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The Dynasty Annuity — Multi-Generational Tax Deferral for High-Net-Worth Families

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OVERVIEW

The current tax environment suffers from a lot of economic and political uncertainty. The general consensus of many tax professionals is that personal tax rates will increase in the near future. The Bush tax cuts are due to expire automatically without Congressional approval to extend these tax cuts on December 31, 2012.[2] In an election year, that type of political will or intervention seems highly unlikely.

The expiration of the Bush tax cuts on December 31, 2012 will result in an increase in the top marginal income tax bracket to 39.6%. Additionally, a Medicare tax related to new federal healthcare provisions will add an additional 3.8% tax on unearned income in excess of $250,000. The long-term capital gain rate increases to 20%. The estate and gift tax exemption decreases from $5 million to $1 million per taxpayer and the top marginal estate tax bracket increases back to 55%. Multiple tax proposals advocate an additional 5.6% tax increase for taxpayers with incomes in excess of $1 million.

Since the mid-1990s, estate planners have employed a series of planning techniques to transfer taxpayer wealth outside of a taxpayer's taxable estate. These strategies focused primarily on the estate tax consequences of taxpayers. The use of grantor trusts proliferated, allowing an asset to be transferred outside of the taxpayer's estate for estate tax purposes while allowing the taxpayer to remain the owner of trust assets for income tax purposes.[3] This planning allowed the taxpayer, as settlor of the trust, to pay the income taxes associated with trust income without depleting trust assets to pay the tax liability, and without the payment of income taxes considered as an additional gift to the trust.

The increase in personal marginal tax rates promises to make grantor trusts more onerous to trust settlors. In the author's personal experience, trust settlors groan every step of the way regardless of the planning logic and sense of grantor trust planning. In any event, the payment of taxes by the grantor of the trust is still an erosion of family wealth, whether the income-generating asset is inside or outside of the taxpayer's estate. No taxpayer is content with the idea that the taxing authorities have taken part of his or her personal wealth when additional taxation could have been minimized.

The lesser known tax problem is the income tax treatment of nongrantor trusts (NGTs). NGTs hit the top marginal tax bracket at only $11,650 of annual income for 2012.[4] The top marginal federal bracket for trusts is 35% for 2012. Many trusts, such as marital trusts, credit shelter trusts, asset protection trusts, and

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[2] *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312, §§101, 102 (sunset provisions).

[3] This type of grantor trust is sometimes referred to as an irrevocable defective grantor trust or IDGT.

[4] *See* Rev. Proc. 2011-52, 2011-45 I.R.B. 701, §3.01.

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dynasty trusts are taxed as NGTs. Income tax planning for NGTs rarely seems to be much of a planning topic discussed by estate planners.

This article addresses the use of private placement variable deferred annuities (PPVA) as a vehicle to maximize tax deferral of trust assets. Because of the unique rules regarding trust-owned annuities, an excellent planning opportunity exists for taxpayers to maximize and extend tax deferral on trust assets for multiple generations. This issue has become increasingly important as wealthy individuals and family offices have allocated a larger percentage of family investment assets to hedge fund strategies that primarily generate short-term capital gain income taxed at ordinary rates. The author refers to this type of arrangement as a ''dynasty annuity.''

This article will also introduce a unique product known as frozen cash value life insurance (FCV) as an additional alternative to PPVA contracts for maximizing the deferral of trust assets over several generations. FCV is a form of private placement life insurance, but it has many attributes that make it much like an annuity. FCV can also provide tax-advantaged accumulation over several generations.

Both of these specialty products can have a dramatic impact on tax-advantaged wealth accumulation within trusts at a very low cost to the taxpayer. These specialty insurance contracts and strategies are not well known and utilized. The author's hope is that this article will place the strategies and products on the radar screen of trust companies and family offices, CPAs, and tax and estate planning attorneys.

WHAT IS A VARIABLE DEFERRED ANNUITY?

