

Private Placement in 2023: An Overview and Benefits Analysis of Puerto Rico Issued International PPVA and PPLI

For sophisticated, international investors, incorporating a Private Placement Deferred Variable Annuity (“PPVA”) contract or Private Placement Variable Life Insurance (“PPLI”) policy as part of a broader wealth plan can generate unique tax and reporting benefits, especially when issued by a Puerto Rico International Insurer.

In this article, we aim to provide advisors with an introduction to private placement — a small piece of the multi-trillion dollar global insurance industry — by outlining the structural differences, mathematical benefits, and practical considerations of PPVA and PPLI and by illustrating when and how to use each product to address common needs of modern domestic and foreign clients. Further, we address the added benefits of private placement issued by a Puerto Rico International Insurer as compared to that issued by domestic carriers.

Private Placement: A Refresher

PPVA contracts and PPLI policies are highly bespoke, variable insurance products offered by international and domestic U.S. insurance companies that can offer lower costs and greater policy customization than traditional “retail” variable annuities and life insurance. Additionally, when structured appropriately, these products can provide unique benefits crucial to modern ultra-high net worth (“UHNW”) individuals and family offices, including income and estate tax optimization, statutory asset protection, underlying investment flexibility, benefits to charitable giving, and increased confidentiality of sensitive information not offered by alternative insurance and investment products.

In practice, advisors can include new or existing investments in hedge funds, private equity, and other tax-inefficient asset classes inside a PPVA or PPLI policy, deferring or completely mitigating associated annual taxes for their client while retaining managerial control of the underlying investments.



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Private placement policies and contracts are sold to a limited number of accredited investors that are represented by their own tax, accounting, legal, and financial advisors and are considered “variable” because policy value and returns are tied to gains or losses on underlying investments rather than to a guaranteed investment return.

While the private placement market has traditionally been focused on United States citizens and residents, more recently the potential tax, reporting, and other benefits of these bespoke insurance products for clients with minimal or no active U.S. tax exposure have become increasingly apparent.

PPVA: A Structural Summary

A private placement variable annuity enables the accumulation of funds, tax-deferred, within a policy which are redistributed to the client at a later date, either in a lump sum or via fixed term lifetime payments. In the U.S., assets held in a variable annuity only incur tax on their income when funds are withdrawn via surrender or distributed per the terms of the contract following a deferral period.

Structurally, the core components of a PPVA can be broken down as follows:

Balance (Year One): Initial Premium Paid – Sales Charge – Administration Charges – Investment Charges + Investment Return = Year One Ending Reserves Value

Balance (Subsequent Years): Year Beginning Reserves Value + any Additional Premium Paid – Sales Charge on Additional Premium – Administration Charges – Investment Charges + Investment Return = Year Ending Reserves Value.

Withdrawal of variable annuity funds, and taxation upon withdrawal of such funds, can be calculated as follows:

PPVA Cash Surrender Value (Pre-Tax): Reserves Value – any Applicable Surrender Charge.

Income Taxation upon Surrender: Pre-Tax Cash Surrender Value – Policy Tax Basis = Gain Upon Surrender that is taxable income to the policy owner.

Note that, for U.S. taxpayers, taxable Gain Upon Surrender is taxed as ordinary income, rather than as capital gains, and that withdrawals incur an additional 10% penalty tax (with some exceptions) for individual insured annuitants younger than 59-1/2 years of age.

PPLI: A Structural Summary

Just like PPVA contracts, PPLI policies also incorporate a variable cash value, funded via policy premiums, that is typically income tax-free unless funds are withdrawn during the lifetime of the

insured. Unlike PPVA contracts, though, PPLI policies also incorporate a death benefit component that equates to the sum of the policy's variable account investment reserves (which are statutorily segregated from the insurance company's general account and protected from its creditors) plus a "Net Amount At Risk," or the additional guaranteed life insurance death benefit provided by the insurance company and funded via additional annual mortality charges to the account. Importantly, in the United States and many other tax jurisdictions, a life insurance death benefit is not subject to any income tax upon the insured's death and subsequent transfer to policy beneficiaries.

