Wealth Planning Insights

Maximizing the Power of Old Annuities Through Private Placement

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Highlights

- High-net-worth individuals may own several annuities that they've purchased at various times during their lives.
- These retail annuities often come with high fees, unnecessary riders, opaque investment options, and adverse tax consequences.
- For such individuals, a private placement variable annuity (PPVA) may offer an attractive solution, including lower fees, streamlined management, and deferred income tax recognition.
- PPVAs may be especially attractive for those planning gifts to charities or leaving assets to beneficiaries through a trust-held annuity.

Over the course of their financial lives, individuals may at various times purchase retail annuities offering tax-deferred investment growth, protection of their principal, and the promise of a steady stream of income for retirement. As life progresses and their wealth grows, high-net-worth individuals may find they have reached a position where they no longer need the guaranteed income or principal protection.

This may create a conundrum: By holding onto the annuities, such individuals will continue to pay high fees for benefits they no longer require. Yet surrendering the policies seems no more attractive since the gain from annuities, no matter how long they are held, is taxed as ordinary income and not at the more attractive rates for long-term capital gains. The annuity owner may also be subject to an additional 10% tax penalty if the annuitant hasn't reached age 59½. Unsure of the best course, holders may let these annuities sit among their assets from year to year.

Private placement variable annuities (PPVAs) may offer an attractive alternative, offering lower fees and other advantages. Instead of simply holding onto retail annuities they no longer need, or surrendering the contracts and recognizing ordinary income taxes, wealthy investors can roll the assets into a PPVA via an IRC section 1035 exchange, allowing for a tax-free transfer of assets from one annuity to another.

Retail Annuities and PPVAs – A Comparison

Annuities marketed at the retail level offer seemingly attractive benefits for many buyers. For example, some annuities offer a guaranteed income stream that may ease concerns about long-term investment performance and outliving one's money. However, the most attractive benefit is that investments in a retail annuity can grow on a tax-deferred basis, similar to IRAs and other retirement accounts.

Yet retail annuities come with high "mortality and expense" (M&E) fees, averaging 1.25% of the contract value and sometimes running as high as 1.75%,[1] plus additional costs for riders guaranteeing income or other provisions. Overall, retail variable annuity fees average 2.3%, sometimes rising above 3%.[2]

While the draw of tax-deferred investing may be alluring upon first blush, with retail annuities, it is likely that the frictional costs of M&E and rider fees described above exceed the tax savings.

[1] Annuity Digest, "M&E Fee." http://www.annuitydigest.com/me-fee/definition
[2] Annuity.org, "Annuity Fees and Commissions." https://www.annuity.org/annuities/fees-and-commissions/

While PPVAs are only available to qualified purchasers and accredited investors — individuals and families that can satisfy certain income and net worth requirements — they are specifically designed to minimize the frictional charges associated with retail annuities. As such, they offer streamlined management and substantially lower fees.

As with retail annuities, investments in a PPVA can grow tax deferred (with the same penalties for early withdrawals). And while retail annuities typically offer limited investment options that change little from year to year, PPVAs often offer more robust actively managed investment options. As such, PPVAs may be an especially pragmatic approach to charitable giving or generational wealth transfer for individuals and trusts with existing retail annuities.

The following analysis (see Exhibit 1) compares two investments by a 65-year-old owner of a $1 million retail annuity with a cost basis of $500,000 and annual fees of 2.25%. The first involves surrendering the annuity and investing in a taxable account, and assumes a net after-tax return of 5.68%. The second involves rolling the assets into a PPVA, assuming an annual gross pretax return of 7.2% and annual M&E fees of .55%.

Case Study: Continued Growth, Lower Fees

Over the course of her working life, a retired 70-year-old physician had purchased several variable annuities from an independent financial advisor. At the time, considering her high-income tax bracket, the annuity provided peace of mind that her contributions would appreciate tax deferred, and the assets would be available for income in retirement.

Yet, now at 70, her wealth is such that she won't need the annuity income for retirement purposes, nor is principal protection a concern. The M&E fees of 1.25%, plus 1% for the income rider, bring her overall fees to a hefty 2.25%.

Working with her Bessemer advisory team, she transfers the assets into a private placement variable annuity. Because there is no income guarantee or principal protection (a feature she doesn't need), fees come to .55%. Additionally, by making the transfer via a 1035 exchange rather than surrendering the annuity outright, she avoids what would have been a significant income tax recognition event. As the assets continue to grow tax deferred for years to come, she has plenty of time to decide what she'd ultimately like to do with the money, such as leaving it to a charity or a loved one.

