectibles cannot be included in PPLI's portfolio due to legal and regulatory limitations.
- Assets such as closely-held or restricted stock under direct investor control are not permitted in a PPLI contract.
- Investments in limited partnerships cannot simply be "converted" to a PPLI portfolio. The IRS has mandated that any PPLI investment choice must only have assets that fund insurance policies (i.e., "insurance dedicated").

Nonetheless, the investor and his/her advisory team should equally recognize that the tax-free compounding of alternative investments in a PPLI policy suggests its use for PPLI-eligible investments, primarily hedge funds and private equity. Any investment returns and income tax savings derived from the policy's portfolio will generate enhanced wealth and make the policy's proportion of the investor's total net worth larger over time.

Of available liquid assets to fund PPLI's premium, past experience says that 10%-40% of the investor's total portfolio will be held in PPLI – the wealthier the investor, the greater the PPLI percent of the investor's total portfolio.

PPLI Portfolio Construction Principles

While historically PPLI was often executed as a stand-alone initiative, advisors now integrate PPLI within the investor's overall portfolio. PPLI becomes a component of the overall investment plan so that PPLI's underlying portfolio can best leverage the policy's unique benefits.

Principle: Use PPLI to support the investor's long-term financial needs

In this context, the overall portfolio is reoriented to match asset classes to a needs-based approach. Figure 2 illustrates that asset and need horizons must be matched to adequately support the investor's assorted portfolio objectives.

The key theme rests on the importance of identifying and targeting investments appropriately suited to the investor's differing needs. In an extreme, misaligned sense, an art collection is no more expected to support the investor's day-to-day cash needs as interest income is destined to create long-term wealth.

PPLI is best suited for the long-term needs an investor possesses. These needs are often encapsulated in the trust and estate plan that, by design, references multiple generations. This

extended time horizon moves PPLI portfolio construction to a different set of objectives than what are used to guide the investor's non-PPLI portfolio (i.e., the portfolio that incorporates short- to mid-term financial needs and not the trust and estate plan's legacy needs).

Principle: Select asset classes that have historically produced the greatest return potential[3]

The most prominent difference from the investment policy of the overall portfolio to the specific policy guiding PPLI's portfolio construction is the vastly reduced need to consider return volatility (the amount of return fluctuation period to period). This long-time horizon sets the stage for one of PPLI's greatest privileges: to largely ignore return volatility and focus on wealth-creating (e.g., high return) investments.

High return potential is the constant driving the selection of PPLI's portfolio investments. Salomon Smith Barney developed Figure 3 that clearly shows the progression in added return that specific investment strategies take as volatility, or risk, is increased. In other words, the greater the risk, the greater the return. PPLI's portfolio, then, should be considered to be the main repository for hedge funds, private equity, and venture capital.

Principle: Allocate to asset classes that most effectively utilize PPLI's structure

Without PPLI, the value of a portfolio of high-return investments would be significantly diminished by the income tax burden that typically results from such investments. The marriage of a very long-term investment horizon with the policy's tax efficiency establishes a unique foundation upon which to build the portfolio.

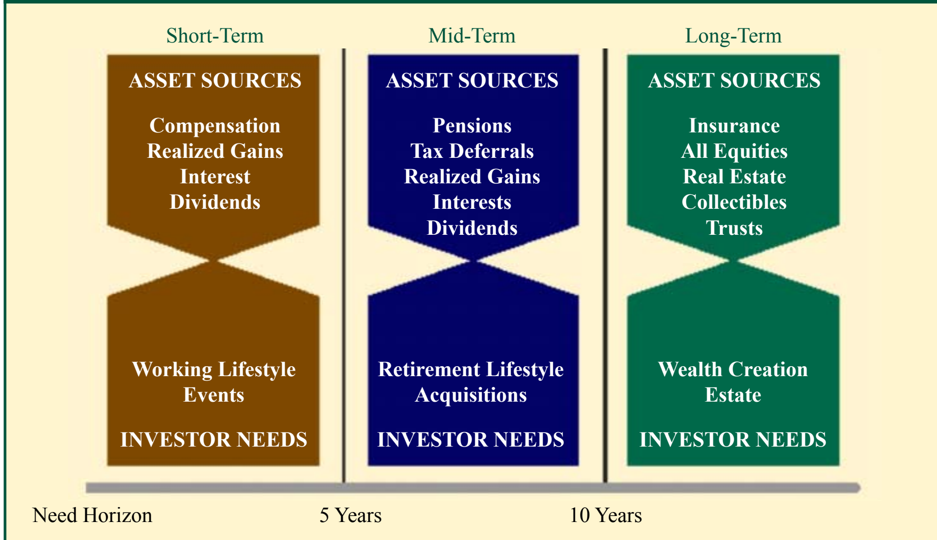
Table 1 illustrates how the goals supporting PPLI's four main applications align with the investment characteristics needed to deliver on the goals.

