



M Financial Group™

# Private Placement Life Insurance

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# What's the Story?

- Private Placement Life Insurance has been around for over 20 years but often existed in the dark shadows of tax planning strategies
  - “This is great... why haven't I heard of it? Why isn't this more common?”
- Hedge fund boom in late '90s propelled PPLI as a tool for sophisticated investors to implement tax planning into investment strategy
- Aftermath of 9/11, Financial Crisis, and Bernie Madoff created headwinds for the widespread utilization of PPLI by HNW
- In 2013, American Taxpayer Relief Act was passed and provided the necessary fuel to accelerate the usage and implementation of PPLI as a tax planning strategy.
- High-profile investment managers and companies have created IDFs in recent years adding to the legitimacy of the application
- Estimated sales of PPLI have grown by 50% CAGR since 2012.

# What is Private Placement Life Insurance?

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- Private placement life insurance (PPLI) is a variable life policy which is not registered with SEC
- PPLI includes unregistered investment subaccount options in addition to registered investment subaccounts typically available in registered variable life (VUL) policies
- Compensation to distributors is not fixed but incorporated into the design of the private placement policy offering (“institutional pricing”)

# Private Placement Investment Options

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- Registered variable life products (VUL) can only invest in registered subaccounts
  - Must have daily valuation
  - Must offer daily liquidity
- Private placement products can be invested in subaccounts that are unregistered
  - Can be valued on a monthly or quarterly basis
  - Can have restricted liquidity and investment terms

# Private Placement Qualifications

- Client must be pre-qualified before any information is discussed regarding Private Placement products
- Policyowner must be Qualified Purchaser
  - Individual or family trust with \$5 million of qualified investments
  - Family-owned company with \$5 million of qualified investments
  - A corporation, partnership, limited liability company, trust, or tax-exempt organization where each beneficial owner is a Qualified Purchaser
  - A corporation, partnership, or trust with at least \$25 million in qualified investments
- Policyowner must also be an Accredited Investor
  - Individuals: Net worth greater than \$1 million, OR reported annual income of \$200,000 (\$300,000 if joint) for the last two years
  - Institutional Investors:\*\* Assets in excess of \$5 million

\*\* Includes Corporations, Financial Institutions, Employee Benefit Organizations, Trusts

# What is a Qualified Investment?

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- Qualified Investments:
  - Cash and cash equivalents
  - Securities as defined in section 2(a)(1) of the 1933 Act (no control issues)
  - Real estate held for investment purposes
  - Commodity interests held for investment purposes
  - Physical commodities held for investment purposes
  - Financial contracts entered into for investment purposes
  - Cash value of life insurance

# Comparison of PPLI to Traditional VUL

|                    | <b>Traditional VUL</b>   | <b>PPVUL</b>   |
|--------------------|--|--|
| Surrender Charges  | Generally, Yes   | No   |
| Distribution Costs | Commissions are usually higher, especially upfront                       | Commissions are usually lower but may include higher ongoing asset-based revenue |
| Mortality Costs    | PPVUL does not usually have lower mortality charges than retail products |  |
| Investment Options | Registered funds   | Registered and unregistered ("exempt") funds                                     |

- The primary advantage of PPLI is the ability to design a life insurance policy to look less like a traditional life insurance policy that is unattractive to HNW clients

# Taxation of PPLI

PPLI enjoys  
the same tax  
treatment as  
traditional  
life  
insurance  
policies

- **Tax deferred growth** – Accumulated investment income credited under a life insurance contract is not subject to current taxation [ I.R.C. §7702(g)(1)(A) ]
- **Income tax-free distributions from Non-MECs** – Withdrawals up to the policy owner's basis are income tax-free [ I.R.C. §72(e)(3) ] and policy loans provide income tax-free access to accumulated investment income [ I.R.C. §72(e)(5) ]
- **Income tax-free death benefit proceeds** – Death benefits received from a life insurance contract, including any accumulated investment income, are generally received income tax free [ I.R.C. §101(a)(1) ]
- **Estate tax-free proceeds** – If properly structured, the proceeds of a life insurance policy paid to an irrevocable trust may be excluded from the taxable estate of the insured
- **Tax-free reallocations** – Policy account values may be transferred among the investment options available within the policy without creating taxable events

# State Premium Tax

- Some states have altered premium tax rates levied on insurance companies to attract large-premium trust-owned PPVUL policies
  - Typical state premium tax charge is 2.00% - 2.50%
  - Alaska, South Dakota, and Delaware charge a much lower rate (zero to 8 basis points) on annual premium in excess of \$100,000
- PPVUL policies are generally the only products designed to pass this reduced charge to policyowners
  - A policy with a \$1 million annual premium can realize a savings of up to \$20,000 per year in premium tax charges

