A BLUEPRINT FOR TAX EFFICIENCY

Shelly Meerovitch and John F McLaughlin explain how purchasing private placement life insurance within US trusts can improve tax efficiency.

US INCOME AND estate taxation motivates many wealthy individuals to seek advice on strategies to reduce tax exposure. One of the building blocks of US estate plans is the irrevocable trust, which can protect transferred assets from the imposition of estate tax upon the grantor’s death. Though effective for estate planning, most irrevocable trusts are less effective in reducing the US income taxes imposed on the transferred assets.

In this article, we review the taxation of trusts in the US, propose that their utility may be considerably enhanced if combined with private placement life insurance (PPLI), and quantify the benefit of such a plan.

TRUSTS

One of the primary US estate planning objectives is to minimise estate taxes by reducing one’s taxable estate. Irrevocable trusts are often used to accomplish this. However, even when the assets of a trust are transferred and excluded from the grantor’s taxable estate, they are still subject to US income taxes.

The income of irrevocable trusts in the US is taxed in one of two ways, depending on the trust’s categorisation as a grantor or non-grantor trust. 1

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Unlike a non-grantor trust – which is taxed like an individual 2 and pays taxes on its income 3 – the income earned within a grantor trust will be treated as if earned by the grantor, and will be taxable to the grantor, even if the grantor does not actually receive such income. 4 Moreover, if the grantor lives in a state that imposes its own additional income taxes, then the grantor will pay federal, state and local income taxes on the trust’s income, even if the trust is set up in a state that does not impose state income taxes. Though the assets of a grantor trust grow tax-free, it may not be financially viable for the grantor to bear the financial burden of those taxes.

Thus, a mechanism that could eliminate the imposition of income taxes on a trust’s income would be very compelling, particularly for a grantor trust and where the trust’s grantor resides in a high-tax state. In certain circumstances, using PPLI may do just that.

PPLI

PPLI is a variable universal life insurance that may help to eliminate the US income tax exposure of trusts.

In the US, owners of life insurance policies do not realise any income from the policy’s underlying investments. 5 Thus, investing some, or all, of a trust’s assets in life insurance can reduce or eliminate the trust’s taxable income, because income earned inside the policy is not currently taxed to the policy owner. Moreover, death benefits paid from the policy, including embedded policy earnings, are not subject to US income tax. 6

KEY POINTS

WHAT IS THE ISSUE?
US irrevocable trusts are effective in reducing estate taxes, but not income taxes. Income taxation can sometimes be minimised, or even eliminated, by purchasing private placement life insurance (PPLI) within trust funds.

WHAT DOES IT MEAN FOR ME?
An introduction to the income tax treatment of US irrevocable trusts, and a discussion of what could make PPLI an appealing strategy to minimise trust income taxes.

WHAT CAN I TAKE AWAY?
Not all US irrevocable trusts are created equal; the impact that PPLI can have on their tax efficiency can have a significant financial impact on family wealth.

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However, life insurance often has a relatively high cost, comprising commissions and fees, with somewhat limited investment options and very limited access to the funds. These factors often outweigh the policy’s income tax savings benefits.

PPLI differs from traditional life insurance in that PPLI policies are generally less expensive (primarily due to much lower or nonexistent broker compensation), while offering more investment options. The potentially higher income and growth of the additional investment options, coupled with the tax savings, might justify the lower cost of PPLI. Moreover, if the PPLI policy is not a modified endowment contract (MEC), funds up to the basis may be accessed during the insured’s lifetime, tax-free, and funds that exceed the basis may be borrowed tax-free on favorable terms. Finally, a PPLI policy can be tailored to a client’s needs.

Theoretically, then, if the income tax savings outweigh the costs, PPLI policies within trusts could allow trust assets to grow income tax-free, thereby increasing the US estate tax savings generated by the trust and potentially enabling a grantor to fund a trust with more assets. The value of this combination can be demonstrated as below.

**ILLUSTRATION**

Mr and Mrs Smith, 50-year-old New York City residents, are contemplating funding an irrevocable trust with USD10 million, following the advice of their estate planning attorney. They do not envision their three minor children (the beneficiaries) receiving any trust distributions in the foreseeable future. The Smiths are weighing the benefits of a trust provision that will cause the trust to be treated as a grantor trust. If the trust is structured as a non-grantor trust, the Smiths are considering creating it in a state that does not impose income taxes, so that the trust’s income would be subject only to federal income taxes.

