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Tax-Efficient Private Credit Investing

Leveraging Private Placement Life Insurance and Variable Annuities to Enhance After-Tax Returns

Key Takeaways

- Today, many investors consider direct lending to be a core component of their strategic investment allocation given the asset class's key tenets: incremental yield in the form of an illiquidity premium, downside risk mitigation, floating rate exposure and diversification.
- Despite significant benefits, tax-sensitive high-net-worth investors have been hesitant to fully embrace direct lending strategies due to perceived tax inefficiencies. This stems from the asset class' investment return largely taking the form of interest income, which is taxable as ordinary income. However, unlike many investment strategies today, traditional fund expenses related to a direct lending fund's loan origination business are often deductible for tax purposes. This partially offsets this perceived tax inefficiency.
- Investors who are sensitive to taxes can further improve their after-tax return by investing through tax-deferred IRAs or Roth IRAs. In cases where retirement accounts are not an option, tax-sensitive investors with long-term investment horizons can still capture similar return benefits by investing through a private placement life insurance (PPLI) policy or private placement variable annuity (PPVA) contract.
- PPLI policies and PPVA contracts differ from traditional retirement accounts in that they do not have required minimum distributions, which allows for a longer period of tax deferral. However, the after-tax return enhancement provided by PPLI and PPVA comes with an additional insurance-related expense that is generally absent with traditional and Roth IRAs. Despite this, we estimate that even after factoring in these costs, investing through a PPVA or PPLI can improve an investor's after-tax net returns by 30%-45% over the long term compared to investing through a taxable account.

Introduction to Private Credit and Direct Lending

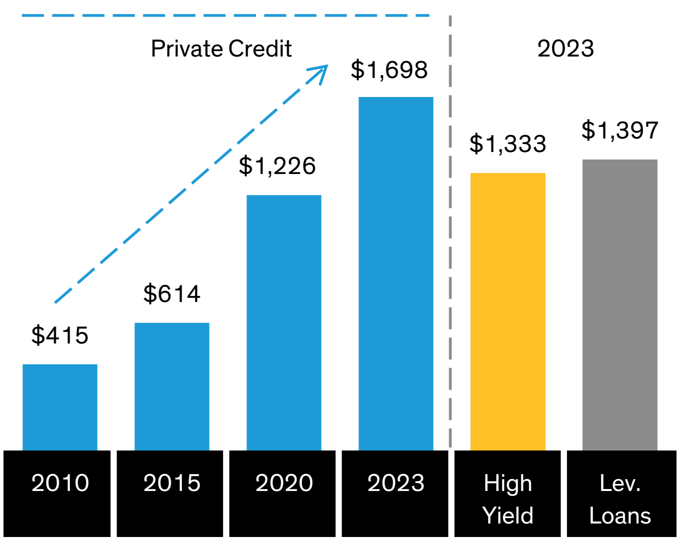
Private credit is a diverse asset class that encompasses many different forms of lending (e.g., corporate lending, commercial real estate lending, specialty finance, etc.), each with its own risk and return profile. That said, private credit is most commonly thought of as private corporate credit—directly sourced and privately negotiated credit investments with a single or small group of lender(s)—with *direct lending* being its largest segment.

In the wake of the Global Financial Crisis, direct lending experienced significant growth as traditional banks pulled back on US middle market lending amid heightened regulatory restrictions (e.g., more stringent capital requirements) and industry consolidation. At the same time, investors began allocating additional capital to alternative lenders, as they pursued incremental yield during a low interest rate environment.

Today, due to a variety of dynamics, the asset class continues to grow (*Display*). These include scaled borrowers increasingly tapping private financing solutions (in lieu of broadly syndicated ones) given the growth in alternative lending platforms and the customization, privacy and relative certainty of execution that direct lending provides.

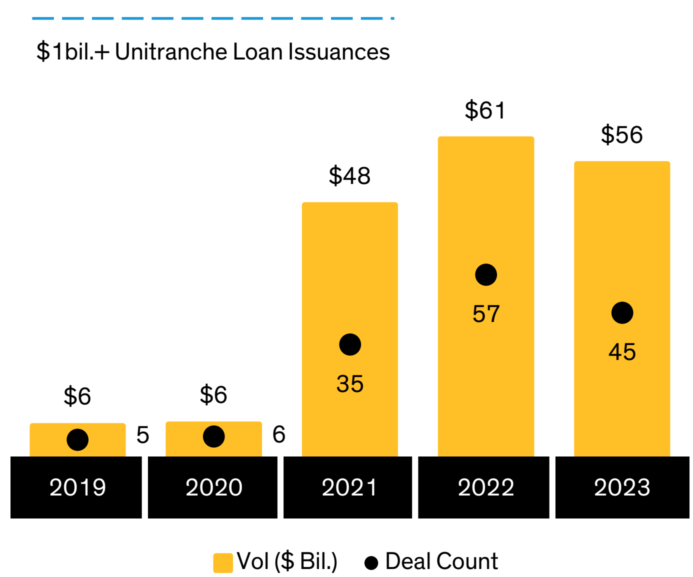
AFTER ROBUST GROWTH, PRIVATE CREDIT NOW EXCEEDS THE SIZE OF THE TRADABLE CREDIT MARKETS...