# Characteristics of PPLI Prospect

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- Not someone with traditional life insurance needs, e.g., income replacement, estate tax liquidity, conservative risk tolerance profile
- Sizeable percentage of wealth in invested assets as opposed to illiquid assets or closely-held business interests
- A portion of investment portfolio invested in tax-inefficient asset classes
- Desire to invest in alternative or non-correlated (to equity markets) asset classes
- Seeks to maximize growth of assets for transfer to next generation



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# Comparison of PPLI to Taxable Account

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# Assumptions

- Male age 50, preferred nonsmoker class
- 8% rate of return, net of investment expenses
- Life insurance designed as non-Modified Endowment Contract (MEC)
- Federal ordinary income tax rate = 39.6%
- Long-term capital gains tax rate = 20%
- Affordable Care Act tax rate on investment income = 3.8%
- Not subject to state income taxes
- Estate tax rate = 40%
- Taxable investment is not held in trust and is subject to estate tax
- Life insurance is not includable in insured's estate

# 100% Ordinary Income

|      |     |                | ACCUMULATED VALUE |                 |                       |            | VALUE AT DEATH                    |            |                                 |            |
|------|-----|----------------|-------------------|-----------------|-----------------------|------------|-----------------------------------|------------|---------------------------------|------------|
|      |     |                | TAXABLE ACCT.     |                 | LIFE INSURANCE        |            | TAXABLE ACCT.                     |            | LIFE INSURANCE                  |            |
| Year | Age | Annual Premium | Net Account Value | Net Taxable IRR | Net EOY Account Value | Net AV IRR | Taxable Account Net of Estate Tax | Net DB IRR | Death Benefit Net of Estate Tax | Net DB IRR |
| 1    | 50  | 1,250,000      | 1,306,600         | 4.53%           | 1,275,185             | 2.01%      | 783,960                           | -37.28%    | 23,309,383                      | 1764.75%   |
| 2    | 51  | 1,250,000      | 2,672,363         | 4.53%           | 2,601,149             | 2.67%      | 1,603,418                         | -26.20%    | 23,309,383                      | 284.71%    |
| 3    | 52  | 1,250,000      | 4,099,967         | 4.53%           | 4,024,364             | 3.57%      | 2,459,980                         | -19.65%    | 23,309,383                      | 124.73%    |
| 4    | 53  | 1,250,000      | 5,592,214         | 4.53%           | 5,551,529             | 4.23%      | 3,355,328                         | -15.33%    | 23,309,383                      | 72.38%     |
| 5    | 54  | 0              | 5,845,429         | 4.53%           | 5,931,921             | 4.96%      | 3,507,258                         | -9.81%     | 23,309,383                      | 50.75%     |
| 6    | 55  | 0              | 6,110,110         | 4.53%           | 6,337,956             | 5.37%      | 3,666,066                         | -6.73%     | 23,309,383                      | 38.74%     |
| 7    | 56  | 0              | 6,386,776         | 4.53%           | 6,770,362             | 5.63%      | 3,832,066                         | -4.75%     | 23,309,383                      | 31.21%     |
| 8    | 57  | 0              | 6,675,969         | 4.53%           | 7,239,846             | 5.83%      | 4,005,582                         | -3.36%     | 20,070,000                      | 23.32%     |
| 9    | 58  | 0              | 6,978,257         | 4.53%           | 7,751,958             | 5.99%      | 4,186,954                         | -2.34%     | 16,310,000                      | 16.84%     |
| 10   | 59  | 0              | 7,294,233         | 4.53%           | 8,314,947             | 6.14%      | 4,376,540                         | -1.56%     | 11,142,029                      | 9.81%      |
| 11   | 60  | 0              | 7,624,516         | 4.53%           | 8,942,267             | 6.28%      | 4,574,709                         | -0.93%     | 11,624,947                      | 9.23%      |
| 12   | 61  | 0              | 7,969,754         | 4.53%           | 9,616,875             | 6.40%      | 4,781,852                         | -0.42%     | 12,309,600                      | 8.91%      |
| 13   | 62  | 0              | 8,330,624         | 4.53%           | 10,342,044            | 6.50%      | 4,998,375                         | 0.00%      | 13,030,975                      | 8.65%      |
| 14   | 63  | 0              | 8,707,835         | 4.53%           | 11,121,581            | 6.58%      | 5,224,701                         | 0.35%      | 13,790,761                      | 8.42%      |
| 15   | 64  | 0              | 9,102,126         | 4.53%           | 11,959,630            | 6.65%      | 5,461,275                         | 0.66%      | 14,590,749                      | 8.22%      |
| 16   | 65  | 0              | 9,514,270         | 4.53%           | 12,860,717            | 6.71%      | 5,708,562                         | 0.92%      | 15,432,861                      | 8.05%      |
| 17   | 66  | 0              | 9,945,076         | 4.53%           | 13,829,416            | 6.77%      | 5,967,046                         | 1.15%      | 16,457,005                      | 7.96%      |
| 18   | 67  | 0              | 10,395,389        | 4.53%           | 14,870,954            | 6.81%      | 6,237,233                         | 1.35%      | 17,547,726                      | 7.88%      |
| 19   | 68  | 0              | 10,866,092        | 4.53%           | 15,990,632            | 6.85%      | 6,519,655                         | 1.53%      | 18,709,039                      | 7.81%      |
| 20   | 69  | 0              | 11,358,109        | 4.53%           | 17,193,927            | 6.89%      | 6,814,865                         | 1.69%      | 19,944,955                      | 7.75%      |
| 30   | 79  | 0              | 17,686,115        | 4.53%           | 35,771,397            | 7.14%      | 10,611,669                        | 2.67%      | 37,559,967                      | 7.32%      |
| 40   | 89  | 0              | 27,539,677        | 4.53%           | 73,499,899            | 7.22%      | 16,523,806                        | 3.15%      | 77,174,894                      | 7.36%      |
| 50   | 99  | 0              | 42,883,010        | 4.53%           | 152,287,643           | 7.29%      | 25,729,806                        | 3.43%      | 152,287,643                     | 7.29%      |

