Planning for uncertainty: private placement life insurance for taxing times

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As Will Rogers once famously quipped, "The difference between death and taxes is death doesn't get worse every time Congress meets."

The United States income tax structure is teetering on unprecedented changes. Phrases or words such as "fiscal cliff" and "Taxmageddon" are frequently used in the media to describe the potentially impending shifts. Without action by the 112th Congress, beginning 1 January 2013, a series of automatic changes to income tax rates will be set in motion, including substantial increases to ordinary income, capital gain, dividend and payroll tax rates, revisions of the marriage penalty and the Alternative Minimum Tax, and a phase out of itemised deductions – to name only a few. In addition to these increases that would occur upon expiration of the Bush tax cuts, enacted through the Economic Growth and Tax Relief Reconciliation Act of 2001[1], the Patient Protection and Affordable Care Act (ACA)[2] introduces a new 3.8% Medicare tax on investment income and a 0.9% increase in the Medicare payroll tax. Further, the lifetime gifting exemption will decrease and federal estate, gift, and generation skipping transfer (GST) taxes may increase. All in, over 70 tax provisions are to experience change.

Will all of these changes occur? The answer to this question is not revealed in this article, nor could it be. Indeed, few individuals have significant influence on its outcome. Nevertheless, it is possible and prudent to plan during this period of uncertainty before inevitable increases become reality.

The major tax changes impacting investment income and transfer of wealth

The major components of the Bush tax cuts are set to expire at the end of 2012 (after being extended in 2010). The possible expiration of these tax cuts, coupled with the investment income tax enacted through the ACA, result in major increases in income tax rates in 2013.

Before the 2010 mid-term election, taxes were expected to increase in two stages: first, as part of the expiring Bush tax cuts beginning 1 January 2011, and then in 2013 as a result of the ACA. However, through a process of congressional can-kicking, all of these tax increases have been deferred until 1 January 2013.

Currently, the highest applicable income tax rate is 35% for ordinary investment income and short-term capital gains and 15% for long-term capital gains and qualified dividends. While the expiration of the Bush tax cuts at the end of 2012 is unlikely (a further short-term deferral is likely), the 3.8% investment income tax enacted through the ACA is very much expected to go into effect on 1 January

Top Effective Individual Tax Rates

	Ordinary Income	Capital Gains	Qualified Dividends	Estate, Gift, GST Taxes
2012	35.0%	15.0%	15.0%	35.0%
2013	43.4%	23.8%	43.4%	55.0%

2013. Without an extension of the Bush Tax Cuts, the changes (outlined in the table above) beginning in 2013 could become reality.

Further, many state income tax rates are increasing due to large budget shortfalls, potentially resulting in a total top income tax rate well in excess of 50%.

Proactive tax planning

Undoubtedly, numerous investment structured products and tax strategies have been developed in response to this changing tax landscape and, as in the past, many will include mechanisms that attempt to convert ordinary income to capital gains or to defer taxation of investment earnings. And while some of these plans may work, they typically only serve to mitigate or defer the applicable tax. Further, many attempts to take advantage of perceived loopholes and weaknesses in the tax code are untested and will be subject to future scrutiny.

For the past 20-plus years, however, a strategy has existed that has the ability to eliminate taxes on a portion of investment portfolio earnings. The strategy is private placement life insurance (PPLI). While it is bona fide life insurance (which has ancillary benefits, discussed below), the tax benefit to investors lies in the advantageous treatment afforded variable life insurance under long-standing and unquestioned tax law (supported by Treasury Regulations, Revenue Rulings, Private Letter Rulings, and case law).

With the pending tax increases, PPLI is a necessary discussion topic between every high-net-worth client and his or her tax attorney and other wealth advisors as part of a value-added and comprehensive investment and tax analysis.

What is PPLI?

PPLI is a product specifically developed for the investing and life insurance needs of high-net-worth individuals. Certain established carriers, both inside and outside the United States, offer PPLI policies that are priced institutionally and comply fully with US tax rules, and therefore, receive the long-standing and established preferential tax treatment of life insurance. Often, the core motivation for acquiring a PPLI product is to create a tax-free investing environment. Such a purchase, if priced and structured correctly, can improve a portfolio's overall tax and risk-adjusted return by increasing allocations to tax-inefficient asset classes and accessing the broadest possible selection of high-quality investment managers, including managers of hedge funds, hedge funds of funds, and other alternative assets classes.