The author is not certain ''when'' and ''why'' variable deferred annuities garnered such a bad reputation with the financial press. When did tax deferral become such a bad thing? Most likely this negative sentiment results from variable annuity product pricing and sales loads. It is rare in the author's experience to find an ultra-high-net-worth client owing a variable annuity contract.

In spite of volatile public equity markets, the retail variable annuity marketplace, according to the *Annuity Fact Book*, has $1.5 trillion of assets under management.[5] These products are sold on an after-tax basis to individuals as well as retirement plans — §§401(k) and 403(b) plans. The variable annuity industry has competed ferociously with the mutual fund industry. In the face of market volatility in recent years, the variable annuity industry has responded with strong contractual guarantees for policyholders. The result of these product features is strong sales of $158 billion in 2011.[6]

A variable deferred annuity contract is an insurance contract that provides for the payment of an annuity in the future. The assets supporting the future annuity payments are tied to the investment performance of investment funds held in the insurance company's separate or segregated account. These investments are not part of the insurer's general account assets, which are subject to the claims of the insurer's creditors. The investment performance is a direct pass-through to the policyholder. The typical retail variable annuity has five to eight years of declining surrender charges and compensates the agent, through his or her broker-dealer, with 4%–6% of contract premiums.

The policy has two levels of fees — insurance contract fees and investment fund fees. At the contract level, the life insurer charges a mortality and expense (M&E) of approximately 125–150 basis points per annum. This load is the primary profit load for most insurers. Most states do not impose a premium tax unless the annuity is ''annuitized,'' i.e., converted to a stream of monthly payments. Each variable subaccount investment option imposes another level of fees for investment expenses. These investments are very similar to mutual funds and impose similar charges based upon the underlying investment strategy.

WHAT IS A PPVA CONTRACT?

Unlike retail product options, PPVA contracts maximize the benefits of tax deferral with institutional pricing and sales loads. The policies have no surrender charges and the contract's investment options may include sophisticated investment options, such as hedge funds. The contract also pays the agent through the agent's broker-dealer an asset-based asset charge of 25–35 basis points. PPVA contracts with customized and negotiated sales loads generally are equal to 1%–2% of premiums. Unlike life insurance, where premium taxes are a percentage of each premium payment (1.5%–2.5%), variable annuities in most states are typically owned and are paid only when the contract is annuitized.

The investment flexibility and range of investment possibilities make PPVA contracts an ideal vehicle for registered investment advisors to utilize as part of the investment planning process. The contract is ideally suited for managing asset classes that generate ordinary income, such as interest, dividend, and short-term capital gain income. PPVA contracts may have alternative investments, such as hedge funds, commodities, and private equity, as part of the fund options in the PPVA's private placement offering memorandum (PPM). The PPM may be amended as needed by the insurer to add new investment options to the contract.

A BRIEF OVERVIEW OF THE LEGAL AND TAX AUTHORITY FOR PPVA

Securities Law

A PPVA contract is treated as a non-registered security for federal and state securities law purposes.

[5] Insured Retirement Institute, *Annuity Fact Book 2011*, at 48.

[6] Insured Retirement Institute Website, ''Variable Annuity Sales Reach Pre-Crisis Levels,'' Mar. 12, 2012.

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The product is available to accredited investors and qualified purchasers as defined in federal securities law. The U.S. Securities Act of 1933, §4(2), provides an exemption from securities registration for accredited investors as defined in Rule 501(a) of Regulation D under the Securities Act.[7]

Private placement life insurance offerings are exempt from the Investment Company Act of 1940 under §3(c)(1) and (7). Under the Investment Company Act of 1940, §3(c)(1), the number of beneficial owners is limited to 99 investors. Investors must be accredited investors or qualified purchasers. A qualified purchaser has investable assets of at least $5 million. Under the Investment Company Act of 1940, §3(c)(7), the number of beneficial owners is limited to 499 investors. The investors must be qualified purchasers. New Security and Exchange Commission (SEC) proposals exclude the value of an investor's principal residence.

Tax Law

Taxation of Variable Annuities

The taxation of annuity contracts is governed by §72. PPVA contracts are subject to the same investment diversification and investor control considerations as retail variable life and annuity contracts under §817(h) and Regs. §1.817-5.

