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Too Good to Be True: Private Placement Life Insurance Policies

by Luís Calderón Gómez

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In this article, Calderón Gómez examines a tax avoidance scheme involving private placement life insurance policies — large policies that potentially allow wealthy taxpayers to move their traditionally tax-inefficient investments in private equity and hedge funds into a life insurance policy and accumulate, borrow against, and pass on those investment gains effectively tax free — and sketches some possible alternatives to stop the abuse of these policies.

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There's a new tax avoidance/evasion[1] scheme in town.[2] In the past few years, high-net-worth and ultra-high-net-worth individuals have flocked to life insurance as the scheme du jour. Thanks to this strategy, they get to accumulate gains tax free in lucrative yet tax-inefficient investments such as private equity and hedge funds, borrow against those accumulated gains tax free when needed, and pass those gains on tax free as a death benefit to their heirs.

Heads I Win, Tails You Lose

As should be evident, they are not using your grandfather's traditional life insurance policy; wealthy individuals are instead using private placement life insurance (PPLI) to achieve their tax goals. PPLI is similar to traditional variable life insurance, with three significant practical differences.

First, unlike traditional life insurance, PPLI is only available to people willing to invest $2 million or more — although it is apparently much more common for people to invest at least $5 million, or at least that is what Congress believes.[3] PPLI policy sizes might be even larger. Recent policies by Lombard International Assurance suggest that the average PPLI policy account might be worth about $7 million.[4] To the extent that the tax treatment of PPLI awards unique tax benefits, it does so exclusively to a few high-net-worth and ultra-high-net-worth individuals, therefore posing serious vertical equity issues.

Second, from the policyholder's perspective, the true value of PPLI is not in the insurance component. In fact, policyholders routinely seek to reduce the insurance death benefit component as much as is allowed under IRS rules to lower the insurance fees on the instrument — and maximize

[1] Some might argue that my use of these concepts is careless, in that tax avoidance and evasion are different animals. While that discussion is outside the scope of this article, I would disagree and merely echo Denis Healey, former U.K. chancellor of the Exchequer: "The difference between tax avoidance and tax evasion is the thickness of a prison wall." Matthew Bishop, "The Mystery of the Vanishing Taxpayer," *The Economist*, Jan. 27, 2000.

[2] Recent *Tax Notes* articles have recounted the growing congressional investigation into PPLI of Senate Finance Committee Chair Ron Wyden, D-Ore. *See, e.g.*, Chandra Wallace, "Custom Life Insurance Defended as Extreme Wealth Management Tool," *Tax Notes Federal*, Oct. 10, 2022, p. 264.

[3] *See* Wyden letter asking Lombard International to provide information on the growing use of PPLI policies as a tax shelter (Aug. 15, 2022).

[4] *See* Wallace, "Wyden to Expand Scrutiny of Private Placement Life Insurance," *Tax Notes Federal*, Sept. 26, 2022, p. 2112.

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accumulation in the policy's investment component.[5] As such, PPLI is being used more as an instrument for tax-favored speculative investment than as an instrument to reduce financial loss upon death. Wrapping ordinary investment activity in a tax-favored vehicle contravenes the rationale for the tax benefits awarded to life insurance and is no more than plain tax avoidance/evasion.[6]

Third, traditional life insurance gives holders the ability to invest in basic and vanilla equity and debt funds, but PPLI offers vastly more options to policyholders, making the policy's investment component much more valuable. The investment component of the policy can be invested in funds that are available exclusively to insurance companies: insurance dedicated funds (IDFs). The IDF market used to be relatively narrow and sleepy, but that has changed. In the last decade, the number of available IDFs doubled, with about 200 IDFs now in the market.[7] As a result, IDFs now offer PPLI policyholders the opportunity to invest in a plethora of sexy yet ordinarily tax-inefficient options (think lots of realized capital gains or short-term capital gains) like private equity, venture capital, and hedge funds. This feature similarly contravenes the purpose of this regime and provides an unwarranted benefit for speculative investing that should be taxed ordinarily while also creating issues of vertical equity vis-à-vis ordinary life insurance policyholders and of horizontal equity vis-à-vis people who invest in these assets directly.

