The Lure of Private Placement

It offers more flexibility and dramatic savings when a large amount of coverage is needed

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Over the past couple of years, there have been numerous articles and presentations at professional seminars on the use of private placement life insurance and annuity products. The primary focus has been the overall tax benefits of investing in a tax-neutral holding vehicle.[1] In many situations, the required life insurance coverage is simply considered a "cost" of getting the tax deferral. However, as a practical planning tool, life insurance coverage for death-benefit purposes is needed in many instances. The possible scenarios include second-to-die policies for estate planning, buy-sell agreements for partnerships/corporations, key person life insurance or employee benefit-planning arrangements. And private placement life insurance (PPLI) can be used as an alternative to retail policies in such traditional planning arrangements.

PPLI DEFINED

Private placement life insurance contracts are variable universal life insurance products that focus to a greater degree on the tax-deferral aspects of life insurance than on the death-benefit coverage of pure life insurance.[2] A PPLI contract, depending on the internal options offered by a carrier, allows the policy owner to have a greater selection of investment options than a traditional retail life insurance contract. In a traditional variable contract, the carrier may offer 10 to 20 mutual funds of varying styles that the policy owner can allocate his cash value among. In PPLI, an individual will often designate a manager to customize the investments of a given policy.[3] Generally speaking, this means that the policy owner will pick up more investment flexibility with fewer costs. The cost reduction is due to the "non-fund" setting that sometimes occurs in the PPLI marketplace.

The true insurance coverage amount in a PPLI contract is usually the minimal amount needed according to one of two tests detailed in Internal Revenue Code Section 7702.[4] In either one of these tests, the long-term amount of insurance can be quite small and still allow the policy to qualify as life insurance. Because of the focus on the tax-deferred nature, and the fact that minimal amounts of insurance will be purchased, most of the insurance companies' profits are derived from the mortality and expense (M&E) costs, the true administrative costs of the policy, rather than the cost of insurance (COI), the actual cost to buy the term insurance coverage of the policy. It is this fact that opens up the opportunity for different types of insurance-oriented planning for PPLI, especially when large amounts of coverage are needed.

SAVINGS

The marketing and sales-related costs of PPLI vs. retail contracts are a key difference between them. Retail contracts by their design are structured to be sold through an established agency system. This is by far the most effective way for a carrier to distribute its products. Although most agents are paid only on commission, there are various fixed costs that must be absorbed in the costs of the policy. First, marketing and distribution costs are much more pronounced for retail contracts. You won't see any ads in magazines or on television for PPLI contracts. Furthermore, a $5 glossy brochure is proportionately more costly for a $1,000 premium than a similar brochure is for a $1 million premium. All things being equal, certain fixed costs of selling a policy can be substantial for small policies, while effectively being a nominal cost for very large policies.

The second element to consider is the fact that the average retail contract is substantially smaller than a PPLI contract as measured by premium. Because many of the fees from a variable contract are asset-based, either via the asset-management fees or via the M&E charge, there is a normal and expected efficiency with larger cases. PPLI contracts have break-point fees, while smaller retail contracts have flat fees. As with any policy, there are normal reporting and administrative costs in simply keeping the policy in force. There are few additional incremental expenses (such as those relating to personnel, computer systems or general administration) to maintain a $100,000 face policy as opposed to a $1 million face policy.

Thus, as the cash value of the contract increases, there is a potentially greater profit level for the larger policies in the retail market. However, the carriers' actuaries and marketing and sales professionals have a fairly good idea of the number, and the average size, of the retail cases that will be sold each year. Without a doubt, the average retail case has premiums of thousands of dollars, not millions. Yet these smaller cases must remain profitable. Actuaries price products so that all size cases will be profitable but don't necessarily adjust the costs for the larger policies.

MORE DISCLOSURE

One of practitioners' biggest complaints is that it is difficult to understand the various pricing constraints of a retail contract. Every planner has seen different premium quotes from the same company for the same amount of death benefit. Nothing is free and something must be given up, be it investment gains, underwriting standards, costs or commissions. With PPLI, there's a higher level of disclosure regarding costs, and there are few, if any, hidden fees to have a substantial impact on policy costs.

