Winged Keel Group Insights

Case Study: Utilizing PPLI to Mitigate Tax Liabilities Related to Spousal Lifetime Access Trust (SLAT) Planning

Winged Keel Group Insights is a publication designed to educate and build awareness around life insurance topics and solutions that may address certain needs of your clients and their multidisciplinary goals.

Utilizing PPLI to Mitigate the Income Tax Consequences of Effective SLAT Planning

Client Profile: An ultra-high-net-worth (UHNW) individual making a lifetime exemption gift to a Spousal Lifetime Access Trust (SLAT).

Background: An entrepreneur, through a number of successful liquidity events, has created significant personal wealth. This client is being advised to max out their lifetime exemption gift into a grantor trust for estate tax planning purposes.

While the client has significant liquidity today, they are reluctant to make a $15M exemption gift. The client is concerned about changes to their future liquidity needs and is daunted by the thought of irrevocably gifting a large sum of capital without an ability to reclaim it.

By setting up a trust with spousal lifetime access, the client will not be irrevocably alienated from the gift. Instead, they will have indirect access via their spouse.

The SLAT is a grantor trust because trust income may be distributed to the spouse. Despite the estate planning benefits of grantor trust status, there is the potentially long-term income tax liability associated with grantor trust status. While there are several options that provide planning flexibility – including spousal distributions for taxes, tax reimbursement clauses, and potentially turning off grantor trust status in the future – all have complexity and drawbacks.

Another consideration is the potential impact of death or divorce on spousal access and the tax treatment of the trust. Under the latter scenario, and based on recent tax law changes, there is a potential for the client to be liable for taxes on a trust benefitting the now ex-spouse.

Assuming a 7.00% net return and a moderately tax-efficient portfolio (assuming 50% long-term capital gains, and 50% short-term capital gains), the cumulative income tax liability to the grantor over the next 40 years is $91.2M.

Action Plan: With a focus on mitigating the future income tax liability associated with the lifetime exemption gift to a SLAT, which would ultimately benefit the couple’s progeny, the trustees considered a variety of alternatives.

One option was to change the proposed investment allocation to be more tax efficient. While this would likely reduce the future income tax liability of the trust, the long-term cash flows required from the grantor to fund the income tax liability would still be significant. This approach could also have an adverse impact on the portfolio’s return profile, reducing the long-term benefits to the non-spousal trust beneficiaries.

Their advisor recommended an alternative: using the full exemption amount to acquire Private Placement Life Insurance (PPLI) to effectively ring-fence the grantor cash flow associated with the planning to only the $15M gift. This would:

- Result in no future income tax liability on the trust assets during the Grantor's lifetime

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- Create the ability to allocate to investment strategies without having to consider tax consequences (which should increase long-term investment performance)
- Allow the beneficiaries to access money tax-free during the insured's lifetime through tax-free withdrawals of basis and tax-free loans, and;
- Preserve the grantor's ability to access the money through the optional spousal lifetime access feature.

Result: The trust acquired a PPLI Account and invested $15M of assets, sequencing the deposits over a three-year period. The trustee and investment advisor worked together to create a custom-mandate for the allocated deposits from the exemption gift. Over the next 40 years, the grantor is expected to save $91.2M in income taxes, which is retained and available for reinvestment, thus increasing the family's overall net worth. In addition, the trust received immediate leverage via the insurance benefit (see chart and notes below). Note that the PPLI insurance benefit is received tax-free and creates a de facto step-up in basis not available for assets held in an estate exempt trust.

PPLI Overview: PPLI Accounts have unique tax characteristics that allow invested assets to grow on a tax-deferred basis and be paid out income tax-free. As the policyowners, the trustees have complete discretion to allocate and reallocate among all the investment options made available by the insurance company. The menu of investment options offered has expanded dramatically in recent years, and for clients making sizable investments in PPLI, it may be possible to create a customized investment offering tailored to meet their objectives.

Additionally, the PPLI Account owner can access 80% – 85% of the account value on a tax-free basis during the lifetime of the insured through a combination of withdrawals of cost basis (FIFO taxation) and low-cost policy loans. The insurance benefits are received income and capital gains tax-free, enhancing the family's ability to efficiently leverage the initial exemption gift to transfer wealth for multiple generations within a GST Exempt Trust.

Conclusion: PPLI continues to be an attractive option for UHNW families as they address planning challenges and goals. It is critical to work with experienced advisors who understand the complexities of PPLI and can provide the appropriate guidance and insight. To learn more, reach out to your Winged Keel Group relationship manager. For more information on Winged Keel, please visit our website at wingedkeel.com.

