

Increasing After-Tax, After-Advisory Fee Retirement Income for High Net Worth Clients:

The private placement life insurance solution many fee-only RIAs and family offices are neglecting



Colva
Actuarial Services

In a low-yield bond environment, taxable bond portfolios are limited in their ability to offset equity risk in the portfolios of high net worth clients who face high ordinary income tax rates on the already low-yielding taxable bond portfolios.

Replacing a part of this taxable bond portfolio with higher yielding alternative asset allocations can offer the diversification that such clients need. But even if these assets are uncorrelated, a client switching asset allocations away from traditional equity/bonds to alternative asset allocations comes with downsides for both clients and their financial advisors.

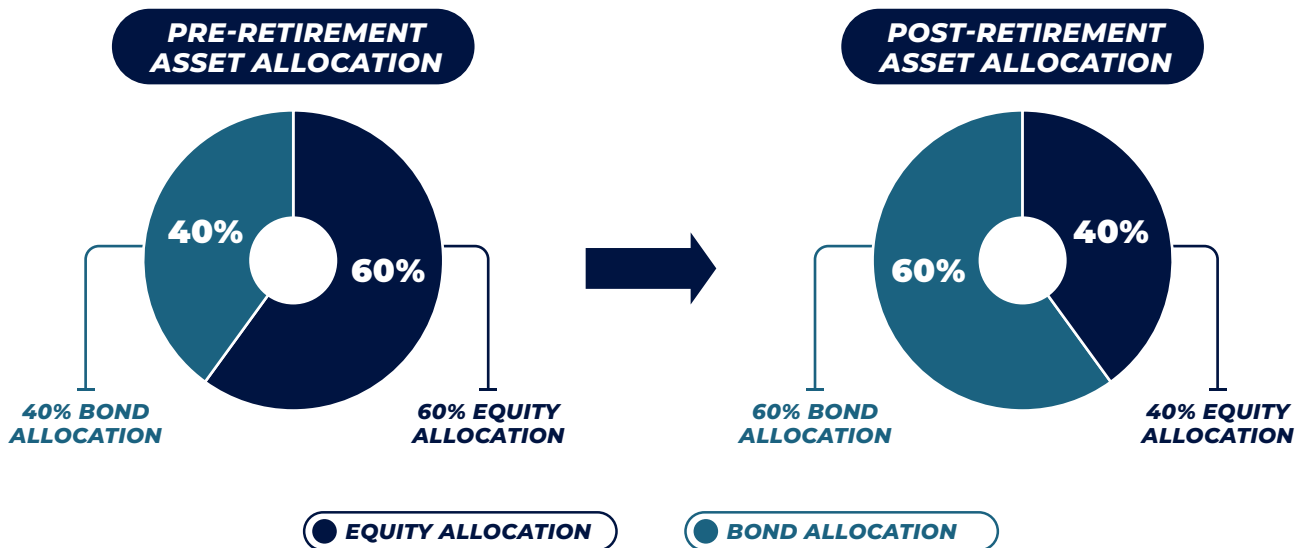
The main downside for high net worth clients is that many alternative assets are taxed at ordinary income tax rates that are higher than the long-term capital gains rates their equity portfolios were being taxed at.

Private placement life insurance, when structured properly, offers a tax-efficient solution for both clients and their advisors. Clients receive a tax-free alternative investment solution that allows them to withdraw both principal and gains, and advisors get to keep these assets under management and continue to earn their regular asset under management fee on the assets in the tax-protected vehicle.

The ability for the advisor to charge his or her financial planning fee on higher-yielding, tax-free, uncorrelated alternative asset on a pre-tax basis offers significant advantages than charging that same fee on a low-yielding, highly taxable bond portfolio subject to interest rate risk on an after-tax basis.

