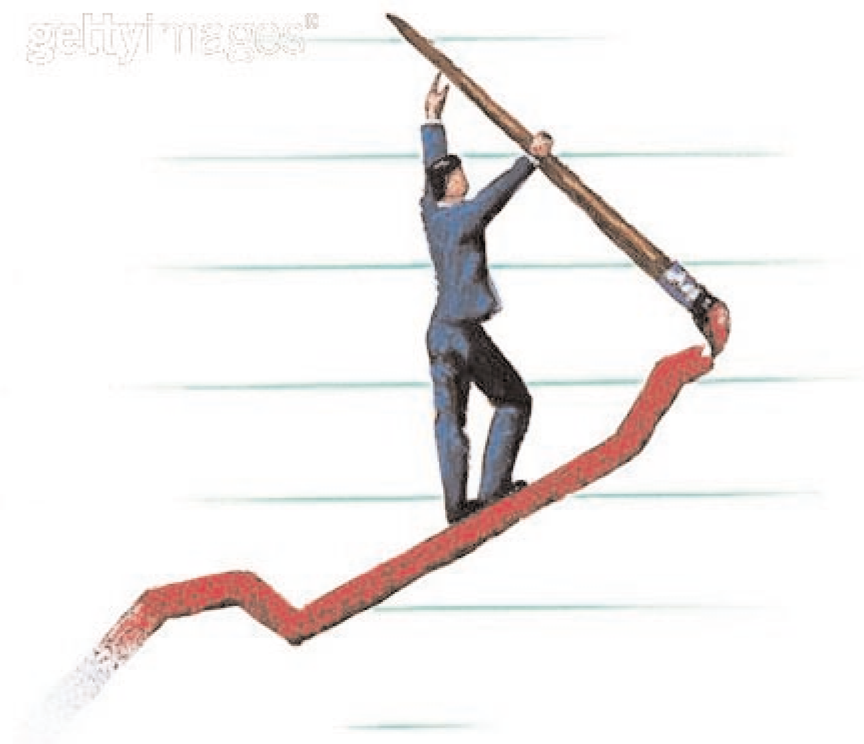
Private Deals, Major Gains

For clients with sizable taxable assets, a private annuity within a variable universal life policy can yield great benefits.

By Roccy DeFrancesco and David Mandell



USING A VARIABLE UNIVERSAL LIFE (VUL) policy in conjunction with a private annuity is a little-known—yet powerful and entirely legitimate way—for clients to reduce capital gains dramatically on highly appreciated assets. What's more, it gives clients a tremendous tool to pass on assets to the next generation, free of onerous estate taxes.

The VUL/private annuity strategy is a complicated transaction from an implementation and technical standpoint, however. This article is meant to introduce advisers to the concept so they can decide whether to explore it further. In addition to your own study, you should have knowledgeable legal, insurance, and accounting experts on your team. If you pick the wrong consultant to set up and administer this strategy, you and your client could have problems with the IRS.

The ideal client is someone with highly appreciated assets (public or private stock or real estate) who would like to defer the capital gains or income taxes after selling the assets and who does not need immediate access to the entire sale proceeds. Clients who are looking for asset protection, a guaranteed retirement income, and favorable estate planning strategies are good candidates for this strategy.

As background, here are the key tax concepts to understand:

A client can defer the tax on the sale of an asset that is exchanged for a private annuity. The tax is deferred until the client actually receives payments. A lot of law (in the form of statutes, cases, and private letter rulings) maps out what is allowable in a private annuity transaction. Planners use specific IRS tables to draft the annuity agreement and to determine the type of payout that will be generated for clients in the future.

In the private annuity transaction, the client transfers assets to a private company in return for a life annuity that may begin immediately or at some later date (which may be as late as age 80). Using the IRS tables based on the client's life expectancy and the IRS's then-applicable interest rate, the future annuity payments are calculated. When the client begins to receive payments, he or she will pay taxes only on the growth of the assets contributed in the private annuity transaction. The "cost

All in the Family

The private annuity allows significant assets to build up for heirs

Often, clients considering the variable univeral life/private annuity strategy may also be evaluating a charitable remainder trust (CRT). In fact, this strategy works like much like a CRT, except that here the family (through the life insurance policy) eventually gets the trust property rather than the charity.

