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Private Placement Group Variable Annuity Contracts—A Market Overview for Tax-Exempt and Foreign Investors

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This article provides an overview of the use of the private place¬ ment group variable deferred annuity contract (also known as a group annuity contract, or GAC) by tax-exempt and foreign investors. While for most tax practitioners the use of the GAC as an investment structuring vehicle for institutional investors is largely unknown, most large life insurers have used this structure for wholly owned investment advisory firms for the last several decades—unnoticed and without the assistance of the same car¬ riers* large agent ield force. The estimate is that well in excess of $50 billion of institutional investments for tax exempt inves¬ tors have been structured using the GAC. The author traces the historical roots of the marketplace, and overviews what other life insurers are now doing in this marketplace. He analyzes the tax considerations and also focuses on alternative tax planning used by tax-exempt and foreign investors for unrelated business tax¬ able income and the consequences under the Foreign Investment in U.S. Real Property Tax Act. The primary focus on the use of the GAC by foreign investors is foreign public (sovereign) and private pension plans.

Introduction

The group annuity contract (GAC) as a planning or structuing solution for unrelated business taxable income (UBTI)[1] or Foreign Investment in U.S.

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1 See IRC §§511-514.

Real Property Tax Act (FIRPTA)2 issues has primarily been a tax planning option available to the wholly owned investment advisors of large life insur¬ ers and has mostly been used with real estate as the asset class. The author believes, however, that at least two different marketing perspectives of the GAC exist in the UBTI realm: (1) an intuitive tax-exempt investor3 will recog¬ nize that the GAC can serve as a single structure for multiple UBTI-sensitive investments providing tax certainty and price eficiency; and (2) investment advisors that sponsor UBTI-sensitive investments may recognize the ease and lexibility of sponsoring a commingled fund within the GAC.

A new frontier of great marketing possibility is the use of the GAC for hedge fund investing by tax-exempt investors. Congress at different times has considered eliminating tax-exempt investors' ability to avoid UBTI by using offshore funds. As tax-exempt investors continue to make larger allo¬ cations to hedge funds, the use of leverage by the funds creates UBTI. The traditional method of avoiding UBTI on hedge funds is investment through the manager's offshore fund. The political environment is such that public pension plans and labor union plans will ind it politically dificult to invest in offshore funds. In addition, some offshore hedge fund strategies generate a lot of dividend income that is subject to the 30 percent withholding tax under Section 871(a).4 The cost of the GAC structure is less than the tax cost to the offshore fund. Therefore, the best method to avoid UBTI will be through the GAC.

The size of the marketplace is substantial. A GAC program for an investment advisor should represent at least $5 million in commitment. The use of the GAC by a large pension plan could represent several hundred mil¬ lions of dollars on an ongoing basis. The typical close-ended real estate fund has a seven- to nine-year life. The pension plan's use of the GAC as a single structure for UBTI-sensitive investments is largely a function of investment allocation strategy. A large state pension plan may have a 3 percent to 10 per¬ cent allocation to real estate. A portion of that allocation may include oppor¬ tunistic real estate.

The GAC for Tax-Exempt Investors

A Currently Under-Utilized Product. The purchase of a GAC by tax-exempt investors for investment in real estate is primarily designed to mitigate

2 See IRC §897.

3 The term "tax-exempt investors*1 as used herein means public or pivate retirement plans, Taft-Hartley plans, and endowments and foundations.

4 All references to Sections in this article are to the Internal Revenue Code of 1986, as amended (the IRC) or the regulations thereunder, unless speciically otherwise indicated.

UBTI considerations afecting the tax-exempt investor. To the best of this author's knowledge, the use of this product came into being in 1994 or earlier.[5]

It is no small coincidence that the investment diversiication regulations contain excruciating detail concerning real property accounts and other asset classes that historically have had no place within retail variable insurance products.[6] One ponders why these regulations were added at a time when the private placement life insurance and annuity marketplace for corporate and high net worth buyers was virtually nonexistent.

Historically, the GAC has been available almost exclusively to the wholly owned real estate investment advisory irms of life insurers like Aetna, John Hancock, CIGNA, Prudential, Principal, The Equitable, Metropolitan Life, Travelers, and New York Life. These life insurers have not made the GAC available to external independent investment advisors primarily for competitive and compliance reasons (due diligence). Real estate investment advisory irms owned by life insurers have had a competitive advantage over competitors because of their ability to deliver real estate investments through the GAC.

