A Penton Media Publication
DECEMBER 2012
$35.00

TRUSTS & ESTATES

The WealthManagement.com journal for estate-planning professionals

Remember to Wipe Your Feet—"Cream of Wheat Advertisement" (39 in. by 18 in.) by Haddon Sundblom, sold for $10,000 at Heritage's Illustration Art Signature Auction in New York on Oct. 13, 2012, p. 4.

By **Edward J. Finley II** & **Michael Liebeskind**

Private Placement Variable Annuities

A powerful tool to address income tax planning uses for high-net-worth individuals

Increasing taxes on the wealthy is very much part of the national dialogue. Most believe it's inevitable that marginal income tax rates will go up, especially for the clients we typically advise. At a minimum, there will likely be higher taxes on dividend income and, perhaps, all investment income. And, things like the charitable income tax deduction seem perilously at risk.

The federal government is very focused on raising revenue, especially from Americans living abroad (evidenced by the Foreign Account Tax Compliance Act (FATCA) and other new reporting requirements). Sophisticated investment vehicles tend to generate investment gains that are subject to the highest effective tax rates. And, especially relevant for foundations, many sophisticated investment vehicles generate unrelated business taxable income (UBTI). Most high-net-worth individuals can shelter a paltry amount of their retirement savings from income tax, making it all the more difficult to achieve their retirement objectives. Taken together, these trends create significant income tax planning challenges for high-net-worth clients.

Advisors should consider using private placement variable annuities (PPVAs) to address these issues. A powerful yet simple tool compared to other planning alternatives, PPVAs are often overlooked. We'll explore the opportunities for using PPVAs, as well as the mechanics for implementing them.

Edward J. Finely II, far left, is managing director at Deutsche Bank Private Wealth Management in New York. **Michael Liebeskind** is co-founder of SALI Fund Services in New York

What It Is

A PPVA is an annuity that's been stripped down to its most basic element: gains are deferred from current period taxation (PPVA investment accounts).

What It's Not

1. **It's not a retail annuity.** PPVA isn't a traditional annuity product. Most advisors are familiar with the high cost and limited investment choices of these products. PPVAs don't have the often expensive bells and whistles of retail annuity products, such as income guarantees or protection of principal in the event of premature death (which generally add an incremental fee of 100 basis points (bps) to 200 bps annually). Instead, PPVA investment accounts generally have no upfront commission loads or premium tax charges, and assets can remain invested until a client chooses to take a one-time distribution or systematic payments over a specified period of time (often referred to as annuitization). The client isn't required to begin taking distributions until he reaches age 95 or 100, at which time most insurance companies require the account to be liquidated over a period no longer than 30 years.

2. **It's not a contrivance.** PPVAs are specifically authorized under Internal Revenue Code Section 72. The Internal Revenue Service has repeatedly considered and ruled favorably on PPVAs, and, in 2008, issued clear safe-harbor guidelines for how investment funds offered within PPVA investment accounts (which are referred to as "insurance-dedicated funds" or IDFs) must be structured and administered to qualify for favorable tax treatment.[1] The client may make deposits into the PPVA investment account in any amount and at any time.

3. **It's not dependent on an individual's health or death.** The fees associated with a PPVA don't depend on the health of the individual. There's no mortality component of a PPVA. There are no medical exams required and no underwriting.

PPVA Limitations

As discussed more fully below, while a client may allocate to any of the IDFs offered on the company's PPVA investment account platform, the client can't control the selection of securities within the IDFs.

If distributions are taken from the PPVA investment account before age 59½, there's a 10 percent penalty in addition to income tax on the gain element of the distribution.

All gains accrued within the PPVA investment account are ultimately subject to the potentially higher ordinary income tax rates (unless distributed to charity).

And, any balance remaining in the PPVA investment account owned on the client's date of death is subject to both income and estate tax (unless left to charity).

So, when could it make sense to consider using PPVA?

