CHAPTER 3

Tax Management

Building Wealth, Reducing Taxes

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It's not what you make; it's what you keep. And investors and their advisers realize that it's not enough to achieve good gross returns. They want to know what they've earned after fees and taxes have been extracted. Of course, taxes have long put a dent in how much gets kept, but private placement life insurance (PPLI) has the potential to eliminate income tax on investment earnings and, with proper estate planning, eliminate the estate tax as well. Indeed, it can provide a large tax-free death benefit for a cost that comes to much less than the tax savings gained.[1]

This chapter takes a closer look at the income tax savings benefits of PPLI, the estate tax savings benefits of such policies, and questions surrounding how the insurance can be used as part of an overall long-term investment strategy. This chapter simplifies what can otherwise be an area with many tax risks and perils, but PPLI should not be undertaken without the help of qualified tax advisers.

Tax-Efficient Investing

U.S. federal income tax law taxes different types of investment returns very differently. Long-term capital gains and qualified dividends, for example, are taxed at 15 percent. Short-term capital gains and most interest income are taxed at 35 percent. Unrealized appreciation in the value of securities is generally not taxed until the securities are sold. Interest on certain municipal bonds is never taxed. Depending on the investment, the same before-tax return can result in very different after-tax returns, as seen in examples 1 and 2.

Example 1. Lauren invests in a portfolio of growth stocks, which pays

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no dividends. She holds on to her stocks until her death. Her gross return averages 12 percent per year. Because Lauren received no dividends and sold none of the stocks, she owes no income tax, so her before-tax and after-tax returns are the same—12 percent per year.

Example 2. Allison also invests in a portfolio of stocks. Some of her stocks pay qualified dividends (taxed at the 15 percent federal rate). Allison often sells some of her stocks with gains after she has held the stock for over one year so that her gains are long-term capital gains, and she frequently sells stocks with losses whether or not she held the stock more than a year. Her net long-term capital gains and qualified dividends are taxed at 15 percent. Therefore, if her before-tax yearly return were 12 percent and all of her income were taxed at 15 percent, her tax would be about 1.8 percent of her portfolio (15 percent of 12 percent) and her after-tax return would be 10.2 percent (12 percent - 1.8 percent). In fact, since Allison defers some of the tax until the sale of the securities, her after-tax yearly return would be higher than 10.2 percent. Because of state and local income taxes, however, Allison's overall after-tax return may be less.

Example 3. Jenna is an active trader of securities, who rarely receives qualified dividends or long-term capital gains. She achieves an average yearly return of 12 percent, but that return is almost all taxed each year as short-term capital gains, so that approximately 35 percent of the return must be paid to the federal government. If Jenna lived in a state with personal income taxes, her return would be further reduced by state and local income taxes. Since she is an active trader, all of Jenna's gains are generally realized for tax purposes, so none of the tax is deferred. If Jenna's combined tax rate were 40 percent, her after-tax yearly return would be only 7.2 percent (12 percent - 4.8 percent). And Jenna's after-tax return would be only 60 percent of her before-tax return.

Clearly, after-tax returns can differ greatly, depending on investment strategies. Some funds provide tax-efficient returns. Private-equity funds, for example, often produce long-term capital gains, and some hedge funds are very tax-efficient. But many are not. They produce short-term capital gains and ordinary income, taxed at rates (including state and local tax) exceeding 40 percent.

Despite their tax inefficiency, the allocation of portfolio assets to hedge funds has been rapidly increasing. Many investment professionals recommend significant portions of a portfolio be invested in them. For investors who are interested in investing a portion of their portfolios in hedge funds or any other potentially tax-inefficient strategy, PPLI provides a way to greatly increase the tax efficiency and thereby greatly increase the after-tax return.

What Is PPLI?

PPLI's tax efficiency hinges on the product's key features:

- ❑ PPLI is life insurance with a separately invested account for that policy's cash value, which may be invested in a hedge fund, a group of hedge funds, or a separately professionally managed account for the insurance company. The separate account can be invested in any diverse portfolio of liquid assets (not necessarily a hedge fund) or any portfolio that has been engineered to support the policy's required liquidity—death benefits, lapses, surrenders, loans, or withdrawals.
- ❑ The pure insurance portion is essentially low-cost term life insurance, which allows the entire investment, including the cash, to qualify as life insurance. The costs of setting up and maintaining the policy are charged to the account, and the account grows (or shrinks) depending on the success of the investment.
- ❑ The life insurance is placed on someone's life (the insured), and at that person's death, the policy pays to the beneficiary the amount of pure (term) insurance then in place, as required by the policy, plus whatever is in the cash account—free of income tax.
- ❑ The entire death benefit (including all the earnings from the hedge funds and/or separate accounts) is received by the beneficiary free of all income tax.
- ❑ If the owner surrenders the policy before the death of the insured, the income generally is taxed at ordinary rates (plus an excise tax of 10 percent of the gain, if he or she is under age 59½). Under certain policies (that is, a nonmodified endowment contract), as long as the contract is not terminated, a substantial portion of the cash can be withdrawn as a loan, income tax–free.

