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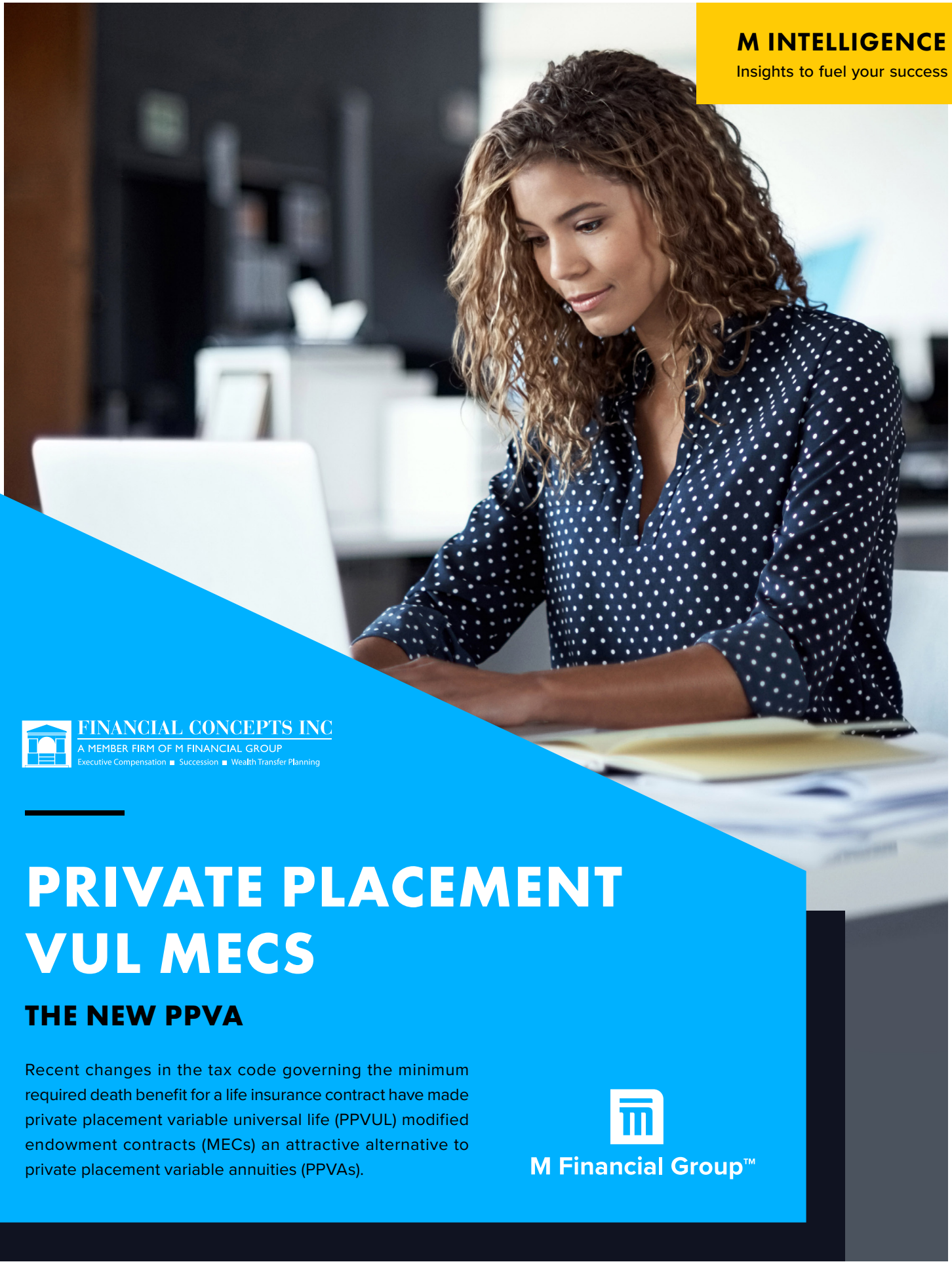

FINANCIAL CONCEPTS INC

A MEMBER FIRM OF M FINANCIAL GROUP

Executive Compensation ■ Succession ■ Wealth Transfer Planning

PRIVATE PLACEMENT VUL MECS

THE NEW PPVA

Recent changes in the tax code governing the minimum required death benefit for a life insurance contract have made private placement variable universal life (PPVUL) modified endowment contracts (MECs) an attractive alternative to private placement variable annuities (PPVAs).