Figure 4 ranks the asset classes in a high net worth investor's total portfolio according to performance over the 10-year period ending in 2002. This 10-year period serves as a solid time comparison because it covers a wide range of positive and adverse geopolitical, economic and financial circumstances. For purposes of PPLI portfolio construction, hedge funds and venture capital command attention.

On the surface, it may be surprising – if not counter-intuitive – that venture capital, with its relatively tax-efficient 15% capital gains rate, should be considered for a PPLI portfolio. However, when one considers that venture capital has historically produced pre-tax rates almost 66% greater than hedge funds (Figure 4), the tax savings is substantial even at the much lower rate. (Note: When adjusting hedge funds and venture capital for PPLI's tax-free structure and the policy's associated fees, venture capital's historical return through PPLI is 71% greater than hedge funds' historical return.)

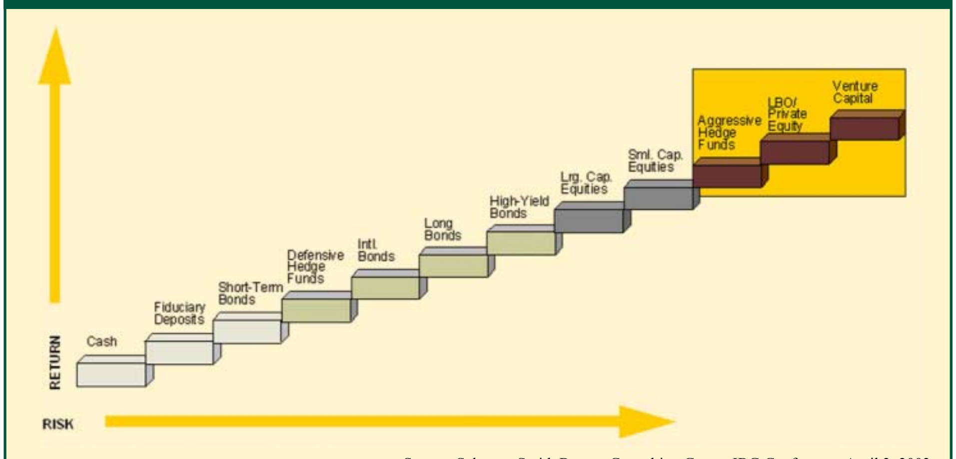
Using an actual example (Figure 5) of a California PPLI investor, it is clear how much

Figure 2.
Introduction: Portfolio Management
Assets Must Be Allocated to Need Horizons



Source: Spenser Trask Asset Management

Figure 3.
PPLI Investments Concentrate on Return
The Risk-Return Staircase



Source: Salomon Smith Barney Consulting Group, IBG Conference, April 3, 2003

venture capital benefits from a PPLI policy. Surprisingly, the benefit is much greater than with hedge funds.

The focus thus far is on asset class allocations, not investment manager allocations. While a favored hedge fund or venture capital manager may not offer an insurance-dedicated fund or tax-compliant product, "best of breed" substitutes previously approved by insurance companies are available, and the number of alternatives is growing. (Note: The ability to add other managers is always an option. If the investor chooses, the non-compliant but favored manager simply stays on the taxable-side of the investor's overall portfolio. Alternatively, the investor can convince the favored manager to create an insurance-dedicated fund; or the fund itself simply becomes a part of an existing insurance-dedicated fund.)