At the same time, independent investment advisors have been concerned about the prospect of a life insurer performing due diligence on it and disclosing proprietary information and processes to its wholly owned real estate investment group. While signiicant real estate assets have been managed within GACs, this technique has been largely under-utilized by tax-exempt investors and independent investment advisors for several reasons, including:

- Carrier inexperience and inlexibility regarding sophisticated investment options;
- Lack of available product options;
- Lack of product intermediaries for promotion of the GAC as a viable planning option;
- Unavailability to endowments and foundations;
- Investor control considerations and the unwillingness of investors to relinquish discretionary investment control to the investment advisor;[7]
- Tax practitioners' unfamiliarity with the GAC and lack of carrier access (tax practitioners generally tend to stick with the existing structures that they have utilized and understand).

5 See American Bar Association Meeting on Tax Advantages and Risk of Investing in Real Estate Through a Life Insurance Separate Account. Oct. 2, 2004. John Hancock senior counsel references John Hancock investment through life insurance separate accounts for a wide range of alternative investments—co-generation, senior housing, timber, agriculture, etc.

6 See Treas. Reg. § 1817-5.

7 Many institutional investors have been unwilling to relinquish control and communication with the investment advisor. Many funds are structured in a manner that allows a group of investors to override the fund advisor's investment discretionary authority. This degree of control is incompatible with the investor control doctrine inherent in variable insurance products.

At the same time, several tax rulings and proposed regulations and look-through provisions have helped to add claity to these more sophisti¬ cated investment options.8 The barrier for entry into the GAC marketplace for a life insurer that is not already in the GAC business and/or operating in the Private Placement Life Insurance (PPLI) business may be insurmount¬ able due to technical and operational challenges.9

GAC Basics. The GAC is a private placement group variable annuity con¬ tract. The product is institutionally priced and available exclusively to accred¬ ited investors who are qualiied purchasers. Registered versions of the GAC are frequently used in the Section 401(k) marketplace. From a tax standpoint, the contract is designed to be in complete compliance with Section 72 (i.e., the tax law deinition of an annuity), Section 817(h) (i.e., the investment diversiication rules for variable insurance products), and the investor con¬ trol doctrine. Note however that a GAC issued to a pension plan as deined in Section 818(a) is not subject to the broad investment diversiication rules of Section 817(h). From an ERISA standpoint, the life insurer issuing the annuity contract is an investment iduciary and subject to ERISA's iduciary standards.

Administratively, the GAC is a single contract that has optional payout annuity purchase provisions. The contract provides pricing assumptions for these payout annuities.

The GAC marketplace for tax-exempt investors envisions two distinct private placement memoranda (PPM)—a qualiied plan offering and a non¬ qualiied plan offering. The GAC contract for the qualiied plan marketplace is an unallocated single contract that provides no named annuitants within the contract but does provide annuity settlement options. Generally, the plan trustee is the applicant, owner, and beneiciary of the GAC. In the case of tax-exempt organizations that are not pension plans as deined in Section 818 (a), such as an endowment or foundation, an allocated GAC contract is frequently used. This contract provides for named annuitants and provides for sub-accounts for each of the primary annuitants. The pimary annuitants represent a group of measuring lives that have some sort of professional afiliation with the tax-exempt organization (for example, the professors of a large university on behalf of the university's endowment). The tax-ex¬ empt organization is the applicant, owner, and beneiciary of the GAC. The

" See Rev. Rul. 2003-91, 2003-2 CB 347; Rev. Rul. 2003-92, 2003-2 CB 350; Prop. Reg.§1.817-5(f)(3)(ii).

9 The author knows this to be true; other independent investment advisors unsuccessfully spent a year to two years attempting to convince a life insurer to develop and issue a GAC.

primary annuitants have no legal interest in the GAC or its beneits. The pri¬ mary annuitants are strictly measuring lives in the event an annuity payment must be made due to a death of a primary annuitant.

In some instances based upon differences in state insurance regu¬ lation, a pension plan may seek to situs the contract in a state that is different from the location of the pension plan. In those instances, the plan trustee may create a single member limited liability company (LLC) to create a legal nexus with a particular jurisdiction. The LLC, which is wholly owned by the pension plan, is the applicant, owner, and benei¬ ciary of the GAC.