USD Billions



...FACILITATING LARGE ISSUERS TAPPING THE PRIVATE CREDIT MARKET FOR FINANCING SOLUTIONS

USD Billions



There can be no assurance that any Fund or investment objectives will be achieved. Left Graph: Lev. Loans and High Yield market size sourced from LSEG and Bloomberg Barclays, Private Credit AUM sourced from Preqin; data as of December 31, 2023. Right Graph: reflects US jumbo unitranche loans defined as loans of $1 billion or more executed with direct lending managers as tracked by Direct Lending Deals; data as of December 31, 2023.

Source: Direct Lending Deals

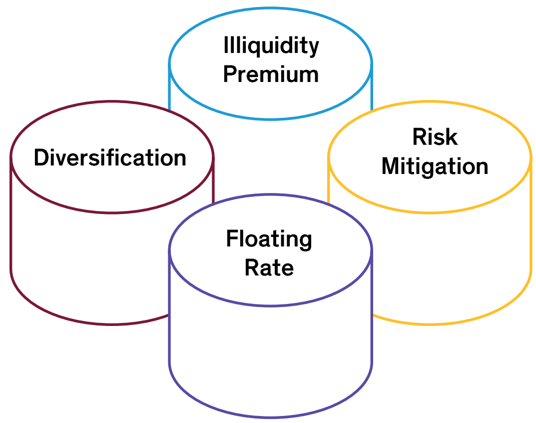
The Case for a Direct Lending Allocation

> **We believe direct lending represents a compelling investment opportunity and should be considered a core allocation in a well-diversified portfolio.”**

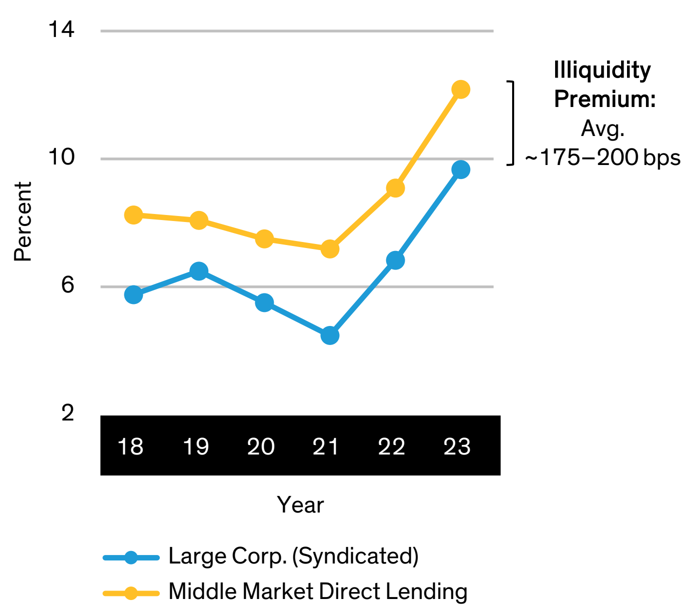
Illiquidity Premium: With the lack of an established secondary market, direct lending transactions require lenders to provide a long-term commitment to borrowers, which consequently requires a long-term capital commitment from investors. In exchange, investors demand incremental yield as compensation—this is known as the illiquidity premium. Historically, the illiquidity premium available in direct lending has averaged ~175–200 bps and is most easily seen between new issue yields in direct lending versus those in the broadly syndicated loan market (*Display*).

Notably, we do not believe the incremental yield represents a credit-risk premium as direct lending historically has provided less risk (i.e., lower instances of principal loss and lower volatility) relative to the broadly syndicated loan market.

