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Private Placement Life Insurance and RIAs

How advisors can leverage this useful tool to deliver benefits to ultra-high-net-worth families.

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Ultra-high-net-worth families and individuals are increasingly turning to independent financial advisors or multifamily offices, most of whom are structured as registered investment advisors, for financial advice. A good RIA can bring simplicity to the complexity of the financial affairs of these families.

In recent years, a theme that has emerged in the planning world centers on how income taxes affect the net after-tax returns of an investment portfolio for a U.S. taxable investor. Asset location, the practice of owning more tax-inefficient assets in tax-exempt vehicles such as 401(k)s and IRAs, and other tax strategies can create some efficiencies. However, for most ultra-high-net-worth U.S. investors, there remains a heavy tax burden on a significant portion of their investment portfolios. With increased frequency, RIAs have begun to explore and utilize Private Placement Life Insurance (PPLI) to enhance the net after-tax returns of certain segments of their clients' investment portfolios. Today, in fact, many leading RIAs and wealth advisors count PPLI as an important tool in their repertoire of solutions for clients.

Before we delve into how RIAs advise on the investments within PPLI, a brief overview on PPLI will provide helpful context. PPLI is an institutionally priced life insurance product. In a PPLI policy (just like any variable universal life policy), premium dollars, or deposits, grow without any current period income tax. At the death of the insured, the insurer pays the policy beneficiary the insurance benefit, which is not subject to income taxes or capital gains taxes, and comprises two components: 1) the account value, which is made up of premiums deposited plus earnings less insurance policy fees; and 2) the life insurance risk component over and above the account value.

In essence, policyowners of PPLI are trading the costs of income taxes for the costs of the insurance policy, and generally speaking the cost of insurance is significantly lower than the annual tax liability. PPLI often offers lower fees and greater transparency than traditional insurance products. Like other insurance policies, when structured as a Non-Modified Endowment Contract ("Non-MEC"), PPLI policies enable the policyowner to access 80% or more of the policy's account value income tax-free (via withdrawals of basis and loans) during the insured's lifetime.

Here's an example of PPLI at work: A wealthy retired corporate executive had implemented estate planning strategies that resulted in more than $100 million of value in a trust for the benefit of his grandchildren and wanted to hire an investment advisor to manage the financial affairs of the trust. Numerous financial services firms, wirehouses, private banks and RIAs competed for the business. One RIA offered to manage the money—and also suggested that he invest it in a tax-advantaged manner through PPLI. The prospective client, who hadn't heard of the concept but performed additional research and due diligence, made the decision to engage that RIA rather than the other suitors, and the RIA now manages substantially more of the client's assets than just this one trust.

While there are clear income tax benefits afforded by PPLI, it's critical that clients find the investment options within PPLI compelling for the structure to fit into their overall wealth planning. Helping clients identify strong investment options stands as a central role of an RIA when working with

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Winged Keel Group is widely recognized as one of the leading experts in the structuring and administration of Private Placement Life Insurance and Annuities, with offices across the country. For more information, please visit www.wingedkeel.com.

clients who own PPLI policies. As RIAs consider how best to assist their client families with investments within PPLI, there are three general approaches, which we outline below and then discuss further:

1. **Pick Off the Roster of Funds:** Policyowners, with guidance from RIAs, can select investments from the insurers' existing menu, which is made up of nearly 200 alternative asset class vehicles called Insurance-Dedicated Funds (IDFs) and more than 390 registered mutual fund and index offerings called Variable Insurance Trusts (VITs). There has been dramatic growth in the number of available investment options in the past five years, with many of the largest brand name managers in the alternatives and mutual fund industries actively participating in the PPLI market.
2. **RIA Builds Its Own Co-Mingled IDF:** In certain asset classes, RIAs often have consistency in allocations across multiple clients. By utilizing co-mingled vehicles, the RIA is able to gain efficiency, and also able to increase the number of clients that can get access to closed or limited capacity managers. Similarly, as RIAs look to make PPLI a component part of their clients' investment portfolios, the RIA can establish an IDF, or series of IDFs, to meet the allocation needs of their clients in certain asset classes.
3. **Establishing a Custom Investment Solution:** For certain clients, RIAs may elect to create a discretionary customized investment solution for the PPLI investments for individual clients. Although a customized account, the RIA needs to manage this vehicle with complete investment discretion

Picking Off the Roster of Existing Funds

The easiest way for an RIA to advise a client on allocations within PPLI is to simply pick off the existing roster of funds currently available on the insurer platform, and in our experience many PPLI clients do in fact allocate with the existing roster of investment options. The investment offerings within PPLI include credit, direct lending, long-short equity, event driven, real estate, private equity, actively managed long only, a variety of indexes and nearly every other asset class available to taxable investors. Policyowners can allocate to any of the vehicles on the platform (provided the asset manager is open to new investments) and construct a diversified account. PPLI investors can build a diversified portfolio similar to how most of us allocate within our 401(k) or other retirement plans: 10% into Fund A, 20% into Fund B, etc. An RIA can be very helpful in conducting diligence on the available managers and integrating the allocation of those selected within PPLI into the client's overall asset allocation.

One misconception with respect to PPLI is how the Investor Control Doctrine is applied. The Investor Control Doctrine is intended to prohibit a policyowner, or related parties, from directly or indirectly influencing the selection of securities within the insurance-dedicated vehicle.

