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Biden's Proposed Tax Plan Would Increase Importance of Insurance and Annuities in Tax Planning

As we progress further into the fourth quarter of a volatile year, we are now faced with one of the most contentious presidential elections in American history. We will shortly come to understand the future implications of this election on a variety of issues – among them energy policy, foreign relations, and global trade and finance. On the minds of many, though, is the outlook for the nation's tax regime in the event of a Biden win.

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Should the election result in a Biden presidency and unified Democratic control of Congress, the most basic expectation is that income taxes will increase for high income taxpayers. Biden has proposed that the top U.S. income tax rate be increased to 39.6 percent, which would largely affect taxpayers with taxable income of $400,000 or more. Additionally, the Biden tax plan contemplates the elimination of favorable capital gains tax rates for taxpayers with taxable income of more than $1 million, and the taxation of such gains at ordinary income rates.

On the estate and gift tax front, the Biden plan proposes the elimination of basis step-up in appreciated assets at death, with the gains on such assets being subject to tax at death. Additionally, the plan contemplates that the current $11.58 million unified gift, generation skipping and estate tax credit would be reduced to a $3.5 million estate and generation skipping tax credit, and a $1 million gift tax credit. These changes would make it much more difficult for individuals to pass on highly appreciated assets to their beneficiaries in a tax efficient manner.

Should these potential changes in U.S. tax law come to pass, we can expect private placement life insurance ("PPLI") and private placement variable annuities ("PPVA") to increase in importance as key components of the wealth structuring planning of high income taxpayers.

PPLI is already a core element of effective long-term wealth structuring strategies for many wealthy individuals and families. We can expect PPLI to increase in importance in this regard if the current step-up in basis for appreciated assets at death is eliminated, as PPLI effectively replicates a basis step-up through a tax-free insurance death benefit paid to beneficiaries. Furthermore, if structured properly, PPLI can also assist in reducing or eliminating estate taxes.

Unlike PPLI, PPVA products provide tax deferral only, and gains on PPVA contracts are taxed at ordinary income rates upon withdrawal or surrender. While this makes PPVA products less advantageous from a tax perspective than PPLI contracts on a relative basis, the value of tax deferral offered by PPVA products should not be understated. That value should be enhanced if favorable capital gains rates are eliminated for high income taxpayers, as a traditional disadvantage of annuities for these taxpayers in comparison to capital assets would likewise be eliminated. Under these conditions, PPVA products can be expected to become a more attractive option for high income taxpayers seeking exposure to a variety of asset classes, and particularly if those taxpayers are unable to benefit from PPLI contracts due to health or insurance capacity issues.

A higher income and estate tax environment will increase the relative utility of both PPLI and PPVA in deferring or eliminating such taxes. Additionally, in comparison to traditional retail life insurance and annuity products, PPLI and PPVA products can provide more diverse investment options, better fee transparency and economies of scale. Given the real possibility of income and estate tax increases in the near term, wealthy individuals and their advisors should be carefully considering the benefits of PPLI and PPVA products as part of their estate and general tax planning.

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