The primary planning benefit of variable deferred annuities is tax deferral. A variable deferred annuity contract has an owner, a beneficiary, and an annuitant. The annuitant is the measuring life for payments in the event the annuity is annuitized. Distributions from the annuity are treated as ''amounts not received as an annuity,'' payments of interest only, or as ''annuity'' payments.

The term ''annuity'' includes any periodic payment resulting from the systematic liquidation of a principal sum. The term ''annuity'' refers not only to payments for the life of the annuitant, but also to installments that do not have a life contingency, such as a fixed period of years. Under §72, a portion of each annuity payment is excluded from gross income as a return of the policyholder's cost basis in the contract and the balance is treated as interest earned on the investment taxed at ordinary rates.[8]

The calculation of the exclusion ratio is slightly different than it is for a ''fixed'' or non-variable annuity. The exclusion ratio for a variable annuity is determined by dividing the investment in the contract (basis) by the number of years of expected payout.[9] The exclusion ratio treats part of each annuity payment as a return of principal. All annuity payments are fully taxable once the investment in the contract is recovered.[10]

Payments consisting of interest only payments are not annuity payments and not taxed under the annuity rules. Periodic payments on a principal amount that are returned intact are interest payments.[11] Any other payment that is not an ''annuity'' payment or an interest payment is treated as an ''amount not received as an annuity.'' An ''amount not received as an annuity'' is taxed under the ''last in, first out'' (LIFO) rules to the extent of investment income within the contract.[12]

Premature distributions from the contract are subject to a 10% penalty tax. These taxes are applicable to payments before the taxpayer becomes age 59½.[13] A number of exceptions apply to the 10% early withdrawal penalty rule, including disability, a pension annuity (i.e., owned by a qualified retirement plan), death of the policyholder, an immediate annuity payment that provides for a series of substantially equal period payments, and a structured settlement annuity.

The non-natural person rule of §72(u) provides that deferred annuities lose the benefit of tax deferral when the owner of the deferred annuity is a non-natural person. Based on the legislative history to §72(u),[14] §72(u)(1)(B) provides an exception for annuities that are ''nominally owned by a non-natural person but beneficially owned by an individual.'' This rule describes the typical arrangement in a personal trust. The IRS has ruled on this issue with respect to trusts at least eight times in Private Letter Rulings and has ruled favorably for the benefit of the taxpayer in each instance.[15]

At the death of the policyholder, the gain in the contract is subject to taxation at ordinary rates. The beneficiary will not be taxed on a lump-sum basis if the beneficiary elects, within 60 days after the policyholder's death, payment under a life contingency or installment option.[16] If the policyholder dies on or after the annuity start date and the entire contract has yet to be fully distributed, the remaining balance must be distributed at least as rapidly as the method being used at the time of the policyholder's death. If the policyholder dies before the annuity start date, the contract must be fully distributed within five years of the policyholder's death.[17] If the policyholder's spouse is the beneficiary of the contract, the distribution requirements are applied by treating the spouse as the owner.

Section 72(s)(6) deals with the distribution requirements of an annuity that is owned by a non-natural person (e.g., a trust). It provides that the death of the primary annuitant is the triggering event for required distributions from the annuity contract.[18] The primary annuitant must be an individual. Distributions must begin within five years following the death of the primary annuitant.

[7] *See* 17 CFR §230.501.

[8] *See* §72(b)(1).

[9] *See* Regs. §1.72-2(b)(3).

[10] *See* §72(b)(2).

[11] *See* Regs. §§1.72-1(b), -2(b).

[12] *See* §72(e)(5).

[13] *See* §72(q).

[14] *See* H.R. Rep. No. 99-426 (1985).

[15] *See, e.g.,* PLRs 199933033, 199905015, 9639057, 920414, 9009047.

[16] *See* §72(h).

[17] *See* §72(s)(1).

[18] *See* §72(s)(6)(A).

