PRIVATE PLACEMENT LIFE INSURANCE
ENHANCING TAX EFFICIENCY OF INVESTABLE ASSETS

OVERVIEW

With the likelihood of rising income taxes, families with generational wealth comprised of investable assets are seeking efficient techniques to reduce ongoing income taxes with respect to the earnings generated by such assets. Recent tax law changes have boosted the opportunity to use private placement life insurance (PPLI) to locate investment assets in a tax-free bucket. Under IRC Section 7702, a PPLI policy will be treated as a "life insurance contract" for income taxes if it satisfies a cash value accumulation test or the guideline premium test and cash value corridor test. The December 2020 COVID Relief Bill, signed into law at the end of last year, reduced the interest rate assumptions used to calculate the two tests referenced above effective January 1, 2021. The result is an increase in the premium deposit capacity into a PPLI policy, which means a higher amount of cash can be used to fund a policy relative to its required death benefit. Given that the required death benefit relative to cash value has decreased under the new guidelines, a policy placed into service after January 1, 2021, likely has less mortality charges (assuming other factors are the same) than a policy dated before the new law.

This article reviews how PPLI works as a tax-efficient investment for individuals or trusts that already own existing life insurance policies and/or for those looking to purchase new policies to relocate investment dollars into a tax-favored environment.

Three Primary Investment Buckets *(Taxable, Tax-Deferred, Tax-Free)*

All investments are held in three primary tax buckets as shown in the table below:

Taxable Bucket	Tax-Deferred Bucket	Tax-Free Bucket
Managed Portfolio/Brokerage Account	Deferred Annuities, 401K, 403(b), 457 Plan, Qualified Employer Plan, Pension, Traditional IRA, Simple Plan, SEP-IRA, Keogh, 529 College Savings Plan, Health Savings Account	Life Insurance and Roth IRAs or Roth 401K (subject to certain restrictions)
Closely Held Business, Immediate Annuities, Stocks, Taxable and Tax-Exempt Bonds, Mutual Funds, Exchange Traded Funds, Hedge Funds, Commodities, Private Real Estate, Real Estate Investment Trusts (REITs), Private Equity, Options & Derivatives	Stocks, Taxable Bonds, Mutual Funds, Exchange Traded Funds, Hedge Funds, Private Equity Funds, Commodities, Real Estate Investment Trusts (REITs) and Private Real Estate subject to certain restrictions	Stocks, Taxable Bonds, Mutual Funds, Exchange Traded Funds, Hedge Funds, Private Equity Funds, Commodities, Real Estate Investment Trusts (REITs) subject to certain restrictions

Copyright © 2021 Colony. All Rights Reserved.

It is common for individuals to have investments in taxable investment accounts and tax-deferred vehicles such as 401(k) accounts and IRA accounts. Some may have taken advantage of Roth 401(k) accounts (when available) or converted traditional IRA accounts into Roth IRAs to place them in a tax-free bucket, however additional contributions are limited by the tax laws which restrict the ability to increase the value of these accounts in a significant way.

UNDERSTANDING PRIVATE PLACEMENT LIFE INSURANCE

Most individuals have some form of life insurance – term insurance or permanent insurance. All life insurance policies are required to meet certain parameters for a contract to qualify as a life insurance policy for income tax purposes. Life insurance proceeds are generally not taxable to the beneficiaries and typically permanent policies are purchased as wealth replacement for estate taxes projected to be owed upon the death of the insured. Term insurance lasts for a specified period (e.g., 10 years, 20 years) and then the policy expires. Term insurance is usually purchased to provide cash to family members in the case of an untimely death of the insured or as part of a buy-sell agreement with closely-held businesses. Certain term policies can be converted to permanent policies at a specific date noted in the life insurance contract. Permanent policies, including PPLI policies, typically are structured to terminate upon the death of the insured so that the death benefit will be paid to the beneficiaries. All life insurance policies enjoy three primary tax advantages compared to taxable managed portfolios:

- Death benefits payable with respect to a life insurance policy are generally not subject to income taxes (certain exceptions apply)
- Cash value build-up inside a life insurance policy is not subject to income taxes
- The cash surrender value of a life insurance policy may be extracted during the life of the insured without negative income tax consequences if certain conditions are satisfied