Four Pillars of Private Credit



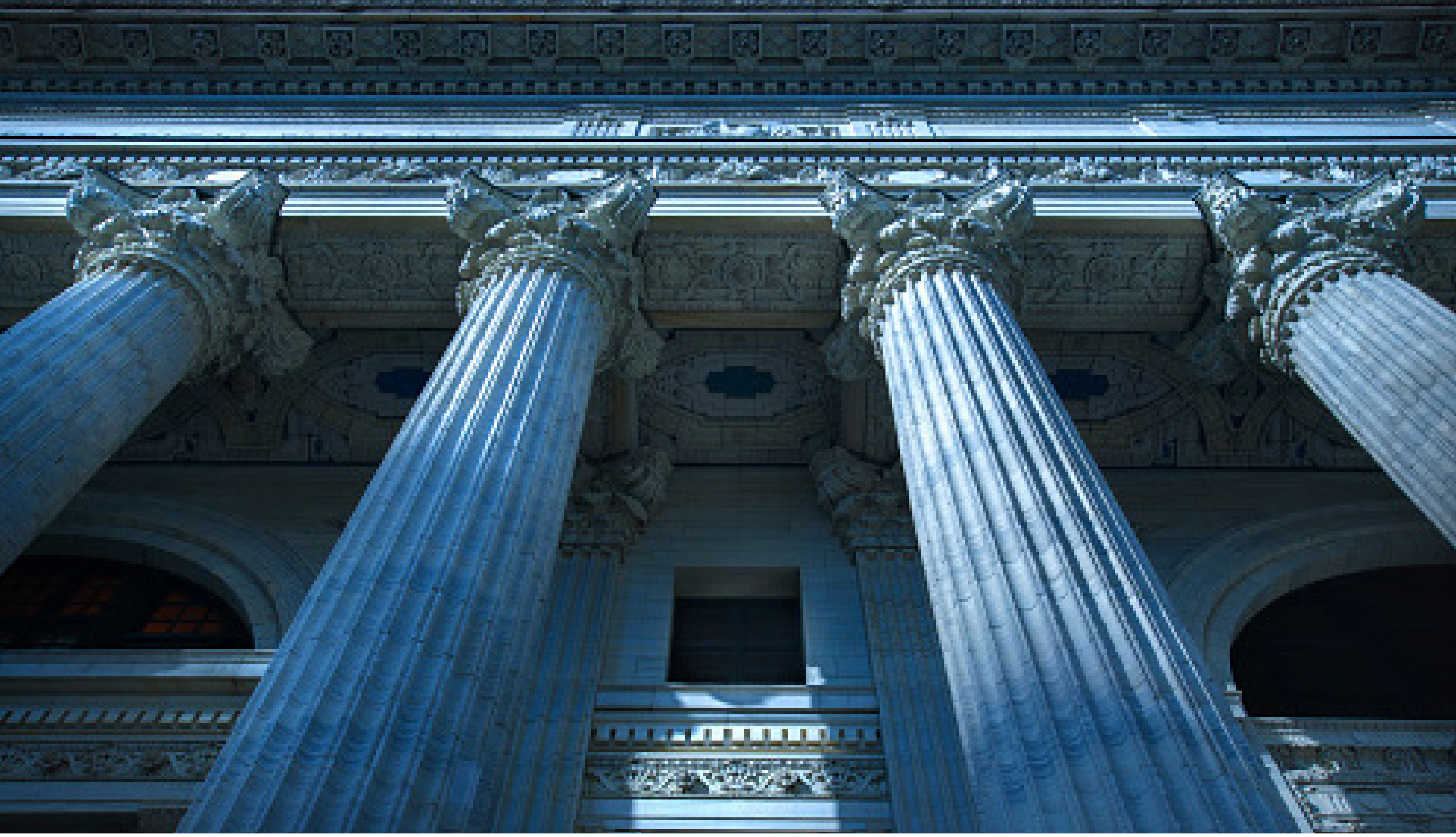
FIRST-LIEN TERM LOAN YIELDS—NEW ISSUE (3-YEAR)



As of December 31, 2023.

Analysis provided for illustrative purposes only and is subject to revision.

Source: LSEG



Risk Mitigation: We attribute direct lending's comparably lower risk profile to a number of features:

- **A Buy-and-Hold Approach**: Direct lending is a buy-and-hold asset class typically requiring a multi-year commitment period and/or other provisions that limit regular liquidity. In addition, managers generally don't actively trade in and out of loan positions; instead, they hold them until they are repaid by borrowers. Because of these dynamics, direct lending is insulated from the technical selling pressures that are typically experienced during down markets in traditional, publicly traded asset classes.
- **Senior Secured Status, Significant Equity Cushions**: Direct loans are often executed at the top of the capital structure and therefore benefit from large equity cushions to absorb potential declines in a borrower's value. These loans are also structured so that lenders generally have a priority claim on a borrower's assets, including equity in the underlying business.
- **Structural Protections**: Direct lenders have the ability to negotiate certain protective covenants such as a limit on the amount of leverage or a required minimum level of liquidity. These covenants provide lenders with negotiating power to amend loan terms in their favor or institute other resolutions if a borrower underperforms.
- **Strong Relationships**: Direct lenders typically lend to companies on their own or with a small group of like-minded co-lenders, which promotes regular communication amongst lender groups, borrowers and sponsors. This frequent and robust information flow allows lenders to maintain a current view on borrowers' performance and outlook, facilitating the early identification of underperformance and proactive resolution of any potential defaults. This level of connectivity and coordination is more challenging to achieve in broadly syndicated loan deals, which tend to involve 50–80 participants or more.

Floating Rate: Direct loans are typically floating rate, providing a hedge against rising interest rates and higher return potential in elevated rate environments, all else equal. What's more, direct loans commonly feature base rate floors, which set a minimum that lenders can expect to receive in periods of particularly low rates.

Diversification: Direct lending covers a diverse set of borrowers across a wide range of sectors and end markets, all of which have varying fundamental drivers. Separately, the asset class also has important structural features (e.g., multi-year commitment periods), which lessen the correlation to traditional asset classes that are more influenced by technical selling and buying pressures.

