Maximizing After-Tax Returns with Private Placement Life Insurance and Annuities

Tax rates are increasing, and capital market assumptions are uncertain for investment returns going forward. As a result, high-net-worth investors are seeking guidance from advisors on strategies to help combat these two nefarious forces. Two of the investment vehicles that can provide a solution in today's market are private placement variable annuities ("PPVA") and private placement life insurance ("PPLI"). When properly structured, private placement annuities and life insurance can provide tax management, investment flexibility, asset protection and even privacy.

A Further Understanding

Private placement variable annuities ("PPVA") and private placement life insurance ("PPLI") are similar to traditional retail variable annuity and variable life insurance contracts but enjoy several very attractive distinctions. Like their traditional variable product counterparts, the contract owner pays a cash premium that is held in the separate, segregated asset account (Separate Account) of the insurance carrier. The contract owner's Separate Account value will fluctuate over time with the performance of the underlying investment portfolio.

In years past, PPVA and PPLI faced several headwinds that constrained their adoption. Originally, there were limited investment options available, uncertain IRS guidance, and opacity surrounding expenses and fees.

However, recent developments in the PPVA and PPLI marketplace have turned these headwinds into tailwinds. The issuance of IRS guidelines on tax compliant structures, and the availability of Separately Managed Accounts (SMAs), which are bespoke, individually designed investment management accounts, have minimized the complexity and policy costs. As a result, these products are easier to implement, understand, manage, and utilize, and should be strongly considered as effective income-tax mitigating vehicles providing access to nearly all available investment asset classes.

Investment Considerations

There are certain investment requirements for PPLI and PPVA. Purchasers must meet the Accredited Investor [(1)] or Qualified Purchaser [(2)] requirements provided under SEC regulations [(3)]. To preserve the income tax-deferral of investment gains inside of PPLI and PPVA, the Separately Managed Account managed by the clients selected Investment Manager must be diversified pursuant to Internal Revenue Code §817(h) and additionally satisfy the Investor Control Doctrine [(4)]. The Investor Control Doctrine limits the amount of direction the policy owner can exert over the investment decisions made in the investment portfolio inside the SMA, within the PPLI or PPVA.

In traditional retail variable life insurance and annuities, investment options are narrow and are typically limited to certain state registered Mutual Funds. This is not the case with PPLI and PPVA. Thanks to the maturation of the marketplace, your current Investment Manager can manage the underlying investment portfolio within the insurance or annuity contract by opening a Separately Managed Account (SMA). The investment manager can then allocate your premium dollars to nearly any investment strategy available on their current custodian platform like Charles Schwab, Fidelity, or Ameritrade. The policy owner can now own investments like Private Credit, Private Equity, ETFs, Managed Futures, REITs, and LP interests within these tax-favored vehicles just as they would in a taxable environment.

Income Taxation

In the United States, PPLI and PPVA both benefit from clear and favorable tax treatment. To avail of this tax treatment, PPLI must qualify as life insurance pursuant to code §7702. In a similar vein, for a PPVA to receive the favorable tax treatment afforded deferred annuity contracts, the contract must qualify as an annuity pursuant to code §72. If these qualifications are met, investment earnings held within either product are not subject to income tax as earned.

If a PPLI policy is structured as a non-MEC [(5)] owners may withdraw funds from the policy cash value (the SMA managed by their investment manager) income tax free, up to their investment cost basis in the contract. Additionally, owners may take policy loans after they have withdrawn their basis to access their investment gains income tax free. These policy loans often offer ultra-low loan interest rates of less than 0.40%.

One should note that a full policy surrender or policy lapse will generate ordinary income to the extent that any cash value received exceeds the owner's basis. So, careful attention must be paid when considering accessing the cash value through withdrawals and loans. If the PPLI policy is held to maturity, [death of the insured], the cash withdrawals and policy loans are recharacterized as life insurance proceeds and as such are not considered taxable.

If owners are planning to access the cash value gain in their PPLI or PPVA strategy, the PPLI structured as a non-MEC is the preferred vehicle to select. The reason for this is due to the less favorable taxation of income from an annuity upon distribution. Withdrawals, loans, and surrenders from an annuity are first taxed as ordinary income up to any gain in the contract with the remainder then received as a return of the owner's basis or investment in the contract. If the withdrawal is made before the client reaches 59½ there will be an additional 10% penalty levied on the amount of gain in the contract. If orderly distributions are taken from the annuity in a form that qualifies them as annuity payments (annuitization) each payment is treated as part return of basis (which is excluded from gross income) and part taxable income. Additionally, for annuities, amounts paid following the death of the owner are deemed income in respect of a decedent (IRD) [(6)]. As a result, any deferred gains to that point will be taxed as ordinary income upon death.

