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Using private placement life insurance in efficient estate planning

Following the 2018 US Tax Reform Act, the use of private placement life insurance (PPLI) is becoming increasingly prevalent in the US but its benefits remain relatively less known outside of the US. In its most basic form, PPLI is a type of permanent cover life insurance offering a broad range of investment options into which the insurance company invests premium payments via segregated accounts on a tax free basis. As with other more traditional types of permanent life cover, any increase in the value of underlying policy investments would not be subject to income or gains tax but unlike traditional policies there is far more latitude as to the types of permissible investments including the ability to involve qualified independent investment advisers.

During the insured's lifetime the performance of the policy would be measured by reference to the underlying investments and, on passing, the policy beneficiaries would receive the value of the investment accounts and a further amount of insurance cover. Increases in value of the underlying investments along with the life cover death benefit would be paid to the US beneficiaries free of any income or gains tax.

For illustration purposes, let's compare a $10,000,000 investment portfolio held directly by a US individual with the same amount of premium payment to an appropriately structured PPLI policy which is gifted to US family members. Assuming a 7% annual investment return and an effective blended income and gains tax rate of 30%, after 25 years the directly held portfolio would be worth approximately $33,000,000 whereas the portfolio within the PPLI policy would be worth approximately $48,000,000 (no income or gains taxes apply but there would be annual fees charged by the insurance company). Further, the $33,000,000 in the directly held portfolio generally would be subject to 40% estate tax on the policy owner's death, leaving just under $20,000,000 for heirs. Compare that to the PPLI policy which would provide a death benefit of $48,000,000 free of estate tax due to the initial gift planning.

In reality, the foregoing $10,000,000 premium payment would be split into two parts. One part would fund the life insurance on an insured and the other would be invested in a segregated asset account of the insurance company. The necessary amount of that life cover would be determined on an actuarial basis as mandated by the US tax code. Qualified insurance agents can provide fact specific illustrations based on actual age and health assumptions. Importantly, this further death benefit provided by the life cover also would be paid out tax free on the insured's passing.

Increased Gift and Estate Planning Opportunities under 2018 Tax Reform Act

While it is entirely possible for ownership of a PPLI policy to be structured to provide a death benefit free of estate tax, this requires additional planning at the time of the policy's acquisition. The increase of the gift/estate tax exemption amount from $5,490,000 to $11,180,000 meaningfully increases estate planning opportunities in connection with PPLI and other insurance policies.

For example, if a US person buys a policy in their own name and continues to own the policy during their lifetime then, on their passing, the policy would be subject to estate tax at 40% rates. If, instead, the

policy were acquired via a properly structured trust or family partnership then the death benefit would be received completely free of both income/gains and estate/gift taxes.

Gift and estate planning for life policies frequently involves establishment of a specially structured insurance trust for the benefit of spouse and/or children and descendants which trust acquires the policy with the premiums being contributed to the trust by the settlor/insured. In this manner, the death benefit would be paid to the trust free of estate taxes rather than going outright to the surviving family members after the payment of estate taxes. The trust generally provides for additional oversight, asset protection and tax benefits (the death benefit it not included in the surviving family members taxable estates). The trust must be irrevocable and the settlor/insured cannot themselves be a beneficiary.

Estate Planning for Persons Deemed Domiciled in the UK

US persons who are deemed domiciled in the UK generally will require further planning as the foregoing type of trust arrangement will typically trigger undesirable UK tax charges upon funding the trust and then again every ten years. Such persons can instead establish a family limited partnership to acquire the life policy and can gift the limited partner interests to their heirs. The general partner interest can be held by the spouse and can be devolved under the spouse's estate plan. In this manner, upon the insured's death, the policy proceeds would be paid to the partnership and the general partner could then decide when and to what extent distributions were to be made to family members.

Considerations for Persons Tax Resident in the UK

US individuals tax resident in the UK will need to factor additional considerations into how their life policies are structured. To start, they will need confirmation that the PPLI policy does not violate the UK private portfolio bond rules. While this is entirely feasible, US compliant policies may need to be tailored to meet these UK requirements. Further, while the UK, like the US, will defer tax on underlying policy investment income and gains, absent special structuring of the policy, on the insured's death the UK will tax the extent to which the cash surrender value of the policy exceeds the aggregate premiums paid into the policy (notwithstanding that for US purposes this amount comes out income tax free).

