Growing Investment Funds Tax-Efficiently within Private Placement Insurance Products

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Abstract: Clients want fixed income investments that grow tax-efficiently. As shown on the following table, $500,000 invested at 8% can grow to $5,000,000 over 30 years if taxes are managed. If, however, clients invest like most investors, they have just $250,000 of $500,000 of earnings to invest after state and federal taxes, as shown in row 2 of 4 on the following table. In fact, the situation is worse because most people pay taxes on investment income, as shown on row 3 of 4, and most investors pay taxes on distributions, as shown on row 4 or 4. Instead of turning $500,000 of income into $5 million, a typical investor might grow this money to just $662,287 over 30 years. This white paper offers a solution so that $500,000 can once again grow to $5 million. For example, the following solution can work especially well if assets grow in mortgage funds yielding 8% or more.

Impact of Investing Excess Income Tax-Efficiently:	Now	20 Years at 6.5%	30 Years at 8%
With Tax-Efficient Planning Tools:	$500,000	$1,761,823	$5,031,328
If 50% of Excess Income is Lost to Taxes Before Investing:	$250,000	$880,911	$2,515,664
If Investment Returns are Reduced by 38% Taxes:	$250,000	$580,265	$1,068,205
If 38% of Accumulated Value is Lost to Withdrawal Taxes	N/A	$359,764	$662,287

Numbers above assume 38% and 50% tax rates. With marginal tax rates over 55% for most wealthy investors in high tax states, there is growing interest in tax-efficient investing. Increasingly the most powerful investment strategy involves investment grade life insurance. Such insurance policies can be issued as private placement variable annuity or variable universal life insurance contracts. Here is a brief summary of how new investment contracts issued by insurance companies differ from traditional insurance:

Understanding Private Place Variable Universal Life Insurance

	Death Benefit	Cash Value	Returns
Traditional Insurance	High death benefit	Low cash value	Low returns on cash invested until death
High Cash Value Investment Grade Insurance Contract	Least allowable death benefit	Cash value greater than premiums paid	Market-rate returns on cash value throughout life

High net worth investors seek tax-planning structures that provide for tax-efficient wealth accumulation and wealth transfer. This planning objective has become more challenging as these investors have made larger investment allocations to alternative investments such as hedge funds, real estate, private equity, and mortgage funds. Some of best fixed income strategies, such as mortgage loan pools, are fundamentally tax-inefficient. They produce a high percentage of short-term capital gain income or dividend income distributions that are taxed at ordinary tax rates.

Private Placement Variable Universal Life, otherwise known as Private Place Life Insurance ("PPLI"), is an institutionally-priced variable universal life insurance policy offered exclusively to accredited investors and qualified purchasers as defined in Federal securities law. PPLI provides for tax-deferred accumulation as well as tax-free access to investment gains within the policy through either partial surrender of the cash value or policy loans. The policy death benefit is income-tax-free. The policy's ownership may be structured to avoid estate taxes as well[i].

PPLI contracts can own a wide variety of investment contracts so long as there is not too much investor control. To manage the control while helping the investor maximize tax benefits, major insurance carriers wrap their insurance contracts around Insurance Dedicated Fund ("IDFs"). These fund typically invest in assets that would normally generate ordinary income, such as hedge funds and mortgage funds. The income generated within the IDF can grow tax-free and distribute tax-free without the ordinary income taxes that can reduce returns by more than half in some states. For instance, IDFs wrapped around short-term loans to real estate developers can net more than the 8% returns in the above example.

The difficult challenge of PPLI is not its planning premise, policy features and benefits, or pricing. PPLI is an insurance policy that requires detailed medical and financial underwriting. Large investments into PPLI require the purchase of policies with large face amounts, which require large death benefits. Many wealthy clients need the death benefits to secure loans from charities, fund buy-sell agreements, and provide estate liquidity. When a client needs both cash value to produce tax-free retirement income and death benefits to produce tax-free wealth transfers, the PPLI can be an excellent investment.

PPLI may work especially well in irrevocable trusts used in estate planning. Many wealthy families have been successful accumulating wealth in multi-generational trusts such as Dynasty or generation skipping trusts. These trusts are very efficient for wealth transfer tax purposes but not necessarily for wealth accumulation purposes. For example, the level of trust investment income required to trigger the top marginal income tax bracket is quite low, $11,950. Therefore, the trustees continue to look for investments that can grow tax-free and make tax-free payments to beneficiaries. PPLI can work very well.