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Taxation of Variable Insurance Contracts

The taxation of variable insurance products is covered in §817(h). Regs. §1.817-5 provides a detailed overview of the investment diversification requirements of variable insurance products. The regulations address a wide range of investment alternatives that are not found in retail variable annuity products, such as direct investment in real estate and commodities. The reason for this (which the author has addressed elsewhere in writing on private placement group variable deferred annuity contracts for institutional investors) is beyond the scope of this article.

Section 817(h) provides that investment diversification is tested separately in each fund within the policy. No single investment may represent more than 55% of the fund; two investments 70%; three investments 80%; and four investments 90%.[19] Therefore, a fund must have at least five investments to meet the diversification requirements. The cliché ''the devil is in the details'' is a fitting statement to describe the application of the rules.

In an annuity contract, it is the policyholder (owner) that has the ability to control and manage the incidents of ownership associated with the policy. One of the incidents of ownership is the ability to control the investment decisions or fund selection within the policy. Two notions of investor control exist. The first notion is the subject of several rulings and cases dealing with ''wrapping'' publicly available investments.

The Service has ruled a number of times regarding the ability of a taxpayer to ''wrap'' investments that are ''publicly available'' — i.e., not limited exclusively to life insurance company separate accounts — and, as ultimately decided in *Christoffersen v. U.S.*,[20] that the taxpayer and not the insurance company should be taxed on the policy's underlying income.[21]

The second notion of the investor control doctrine is the more sinister problem. It deals with the idea that a policyholder retains so much direct or indirect control over investments that the policyholder is deemed to be in constructive receipt of the underlying investments within the policy. The consequence of this problem is that the policyholder forfeits the substantial tax advantages of life insurance and annuities. The determination of what constitutes investor control for tax purposes is a fact-specific determination.

On a certain level, the investor control is somewhat of a mystery. It is not a tax issue that has seen much notice. A number of tax practitioners are of the belief that the investment diversification rules of §817(h) and Regs. §1.817-5 were designed to replace the investor control doctrine. A number of practitioners would love to litigate the issue but not at the risk of making their clients famous, as the saying goes. The IRS does not agree with this point of view. This discussion is observed in the preamble to the 2005 regulations under §817.[22]

The Service updated the earlier Revenue Rulings cited above with the issuance of Rev. Rul. 2003-91[23] and Rev. Rul. 2003-92.[24] These rulings dealt with the issue of non-registered partnerships — i.e., hedge funds — that were not exclusively limited to investment by insurance company separate accounts and the ability to look-through to the underlying investments of these non-registered partnerships for purposes of meeting the diversification requirements. T.D. 9185 changed Regs. §1.817-5(f) by removing the section pertaining to non-registered partnerships as well as the example to the rule.

Taxation of Grantor Trusts

The tax rules for grantor trusts are found in §§671–679. Grantor trusts have been a mainstay of advanced tax and estate planning for the last 15–20 years using a number of techniques. Advanced planning has focused on the combination of the use of tax valuation planning techniques, such as family limited partnerships and family limited liability companies (LLCs), with the sale of a limited partnership or LLC interest to a grantor trust.

Under the grantor trust rules, the trust settlor is considered the owner of trust assets for income tax purposes. As a result, all trust income and losses flow through the trust to the settlor. The trustee is able to accumulate assets without any depletion for income tax purposes. The grantor or settlor's payment of the income tax liability is not considered an additional gift to the trust. At the same time, the trust assets are outside of the settlor's taxable estate.

The sale to a grantor trust is an outstanding estate freezing technique. In the typical sale to a grantor trust, the taxpayer sells capital assets to the grantor trust. The sale results in no gain to the seller. The seller is the settlor of the trust. The sale is usually made on an installment basis with the interest rate on the note set at the long-term applicable rate. Interest rates have been at historically low rates for the last five to seven years. In the event the trust sells the underlying asset, the taxable gain is reportable to the settlor and paid by the settlor. The settlor's estate is reduced by the amount of the tax liability. The trust corpus has not been eroded.