Direct Lending Tax Considerations

Despite the compelling investment thesis and attractive risk-adjusted returns, tax-sensitive investors may be hesitant to invest in direct lending for tax reasons. Put simply, many investors believe that the majority of their return will be taxed as ordinary income, subject to a top federal tax rate of 40.8%, as opposed to long-term capital gains taxed at a much lower 23.8% rate.[1]

It is important to highlight that direct lending, as a loan origination strategy, may be considered a "US Trade or Business." That designation may allow investors to deduct expenses incurred in connection with the trade or business to determine their taxable income. Accordingly, investors may be able to deduct certain fund expenses (e.g., management fees, portfolio financing expenses, operating expenses) so that they are only taxed on their income, net of related expenses. This feature improves the tax efficiency of direct lending relative to other credit products (e.g., a high yield index fund), which may not allow for the same degree of deductions.

For investors seeking a more tax-efficient direct lending solution, one option is to access the asset class via tax-deferred individual retirement accounts (IRAs) or tax-exempt Roth IRAs. However, because of their relatively low annual contribution limits, retirement accounts typically comprise only a small fraction of most high-net-worth investor portfolios. Further, while not an issue with Roth IRAs, traditional IRAs require minimum distributions beginning at age 73; This distribution requirement may be an obstacle when investing in direct lending funds given the uncertainty around the timing of their liquidity. Separately, not all direct lending funds are structured to accept retirement account assets, further reducing the investable universe for retirement accounts.

When an investor is contemplating an allocation beyond an amount available in retirement accounts, one alternative is to access direct lending through an insurance dedicated fund (IDF). This can be achieved via a private placement variable annuity (PPVA) contract or a private placement life insurance (PPLI) policy, which can provide tax deferral and enhance after-tax returns when structured properly. Based on our analysis, investing through a PPVA or PPLI can improve an investor's after-tax net returns by 30%–45% over the long-term, as outlined below.

1 Tax rates include the additional 3.8% net investment income tax imposed by IRC §1411.

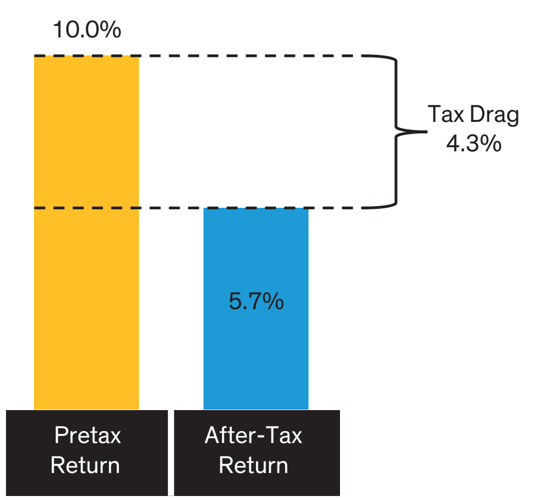
After-Tax Return Analysis

Using a simple example and not accounting for direct lending's "US Trade or Business" related fee deductions, a pretax annual return of 10.0% on a traditional fund investment becomes 5.7% after-tax. This occurs when the return consists entirely of ordinary income subject to immediate taxation at the highest federal income tax rate over the next ten years, equating to a (4.3%) annualized tax drag (*Display 1*).

On a $5 million investment, this tax drag can total $4.3 million over ten years and an astonishing $61 million over 30 years, using the assumptions described above (*Display 2*). For some investors, state income tax rates can increase the annualized tax drag to as much as (5.1%), reducing the after-tax return to only 4.9% for a top taxpayer in California.[2]

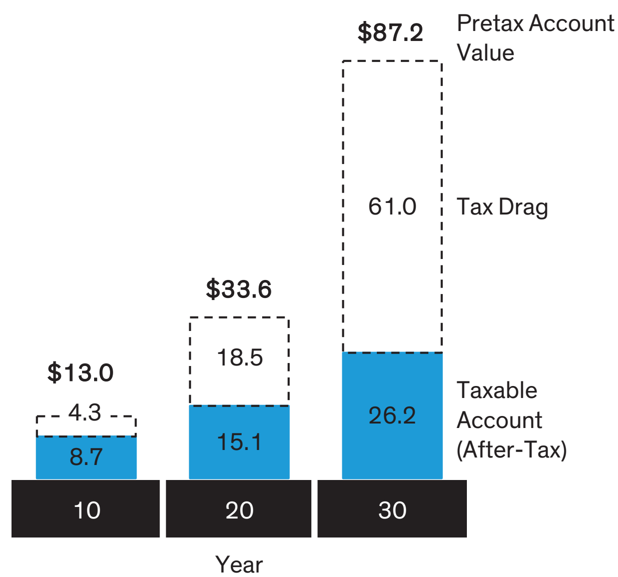
DISPLAY 1: TAX DRAG OF INVESTMENT ACCOUNT

10% Pretax Annual Return
Taxed as Ordinary Income



DISPLAY 2: GROWTH OF $5 MILLION INVESTMENT ACCOUNT

10% Pretax Annual Return
USD Millions (Nominal)



For illustrative purposes only. Data do not represent past performance.