But why make these investments through PPLI rather than directly? The law is relatively simple: Realized gains in the investment component of PPLI generally do not subject the policy owner to federal income tax — and the death benefit is received tax free by the policy's beneficiary under section 101(a). Yet one need not die to receive tax-free funds. In a crunch, the policyholder can generally borrow funds from the investment component of the policy, tax free.[8]

Summing up: PPLI allows wealthy individuals to invest tax free in traditionally tax-inefficient investments like hedge funds. Moreover, unlike other instruments that restrict or penalize the investor for withdrawing funds (for example, before the owner's death), a policyholder can with ease effectively withdraw funds by borrowing against the PPLI's investment component.

So what's the catch? Are there any tax restrictions[9] on the tax advantages offered by PPLI? Promoters tend to think about two main restrictions on PPLI.[10] The first is that the policyholder cannot have investor control over the policy. As a result, the insured can (within bounds) choose the types of investments and the risk level with which she is comfortable but cannot select or recommend particular investments, cannot communicate directly (or indirectly) with the policy's investment manager or adviser regarding investment strategies, and cannot have legal or equitable rights or interests in the investments other than those of a policyholder. Also, the policy must only invest in assets that are exclusively available to insurance policies.

The second is the diversification requirement, which as a practical matter mainly requires that the policy hold at least five investments and not be too heavily concentrated in a single one. This second requirement, however, is easy to satisfy with appropriate planning, leaving the investor control requirement as the main safeguard against the abuse of PPLI.

The Government Takes Notice

Perhaps PPLI is too good to be true, as the federal government has recently taken notice of

[5] *See supra* note 1. The parties to the transaction are also trying to avoid application of the modified endowment contract rules, the application of which would significantly neutralize the tax advantages of the PPLI. *See* sections 72(e)(10) and 7702A.

[6] *See, e.g.*, *Christoffersen v. United States*, 749 F.2d 513 (8th Cir. 1984).

[7] *See* Cameron Vail, "Now More Than Ever: Why Today's Insurance-Dedicated Fund (IDF) Investment Options Make Sense for the Corporate-Owned Life Insurance (COLI) Market," SALI Fund Services (Mar. 29, 2021).

[8] *See* section 72.

[9] A restriction on its use is the securities' law requirement that PPLI be offered only to accredited investors to avoid registration hassles. However, as discussed, most of the investors in PPLI are ultra-high-net-worth individuals, so requiring them to be accredited investors is not a big practical restriction on PPLI.

[10] Another restriction, the modified endowment contract rules, is easily planned against by making sure the policy has the minimum death benefit component and that payments to the policy are made according to the code's guidelines. *See* section 7702A.

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its increased popularity. Two years ago, the Department of Justice entered into a deferred prosecution agreement with the Swiss Life Group and some of its subsidiaries regarding their sale of PPLI to U.S. citizens with the goal of hiding their ownership of offshore assets and evading federal income taxes.[11] Under the agreement, Swiss Life agreed to pay more than $77 million in restitution, forfeiture of fees, and penalties — and to report more information on abusive policies to the government.

Congress started taking more aggressive action last year. Senate Finance Committee Chair Ron Wyden, D-Ore., began an investigation into PPLI and sent a letter to Lombard International (an insurer owned by Blackstone Inc.) inquiring about the PPLI products it offered clients.[12] A month later, Wyden followed up with a letter to several insurers seeking to obtain information on these instruments and how they are being marketed.[13] The investigation thus seems to be gaining steam.

Possible Avenues for Reform

Strongly worded letters and fines are unlikely to put an end to these lucrative schemes — after all, the benefits are too large to ignore. What would stop the abuse is a congressional fix that bars investors from dressing up their investments in private equity or hedge funds in PPLI.

Congress could reduce the abuse of PPLI by eliminating its investment edge over traditional insurance policies. Congress could act from the securities' regulation angle and impose limitations on the investments available to PPLI, for example, by restricting them to those that are generally available to ordinary life insurance policy owners. Lawmakers could also revise the definition of diversification regarding PPLI and other complex variable life instruments — excluding hedge fund and private equity investments from the calculation of diversification. Alternatively, lawmakers could bar policyholders from contributing premiums "in-kind," determining that such payment is akin to selecting the policy's investments. In adopting any of these, Congress would reduce the transformation of life insurance into a speculative investment vehicle (or at least push for traditional policies to similarly benefit from additional investment options), alleviating concerns about equity and policy abuse.