The problem with moving high net worth client portfolios to larger bond allocations as they near retirement in a low yield environment

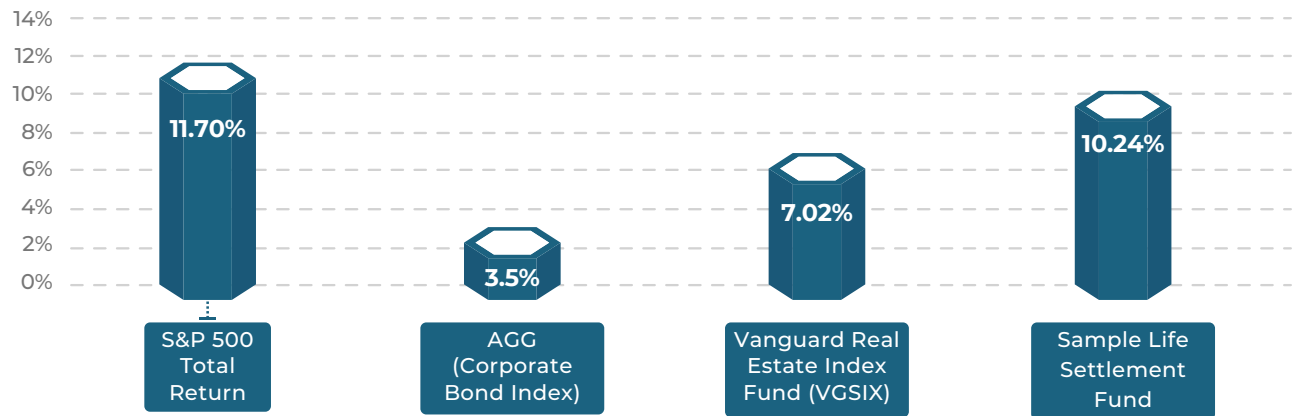
In an increasingly volatile equity market, clients nearing retirement often switch their asset allocations from a majority equity position to a majority bond position. In a low interest rate environment like the one we're in, this comes at a high cost—especially for high net worth clients. Not only do clients lose pre-tax return by switching from the higher earning equity allocations to the lower earning bond positions, they also pay a significantly higher ordinary income tax rate on the lower earning bond assets relative to the lower long-term capital gains tax rate they were paying. Furthermore in a low-yielding bond environment, these bond allocations are subject to significant interest rate risk as interest rates rise.



As clients near retirement, they typically shift their asset allocations from a majority equity position like a 60%/40% equity to bond split to a majority bond position (like a 40% equity to 60% bond split) to protect from volatility in the equity markets. For a high net worth client this means giving up a high yielding asset for a lower yielding one and paying a significantly higher tax rate on the lower yielding asset as well. As a result, clients and their managers are constantly in search for high yielding uncorrelated assets to invest in instead of low-yielding, highly taxable bonds.

A solution for this quandary is often to switch allocations to a larger alternative asset allocation instead of a larger bond allocation. Alternative assets can offer an expected return equal to or greater than equity markets. The downside of using alternative assets, however, is that often they can be just as volatile—if not more so—than equity investments while also being subject to higher short-term capital gains or ordinary income taxation. Furthermore, for financial advisors of these clients the result of a client pulling money out of an equity allocation that the advisor manages for the client into an alternative asset strategy that advisor doesn't manage, is a loss of AUM fees on those assets the client is moving away from the advisor.