Examples assume a 10% pretax annual return that is taxable as ordinary income each year. An ordinary income tax rate of 40.8% is applied during the first two years of the analysis and a 43.4% rate applies for all remaining years to account for the scheduled increase in the top federal tax rate after 2025 under current law. Tax rates stated included the 3.8% net investment income tax.

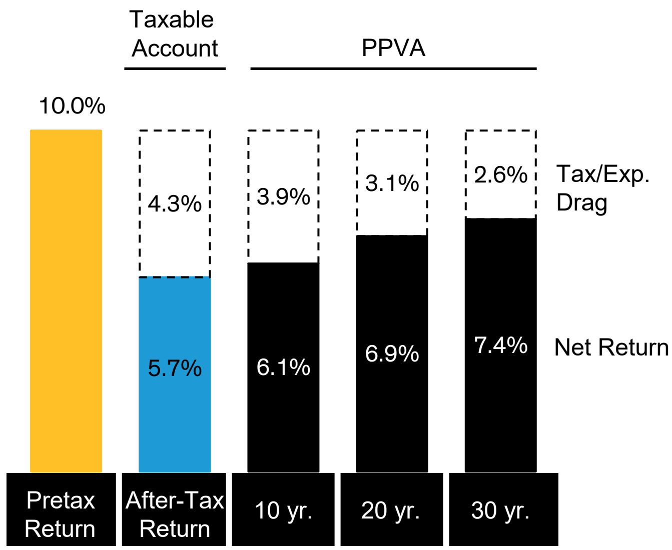
Bernstein is not a legal, tax, estate, or insurance advisor. Individuals should consult these professionals as appropriate before making any decisions.

2 Assumes a blended state and federal tax rate of 54.1% for two years and a tax rate 50.9% for all remaining years to account for the scheduled increase in the top federal tax rate to 39.6% and an uncapped state and local tax deduction. Tax rates include the 3.8% net investment income tax.

However, investing through a low-cost PPVA contract can decrease the tax drag over time. This is accomplished by compounding an investor's tax-deferral benefits, resulting in significantly more after-tax wealth when the contract is surrendered in the future, even after accounting for additional expenses (described in more detail below). For example, if an investment generating a 10% pretax annual return is held in a PPVA contract with an annual expense of 0.7%, the after-tax return increases from 5.7% to 6.1% after ten years, 6.9% after 20 years, and 7.4% after 30 years (*Display 3*). This benefit stems from low-cost tax deferral, which allows the full value of the investment less contract expenses to compound without a tax drag until the owner chooses to distribute or annuitize the PPVA contract. For a $5 million investment, this low-cost tax deferral allows the investor to keep an additional $300,000 after ten years and a staggering $16.3 million over 30 years (*Display 4*).

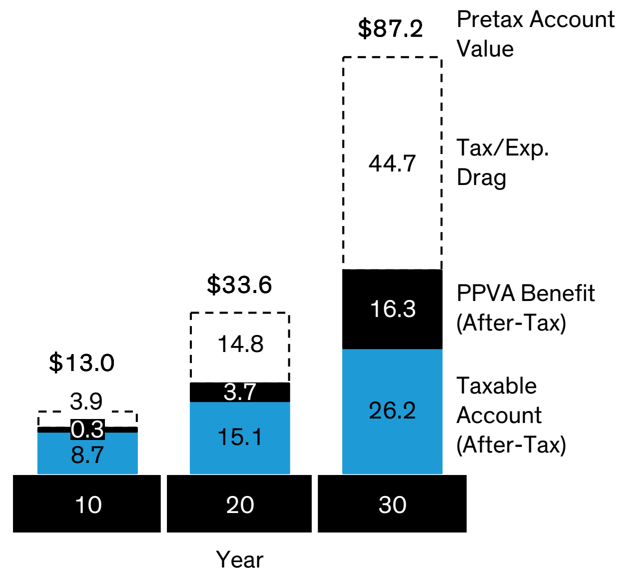
DISPLAY 3: PPVA CAN REDUCE TAX DRAG

10% Pretax Annual Return



DISPLAY 4: GROWTH OF $5 MILLION INVESTMENT

10% Pretax Annual Return
US Millions (Nominal)



For illustrative purposes only. Data do not represent past performance.

The Taxable Account example assumes a 10% pretax annual return consisting entirely of ordinary income taxed at 40.8% for two years and 43.4% for all other years to account for a scheduled increase in the top federal tax rate after 2025 under current law. The PPVA example assumes a 10% pretax return before fees and expenses. "Net Return" is the after-tax return assuming the annuity contract is liquidated with all deferred taxes being paid in the year noted and is net of fees and expenses—PPVA fees and expenses total 70 bps per annum based on the average account value for the year and is intended to account for both investment administrative expenses and insurance company mortality and expense charges. Further, the example assumes the PPVA owner is over age 59½ when the annuity is surrendered or funds are withdrawn. Therefore contract earnings are not subject to the additional 10% excise tax on early distributions. The tax rates listed include the additional 3.8% net investment income tax imposed by IRC §1411.