In contrast, a further and very significant benefit of PPLI is that it provides a tax-free death benefit which may be structured to avoid exposure to estate taxes.

No Free Lunch:

PPLI and PPVA are devices that provide tremendous tax arbitrage opportunities when structured correctly. The arbitrage they create is a function of a simple formula. If you pay less in insurance costs than you do in portfolio generated income taxes, there is an obvious win. This arbitrage could be considered a type of structural alpha.

The costs associated with PPLI and PPVA are completely transparent to the policy owner. This transparency, which is not typical of traditional life insurance transactions, is a comforting and refreshing experience for buyers and their advisory teams. The following details breakdown all costs associated with PPLI:

Placement Fee to an Insurance Agent: The Placement Fees charged on PPLI and PPVA are substantially less than commissions on traditional policies and are typically levied based on a disclosed percentage of the premiums paid into the policies. This fee depends on varying factors including the complexity of the planning, the cost of time and resources dedicated to the underwriting, and the size of the initial premium and ranges anywhere from 0-4%.

AUM fees to your investment manager: PPLI and PPVA are life insurance and annuity products that allow your Investment Manager of choice to manage the underlying investments on a bespoke basis. Fees for your investment managers will vary, but just as you hire them to manage your qualified and non-qualified assets, now you can hire them to manage your insurance or annuity assets. This fee can be anywhere in the range of 0.25% to 1% depending on the investment manager.

M&E charges (mortality and expense charges): The M&E charges associated with PPLI policies combine separate charges. These fees include the charges taken by insurance carrier (0.20% to 0.30%) and the agent AUM trail fee (0.15% to 0.40%). These M&E charges are levied against the account value of the policy.

Costs of Insurance (COIs): COIs are the fees that the insurance carrier charges on the amount of death benefit "at risk" (Net Amount at Risk, or the delta between the gross death benefit and the policy cash value) in the life insurance policy. The fee associated with the death benefit purchased will vary dependent on age, gender, and underwriting classification. [7]

State Premium taxes: Each state charges a state premium tax based on the amount of premium deposited in your policy. State premium taxes can range from 0.075% to 3% so careful attention must be paid to where the policy is owned. The savings should be a significant consideration in choosing ownership in one state over another.

DAC taxes (Federal Deferred Acquisition Costs): These fees are charged by the insurance company to recover costs and are also charged on the amount of premium dollars deposited in your policy. Life Insurance carriers incur costs associated from the tax code's requirement to amortize their expenses of issuing an insurance policy. A detailed analysis of DAC is not necessary, but it is important to know that it varies from carrier to carrier. A DAC tax of approximately 0.75% to 1.5%

is normal. [8]

Total PPLI costs can range between 0.60% and 1.30% annualized including all fees, and a PPVA can cost between 0.35% and 0.55% annually The PPVA structure is subject to similar costs and expenses as a PPLI policy except that there is no cost of insurance as there is no death benefit associated with an annuity, and there are no charges for DAC tax.

Benefits:

The US onshore PPLI and PPVA market is now mature enough to ensure the complete confidence of UHNW investors, domestic insurance carriers, financial regulators, broker dealers, and the entire asset management industry. They are now regarded as viable and practical wealth management tools that have many potential benefits including:

- Wealth Creation - PPLI and PPVA support any investment strategy including high return, wealth generating assets such as venture capital and private equity. The growth of the investment allocation is further aided by tax-deferred compounding of growth inside these structures.
- Tax Management - PPLI & PPVA are low-cost products that eliminate taxation on your investment portfolio. Such tax efficiency accelerates wealth creation as the income tax savings compound in addition to the investment rate of return. They also eliminate 1099s and K-1s for certain alternative investments you own which simplifies income tax reporting.
- Wealth Transfer - PPLI provides a highly efficient means to transfer wealth within a family. PPLI and PPVA can also serve as a terrific funding source for the family's dynasty trusts and philanthropic desires.

Further Food For Thought

When planning with PPLI and PPVA, special considerations need to be made. Among these considerations are; what insurance carrier should be selected, jurisdiction of ownership, and whether PPLI or PPVA is the best vehicle to use. The ensuing summary outlines further details that buyers and their advisory teams must consider.

