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Although the use of variable insurance policies to invest in sophisticated investment strategies such as hedge funds, hedge fund of funds, real estate, options and commodities is not a new planning strategy, it has received renewed attention in light of the significant increase in federal income tax rates. While hedge funds and other similar investments can offer high net worth individuals attractive risk-adjusted returns, they are often tax inefficient. Private placement life insurance (“PPLI”, also known as private placement variable life insurance) and private placement variable annuities (“PPVA”) not only offer a way to minimize or even eliminate the income tax inefficiencies associated with these and other types of investments, but they can also provide high net worth individuals with a comprehensive means of minimizing estate taxes and maximizing the amount of wealth available for transfer to their families and charity.

How They Work

Private Placement Life Insurance

PPLI is essentially an investment account “wrapped” within a life insurance policy. The policy owner pays premiums into a segregated investment account of the insurance company. A portion of each premium payment covers the expenses and mortality (“M&E”) charge associated with the insurance policy, while the remainder is allocated to one or more investment options selected by the policy owner from a list of professional investment managers approved by the insurance company. While the policy’s cash value will fluctuate based on the performance of the investments in the segregated account, the death benefit paid upon the insured’s death will generally never fall below an initial guaranteed amount, unless premiums are not paid or significant withdrawals are made.

What makes PPLI so attractive is the fact that, if structured properly, all investment returns within the account accumulate on a tax-deferred basis during the insured’s life as long as the income remains in the policy. If needed by the policy owner, the cash value in the account can be accessed on a tax-free basis through a policy loan up to the entire account balance, or alternatively via a withdrawal up to the cost basis in the account. Upon the death of the insured, both the investment account and the death benefit pass to the beneficiaries of the policy free of all income tax. In addition, if the policy is owned by a trust or other estate planning vehicle that is outside of the insured’s estate, no estate taxes will be imposed upon the amounts paid to the beneficiaries at the insured’s death. As an estate planning tool, PPLI is therefore a very effective technique to pass a significant amount of wealth to family members free of both income and estate taxes.

Private Placement Variable Annuities

Similar to PPLI, a PPVA is an investment account within a variable annuity policy that allows the investor (the “Owner”) to grow premiums contributed to the annuity in a tax-deferred manner as long as they remain within the policy. Unlike PPLI, however, if withdrawals are taken from the investment account, deferred gains are taxed at ordinary income tax rates. In addition, withdrawals taken prior to age 59½ are subject to a 10% penalty tax. And finally, all policy benefits paid to family members or trusts for their benefit upon the Owner’s death are subject to estate taxes as well as income taxes. For these reasons, variable annuities are traditionally thought of as a retirement planning strategy and not as a tax efficient means for transferring wealth to family members. For the high net worth individual with significant philanthropic goals, however, PPVA provides a very effective vehicle for increasing the amount of funds available for charity both during life and at death. While withdrawals taken from the policy during the Owner’s lifetime will be subject to income taxes, if they are in turn contributed to charity (which may include the Owner’s private foundation), the charitable deduction available to the Owner should net out all attributable income tax liability other than the 3.8% Medicare unearned income tax. In addition, withdrawals received by the Owner will increase the Owner’s adjusted gross income to the extent that they constitute...
deferred gains. This will increase the Owner’s allowable charitable deduction and, in turn, the Owner’s giving capacity. Finally, upon the Owner’s death, if a charity or private foundation is designated as the beneficiary of the annuity, all funds will be distributed free of income and estate taxes.

Example - Benefits of Tax Deferral of PPVA

To more fully understand the benefit of the tax-deferral aspect of PPVA, please refer to the table below, which compares a hypothetical portfolio invested at various nominal rates of return in a traditional, non-tax-deferred hedge fund portfolio (the “Taxable Portfolio”), with the same portfolio invested on a tax-deferred basis within a PPVA structure (the “Tax-Deferred Portfolio”).