Structurally, the core components of a PPLI policy can be broken down as follows:

Balance (Year One): Initial Premium Paid – Sales Charge – Administration Charges – Mortality Charges – Investment Charges + Investment Return = Year One Ending Reserves Value

Balance (Subsequent Years): Year Beginning Reserves Value + any Additional Premium Paid – Sales Charge on Additional Premium – Administration Charges – Mortality Charges – Investment Charges + Investment Return = Year Ending Reserves Value

Note the addition of quarterly or annual mortality charges, which are the core structural difference between PPVA and PPLI and which fund the life insurance policy's death benefit.

Withdrawal of funds, and taxation upon withdrawal of such funds, can be calculated as follows:

PPLI Cash Surrender Value (Pre-Tax) = Reserves Value – any Applicable Surrender Charge or Cash Value Restriction.

Income Taxation upon Surrender (if During Lifetime of Insured): Pre-Tax Cash Surrender Value – Policy Tax Basis = Gain Upon Surrender that is taxable income to the policy owner.

Income Taxation upon Death of Insured = \$0.

Inclusion of an income tax-free death benefit is the defining mechanical advantage of a PPLI policy as compared to a PPVA contract.

It is important to note that any policy considered to be a modified endowment contract ("MEC") under the U.S. tax code may lose critical tax benefits typically associated with PPLI, specifically those related to treatment of withdrawals or loans during the policy's lifetime. While PPLI policies that avoid MEC status can have lifetime tax advantages including no taxation on loans taken against the policy, in practice, U.S. tax requirements make it extremely difficult and expensive to issue large policies that fulfil non-MEC requirements.

The Mathematics of Private Placement

Example 1: To illustrate the potential financial benefits of private placement insurance and annuities, assume that a male, age 51, invests \$5,000,000 via single premium into each of the following:

- (1) a U.S. tax compliant PPVA
- (2) a U.S. tax compliant PPLI policy¹
- (3) a U.S. tax compliant taxable investment account

Further assume that each variable account achieves a 6.0% pre-tax annual return and that the combined federal, state, and local income tax rate is 40.0%.

The table below illustrates the performance of these three accounts over 24 years until the man reaches age 75 and either surrenders the account, receiving the cash value, or dies:

	Year 24 (Age 75)			
	Starting Value	Account Value	Net After-Tax Value (Surrender)*	Net After-Tax Value (Death)
1. PPVA	\$5,000,000	\$18,943,445	\$13,366,067	\$13,366,067
2. PPLI	\$5,000,000	\$17,200,830	\$12,320,498	\$18,404,888
3. Taxable Account	\$5,000,000	\$11,684,399	\$11,684,339	\$11,684,339

* Includes illustrative surrender charges

A few things become immediately clear:

First, the PPVA performs significantly better over time than does the traditional taxable account, achieving a positive delta at surrender of \$1.68m over 24 years from tax-deferred investment compounding alone. When considering that the PPVA's deferred taxation may also empower advisors to allocate additional client funds to potentially high performing asset classes like hedge funds and private equity without incurring the tax drag traditionally associated with such investments, this after-tax delta may increase further.

Note that PPVA contracts are especially useful for clients in transient tax situations, as proper implementation within a broader financial plan can enable fully compliant tax deferral until a taxpayer wants and is able to access their investments in a lower or zero tax rate environment.

Example use cases for PPVA contracts include high income working individuals living in high state income tax jurisdictions such as New York and California and who plan to retire to an income tax-free state like Florida or Texas; non-U.S. persons planning to become a U.S. taxpayer for several years before returning

¹ MEC with initial death benefit of \$15,335,264 that is U.S. Section 7702 Guideline Premium / Corridor Test compliant.

to non-U.S. tax resident status; and U.S. or foreign clients living abroad experiencing difficulties accessing direct U.S. investments or in need of investments with more efficient home country reporting.