Because PPLI policies normally don't have surrender fees, amortization of fees is rare, so one does not have to factor in this cost. Producers and distribution sources will normally mark up the M&E but not the COI. This leaves those who are seeking the insurance death benefit with an opportunity to take advantage of this "wholesale" fee structure.

It is for these reasons that PPLI can actually be a much more advantageous structure than a retail contract. Keeping the COI, while keeping the drain on the cash value at a min-

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imum, helps support a larger death benefit with smaller premiums.

COMPARING PRODUCTS

One of the driving elements of any insurance product, especially for those products where a large amount of insurance is required, is the COI. Of all the costs, this is by far the one that is least understood by the planning community and is also the hardest to compare.

In a variable life insurance contract, an insurance company will purchase, on a monthly basis, the net amount of risk required for each policy. The net amount of risk is defined as the difference between the face amount of the contract (the stated death benefit) and the cash value of the contract (the investment element).

In a PPLI contract, the COI of most carriers is only slightly above the true reinsurance cost of this risk. Although some carriers have substantial markups, as much as 250 percent,[5] many carriers mark up the costs by less than 10 percent. The difference is even more pronounced between retail and PPLI contracts. What this means is that if the true cost of $1,000 of coverage for a particular individual is $10 for a particular year, the range of costs among carriers could be anywhere from $11 (a 10 percent markup) to $25 (a 250 percent markup). Although this may not seem substantial, these numbers become quite important for large cases.

If, for instance, $10 million of net risk coverage is needed, a policy may incur a COI cost in that year of between $110,000 and $250,000, depending on the carrier. Multiply this difference over a 20- or 30-year period, and substantial savings may be realized. More importantly, this may only be a difference of $150,000, but as measured against a few million dollars of cash value, it represents a substantial percentage difference in that year and each subsequent year.

CASE STUDY

Let's compare a retail and PPLI contract from the same carrier, taking a 54-year-old male seeking $15 million of insurance coverage for a buy-sell arrangement. Further, let's assume that straight term insurance is not the best fit. Finally, assume that the client wishes to purchase the insurance from a "major" life insurance company.

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Traditionally, the client would seek the advice of his insurance agent, who would obtain various quotes from the required carriers. For the sake of this article, we obtained illustrations from several insurance companies in order to establish a baseline. Furthermore, we assumed that the individual has a preferred rating and that the gross growth rate on the account will be 6 percent. Obviously, different insurance companies have different cost assumptions, and different crediting rates. The range is about $750,000 to $1 million of premium for five years to support this coverage to age 100. This assumes normal fees and commissions for this type of product.

In a similar case and sometimes even with the same issuing company, PPLI can result in dramatic savings to the client. There are also variations among PPLI companies, but the average result is that with a premium of perhaps $500,000 per year for five years, the $15 million of coverage can be maintained (also assuming normal fees and commissions for this type of product).

The overall savings in premium outlay ranges from around 20 percent to 50 percent at these growth rates. With larger growth rates, the savings would be even more pronounced. Finally, in a PPLI arrangement with larger premiums, the administrative fees shrink quite dramatically. In other words, the larger the policy, the more efficient PPLI becomes.

This is the scenario that best emphasizes the cost savings: Clients who need $10 million or more of death benefit for any reason always want the cheapest policy with the best company. Estate planners find it much easier to conduct transfer-tax planning on $500,000 than for $1 million. Money managers would much rather manage the money than lose it to an insurance company. Obviously, there is benefit for almost everyone except the retail policy salesperson who won't sell the PPLI version.

But that doesn't mean that the retail salesperson shouldn't use PPLI. For those unusually large cases that he may come across, a sale may never occur with a retail contract if a PPLI contract is also offered. For larger cases, PPLI is logically one of the best ways to go.