Enhance Tax Efficiency

Clients with exposure to traditionally tax-inefficient asset classes (for example, hedge funds, high-yield bonds and growth-oriented equities) could benefit from using PPVA. It's important, however, not to let the tax "tail" wag the investment "dog." Typically, only if a top performing manager is available on the PPVA investment account platform could this make sense.

More broadly, though, clients with a typical multi-asset class portfolio in a higher income tax regime could also benefit from a PPVA.

A PPVA works in either case for the same reasons that retail investors have for years benefitted from investing in their individual retirement accounts: Income tax deferral almost always makes sense.

"After-Tax Advantage," this page, illustrates the benefit of owning a higher income tax portfolio in a PPVA investment account. After about five years, the PPVA account outperforms the taxable account.

Practice tip: While the client owns the PPVA investment account and can choose to allocate to any of the IDFs offered by the insurance company on its PPVA investment account platform, the IDFs are deemed to be owned by the insurance company's separate account. Therefore, investors in vehicles like hedge funds would like the fact that the K-1s are delivered to the insurance company, not to the PPVA investment account owner.

Charitable Legacy Planning

Extremely wealthy individuals who plan on making a substantial gift to charity at death have also awakened

After-Tax Advantage

Here are the differences in value between a PPVA account and a taxable account over a 30-year period, assuming four different growth rates

Net Growth Rate	Value					
4%	$20,399	$108,784	$254,231	$470,125	$772,471	$1,180,380
6%	$8,638	$166,435	$493,941	$1,058,454	$1,949,502	$3,285,711
8%	$6,299	$290,820	$963,216	$2,241,686	$4,447,493	$8,050,628
10%	$14,271	$497,774	$1,748,827	$4,330,606	$9,156,985	$17,698,012
	5	10	15	20	25	30
	Years of Deferral					

Returns are net of an assumed 1.5 percent of fund management fees on a $5 million investment in a taxable account and a private placement variable annuities account; 75 percent of realized gains are taxed at ordinary income rates; and no withdrawals are made before age 59½. Ordinary income tax rate is assumed to be 40.7 percent in Year 1 and 48.7 percent thereafter. Capital gains tax rate is 20.7 percent in Year 1 and 29.1 percent thereafter. Assumes that the investment management fees aren't tax deductible in the taxable investment account due to the 2 percent of adjusted gross income threshold for itemized deductions.

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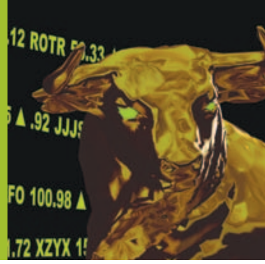


to the impact of potentially higher income taxes on their giving goals. Over about 15 years, the same charitable gift could be halved if it's subject to income taxes. However, few are willing to make an absolute transfer to charity (or a charitable remainder trust) today to reduce that burden. The solution could be a PPVA.

PPVAs allow charitably inclined individuals to maintain full ownership and broader investment options for earmarked assets throughout their lifetime, while deferring the income taxation of investment gains on those assets. A client can make deposits or take withdrawals (for personal consumption or charitable gifting), adjust the asset allocation and/or change the beneficiary designation at any time.

The net result, if the PPVA investment account is left to charities or foundations, is that all the assets pass undiminished by income and estate taxes. "Optimizing Charitable Gifts," this page, shows the values passing to charity for an initial allocation of $5 million in a PPVA versus a taxable account. Simply by changing the location of the assets from a taxable account to a PPVA investment account, the family can multiply their potential charitable legacy assets (or substantially reduce the wealth needed to fund a specific large gift). In addition, many public charities give donor recognition credit for PPVA investment account beneficiary designations, which are fully revocable if the account owner is at least 65 years old.