Income Tax Savings

Placing the investment within a life insurance policy eliminates current taxation, and the payment of the appreciation through a death benefit is tax-free. Therefore, the appreciation can be free of all income taxes. Within such a framework, a tax-inefficient investment can become a tax-efficient one. For Jenna, instead of reducing the return from 12 percent to 7.2 percent for the 40 percent income tax paid—a reduction in the internal rate of return by 4.8 percent—the reduced internal rate of return under the policy may be less than 1 percent, thereby increasing the internal rate of return from 7.2 percent to more than 11 percent. The reduction of less than 1 percent in the internal rate of return is based on the insurance costs rather than the federal tax rate and will vary depending on the policy.

FIGURE 3.1

AGE	SINGLE PREMIUM	END-OF-YEAR CASH VALUE	DEATH BENEFIT (INCLUDING CASH VALUE)	TAXABLE ACCOUNT (AT 35% TAX)
50	$5,000,000	$5,398,996	$17,782,027	$5,390,000
53		6,561,573	7,782,027	6,263,632
60		13,594,803	18,217,036	10,596,382
70		39,928,676	46,317,264	22,456,663
80		117,942,390	123,839,720	47,591,877
90		343,582,426	360,761,548	100,860,340

Although the underlying investment can be any investment that conforms to the insurance company's standards and complies with the various insurance and tax regulations, let's assume here that the investment will be a hedge fund or group of hedge funds—an investment that would be tax-inefficient outside of an insurance policy.

FIGURE 3.1 compares the return on a sample hedge fund life insurance policy purchased at age 50 for $5 million against a taxable investment of $5 million. The chart assumes a 12 percent return per year on the hedge fund investment and uses the costs of an actual policy. The taxable account column assumes a 35 percent tax rate. Of course, the chart simply shows illustrated results. The final results will depend on, among other things, the charges imposed by the insurance company, the actual investment performance achieved by the hedge funds selected, and the investor's marginal income tax rate.

The death benefit greatly exceeds the taxable account value at all ages. Obviously, the after-tax benefit of the insurance policy would be substantially higher if the average returns on the hedge fund investment substantially exceeded 12 percent and would be much lower if the average returns were much less than 12 percent. The tax benefit would also be substantially higher if the investor's assumed tax rate were more than 35 percent. (Many hedge fund investors' marginal tax rates are between 40 percent and 50 percent when state and local taxes are included.)

Estate Tax Savings

A key element of effective estate planning is to make gifts of assets in trust, so that the assets in the trust will not be subject to estate tax for the person who makes the gift (the donor). The beneficiaries of the trust are often the donor's spouse, children, and/or grandchildren. As long as the donor's spouse is living and friendly with the donor, the assets in the trust can be recaptured by distribution to the spouse if they're really needed. A Treasury ruling in 1995 made it possible for the donor to keep substantial control over the trust by retaining the right to fire and replace the trustee. The replacement trustee can be anyone the donor selects except a close relative or subordinate employee.

The best assets to place in such a trust are assets that will grow substantially over time, such as hedge funds and private equity. For example, suppose a donor creates a trust in December 2003, when he or she is 50 years old, and puts $2 million into it. If the donor and the donor's spouse have not used any of their gift tax exemption, this gift would be exempt from U.S. gift tax. Then the donor loans the trust $3 million at the lowest interest rate allowed for a long-term loan (to prevent the loan from being taxed as a gift). These rates, which are set by the IRS, change monthly. Assume that the loan is kept in place for 40 years, until the donor dies at age 90. At that point—at an interest rate of, say, 5.12 percent—the trust owes the donor's estate about $21.1 million on the loan.

The trust invests the $5 million in a PPLI hedge fund portfolio. At the donor's death (see figure 3.1), assuming a 12 percent return, the trust (or donor's beneficiaries) would receive an insurance death benefit of about $360.8 million, which comes to about $350 million after paying the estate tax on the loan. This trust benefit would be free of income, estate, and generation-skipping taxes. In a number of states including Delaware and New Jersey, which have repealed the rule against perpetuities, the trust could continue forever, free of estate and generation-skipping taxes.