Tax Benefits of PPLI

As an investment and income tax planning tool, PPLI enables continued access to sophisticated investment strategies, yet reduces income tax liabilities by permitting such investments to grow income tax-free. Because PPLI is a life insurance product, it capitalises on the income tax benefits of life insurance, which include the following features:

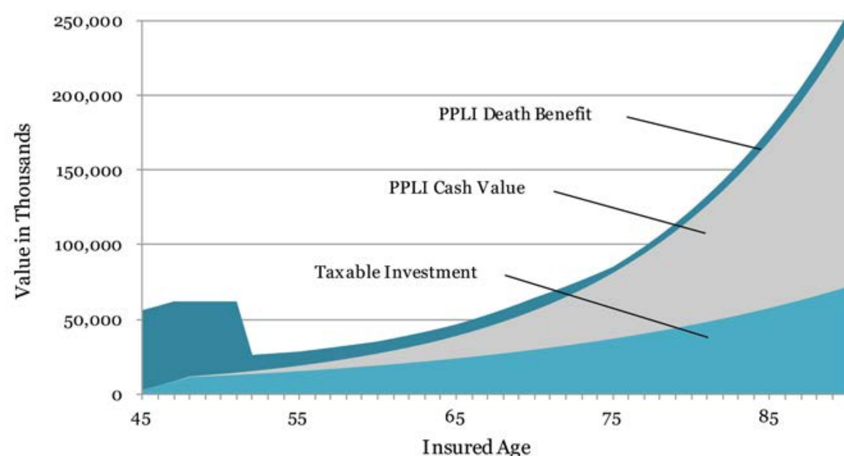
- the cash value of a life insurance policy grows faster than a taxable investment portfolio because earnings, including dividends, interest, and capital gains, are not taxable as they accumulate within cash value accounts associated with the policy;
- the policyholder can generally make tax-free withdrawals and loans against the policy's assets during the insured's lifetime and the proceeds payable upon the death of the insured are not taxable to the beneficiary. This favourable tax treatment allows the investor (working with investment advisers and consultants) to strategically allocate assets in a PPLI portfolio to investments which would otherwise be tax-inefficient investments without worrying about the negative tax consequences that would occur with the same investments in a traditional investment portfolio. (As a practical matter, because the investment is made through an insurance policy, the client will not receive a K-1 from the underlying investments in which the policy cash value is invested. Most clients are quite pleased with the resulting reduction in complexity surrounding preparation of their annual individual tax returns.)

Different from traditional insurance

While the PPLI product is similar to a traditional variable universal life insurance policy in its mechanics, PPLI has some exceptional differences that separate it in the context of the high-net-worth client:

- The policy owner has broader flexibility with regard to the policy's underlying investments; many hedge funds and other tax-inefficient investment choices (such as discretionary, actively managed separate accounts) are available. Importantly, although not unlike an after-tax investment in hedge funds and other discretionary managed accounts, the policy owner cannot exercise direct or indirect control over the investment of the policy assets,

Why PPLI makes sense - a graphical depiction



Year	Age	Cumulative Premium	Taxable Portfolio		PPLI Policy			
			Value	IRR	Cash Value ("CV")	CV IRR	Death Benefit ("DB")	DB IRR
5	49	10,000,000	11,690,859	4.53%	12,456,276	6.40%	61,965,799	61.78%
10	54	-	14,588,466	4.53%	17,575,739	6.83%	27,593,910	12.57%
20	64	-	22,716,218	4.53%	36,012,937	7.15%	43,935,783	8.31%
30	74	-	35,372,230	4.53%	75,267,081	7.33%	80,535,776	7.58%
40	84	-	55,079,355	4.53%	157,493,975	7.41%	165,368,674	7.55%

Assumptions:

1] Earnings rate of 8%, net of management and custody fees.
2] PPLI Non-MEC policy insuring the life of a male, age 45, preferred non-tobacco rating.
3] Four annual premium deposits of $2.5 million.
4] Future effective Investment Income Tax Rate: 43.4%.

yet can still choose from a wide variety of investment mandates.
- Insurance fees are significantly more competitive than retail insurance products. In most cases, there are low front-end loads on premium payments (less than 1-2% as compared to retail insurance products, where such loads can exceed 50-90% of the first year premium), the annual charges against policy cash values are a small fraction of the annual tax cost associated with similar investments in a taxable environment, and PPLI policies typically have no surrender charges. As a general rule, total policy fees should be less than 1%-1.25% as expressed as a percentage of the cash value over a reasonable investment horizon. Stated another way, an 8% investment return of the underlying investment values will yield a return on the cash value of the policy of approximately 7% - significantly higher than an otherwise after-tax return of 4.5% (assuming a 43.4% tax rate applied on an 8% return).