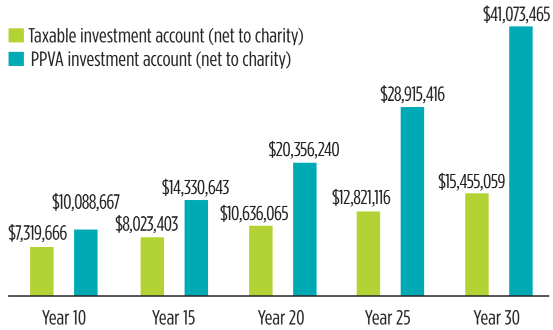
Practice tip: Name the charity as the primary beneficiary of the PPVA investment account, or, if the client hasn't completely committed to leaving the PPVA to the charity, consider naming the charity as the contingent beneficiary of the PPVA. This could allow any of the primary beneficiaries (for example, a surviving spouse or children) to disclaim any part of the PPVA investment account assets to charity.

U.S. Clients Residing Abroad

Many advisors with U.S. clients living abroad are struggling with the complications of how best to structure those clients' investments. Those clients typically can't access U.S. onshore investments, because they reside abroad. Offshore investments, while readily available, don't provide the necessary U.S. reporting and might

Optimizing Charitable Gifts

By Year 25, the PPVA account nets more than double the taxable account



Assumes 1.5 percent of fund management fees and an 8 percent return after fund management fees on a $5 million investment in a taxable account and a private placement variable annuities account; 75 percent of realized gains are taxed at ordinary income rates; and no withdrawals are made before age $59\frac{1}{2}$. Ordinary income tax rate is assumed to be 40.7 percent in Year 1 and 48.7 percent thereafter. Capital gains tax rate is 20.7 percent in Year 1 and 29.1 percent thereafter. Assumes that the investment management fees aren't tax deductible in the taxable investment account due to the 2 percent of adjusted gross income threshold for itemized deductions.

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not be efficient for local tax purposes. If that weren't bad enough, new FATCA and other requirements for U.S. persons with investments abroad make this process more complicated.[2]

A PPVA investment account, properly structured, could access U.S. onshore investments and hold them without current U.S. taxation. In many places around the world, the PPVA itself could completely defer taxation on the investment portfolio while the individual resides in that country. And, distributions could be deferred until the client returns to the United States, making taxation simpler. But, perhaps most important, the PPVA investment account could hold offshore investments and should be exempt from foreign financial institution reporting requirements.

Practice tip: The PPVA investment account also can operate effectively for a non-U.S. person planning to reside temporarily in the United States. Offshore investments could be held while the client is a U.S. resident

without the adverse U.S. tax consequences typical of offshore investments. Moreover, the client's portfolio should be sheltered from U.S. taxation during his stay in the United States.

Retirement Planning

Many clients, especially business owners, are subject to qualified plan limitations and can't put as much as they would like into tax-deferred retirement vehicles. These clients could use a PPVA investment account as a simple, yet effective, tax-deferred savings vehicle. The tax-deferred accumulation allows the PPVA account to generate substantial incremental retirement income relative to a taxable investment account.

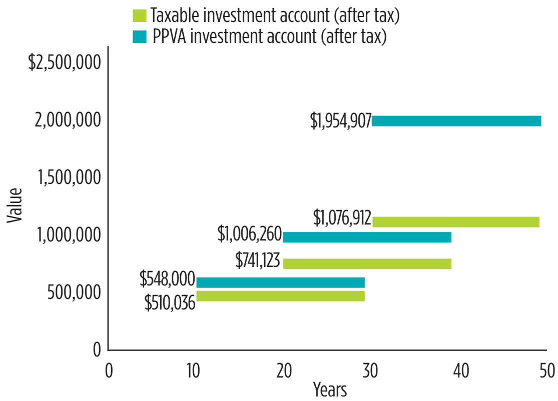
> The PPVA investment account should enable tax-exempt entities to invest without penalty in investments that would otherwise introduce UBTI.

"Optimizing Retirement Income," this page, shows how much more can be withdrawn each year from a retirement account allowed to accumulate for different periods. When allowed to accumulate for 20 years, a PPVA investment account allows a client to withdraw almost 50 percent more per year for 20 years than a taxable account.