Compare this result to three much-less-favorable alternatives. Let's assume that the donor dies at age 90 (in the year 2043) and that the donor's estate will be subject to a 50 percent estate tax. Of course, the rate of the estate tax that far into the future—if the tax is still in place at all—is speculative, but most tax advisers believe it's very likely that there will continue to be an estate tax of 50 percent or more on very large estates. The first alternative is a direct investment in the hedge fund (not through an insurance policy) without a trust. If the donor invested the $5 million in the hedge fund directly, he or she would end up with about $100 million (see figure 3.1, Taxable Account) and the investor's beneficiaries would end up with about $50 million after the 50 percent estate tax—about a seventh of what they end up with under the optimal

planning (that is, using a trust as the owner of a PPLI policy).

Under the second alternative, the donor sets up the trust, the trust invests in the hedge fund directly, and the beneficiaries end up with about $100 million. Under the third alternative, the donor buys hedge fund insurance but not in a trust. Under this alternative, the beneficiaries end up with about $180 million (the $360 million death benefit less a 50 percent estate tax). With these assumptions, all three alternatives are much worse than the optimal PPLI planning. Clearly, PPLI invested in a hedge fund can add value in estate planning. It can result in considerable income and estate tax savings, substantially increasing the amount the investor gets to keep.

Domestic versus Offshore Policies

PPLI can be purchased from U.S. or offshore insurance companies (see chapter 17). For U.S. policy owners, the same rules concerning tax deferral or elimination apply to domestic and offshore policies. But an annuity or life insurance policy issued by an offshore foreign company is generally subject to a 1 percent U.S. excise tax. Such foreign companies generally do not pay the state premium taxes or federal deferred acquisition cost (DAC) tax to which domestic policies are subject. The DAC tax for domestic policies usually results in a charge by the insurance company of approximately 1 percent, so that the effective cost of a policy from a domestic insurance company is similar to that of an offshore insurance policy once the excise tax is added. The state premium tax is additional—often 2 percent of the premium—but varies by state and is de minimis in some states.

U.S. insurance companies provide the protection of U.S. regulation and U.S. law. Although foreign laws protecting the cash value from insurance companies' creditors may be similar to U.S. laws, most U.S. investors feel more comfortable with an insurance company that is subject to U.S. law and regulation. Most investors do not have as much confidence in tax-haven countries' laws, courts, legal systems, or political stability as they do in U.S. jurisdictions. Furthermore, many offshore insurance companies have insignificant assets or business, are recently formed, and, in some instances, may ignore U.S. securities law and/or state insurance law requirements. In addition, domestic policies can legally be sold and marketed only in the United States. Foreign insurance companies' policies must be applied for and solicited outside the United States.

Some investors have a concern—unrealistic as it may be—that these small offshore insurance companies will run off with their money. Although the money will generally be under the control of an asset allocator in whom the investor has confidence, and possibly a custodian as well, the investments will be in the name of the insurance company's separate

account. Legal protections can be imposed, but the protections often increase the tax risks, and they can never eliminate the risk that the principals or employees of the offshore insurance company may take the money. Although embezzlement is also possible in the United States, U.S. insurance companies are highly regulated and the risk is significantly reduced.

Offshore insurance companies marketing in the United States or otherwise subjecting themselves to U.S. jurisdiction may be violating U.S. securities or insurance laws. Although this is primarily a concern for the insurance companies and not policy owners, it's obviously preferable not to place substantial assets with a company that may be violating U.S. law. It may also be more likely that the IRS would disallow the advantages of a policy issued by an insurance company that is not "real" or substantial, resulting in the policy losing its tax status.

On the other hand, offshore insurance companies may be less likely to catch the attention of the IRS, may be more suitable for asset protection, may allow investment in offshore investments not open to a U.S. insurance company (or those available only with higher minimum investment or with less favorable liquidity rights than those available in the United States).[2] Offshore insurance policies may give investors greater control of their own investments, but this benefit may carry additional tax risks. The income tax and estate-planning benefits generally apply equally to domestic and offshore policies.

Appropriate Investors

PPLI is not for everyone. Insurance companies often require minimum premiums—sometimes as high as $5 million—to open a separate account or $1 million in premiums for each policy, requiring, for example, five $1 million policies or one $5 million policy to get started. Investments of this size are appropriate only for wealthy individuals or families.