Virtually any estate planner on the planet would agree that the tax results associated with the sale to an intentionally defective trust (also known as a grantor trust) are outstanding. The author agrees with everyone else. However, the author believes that the tax results are enhanced even more if the grantor does not have to reduce his or her taxable estate by the amount of the annual income tax.

The likelihood of increased marginal tax rates at both the federal and state level along with an increase in the capital gains tax make the benefits of tax-advantaged compounding even more compelling.

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[19] *See* §817(h); Regs. §1.817-5(b).

[20] 749 F.2d 513 (8th Cir 1984), *cert. denied*, 473 U.S. 905 (1985).

[21] *See* Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B.12.

[22] T.D. 9185, 70 Fed. Reg. 9869 (3/1/05).

[23] 2003-33 I.R.B. 347.

[24] 2003-33 I.R.B. 350.

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Taxation of NGTs

Trusts that are not taxed as grantor trusts are taxed as separate taxable entities. In general, marital trusts and most testamentary trusts are NGTs. Most asset protection trusts are also NGTs for income tax purposes. Unfortunately, it takes very little investment income to push a NGT into the top marginal tax bracket — $11,650 for 2012.

Many wealthy families have generation-skipping trusts that are taxed as NGTs. An NGT is a trust that does not fall within any of the provisions of §§671–679. One method used to classify a trust as an NGT is the settlor's retention in the trust agreement of a power to control beneficial enjoyment pursuant to a §674(b) exception. The settlor's transfer to a trust with the retention of certain such powers may render the transfer an incomplete gift for gift tax purposes. The second method to avoid grantor trust treatment is to require the consent of an adverse party on any trust distributions.

The major focus of this article is tax-advantaged wealth accumulation across multiple generations. Many wealthy families and family offices have multigenerational planning as a component of their tax planning. It makes a lot of sense to reduce the ''drag'' of income taxation along with the avoidance of future estate and generation-skipping transfer taxation.

INTRODUCING THE DYNASTY ANNUITY

The dynasty annuity involves the purchase of a PPVA contract by the trustee of a family trust. The trustee selects young annuitants (grandchildren or great grandchildren) as the measuring lives of the annuity to maximize tax deferral within the PPVA contract. This structure maximizes tax deferral over the lifetime of the PPVA's young annuitant(s). In the case of a three-year-old grandchild, tax deferral could be accomplished for more than 80 years before a distribution is required.

As mentioned above, it is the death of the annuitant that triggers the requirement to distribute tax-deferred income within five years of the death of the annuitant or over the lifetime of the beneficiary.

The steps of the transaction can be summarized as follows:

(1) Purchase of a PPVA Contract. The trustee of the family dynasty trust is the applicant, owner, and beneficiary of a PPVA contract(s).

(2) Selection of Young Annuitants. The critical element in the maximization of tax deferral is the selection of a young annuitant(s) with the greatest potential of outliving their normal life expectancy(ies) for each separate PPVA contract. The trustee may purchase multiple policies with different individual annuitants to ''hedge'' against the possibility of exposing the trust to a tax burden as a result of distribution requirement caused by the premature death of the annuitant.

All of the investment income and gains from the PPVA will accrue within the contract on a tax-deferred basis. At any time before the death of the annuitant, the trustee may request a distribution from the life insurer so that the trustee may make a distribution to a trust beneficiary. At the death of the annuitant, the trustee will be required to make a distribution of the annuity based upon the life expectancy of trust beneficiaries.

The approximate cost of the PPVA contract is 40 basis points per year. The PPVA contract has the investment flexibility to add investment options to the contract. The customized account provides an open architecture allowing the investment advisor to manage based upon its asset allocation model and changes to the model. The PPVA contract is ideally suited to manage trust assets that generate ordinary income.

A $10 million single-premium invested into a PPVA contract earning 8% per year over an 80-year period grows to $2.5 billion in the 80th year. This small example illustrates the power of tax-deferral compounding over a long time period.