Practice tip: Consider allocating the most tax-inefficient segment of a client's portfolio to the PPVA investment account. This will optimize the leverage derived from deferring the investment gains from current period taxation. The PPVA provides significant flexibility in managing a client's retirement income, because scheduled withdrawals can be postponed or accelerated as needed. If the PPVA investment account values are allocated to alternative asset class investment vehicles, careful planning is necessary to assure that the required liquidity notices are submitted to the investment managers in a timely fashion.

Optimizing Retirement Income

If your client contributes $5 million to a PPVA account or taxable account and allows that money to accumulate for 10, 20 or 30 years, and then the client takes equal distributions for the next 20 years, here's what the annual distributions will be for each scenario



Assumes 1.5 percent of fund management fees and an 8 percent return after fund management fees on a $5 million investment in a taxable account and a private placement variable annuities account; 75 percent of realized gains are taxed at ordinary income rates; and no withdrawals are made before age 59½. Ordinary income tax rate is assumed to be 40.7 percent in Year 1 and 48.7 percent thereafter. Capital gains tax rate is 20.7 percent in Year 1 and 29.1 percent thereafter. Assumes that the investment management fees aren't tax deductible in the taxable investment account due to the 2 percent of adjusted gross income threshold for itemized deductions. Distributions are shown on an end-of-year basis.

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Foundations with UBTI Investments

Many charities and charitable trusts allocate to asset classes that are deemed to be active business interests, rather than passive investments. These asset classes generally generate UBTI; for example, timber, certain types of real estate, energy transportation and master limited partnerships, which can create current tax liabilities and even endanger the charitable entities' tax-exempt status. A PPVA investment account could be a simple, effective

and inexpensive blocker of UBTI.

A PPVA investment account eliminates UBTI by changing the character of the underlying IDF investment from UBTI to passive income. IRC Section 72(u)(1) states that the income earned in an annuity owned by a non-natural person won't be tax- deferred, but, instead, will be currently taxable as annuity income. The PPVA investment account should enable tax-exempt entities to invest without penalty in investments that would otherwise introduce UBTI.

The IRS has issued several favorable private letter rulings to tax-exempt organizations, including endowments and foundations, which have supported a PPVA investment account's ability to block UBTI.[3]

Current UBTI blocker arrangements should be reviewed and compared to a PPVA investment account, particularly offshore arrangements that can be complex, expensive and potentially subject to greater scrutiny.

How It Works

IRC Section 72 states that a PPVA qualifies for tax treatment as an annuity if:

1. It's administered by an insurance company and allows for the systematic distribution of principal over a period of payments;[4] and

2. Its investment offerings are structured as IDFs that are available only to qualified insurance companies.[5]

PPVA investment account values are treated as separate account assets and, therefore, aren't subject to the claims of an insurance company's creditor.

The reallocation of PPVA account assets from one IDF to another shouldn't be a taxable event, and the PPVA account can be transferred tax-free under IRC Section 1035 from one insurance company's administration platform to another's. Because there are generally no upfront fees relating to PPVA investment accounts, this transfer is a frictionless transaction.

Withdrawals from a PPVA account are taxed on a last-in, first-out basis (with the taxable gain recognized until all that remains is the cost basis), and there's a 10 percent excise tax on gains for withdrawals taken before the owner's age 59½.[6]

Structuring Customized Account

The process of creating a new IDF with an investment manager and an investment mandate that a client finds attractive has become dramatically less expensive.

As the time and cost to create a safe-harbor IDF has declined, more and more top-tier investment management firms have created, or are in the process of creating, IDFs to enable the most tax-inefficient segments of their investment portfolios (alternative asset class investments, such as hedge funds, high-yield bond funds, direct lending credit vehicles and high turnover portfolios) to be managed on a tax-deferred basis through a PPVA investment account.

> To qualify for a PPVA investment account, a client must be an accredited investor.

In addition, many leading investment managers manage more traditional multi-asset class portfolios in customized IDFs. In many cases, a customized IDF can be created and attached to an insurance company segregated asset account platform cost effectively with as little as $25 million.