The Issue of Unrelated Business Taxable Income

What UBTI Is. UBTI is deined in Section 512 as income from a "trade or business" that is regularly carried on by the tax-exempt organization but which is not substantially related to the exempt organization's exempt pur¬ pose or function. Congress instituted this tax to prevent tax-exempt organi¬ zations from having an unfair advantage over taxable organizations. UBTI is of concern to pension plans and tax-exempt investors because it converts income that would otherwise be treated as tax-exempt into taxable income. In the case of a charitable remainder trust, it could make all of the trust's income taxable in the year that the trust has UBTI. A tax-exempt investor typically is also adverse to UBTI, because of fear that UBTI will increase audit exposure on the organization's other activities.

UBTI exists only where there is a "trade or business." Under Section 513, gross income will be treated as UBTI if:

1. It is income from a "trade or business";
2. The "trade or business" is regularly carried on by the organization; and
3. The conduct of the "trade or business" is not substantially related to the purposes of the organization.10

UBTI includes income from debt-inanced property. Debt-inanced property is property used to produce income which uses "acquisition indebtedness."11 Acquisition indebtedness is debt incurred either in the cur¬ rent taxable year or within twelve months of the property's sale.12

IUTreas. Reg. § 1 .513-1

11 See IRC § 514(b).

"See IRC § 514(c).

Section 512 (b)(1) speciically exempts annuity income from UBTI treatment (along with other notable categories of income such as dividends, interest, capital gains, and rents). But Section 514(g) provides the Treasury with the ability to add regulations to curtail the use of insurance company separate accounts as a method for avoiding UBTI:

> The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations to prevent the circumvention of any provision of this section through the use of segregated asset accounts.

Fortunately, Treasury does not presently have any regulatory projects affect¬ ing the tax treatment of annuity income for tax-exempt investors; any future regulations would only be prospective and effective from the date that inal regulations are issued.

Whether an activity is a "trade or business" is determined under the meaning of Section 162.13 Under that section, a "trade or business" includes any activity carried on for the production of income from the sale of goods or performance of services. The ownership of an annuity is in itself not an "activity," and it does not produce income from the sale of goods or the per¬ formance of services. In Revenue Ruling 69-574,14 the IRS held that a trust's receipt of income is primarily of a passive nature.

In Higgins v. Commissioner™ the Supreme Court held that a wealthy individual's extensive investment portfolio did not amount to a "trade or business " In addition, since the "investor control" doctrine prevents the taxexempt organization from taking any active role in the investment of the annuities' premiums, the exempt organization can only be a passive investor in the annuity. Thus, the ownership of an annuity by a tax-exempt organiza¬ tion should not create UBTI.

How UBTI Is Taxed. A tax-exempt entity subject to UBTI pays taxes at the full corporate rate (or trust rate, if applicable) subject to a $1,000 exemp-

carrying

unrelated business.16

What Types of Investments Create UBTI? Not all investments have the potential to create UBTI. The following categories are excluded from

13 SeeTreas. Reg. § 1.513-1(b).

14 1969-2 CB 139.

15 312 U.S. 212 (1941).

16 See IRC § 511(a), (b).

UBTI: dividends; royalties; interest; annuities; interest on margin loans paid to brokers; option income; and income from notional contracts.17 Also excluded are rents from real estate as well as rents on personal property—provided the rents are incidental and do not exceed 10 percent of total rents from leased property. (Rents based on income or proits are not excluded from UBTI.)18 Capital gains realized upon a disposition of a capital asset are also exempt from UBTI unless the property is stock in trade or inventory (dealer property). The issue of whether a property is dealer property is based upon a facts and circumstances analysis. The factors include the purpose for the acquisition, length of ownership, effots to sub-divide the property, sales efforts, use of brokers, and number of sales. "Quick flips" (short-term pur¬ chases and sales) of properties are likely to result in dealer status and taxation as ordinary income.

That said, broad ranges of investments, discussed below, are poten¬ tially subject to UBTI. A primary indicator of whether investments generate UBTI is determined through a review of the investment's use of "leverage" or "acquisition indebtedness."

Hedge Funds. Securities trading that relies on the use of a margin account is likely to create UBTI. Hedge funds are the best example of funds that create UBTI for tax-exempt investors through use of leverage. Endow¬ ments and foundations now have far greater hedge fund exposure than public and private pension plans. For example, endowments such as Harvard's and Yale's have signiicant hedge fund exposure.

The hedge fund marketplace is experiencing an increase in institutional investment and interest from public and private pension plans. In the past, bar¬ riers to entry for hedge funds in the pension plan marketplace have included lack of transparency, high fees, lack of long-term track record, and lack of liquidity. But tax-exempt investors' comfort level is increasing at the same time that the hedge fund industry is coming under pressure for increased oversight and regulation.