Carrier and Jurisdiction Selection

Clients need an astute insurance broker to assist them when purchasing PPLI and PPVA. The broker should have deep knowledge on the insurance carriers that manufacture the products and have a thorough understanding of the numerous jurisdictions and laws associated with the most favorable states in which to site ownership of the policies.

Additionally, a jurisdictional analysis should also take place when acquiring them. In the last 25 years this decision involved selecting whether to place your policy in an offshore or onshore jurisdiction. However, thanks to advancements in asset protection laws, more favorable investment options and state premium tax treatment domestically, offshore PPLI and PPVA have become less and less popular. So, when purchasing a domestic (or US based) policy, a state-by-state analysis should be completed. This will entail consideration of state premium tax rates and certain state regulations. In the United States, Wyoming, South Dakota, Alaska, and Delaware are all popular states in which to own PPLI and PPVA.

Thorough due diligence must be performed regarding any recommended insurance carrier as the client is reliant on the insurance carrier's ability to fulfil its contractual obligations and provide the owner with access to the policies underlying cash value during life (or other qualifying distributions), and Death Benefit upon passing. Furthermore, the anticipated duration of these policies requires special attention to the carrier's creditworthiness.

PPLI or PPVA or both?

The choice between purchasing PPLI or PPVA depends on the clients' goals and objectives. If income and estate tax mitigation combined with dynastic planning is of utmost importance, then PPLI may be the vehicle of choice. It is more attractive due to the FIFO treatment of policy withdrawals. These provisions further allow the policyholder to harvest investment gains from inside the PPLI policy income tax-free during the policy owner's lifetime by using low interest policy loans. Of course, these income tax benefits are only afforded to non-MEC policies so careful product design upfront and prudent policy management by your broker is required.

Policy costs also need to be considered. PPLI policies are more expensive than PPVAs as PPVAs do not incur any of the cost of insurance associated with maintaining a Death Benefit. PPLI implementation is also a bit more cumbersome, requiring medical and financial underwriting.

Because PPVA's are generally not used for estate planning, and their acquisition rarely involves the creation of a trust (except in the case when they are combined with a charitable lead or remainder trust), there tends to be less complexity establishing them. Moreover, their application does not require medical underwriting. However, there are tradeoffs for this simplicity. The most evident tradeoff comes in the form of a heavier tax burden. With a PPVA, income tax is only deferred. Therefore, it may be subject to both estate and income taxes (in the form of IRD) upon the passing of the annuitant. A solution to this double taxation risk would be to integrate the PPVA with the clients' charitable planning. If a charitable entity is named as beneficiary of the PPVA, the client can avoid the adverse tax issues associated with the vehicle. In the case of a PPLI policy, income tax can be eliminated altogether.

Who should own PPLI and PPVA?

All too often investment returns are discussed without regard to the impact of taxation on the investment portfolio, and recent Greenbrook releases lead us to believe taxes will be increasing soon. In light of this, it is imperative that investment returns in all high-net-worth client investment portfolios be reviewed from an income tax perspective. If taxes go up, net rates of return in portfolios will decrease and PPLI and PPVA should be considered as potential solutions to this ever increasing problem. By mitigating taxes with PPLI or PPVA, clients can achieve higher net rates of return and structural alpha.

Estate Planning Considerations

Every estate plan incorporates elements of tax mitigation techniques, whether it is the complete or partial elimination of gift, estate, income, or a combination of all three taxes. Both PPLI and PPVA contracts can be leveraged in concert with all aspects of estate and tax planning work. It is a simple matter of using these IRS blessed constructs to create even greater alpha for clients within their estate and tax planning strategies.

PPLI Example:

Case Study: The clients are California residents (aged 55 & 51) with no current life insurance in place. They are planning on transferring their wealth to their heirs and to charity. They desire tax-relief on $5 million of their liquid investment portfolio that is held in a family LLC. The family's Investment risk tolerance is moderate. As such, the assumed gross rate of return on their portfolio is assumed to be 5.95%

Maintaining the existing investment allocation, the chart below details the couple's initial investment of $5 million in a brokerage account compared to a PPLI product over their lifetime (a 40-year time horizon). The PPLI creates an additional $13.8 million for the client's heirs and charitable beneficiaries as detailed in the below table.