There are two basic rules that must be followed for an IDF to achieve deferral from current period taxation:

1. **Diversification.** The IDF must be properly diversified. The diversification requirement is defined in IRC Section 817(h) as: no more than 55 percent of the IDF assets may be allocated to one underlying fund or security; no more than 70 percent of the IDF assets may be allocated to any two underlying funds or securities; no more than 80 percent of the IDF assets may be allocated to any three underlying funds or securities; and no more than 90 percent of the IDF assets may be allocated to any four underlying funds or securities. A violation of the diversification requirement can result in the PPVA investment account being subject to current period taxation on all embedded gains in the contract and cause the loss of tax deferral

going forward (even if only a fraction of the PPVA investment account assets are allocated to the violating IDF). This is a severe penalty; therefore, the IDF administrator and/or investment manager must have controls in place to assure ongoing compliance.[7]

2. **Investor control.** The owner of the PPVA account can't influence the IDF manager, directly or indirectly, with respect to the selection of underlying funds and/or securities to which the IDF assets will be allocated. This means that the IDF investment manager must select underlying funds and/or securities on a completely discretionary basis.

The IRS has provided guidance through PLRs 9752061 (Sept. 30, 1997) and 9433030 (May 25, 1994) that a client may work with an investment advisor to create a clearly defined investment mandate according to which the investment advisor will manage the account with complete discretion. The PPVA investment account owner should thereby have some understanding of how the IDF assets should be managed. The IRS has provided very little additional guidance on the investor control doctrine, and there's been quite a lot of confusion as individual attorneys seek to advise their clients. The bottom line is that a PPVA investment account owner should use common sense and avoid any actions that might be construed as directly or indirectly influencing the IDF manager with respect to the sel=ection of underlying funds and/or securities.

To qualify for a PPVA investment account, a client must be an accredited investor. But because most IDFs are structured as Section 3(c)(7) investment vehicles under the Investment Company Act of 1940, as a practical matter, a client must be both an accredited investor and a qualified purchaser to utilize a PPVA investment account.

Bottom Line

Income tax planning for high-net-worth clients is about to become much more challenging. Whether a family is looking to increase the tax efficiency of an asset class, increase the power of their charitable giving, control their portfolio while living abroad, enhance their retirement planning or block UBTI from their private foundation or charitable remainder trusts, advisors should take note of the benefits and facility of PPVAs.[8]

—The authors wish to thank Eric Naison-Phillips, a principal at SALI Fund Services in New York, for his assistance in the preparation of this article.

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Endnotes

1. Internal Legal Memorandum 200840043.
2. Carolyn Reers, principal at Cummings & Lockwood LLC, "U.S. Tax Compliance Rules Applicable to Taxpayers Resident Abroad and Private Placement Variable Annuity Solutions."
3. Private Letter Rulings 200206047 (Nov. 13. 2001) and 9708022 (Nov. 26, 1996) both state that:

   > In view of the contract's status as an annuity contract under subchapter L, the tax treatment of the contract holder under section 72(u)(1)(A) does not preclude the contract from satisfying the requirements of sec-tion 817(d)(2)(A) for purposes of determining Taxpayer's income.

   Most practitioners interpret this statement as characterizing the income as annuity income for tax purposes to be reported on a Form 1099.
4. Internal Revenue Code Section 72.
5. The private placement variable annuities (PPVA) investment account must qualify as an annuity as defined by Internal Revenue Code Section 72, and the investment offerings must be properly structured as insurance dedicated funds to adequately satisfy IRC Section 817(h) diversification requirements and the investor control doctrine defined by Revenue Ruling 81-225; *Christofferson v. United States*, 749 F.2d 513 (8th Cir. 1984), *rev'g* 578 F. Supp. 398 (N.D. Iowa 1984). Revenue Rulings 2003-91 and 2003-92, recently summarized by the Internal Revenue Service in ILM 200840043.
6. IRC Section 72(s).
7. IRC Section 817(h).
8. For purposes of acquiring a PPVA, an accredited investor is an individual whose net worth is in excess of $1 million or who has had income in excess of $200,000 in each of the two most recent years. A qualified purchaser is an individual with qualified investments of $5 million.