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The Last, Best Tax Shelter Ever?

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As tax rates declined from the stratospheric levels that prevailed in the middle of the Twentieth Century, the need for tax shelters diminished. And as the US government's appetite for spending has grown ever more voracious, one tax shelter after another has been choked off by the IRS and/or Congress.

Recently, however, tax rates on the wealthy have begun to go up again. Between tax increases at the Federal level, tax increases at the state and local level, the Affordable Care Act surtax, and so on, many high-bracket investors are discovering that this really is their grandfather's tax environment.

As a result, taxpayers have begun to take a second look at the few legitimate tax shelters still available, and this has renewed interest in investing through insurance dedicated funds (IDFs).

IDFs come in two basic flavors:

Private placement variable annuities (PPVAs). A PPVA is best understood as a kind of supercharged IRA. The great benefit of an IRA is that it is purchased with pre-tax dollars and compounds tax-free until you withdraw the money. But IRAs also have serious drawbacks: if you need the money too soon, you pay ordinary income tax on the withdrawal, plus a 10% penalty; you must begin to withdraw the money at age 70½, whether you need it or not, limiting the length of the compounding period; and, finally, there is a proposed $3 million limit on the amount that can be sheltered in an IRA.

PPVAs, specifically authorized by IRS Code §72, are established with after-tax capital and there is also a penalty for early withdrawal. However, unlike retirement plans, you need not begin withdrawing capital at any specific age, thus allowing the money to continue to compound on a tax-deferred basis. Since the PPVAs are purchased with after-tax capital, every distribution is partly a return of capital, lessening the eventual tax bite. Best of all, there is no limit on the amount you can put in a PPVA.

Private placement life insurance (PPLI). Although PPLI has been around for a long time, and although the IRS issued proposed regulations and several revenue rulings a decade ago, most investors have paid little attention to the product. But two things have happened that warrant a second look. First, as noted above, the need for tax shelter has increased and is likely to continue to increase. Second, the industry has matured onshore and offshore, making PPLI more of a mainstream product.

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Because PPLI is an insurance product, it has many of the characteristics of any insurance policy, including complexity. However, the main benefit of PPLI is that insurance proceeds flow tax-free to the beneficiary. Thus, after compounding tax-free for many years, after the death of the policyholder the beneficiary (usually a trust) gets a very large distribution.

We've organized this paper as a Q&A and designed it for the lay investor. Please keep in mind that there are legal and tax complications that any competent advisor can guide you through, but we've simplified all that to keep the discussion relatively short and accessible.

❖ How does a PPVA work?

A PPVA is a straightforward product. Assume you buy a PPVA for $25 million. The money goes into an insurance-dedicated fund (IDF) that you select and that must meet certain IRS rules regarding diversification, exclusiveness (to the insurance world) and lack of investor control over buy and sell decisions (See below). After that, the annuity simply compounds tax-free until you decide to start withdrawing the funds. Note that if you assign the annuity benefits to a charity, they will never be taxed (and you can avoid having to give away other personal assets). As noted above, part of the distributions to you are considered to be a return of capital, reducing the tax bite.

❖ How does PPLI work?

Suppose you have $25 million you don't expect to need during your lifetime and you want to pass it on to younger generations tax-free. You've used up your lifetime exemption. You could purchase a PPLI contract on the life of a younger family member. Under the terms of the contract you get $25 million of life insurance coverage immediately, and the value of the policy (the actual death benefit) will be determined by how successfully the money on deposit is managed. The money must be invested in an IDF selected by you and subject to the rules mentioned above.[1]

❖ But I don't need any more insurance!

The insurance angle (basically, low-cost term insurance) is really incidental to the contract. If you die soon after acquiring the PPLI policy, the insurance will pay off and your estate will get the money back. But what you hope is that you'll live for many decades and allow the $25 million to compound tax-free for a long time.

[1] Contact legal or tax counsel regarding gift tax consequences.

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❖ How much difference does compounding make?

A lot, depending on how long the capital compounds. Sellers of PPVAs and PPLI can show you charts that will make your eyes pop out.[2]

❖ How should the PPVA or PPLI be invested?

It's best to think about these products as part of your overall investment portfolio, and to place investments in them that would otherwise be tax disadvantaged. For many investors this will suggest hedge funds or portfolios that include substantial hedge fund exposure. But the appropriate investment strategies should probably be different depending on what you plan to do with the ultimate proceeds.

If you have purchased the annuity version (PPVA) and plan to withdraw the money and spend it yourself later in life, you might consider the annuity as an appropriate vehicle for all or part of your hedge fund allocation. But even in this case, if the holding period is quite long you might think about diversifying the annuity beyond hedged strategies.