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# 50% Ordinary Income / 50% LT Capital Gains

|      |     |                | ACCUMULATED VALUE |                 |                       |            | VALUE AT DEATH                    |            |                                 |            |
|------|-----|----------------|-------------------|-----------------|-----------------------|------------|-----------------------------------|------------|---------------------------------|------------|
|      |     |                | TAXABLE ACCT.     |                 | LIFE INSURANCE        |            | TAXABLE ACCT.                     |            | LIFE INSURANCE                  |            |
| Year | Age | Annual Premium | Net Account Value | Net Taxable IRR | Net EOY Account Value | Net AV IRR | Taxable Account Net of Estate Tax | Net DB IRR | Death Benefit Net of Estate Tax | Net DB IRR |
| 1    | 50  | 1,250,000      | 1,316,400         | 5.31%           | 1,275,185             | 2.01%      | 789,840                           | -36.81%    | 23,309,383                      | 1764.75%   |
| 2    | 51  | 1,250,000      | 2,702,727         | 5.31%           | 2,601,149             | 2.67%      | 1,621,636                         | -25.61%    | 23,309,383                      | 284.71%    |
| 3    | 52  | 1,250,000      | 4,162,696         | 5.31%           | 4,024,364             | 3.57%      | 2,497,618                         | -18.99%    | 23,309,383                      | 124.73%    |
| 4    | 53  | 1,250,000      | 5,700,218         | 5.31%           | 5,551,529             | 4.23%      | 3,420,131                         | -14.63%    | 23,309,383                      | 72.38%     |
| 5    | 54  | 0              | 6,003,014         | 5.31%           | 5,931,921             | 4.96%      | 3,601,808                         | -9.09%     | 23,309,383                      | 50.75%     |
| 6    | 55  | 0              | 6,321,894         | 5.31%           | 6,337,956             | 5.37%      | 3,793,136                         | -6.00%     | 23,309,383                      | 38.74%     |
| 7    | 56  | 0              | 6,657,713         | 5.31%           | 6,770,362             | 5.63%      | 3,994,628                         | -4.02%     | 23,309,383                      | 31.21%     |
| 8    | 57  | 0              | 7,011,371         | 5.31%           | 7,239,846             | 5.83%      | 4,206,823                         | -2.63%     | 20,070,000                      | 23.32%     |
| 9    | 58  | 0              | 7,383,815         | 5.31%           | 7,751,958             | 5.99%      | 4,430,289                         | -1.60%     | 16,310,000                      | 16.84%     |
| 10   | 59  | 0              | 7,776,043         | 5.31%           | 8,314,947             | 6.14%      | 4,665,626                         | -0.81%     | 11,142,029                      | 9.81%      |
| 11   | 60  | 0              | 8,189,107         | 5.31%           | 8,942,267             | 6.28%      | 4,913,464                         | -0.18%     | 11,624,947                      | 9.23%      |
| 12   | 61  | 0              | 8,624,112         | 5.31%           | 9,616,875             | 6.40%      | 5,174,467                         | 0.33%      | 12,309,600                      | 8.91%      |
| 13   | 62  | 0              | 9,082,225         | 5.31%           | 10,342,044            | 6.50%      | 5,449,335                         | 0.75%      | 13,030,975                      | 8.65%      |
| 14   | 63  | 0              | 9,564,673         | 5.31%           | 11,121,581            | 6.58%      | 5,738,804                         | 1.11%      | 13,790,761                      | 8.42%      |
| 15   | 64  | 0              | 10,072,748        | 5.31%           | 11,959,630            | 6.65%      | 6,043,649                         | 1.41%      | 14,590,749                      | 8.22%      |
| 16   | 65  | 0              | 10,607,812        | 5.31%           | 12,860,717            | 6.71%      | 6,364,687                         | 1.68%      | 15,432,861                      | 8.05%      |
| 17   | 66  | 0              | 11,171,299        | 5.31%           | 13,829,416            | 6.77%      | 6,702,780                         | 1.91%      | 16,457,005                      | 7.96%      |
| 18   | 67  | 0              | 11,764,719        | 5.31%           | 14,870,954            | 6.81%      | 7,058,831                         | 2.11%      | 17,547,726                      | 7.88%      |
| 19   | 68  | 0              | 12,389,661        | 5.31%           | 15,990,632            | 6.85%      | 7,433,796                         | 2.29%      | 18,709,039                      | 7.81%      |
| 20   | 69  | 0              | 13,047,799        | 5.31%           | 17,193,927            | 6.89%      | 7,828,680                         | 2.45%      | 19,944,955                      | 7.75%      |
| 30   | 79  | 0              | 21,893,534        | 5.31%           | 35,771,397            | 7.14%      | 13,136,121                        | 3.44%      | 37,559,967                      | 7.32%      |
| 40   | 89  | 0              | 36,736,221        | 5.31%           | 73,499,899            | 7.22%      | 22,041,733                        | 3.93%      | 77,174,894                      | 7.36%      |
| 50   | 99  | 0              | 61,641,484        | 5.31%           | 152,287,643           | 7.29%      | 36,984,891                        | 4.21%      | 152,287,643                     | 7.29%      |