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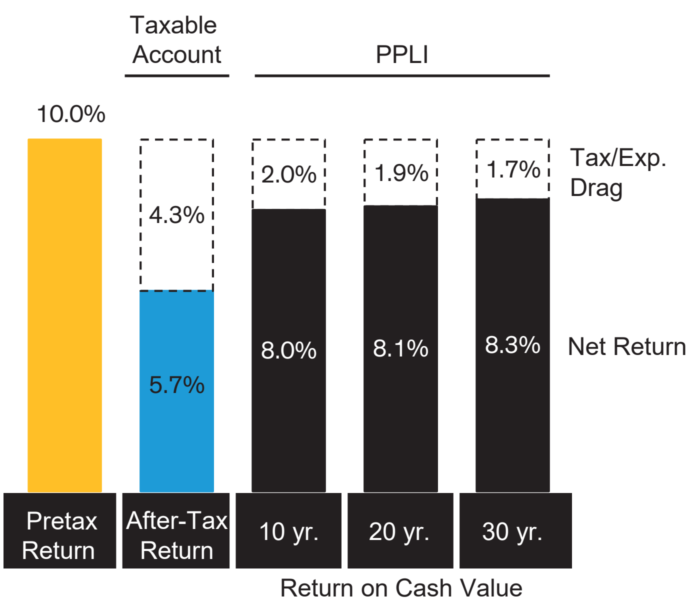
Investing through a PPLI policy can further enhance after-tax returns, especially if the policy is maintained for the insured's lifetime. Since policy death benefits are generally nontaxable when paid to beneficiaries, this can provide significant tax benefits. Although there is a modest return drag due to insurance policy expenses, including an upfront premium load and annual policy expense, PPLI becomes attractive for investments with tax costs exceeding these policy expenses. This is almost always the case with direct lending funds. For example, if the 5.7% net annual return in the previous example is held in a PPLI policy with an upfront premium load of 2.1% and annual policy expenses between 0.7% and 1.8%, the return increases to over 8% after 10 years (*as shown in Display 5*). For a $5 million policy, the relative benefit of the PPLI policy to a fully taxable account is $2.1 million over 10 years, $8.7 million over 20 years, and $28 million over 30 years (*as shown in Display 6*). Therefore, investing through a PPLI policy can be a smart strategy for maximizing after-tax returns and minimizing tax costs.

That said, PPLI fees and expenses vary by carrier and are based on the insured's age, underwriting class and the state of issuance, among other factors. Notably, these benefits diminish if the policy were surrendered and taxed during the insured's lifetime. While PPLI policies generally must be maintained over the insured's remaining lifetime to enhance wealth to the degree described above, when properly structured, a large portion of the cash value can be accessed during the insured's life through low-cost, nontaxable loans.

DISPLAY 5: PPLI CAN REDUCE TAX DRAG EVEN FURTHER

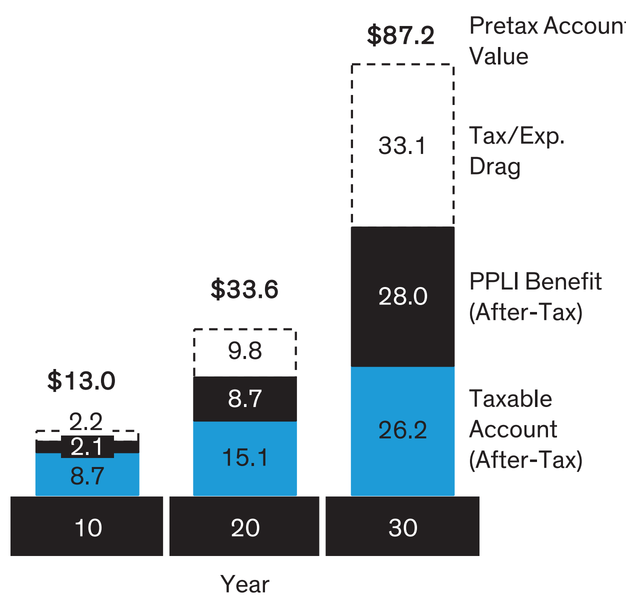
10% Pretax Annual Return



DISPLAY 6: GROWTH OF $5 MILLION INVESTMENT

10% Pretax Annual Return

USD Millions (Nominal)



For illustrative purposes only. Data do not represent past performance.

The Taxable Account example assumes a 10% pretax annual return consisting entirely of ordinary income taxed at 40.8% for two years and 43.4% for all other years to account for the scheduled increase in the top federal income tax rate after 2025 under current law. The PPLI example assumes a 10% pretax return before fees and expenses. Values represent the PPLI policy's pretax cash value and are net of fees and expenses—PPLI fees and expenses as a percentage of the average account value are 3.85% in year one, 1.75% in year two and then declining slightly each year to 0.71% by year 30. PPLI fees and expenses are intended to account for both investment administrative expenses (incremental to taxable account) and insurance company mortality and expense charges. The example assumes the policy has a death benefit in excess of the cash value meeting the minimum requirements to be considered a non-Modified Endowment Contract. Tax rates listed include the additional 3.8% net investment income tax imposed by IRC §1411.