APPLYING THE SAVINGS

The key benefit to PPLI in a traditional insurance-needs situation is that more death benefit can be bought for less money. This becomes especially important when one is dealing with transfer taxes where mitigation of the costs is important. In employee-benefit situations, the company can provide the same or a better benefit at a lower cost. And finally, for any other insurance-needs situation, the client can effectively maintain the prevalent philosophy of "buying term and investing the difference."

Customization of PPLI contracts can help smooth out fluctuations in account values and interest rates.

If the client were to obtain the investment flexibility of a PPLI contract and earn more in doing so, this efficiency would help in making each dollar go further. Depending on the amount of additional death benefit required, an increase in the growth rate by 1 percent to 2 percent can effectively fully cover the costs of these policies. In addition, this 1 percent to 2 percent could actually be the average annual tax savings on the investments within the policy. Once again, the overall efficiency of PPLI can oftentimes cover, and even exceed, the hard costs of the mortality coverage.

PREMIUM FINANCING

Many premium financing programs have been tested and established over the years. Unfortunately, many of them assume a substantial spread between growth rates and interest rates on the financing, regardless of some foreign hedging with various currencies. If the assumptions don't hold up, the whole program can collapse. The use of PPLI in conjunction with premium financing helps to stabilize some of the uncertainties of the program. Due to the customization of the policy, and the ability to have lower costs, especially in the first years, the policy owner has a greater possibility of making the program work. What all these programs need is the ability to stabilize the interest rate over a longer period of time rather than the normal period of three to five years. With break-even points often in the 10- to 15-year time horizon, policyowners take substantial risks of fluctuation in their account values vs. even more fluctuation in future interest rates.

Once again, the customization of PPLI contracts can be adapted to help smooth out these fluctuations. By keeping overall fees low and by converting heavy up-front commissions to a smaller trailer-based fee, the spread needed between the interest rate and growth rate of the cash value can be compressed.

STILL LIFE INSURANCE

The key thing to remember is that PPLI contracts are still life insurance contracts. For those individuals who need life insurance coverage in excess of $10 million, substantial cost savings can be incurred by using a PPLI contract over a traditional retail contract. This is not to say that some clients will not be well served by retail contracts. For those who seek simplicity, don't desire flexible investment options and don't mind paying a little bit more, retail contracts will fit the bill. However, for the sophisticated client who earned his money the hard way, and has a tendency to be a tough negotiator on fees, PPLI offers a comfortable home.

The key issue in this analysis is that an actual insurance need exists. Too often insurance is used to fill a gap that adequate income or estate-tax planning could have reduced from the beginning. Therefore, it is critical to bring a large insurance contract into the big picture only when it provides the most efficient and manageable solution for the client. ▮

Endnotes

1. David S. Neufeld and Grant R. Markuson, "Tax Planning with Private Placement Life Insurance: Practical Considerations and Real World Uses to Achieve Tax-Free Investment Returns," Vol. 4, *Asset Protection Journal* 48 (Summer 2002).
2. For a detailed discussion of the tax rules and practical aspects of private placement life insurance, see Grant R. Markuson, "Private Placement Life Insurance: New Insights for an Enduring Technique," a special advertising supplement to *Trusts & Estates* (December 2002).
3. It is important to understand that the client cannot have too much control over the underlying assets and thus violate the Investor Control Doctrine. For a detailed discussion of this subject, see David S. Neufeld, "The 'Keyport Ruling' and the Investor Control Rule: Might Makes Right?," *The Insurance Tax Review*, March 2003, p. 383.
4. See IRC Section 7702. For a detailed discussion of the testing under IRC Section 7702, see Howard M. Zaritsky and Stephan R. Leimberg, *Tax Planning with Life Insurance: Analysis with Forms* (Warren, Gorham & Lamont, 2nd ed., 1998).
5. It is important to note that for marketing purposes, some carriers start out with very low COI markups but gradually increase them over the years. Unless one is specifically looking at COI incremental shifts, it is very easy for a carrier to increase these costs without anyone noticing. For pure PPLI products where minimal death benefit is needed, these incremental costs are not that important. However, if one is looking to buy additional mortality, the cost of the product becomes much more pronounced.