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# 25% Ordinary Income / 25% LT Capital Gains / 50% Unrealized Gains

|      |     |                | ACCUMULATED VALUE |                 |                       |            | VALUE AT DEATH    |            |                                 |            |
|------|-----|----------------|-------------------|-----------------|-----------------------|------------|-------------------|------------|---------------------------------|------------|
|      |     |                | TAXABLE ACCT.     |                 | LIFE INSURANCE        |            | TAXABLE ACCT.     |            | LIFE INSURANCE                  |            |
| Year | Age | Annual Premium | Net Account Value | Net Taxable IRR | Net EOY Account Value | Net AV IRR | Net of Estate Tax | Net DB IRR | Death Benefit Net of Estate Tax | Net DB IRR |
| 1    | 50  | 1,250,000      | 1,333,200         | 6.66%           | 1,275,185             | 2.01%      | 799,920           | -36.01%    | 23,309,383                      | 1764.75%   |
| 2    | 51  | 1,250,000      | 2,755,138         | 6.66%           | 2,601,149             | 2.67%      | 1,653,083         | -24.60%    | 23,309,383                      | 284.71%    |
| 3    | 52  | 1,250,000      | 4,271,720         | 6.66%           | 4,024,364             | 3.57%      | 2,563,032         | -17.86%    | 23,309,383                      | 124.73%    |
| 4    | 53  | 1,250,000      | 5,889,245         | 6.66%           | 5,551,529             | 4.23%      | 3,533,547         | -13.41%    | 23,309,383                      | 72.38%     |
| 5    | 54  | 0              | 6,281,234         | 6.66%           | 5,931,921             | 4.96%      | 3,768,740         | -7.87%     | 23,309,383                      | 50.75%     |
| 6    | 55  | 0              | 6,699,313         | 6.66%           | 6,337,956             | 5.37%      | 4,019,588         | -4.77%     | 23,309,383                      | 38.74%     |
| 7    | 56  | 0              | 7,145,219         | 6.66%           | 6,770,362             | 5.63%      | 4,287,131         | -2.77%     | 23,309,383                      | 31.21%     |
| 8    | 57  | 0              | 7,620,805         | 6.66%           | 7,239,846             | 5.83%      | 4,572,483         | -1.37%     | 20,070,000                      | 23.32%     |
| 9    | 58  | 0              | 8,128,045         | 6.66%           | 7,751,958             | 5.99%      | 4,876,827         | -0.33%     | 16,310,000                      | 16.84%     |
| 10   | 59  | 0              | 8,669,048         | 6.66%           | 8,314,947             | 6.14%      | 5,201,429         | 0.47%      | 11,142,029                      | 9.81%      |
| 11   | 60  | 0              | 9,246,060         | 6.66%           | 8,942,267             | 6.28%      | 5,547,636         | 1.10%      | 11,624,947                      | 9.23%      |
| 12   | 61  | 0              | 9,861,478         | 6.66%           | 9,616,875             | 6.40%      | 5,916,887         | 1.61%      | 12,309,600                      | 8.91%      |
| 13   | 62  | 0              | 10,517,857        | 6.66%           | 10,342,044            | 6.50%      | 6,310,714         | 2.04%      | 13,030,975                      | 8.65%      |
| 14   | 63  | 0              | 11,217,926        | 6.66%           | 11,121,581            | 6.58%      | 6,730,756         | 2.40%      | 13,790,761                      | 8.42%      |
| 15   | 64  | 0              | 11,964,591        | 6.66%           | 11,959,630            | 6.65%      | 7,178,755         | 2.71%      | 14,590,749                      | 8.22%      |
| 16   | 65  | 0              | 12,760,954        | 6.66%           | 12,860,717            | 6.71%      | 7,656,573         | 2.98%      | 15,432,861                      | 8.05%      |
| 17   | 66  | 0              | 13,610,324        | 6.66%           | 13,829,416            | 6.77%      | 8,166,194         | 3.21%      | 16,457,005                      | 7.96%      |
| 18   | 67  | 0              | 14,516,227        | 6.66%           | 14,870,954            | 6.81%      | 8,709,736         | 3.42%      | 17,547,726                      | 7.88%      |
| 19   | 68  | 0              | 15,482,427        | 6.66%           | 15,990,632            | 6.85%      | 9,289,456         | 3.60%      | 18,709,039                      | 7.81%      |
| 20   | 69  | 0              | 16,512,937        | 6.66%           | 17,193,927            | 6.89%      | 9,907,762         | 3.76%      | 19,944,955                      | 7.75%      |
| 30   | 79  | 0              | 31,454,099        | 6.66%           | 35,771,397            | 7.14%      | 18,872,459        | 4.77%      | 37,559,967                      | 7.32%      |
| 40   | 89  | 0              | 59,914,255        | 6.66%           | 73,499,899            | 7.22%      | 35,948,553        | 5.25%      | 77,174,894                      | 7.36%      |
| 50   | 99  | 0              | 114,125,603       | 6.66%           | 152,287,643           | 7.29%      | 68,475,362        | 5.54%      | 152,287,643                     | 7.29%      |