If you plan to leave the proceeds to your beneficiaries outright or to a trust (a GST, for example) for their benefit, or if you plan to leave the proceeds to a charity (perhaps your family foundation), the PPLI or PPVA should almost certainly be viewed as a total portfolio and should be fairly broadly diversified. Otherwise, you might have concentrated the investment in narrow IDFs that turn out to be unproductive.[3]

As noted below, IRS diversification rules require that a policy have a minimum of five different investment classes. The IRS looks through IDFs to the underlying investments to determine whether the rules have been met. IDFs are mostly designed to meet these rules.

❖ You mentioned onshore and offshore policies. What's the difference?

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[2] More objective observers also calculate very worthwhile savings. If you invested $25 million in a PPVA at age 40 and achieved an 8% net return, at age 70 the account would be worth about $205 million, versus $77 million if the money had been invested in a taxable account. See Liebeskind and Naison-Phillips, *Planning Makes Perfect*, Private Asset Management, October 2012.

[3] For example, if you invest mainly in hedge fund IDFs in an annuity that you plan to spend yourself, and if the hedge fund sector turns out to be a poor investment, you haven't really lost much since you would have had a hedge fund exposure even without the annuity. But if you are planning to leave the proceeds to a beneficiary or charity, having the entire fund in underperforming hedge IDFs could seriously undermine the value of the fund.

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In the bad old days offshore insurance policies had an unsavory reputation, as they were sometimes used as tax dodges and some of the companies were fly-by-night enterprises. But those days are long gone. Today, the constraints imposed on onshore insurance companies can make their investment products less flexible and somewhat more expensive than offshore products. On the other hand, US companies tend to be well-capitalized (especially if you stick to companies rated A or better by A.M. Best.)[4] The main reasons to use offshore products are for asset protection trusts or investment flexibility. The main reason to use an onshore product is that it's a mainstream, common way to proceed.

❖ What does all this cost?

The question is not so much the outright cost of PPVA and PPLI contracts, but the cost-benefit analysis. Costs can vary depending on the age and health of the insured and many other factors,[5] but most carriers will be happy to provide a realistic example of the costs before a contract is purchased. In most cases, annual costs will approximate 2% per annum or less, plus the (relatively low) cost of the insurance benefit in the case of PPLI. While this would be a high fee under ordinary circumstances, it will likely represent only a small portion of the expected tax savings over the life of the contract.

❖ Are there special issues I should be aware of?

Yes. Here are some issues to be aware of, but please check with your legal and tax advisors.

Surrender of the policy. As noted above, you shouldn't purchase a PPVA or PPLI with money you might need in the near future.

Size. PPVAs and PPLI aren't designed for modest sums of money. Many insurance companies have a $1 million or even $5 million minimum premium size.

Loss of control. The IRS has strict rules that limit how much control the owner of a PPVA or PPLI contract can have over the account. The owner can select investment managers and can change managers, but the owner cannot direct the investment manager in any way and only the insurance

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[4] Laws in many offshore jurisdictions require customer capital to be segregated from the assets of the insurance company, much in the way that banks in the US are required to segregate assets held in trust or custody. Thus, even in the unlikely event the company should fail, the insured's capital should not be at risk.

[5] Onshore policies are subject to a Federal deferred acquisition cost tax (DAC) of 1%, plus state premium taxes of roughly 2%. Offshore policies are subject to a 1% excise tax but no state premium taxes.

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company can terminate a manager. (An owner can, however, move the policy from one insurance carrier to another, although such moves can incur various costs.)

Diversification. IRS rules require that assets inside an IDF policy be properly diversified. Investing in only one hedge fund or mutual fund would not meet the diversification test, as the IRS rules require at least five underlying funds.

Exclusivity rules. IRS rules require that the investment options available under a PPVA or PPLI contract (i.e., an IDF) must be available only to insurance company customers. As a result, many hedge funds and funds of funds have created insurance dedicated versions of their non-tax-deferred products.[6]

❖ Summary

For some investors, PPVAs and/or PPLI might deserve a second look. As taxes go up and up and shelters get fewer and farther between, taking advantage of one of the few legitimate shelters available could help appropriate investors preserve their family capital. Remember to check with your legal and tax advisors.

This paper was written by Gregory Curtis, Chairman, of Greycourt & Co, Inc., and Joel M. Nagel, Esq., of Nagel & Associates. Mr. Curtis can be reached by phone at 412.361.0100 or by email at gcurtis@greycourt.com, and Mr. Nagel can be reached by phone at 412.749.0500 or by email at nagellaw@aol.com.

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[6] Full disclosure: Greycourt has been asked by several investors to create an insurance dedicated fund and we are looking into that possibility.

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