Nonetheless, when PPLI creates too many underwriting challenges, private placement annuities can provide a simpler, albeit, less tax-efficient solutions. As mentioned above, PPVA's are institutionally priced variable deferred annuities designed for accredited investors and qualified purchasers. These products allow for an expansion of the contract's investment menu to sophisticated investment options such as non-registered funds (e.g. mortgage pools).

Understanding Private Annuities

Like PPLI, Private Placement Variable Annuities ("PPVAs") are institutionally-priced variable deferred annuities offered exclusively to accredited investors and qualified purchasers. PPVA's also provide for tax-deferred accumulation, with the proviso that withdrawals are treated as income (as compared to return-of-principal) first and that there is a 10% penalty tax on withdrawals prior to age 59 1/2 (subject to certain exceptions). There are no policy loans and death benefits are not income tax free.

PPVA contracts may be a more viable tax advantaged vehicle for wealth accumulation than PPLI for the high net worth family with significant assets already in multi-generational trusts. A wealthy family may not have a traditional need for life insurance and/or may be adverse to the level of medical and financial disclosure required in the life insurance medical underwriting process.

The PPVA investment process is more like a traditional investment transaction. Moreover, the cost structure of the PPVA is approximately twice as efficient as the PPLI cost structure because there is no cost of death cost of death benefit charges.

According to the National Association of Variable Annuities, the average annual cost of a deferred annuity is approximately 140 basis points before fund expenses. The average annual cost of a PPVA with a $1 million account balance is approximately 50 basis points. The greater difference between retail variable annuities and PPVA's is related to the degree of investment flexibility. Retail annuities almost exclusively feature registered funds that are very similar to mutual funds. PPVA contracts may feature alternative investments- real estate, hedge funds, LBO, private equity, and mortgage funds.

Choosing Between PPLI and PPVAs

This cost differential between PPLI and PPVA contributes to a significant degree of difference is tax-deferred compounding. Clients can accumulate much more money in an annuity. The downside, of course, is that death benefits are taxed as ordinary income. This is a big problem for clients who expect to be in high tax brackets when they withdraw funds from the annuity.

The vast majority of states have relaxed the investment liquidity requirements of PPVA contracts, to accommodate less liquid investment strategies. PPVAs may also incorporate registered funds on a customized basis as well to provide a complete array of investment options. PPLI contracts may not have the same liquidity because of the need to fund policies over multiple years according to strict IRS guidelines.

Evaluating Practical Considerations

To qualify a fund for inclusion in a PPVA or PPLI contract, there must be underwriting due diligence performed by a third party such as Duff and Phelps. Once approved, a Customized Account within the PPVA contract can be structured as an insurance dedicated fund ("IDF").

The Customized Account provides an open architecture allowing the investment advisor to manage based upon its asset allocation model and changes to the model. All of the investment income and gains from the Customized Account will accrue within the contract on a tax-deferred basis. Prior to the death of the annuitant, the trustee may request a distribution from the insurance carrier. At the death of the annuitant or insured, the trustee will be required to make a distribution.

Conclusion

Insurance contracts remain one of the most tax-efficient investment vehicles available. Clients may express the greatest interest in the insurance contract investments if taxable funds can be generate tax-free returns and ultimately pass to beneficiaries tax-free. Attractive opportunities exist to create customized accounts that own mortgage funds within PPLI or PPVA contracts. Mortgage pools or hedge funds can often be structured as insurance dedicated funds ("IDFs"). Both PPLI and PPVA contracts can shelter customized mortgage accounts from taxes. Astute investors can use these PPLI and PPVA investments as key elements in retirement and estate plans. Wise investors can work with their advisers to illustrate how PPLI and PPVA contracts can produce much better after-tax returns than would be available if investing in traditional investment vehicles.

ENDNOTES

[i] Some of the most powerful estate planning vehicles involve the transfer of assets to an irrevocable trust in exchange for a split dollar agreement ("SDA"). A discussion of the benefits of split dollar planning for estate tax minimization goes beyond the scope of this white paper. Nonetheless, it is important to note that private placement life insurance can overcome the biggest objections to using SDAs in estate planning. In particular, when clients object to moving money to high cash value life insurance policies in order to use SDAs, the concerns about investing in life insurance usually involve the limited investment choices inside the insurance contracts or the 2 to 3% (or higher) annual mortality and administrative charges inside the insurance contract. To overcome these objections, experienced legal and insurance professionals can sometimes structure the clients' existing investments inside a PPLI contract with very low mortality and administrative costs. Therefore, for relatively small additional costs, the client can receive greater income tax benefits than are available with current investment portfolios (because assets can now grow tax-free and distribute tax-free) AND the client can also receive the benefits of using SDAs to move assets very tax-efficiently to trusts that are exempt from estate, gift, and generational skipping taxes.