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Tax-Efficient Investing Through Private Placement Annuity and Life Insurance Investment Accounts

A brief overview

By **Aaron Abrahms**

Wealthy families and individuals interested in tax-efficient investing are increasingly drawn to the benefits associated with Private Placement Variable Annuity (PPVA) and Private Placement Variable Universal Life (PPVUL) Investment Accounts. This article seeks to give an overview of these investment account structures.

Private Placement Variable Annuity Investment Accounts

A PPVA Investment Account permits investors to defer income tax on investment gains. Investors can make deposits and take distributions from these accounts with the same flexibility as they would from any investment account (however, there's a 10 percent excise tax levied on any gains that are distributed from the account before the annuitant's age 59½). After age 59½, any gains from the PPVA Investment Account will be taxed as ordinary income on distribution. The owner of the PPVA Investment Account remains in full control of the assets within the account. The owner can make deposits, adjust the asset allocation among various investment options and change the beneficiary designation at any time. Unlike a traditional retail annuity, a PPVA Investment Account doesn't have features such as income guarantees or principal protection. As a result, PPVA Investment Accounts generally have substantially lower fees than a traditional retail annuity. Additionally, PPVA Investment Accounts allow individuals to invest in non-registered investment offerings, such as hedge funds.

PPVA Investment Accounts are often utilized by ultra-affluent individuals and families who intend to leave assets to a public charity or private foundation at their passing. If a charitable entity is named as the beneficiary of a PPVA Investment Account, all the deferred gains pass tax-free to the charity. However, unlike other charitable strategies that are irrevocable in nature, PPVA Investment Accounts provide flexibility for the individual or family if there's ever a desire to access the assets during the owner's lifetime. The PPVA Investment Account owner also retains full control during its lifetime to change the beneficiary from one charitable entity to another.

Private Placement Variable Universal Life Investment Accounts

PPVUL Investment Accounts are similar to retail Variable Universal Life insurance contracts in that they both contain a death benefit and an investment account. The cash value in PPVUL Investment Accounts is invested at the policyowner's direction among a variety of available registered and non-registered fund options. As long as the life insurance policy remains in force, the investment gains within the account aren't subject to income tax. The policyowner can access the account value in one of two ways, both of which are income-tax free. He or she may: (1) withdraw the cost basis of the policy, which is equal to the cumulative premium amount deposited in the PPVUL Investment Account; or (2) take a low-cost loan from the account. When the insured passes away, all the deferred investment gains

Aaron Abrahms is a Principal of Winged Keel Group (WKG). WKG is widely recognized as one of the leading experts in the structuring and administration of Private Placement Life Insurance and Annuity Investment Accounts.

are paid to the beneficiaries of the policy as an income tax-free insurance benefit.

PPVUL Investment Accounts are often owned by large trusts where a portion of the assets in the trust would otherwise be invested in tax-inefficient investment strategies (for example, hedge funds and other alternative asset class investments). The trustee will often utilize a PPVUL Investment Account to locate the tax-inefficient investments. If the trustee needs to make a distribution to a trust beneficiary during the insured's lifetime, he simply withdraws (or borrows) from the investment account value.

Basic Process

PPVA and PPVUL Investment Accounts are available through a licensed insurance broker and are offered by multiple insurance companies.

PPVA Investment Accounts can be set up with basic paperwork similar to a typical hedge fund subscription. PPVUL Investment Accounts also require the insured to go through a simple life insurance underwriting process, including providing evidence of insurability through an insurance physical.

The owner of the PPVA and/or PPVUL Investment Account will need to choose how the assets will be invested among a variety of registered and non-registered investment vehicles. Each life insurance company offers a list of the funds that are available on their platform. In some cases, with larger deposits to these structures (typically $50 million or greater), the policyowner may request that the insurance company add a fund manager that is not currently available on their roster of investment vehicles.

While sophisticated investors and family offices select the Insurance-Dedicated Fund (IDF) in which the account will be invested, they are prohibited from influencing the fund manager's investment decisions. If this doctrine isn't followed, the tax benefits of the structures may be lost.

What Are the Downsides of These Vehicles?

One of the largest considerations with PPVA Investment Accounts is that all the deferred gains are taxed as ordinary income on withdrawal. This treatment means that even if an investment would normally qualify for some Long Term Capital Gain treatment, on withdrawal from a PPVA Investment Account all the gains are taxed at ordinary income tax rates. Because of this status, PPVA Investment Accounts are generally utilized for the most tax-inefficient portion of a high-net-worth individual's overall portfolio. For example, a municipal bond fund wouldn't be a strong candidate for a PPVA Investment Account.

Investors utilizing PPVUL Investment Accounts must consider the upfront, premium-based charges, such as Federal and State premium taxes. In most cases, investors utilizing a PPVUL Investment Account should adopt a time horizon that is longer than 10 years.

Another consideration is that, while both PPVA and PPVUL Investment Accounts have numerous investment choices, there are still fewer options than are otherwise available outside of these structures.

Conclusion

PPVA and PPVUL Investment Accounts may be beneficial for tax-sensitive investors, especially those seeking to invest in hedge funds or funds of hedge funds.

PPVA Investment Accounts can be a beneficial vehicle for families or individuals looking to maximize their charitable giving. The tax-free compounding associated with a PPVA Investment Account will result in larger donations to public charities or private foundations. By designating a private foundation or public charity as the beneficiary, assets within PPVA Investment Accounts become income and estate tax-free as well.

While PPVUL Investment Accounts are more complicated to implement than PPVA Investment Accounts, they do allow for income tax-free access to the accumulated value within the account during the lifetime of the insured and an income tax-free insurance benefit at the insured's death. PPVUL Investment Accounts are often owned within large, dynastic trust structures, which further increases the benefit of this particular investment structure.

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