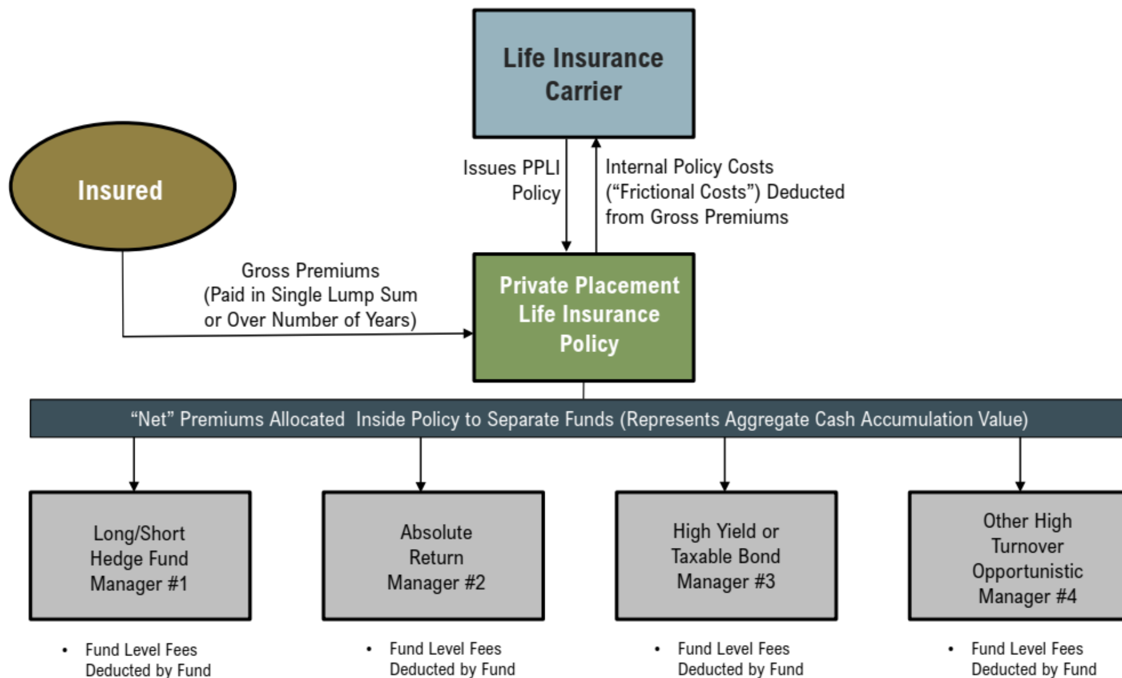
PPLI is distinguished in that it can be used to “warehouse” earnings from taxable investments inside a life insurance “wrapper” to defer and potentially eliminate income taxes on the earnings. The decision to purchase PPLI could be considered an asset location decision versus an investment selection decision if similar investment options are offered both inside and outside the life insurance policy wrapper. The premiums invested in the PPLI policy, after deducting certain contract expenses, are held in an investment account in addition to the life insurance contract. By paying premiums into the PPLI policy in excess of the cost of insurance and mortality expenses, the assets are located in a tax-free bucket.

So why is the taxation of investments particularly important now? President Biden has stated his plan to raise income taxes specifically targeted toward high net worth individuals with legislation expected later in 2021. Families are utilizing PPLI as a tax-efficient vehicle to hold investable assets that are susceptible to generating income taxed at the highest ordinary income tax rates. For example, some hedge funds have high turnover within the portfolio and pass through income to investors at ordinary or short-term capital gain rates. Similarly, a taxable bond portfolio or high-yield debt portfolio earns interest income, which is taxed at the ordinary income tax rate. Moving taxable assets into a tax-free bucket enhances the return on these investments for individuals and their families.

Limits on Amount of Premium

The amount of premium an individual or trust can invest in a PPLI policy depends on the age of the insured and the mortality risk that the carrier can assume (including the risk assumed by their reinsurers). The shorter the insured person’s life expectancy, the higher the amount of premium that can be paid into the policy. Alternatively, the longer the insured person’s life expectancy, the lower the amount of premium that can be paid into the policy. The maximum amount of premium allowed to be paid will be calculated by the PPLI carrier.

Copyright © 2021 Colony. All Rights Reserved.



Note: Sample allocation for illustrative purposes only. Actual asset allocation to be consistent with client's risk profile.

Advantages

Lifetime Income Tax Benefits

The cash value build-up of PPLI is not subject to income taxes. As such, PPLI is most advantageous when used as a tax-efficient vehicle for high turnover assets that are susceptible to generating short-term capital gains and investment income taxed at ordinary income tax rates.

Cost Effective Structure

The hallmarks of PPLI, as distinguished from higher priced retail insurance and annuity products, are lower relative expenses. PPLI carriers utilize institutionally priced products reserved for accredited investors and qualified purchasers. Internal sales and surrender charge loads are minimized and external sales fees are negotiable. Insurance company annual expense charges are fully disclosed and "unbundled." The fund level investment fees are standard fees, generally charged at the same rates or lower rates than outside the life insurance wrapper.

Asset Protection

Life insurance cash value build-up is exempt from claims of creditors in most states. When properly structured, assets in separate accounts are segregated from the claims of insurance company general account creditors.