Let's compare the strategies. In a CRT, the client transfers an appreciated asset to a charity through a trust. The client gets an income tax deduction for the present value of the gift. Because the charity has benefits under the tax law, it can sell the appreciated asset and not pay capital gains tax. The resulting proceeds can be invested in the market only in a conservative portfolio.

Using the IRS tables based on interest rates and the client's life expectancy, the trust will pay back an annuity to the client over his or her lifetime. This annuity will be taxed partially as income, partially as capital gains tax, and partially as return of basis. When the client dies, the trust property goes to the charity. The family is left with nothing.

With the private annuity, the client transfers an appreciated asset to an annuity company under the umbrella of a VUL policy through a trust. The client does not get an income tax deduction for this transfer. Because the insurance policy has benefits under the tax law, the annuity company under its umbrella can sell the appreciated asset and not pay capital gains tax.

The resulting proceeds can be invested in the market in an aggressive or conservative portfolio. Using the IRS tables based on interest rates and the client's life expectancy, the annuity company will pay back an annuity to the client over his or her lifetime. As above, this annuity will be taxed partially as income, partially as capital gains tax, and partially as return of basis. When the client dies, the trust property, including the entire remaining investment portion and death protection portion, goes to the family through the trust. The family is left with everything, and they receive it income and estate tax-free.

The upside to this strategy is that the family ends up with everything income and estate tax-free rather than nothing. The downside is that there is no income tax deduction initially, and of course no gift to the charity. Because this strategy beats the CRT significantly on a present value basis, however, the client can always direct proceeds from his or her enlarged estate to be paid to the desired charity.—*RD & DM*

basis" in the original asset is transferred to a portion of every annuity payment.

Funds growing within a VUL product do so tax-free. VUL policies (not term policies) allow for tax-free build-up of cash values (no capital gains or dividend taxes are paid inside the policies). These policies have been used for years as savings vehicles because they provide tax-free death benefits to heirs, and they allow owners to take tax-free loans from the cash values of the policies. The loans are then paid back to the insurance company with a portion of the death benefits.

Life insurance policies owned by an irrevocable life insurance trust (ILIT) will pass to the beneficiaries free of income and estate taxes. When the ILIT buys the policy for the family, it is not in a taxable estate. So when the insured dies, the policy will pay to the trust beneficiaries without income or estate taxes.

Our strategy combines the three concepts described above, which are solidly supported by the tax code. Here are the steps to take:

1. The client sets up an ILIT to buy a life insurance policy. Using that ILIT, the client purchases VUL from an insurance company. The VUL combines a term insurance portion with an investment portion. The term portion (real death risk protection) is reinsured to a large U.S. company. The investment portion is mostly funded through the annuity transaction described next.

As a private placement variable policy and by U.S. law, the assets of the policy are owned by the policy owner (the trust). They are not assets of the insurance company. The policy assets are also not assets of the company and can't be reached by the insurance company's creditors. If the insurance company should be dissolved, the assets of the variable policy are not affected.

2. The client engages in a private annuity transaction with the appreciated asset. At the same time, the client transfers a highly appreciated asset to an annuity company for a private annuity contract drafted according to IRS guidelines. The annuity company that offers this annuity is owned by the client's VUL. One of the investments of the client's insurance policy (his or her particular policy, not the insurance company) is the stock in the annuity company.

3. The annuity company (under the insurance policy) sells the asset tax-free and reinvests tax-free. Once the annuity company owns the asset, it can sell it on the open market and not owe any tax because the company is owned by an insurance policy, where assets can be sold without capital gains taxes.

The sale proceeds that are garnered by the annuity company can be reinvested in a diversified portfolio using a licensed money manager. Because the funds are still under the umbrella of the client's VUL, they grow tax-free. This investment portfolio then becomes the majority of the investment portion of the VUL policy. There is also an additional smaller investment portion of the policy. The client's family (through the trust) can take loans against this portion if they choose to do so.

4. The client gets annual annuity payments for life. According to the terms of the private annuity contract, which are predetermined with the client in advance, the client will begin to receive payments at some point in the future. Those payments will be taxed partially as income, partially as capital gain, and partially non-taxable as a return of basis. The client will receive these annual payments for life.