The biggest problem for a potential investor, other than the high minimum, is the loss of investor control. Although the investment manager of the insurance company's separate account can generally change investments or reallocate among hedge funds when desired, the policy owner cannot direct the investment manager in any way other than to make broad allocation decisions from one investment option to another. The insurance company ultimately has the power to hire or fire the investment manager. Indeed, the insurance company, not the policy owner, is the investment manager's client. Of course, the policy owner can always surrender the policy and accept the accompanying negative tax consequences or move the policy to a different insurance company and incur brokerage commissions and other costs. Investor control is a critical issue, given that the IRS may find that the policy owner's involvement in the portfolio's

management invalidates the policy's insurance status and claim that the investor should be taxed on the earnings currently (see chapter 12).

Recent Developments

In 2003, the IRS released a proposed regulation[3] and two revenue rulings[4] that place some restrictions on the tax advantages of PPLI invested in hedge funds (see chapter 12). The proposed regulation does not prevent such policies from investing in hedge funds; nor does it change the income tax deferral and elimination or estate tax–planning benefits of such policies. To meet the diversification requirement so that the policy owner will not be taxed on hedge fund earnings, the regulation requires that the insurance policies either invest in a hedge fund that is open only to insurance companies (see chapter 14) or invest in a diversified portfolio of at least five hedge funds, when those funds are open to noninsurance investors. Although the rulings permit some flexibility, most insurance companies have taken the conservative route and permit only insurance-dedicated hedge funds and private-equity funds. The revenue rulings also restrict the insurance policy owner's ability to choose the underlying hedge fund investments (especially if the hedge funds allow noninsurance investors).

These developments have prompted many hedge funds or funds of funds to form insurance-dedicated funds, open only to insurance companies (see chapter 14). The investments in an insurance-dedicated fund (sometimes called a cloned fund) often mirror the investments of the manager's existing hedge fund or fund of funds and therefore have the same or similar investment returns. Some insurance companies are issuing policies that allow investors to choose from many such insurance-dedicated funds. Properly structured, the IRS guidelines allow such investments, including the investor's right to periodically reallocate the investment among a number of cloned funds. The policy owner can also allow an independent manager appointed by the insurance company to allocate the insurance account among five or more hedge funds open to investors who are not insurance companies.

The lack of investor control and other limitations may be a problem for some, but the degree of control permitted varies from policy to policy. In any case, the tax-free earnings with successful hedge fund managers as well as the income tax–deferred or income tax–free—and possibly estate tax–free—payout at death make these policies worthwhile for certain wealthy investors.

PPLI in the Overall Portfolio

The greatest tax benefits from PPLI result when the policy is held until the death of the insured, because the death benefit is received free of income tax and possibly estate tax. That's why PPLI is often purchased with only a portion of a wealthy investor's assets—the portion not expected to be needed before the death of the insured (see chapter 8).

Most wealthy investors have a diversified portfolio of investments consisting of different investment strategies. In deciding the investment strategy for PPLI, the policy owner's overall investment mix should be considered. Diversifying a portfolio with high-yield, short-term trading, or other tax-inefficient strategies is often considered beneficial for minimizing risk and increasing after-tax returns. PPLI often allows high-yield and short-term trading strategies to be added to one's investment mix without adding tax inefficiency.

Because a tax deduction to the policy owner is not available for losses on returns inside the policy, assets expected to produce high, consistent, absolute returns are good candidates for PPLI. Investments that are either highly tax efficient or so speculative that losses are contemplated are generally not the best candidates for PPLI investments—unless, of course, the investments produce large returns. That means PPLI is an attractive option even at 15 percent capital gains rate (see chapter 8). Generally, the policy owner can choose the type of investment strategy for the PPLI policy.

Chapter Notes

1. Portions of this chapter were adapted from or originally appeared in the *Journal of Private Portfolio Management* 2, no. 3 (winter 1999): 27, published by Institutional Investor and the *Journal of Wealth Management* 7, no. 2 (fall 2004). To view the original articles, visit www.iijournals.com.

2. The offshore company may be subject to U.S. withholding tax on certain U.S. source income (such as the 30 percent tax on U.S. dividends) and would not be entitled to U.S. tax treaty benefits, both of which might significantly reduce investment returns.

3. Proposed Regulation revoking Reg. Section 1.817-5(f)(2)(ii) [68 FR 44689; July 30, 2003].

4. Revenue Ruling 2003-91 and Revenue Ruling 2003-92.