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Voices: Tax planning with private placement life insurance

By Steven A. Horowitz, Henry Montag - January 04, 2022

For the past 60 or more years, the community of estate planners (tax attorneys, accounting firms, financial planning firms, etc.) have utilized cash value life insurance policies and death benefits, which they provide for many reasons in financial and estate planning for their clients.

The policies provide both an exceptional level of tax-favored savings based upon the fact that the inside build-up on the policies is tax-free (or deferred until surrender or lapse), and the death benefit proceeds are income-tax-free and, with proper planning, estate- and gift-tax-free. As such, these policies create an excellent source for the payment of estate and other transfer taxes as well as the augmentation of family income and wealth after the death of the senior generation. It is not uncommon to refer to the life insurance policy as a tool whereby clients can pay for the transfer tax for their family through the use of discounted dollars. The life insurance policy premiums provide income- and estate-tax-free dollars for the family unit by making them owned by and payable to an irrevocable life insurance trust (which will lend money to the estate or buy illiquid assets from the estate) to pay the taxes instead of having the client create a sinking fund of cash to provide the full amount of taxable capital to pay the taxes (or to fund a trust with 100 cents on the dollar to pay the taxes).

Life insurance has traditionally been used to provide a source of income continuation for their clients when the primary breadwinner dies. Recently, the industry has evolved, as has the planning process. It is now far more common for us to do planning with variable life insurance policies for entire segments of the upper income and high-net-worth marketplace of consumers. High-net-worth (HNW) and ultra-high-net-worth clients are now far more interested in acquiring life insurance policies as an asset class that can provide favorably taxed income distributions, as well as income and estate tax free death benefits to meet their estate tax and wealth preservation objectives. This comes as a result of an insurance strategy that now allows a larger amount of accumulated cash value to grow and accumulate tax deferred indefinitely, despite the recently enacted SECURE Act.

Recent changes to Section 7702 and the full-frontal onslaught that the UHNW client faces as a result of the current proposed tax plans have made private placement life insurance even more efficient than it was just last year. Equally significant is that PPLI offers better pricing and lower costs due to participants having better health care access, which the insurer in turn passes on to the insured. These factors, in addition to significantly reduced institutional rather than retail commissions, result in a larger cash value buildup and unlike their retail counterparts have no early withdrawal surrender charge penalties.

Such a strategy also offers the insured access to institutional hedge funds rather than traditional retail mutual funds. The combination of hedge funds, venture capital and equity markets in a tax-deferred insurance company wrapper provides a significant benefit to the insured. What makes it even more meaningful is that upon the passing of the insured, the death benefit passes from one generation to the next, on a 100% income tax free and estate tax free basis which, if set up correctly in an irrevocable life insurance trust, provides the most tax efficient transactions and investment returns to the family. It can be thought of as a Roth IRA on steroids.

Life insurance policies today can also be viewed as an asset class that can provide the insured as well as their beneficiaries a significant cash flow as a living benefit on a tax-favored basis. For example, it can provide tax-free leveraged distributions to pay for any long-term care needs directly from the death benefit of a life insurance policy. Moreover, the PPLI policy is often used in single or multi-family offices to provide for income tax deferral on growth during life, as well as access to cash values via a strategy of surrenders and borrowing from the policy that can provide for a tax-free rollover of the death benefit into an immediate or deferred annuity. If the distributions from an immediate annuity are used to pay for long-term care premiums directly to an insurer, the exclusionary ratio is 100%.

Implementation of a PPLI strategy offers significant tax and other benefits to the insured policyholder and beneficiaries. However, since PPLI is a security and requires a private placement memorandum involving the coordinated efforts of a tax attorney, an accountant and an experienced insurance professional, to properly structure and customize the strategy to the specific needs of the clients, it is costly to set up. The strategy only makes sense from an economic perspective when the policy premiums and/or assets transferred into the policy exceed certain thresholds. However, where the scale is sufficient, it makes sense to utilize a PPLI, whether from a boutique specialty insurer or offered by several of the major insurers, as they enable the insurance professional the opportunity to offer their clients life insurance on an institutional basis with lower costs and fees, rather than on a traditional retail basis. Further, a good general rule to follow would be to review any current retail premium in excess of $500,000 to make certain clients are receiving the most tax-efficient and cost-effective death benefit dollar in exchange for the premium they are currently paying.

Either way, the newfound ability to acquire these types of investments inside a life insurance policy or an annuity contract, and thereby meet the clients' goals and objectives, has facilitated the funding of large amounts of dollars in these types of policies. The burgeoning of the market for these types of policies and structures has led to the establishment of a variety of products and has energized the private placement variable life insurance market. When you consider the timing of Section 7702 and the SECURE Act, it is clear that the government has sent a strong signal that favors life insurance over the traditional IRA as the right vehicle to shelter tax-deferred growth from income and/or capital gains taxes on an indefinite basis and then at death, and allow the principal and gains to pass to the next generation 100% income and estate tax free, if set up correctly.

The growth of the PPLI market and the demand for new investment vehicles have fueled and facilitated a significant expansion in the offerings of these types of products in the family office setting and created what is now a distinct and often misunderstood asset class. The acceptance of these types of policies in the market has created a solid and stable foundation for growth. The PPLI marketplace has now become an industry segment suitable for the HNW as well as UHNW individual marketplace, which is often used by single-family and multi-family offices to obtain the most value for their families throughout the country. Private placement life insurance adds flexibility to a variable universal life insurance product's construction, pricing and asset-management offerings. Every transaction can be individually negotiated and custom designed for the specific investor. The tax benefits it offers to policy owners are available from few, if any, other investment vehicles, particularly since they accrue without the need for complex trust structures.

What really differentiates PPLI from more traditional policies of life insurance is the ability to custom tailor the investment component of the contract. Family office managers utilize the fact that PPLI policies provide access to sophisticated and alternative investment classes and strategies, such as hedge funds, funds of funds, commodities, real estate and currency diversification. Clients, with the help of their attorney, CPA or family office manager, are free to designate a traditional asset manager as long as certain additional requirements are met. Specifically, the manager must have full discretion, although policy investment guidelines may be implemented and modified from time to time.

Most wealthy investors have a diversified portfolio consisting of different investment strategies to diversify a portfolio with high-yield, short-term trading, or other tax-inefficient strategies, as it is often considered beneficial for minimizing risk as well as for increasing the client's and family's after-tax rates of return. The PPLI policy strategy allows for the super-charging of the portfolio based upon the elimination of the income tax drag or coefficient of tax friction, plus the creation of an additional tax-favored leveraged asset, as only a life insurance death benefit can do.

Investments that are already highly tax efficient (such as tax-managed offset funds) are not the best candidates for PPLI policy investments. Likewise, highly speculative investments that stand a high probability of losing value are not PPLI investment candidates. That means PPLI is an attractive option even at a 15 to 24% capital gains tax rate, including the net investment income surtax. These benefits will be even more pronounced under President Biden's plan if the potential for increases in the capital gains tax rate becomes a reality. The policy owner can choose the type of investment strategy for the PPLI policy.

The sophisticated client, through their investment advisor's family office, gains the ability to analyze all elements in the contract and make informed cost comparisons. The product is more flexible and therefore requires more communication, coordination and knowledge between the accountant, the attorney, the insurance professional and the family office manager to better understand, construct, transact and manage the strategy on an ongoing basis for the benefit of the family.

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