ANOTHER DEFERRAL OPTION — RESTRICTED CASH VALUE PRIVATE PLACEMENT LIFE INSURANCE (FCV) POLICIES

FCV is best known as a flexible premium variable adjustable (universal) life insurance policy that is issued by offshore life insurance companies domiciled in tax-haven jurisdictions, such as Bermuda or the Cayman Islands. The policy is intentionally designed to violate §7702, the tax law definition of life insurance. FCV is an excellent alternative to the PPVA contract. Ultimately, the FCV contract provides for better tax treatment.

The other legal considerations are imposed under the insurance laws of the jurisdiction where the coverage is issued.

Under most FCV contracts, the death benefit is equal to the sum of the guaranteed specified amount of death benefit plus the cash value on the claim date plus the policy's mortality reserve value on the claim date. This amount is essentially the cumulative premiums plus or minus investment experience along with a death benefit corridor, which most carriers express as a fixed percentage between 102.5%–110%. Some life insurers issues policies with a fixed amount of coverage — $1 million above the initial premium and mortality reserve.

The cash value under most FCV policies is defined as the fair market value of all assets constituting the

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policy fund, less any policy loans and less any accrued unpaid fees or expenses due under the terms of the policy. The ''cash surrender value'' of the of the policy is the lesser of (a) the cash value or (b) the sum of all premiums paid under the policy, computed without regard to any surrender charges and policy loans under the terms of the policy.

The cash value increases or decreases depending upon the investment experience of the policy fund. FCV policies do not provide for or guarantee any minimum cash value. The insurer holds the appreciation of the assets (in excess of the amount of cumulative premiums) in the separate account as a mortality reserve solely for the purpose of funding the payment of the death benefit payable under the FCV policy.

Under most FCV contracts, the policyholder may take a tax-free partial surrender of the policy cash value up to the amount of cumulative premiums within the policy. The policyholder may also take a policy loan up to 90% of the policy's cumulative premiums. The surrender and loan proceeds are tax-free under any circumstance and provide the policyholder with access to policy assets on a tax-free basis.

For the U.S. taxpayer, the policy is taxed under §7702(g). Technically, the taxation of the defective life insurance policy would result in the taxation of the policy's inside buildup as well as the mortality cost based upon the policy's net amount at risk. The net amount at risk is the difference between the policy death benefit and cash value. The FCV contract defines the cash value as cumulative premiums so that there is never any inside buildup under the contract. The net amount at risk is limited to a fixed amount or percentage. Section 7702(g) provides that the death benefit is income tax-free under §101(a).

FCV contracts are an excellent planning tool in certain situations. Large investment deposits into a traditional private placement life insurance contract may not be possible because of the limitations of the life reinsurance market. The FCV contract provides better tax results than a PPVA contract during lifetime or at death. The single-premium deposit is not subject to the modified endowment contract (MEC) rules of §7702A. The inside gain because of investment performance is not accessible during lifetime, but a substantial portion of the initial premium (90%) may be borrowed by the policyholder income tax-free.

Unlike a deferred annuity contract that mandates taxable distributions at death under §72(s), the FCV contract provides for the payment of an income tax-free death benefit. Unlike a deferred annuity contract, the FCV contract is not subject to the non-natural person rules of §72(u) so the FCV contract may be considered in circumstances where an annuity would have been used but for the non-natural person rules.

STRATEGY EXAMPLE

Facts

The Jones Family Office was established by Pierre Jones, age 72, following the sale of his technology company to Peachtree Computers for $100 million. Pierre was able to transfer stock to the Jones Family Trust early on, before the company was worth much. Southern Trust is the trustee of this trust. The trust is a grantor trust. The trust has $50 million of corpus that is invested in a diversified portfolio. Pierre's children and grandchildren are beneficiaries of the trust.

Pierre is a resident of New York City. Assuming the expiration of the Bush tax cuts at the end of 2012, he will be in a combined marginal income tax bracket of 53.4%. The trustee has invested $10 million in a diversified hedge fund portfolio. The portfolio has consistently been returning 10% net of all fees. The investment income is all short-term capital gain income taxed at ordinary rates.