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An Overview of Insurance Dedicated Funds, PPVAs and PPLI Policies

While it's easy to see the potential after-tax return benefits of investing in an IDF via a PPVA or PPLI, an investor should understand the mechanics and considerations of each before moving ahead.

IDFs are commingled investment vehicles that only accept contributions from life insurance or annuity contract separate accounts. While similar to other available commingled funds, IDFs are carefully designed and managed to comply with certain diversification and control requirements.[3] This helps to preserve the tax advantages afforded to life insurance or annuity contracts investing in them. Tax law does not allow an IDF to simply act as a feeder into an investment manager's master fund, but managers with a sufficient number of funds often establish IDFs as fund-of-fund structures investing across their existing fund platform. Ultimately, IDFs provide a tax-efficient way to invest in direct lending as well as other asset classes that generate a higher mix of ordinary income.

Unlike typical insurance products, PPVA and PPLI are only offered privately to accredited investors and qualified purchasers, rather than to the public through a formal securities registration.[4] As a result, PPLI and PPVA contracts can provide access to a wider array of investment solutions, such as private credit IDFs.

PPVAs are the simpler and less expensive of the two. Generally, PPVA contracts do not have upfront or surrender charges and often carry significantly lower annual expenses than common registered or retail annuity contracts. When structured correctly, gains and earnings generated by investments held within PPVAs are taxed only when the account owner withdraws them from the annuity contract in the future. Typically, a contract holder can defer the taxes on investments held within PPVAs until the annuitant reaches age 95—or even longer in many cases. In addition, no tax reporting is required by annuity owners until they take distributions.

- If the owner of the PPVA contract elects to "annuitize" the contract (i.e., convert into a stream of periodic payments), each payment will be treated (i) partly as a tax-free return of the investor's premium payments and (ii) partly as growth of the account value taxed at ordinary income tax rates.
- In contrast, a withdrawal from a PPVA contract will be treated first as a receipt of growth (i.e., the total account value minus the premium payments) taxed at ordinary income rates; only after all the contract's growth has been distributed will further withdrawals be treated as a tax-free return of the contract holder's premium.
- Earnings distributed before age 59½ are subject to an additional 10% early withdrawal penalty tax.
- At death, the PPVA contract is transferred to the beneficiary designated by the annuity's owner. Distributions of earnings from the annuity contract to the beneficiary are subject to ordinary income tax rates but without the additional 10% early withdrawal penalty tax.

While a PPVA defers income taxes, **PPLI policies** potentially eliminate income taxes altogether. However, due to their more complicated nature and incremental expense relative to PPVAs, a thorough assessment of the trade-offs between the two is

3 See IRC § 817(h) and Treas. Reg. §1.817-5
4 Offerings exempt from SEC's registration requirements pursuant to Section 4(a)(2) of the Securities Act of 1933 or its safe harbor under Regulation D.

essential. Like any life insurance contract, PPLI's income tax benefits are forfeited if the policy does not comply with various insurance regulations and tax requirements. Further, the insured is subject to the traditional medical and financial underwriting processes. That said, PPLI serves a different purpose than traditional life insurance.

The traditional life insurance model aims to pay the lowest possible premiums in exchange for the greatest possible death benefit, as a traditional policy is hedged against an early death. PPLI is the opposite. The twin objectives of PPLI policies are to:

- invest the greatest amount of premium dollars as quickly as possible, and
- acquire the least additional incremental death benefit that tax laws will allow.

As such, PPLI policies are often fully funded with large premium payments shortly after issuance. By reducing the policy's death benefit to the lowest possible level, PPLI policy expenses are generally kept to a minimum. This gives the investment portfolio the greatest opportunity to grow without the impact of income taxes.

In addition to the tax benefits described above, PPLI may also allow the policy owner to access the accumulated cash value tax—efficiently during their lifetime. Assuming the policy is structured correctly, the tax rules allow the owner to withdraw their cost basis in the policy tax-free and access the policy's accumulated earnings through non-taxable low-interest-cost loans from the policy. Keep in mind that the cash value not withdrawn or borrowed must be able to support the policy's annual expenses. At the insured's death, the value of the outstanding loan is repaid tax-free by the policy's death benefit. Furthermore, the total death benefit (which includes more than just the policy's cash value) is nontaxable to the policy's beneficiary.

It is worth mentioning that basing the success or failure of a life insurance policy (presumably a very long-term strategy) on a single investment theme presents incremental risk. For that reason, while it is common to see PPVA contracts allocated to one fund or investment theme, it is prudent to diversify the investments held within a PPLI policy across several funds and investment themes. This better protects the long-term viability of the PPLI policy by ensuring funds remain available to meet insurance expenses if one of the investment funds or themes underperforms.