As previously mentioned, offshore funds that generate signiicant divi¬ dend income will be subject to the 30 percent withholding tax under Section 871 (a). In a recent discussion, the CFO of a large hedge fund told the author that its cost of tax structuring for its offshore fund due to high dividend income was 50 basis points (as a percentage of assets under management). The cost of a GAC based on the size of the fund would have been one-ifth of this cost.

Real Estate. Real estate investments such as senior housing, real estate development, hotels, and condo conversions are likely to create UBTI.

17 See IRC § 512(b)(1)

18 See IRC § 512(b)(3)

Agricultural investments may also generate UBTI. Many of these opportu¬ nistic investments constitute "dealer income" that is taxed at ordinary rates as income from a trade or business.

Recall that the second UBTI trigger for real estate investments is unre¬ lated debt-inanced income. Debt-inanced income is a percentage of income from debt-inanced property, calculated as the average acquisition indebted¬ ness during the taxable year divided by the amount of the adjusted basis of the debt-inanced property duing that year. Acquisition indebtedness is gen¬ erally debt incurred in acquiring and improving the property. Real property acquired by a "qualiied organization"—i.e., an educational organization, pension trust, or other exempt organization—is generally exempt from the unrelated debt inance rules.

Timber. Some of the earliest uses of the GAC for UBTI structuring have been in the area of tax-exempt investment in timber.[19] The typical tim¬ ber investment is a 15-20 year investment, and is favored by large public pension plans for its non-correlated real returns of 10 percent to 12 percent. Public pension plan investments in timber are often commitments of several hundred million dollars.

The GAC also provides greater lexibility for investment strategies for land sales to developers near urban areas. This investment income is treated as dealer income and subject to UBTI tax treatment. The Section 631(b) elec¬ tion is of no beneit for this investment strategy.

Natural Resources. Large institutional investors have also made invest¬ ment allocations to natural resources, including equity investment in agicul¬ ture, co-generation facilities, and oil and gas. These investments also tend to create UBTI.

Mezzanine Financing. Mezzanine investments are private equity invest¬ ments structured as unsubordinated debt. These investments, which may use leverage, provide high-yield income as well as capital gains, and target a total investment return of 20 percent to 25 percent. In many cases, these invest¬ ments will create UBTI for the tax-exempt investor. A real estate mezzanine fund may be structured as a pivate real estate investment trust (REIT) or through an offshore fund structure. Generally, investments in target compa¬ nies that are structured as pass-through entities such as LLCs create UBTI.

Until recently, Small Business Investment Company (SBIC) mezzanine funds had great dificulty attracting tax-exempt investors because of such funds' inability to eliminate UBTI. After several years, the National Association of

19 For example, John Hancock Natural Resources Group is the largest timber investment management organization (TIMO); the company has actively used the GAC and has approxi¬ mately $2 to $4 billion of timber assets under management within GACs.

Small Business Companies was able to lobby Congress successfully for an exception to the UBTI rules for SBICs.[20]

Non-SBIC mezzanine funds attempt to create funds that provide investment income as interest and capital gain income in order to avoid UBTI.

Issues for Endowments and Foundations

The use of GACs by endowments and foundations has been somewhat controversial in the past. A number of carriers took the conservative tax position that they would not issue GACs to endowments and foundations based on a literal interpretation of Section 72(u) and the non-natural policyholder rule. Recently, however, carriers such as John Hancock and Prudential have reversed their previously conservative positions and now issue GACs to endowments and foundations.

Section 72(u)(l) states that an annuity owned by a non-natural person will not be treated as an annuity for tax purposes, and thus any investment income will be currently taxable. The "defective" annuity continues to be treated as an annuity under Subchapter L of the Internal Revenue Code for the life insurer.

Section 72(u)(4), however, carves out several exceptions to the rule including retirement plans, immediate annuities, and annuities which are beneicially owned by individuals but nominally owned by non-natural persons such as trusts. In addition, two private letter rulings, PLR 200206047[21] and PLR 9708022,[22] are favorable rulings for taxpayers that are tax-exempt entities such as endowments and foundations. The PLRs focus on the application of Section 72(u) and the use of a GAC purchased by an endowment or foundation. The underlying investment of the GAC was a real estate fund (presumably funded with debt inancing). The PLRs state that while the GAC violated Section 72(u), the annuity continued to be treated as a valid variable contract under Section 817(d).