Legislators could also curtail the use of PPLI as a speculation vehicle by increasing a policy's required insurance component. To that end, Congress could tighten restrictions on the amount of death benefit required relative to cash value in a life insurance policy under section 7702[14] to the point of making PPLI policies economically unattractive vehicles for speculation.[15] That move would reimpose insurance as PPLI's intended purpose.

Another alternative to reducing the attractiveness of PPLI policies would be to simply limit their use. Congress could either cap the size of policies that qualify for life insurance treatment or limit the exemption of death benefits under section 101. This approach is more Band-Aid than cure, but it is consonant with previous congressional proposals to limit the abuse of other tax-advantaged instruments, such as IRAs.[16]

We are, however, unlikely to see any legislative fixes anytime soon now that we are set for at least two years of a divided (and probably deadlocked) Congress.

Regulatory Action

But, let's not forget about Treasury and the IRS. As has been the case with other abusive

[11] See Department of Justice release on Switzerland's largest insurance company admitting to conspiring with U.S. taxpayers to hide assets and income in offshore accounts (May 14, 2021).

[12] *Supra* note 2.

[13] Senate Finance Committee release on Wyden's continuing investigation into PPLI schemes (Sept. 21, 2022).

[14] Congress could similarly achieve this goal by broadening the application of the modified endowment contract rules through an increase of the minimum threshold for their application.

[15] Congress has a plethora of options to make these instruments less attractive for speculation. For example, changes made in 2017 to section 7702's complex insurance requirements allowed for faster funding by the policyholder, resulting in potentially faster and larger tax-free accumulation of investment gains, therefore increasing the popularity of PPLIs. *See* Brian M. Balduzzi and Bryan Bloom, "Using Private Placement Life Insurance Policies as a Tax Minimization and Wealth Transfer Strategy," Faegre Drinker Biddle & Reath LLP (Sept. 1, 2022) ("Therefore, this change increases reserve levels and cash value levels for new policies, such that taxpayers can fund these policies more quickly."). Reversing these changes would make PPLI less attractive and therefore reduce their abuse.

[16] *See, e.g.*, Caitlin Mullaney, "Mega-IRAs and Some Backdoor IRAs Under Fire in House Bill," *Tax Notes Federal*, Sept. 20, 2021, p. 2011.

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transactions, Treasury and the IRS could first act by listing PPLI arrangements as reportable transactions in the hopes that sunlight would be the best disinfectant. But doing so would be considerably more complicated, given potential taxpayer responses in the wake of the Court's decision in *CIC Services*[17] and the Sixth Circuit's decision in *Mann Construction*.[18] The IRS's newfound Administrative Procedure Act problems are likely to render listing PPLI transactions an impractical, slow, and ineffective option.

Instead of focusing on disclosure, the IRS could focus on improving the law on PPLI. A welcome first step would be for the IRS to systematically review its relevant guidance and revoke several unduly lenient rulings as no longer in accord with the agency's views.[19]

Several letter rulings opened the door to PPLI abuse, especially through the erosion of investment control safeguards, a critical antiabuse tool. For example, LTR 201502003 has been liberally interpreted to allow an owner or member of an investment firm to obtain PPLI and then invest those funds in her firm's IDF.[20] That lenient rule worryingly shrinks the distance between investor and policyholder, setting the stage for a type of abuse that is particularly hard to police.

Another example is LTR 201436005. This ruling has been similarly interpreted to further erode investor control requirements, allowing an IDF's investment strategies to perfectly mimic a taxable fund's (that is, a retail fund available to ordinary investors outside the insurance context) strategies.[21] As a result, a policyholder can practically cherry-pick the investments in an IDF because they can always look at the publicly available fund's particular investments. This provides the policyholder with sufficient information to make fairly targeted investment decisions in publicly available investments — a result plainly unintended by Congress.[22] Moreover, that result is clearly in tension with one of the purposes of the investor control doctrine; a policyholder's investment in this IDF would place her in a position that "is substantially identical to what . . . her position would have been if . . . she had directly or indirectly . . . purchased an interest in the asset held by the [IDF]."[23]

The IRS could also improve the law through strategic litigation, seeking to cement positive precedent to deter potential PPLI abusers, as it has done in the past.