Practical considerations in procuring a PPLI policy

In addition to the tax issues discussed above, PPLI purchasers, advisers, and investment consultants must consider a number of purely practical issues, described below.

Cost of Acquisition

Meaningful differences in cost structures exist depending on whether the PPLI is purchased from a US domestic carrier or an international carrier. The primary difference is the application of the state premium tax (assessed as a percentage of premium), which in the US averages 2%, but can be as high as 4%, versus 0% with an international carrier. Using an international carrier will require that the policy be procured outside of the US. The client should travel outside the United States to negotiate the contract, take a physical exam, and complete the necessary application paperwork. More often than not, the cost savings of 2% of the premium far exceeds the costs of travelling outside the US to procure the policy.

Underwriting

PPLI purchasers must pay careful attention to the "insurance" nature of the life insurance contract, despite its tax and investment advantages. The insurance company must assume risk in the transaction, and the client must go through financial and medical underwriting that allows the carrier to assess that risk. Carriers typically require clients to share enough financial information to establish the need for insurance and an insurable interest. Clients also must submit medical information and undergo an insurance-specific medical examination by a qualified physician, typically a board-certified internist.

Professional involvement: an integrated approach

Investment consultant

The client should work with his or her investment consultant (and other advisers such as attorneys and accountants) during the PPLI acquisition process. The investment consultant has an important role in considering, evaluating, and recommending the PPLI underlying investment choices, while referring non investment components to appropriate legal and/or insurance professionals.

Lawyer

The lawyer's role in PPLI acquisition is fairly broad. The lawyer first will educate the client about PPLI planning, including the relative merits of domestic versus international PPLI, and may recommend various ownership structures to fit within the client's existing estate plan. The lawyer will act as tax counsel, analysing the structure with an eye toward tax compliance; negotiate contract points with prospective carriers; and work with the insurance broker (if any, as international transactions may not require an insurance broker, which significantly reduces the total cost of the acquisition) to implement the policy while ensuring that the client's financial, medical, and personal information are processed with the highest degree of confidentiality.

Finally, it should be the lawyer who confirms the financial solvency of the client prior to any transfers into a PPLI policy.

Other benefits of PPLI

The death benefit component of PPLI should not be overlooked, as it provides tremendous wealth transfer and estate tax mitigation strategies, and may also be used to create a family philanthropic legacy. The beneficiary of the death benefit could be a charity, church, school, or family foundation, or still yet, used to create a private family foundation for future generations.

Now through to 31 December 2012, up to USD5.12 million per individual (and USD10.24 million per couple) may be gifted outside the client's estate. Such amounts, once gifted, can be used to fund a PPLI policy, and if structured properly, not only eliminate the death benefit from federal income tax, but also estate tax. Absent congressional action, a wealthy individual's gift and estate tax liability is scheduled to increase substantially if the lifetime exemption reverts back to USD1 million and the top gift and estate tax rates soar from 35% to 55%.

PPLI mitigates estate tax liabilities while facilitating the orderly disposition of assets at death. Most importantly, the death benefit proceeds of a PPLI policy pass to the policy's beneficiaries free of any federal income tax, and if structured properly, free of any estate tax. The liquidity provided from the policy's death benefit may be used to eliminate or mitigate the need to liquidate other family assets in order to pay estate tax. These proceeds can also be used as a powerful tool for augmenting a client's philanthropic goals.

Further, as an asset protection vehicle, PPLI offers financial privacy and, in some cases, significant protection from future creditors.

Conclusion

While PPLI's tax benefits are evident even in today's low tax environment, the pending tax increases that are likely for 2013 make PPLI's tax advantages all the more significant.

PPLI is most often used as a simple, tax-efficient investment vehicle. However, by adding varying layers of complexity and employing competent counsel and advisers, PPLI should be a part of every high-net-worth individual's investment, tax and estate plan. Because the gain on investments within the PPLI policy is not taxed, the compounding of the investment returns is significantly accelerated, and investors have the opportunity to experience increased returns from investments made through the PPLI policy. Provided the policy remains in force, the tax-free accretion of investment earnings, tax-free access to the policy assets, and tax-free death benefit present an unparalleled planning tool that simply cannot be ignored by high-net-worth individuals, their estate planners, and wealth advisors to the high-net-worth community.

END NOTES:

1. *The Bush tax cuts refer to the US tax code changes, the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003, which were passed during the presidency of George W. Bush.*
2. *In January, the tax increases in the ACA impose (i) a 3.8% surcharge on a taxpayer's net investment income, and (ii) a Medicare payroll tax increase from 1.45% to 2.35%.*