PPLI

- Aims for **high cash value** and a **relatively low death benefit** to minimize the fee drag
- Allows the **cash value** to ultimately **drive up the death** benefit over time
- Commonly held until death since **the benefit is not usually subject to income tax**
- Proper structuring helps ensure **access to the cash value tax-free during the owner's lifetime***

PPVA

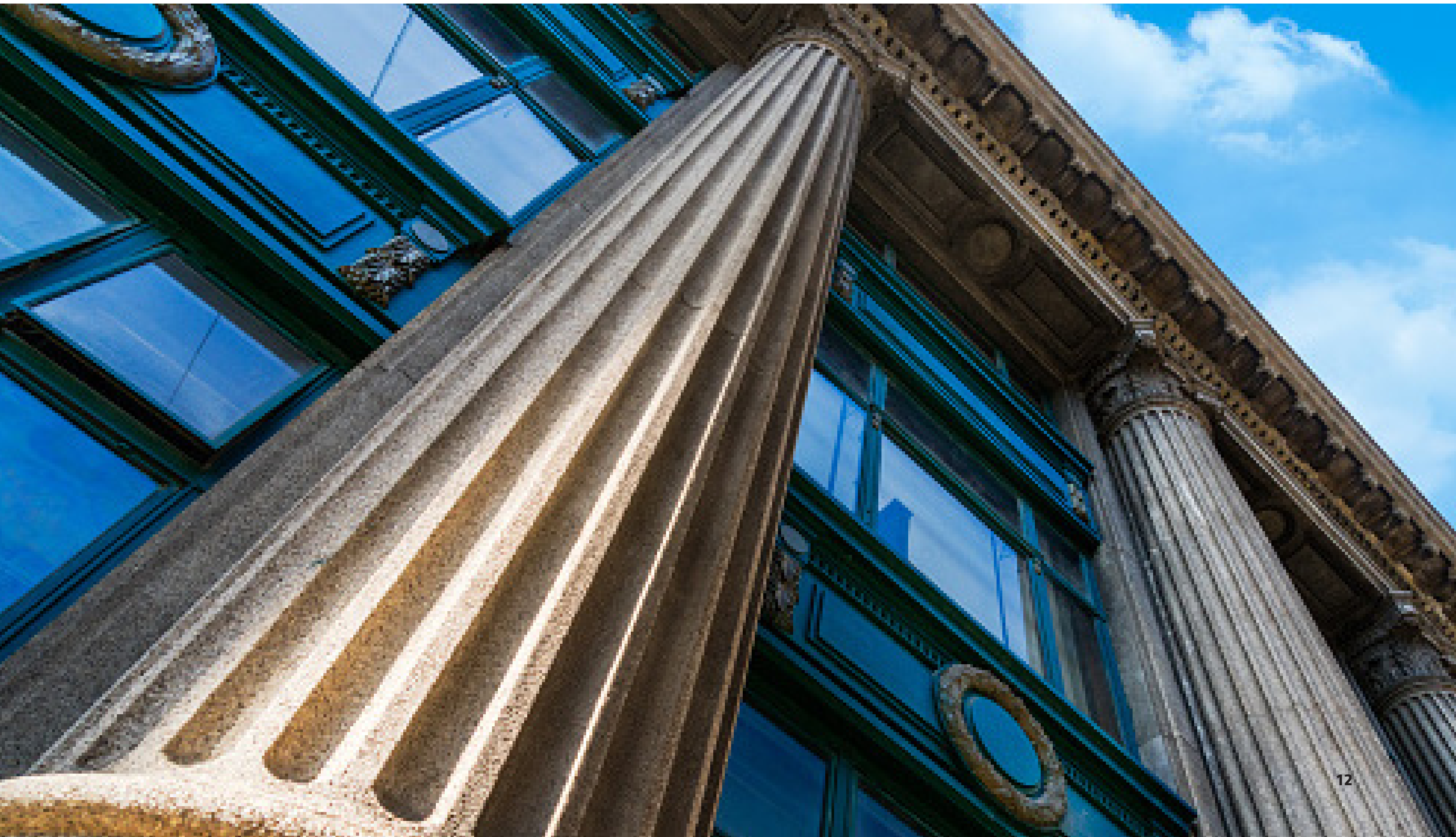
- Aims to **defer income tax**
- Commonly **matures late in life** (often at age 95 or later), then annuitant must begin receiving **annual or monthly annuity payments**
- Or, **can be surrendered**, and the deferred income tax liability paid
- Accumulated earnings **taxed as ordinary income** when distributed or if surrendered[†]
- Annuity can't be donated tax-efficiently during life, but **can be left to charity at death tax-free**

*Via a combination of withdrawals of nontaxable basis and low-interest policy loans

†An additional 10% early withdrawal penalty may apply on earnings distributed before age 59½.

Insurance Dedicated Funds for Tax-Sensitive Investors

Overall, direct lending can be a valuable addition to an investor's portfolio and should be considered as part of a core allocation. For tax-sensitive investors, the after-tax returns from direct lending can be significantly improved when held in tax-deferred or tax-exempt retirement accounts. For an allocation beyond that, tax-sensitive investors should consider accessing direct lending through an insurance dedicated fund (IDF) held in a PPVA and PPLI policy, depending on their time horizon and objectives. Ultimately, by carefully considering the tax implications and investment goals, investors can more effectively benefit from the potential returns of direct lending.



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