INCOME PLANNING

Are Your Clients Impacted by the "Ultra-Millionaire" Wealth Tax?

"The threat of higher income tax on the horizon, combined with a broader acceptance of SMA structures, has created a perfect planning opportunity for RIAs. Whether you are already advising UHNW clients or looking to expand your reach into the private client or family office space, now is the time to educate yourself on this strategy."

A few months ago, Senator Elizabeth Warren (D – MA) was in the media sharing details on her proposed "ultra-millionaire" wealth tax. I have no interest in debating the politics of why such a tax might be a good thing or a bad thing. However, it does present a new opportunity to registered investment advisors (RIA) who have broadened their services to include family offices, private client groups, or both. If they have not already, your ultra-high-net-worth (UHNW) clients will be looking to you for ideas and strategies to mitigate their potential increased income taxation.

Roth conversions and maxing out IRAs will not help clients with this amount of wealth. However, there is one solution you need to know about and be prepared to discuss when the inevitable question arises. Fortunately, due to some recent regulatory and procedural changes, this solution has never been more attractive than now for your UHNW clients.

"Ultra-Millionaire" Wealth Tax

Senator Warren's plan proposes a 2% annual tax on any household with a net worth between $50 million and $1 billion. For households and trusts over $1 billion, the tax increases to 3% overall. Add this to President Biden's tax proposal of increasing the top tax rate on ordinary income from 37% to 39.6%, and a proposed increase of the top tax rate on long-term capital gains and qualified dividends from 20% to 39.6%.

Depending on the size of your client's portfolio, the tax impact could be tens or hundreds of thousands of dollars in new taxes. Possibly even more.

As an advisor, the other item you need to consider is how your UHNW clients will be paying these additional taxes. If the plan is to liquidate assets currently under your management (AUM), you will see a decrease in AUM. Even if you or your staff are not considered UHNW, any AUM reduction because of an "ultra-millionaire" wealth tax could negatively impact your revenue and profit as a firm.

The Solution?

The question becomes, is there a way for you to help mitigate the new income taxes being proposed for your wealthiest clients without you losing the ability to advise on those assets under management? The answer is yes!

Private placement life insurance (PPLI) could be the perfect solution. When properly structured, PPLI allows you to allocate those assets that otherwise would be taxed at the proposed higher tax rates into a private placement variable universal life insurance (PPVUL) chassis. Once allocated to the PPVUL, the assets are given the same favorable tax treatment as all life insurance assets. This means income tax-deferred growth of your assets inside the PPVUL for as long as it remains in force.

Why Haven't I Ever Heard of This?

For years, PPLI has been a popular income tax mitigation solution in states such as California (CA) and New York (NY). This is largely due to their state income taxes pushing the effective tax rate over 50% in some cases. California's top marginal income tax rate is the largest in the country at 13.3%. Additionally, CA state legislators have proposed three new surcharges, starting with those having a gross income of more than $1 million. Not to be outdone, NY's Governor has proposed raising the top NY state income tax rate from 8.82% to 10.86%. New York City residents would pay a top tax rate of 14.7% in combined state and local city taxes, making it the country's highest tax rate.

Historically, the interest in PPLI was not as strong in states with relatively low or no state income taxes. However, because many of the much-publicized income taxes are proposed at the federal level, UHNW clients will not be immune, even in states like Texas and Florida.

Why Now?

You may not be familiar with PPLI because the funding structure that has dominated the industry has been a co-mingled fund structure called an Insurance Dedicated Fund (IDF). Many RIAs passed on the IDF structure for one of two reasons.

1. They either balked at the premium requirements most carriers required to launch and onboard an IDF (sometimes as much as $50 million or more).

2. Or, the RIA did not like the one-size- ts-all co-mingled structure. For that reason, most IDFs were created by third-party investment management firms with an already established culture of building and managing co-mingled funds.

Recently, that has begun to change as more prominent, and highly rated PPLI insurance carriers accept separately managed accounts (SMA). The SMA structure allows the RIA to manage the client's assets inside the PPLI structure and custody those assets with their current custodial companies – such as Fidelity and Schwab. Plus, the SMA structure permits the RIA to open an SMA account for each client – no longer forcing one investment strategy for all their clients into one co-mingled account. This also allows the premium commitment to be based on a per client minimum rather than a per fund (IDF) minimum, which can be as low as $5 million of committed premium.

Rules are governing how assets must be managed inside an SMA for a PPLI structure. However, that would be too detailed for this blog. For that reason, most RIAs choose to work with third-party administrators who have extensive experience creating and safeguarding the SMA platform.

Yet, most carriers and fund administrators will also have a minimum AUM requirement for the RIA to whom they can offer their SMA platform. For that reason, the SMA platform is only available to RIAs with $1B+ AUM.

PPLI Is Not for Everyone

Advisors will differ in opinion on who or what defines a UHNW investor. I have heard the argument for as little as $10 million in investable assets. Many of the experts I know in the industry would suggest $20 million of investable assets as the starting point. Still, others would say $50 million investable assets and up. Regardless, the SEC's definition for qualifying for PPLI would be meeting both the Accredited Investor (AI) and Qualified Purchaser (QP) requirements.

Under the Securities Act of 1933, the SEC de nes an Accredited Investor as "an individual with a net worth over $1 million or an annual income exceeding $200k for the last two consecutive years." A QP is an individual or business/ trust with at least $5 million in qualified investments, as defined by the Investment Company Act of 1940.

In addition, the premium requirements often start with a $5 million commitment "bled" in over four to ve years annually. While this might sound like a lot of money, a $5 million commitment represents only 10% of a $50 million UHNW portfolio or 20% of a UHNW client's $25 million portfolio.

A "Perfect Storm"

The threat of higher income tax on the horizon, combined with a broader acceptance of SMA structures, has created a perfect planning opportunity for RIAs.

Whether you are already advising UHNW clients or looking to expand your reach into the private client or family office space, *now* is the time to educate yourself on this strategy in preparation for the possibility of an upcoming storm.

This concept is sophisticated, and because these are probably your biggest and best clients, you should talk with a Palladium Group expert before approaching your clients with this concept. At Palladium Group, we mirror your duciary responsibility and have the expertise to help you determine if this is a solution that can help your UHNW clients.

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