Flexible Liquidity Options

Loans can be taken during lifetime up to the cash value and are subject to interest charges.

Copyright © 2021 Colony. All Rights Reserved.

Disadvantages

Limited Investment Options with Certain Carriers

Underlying investment options within a PPLI "wrapper" may be more limited than the universe of investment fund options outside the PPLI structure. However, in certain platforms, the investment account owner may request that the company add a fund manager, allowing increased investment flexibility. Colony is an approved separate account manager with the largest PPLI carrier in North America. Interested investors are not limited to a standard list of investment options common to retail life insurance products. Based on our arrangement with this carrier, Colony is able to utilize what it believes are best-in-class separate account money managers and alternative funds even if those managers or funds do not have a relationship with the carrier.

Potential Increase in Carrier Costs

Depending on the terms of the policy, the life insurance carrier could unilaterally increase the administrative costs applied to the policy.

Consequences of Surrender or Termination

If the owner surrenders or terminates the PPLI policy (as opposed to borrowing against the cash value), the owner could owe income taxes at the highest federal and state ordinary income tax rates on the inherent gain in the policy. The gain is calculated based on the difference between the policy's cash value over the premiums paid into the policy.

Tax Law Changes

Congress could enact legislation that removes the favorable tax advantages of life insurance. Based upon history, it is likely certain items would be grandfathered.

Solvency of Carrier

Although the cash value build-up is not subject to the claims of the carrier's creditors, the solvency of the carrier is nevertheless important to consider in terms of the carrier's ability to satisfy all contractual death benefit claims.

Key Decisions in Structuring

Ownership of PPLI Policy

For the majority of high net worth families, their advisors have recommended owning life insurance policies in irrevocable life insurance trusts (ILITs). These trusts may be taxable in the estate of the beneficiaries. Alternatively, the policies may be in generation skipping trusts (GST trusts), which escape estate taxation as long as the applicable state law where the trust was formed allows. If existing whole life or universal life policies are in place, certain policies may be used as an underlying contract for the PPLI policy. The PPLI provider will evaluate the policies and determine if this is possible.

Choosing the PPLI Carrier

Evaluating the costs charged by the PPLI carrier is of tantamount importance. Individuals and families should engage experienced advisors to work with the individual and family to minimize costs.

Copyright © 2021 Colony. All Rights Reserved.

SUMMARY

The recent tax law changes at the end of 2020 increase the amount of premium that can be invested in a tax-free environment utilizing PPLI. The decision to purchase PPLI requires analysis of what investment managers or investment options are available on the carrier's platform. The individual and/or family will also have to evaluate the source of funds available to pay the premium(s) and the potential tax consequences of liquidating investments to pay the premiums. Investing in PPLI can be an effective and tax-efficient tool for high net worth individuals and families who have wealth transfer goals for future generations of beneficiaries, typically family members.

* * *

Disclaimer

This material is furnished on a confidential basis to the recipient for informational purposes only and does not constitute investment, legal or tax advice and should not be used as a substitute for the advice of a professional legal or tax advisor. This presentation does not constitute an offer to sell, or a solicitation of an offer to buy, any interest in any investment vehicle, and should not be relied on as such. Targets, ranges and expectations set forth in this presentation are approximations; actual results may differ. Colony Family Offices does not accept any responsibility or liability arising from the use of this material. No representation or warranty, express or implied, is being given or made that the information presented herein is accurate, current or complete, and such information is at all times subject to change without notice. This presentation may not be copied, reproduced or distributed without prior written consent of Colony Family Offices.

By accepting this presentation, you acknowledge that all of the information contained in this presentation shall be kept strictly confidential by you. This information is limited in scope and is not intended to provide an exhaustive analysis. Colony Family Offices and its directors, officers, agents and employees are not permitted to render tax or legal advice. Please consult with your tax and legal advisors prior to entering into or implementing any financial transactions. Any tax related material contained within this communication is subject to the following disclaimer required pursuant to IRS Circular 230: Any tax advice contained in this written communication is not intended to be used, and cannot be used, for purposes of (i) avoiding penalties imposed under the United States Internal Revenue Code or (ii) promoting, marketing or recommending to another person any tax-related matter.

Colony Family Offices is a registered investment advisor. More information about the firm, including its investment strategies and objectives, can be found in our ADV Part 2, which is available, without charge, upon request. Our Form ADV contains information regarding our Firm's business practices and the backgrounds of our key personnel. Colony Trust Company is a North Carolina state chartered non-depository trust company and is regulated by the North Carolina Office of the Commissioner of Banks. CFO-21-19. CTC-21-11.

Copyright © 2021 Colony. All Rights Reserved.