Second, in the lifetime surrender scenario, the PPVA will net over \$1.0m more, after tax and surrender penalties, than will the PPLI policy after 24 years. This is because the latter incurs annual mortality charges, hindering its growth as compared to the unburdened PPVA.

This advantage switches in the death scenario whereby the PPLI policy returns over \$5m more, after tax, than does the PPVA in the same 24-year period. This can be attributed to the aforementioned income and estate tax benefits of compliant MEC PPLI policies at the death of the insured, which do not apply to PPVA contracts.

Summarized, a PPVA is generally preferable to a MEC PPLI policy if the goal is to access funds during client lifetime. Oppositely, if funds are not likely needed during the policy owner's lifetime, the additional tax-free death benefit of a MEC PPLI generally makes it a far more efficient estate planning tool than the PPVA.

In both cases, though, the PPVA and PPLI policy outperform the taxable account due to their favorable treatment under U.S. tax code.

Layering On the Advantages of International Insurance

International insurance companies (those domiciled in Cayman, Bermuda, etc.) often receive additional advantages when issuing private placement, largely because they fall outside of U.S., LatAm, European, and Asian securities registration requirements and domestic insurance regulatory constraints. These additional benefits can include:

Pass-through cost savings: International insurers typically operate in lower tax rate jurisdictions than do their domestic counterparts, and they often pass these tax savings on to clients. Additionally, the relatively high minimums for international private placement premiums (generally \$2,500,000) underpin significant operational cost savings as international insurers may administer less policies than domestics and stay profitable and competitive. In practice, the pass-through result for a client is that annual carrying costs for an international PPLI policy or PPVA can be half or less than half of those for a similar, domestic product.

Additional flexibility of underlying investments: International insurers are able to support a broad selection of underlying investment managers, custodians, and strategies that generally fall outside the scope of domestic insurers. While never guaranteed, this greater investment flexibility can lead to better risk-adjusted returns, especially for sophisticated advisors who may have access to unique alternative investment and fund opportunities for their clients that are impractical or impossible to house within a domestic PPVA or PPLI policy due to insurer constraints.

Greater policy customization: International insurers are able to customize individual client policies and contracts to a far greater extent than are domestic insurers, largely because their smaller client list and minimal regulatory constraints enable a significantly more hands-on approach, while domestics operate on a volume business model driven by highly-regulated transactions.

International designs such as Restricted Cash Value and Death Benefit Only policies, wherein lifetime cash value is contractually limited, are highly bespoke and can substantially decrease a policy's annual mortality charges. Importantly, these policy types are also designed to emphasize "risk shifting", a core doctrine in modern insurance regulation, via greater restrictions on lifetime cash value access and larger death benefits relative to policy cash value.

Broader implementation: In many cases, international insurers, as well as some domestic, non-U.S. insurers, operate under more lenient statutory home country Death Benefit requirements, wherein a PPLI policy's Net Amount at Risk may only need to be 10% of premiums paid in order to qualify as a life insurance product (U.S. code requires a much larger Death Benefit for similar treatment). Accordingly, mortality charges on these policies can be significantly smaller than those incurred by otherwise similar U.S.-native products, in turn strengthening each policy's compounding power over time.

Example 2: The unique elements of international, as compared to domestic, private placement can help to achieve two key goals: decreasing carrying costs for policy owners and increasing gross annual investment returns. When paired, these can significantly increase net returns, which compound over the life of an account.

To illustrate, assume that a male, age 51, non-smoker, in good health, invests \$5,000,000 via single premium into a fully-compliant MEC PPLI policy. Over its lifetime, the policy might experience a net annual return of 4.0%, or 6.0%, or 8.0%, depending on the combination of its underlying investment performance and the policy's carrying costs.