5. When the client dies, the insurance policy (both investment and term portions) pays out to the trust beneficiaries income and estate tax-free. When the client dies, the life annuity contract ceases. Any funds left in the annuity company will be a profit to the annuity company and become an asset of the VUL policy. This annuity company profit will be combined with the real death risk protection portion of the policy (term insurance) and paid out through the policy to the ILIT. As with all ILITs, the trust takes the proceeds income and estate tax-free, and the trustee pays the funds out to the beneficiaries as the trust document instructs. Of course, the client instructs the attorney how to draft the ILIT upfront.

Let's work through an example of this strategy. Assume a client, age 38, has an asset (stock) worth $5 million for which he paid $100,000. He would like to sell it and diversify his portfolio. But if he does, he will owe more than $1 million in long-term capital gains tax (or $2.4 million if it is short-term capital gains) to the IRS and state treasury. In this situation, the client's goal is fourfold—to avoid the tax, grow the asset's proceeds tax-free, shield the funds from lawsuits, and enjoy a handsome income stream in retirement.

Step 1. The client sets up an ILIT. He contributes $32,000 now (and annually over six more years) to purchase a $1 million VUL policy. As a married couple with two children, the client and his wife can make tax-free annual gifts of up to $44,000 to a trust with their children as beneficiaries. No gift tax is due on his part.

Step 2. As a private placement VUL, the assets are those of the policy owner (the trust), not of the insurance company. The policy reinsures the death protection risk in a reinsurance contract with the re-insurer. The policy then sets up five investment accounts under its umbrella. One of these accounts is called ABC Annuity Corp.

Step 3: The client enters into a private annuity transaction with ABC Annuity Corp. He contributes the $5 million asset to ABC in exchange for an annuity, which will begin to pay him in seven years. Based on a 9% return, that annuity will pay him $360,000 per year for life. Not all of the $360,000 will be taxable. (We use 9% for an expected return in a variable portfolio; a more conservative or aggressive assumption could also be used.)

Step 4: ABC sells the appreciated asset and then receives the $5 million in proceeds. It appoints a reputable money manager to manage the funds.

Step 5: In the seventh year, the client begins to take the $360,000 per year for life. He will only be 45 at that time. Assuming a 9% return, within a few years the policy will have upwards of $900,000 in cash value against which the trust can take loans if it chooses. Like any other loans from an ILIT, the proceeds would be tax-free, and the loan amount, if not paid back to the trust, would simply reduce the death benefit ultimately paid to the trust.

There is no three-year lookback rule when the ILIT pays the premium, so you don't have to worry about the asset proceeds flowing back into the client's taxable estate.

Step 6: At the time of the client's death, the ILIT receives the $1 million policy death benefits plus the profit inside ABC Annuity Corp. The profit will be the $5 million contribution plus all appreciation, minus the payouts distributed under the life annuity agreement and any loans taken by the trust. Assuming the 9% return and death at age 75, the total tax-free benefit to the client's family would be in the neighborhood of $12 million. That's a nice neighborhood to be in.

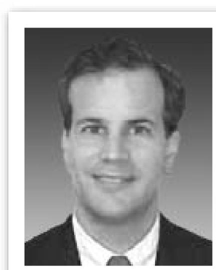
What are the drawbacks to this strategy? It used to be done entirely offshore, and many advisers are uncomfortable dealing with offshore entities. No U.S. state insurance laws were written to allow for this type of transaction. Recently, however, states like South Carolina have changed their insurance laws to be more consumer friendly, and now the VUL/private annuity can be done 100% onshore.

Clients may also worry that they will need access to cash from the asset sale earlier or in much greater amounts than expected. After the sale contract and the annuity are established, the client will get paid via the annuity, no matter how much he or she would like more money at an earlier time. So it's definitely important for the adviser and the client to draw up a good budget before entering into the transaction.

In addition, if the client dies prematurely, advisers should realize the strategy still works. There is no three-year lookback rule when the ILIT pays the premium, so you don't have to worry about asset proceeds flowing back into the taxable estate.

How much will all of this cost—and what will the adviser get? The upfront fees involved typically run to 3% of the asset used in the annuity transaction. In our $5 million example, that would be $150,000.

These fees mostly go to the legal, insurance, and accounting professionals involved in structuring the strategy. But remember the client has now converted a large asset—normally real estate or privately held business stock that the adviser doesn't manage—into an asset that the adviser, or a contracted money manager, will now oversee. This conversion cannot be your motivation to propose the strategy, of course; it must make sense for the client on every level. If it does, the client will appreciate your expertise and be happy to have you manage or oversee the VUL portfolio. **FP**



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