The presumption is that a life insurer would issue a Form 1099 to the endowment or foundation each year for any current income created due to the violation of Section 72(u). The tax issue for the tax-exempt taxpayer is the character of the income. The two letter rulings state, essentially, that in view of the contract's status as an annuity contract under Subchapter L, the tax treatment of the contractholder under Section 72(u)(l)(A) does not preclude the contract from satisfying the requirements of Section 817(d)(2)(A) for purposes of determining the taxpayer's income. The author believes that this should be

20 PLR 200701016 (Oct. 5, 2006); PLR 200248021 (Aug. 27, 2002); PLR 9743054 (Aug. 1, 1997).

21 Nov. 13, 2001, issued to Prudential.

22 Nov. 26, 1996, issued to Aetna.

interpreted as follows: the character of the income for tax purposes is "annuity" income in spite of the fact that the GAC violates Section 72(u).23

From a tax perspective, the GAC for endowments must comply with all of the federal tax provisions regarding investor control and investment diversiication. Unlike GACs for pension plans, the GAC for endowments and foundations must comply with Section 817(h).

How Do Tax-Exempt Investors Currently Avoid UBTI?

The general issue to consider when analyzing a potential investment that generates UBTI for a tax-exempt investor is not the level of tax savings but rather how dificult and how secure the UBTI solution is.

In most cases, the fund's tax structure will attempt to deliver investment income that falls within one of the exempt categories of income—interest, dividend, capital gain, and lease income. The investment advisor has the burden of recommending a UBTI-relieving structure for potential tax-exempt investors.

Some state and municipal pension plans take the tax reporting position that they are not subject to UBTI based upon Section 115, which states that gross income does not include income derived from the exercise of a governmental function. These plans argue that investing for retirement is an essential governmental function. However, many conservative state and municipal plans consider the issue uncertain and want to avoid any constitutional challenge. These plans take all the necessary precautionary planning measures to avoid UBTI.

The three most-used "blocker" structures for UBTI purposes are;

1. C corporations: A C corporation operates to block UBTI because dividends are exempt from UBTI treatment. The corporation pays corporate taxes, but the tax-exempt investor avoids UBTI (important, because many tax-exempt investors believe that reporting UBTI is a trigger for an IRS audit). However, the UBTI tax advantage achieved erodes investment returns through the potential tax burden at the corporate level.
2. Group trusts: A group trust may be formed for pension plans to pool all or a portion of their funds. If the group trust is made up exclusively of tax-exempt investors, the trust will be subject to UBTI. The group trust is only available to pension plans and only shifts the UBTI tax burden from the qualiied plan to the group trust.

23 A second issue for consideration is satisfaction of state insurance law and the need for a valid group; the cases that the author is aware of have used the employees of the endowment and foundation as representing a valid group.

3. REITs: Tax-exempt investors generally do not incur UBTI with respect to REIT investments. Investment in the REIT removes the tax-exempt entity from direct ownership of the real estate assets. The REIT also provides property type and market diversiication, investment scale, and allocation. REIT income is distributed pri¬ marily through dividends and capital gains.

Using Private REITs. The majority of real estate investments for tax-exempt investors are structured as either private REITs or public REITs. Private REITs seem to have far greater attraction for tax-exempt inves¬ tors than do publicly traded REITs, which are adversely affected from a valuation standpoint by factors such as interest rate changes, corporate scandals, day trading, and general market conditions. In short, the public markets introduce a whole new realm of market volatility to a real estate fund.

The fee structure for private REITs varies depending upon the spon¬ sor. A cursory review suggests that the cost of the REIT, independent of real estate management fees and investment advisory charges, is 35 to 50 basis points.

The private REIT offers several beneits as an investment vehicle:

- Single level of taxation: The REIT, whether private or public, deliv¬ ers a single level of taxation at the individual level.
- State tax iling: REIT shareholders do not have to ile state income tax returns in every state where the REIT owns property (unlike partners in a partnership). REIT shareholders need only ile returns in their state of residency.
- Leverage: REITs allow the investment manager to employ leverage at the fund level. In contrast to the REIT, investments through part¬ nerships typically rely on the fractions rule of Section 514(c)(9)(E).

Under the fractions rule, the exception for qualiied tax-exempt organi¬ zations to the acquisition indebtedness rules does not apply unless the allo¬ cation of items to the tax-exempt investor does not result in the tax-exempt investor having a share of partnership income which is greater than the taxexempt investor's share of partnership loss. The allocations must have a substantial economic effect. The REIT alleviates the technical and adminis¬ trative complexity of the fractions rule for partnership investments. However, REITS are subject to highly technical income, asset, distribution, and share ownership requirements.