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# Unwinding the PPLI Policy

## LIFE INSURANCE

| Year | Age | Annual Premium | EOY Annual Withdrawal | EOY Annual Loan | Net EOY Account Value | Net AV IRR | Net EOY Death Benefit | Net DB IRR |
|------|-----|----------------|-----------------------|-----------------|-----------------------|------------|-----------------------|------------|
| 1    | 50  | 1,250,000      | 0                     | 0               | 1,275,185             | 2.01%      | 23,309,383            | 1764.75%   |
| 2    | 51  | 1,250,000      | 0                     | 0               | 2,601,149             | 2.67%      | 23,309,383            | 284.71%    |
| 3    | 52  | 1,250,000      | 0                     | 0               | 4,024,364             | 3.57%      | 23,309,383            | 124.73%    |
| 4    | 53  | 1,250,000      | 0                     | 0               | 5,551,529             | 4.23%      | 23,309,383            | 72.38%     |
| 5    | 54  | 0              | 0                     | 0               | 5,931,921             | 4.96%      | 23,309,383            | 50.75%     |
| 6    | 55  | 0              | 0                     | 0               | 6,337,956             | 5.37%      | 23,309,383            | 38.74%     |
| 7    | 56  | 0              | 0                     | 0               | 6,770,362             | 5.63%      | 23,309,383            | 31.21%     |
| 8    | 57  | 0              | 0                     | 0               | 7,239,846             | 5.83%      | 20,070,000            | 23.32%     |
| 9    | 58  | 0              | 0                     | 0               | 7,751,958             | 5.99%      | 16,310,000            | 16.84%     |
| 10   | 59  | 0              | 0                     | 0               | 8,314,947             | 6.14%      | 11,142,029            | 9.81%      |
| 11   | 60  | 0              | 0                     | 0               | 8,942,267             | 6.28%      | 11,624,947            | 9.23%      |
| 12   | 61  | 0              | 0                     | 0               | 9,616,875             | 6.40%      | 12,309,600            | 8.91%      |
| 13   | 62  | 0              | 0                     | 0               | 10,342,044            | 6.50%      | 13,030,975            | 8.65%      |
| 14   | 63  | 0              | 0                     | 0               | 11,121,581            | 6.58%      | 13,790,761            | 8.42%      |
| 15   | 64  | 0              | 0                     | 0               | 11,959,630            | 6.65%      | 14,590,749            | 8.22%      |
| 16   | 65  | 0              | 5,000,000             | 6,250,000       | 701,319               | 6.62%      | 2,141,623             | 7.46%      |
| 17   | 66  | 0              | 0                     | 0               | 692,708               | 6.59%      | 2,108,802             | 7.36%      |
| 18   | 67  | 0              | 0                     | 0               | 683,849               | 6.56%      | 2,072,530             | 7.27%      |
| 19   | 68  | 0              | 0                     | 0               | 674,646               | 6.53%      | 2,032,464             | 7.18%      |
| 20   | 69  | 0              | 0                     | 0               | 664,913               | 6.50%      | 1,988,139             | 7.10%      |
| 30   | 79  | 0              | 0                     | 0               | 565,497               | 6.33%      | 1,156,653             | 6.48%      |