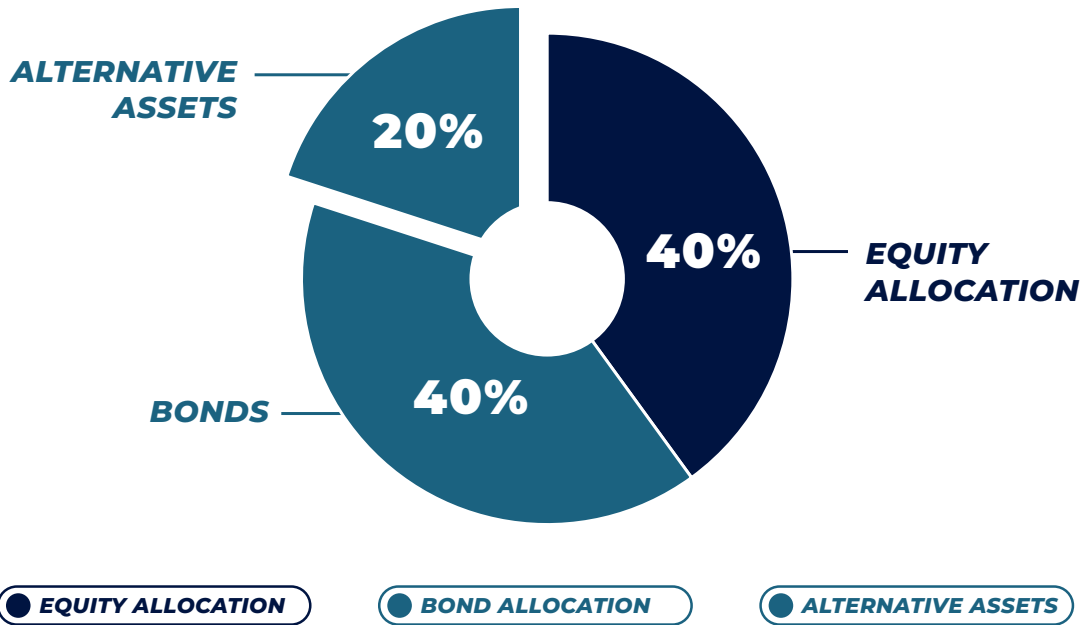
2015-2019 COMPOUND ANNUAL RETURN



During the past 5 years, investors in equity markets like the S&P 500 have benefited from a strong bull run. For clients nearing retirement, the thought of moving their money to low-yielding bond funds (like the AGG) is unappealing—especially given the high tax rates they would pay on their bond gains instead of the significantly lower long-term capital gains rates they were used to paying on their equity gains.

Alternative assets like real estate funds or life settlement funds can be attractive options given their high returns. Alternative assets like life settlements that have a low-correlation or are uncorrelated to traditional equity or bond markets are particularly appetizing as an alternative to a low-yielding bond market.

INVESTING PORTION OF CLIENT'S BOND PORTFOLIO IN ALTERNATIVE ASSETS



For clients nearing retirement, pulling money out of their low yielding, tax-inefficient bond portfolio subject to interest rate risk and investing in alternative assets might make economic sense for the client. But if the client is pulling money out of their bond portfolio that their financial advisor manages and investing in alternative assets that are not under their advisors' management, this means a loss of revenue for the advisor.

What clients and their advisors need is the ability to invest in alternative assets—or even equity investments—in a more tax-efficient structure which allows their financial advisors to still collect their asset under management fee. Utilizing the tax-benefits of variable life insurance through private placement variable universal life insurance is the most optimized way to accomplish these goals for both the client and their advisor.

Even if RIAs are able to manage alternative asset allocations for their clients, they're still forced to charge clients their AUM fee on an after-tax basis instead of a pre-tax basis. Charging clients advisory fees on an after-tax basis further reduces the client's net returns.

NET AFTER-TAX CLIENT RETURNS ON GROSS 8% RETURN PAYING RIA FEES WITH AFTER-TAX MONEY

| Year | Age of Client at End of Year | Gross Taxable Return | Gross After-Tax Return (But before RIA fee) | Total Net After-Tax Return for Client (After taxes and RIA fees) |
|------|------------------------------|----------------------|---|--|
| 1 | 56 | 8.00% | 4.00% | 3.25% |
| 5 | 60 | 8.00% | 4.00% | 3.25% |
| 10 | 65 | 8.00% | 4.00% | 3.25% |
| 15 | 70 | 8.00% | 4.00% | 3.25% |
| 20 | 75 | 8.00% | 4.00% | 3.25% |
| 25 | 80 | 8.00% | 4.00% | 3.25% |
| 30 | 85 | 8.00% | 4.00% | 3.25% |

In the above example, a high net worth client at a 50% marginal tax rate decides to invest in tax-inefficient alternative assets at an 8% return. Taxes reduce the client's net return by 50% and then the client has to pay the RIA's 0.75% fee on the after-tax money further reducing the client's net return.