The trustee would like to manage this alternative asset class with a tax-advantaged structure on a long-term basis. The balance of the portfolio is able to generate income for trust beneficiaries.

Strategy

PPVA

Southern Trust, as trustee of the Jones Family Trust, is the applicant, owner, and beneficiary of four PPVA contracts. Each contract is funded with a $2.5 million single premium. The underlying investment within the contracts is a customized insurance-dedicated fund (IDF) managed by the family's investment advisor. The IDF is a customized portfolio that has invested $1 million with 10 different fund-of-funds and single-strategy hedge funds.

Each annuity contract has a different annuitant. The Jones grandchildren are named the annuitants of each contract. The ages of the annuitants are two, four, six, and eight. The annuitant is strictly a measuring life and has no control over contract assets.

Over an 80-year period, the chart below illustrates the powerful effect of tax-deferred compounding versus a taxable account. At the death of each annuitant on each separate PPVA contract, the trustee has several choices. The trustee can take a lump-sum distribution resulting in a very substantial taxable event at ordinary rates. Alternatively, the trustee can annuitize the contract and achieve an extended deferral by paying out the account balance over the life of the trust beneficiary(ies). Distributions during lifetime are treated as taxable income and are taxed at ordinary rates. The trust may take a deduction as part of its distributable net income (DNI) and the beneficiary(ies) will be taxed on the trust distribution. The after-tax column in the chart reflects the income taxation of the grantor based upon the combined marginal tax rate.

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Male Age 50 — $10.0 Million
PPVA HYPOTHETICAL ILLUSTRATION

Year	Net Taxable Investment Value @ 53.4%	PPVA End of Year Policy Cash Value	PPVA Death Benefit	Net Taxable Investment IRR	Death Benefit IRR
1	10,466,000	10,950,000	10,950,000	4.66%	9.5%
10	15,769,141	25,009,530	25,009,530	4.66%	9.5%
20	24,866,497	61,461,121	61,461,121	4.66%	9.6%
30	39,212,263	152,203,127	152,203,127	4.66%	9.7%
40	61,834,267	377,193,992	377,193,992	4.66%	9.7%
50	61,834,267	1,024,074,091	1,024,074,091	4.66%	9.7%
60–70	97,507,163	2,584,625,676	2,584,625,676	4.66%	9.7%
80	382,347,656	16,463,804,711	16,463,804,711	4.66%	9.7%

SUMMARY

The wealth accumulation potential of the dynasty annuity concept is immense. The power of the compounding of the tax savings along with the time value of money produces a long-term result that is five to 10 times more powerful than its taxable equivalent. The grantor trust has been a sophisticated solution, but the payment of income taxes by the grantor reduces family wealth. In the case of a New York or California resident, the income tax consequences are more onerous than the estate tax consequences currently. Tax-advantaged accumulation produces a much better long-term result. The author submits that a wealthy family will be a lot wealthier if it does not have to pay taxes on certain investment income over several decades.

The NGT is the taxpayer with the greatest propensity for being heavily taxed. In 2012, the top marginal tax bracket is reached at only $11,650 of taxable income. How many marital trusts, credit shelter trusts, asset protection trusts, and dynasty trusts face this problem currently?

The dynasty trust can perpetuate family wealth from an income, estate, and generation-skipping transfer tax standpoint. Inevitably, trustees, as part of their asset allocation model, will have a reasonable allocation to investment asset classes that are taxed as ordinary income. The flexible investment structure of PPVA provides a platform for customizing investment options on an ongoing basis. The example in this article demonstrates the significant advantage for tax-deferred compounding over a long period of time.

Tax and estate planners have been familiar with the tax advantages of insurance contracts for some time but, unfortunately, have been limited to fully commissionable insurance contracts suffering from a lack of investment flexibility. Private placement insurance contracts are more than a viable solution to the problem. The problem has been the lack of information regarding private placement insurance contracts for tax and estate planners. Hopefully, this article will add another arrow to the quiver of tax and estate planning attorneys.

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