| 40   | 89  | 0              | 0                     | 0               | 248,856               | 6.21%      | 1,094,501             | 6.34%      |
| 50   | 99  | 0              | 0                     | 0               | 24,699                | 6.18%      | 24,699                | 6.18%      |

- Assumes distribution from the policy in year 16, which is a combination of a withdrawal of basis and policy loan
- The policy loan is repaid at death from the gross policy death benefit
- Assumed investment rate of return after year 15 is 0%

# Tax-Inefficient Investments

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- PPLI should be considered as a placeholder for the portion of the client's investment portfolio that is considered to be "tax-inefficient"
  - Generate a significant amount of taxable income as a result of:
    - High asset turnover
    - Use of short-term instruments such as options
    - High yield assets
- "Tax Drag" – Loss of income from taxation

# Tax Drag by Asset Class

| <b>Asset Class</b>                      | <b>Expected Annual Return (Including Yield)</b> | <b>Expected Annual Yield</b> | <b>Expected Turnover</b> | <b>Expected Tax Drag</b> |
|---|---|------------------------------|--------------------------|--------------------------|
| Emerging Market Equities                | 12.20%  | 1.40%                        | 60%                      | 3.59%                    |
| Pacific Ex-Japan Equities               | 11.84%  | 0.50%                        | 60%                      | 3.52%                    |
| European Equities                       | 11.60%  | 1.25%                        | 70%                      | 3.69%                    |
| U.S. Small-Cap Equities                 | 10.58%  | 0.40%                        | 60%                      | 3.15%                    |
| U.S. Mid-Cap Equities                   | 10.35%  | 0.80%                        | 40%                      | 2.86%                    |
| U.S. Large-Cap Equities                 | 10.12%  | 1.20%                        | 40%                      | 2.86%                    |
| Japanese Equities                       | 9.43%   | 0.90%                        | 60%                      | 2.78%                    |
| Commodities                             | 8.51%   | 1.70%                        | 60%                      | 2.70%                    |
| High-Yield Bonds                        | 7.71%   | 6.50%                        | 80%                      | 2.91%                    |
| Directional Hedge Funds                 | 7.90%   | 0.00%                        | 80%                      | 2.46%                    |
| Emerging Market Bonds                   | 6.72%   | 3.70%                        | 150%                     | 2.52%                    |
| Real Estate Investment Trusts           | 6.75%   | 2.50%                        | 20%                      | 2.14%                    |
| Non-Directional Hedge Funds             | 5.60%   | 0.00%                        | 80%                      | 1.75%                    |
| International Bonds                     | 4.32%   | 3.00%                        | 150%                     | 1.64%                    |
| Treasury Inflation Protected Securities | 4.07%   | 3.50%                        | 100%                     | 1.55%                    |
| Taxable Bonds                           | 3.43%   | 3.43%                        | 75%                      | 1.34%                    |
| Cash                                    | 1.43%   | 1.40%                        | 0%                       | 0.56%                    |