NET AFTER-TAX CLIENT RETURNS ON GROSS 8% RETURN PAYING RIA FEES WITH PRE-TAX MONEY

| Year | Age of Client at End of Year | Gross Return | Gross Taxable Return (After Pre-Tax RIA fee) | Total Net After-Tax Return for Client (After taxes and RIA fees) |
|------|------------------------------|--------------|--|--|
| 1 | 56 | 8.00% | 7.25% | 3.625% |
| 5 | 60 | 8.00% | 7.25% | 3.625% |
| 10 | 65 | 8.00% | 7.25% | 3.625% |
| 15 | 70 | 8.00% | 7.25% | 3.625% |
| 20 | 75 | 8.00% | 7.25% | 3.625% |
| 25 | 80 | 8.00% | 7.25% | 3.625% |
| 30 | 85 | 8.00% | 7.25% | 3.625% |

In the above example, a high net worth client at a 50% marginal tax rate decides to invest in tax-inefficient alternative assets at an 8% return but is able to pay the RIA's fee with pre-tax money. This reduces the taxable gain from 8% to 7.25% which means the client ends up paying the 50% tax rate on a lower amount. This results in a higher net after-tax return of 3.625% for the client than if the RIA's fees were to be paid with after-tax money.

As the above example shows, any prudent financial advisor should always look at trying to put tax-inefficient assets (whether it be alternative assets or taxable bonds) into a structure where the RIA can charge their fee on a pre-tax basis instead of an after-tax basis.

The benefits of private placement variable universal (PPVUL) life insurance for high net worth clients

For decades now life insurance, particularly variable universal life (VUL), has offered high-net worth clients the coveted holy grail of investments: tax-free gains. While these products can offer life insurance protection and estate protection as a bonus, the key benefit for clients is that they can invest their money into a wide variety investment options in the product and then pull out the vast majority of their principal and gains via a tax-free loan—while still having a residual death benefit that can be passed onto their beneficiaries tax-free and exempt from estate taxes.

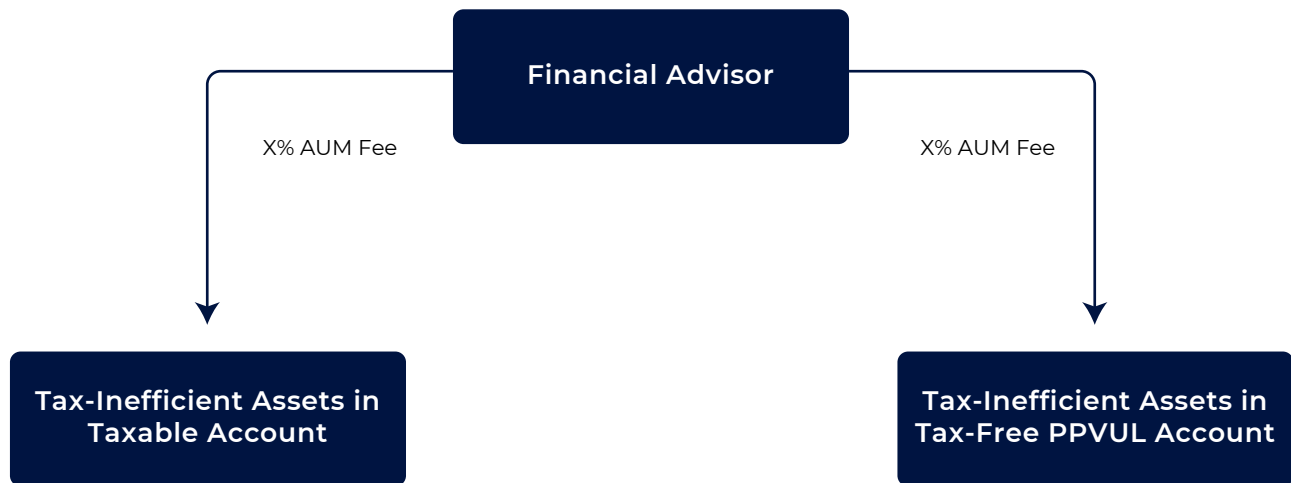
Unfortunately though, traditional VUL policies have high commissions and expenses that often eat up a large amount of the tax savings the product provides. Unless the gross investment return within a traditional VUL policy is sufficiently high, the expenses within the product will often eat up most, if not all, of the potential tax-savings—particularly in the early years of the policy. In such cases the client would be better off investing directly in the underlying investments and paying the required tax on them. Furthermore, traditional VUL policies do not allow the RIA/family office to create its own alternative investment strategy. This means that RIAs wanting to use VUL policies would be forced to put their clients into strategies created by other investment managers.