Take *Webber*,[24] for instance. In that case, the IRS successfully challenged a taxpayer's PPLI arrangement on investor control grounds, reiterating to taxpayers that they could not expect to play day traders on their insurance policy's investment account. *Webber* reminded PPLI promoters of the investor control requirement that some had presumed dead[25] and closed the door on PPLI arrangements in which the policy owner retained too much control. *Webber* has thus helped deter some abusive practices, such as artificially prearranging investment decisions or allowing free-flowing communication between policyholders and investment managers.

The IRS should take the next step and strike at the heart of PPLI. It should challenge abusive arrangements on substance-over-form or sham transaction grounds, pointing to how, in the paradigmatic abusive PPLI arrangement, the insurance aspect of the transaction is barely present (or merely incidental). Rather, the policyholder's ownership of the PPLI is best categorized as an ordinary direct investment in the policy's underlying assets, with the

[17] *CIC Services LLC v. IRS*, 141 S. Ct. 1582 (2021) (holding that the Anti-Injunction Act did not bar lawsuits challenging the application of the reportable transaction rules).

[18] *Mann Construction Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022) (holding that Notice 2007-83, 2007-45 IRB 960, listing some cash value life insurance arrangements as reportable transactions, violated the APA's notice and comment procedures).

[19] *See* reg. section 601.201(l)(1); IRM section 32.3.1.6.1.

[20] Jonas Katz and Cameron Vail, "The Insurance Dedicated Fund Marketplace Explained," WealthManagement.com (July 12, 2019).

[21] *See supra* note 19.

[22] H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1055, 1984-3 (Vol. 2) C.B. 309 (cited in LTR 201502003). *See also* Rev. Rul. 81-225, 1981-2 C.B. 12 (ruling that there was investor control in situations in which "the policyholder's position . . . is substantially identical to what his or her position would have been had the mutual fund shares been purchased directly" rather than through an insurance policy).

[23] LTR 202041002 (citing Rev. Rul. 81-225).

[24] *Webber v. Commissioner*, 144 T.C. 324 (2015).

[25] Mary Ann Mancini, "Understanding Private Placement Life Insurance," Loeb & Loeb LLP, at 12 n.32 (Oct. 12, 2016) (noting that "Many practitioners took this to mean that Section 817 superseded the IRS rulings on investor control and the only requirements a policy must meet were set forth under Section 817.").

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accompanying tax consequences (for example, income inclusion upon receipt of dividends and realization of capital gains, no death benefit exclusion).

Conclusion

PPLI policies seem like they are here to stay. While the government appears to have caught on to the rampant abuse of these instruments by ultra-high-net-worth individuals, congressional investigations and one-off fines are unlikely to stem their abuse. A legislative fix, while plausibly optimal from a policy perspective, is unlikely in a divided Congress. That, however, does not mean that the government is out of luck. The IRS has several tools at its disposal, such as revoking unduly lenient rulings that have unintentionally facilitated the abuse of PPLI and engaging in strategic litigation. ■

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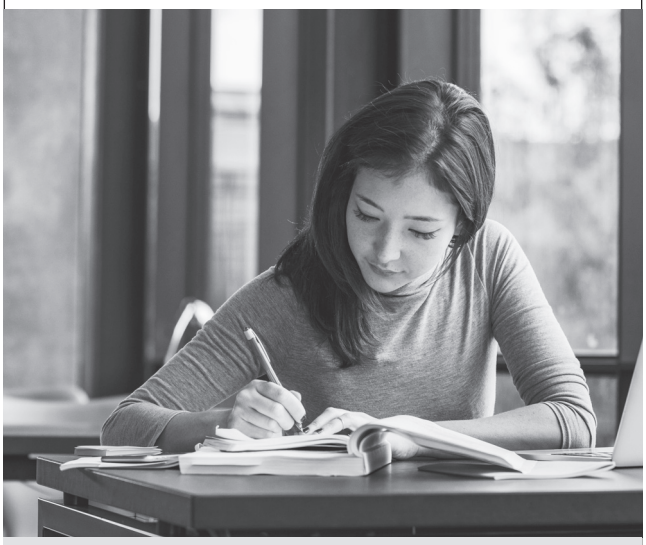

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