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OVERVIEW

For those interested in accumulating assets in tax-efficient investment funds, a compelling new option is available because of recent IRC §7702 changes, which govern the income tax definition of life insurance tests. The changes allow contracts to accept higher premiums or have lower face amounts and still retain their tax status as life insurance.

The upshot is that a private placement variable universal life modified endowment contract is now an attractive alternative to a private placement variable annuity. In fact, our findings indicate that PPVUL MECs have IRRs that are 10-40 basis points higher than before the change. An additional advantage is derived from policy treatment at death. The PPVUL's death benefit is tax-free to the beneficiary, while the PPVA's gains are recognized as taxable ordinary income. Clients, particularly younger insureds whose contracts' account values hold up better relative to a PPVA, may want to consider the PPVUL MEC.

PPVAs are designed primarily for buyers who are interested in accumulating assets without recognizing income for tax purposes. Due to the qualification threshold for private placement investments, PPVA holders generally are not looking for the guaranteed return benefits found in registered VAs. As a result, PPVAs are usually much less expensive than registered VAs.

In addition, because growth in the value of an annuity is tax-deferred, PPVAs are especially attractive vehicles for investors who are interested in accumulating assets in investment funds that are tax-inefficient, or annually generate a high degree of ordinary income in their investment returns. This has been the traditional selling point of a PPVA.

The other selling point of PPVAs for clients seeking to access non-traditional investment strategies in tax-advantaged insurance structures is that no medical underwriting is required, as is the case for a PPVUL. Despite the obvious advantages PPVULs offer from a tax perspective (i.e., tax-free death benefit), PPVA has traditionally been more desirable for clients seeking a simple option to defer taxes on investment income.

WHAT IS AN ANNUITY?

An annuity is a contract with an insurance company that accumulates value on a tax-deferred basis (the "accumulation phase") and allows the annuitant to annuitize the contract value for a guaranteed stream of income (the "distribution phase"). During the accumulation phase, the contract's value can grow without recognition of income for tax purposes (IRC §72). While annuities are required to begin paying income (annuitize) by a certain point (usually age 95 or 100), they also allow policyowners to access account values in either partial installments or lump-sum withdrawals. Withdrawals are taxed as ordinary income to the extent that the policy's value exceeds basis, or the premium paid into the policy. In addition, a 10% penalty can be levied on the taxable amount if the withdrawal occurs before the annuitant's age 59½.

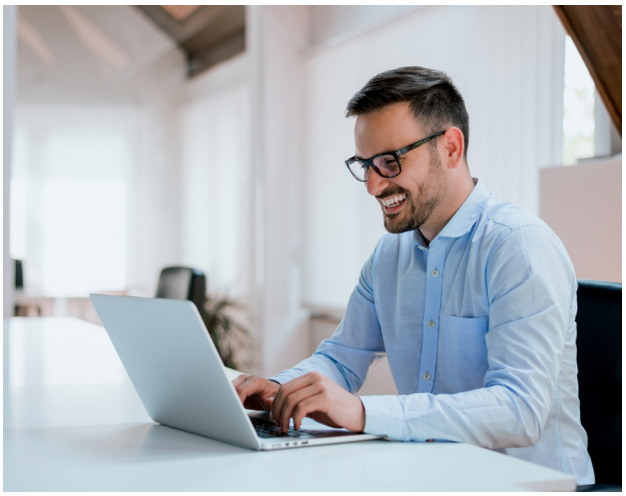
CONSOLIDATED APPROPRIATIONS ACT OF 2021 AND IRC §7702

In December 2020, the Consolidated Appropriations Act of 2021 was signed into law. Included in the bill was a provision changing the applicable rates in IRC §7702 governing the income tax definition of life insurance tests. As a result of this change, policies are allowed to accept higher premiums (or lower minimum required face amounts) and retain their tax status as life insurance.

One of the impacts of the changes to §7702 is that PPVULs can now be designed to perform similarly to the performance of a PPVA from a cash accumulation perspective with an added upside that PPVAs can't offer: tax-free transfer of assets at death.