That said, a successful investment with an alternative investment manager is highly tied to the manager's ability to generate alpha (i.e., top-end security selection skill). Dramatically, all other risk factors pale in comparison to the importance of identifying and monitoring the best portfolio managers. Due diligence rises to be a critical success factor for all sides of the PPLI marketplace - (1) the investor, (2) the investor's advisory, tax and legal team, and (3) the insurance company.

In this context, due diligence involves three key aspects:

1. **Style Longevity** – the length of time the investment firm has actually managed outside assets in the investment style under consideration.
2. **Reputation** – the ability of the firm to demonstrate success across market cycles.
3. **Resources** – the capital base to weather market environments that dramatically reduce revenues.

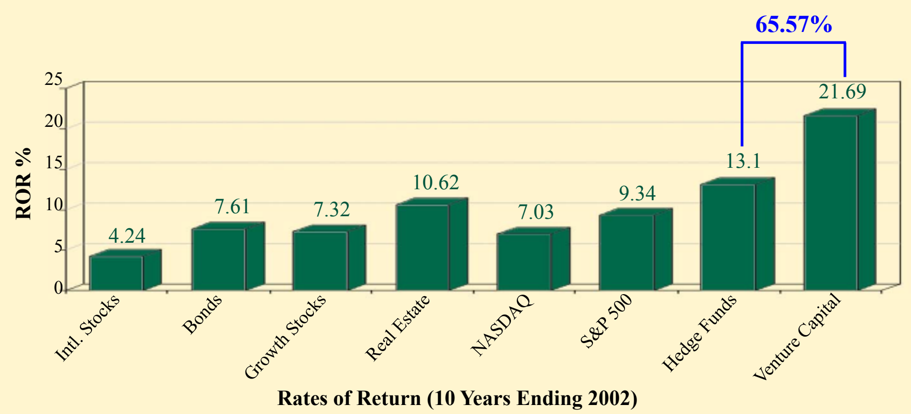
Fortunately for PPLI investors, the due diligence burden falls on the insurance company offering the policy. While there are differences from one insurance company to the next in terms of the due diligence effort and process, any investment firm that intends to offer a PPLI investment option must be prepared to get into very detailed disclosure.

Many insurance companies are known to be methodical and cautious. For PPLI investors who are entering into a relationship that may

Table 1.
Matching PPLI's Goals to Investment Characteristics

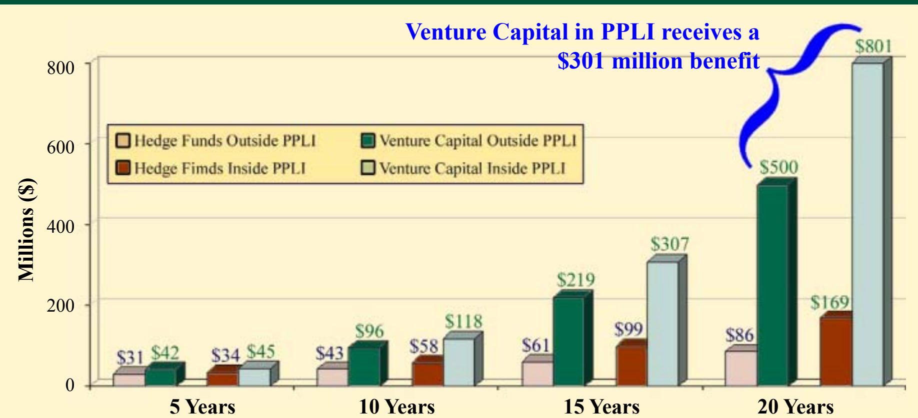
PPLI Goal	Ideal Investment Characteristic	Explanation
Wealth Creation	High Return	Wealth Creation arises from compounding the tax savings of high-returning assets.
Asset Protection	High Return	Assets with the highest historical return produce the largest long-term value and become the most attractive to creditors and/or litigants.
Tax Management	Large Tax Exposure	Intolerable tax exposure results from: • Ordinary income taxed at the highest rates and • The realization of large investment gains.
Wealth Transfer	High Return	Intergenerational asset transfers elongate the investment horizon 2-3 times, thus requiring the investments to counteract inflationary erosion.