The following table illustrates how these different return profiles would impact policy growth and terminal value over the course of the account's 24 year lifetime:

		Year 24 (Age 75)		
	Starting Value	Account Value	Net After-Tax Value (Surrender)*	Net After-Tax Value (Death)
PPLI Net 4%	\$5,000,000	\$10,632,423	\$8,379,454	\$11,376,693
PPLI Net 6%	\$5,000,000	\$17,200,830	\$12,320,498	\$18,404,888
PPLI Net 8%	\$5,000,000	\$27,435,594	\$18,461,357	\$29,356,086

* Includes illustrative surrender charges

The layered cost and diversification advantages of international PPLI can assist in generating seemingly small increases in annual net returns which, over time, have an outsized effect on policy value. When combined with the tax-free death benefit of a properly structured PPLI policy, this effect becomes significantly more beneficial.

Puerto Rico as an International Insurance Domicile

Despite being generally considered an international insurance domicile similar to those mentioned in the previous section, Puerto Rico's unique position as a U.S. territory allows its insurance industry to operate as a functional middle-ground between international and domestic, with insurers and their clients enjoying many of the benefits of both with few of their respective downsides:

- Puerto Rico insurers are exempt from both OECD's Common Reporting Standards ("CRS") and U.S. FATCA reporting requirements, which dictate international sharing of detailed account information between financial institutions. Similarly, Puerto Rican insurance clients are exempt from U.S. FBAR reporting.
- While Puerto Rico international insurers receive non-U.S. tax treatment, they enjoy the strength and protections offered by the U.S. government and its legal, banking, and globally-respected insurance regulatory systems, including U.S. compliant and enforceable segregated account and statutory asset protection backed by clear U.S. legal precedent. The same cannot be said for traditional "offshore" international insurance carriers.
- Puerto Rico's insurance regulator is NAIC-accredited and its flexible insurance framework has been specifically designed with the intention to enable bespoke private placement transactions that are both workable for global UHNW and family office clients and fully U.S. tax compliant.
- Finally, as a U.S. territory and unlike virtually all other international insurance domiciles, Puerto Rico is not subject to the relentless regulatory scrutiny and legal challenges associated with offshore tax havens touting similar insurance benefits. This results in optimized operations for Puerto Rico's insurers and peace of mind for private placement policy and contract owners.

Example 3: For non-U.S. persons with U.S. investments such as stocks, bonds, and real property, U.S. federal estate tax generally applies at 40.0% upon death with only a \$60,000 exemption. Historical workarounds, such as those involving the transfer of assets to a BVI (or other tax-friendly jurisdiction) HoldCo to avoid direct ownership, have long triggered "economic substance" tests and other adverse rules and regulations.

Alternatively, a Puerto Rico PPLI policy housing these, or similar, U.S.-domiciled investments incurs no U.S. estate tax at death and is privately paid to beneficiaries with no estate administration or public probate process nor any forced heirship restrictions.

Assuming a non-U.S. person dies owning a \$10,000,000 portfolio of U.S. stocks and bonds, the U.S. federal estate tax due would be more than \$3.9m. If the same non-U.S. person dies owning a Puerto Rico issued PPLI policy holding the same \$10,000,000 portfolio of U.S. stocks and bonds, the combined U.S. federal and Puerto Rico estate tax due is \$0.

Conclusions

Private placement insurance products can be useful tools when incorporated into the financial planning strategies of high wealth U.S. and foreign taxpayers, including family offices with complex wealth and estate planning requirements. While each situation and timeline is unique, generally a PPVA is best for situations where a client may need access to account funds during their lifetime while a PPLI policy is best if funds are anticipated to remain untouched until death of the insured.

Today, international insurers are often able to leverage advantageous cost structures and flexible investment and policy design frameworks to drive stronger net returns for clients than are their domestic counterparts.

Puerto Rico's special relationship with the U.S. has created a favorable environment for its locally-domiciled international insurers and their clients to enjoy the same protections afforded to the U.S. domestic insurance market while enabling atypical policy flexibility, minimal reporting requirements, and some tax advantages. ■

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