Private placement variable universal life (PPVUL) on the other hand, drastically changes this dynamic. By ripping out the majority of the commissions and expenses in these products, high net-worth clients get significantly better after-tax results than they would achieve if they were to simply invest in the underlying assets directly.

| Expense Category | Traditional VUL Policy | PPVUL Policy |
|--|--------------------------------|-----------------------------|
| Upfront Commission (Year 1) | 80%-100% of First Year Premium | 1%-3% of First Year Premium |
| Trail Commission (Years 2+) | 2-3% of Premiums | 0% |
| Premium Loads | 18% | 2%-3.25% |
| Administrative Charge Per Year | \$48,950 | 0.25% of AUM |
| Outside Portfolio Manager AUM Fee Per Year | 0.66% | 0% |
| RIA Advisory Fee | 0% | 0.25%-1.25% of AUM |

In exchange for a high premium contribution (\$500k-\$2M+), the PPVUL policy is able to drastically reduce the commissions and expenses in comparison to the VUL policy. Furthermore, while the VUL policy requires that the client take their money away from their financial advisor and pay an outside portfolio manager to manage the assets, the PPVUL product allows the financial advisor to create their own investment strategy and earn the same AUM fee on the assets in the tax-efficient PPVUL structure that they would be earning if those assets were in a taxable account instead.