Opportunistic real estate investments are dificult to structure through private REITs. REITs have many restrictions that limit the ability of the manager to administer these types of investments effectively. REITs have the following restrictions:

- Closely held limitation: It is impermissible for 50 percent of the REITs value to be owned directly or indirectly by ive or fewer individuals. Stock owned directly or indirectly by a corporation, partnership, or trust is considered to be proportionately owned by its shareholders, partners, and beneiciaries.
- 100 shareholder test: REIT stock must be beneicially owned by 100 or more shareholders during at least 335 days of the tax year beginning with the second year. Each entity that holds an interest in the REIT is treated as a shareholder.
- REIT distribution requirements: The fund must distribute at least 90 percent of its real estate investment income as a dividend annually. Dealer income is subject to a special 100 percent tax.
- REIT asset tests: The REIT must have at least 75 percent of the fund's total assets invested in qualiied real estate assets at the end of each quarter. The fund has a year to achieve this requirement. Qualiied real estate assets include real property interests and mortgages on real property interests. The remaining 25 percent of REIT assets may be invested generally without restriction. However, in the case of a taxable REIT subsidiary, securities in this class may not exceed 20 percent of the REITs total assets. The value of a single security cannot exceed more than 5 percent of the fund's value. The REIT cannot own more than 10 percent of the value of the voting securities of a single issue.
- REIT gross income tests: At least 75 percent of a REITs gross income must consist of qualifying income (qualifying income is primarily real property income or mortgage income on real property) and at least 95 percent of its gross income must come from qualifying property or other passive income. REITs must operate on a calendar year basis.

A "pension-held REIT' is a REIT where either (1) a single pension plan owns at least 25 percent of the REIT or (2) pensions own at least 50 percent of the REIT with each pension owning more than 10 percent of the REIT. In a pension-held REIT, the pension will receive dividends constituting UBTI in the same ratio that income constituting UBTI represents of total REIT income. If this ratio is less than 5 percent, no dividends will be treated as UBTI.

Alternative Structures Used to Overcome Disadvantages of REITs. The technical and administrative dificulty from a compliance standpoint for opportunistic real estate is signiicant. These deals often generate dealer income, which would create a 100 percent tax to the REIT.

A prohibited transaction includes property held primarily for sale in the ordinary course of a trade or business (i.e., a transaction that would generate dealer income). An example of a prohibited transaction would be the sale of land lots to developers.

Investment advisors have heretofore gone to great length to avoid UBTI treatment on real estate investments that might generate UBTI through com¬ plex joint ventures with taxable operators combined with a lease arrangement with the REIT. Several examples are set out below.

Participating Loans. Participating loans are utilized by tax-exempt investors in order to enable them to report "interest income" rather than a share of income from the underlying property. This debt instrument will create interest income, which is expressly exempt from UBTI treatment (as opposed to taxable partnership income that will pass through any UBTI). The debt instrument will also allow the investment partner to avoid any iduciary duty.

The disadvantages of participating loans include the investor's inability to vote its capital interest or participate as a board member of the borrower. The loans must also have a ixed maturity date.

Options. A tax-exempt investor may purchase a call option that allows it to invest in a partnership that generates UBTI. The exercise price of the call option is equal to the fair market value of the underlying partnership interest as of the date the option was granted. The exercise date is triggered by certain events, such as the sale of all of the partnership assets or an IPO. An exercise of the option prior to the sale of the patnership assets allows the investor to partic¬ ipate in the appreciation without realizing any UBTI from partnership assets.

The strategy uses a put option as well, in order to enable the investor to require the patnership to repurchase the call option for cash and to provide the tax-exempt entity with an alternative way to realize a share of the appre¬ ciation. The price the partnership would pay when the tax-exempt investor exercises the put option would be set at the fair market value of the partner¬ ship interest that underlies the call option or the strike price of the call option itself, whichever is greater.

Total Return Swap. Under the terms of a hypothetical swap, the tax-exempt entity would make payments to the swap counterparty as follows: (1) quarterly, the tax-exempt entity would pay an amount equal to the cal¬ culation amount multiplied by a cetain speciied index (e.g., a U.S. Trea¬ sury based index or LIBOR); and (2) at maturity of the swap, the tax-exempt entity would pay an amount equal to the net capital depreciation, if any, in the value of the capital account of the hypothetical investment in the fund, from inception of the swap to maturity. The swap counterparty, in turn, would make payments to the tax-exempt entity as follows: (1) quarterly, the swap counterparty would pay an amount equal to any net cash low distibutions that would have been made by the fund with respect to the calculation amount during the quarter; and (2) at maturity of the swap, the swap counterparty would pay an amount equal to the net capital appreciation, if any, in the value of the capital account of the hypothetical investment in the fund, from inception of the swap to maturity. The term of the swap would be materially less than the anticipated term of the fund. A total return swap could also be adopted for a particular real estate investment.