Source: Deutsche Asset & Wealth Management; "Building Portfolios Inside PPVAs and PPLI", Trusts & Estates, June 2014

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# Insurance-Dedicated Funds (IDFs)

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# “Hedge” Funds in Private Placement

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- Alternative “unregistered” investment funds generally have some tax-adverse features, despite what may be an attractive investment strategy
  - Actively managed unregistered investment partnerships are usually less tax efficient and report a large amount of ordinary income
  - Investment partnerships typically issue K-1s to investors for tax reporting purposes
- Investments within life insurance contracts do not incur taxable income and do not require K-1s to be distributed to policyowners

# Private Placement Investment Options

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- “Can I put my investments into a life insurance policy?”
- Permissible investment options for insurance contracts should meet the following requirements:
  - Only accepts assets from insurance contracts; not available to the general public [*Revenue Ruling 2003-92*]
  - Policyowner should not have any control or direction over investment decisions made by fund manager [*Revenue Ruling 2003-91*]
  - Fund has minimum level of diversification [*IRC Section 817(h)*]
  - IRS has clearly stated that insurance-dedicated funds (IDFs) are approved for life insurance policies

# Considerations for Creating an IDF

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- Investor Control
  - Policyowner cannot control investments in segregated account
  - Disqualifies policy for treatment as life insurance
- Diversification
  - No more than 55% of fund assets can be invested in a single fund or security; 70% in two securities; 80% in three securities; and 90% in four securities
- Liquidity
  - Funds may be needed to meet policy distributions, policy charges, and/or death claims
  - Funds with favorable liquidity and lock-up provisions will be more acceptable to insurance companies
- Asset Valuation
  - Insurance companies require periodic valuation of shares to process policy charges and distributions



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# Case Studies

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# Case Study #1

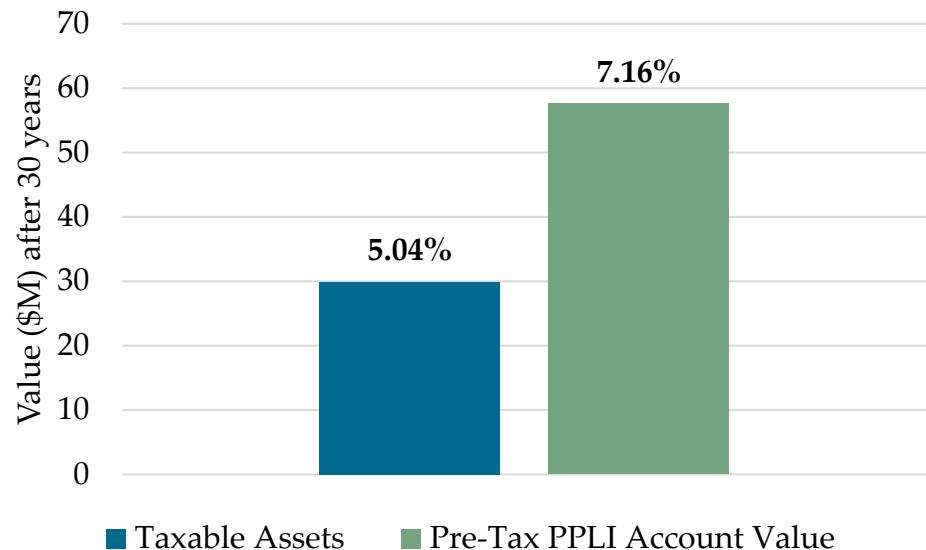
- 59 year-old Patriarch built wealth in real estate, net worth in excess of \$240 million
- \$65 million in liquid investment assets with some in trust; exposure to alternative investments
- Invested assets are creating a marginal income tax rate of 37%
- Aside from charitable intentions, client's goal is to maximize wealth transfer to heirs
- Plan involved moving \$8 million into PPVUL
  - Assumed investment rate of return = 8% net of management fees
  - Four premiums into non-MEC policy
  - Allocation to multi-strategy fund of funds

# Case Study #1

| Year | Taxable Assets | Pre-Tax PPLI Account Value | Tax-Free PPLI Death Benefit |
|------|----------------|----------------------------|-----------------------------|
| 1    | 2,100,800      | 2,024,794                  | 28,233,679                  |
| 5    | 9,060,096      | 9,615,438                  | 26,208,885                  |
| 10   | 12,169,174     | 13,599,268                 | 15,911,144                  |
| 20   | 19,897,945     | 27,982,664                 | 29,381,797                  |
| 30   | 32,535,340     | 57,647,597                 | 60,529,977                  |