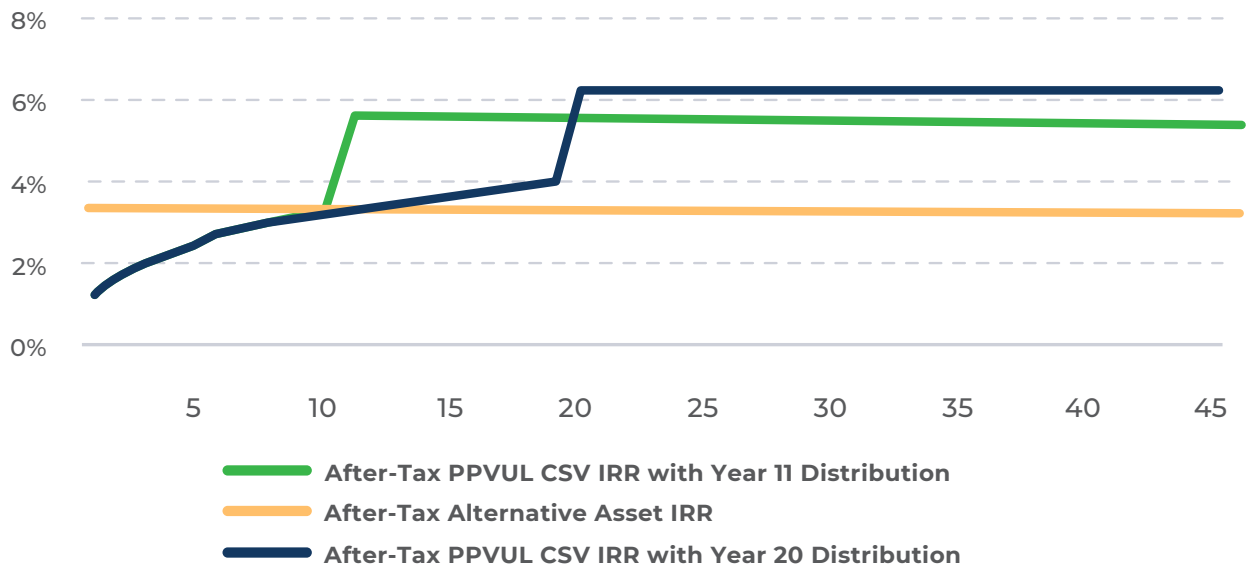
Another key advantage that PPVUL creates for financial advisors is that it allows the RIA the ability to create its own investment strategy and have the client invest in that strategy through the tax-efficient PPVUL structure (the PPVUL policy essentially serves as an insurance wrapper for the advisor's own strategy) without paying an outside portfolio manager to manage the assets. This allows the advisor to charge the same AUM fee on the assets inside the tax-efficient PPVUL structure as they would if the assets were kept inside a taxable account managed by the advisor.



A PPVUL policy allows the advisor to keep the assets under the advisor's control while benefitting from the tax-free nature of the life insurance policy. The advisor is able to earn the same asset-under-management fee on the assets in the PPVUL structure as they would if they kept the assets in a taxable account. The difference is that the client is getting a better after-tax return by putting their tax-inefficient assets inside of a tax-free structure like the PPVUL. In the long-run, putting tax-inefficient assets inside of a tax-free structure like the PPVUL structure will accumulate larger assets for the client and a larger asset-under-management fee for the advisor.

It's no wonder then that when we look at the liquidity and IRRs of the PPVUL product in contrast to investing in tax-inefficient alternative assets directly, that the PPVUL product provides significant advantages—while still allowing the RIA to charge an AUM fee on the assets.

AFTER-TAX PPVUL IRR WITH DISTRIBUTION IN YEAR 11 VS DISTRIBUTION IN YEAR 20



The PPVUL structure allows clients the ability to invest in alternative assets and take up to 90% of the principal and gains in the policy out via a tax-free loan. The longer the client keeps their money in the tax-efficient PPVUL structure, the higher their IRR will be. The above graph shows a client taking 90% of their principal and gains out in year 11 vs year 20 from a PPVUL structure versus investing in the tax-inefficient alternative assets directly.

The above after-tax IRR graph was done assuming the high net-worth client is in a 50% marginal tax rate and the gross investment IRR is 8% and the RIA's fee is 0.75%.

As the above graph shows, the longer the client allows their money to grow tax-free within the PPVUL structure prior to taking their money out via a tax-free loan, the better returns they'll experience. The bulk of the advantage of the PPVUL structure over investing in tax-inefficient assets directly comes from taking out the principal and gains tax-free in the later years (as opposed to liquidating the gains early and paying taxes on it). However, the lower expenses in the PPVUL product still allow for liquidity and positive after-tax returns in the early years if the client decides they want to exit early.

Important PPVUL considerations

While PPVUL can provide great after-tax advantages for high net worth clients and their advisors looking to invest in tax-inefficient alternative assets, there are some important considerations advisors should be aware of when evaluating the strategy:

1 Not all PPVUL products are the same.

Like any permanent life insurance product, not all PPVUL products are the same. Some have higher cost of insurance (COI) rates, and limitations in their ability to take a tax-free loan than others. Others afford more preferential treatment to certain health conditions than others. Furthermore, different states/countries can have different premium load taxes. As such it's important to research and do comparative analysis against different options available to the client.