Figure 4.
PPLI Investors Freely Pursue Return
Venture Capital Is The Supreme Wealth Creator



Source: www.investworks.com, Spencer Trask Asset Management, Thomson Financial, HFR, NAREIT

Figure 5.
PPLI Dollar Impact



Example: California individual incurring a total ordinary tax rate of 41.05% (i.e., federal, state and local) and a total capital gains of 22.91%. $5 million annual premium installments for five years.

Source: Winged Keel Group

last decades, these traits can give comfort knowing that such due diligence takes place.

Core/Satellite Investment Structure

A well-grounded portfolio-building strategy is to establish a core investment position representing the broad market that the portfolio seeks to mimic. A well-designed PPLI portfolio holds the core position in a diversified hedge fund-of-funds vehicle. (Note: The strategy diversity needs both strategy breadth as well as investment manager depth in each strategy.) The core's role is to serve the portfolio's wealth preservation objective.

Around this core, the advisor will then allocate to specific high growth strategies, or satellites, that complement the hedge fund core. The primary complementing characteristics will be low correlation to the core while exhibiting high historical returns. Also, in order for a satellite investment to achieve its intended purpose for the portfolio, it must be of sufficient size to have an impact but not too large that it causes a disruption in meeting the portfolio's long-term objectives. Sound practice recommends deploying satellites ranging in size from 10% to 25% of the PPLI portfolio. Here, the satellites target the wealth creation objective. The core/satellite structure is illustrated in Figure 6.

Figure 6. Satellite Investments Seek Higher Returns

PPLI's Core/Satellite Portfolio Structure

Venture capital is a case in point. Venture capital has far exceeded the performance of any other asset class (see Figure 4) while exhibiting some of the lowest correlations to different hedge fund strategies. For the 10-year period ending in 2002, venture capital had the second lowest correlation to non-defensive hedge funds; the lowest correlation strategy was Short Selling.[3] Thus, the Venture Capital satellite carries the high-impact, wealth-creating role for the PPLI portfolio.

One final note, PPLI's portfolio, as mentioned previously, should be built within the context of the investor's overall portfolio. Table 2 calculates how an allocation to a PPLI satellite investment relates to the investor's overall portfolio allocation. For example, if an investor chooses to invest 30% of his or her assets into PPLI and the satellite allocation is 25% of the total PPLI allocation, the investor still only has 7.5% of their total portfolio allocated to "wealth creation" strategies. This is reflected by the last line in Table 2. The investor and his or her advisory team can rest assured that a satellite allocation within a PPLI policy will not significantly skew the Total Portfolio's structure.

Other satellite allocations involve the more aggressive hedge fund-of-fund strategies that employ significant leverage such as Macro, Managed Futures and Long/Short Equity. Also, an investor's favored, single hedge fund strategy manager that has an insurance-dedicated fund approved by the insurance carrier also is a satellite candidate.

As the PPLI market matures and real estate, LBO, and other alternative investment managers engineer funds for the policies, these asset classes will expand the satellite manager choices.

Execution Practices

The PPLI policy must be fully compliant with state and IRS regulations. Lacking such compliance can cause the entire portfolio to be taxable. The key compliance areas are as follows:

- Insurance-dedicated investment options
- Appropriate diversification with a minimum of five approved investments
- Avoiding the Investor Control Doctrine
- Monthly valuations
- Quarterly reporting
- Annual reporting

Table 2. Total Portfolio Impact of PPLI Satellites

PPLI Satellite Allocation	PPLI % of Total Portfolio	Satellite to the Total Portfolio
10% Satellite	10.0%	1.0%
10% Satellite	20.0%	2.0%
10% Satellite	30.0%	3.0%
25% Satellite	10.0%	2.5%
25% Satellite	20.0%	5.0%
25% Satellite	30.0%	7.5%

- Monitoring investments according to the investment manager's stated objectives and processes
- Ongoing review of newly approved investment managers
- Legal review of all agreements and documents
- Maintaining strong relationships with the insurance carriers
- On-going interaction with legislative and regulatory bodies

Once a determination has been made that a private placement life insurance structure is appropriate from a suitability and investment perspective, the prospective policy owner must work with a qualified insurance firm to arrange the insurance contract. There are five basic steps to the process.