<table>
<thead>
<tr>
<th>Nominal Return</th>
<th>Annualized Net Return</th>
<th>Return Differential</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Taxable Portfolio</td>
<td>Tax-Deferred Portfolio</td>
</tr>
<tr>
<td>10.00%</td>
<td>4.76%</td>
<td>8.10%</td>
</tr>
<tr>
<td>9.00%</td>
<td>4.28%</td>
<td>7.10%</td>
</tr>
<tr>
<td>8.00%</td>
<td>3.81%</td>
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</tr>
<tr>
<td>7.00%</td>
<td>3.33%</td>
<td>5.10%</td>
</tr>
</tbody>
</table>

Key Assumptions:
- All annual returns are net of underlying investment manager fees.
- 75% of Nominal Return taxed at ordinary income rates; 25% taxed at long term capital gains rates.
- Federal ordinary income tax rate of 44.6% and long term capital gains rate of 25%, both of which include 3.8% Medicare unearned income tax and 1.2% effective tax attributable to itemized deduction phase out (Pease Amendment) but do not include allowable deduction for state and city taxes, resulting in an overall blended federal rate of 39.7%.
- Combined New York state and city taxes of 12.7%.
- Tax-Deferred Portfolio assumes Athena investment management fees of 125 basis points, one-time insurance agency fees of 25 basis points and annual M&E fees of 40 basis points. Actual cost will vary depending on the size of the portfolio and any special requirements.

Additional Considerations and Conclusion

Despite the unparalleled advantages of using PPLI and PPVA as tax efficient strategies to access alternative investment classes and to maximize wealth passed to family and charity, there are several limitations. While the owner of the policy has significant flexibility in the selection of the policy’s underlying investment manager, and many hedge funds and other investment choices are available, in order to satisfy tax rules the policy owner is not permitted to exercise any undue control over the choice of underlying investments. Furthermore, while PPLI and PPVA offer investors the ability to customize their investment options to include investments in a variety of asset classes, the IRS imposes complex and strict investment diversification rules that must be observed in structuring any PPLI or PPVA policy. To ensure that any PPLI or PPVA policy adheres to these tax rules, it is important to work with an experienced advisor familiar with the various restrictions.

In sum, PPLI and PPVA provide comprehensive and unique wealth transfer solutions for high net worth investors and offer such investors access to a variety of sophisticated investment strategies and products. PPLI and PPVA are extremely tax efficient and flexible ways to protect assets during life, facilitate the orderly disposition and transfer of assets upon death, mitigate estate tax liability and augment philanthropic goals. Of course, PPLI and PPVA are not appropriate for everyone and must be structured properly in order for the policies to qualify for favorable tax treatment. Accordingly, an experienced advisor should be consulted to help determine if PPLI or PPVA are appropriate for any given investor.
About Athena Capital Advisors (www.athenacapital.com)

Founded in 1993, Athena Capital Advisors is a privately held firm with over $4.8 billion in assets under management (as of 12/31/2013). Athena serves ultra-high net worth private clients, foundations and endowments. Athena serves as its clients’ chief investment officer and investment staff, providing comprehensive and highly customized portfolio solutions. In addition, Athena provides guidance on estate and wealth planning matters. In 2012, both REP Magazine and Bloomberg named Athena one of the Top 50 Family Offices globally by assets under management and AdvisorOne Magazine ranked Athena #2 amongst Top Wealth Managers by average AUM per client.

About Anne Marie Towle

Anne Marie Towle joined Athena in 2008. She is a Managing Director and the firm's Director of Wealth Strategies. An experienced estate planning attorney and trustee, Anne Marie came to Athena from Choate Hall & Stewart LLP, where she managed the 13-attorney estate planning practice and advised clients on wealth transfer issues. Anne Marie was recognized as a "Massachusetts Rising Star" in the area of estate planning and trusts in the 2006 issue of Boston magazine, and as a “Massachusetts Super Lawyer” and a “New England Super Lawyer” in the 2006 and 2007 issues, respectively.

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