2 Need to be actively managed

Since the client is investing in assets with variable returns, it's important that the advisor actively manage the policy. Since most PPVUL products have high COI rates in the later years it's important that the advisor is proactive in managing the policy in years in which the underlying assets have poor returns—particularly if the insured is in the later years. Doing so prevents the COI charges from getting astronomical and causing the policy to lapse.

3 Utilizing high-yielding tax-inefficient assets (preferable uncorrelated to equity markets)

One of the main problems with traditional VUL products is that they invest in underlying equities in which the client would typically be taxed at lower capital gains tax-rates if they invested in the assets outside the VUL structure. By investing in these types of assets within the insurance structure, the client is now exposed to insurance charges instead of tax-charges. Often times, the capital gains tax-rates are low enough such that benefits of investing in such assets within a tax-free structure does not offset the cost of the insurance and expense charges that the client will have to pay to put the assets in the structure.

Therefore, when choosing the assets to place within the structure the advisor really wants to focus on high yielding tax-inefficient assets in which the tax-benefits of investing through the structure significantly outweigh the insurance and expense costs of doing so. Ideally the advisor also wants to focus on assets that are uncorrelated to the equity assets that the client will be investing through taxable accounts in order to try and help provide the portfolio diversification that bond allocations would play.

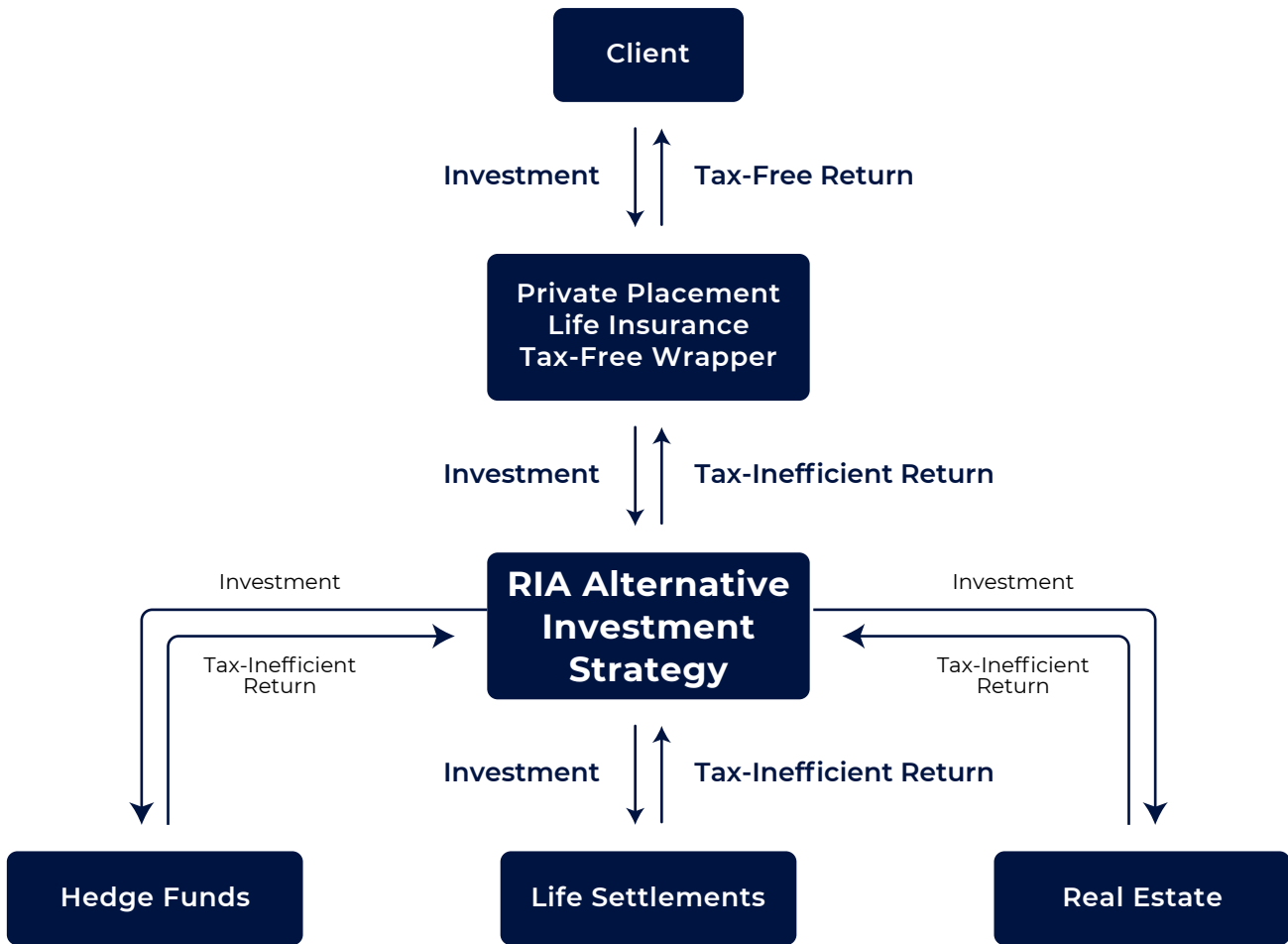
Conclusion

In a low-yielding interest rate environment, financial advisors can no longer settle for merely putting high net worth clients into taxable bond portfolios to offset equity risk as clients near retirement. Such allocations subject these clients to significantly lower gains, higher taxes, and interest rate risk that won't provide the diversification against equity risk that higher yielding bond portfolios have provided in the past. On top of that, an investment into taxable bonds means that high net worth clients will have to pay the advisor's fee with after-tax money on already heavily reduced after-tax yields.