The use of notional principal contracts to mirror a real estate fund is complicated. The term of the swap must be less than the anticipated term of the fund in order to avoid arguments that the investor owns an interest in the fund. Liquidity is another issue that is dificult to manage using swaps.

Offshore Hedge Funds. Endowments and foundations in the past have avoided UBTI by investing in offshore hedge funds. These funds are usu¬ ally formed as corporations that are not controlled foreign corporations for tax purposes and distribute income as dividends to the tax-exempt investor. Dividend income is not subject to UBTI, However, the current political sen¬ sitivity and perceived political incorrectness of investing in tax-haven juris¬ dictions may warrant consideration of other structures instead. Offshore investing has come under great scrutiny. Offshore funds also face an inter¬ nal 25 percent limitation in the amount of ERISA funds they can manage.

Summary of Market Applications for GACs

The following two examples show how a GAC might be used by a tax-ex¬ empt investor or an independent real estate investment advisor targeting taxexempt investors.

> Example 1: John Smith is the director of real estate within the XXX State Retirement Plan. XXX is looking to allocate $250 million to several different opportunistic real estate investments that are UBTI-sensitive: senior housing ($50 million); hotel ($50 million); real estate mezzanine ($50 million); condo con¬ versions ($50 million); and timber ($50 million). Each of the programs has a different investment advisor. The programs will have multiple investments. Each of these investment funds is a managed account (i.e., not a commingled fund).
>
> Investment Structure: Acme Life creates a GAC program with aggregate pricing. Each investment advisor creates a limited part¬ nership that is exclusively available for investment through the pur¬ chase of the GAC. Each program will make multiple investments within the program. The program uses a capital call structure.

Acme has implemented a standby letter of credit (LOC) with XXX as a default mechanism for capital calls. The standby LOC structure works as follows:

XXX obtains a standby letter of credit nominating Acme Life as the beneiciary of the LOC.
Acme Life has the right to draw on the letter of credit to the extent that a tax-exempt investor defaults on premium/investment in the GAC.
Acme pledges its rights as beneiciary of the LOC to the lender.
The life insurer executes a power of attorney assigning its right to proceeds to the bank issuing the LOC (only to the extent the LOC is utilized).

Note that in the structure shown in Example 1, lenders will have the right to draw on the LOC if the investor (insurer, on behalf of the separate account) fails to pay to the fund (which failure would be based on the non¬ payment of the tax-exempt investor to the insurer). Also, the insurer, Acme, will be able to amend the PPM to include the additional fund offerings as the situation ripens.

Example 2: Armory Real Estate Fund is a real estate development fund marketing primarily to tax-exempt investors. The fund gen¬ erates dealer income that would be fully taxable to a tax-exempt investor as ordinary income. The investment strategy does not qualify for inclusion in a REIT because the dealer income created would subject the REIT to a 100 percent tax. The fund will even¬ tually have 20 to 30 different properties. The capital structure is identical to that outlined in Example 1.

Planning Solution: Armory creates a fund offering that is exclu¬ sively available through the purchase of the GAC, using a capital call structure. Acme Life is the beneiciary of a line of credit using the tax-exempt investor's creditworthiness. Acme draws on the line of credit to fund Armory's capital calls. The GAC is to be marketed to pension plans, endowments, and foundations.

The GAC Market for Foreign Investors

Overview, Foreign real estate investors and their investment advisors have a high degree of interest in tax structuring for investment in U.S. real estate. While some of the tax structures used are very complicated and deliver lim¬ ited results, the GAC has the potential to deliver very compelling results to the foreign investor.

Prior to the adoption in 1980 of FIRPTA—which was adopted to ensure that foreign investors would pay U.S. taxes—sophisticated real estate investors were able to avoid U.S. taxes on the disposition of their U.S. real property holdings. The tax rules for FIRPTA are found in Section 897. Now, a foreign real estate investor is treated as being engaged in a U.S. trade or business in the year of sale. The gain or loss from the transaction is treated as effectively connected with a U.S. trade or business.

FIRPTA introduced a federal withholding system that requires the buyer of the property to deduct, withhold, and remit to the federal government 10 percent of the gross sales price within 20 days of the sale. The buyer becomes personally liable for this withholding procedure. The foreign investor who is subject to regular U.S. taxes on rents and capital gains must apply for a refund to the extent that the tax withholdings exceed the actual tax liability.