1. **Selection of a Qualified Firm**. Due to the specialized aspects of this type of policy, it is important to work with a firm that has expertise in the private placement life insurance space. Such a firm should be knowledgeable and experienced with the small group of carriers offering competitively priced and tax-compliant products in this market segment. The firm needs to have the design capability to model a variety of alternative policy structures, funding strategies, investment return assumptions, policy expenses and insurance amounts. In addition to design capability, the firm needs the underwriting capability and experience to acquire the large amounts of coverage required to accommodate the desired level of investment (premium). Finally, the firm needs to have the service and administrative capacity to deal with the policyowner's

changing circumstances and reporting needs.

2. **Plan Design Once**. a firm has been chosen, the policyowner needs to review the policy design including all expense elements. It is essential that all of the insurance-related costs including premium loads, state and federal premium taxes, carrier mortality and expense (M&E) charges, mortality costs and administrative fees be disclosed. It is important to know the guaranteed and non-guaranteed elements of the proposed policy. In concert with the level of premium commitment, policy design must be tested for compliance with modified endowment contract (MEC) rules and insurance risk measurement requirements (IRC sec. 7702). This can be done in generic form before a carrier is chosen.
3. **Carrier Selection**. The selection of a carrier or carriers to insure the risk is the final element of initial policy design before submitting a case to underwriting for risk assessment and classification. Among the aspects to be considered are: contractual provisions, carrier credit ratings, number of years in the private placement life insurance business specifically, marketshare as measured by assets under management, tax compliant funds available for allocation within the policy, capability of adding new funds, policy holder statements and other administrative services, product pricing and guarantees, review of private placement memorandum language, and underwriting and reinsurance capacity.
4. **Underwriting and Risk Classification**. Medical exam results and medical history for the proposed insured will be submitted to the proposed carrier or carriers. In addition, confidential financial data will be submitted for review in order to justify the level of risk proposed. It may be important to review various carrier offers from a risk classification view and provide financial measurement of any ratings or extra premiums required before the final issuing carrier or carriers are selected.
5. **Policy Issuance, Delivery, Service and Administration**. The final step in the insurance acquisition process is a verification that the offered contract complies with the proposed design, delivery to the policy owner and funding of the coverage by investing the premium. After the policy has been delivered, administrative services include: (1) performance reporting, (2) re-projections of policy performance, (3) facilitation of policy loans or withdrawals and (4) beneficiary management should be provided by the firm. ■

Notes

1. Under current tax law, if the policy lapses or is surrendered, all investment gains in excess of the policyowner's basis are taxed to the policyowner as ordinary income in the year the policy lapses or is surrendered.
2. Please make inquiries to Kirk Loury (email: KLoury@spencertrask.com) for a copy of a draft PPLI Investment Policy document.
3. Source: www.Investworks.com

About the Authors

Kirk Loury is the President and Chief Investment Officer for Spencer Trask Asset Management (STAM), a wholly owned registered investment advisor of Spencer Trask & Co. (Spencer Trask is a venture capital firm catering to the private equity needs of high net worth individuals and investment advisors.) Serving as a champion for Private Placement Life Insurance (PPLI), Mr. Loury has taken on a broad industry role as an educator and portfolio advisor.

With over 30 years of professional experience, **Campbell T. Gerrish** is a principal in Winged Keel IDI with offices in New York and Austin, Texas. Campbell is a recognized leader in the financial services industry today and is a past President of the Association for Advanced Life Underwriting, the leading life insurance industry organization located in Washington, D.C.

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