In such times, advisors really need to dig deep into their financial planning toolbox and determine how to account for the financial problems posed by low-yielding taxable bond portfolios for their high net worth clients. One such way to provide the diversification that taxable bond portfolios used to provide is to use alternative assets (particularly uncorrelated assets) as a partial replacement for the taxable bond part of a client's portfolio.

However, alternative asset investments are often taxed at high ordinary income/short-term capital gains tax rates. Proper structuring of private placement life insurance allows clients the ability to invest in these assets tax-free within the structure while paying insurance costs that are significantly less than the taxes that would be owed if clients were to invest in these assets directly. It also allows for RIAs to create their own alternative investment strategies that they can then charge clients their advisory fee on a pre-tax basis which is significantly better than these clients taking their money away from the advisor and investing in these tax-inefficient assets directly.

CREATING TAX-FREE ALTERNATIVE INVESTMENT STRATEGIES FOR CLIENTS



Private placement life insurance allows RIAs to create their own alternative investment strategies for their clients which they can bill their client on a pre-tax basis while providing the client a tax-free return which is higher than what the client would achieve from investing in these tax-inefficient assets directly

To learn more about how to use PPVUL for your clients, visit www.colvaservices.com or contact us at (800) 561-4028 or support@colvaservices.com.

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Rajiv Rebello, FSA, CERA is the Principal and Chief Actuary of Colva Actuarial Services (www.colvaservices.com). Rajiv works with fiduciary RIAs to help them implement fiduciary life insurance, annuity, and alternative investment solutions (including tax-free PPVUL solutions) into their current practice in order to help increase clients' after-tax returns and reduce volatility in their clients' portfolios. By helping to establishing fiduciary insurance solutions within fiduciary RIA practices, these RIAs no longer have to refer clients to outside parties who would take assets away from the RIA and invest them in non-fiduciary and often high-commission life insurance solutions. Rajiv can be reached at rajiv.rebello@colvaservices.com.