

Keeping It All

Using Private Placement Life Insurance To Achieve Tax Free Investment Returns

*By David Neufeld and Grant Markuson,
tax attorneys with Markuson & Neufeld, LLC*



Few financial choices are more critical than protecting an investment portfolio from taxes. One of the most powerful but little known and under-used tools to achieve this is a private placement life insurance policy. By placing an investment portfolio within this life insurance vehicle, investors can convert an otherwise taxable portfolio into one in which no income or capital gains taxes accrue, ever.

Private placement life insurance can be especially relevant to angel investors who have a wide range of investments — including private equity — that have the potential to produce sizable capital gains. As a service to our readers,

Angel Investor asked David Neufeld and Grant Markuson, tax attorneys at Markuson & Neufeld, to introduce our readers to this important investment vehicle.

[What is Private Placement Life Insurance?](#)

Private placement life insurance ("PPLI") is an insurance product that can achieve income tax savings and estate tax savings by marrying the PPLI policy to an array of tax planning techniques.

As a life insurance policy, PPLI has the potential to:

- Enable approximately 95 to 98% of the premium to remain as investable assets;
- Allow the capital gains, dividends and interest to be received income tax free; and
- Allow the cash value to be borrowed tax free when cash is needed.

No other life insurance product, or any investment product for that matter, can provide all of these potential benefits.

When an individual purchases a PPLI policy, the insurance company places the cash in a segregated account allocated only to the PPLI policy. This segregated account is insulated from the creditors of the insurance company, and reflects only the investment results of the assets in that account.

Furthermore, the investments in the segregated account are individual to a policy owner. This means that the portfolio can be customized,

How Much Can Be Saved Using PPLI?

Consider an individual who wants to place \$1,000,000 of investments into a private equity portfolio held underneath a life insurance policy. Let's assume that this portfolio generates a 25% pre-tax rate of return, with an average annual after-tax rate of return of 15% (considering a turnover of the investments). We will further assume that the average annual administrative and insurance costs of the PPLI policy are 1% of the account value.

Without the use of the PPLI, this individual's account would grow on average by 15% a year, after taxes, and assuming all assumptions are constant, the account would increase to \$4,045,558 in ten years.

By utilizing PPLI, the account would be able to invest in exactly the same investments, but the compound rate of return would be 24% (25% gross minus 1% for administrative costs). In ten years the PPLI account would be worth \$8,594,426, all things being equal.

By avoiding the ongoing annual taxes, the account has more than doubled. Assuming the same assumptions over a 20-year period, the account would almost quadruple in value. The investment was the same, but ongoing taxes were eliminated. Ultimately, these taxes may never be paid.

and can contain virtually any investable asset selected by the policy's owner, including, but not limited to, publicly traded equities, private equities, bonds, and hedge funds. Due to the structure of PPLI, the portfolio can compound tax free.

The amount of pure insurance purchased in this manner is surprisingly small and inexpensive in light of the funds that may be placed into the policy. The insurance company provides insurance in an amount that is, at a minimum, prescribed by the Internal Revenue Code, usually at a cost

that is less than one percent of the annual cash value. Most companies offering PPLI make it available directly to the customer without insurance agents or brokers, thereby avoiding the commissions that often unnecessarily run up the costs of insurance. When compared to the tax savings, the costs often can be recovered within the first year.

How PPLI Works

As with any life insurance policy, the policy owner initiates coverage by completing an application and the individual to be insured undergoes a medical examination. Once the application and the medical underwriting have been completed, the cost of insurance and, by extension, the premium amount, will be set.

At this point, the policy owner will instruct the insurance company with regard to his or her broad investment objectives. The owner can then choose among the then-approved list of independent investment advisors. Please note that investment advisors can be placed on this list subject to a review by the insurance company.

The client can fund the policy by remitting funds to the insurance company, which will then forward these funds, less the cost of the policy, to the investment advisor. The investment advisor will invest the funds along the lines set forth by the policy owner. Certain restrictions may apply depending on the rules of the jurisdiction governing the policy. The investment advisor will also monitor the investments and, along with actuaries, ensure that several tests are met that are prescribed by the IRS.

Using PPLI as a Component of an Estate and Income Tax Plan

Standing alone, PPLI offers powerful income tax planning opportunities. The gains and income earned on the investments forming the underlying funding of the policy do not incur federal or state income tax. Equally important, this tax saving is permanent, not simply a deferral to some future date. Once the insured dies, the insurance proceeds — reflecting the then-current value of the investments plus the insurance component — should be received by the beneficiaries income tax free.

The policy does not only benefit the beneficiaries upon the death of the insured; it also can benefit the policy owner during his or her life, by permitting loans of the cash value without triggering any income tax on the realized gain. Interest payments simply go back into the policy value.

However, a standalone PPLI may create gift tax or estate tax consequences, triggered by the funding, the policy loans or other aspects of the transaction. Proper structuring of ownership and ancillary transactions, such as trust or partnership ownership, can help to avoid or minimize these taxes, as well.

Domestic and Offshore Variations

Many investors who are aware of PPLI have heard of it in the context of offshore life insurance. It is important to note that these policies are offered by AAA-rated companies both within the U.S. and without. While beyond the scope of this article, the choice of offshore or domestic policies depends on many variables relating to costs, investment flexibility, and rules governing funding and payout, among other things. Domestic policies are best in some instances, while offshore policies are best for others. This is a choice to be made by policy owners and their legal advisors. To help ensure that a PPLI policy achieves maximum efficiency, policy owners would be prudent to seek the advice of a sophisticated tax planner.

Whatever the investment philosophy, PPLI can help a policy holder to avoid or minimize taxes on a traditionally taxable portfolio, without altering the investment itself. 💡