PPVAs are commonly funded with a single premium at inception. A PPVUL can be designed with a single-premium as a MEC. While MECs have less advantageous tax treatment for policy withdrawals than non-MECs[1], they offer the ability to have a much lower death benefit (and, therefore, lower policy costs) with identical treatment for withdrawals as found with PPVAs.

The advantage for a PPVUL over PPVA is derived from the treatment of each type of policy at death. PPVAs transfer policy value at death to the beneficiary with full recognition of the gains as taxable ordinary income. PPVULs transfer a death benefit tax-free to the beneficiary.



[1] Properly structured Non-MECs allow for withdrawals of policy values to be considered a non-taxable return of basis. Withdrawals from MECs are taxable to the extent the policy has gains, and then non-taxable for return of basis.

COMPARISON OF ACCOUNT VALUES OF PPVUL MEC TO PPVA

Table 1 shows a comparison of accumulated policy values and after-tax internal rates of return (IRRs) at death. It shows that the younger the insured is for a PPVUL MEC, the better the account value holds up relative to a PPVA. It also shows the impact of the tax due on policy gains for a PPVA compared to the tax-free death benefit of a PPVUL. At age 95, the difference in the example is 100–130 basis points in after-tax return to the policy beneficiary. The table also shows the impact of the change in statutory rates in §7702. Account value IRRs for a PPVUL MEC are 10–40 basis points higher than what would be seen with a likewise policy designed under the rules before the passage of the Consolidated Appropriations Act of 2021.

Assumptions

- $1 million Guideline Single Premium at inception
- 7% investment return, net of investment management fees
- Broker Compensation = 1% on premium, 0.25% trail commission on account value
- Preferred Non-Smoker underwriting class on PPVUL policy
- Ordinary Income Tax Rate = 37%

TABLE 1 — POLICY ACCOUNT VALUE IRRS

	MALE AGE 40			MALE AGE 45			MALE AGE 50		
Year	PPVA	PPVUL MEC	Pre-2021 PPVUL MEC	PPVA	PPVUL MEC	Pre-2021 PPVUL MEC	PPVA	PPVUL MEC	Pre-2021 PPVUL MEC
1	5.31%	6.15%	5.88%	5.31%	6.10%	5.81%	5.31%	6.09%	5.82%
2	5.84%	6.08%	5.76%	5.84%	6.04%	5.69%	5.84%	6.02%	5.71%
3	6.01%	6.06%	5.71%	6.01%	6.02%	5.65%	6.01%	6.00%	5.66%
4	6.10%	6.05%	5.69%	6.10%	6.01%	5.63%	6.10%	5.99%	5.64%
5	6.16%	6.05%	5.68%	6.16%	6.01%	5.62%	6.16%	5.99%	5.62%
10	6.26%	6.07%	5.70%	6.26%	6.04%	5.64%	6.26%	6.01%	5.63%
15	6.30%	6.17%	5.91%	6.30%	6.15%	5.87%	6.30%	6.13%	5.86%
20	6.32%	6.23%	6.03%	6.32%	6.21%	6.00%	6.32%	6.19%	5.99%
25	6.33%	6.29%	6.13%	6.33%	6.27%	6.10%	6.33%	6.26%	6.10%
30	6.33%	6.33%	6.20%	6.33%	6.32%	6.18%	6.33%	6.31%	6.17%
35	6.34%	6.36%	6.25%	6.34%	6.35%	6.23%	6.34%	6.33%	6.22%
40	6.34%	6.38%	6.28%	6.35%	6.36%	6.26%	6.35%	6.34%	6.23%
45	6.36%	6.39%	6.31%	6.36%	6.36%	6.27%	6.36%	6.34%	6.25%
50	6.37%	6.39%	6.31%	6.37%	6.36%	6.28%			
55	6.38%	6.39%	6.31%						
After-Tax IRR @ Death, Age 95	5.10%	6.41%		5.30%	6.38%		5.36%	6.36%	

The substantial impact of the new tax compliance rates upon the required ratio of premium to death benefits, especially for younger clients, is bringing the PPVUL MEC into the picture as an attractive alternative to a PPVA. Table 2 shows the change in minimum required death benefits in 2021 with the application of the new rules.

