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PPLI

***A New Day for
Private Placement
Life Insurance
Planning in
Delaware***



Yes PPLI please!

A New Day for Private Placement Life Insurance Planning in Delaware

by
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Delaware's House and Senate have recently passed a bill that amends Section 702 of Title 18, which pertains to the State's premium tax on life insurance policies issued in Delaware. The bill adds new Subsection 702(c)(3) to the Section, providing that the premium tax on private placement life insurance ("PPLI") policies delivered in the State of Delaware shall be 2.0% on the first \$100,000 of net premiums, and shall be 0.0% on net premiums exceeding \$100,000. House Bill number 237 is currently awaiting the Governor's signature at the time this article is being written. This change to Delaware's PPLI premium tax makes Delaware much more competitive with other jurisdictions that have historically attracted virtually all of the PPLI trust planning business.

PPLI

PPLI is a rapidly growing market in which life insurance policies are used as sophisticated, and flexible investment vehicles designed to enhance the performance and tax-efficiency of certain investments. PPLI is only offered to owners who are qualified purchasers and accredited investors and the annual premium payments generally range between \$1 million to \$5 million. PPLI death benefits are generally quite large, often in the tens of millions of dollars. As a

life insurance product, a key advantage of PPLI is that it permits income tax-deferred buildup of the investments maintained inside the insurance product during the insured's lifetime and provides an income tax-free death benefit. The tax benefits of PPLI are heightened when the investments held as a part of the policy are the types of investments that are tax-inefficient, such as certain mutual funds, hedge funds and investment partnerships that spin off taxable income. Unlike other types of life insurance that include an investment component, such as variable, universal and whole life policies, PPLI offers the policy owner the flexibility to change investment fund managers to take advantage of different investment styles and allocations within the policy to adjust to the insured's investment objectives and risk tolerance. There are complicated rules that prevent the owner of a PPLI policy from having control over the investments and he or she cannot dictate investment decisions. However, the policy owner can choose a fund manager and make adjustments to that choice based upon the asset manager's investment allocations and philosophy. As the current tax environment has made income tax planning even more important to investors, tax deferral and tax efficient investment planning such as that available with PPLI is becoming a higher priority for high net worth clients.

Often, PPLI policies are held in a trust structure. A properly designed trust can provide creditor protection as well gift, estate and GST tax planning opportunities. A policy owner may also use a trust as the owner of PPLI because the policy owner wants to take advantage of the lowest premium tax law environment and holding the PPLI in a revocable trust whose situs is in a low tax jurisdiction can trigger the application of that state's tax laws. The selection of a trust situs is based on many decisions, but all things being equal, the administrative cost savings available in a jurisdiction that has a favorable state premium tax is the strongest driver.

Delaware has historically been a far less attractive option than jurisdictions such as South Dakota and Alaska for PPLI planning. The Delaware tax rate on premiums has been 2%. The current premium tax rate in South Dakota is 0.08% on annual premiums in excess of \$100,000. Alaska also has a very attractive tax rate of 0.10%. Consequently, most sophisticated planners looking to design life insurance trusts holding PPLI have turned to South Dakota or Alaska, and not Delaware, and Delaware has attracted little or no PPLI trust business in the past. The repeal of the PPLI premium tax in Delaware on net premiums over \$100,000, combined with the many other well-known advantages of using Delaware trusts for such planning, should attract new PPLI trust business to Delaware. And because these policies are so large, the assets under administration in Delaware, particularly after the death benefit is paid, could be substantial.

Delaware Advantages

One key aspect of Delaware law that makes it among the most attractive jurisdictions in the country for trust settlors is the ability to create a directed trust. Because a life insurance trust holds a concentrated position in a single asset (i.e. the life insurance policy) it often makes sense to use a directed trust and limit fiduciary duties to diversity in the trust agreement, so

that the trustee is not pressured to liquidate the insurance policy under common law duties to diversify. Section 3313 of Title 12 of the Delaware Code, and Delaware's well-developed trust law on the subject, has made Delaware the leading jurisdiction for direct trusts.

Additionally, Section 3302(d) of Title 12 of the Delaware Code provides trustees with a special set of rules applicable to life insurance held in trust on the life of the settlor or the settlor's spouse. It provides that when the trust agreement references that statute, the trustee may acquire or retain a contract of life insurance upon the life of the trustor or the trustor's spouse, without liability for a loss arising from the trustee's failure to: (1) determine whether the life insurance contract is or remains a proper investment; (2) investigate the financial strength or changes in the financial strength of the life insurance company; (3) make a determination of whether to exercise any policy option available under the life insurance contract; (4) make a decision of whether to diversify life insurance contracts relative to one another or to other assets, administered by the trustee; or (5) inquire about changes in the health or financial condition of the insured or insureds relative to any life insurance contract. This allows the express provisions of the Delaware trust agreement to carry out the settlor's intentions with respect to a life insurance trust: that the trustee simply hold the life insurance policy and pay the premiums, without being forced to sell it or diversify.

Another advantage of Delaware trust planning that applies to a Delaware life insurance trust is that Delaware does not impose any state income tax on Delaware resident trusts that have no Delaware resident beneficiaries. Delaware trusts are entitled to a distributable net income deduction for income distributed to beneficiaries similar to that provided for under Federal law. Additionally, under Section 1636 of Title 30 of the Delaware Code, Delaware resident trusts are entitled to a non-resident beneficiary deduction for income accumulated for beneficiaries who are not residents of the State of Delaware. The effect of these two deductions is that Delaware trusts that have no Delaware resident beneficiaries do not pay any Delaware state income tax on the income of the trust. When the life insurance trust becomes a non-grantor trust for Federal income tax purposes, the trust could benefit from state income tax savings.

Strategies

One planning strategy for PPLI is to use a dynasty trust for wealth transfer planning. Such a trust may be useful as an estate planning strategy because the trust assets would not be included in the settlor's taxable estate and would be exempt from generation skipping transfer tax. However, if the insured's objectives for the PPLI include withdrawal of investment proceeds as a tax-deferral strategy, then a traditional dynasty trust is not an appropriate vehicle because the assets of the trust would not be available for distribution to the settlor. There are some more sophisticated planning options that might be available to accomplish the estate planning goals in addition to permitting the settlor to get access to trust distributions, such as a completed gift asset protection trust or a spousal lead access trust (which is generally a very similar structure to a traditional irrevocable life insurance trust).

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Alternatively, in cases where a primary motivation for the PPLI is income tax savings and deferral of investment-related income, the insured may want the flexibility of accessing funds held in the policy during his or her lifetime. Access to investment returns within PPLI is done in a way that is similar to what is common with other forms of life insurance that include an investment component, like variable, universal and whole life policies. To achieve this goal when PPLI is held in a trust, the insured will need to have access to distributions from the trust holding the PPLI. The trust could be structured as a revocable trust with a Delaware trustee in order to take advantage of the state's favorable premium tax. The settlor can essentially withdrawal assets from a revocable trust at any time. The trust could also be structured as an irrevocable Delaware asset protection trust to achieve creditor protection. Of course, if an asset protection trust is used, trust distributions could only be made in the trustee's sole discretion, and the settlor would not have the ability to directly access the assets.

This new change to Delaware's PPLI premium tax could present a big opportunity for the Delaware trust industry to attract a new area of large asset trust business to the State of Delaware that was not otherwise coming to the state.



Todd Flubacher works with national and local clients on the creation, migration, modification and administration of Delaware trusts. He represents Delaware trustees, beneficiaries, law firms



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