This does not in any way prohibit policyowners from actively allocating among IDFs and VITs that are managed by third parties. Thus, by allocating among existing IDFs and VITs managed by third parties, the RIA and client are staying well within the framework of the Investor Control Doctrine, which we will discuss below.

Another often misunderstood element of PPLI is that a client can in fact allocate the entire investment value of the policy in a single IDF or VIT off the menu. The IDFs and VITs themselves must satisfy the diversification requirements under Internal Revenue Code Section 817(h) (Section 817(h)). Thus, as a policyowner allocating to existing vehicles, because each IDF or VIT meets the diversification requirement, it is totally acceptable, and somewhat common, to allocate all the PPLI account value to one or a few vehicles.

Because each insurance carrier has its own process for adding funds to a platform, the fund list with each insurance company differs. However, there is a growing consistency of availability of investment options across carrier platforms, and insurance companies will generally add an established IDF or VIT that is available on other platforms, if there is sufficient demand from their policyowners. With the robust selection of investment options within PPLI, and increased allocation flexibility that affords to investors, many RIAs are able to effectively construct suitable portfolios with the currently available funds.

RIA Builds Its Own Co-Mingled IDF

When an RIA does not find the existing menu entirely suitable or desirable for its clients, building an IDF to supplement the existing offerings can be a solution. With an IDF, the RIA establishes a separate legal entity, either independently or in conjunction with a turnkey provider, and has it attached to one or more insurance carriers as an available investment option. The insurance company will put the strategy, and RIA, through an investment and operational due diligence process. Once the IDF has been approved on the carrier platforms, it will serve as a commingled fund and can be available to all clients of the RIA who purchase a PPLI policy. The RIA has the right to decide whether they will let policyowners that are not clients of the RIA allocate to the IDF.

For RIAs who have a number of clients in mind for PPLI, establishing their own IDF might be the preferred way to solve the "PPLI puzzle." If RIAs create a new IDF, they can choose among nearly any available investment like they would for a taxable account, as opposed to just managers with IDFs or VITs available on the insurance carriers' rosters. In essence, the insurance carriers approve the RIA to manage a discretionary portfolio of investments within PPLI, and that RIA's IDF becomes a "fund" available at the insurance carrier level.

As manager of an IDF, the RIA must follow certain rules, including, most notably:

1. Ensuring the IDF is broadly diversified (essentially, with five or more different funds or positions), as outlined in Section 817(h).
2. Maintaining complete discretion and control over selection of the underlying funds or securities in accordance with the Investor Control Doctrine.

Adherence to the Investor Control Doctrine is a critical requirement for an RIA since the IDF must be managed with complete discretion and both the form and substance of the Investor Control Doctrine to achieve the desired tax treatment. Revenue Ruling 77-85 provides that policyholders will be treated as the tax owners of the investment accounts inside of a PPLI policy if (a) they possess significant control (or other benefits and burdens of policy ownership) over the underlying assets, even if the insurance company retains possession of, and legal title to, the assets; or (2) the assets are available to the general public and not exclusively through the purchase of a PPLI policy. Over the past decade, greater clarity has been provided on the investor control doctrine through tax court rulings, pronouncements and private letter rulings, and we encourage RIAs seriously considering establishment of an IDF to review *Webber v. Commissioner* as well as private letter rulings ("PLRs") 201502003, 201105012, 200420017 and 9433030. While a complete discussion of the jurisprudence of the Investor Control Doctrine is beyond the scope of this article, we would highlight that Revenue Ruling 2003-91, 2003-2 C.B. 347 and PLR 201502003 highlight several factors for determining compliance with the doctrine. One of these many factors is that there be no arrangement, plan or agreement between the policyowner and the insurer or between the policyowner and the RIA regarding the specific underlying investments of the IDF.

With the evolution of turnkey IDF administrators, the hassle and expense of creating and administering an IDF is minimal, and we have not found establishing an IDF to be a limiting factor as RIAs explore this option. It is also important to note that strategies one and two are not mutually exclusive and RIAs can allocate a portion of their clients' PPLI portfolios to third party IDFs and VITs and a portion to their own IDF.

Establishing a Custom Investment Solution

For some RIA clients, whether because of their amount of investable assets, investment objectives or other factors, establishing a custom investment solution for certain clients can be the best way to invest in PPLI. Like a commingled IDF, a custom or bespoke investment mandate requires full compliance with the Section 817(h) diversification requirement and Investor Control Doctrine outlined in the case law and PLRs enumerated above.

In the end, each RIA and each client situation is different, and investors should undertake a review of all the potential methods. Satisfying the investment needs of the client by using existing funds on the carrier menus is certainly the easiest way for an RIA to assist a client investing in PPLI. In addition, RIAs can charge for services similarly to how they charge for taxable investments. If an RIA finds PPLI to be a valuable tax planning tool for certain clients and anticipates multiple clients utilizing PPLI, a comingled IDF, or series of asset-class-specific IDFs, can often provide the most leverage for the RIA while also offering additional investment flexibility to the end client. Finally, a custom or bespoke investment mandate can be a good solution for an RIA building an investment portfolio for a one-off client or a particular investment mandate that isn't covered with its IDF or the current roster of existing funds.

Any RIA who is focusing on after-tax investment returns needs to look closely at PPLI and can solve this puzzle with the right information on hand. While a bit daunting, PPLI is like everything else in financial services—it is not terribly complex once the details are studied, and the benefit to the client—in the form of after-tax investment returns—often warrants becoming familiar with this ever-growing space.

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