Exhibit 1: Private Placement Variable Annuity vs. Taxable Investment ($1 Million Investment)

Key Takeaway: Retail annuity assets rolled into a tax-deferred PPVA may produce greater benefits than surrendering the annuity and investing in a taxable account — especially over time.

Year	Age	Current Retail Annuity ($)	Surrendering Annuity and Investing in Taxable Account ($)	Private Placement Variable Annuity ($)
1	65	1,000,000	815,000	1,000,000
11	75	1,608,839	1,416,073	1,889,512
16	80	2,040,652	1,866,593	2,597,314
26	90	3,283,082	3,243,230	4,907,656
36	100	5,281,951	5,635,154	9,273,076

Assumptions:

1. Based on current annuity value of $1 million with a tax basis of $500,000 and total variable annuity charges of 2.25%.
2. Model assumes ordinary income tax rate of 37% and long-term capital gains tax rate of 23.8%.
3. PPVA assumes annual gross pretax return of 7.2%, with the carrier deducting annual M&E fees of 55 basis points (.55%).
4. Taxable portfolios assume net after-tax return of 5.68%.
5. Pretax and after-tax returns are based on the Bessemer Trust Implication Model – Balanced Growth Model.

Source: Bessemer Trust

Case Study: Using a PPVA to Preserve Basis in a Life Insurance Policy

A PPVA may also be an effective way to preserve potential tax advantages in a lapsing life insurance policy. Say, for example, an individual holds a life insurance policy he no longer needs, with a cost basis of $500,000, and $100,000 in cash value. Simply cashing out the policy would give him the $100,000, but he would sacrifice $400,000 in potential growth before triggering ordinary income taxes. Instead, he rolls the policy into a PPVA. Now, that $100,000 can continue to grow to $500,000 before triggering any ordinary income taxes upon surrender.

PPVAs to Enhance Charitable Giving and Estate Strategies

As with tax-deferred IRAs, holders of annuities (whether retail or private placement) must pay tax on distributions, at ordinary income tax rates — currently 37% for those in the top income bracket. Because the wealthy holder of a PPVA likely won't need the income, the policy may be an attractive way to meet other objectives, such as maximizing gifts to charity.

An annuity owner can decide to leave the asset to a charity simply by naming the charity as the beneficiary. As a result, upon the death of the owner, the value of the annuity will not be included in the owner's taxable estate, and the charity, as a 501(c) tax exempt organization, will not have to recognize the significant ordinary income tax on the annuity's gain. The lower fees (compared with a retail annuity) give the PPVA that much more power to grow. Additionally, at any point prior to death, the annuity owner may decide to change or add a beneficiary or leave it outright to their loved ones.

Generally speaking, annuities (whether retail or PPVA) are inefficient wealth transfer vehicles when left to noncharitable beneficiaries. Not only will the annuity be subject to potential estate taxes, but beneficiaries will have to pay income tax on the distributions, without the advantage of a step-up in basis that comes when assets subject to capital gains taxes are left in an estate. Yet, if the annuities are held inside an irrevocable trust, that picture changes.

Annuities held in irrevocable trusts may offer significant advantages. Because the annuity can grow on a tax-deferred basis, the assets won't be subject to annual taxes on trust earnings (income taxes will apply upon distribution). Moreover, annuities held in irrevocable trusts are typically not included in the grantor's taxable estate. And the trust structure gives the trustee considerable latitude to make distributions as needed, while keeping the rest potentially growing on a tax-deferred basis for the remainder of the annuitant's life. Finally, a post-death 1035 exchange to the trust's beneficiaries may allow for the annuity's tax deferral to extend to the next generation after the passing of the original annuitant.

Making the Decision

As with any investment decision, a PPVA does entail risks. For example, the investments could fail to perform as expected, leaving you less money than you anticipated to give to charity or leave to a loved one. And because the lower fees come in exchange for giving up features such as principal protection and guaranteed income, it's important to be sure that you won't need these features before transferring from an existing annuity into a PPVA.

Yet for investors stuck between two less than optimal choices — holding onto an expensive annuity with features they no longer need or surrendering and paying the price — PPVAs may offer an attractive solution.

If you would like more information on whether this approach could make sense for you, please contact your Bessemer advisor.

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