To note,

	Current Allocation	Utilizing PPLI	PPLI Advantage
Gross Weighted Return*	5.95%	5.95%	**N/A**
Weighted Tax Rate**	36.09%	0.00%	**-36.09%**
Weighted Net ROR	3.83%	5.32%	**1.49%**
Cost over Lifetime (taxes vs. ins. costs)	$ (9,180,454)	$ (4,080,590)	**$ 5,099,864**
Projected Balance at Life Expectancy	$ 21,255,451	$ 35,096,340	**$ 13,840,889**

- **All capital markets assumptions for the investment portfolio were provided by the Wealth Management Firm*
- ***Actual Taxable Income on the Investment Portfolio supplied by the Wealth Management Firm; OI, LTCG, & NIIT*

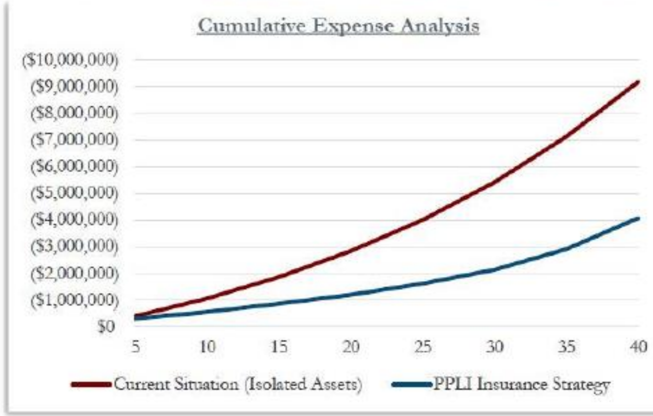
The below table illustrates the tax friction of keeping the $5 million in the couple's brokerage to the costs of the PPLI product over the next 40 years. By relocating the $5 million of their portfolio to PPLI and keeping the investment holdings the same, the family benefits from the tax-mitigation and the compound annual growth of the savings created. Over a 40-year holding period the clients save over $9 million in taxes which adds an additional $13.8 million to their Net Worth.

Comparing the Expenses of Each Strategy

	Current Situation (Isolated Assets)		PPLI Insurance Strategy		Life Advantage	
Year	Account Value	Cumulative Expense	Account Value	Cumulative Expense	Account Value	Expense
5	$5,707,613	($399,633)	$5,780,748	($309,855)	$73,135	($89,778)
10	$6,886,971	($1,065,689)	$7,434,204	($566,298)	$547,233	($499,391)
15	$8,310,017	($1,869,370)	$9,597,303	($867,571)	$1,287,286	($1,001,799)
20	$10,027,106	($2,839,116)	$12,447,475	($1,204,951)	$2,420,369	($1,634,165)
25	$12,098,995	($4,009,239)	$16,164,043	($1,625,621)	$4,065,048	($2,383,618)
30	$14,598,995	($5,421,144)	$21,022,154	($2,146,788)	$6,423,159	($3,274,356)
35	$17,615,568	($7,124,788)	$27,242,882	($2,909,754)	$9,627,314	($4,215,034)
40	$21,255,451	($9,180,454)	$35,096,340	($4,080,590)	$13,840,889	($5,099,864)

- Current Situation expenses consist of:
  - Federal and State Income Tax
  - Long Term Capital Gains Tax
- Insurance Strategy expenses consist of:
  - Premium Load
  - Admin & Policy Fee
  - Rider Charge, if applicable
  - Cost of Insurance (COI)

* Investment management fees are assumed to be the same for both the taxable and PPLI accounts.