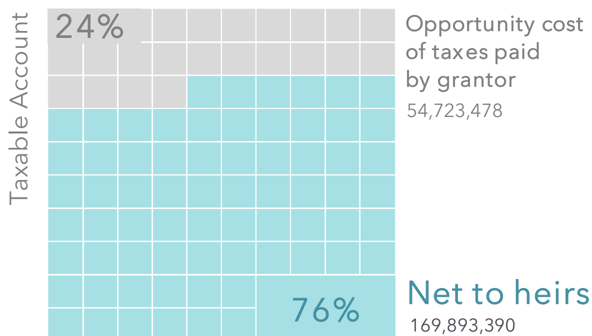
Hypothetical PPLI Account versus Hypothetical Taxable Account

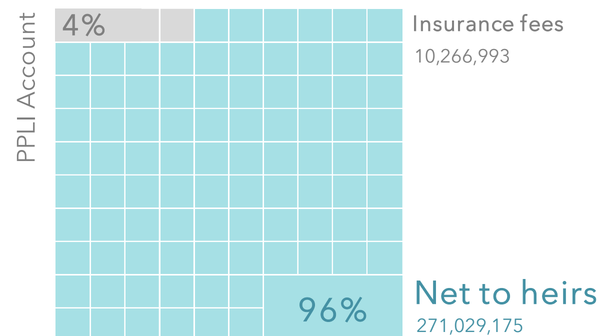
Comparative Economic Results: $15 Million Investment* See Notes

Male Age 40; Preferred Non-Smoker Life Insurance Risk

7.00% Net Annual Rate of Return; 50% STCG / Ordinary Income; 50% LTCG

Summary Values Year 40





Recap: Over the 40-year period, utilizing PPLI reduces the grantor's tax liability by more than $91M and increases the net to heirs by over $100M, all with the same $15M investment (via the full lifetime exemption).

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Notes:

1. These results are for illustrative/informational purposes only and may not reflect the typical purchaser's (client's) experience. These results are not intended to represent or guarantee that any client will achieve the same or similar results.
2. Assumes the net level annual rates of return shown above after a 0.75% investment management fee and before insurance-related charges on a $15 million investment in a PPLI Account and a Taxable Account, 50% of realized gains are taxed at the Short Term Capital Gains (STCG)/Ordinary Income rate, and 50% of realized gains are taxed at the Long Term Capital Gains (LTCG) rate.
3. Assumes that investment management fees are not tax-deductible in the Taxable Account.
4. Assumes a STCG/Ordinary Income tax rate of 47.80% and LTCG tax rate of 30.80%. Assumes the tax rates shown will be applicable for all years.
5. Assumes Insured, a male age 40, will be classified as a Preferred non-smoker life insurance risk. The life expectancy of a male age 40 classified as a Preferred non-smoker life insurance risk is 50 years, based on Society of Actuaries' 2008 VBT Select mortality table.
6. Assumes the PPLI policy is issued in South Dakota and qualifies as a non-Modified Endowment Contract (non-MEC). Under current tax law, if the policy lapses or is surrendered, all investment gains in excess of the policyowner's cost basis are taxed to the policyowner as Ordinary Income in the year the policy lapses or is surrendered.
7. The analysis above does not include any fees charged by professional advisors engaged by the client for tax and/or legal advice.

DISCLOSURES

A Private Placement Life Insurance (PPLI) Account is an unregistered securities product and is not subject to the same regulatory requirements as registered products. As such, a PPLI Account should only be presented to accredited investors or qualified purchasers as described by the Securities Act of 1933.

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A PPLI Account combines the protection and tax advantages of life insurance with the investment potential of a comprehensive selection of variable investment options. The insurance component provides death benefit coverage and the variable investment component provides you the flexibility to potentially increase the PPLI Account's surrender and loan value.

The tax and legal references attached herein are designed to provide accurate and authoritative information with regard to the subject matter covered and are provided with the understanding that Winged Keel Group is not engaged in rendering tax, legal, or actuarial services. If tax, legal, or actuarial advice is required, you should consult your accountant, attorney, or actuary. Winged Keel Group does not replace those advisors. This analysis does not include any fees charged by professional advisors engaged by the client for tax and/or legal advice.

The tax rates and tax treatment of earnings may impact comparative results. Lower maximum tax rates on capital gains and dividends would make the investment return for the Taxable Account more favorable, thereby reducing the difference in performance between the accounts shown. Investments in securities involve risks, including the possible loss of principal. When redeemed, units may be worth more or less than their original value.

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The financial illustrations and other statements within this report, as well as comments made by any individuals, are not guaranteed and do not constitute a contract. Any contract entered into is between the PPLI Account owner and the insurance company, through its PPLI policy. You should read the PPLI Account contract and offering documents thoroughly.

Investors should consider the investment objectives and horizons, income tax brackets, risks, charges, and expenses of any variable product carefully before investing. This and other important information about the investment company is contained in each fund's offering memorandum, which can be obtained by calling 212.527.8000. Please read it carefully before you invest.

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