TABLE 2 — MINIMUM FACE AMOUNTS PER $1 OF PREMIUM*

	GUIDELINE PREMIUM TEST			CASH VALUE ACCUMULATION TEST		
Male	**Post 1/1/21**	**Pre 1/1/21**	**Reduction in Face Amount**	**Post 1/1/21**	**Pre 1/1/21**	**Reduction in Face Amount**
Age 30	5.12	10.72	–52%	2.63	6.20	–58%
40	3.75	6.96	–46%	2.20	4.45	–51%
50	2.79	4.57	–39%	1.85	3.22	–43%
60	2.07	2.98	–31%	1.56	2.33	–33%
Female						
Age 30	5.72	12.89	–56%	2.79	7.06	–60%
40	4.12	8.05	–49%	2.31	4.94	–53%
50	2.99	5.09	–41%	1.93	3.49	–45%
60	2.20	3.26	–33%	1.62	2.50	–35%

*Values are approximate and will vary from product to product.

COMPARISON OF TAX TREATMENT OF PPVUL MEC TO PPVA

The tax treatment for a PPVUL MEC is identical to a PPVA, with one significant exception. At the death of the PPVA contract holder, the policy benefits are paid to the beneficiary and are fully taxable as ordinary income to the extent the contract has gains. The death benefit of a PPVUL MEC is paid to the beneficiary completely tax-free. This is an important difference since the vast majority of PPVAs are not purchased to access guaranteed lifetime income but to defer recognizing taxes on investment returns. Taxes cannot be eliminated on annuity values unless the beneficiary is not a taxpayer (e.g., a 501(c)3 charitable organization). By contrast, all death benefit proceeds of a life insurance contract are not taxable to the beneficiary.

TABLE 3 — TAX TREATMENT OF POLICY VALUES AND EVENTS

	PPVUL MEC	PPVA
Tax-free reallocations among investment accounts	✔	✔
Deferral of tax on policy gains inside contract	✔	✔
Distributions treated as taxable gains first, then tax-free basi	✔	✔
10% penalty on distributions before age 591/2	✔	✔
Tax-free distribution of death benefi	✔	✘

CONSIDER THIS

A buyer considering acquiring a PPVA may find a PPVUL to be equally attractive on an accumulation basis with the advantage of a tax-free death benefit. Among the factors that should be considered in the evaluation of a PPVUL are:

- The health status of the proposed insured
- The underwriting requirements for the PPVUL, which are more burdensome if the death benefit is sufficiently large
- Additional policy charges that may be contained in the PPVUL which are not present in a PPVA

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PPLI 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 fl xibility to potentially increase the PPVL Account's surrender and loan value.

PPVA Accounts are long-term investments. The value of a PPVA Account will fluctuate and, when redeemed, may be worth more or less than the original deposit. Withdrawals or other distributions, including death benefit payments, will be subject to ordinary income tax. If withdrawals or other distributions are taken prior to age 59½, a 10% excise tax may apply to the gain element. Maine, South Dakota, and Wyoming charge a premium tax for PPVA Account deposits. California, Nevada, and West Virginia charge a premium tax upon deposit or annuitization of a PPVA Account. A PPVA Account may include additional fees such as placement fees and performance fees. None of the illustrations contained herein assume these fees. The returns would be lower if these fees become applicable.

These calculations make assumptions as to future investment returns, mortality costs, and administrative expenses and are not guaranteed. Actual results may be higher or lower than illustrated. Loans and partial withdrawals will decrease the death benefi and cash value and may be subject to PPLI limitations and income tax.

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If the life insurance policy is or will become a Modified Endowment Contract (MEC), be aware that the following considerations apply:

- Unlike non-MECs, which allow policy owners to first recover their non-taxable "investment in the contract" (i.e., policy basis) when making policy withdrawals, MECs follow a "last in, first out" ("LIFO") rule, which requires policy owners to firs withdraw taxable income from the MEC.
- If the MEC has income accumulation, income taxation will be triggered on withdrawals, policy loans, pledges of the MEC as loan collateral, cash dividends, and dividends retained and applied by the insurance company to policy loans.
- An additional 10% tax also applies to the taxable portion of a MEC distribution, unless the distribution: (1) is made after the policy owner attains age 59½ or becomes disabled or (2) is part of a series of substantially equal periodic payments that are made at least annually for the life expectancy or joint life expectancies of the policy owner and his or her beneficiary (the "added 10% tax")

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