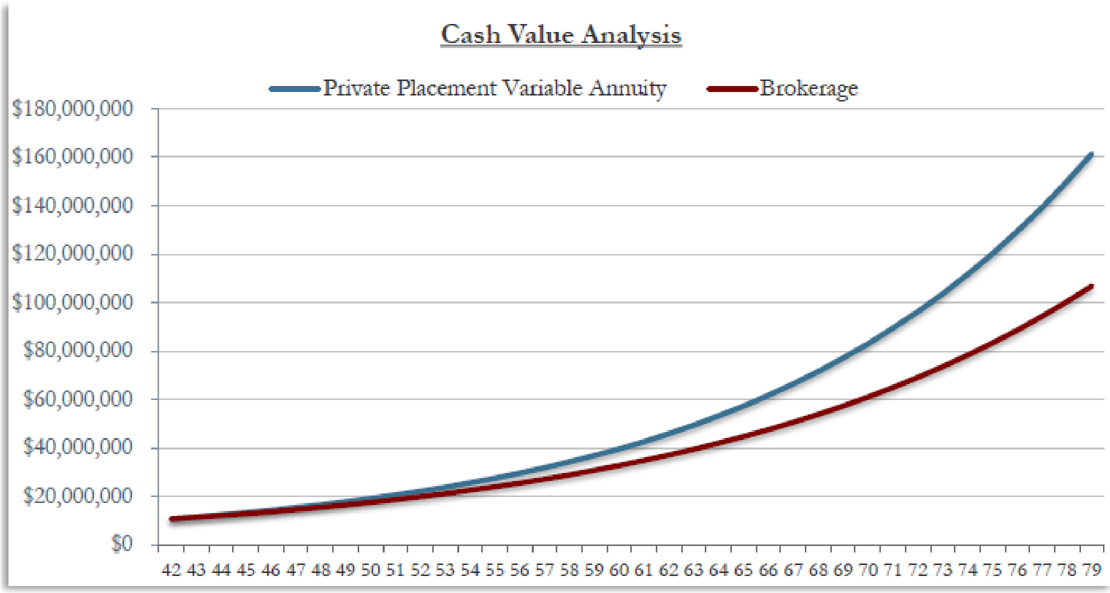
<u>PPVA Example</u>:

Case Study: A Colorado resident (41) is looking for income tax-relief on a portion of his $50 million liquid investment portfolio that is held in trust. His investment risk tolerance is high given his age, investment experience and his time horizon. The financial advisor recommended the client allocate $10 million of his portfolio to a PPVA. The expected return of the portfolio provided by the client's financial advisor was 8%.

Illustrative PPVA Case Study

Carrier	Product	Premium	Account Value*	DB IRR*
Lombard International	Private Placement Variable Annuity	$10,000,000	$161,502,068	7.60%
Taxable Account	Brokerage	$10,000,000	$106,844,745	6.43%
		PPVA Advantage	**$54,657,323**	**1.16%**

* At Life Expectancy



- *Capital market assumption of 8% on the investment portfolio provided by Wealth Management Firm*
- *Actual Taxable Income on the Investment Portfolio supplied by the Wealth Management Firm; 30% Ordinary Income at 45.43%, 70% Long Term Capital Gain at 28.43%, Long Term Capital Gain Turnover Rate at 30%*

By relocating $10 million of his portfolio inside a PPVA the client has increased his IRR by 1.16% annually. This results in an advantage of $54 million in the PPVA compared to the same investment allocation in a taxable brokerage account. To further note, the client named his family foundation as the beneficiary of the PPVA. This strategy will allow him to leave $54 million more to charity.

Conclusion:

PPLI and PPVA are exceptionally tax favored, transparent and low-cost investment vehicles. With heightened concerns over increasing taxes, the potential elimination of step up in basis at death, and reductions in gift and estate tax exemptions, these vehicles should be considered during every high-net-worth individual's and families financial planning.

The complexity of the products and the necessity for ongoing administration, creative planning, and attention to the underlying investment accounts requires the involvement of an engaged and experienced advisory team working collaboratively on the clients' behalf. This team needs to be well versed in the PPLI and PPVA market so they can provide optimal guidance and service when implementing and managing the strategies. Thus, the collaboration of the Trust and Estate Attorney, CPA, Investment Manager, and Insurance Broker is vital.

Bibliography

(1) Rule 501(a) promulgated under the 1933 Securities Act
(2) Section 2(a)(51)(A) of the 1940 Investment Company Act
(3) See 15 USC §80a-2(a)(51); 17 CFR §230.501(a)
(4) Rev. Rul. 2003-91
(5) Usually, non-MECs involve premiums paid for over three or more years. If the policy is a non-MEC, the client can access the cash value inside the policy tax-free via withdrawals and loans. See Code §7702A
(6) Internal Revenue Service. (n.d.). Publication 575 (2016), Pension and Annuity Income. Retrieved https://www.irs.gov/publications/p575#en_US_2016_publink1000226982
(7) I.R.C. § 7702
(8) I.R.C. § 848.

About the Author

Aidan Elliott, CFP® CLU® ChFC®

Aidan Elliott is a Client Advisor at WealthPoint in Denver, Colorado. He works with ultra-affluent and entrepreneurial family groups, as well as their advisor teams, in the areas of complex estate planning and designing sophisticated life insurance portfolios. He has been a student of Private Placement Life Insurance for the last five years and he helps Registered Investment Advisory firms build their Separately Managed Account Private Placement Life Insurance platforms and assists them throughout the internal and client education process. Contact him at aidan@wealthpoint.net