UK income tax on policies can be eliminated by structuring the policy's surrender value such that it never increases beyond the value of the premiums paid. That does though mean that during the insured's lifetime, withdrawals from the policy cannot ever exceed the amount of premium invested into the policy no matter to what extent the underlying policy investments may have grown. With such a level surrender value policy, the increases in investment value only would be accessed following the death of the insured.

Accordingly, while level surrender value policies may be ideal for families wishing to make long term tax free gifts to children and grandchildren, they may be less well suited for individuals who want to themselves be able to access investment value build up within the policy during their lifetimes. Such individuals may wish to instead consider PPLI policies which do not limit cash surrender value. From a US perspective, cash value build up could be accessed tax free via loans. From a UK perspective, over a 20 year period the amount of premiums paid could be accessed tax free under the so called '5% withdrawal rule', withdrawal or borrowing of additional amounts from the policy would be subject to ordinary income tax charges.

Clean Capital, Non-Reporting Funds and PFICs

For US persons resident in the UK, PPLI policies can provide a number of further benefits.

PPLI policies initially funded with clean capital will effectively preserve ongoing access to clean capital from the policy under the UK's 5% withdrawal rule. This applies notwithstanding that the investment accounts within policy mix capital, capital gains and income. By way of illustration, if 100 of premium grew to 350 over 20 years, the initial 100 could be withdrawn as tax free clean capital for use in the UK notwithstanding historic income and gains within the investment accounts inside the policy. Of course, one need not wait till year 20 to withdraw funds, rather each year they could withdraw up to 5% of the premiums paid (and amounts not withdrawn in one year would aggregate and roll forward to be available in later years).

While many UK resident non-domicilliaries have historically found themselves with 'tainted' non-UK funds which are not suitable for remittance into the UK, the 2017 UK tax changes create a one off opportunity to segregate what was originally clean capital from historic income and gains thereby effectively allowing for the creation of new pots of clean capital. As noted above, this newly created clean capital can be invested in a PPLI policy and then later withdrawn and remitted into the UK as clean capital under the 5% withdraw rules. Importantly, this opportunity to create clean capital will come to an end in April 2019 and typically requires time for an accountant to undertake a thorough review of the historic investment position in order to implement an effective cleansing.

PPLI policies also could invest in PFICs without creating adverse tax consequences. From a US perspective, US persons should generally be aware that most non-US collective investment vehicles will be classified as PFICs for US purposes and subject to adverse tax charges upon generating income and gains. This US tax classification typically applies to most non-US fund vehicles and can lead to penal taxation for investors not aware of their non-US fund investment's status.

From a UK perspective, a non-reporting fund is the rough equivalent of a PFIC and persons resident in the UK who are not on the remittance basis will find themselves subject to adverse tax treatment on any non-reporting fund investments they may hold. Not only will the profits from non-reporting funds be subject to income taxation (rather than capital gains taxation) but also clean capital invested into non-reporting funds will become forever tainted. Generally speaking, pretty much any US mutual fund would be classified as a non-reporting fund unless the fund has specifically obtained reporting status in the UK. While it could be less than ideal for US investors to hold these funds directly, they could instead be held under PPLI policies without adverse consequences.

Bringing it All Together

While PPLI offers many advantages, US families living outside of the US also need to consider the local implications of such policies and the best structure for acquiring them.

PPLI policies are offered by both US and non-US insurance companies. In both cases, policies intended for US individuals will have been specifically designed to meet various relevant US tax code requirements (e.g. diversification and investor control) necessary to defer and eliminate income and gains tax in connection with underlying investments. Such policies are typically supported by an opinion from counsel confirming their US tax compliance position. As a general rule of thumb, policies offered by non-US

insurers that have not been specifically designed to meet US tax code requirements will not be suitable for US individuals. Further, as noted above, where the US individuals are UK tax resident, US compliant policies may need to be tailored to meet UK requirements.

In fact, PPLI planning requires interaction by a number of professionals typically including an insurance agent, who will involve insurance carriers, underwriters and reinsurers, one or more investment managers and custodians, accountants and local tax advisers and general legal counsel.

Withers has substantial experience in assembling and coordinating the various professionals required to implement a successful PPLI strategy and guiding clients through the relevant considerations from both a US and the UK perspective resulting in solutions tailored to the needs of individual families.

The information and opinions contained in this publication do not constitute professional advice. If you do not wish to receive information from Withers/Withers Bergman email unsubscribe@withersworldwide.com with your details.