The diagram at the bottom left of this page shows the economic impact of the trust paying its own federal income tax as compared with the grantor’s paying both state and federal taxes on the trust’s income. Clearly, subjecting the non-grantor trust’s income to federal income taxes would mute the trust’s performance over 40 years, as compared with the grantor trust, which grows income tax-free. But that growth comes at a considerable cost to the grantor over such a lengthy period.

If a PPLI policy is purchased within the non-grantor trust, the federal income tax liability would be eliminated, resulting in USD46 million of additional wealth created within that trust. Though the growth of the grantor trust will still exceed that of a non-grantor trust that owns PPLI by USD38 million, this additional growth comes at a cost to the grantor of USD102 million in income taxes and reduced personal wealth. Incurring over USD100 million in costs to transfer an additional USD38 million to the next generation is a far less compelling value proposition than eliminating all income taxes for the costs of implementing PPLI within the trust.

It is important to note that these figures are based on a portfolio of tax-efficient investments. The benefits of PPLI could be significantly greater if the underlying portfolio was invested in tax-inefficient strategies, as illustrated in the diagram on page 75.

Thus, in addition to enhancing their family’s wealth, using PPLI would give the Smiths greater flexibility to choose investments based on their total-return potential. Their options could include tax-inefficient investments that generate a lot of ordinary income, which are typically avoided within grantor trusts. It would also substantially reduce the complexity and cost of annual compliance.

**APPLICATION**

PPLI is generally attractive in situations where access to funds is not generally contemplated, the underlying investments are allocated to growth or to tax-inefficient strategies, and the portfolio’s time horizon is long.

PPLI is most attractive when assets are outside the grantor’s estate and the subsequent asset growth will
PPLI IS EVEN MORE ATTRACTIVE IF INVESTMENTS ARE TAX-INEFFICIENT

Assumes tax-inefficient portfolio with 8 per cent return

Trust values at year 40
USD (millions)

$73  $179  $217

Taxable trust  PPLI death benefit  Grantor trust

+ $106 + $144

*Assumes 8 per cent return each year, consisting 3/5 of ordinary income/short-term capital gain and 2/5 of long-term capital gain/qualified dividends (2/5 long-term capital gain with three-year holding period and 2/5 qualified dividends). Income taxes computed at an effective ordinary income/short-term capital gain tax rate of 43.4 per cent and an effective long-term capital gain/qualified dividend tax rate of 23.8 per cent. For each year depicted, ‘taxable portfolio’ is the value of the portfolio net of taxes due for income and realised capital gains. ‘PPLI death benefit’ represents the death benefit (no tax). ‘Grantor trust’ taxes are assumed to be paid by the grantor. PPLI assumptions – insured: male, age 50, preferred; situs: Delaware; modified endowment contract (MEC); face amount: USD40.5 million; investment: USD10 million; policy underwriting charge: USD2,000; premium load components – year one: USD15,000 total (federal DAC tax: USD100,000, state premium tax: USD2,000, distribution charge: USD50,000); annual M&E (assessed on total account value): USD10 million to USD40 million > 0.45 per cent, USD40 million and above: 0.35 per cent; annual COI (cost of insurance); cost of providing death benefit. Data does not represent past performance and is not a promise of actual future results or a range of future results. Based on AB analysis and illustration provided by insurance provider. AB is not a legal, tax, estate or insurance advisor. Investors should consult these professionals as appropriate before making any decisions.

CONCLUSION

Trusts have long been used by US practitioners as an effective estate-tax saving technique, but not as an income tax-saving tool. By combining a trust with a PPLI policy, practitioners can create a plan that addresses both estate tax savings and income tax savings. Whether the trust is taxed as a grantor trust or a non-grantor trust, the cumulative income tax savings generated by using PPLI can offset the costs of implementation. PPLI is especially attractive where access to all of a trust’s funds is not required, income taxes imposed on a trust’s income will be high, and the time horizon is long.

Though we have highlighted the impact of investing all of a trust’s assets in PPLI for illustrative purposes, in practice, some combination of liquid investments and PPLI may provide the best client outcome.

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