Plan involved moving \$8 million into PPLI structured with four \$2 million premiums into non-MEC policy

- Male age 59, preferred non-tobacco user
- Assumed net investment return of 8%
- Assumed tax rate on taxable assets of 37%
- Graph shows values after 30 year holding period
- Comparison would vary under different return assumptions; tax expense on taxable assets would be dramatically lower if returns are very minimal or zero



## Case Study #2

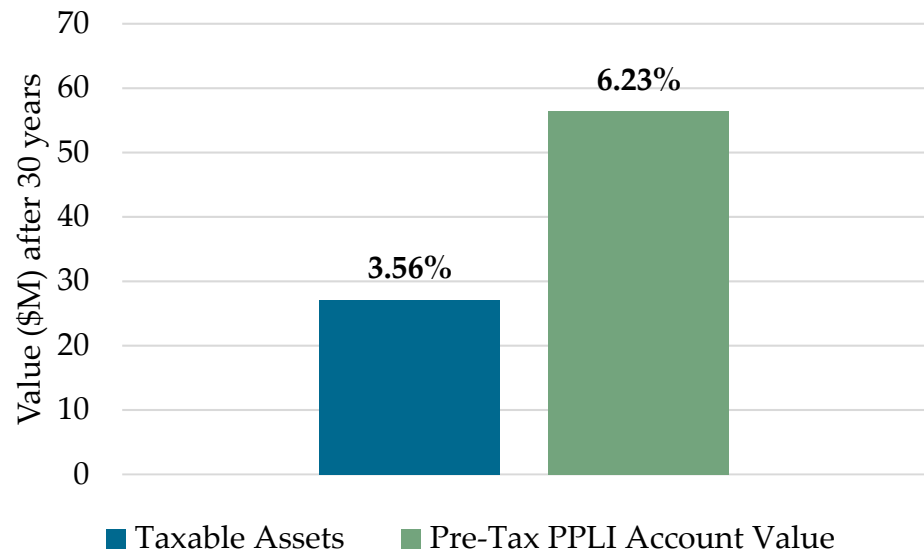
- Male age 60 and Female age 54 had previously set up GST with \$10 million exemption
  - Wife was in good health but husband had some history of medical issues, including high blood pressure which was being controlled with medication
- Trust is defective grantor trust so couple are paying taxes on investment returns
- Currently investing in tax-exempts and ETFs to minimize tax liability but would prefer to invest in equities and private partnership structures
- Marginal tax rate of 49.15% on investment income
- Assumed rate of investment return for comparison purposes was 7% net of management fees and expenses

# Case Study #2

| Year | Taxable Assets | Pre-Tax PPLI Account Value | Tax-Free PPLI Death Benefit |
|------|----------------|----------------------------|-----------------------------|
| 1    | 2,588,988      | 2,545,765                  | 50,989,191                  |
| 5    | 10,922,118     | 11,870,379                 | 50,989,191                  |
| 10   | 13,472,448     | 16,069,862                 | 50,989,191                  |
| 20   | 19,113,753     | 29,839,680                 | 50,989,191                  |
| 30   | 27,117,236     | 56,126,305                 | 58,932,620                  |

Because of male's health and the efficiency of a joint-life design, client acquired joint-life survivorship PPVUL policy allocating \$10 million from GST over four-year period into non-MEC

- Male age 60, standard non-tobacco user & Female age 54, preferred non-tobacco user
- Assumed net investment return of 7%
- Assumed tax rate on taxable assets of 49.15%
- Graph shows values after 30 year holding period
- Comparison would vary under different return assumptions; tax expense on taxable assets would be dramatically lower if returns are very minimal or zero



# Conclusion

- PPLI is attractive as an instrument to shield invested wealth from the drag caused by income and other current taxes
  - Rather than let the tail (tax) wag the dog (investment strategy), PPLI allows clients to access the desired investment strategy without the unpleasant tax consequences
- Over time, tax on investment returns can deplete assets for transfer to heirs more than the impact of estate tax
- PPLI enables access to a substantial percentage of invested assets without incurring taxable income to the policyowner
- Properly structured, PPLI can transfer invested wealth without income or estate taxes at the death of the insured
- Biggest challenge to the implementation of a PPLI structure is the client's tolerance for complexity and nuisance with an investment-focused solution
  - Many HNW clients are willing to tolerate complexity of estate planning solutions