The following observations provide a technical overview of how the GAC works for foreign investors and how other providers have structured real estate transactions using the GAC.

Who Is a Foreign Real Estate Investor? A foreign investor is consid¬ ered a non-resident taxpayer for U.S. tax purposes. Generally speaking, for tax purposes, a resident either has a "Green Card" or spends too much time in the U.S. under the substantial presence test. U.S. residents are taxable on worldwide income.

How Are Foreign Real Estate Investors Taxed? Taxation depends on whether the real estate activity rises to the level of being considered involved in a U.S. trade or business. If the foreign investor is deemed not to be involved in the conduct of a trade or business, the tax is equal to 30 percent of the gross rents without the beneit of any deductions (however, a tax treaty may reduce this rate). If the real estate activity rises to the level of a U.S. trade or business, the foreign investor is taxed on net income under the regular progressive tax rate structure and receives the beneit of any related deductions. Section 871 subjects "ixed and determinable income" (including rents and annuities) to a 30 percent withholding tax. Section 871 (a) subjects real estate income and capital gains to a 30 percent with¬ holding tax. This level of taxation is generally followed in most income tax treaties with the United States.

A foreign real estate investor may elect under Section 882(d) to treat its real estate activity as a U.S. trade or business. Foreign corporations involved in U.S. real estate may also be subject to an additional tax, the branch proits tax.

Foreign investment in U.S. real estate funds will generally create investment income that is treated as effectively connected to a U.S. trade or business for federal tax purposes. This income is subject to taxation at graduated rates based upon the distibuted (i.e., realized) income. "Effectively connected income" is subject to a 35 percent withholding tax under Section 1445. This is applied to the gain recognized on the disposition of a U.S. real estate fund or the sale of a "United States real property interest" to the extent that the gain is allocable to a foreign partner. A United States real property interest is any interest (including stock in a "United States real property hold¬ ing corporation") in real property located in the United States other than an interest solely as a creditor.24

A United States real property holding corporation is a corporation in which U.S. real property interests equal or exceed 50 percent of the fair mar¬ ket value of its total real property interests plus any other assets.25

The private REIT is a common structure for foreign investment in U.S. real estate. Most tax treaties have a reduced rate for dividend income of 15 percent.26 Whereas the capital gain for the sale of REIT shares is gener¬ ally not subject to taxation for the foreign investor, the distribution of capital gain from the sale of a property is subject to the FIRPTA withholding rules. Shares in a "domestically controlled REIT" are not considered U.S. real prop¬ erty interests and thus are not subject to the FIRPTA withholding. A domes¬ tically controlled REIT is any REIT where foreign persons own, directly or indirectly, less than 50 percent of the REIT during the testing period. The testing period is the shorter of the ive-year period ending on the date of the disposition or the period during which the REIT was in existence.27

A "foreign controlled REIT" is a U.S. real property interest subject to the withholding rules of Section 1445. Note that, under Section 1446, a real estate fund is required to make periodic installment payments of a withholding tax to the IRS based on the highest corporate or individual rate. If a fund uses this installment approach, the fund is not required to withhold under Section 1445 and thus is not considered a foreign controlled REIT. Moreover, a fund's withholding obligation does not alleviate a foreign partner's tax obligation to ile a federal tax return. The withheld tax is treated as an estimated tax pay¬ ment and is applied as a credit against the ultimate income tax liability.

How May the GAC Be Used by Foreign Investors in U.S. Real Estate? The annuity provisions of the Model Income Tax Treaty28 have been incorporated in the majority of existing tax treaties. Model Income Tax Treaty

24 IRC § 897(c)(1).

25 IRC § 897(c)(2).

26 See, e.g., the Danish, German, Finnish, and Belgian Treaties which have reduced withholding taxation on qualiied dividends.

27 See Treas. Reg. § 1 .897-1 (c)(2).

"Model Income Tax Treaty, Nov. 15, 2006, Article 17-1, 17-3, and 18.

Article 18 provides favorable treatment for annuity income: it is taxed only in the home jurisdiction and is not subject to taxation or withholding in the U.S. Most pension plans will not be subject to taxation in the home jurisdiction. Many foreign jurisdictions also provide favorable taxation for life insurance and annuities.

The tax treaty definition of an annuity is quite basic in most cases. In a few of the newer treaties, the tax beneits are applicable only to annuities that are beneficially owned by individuals, in a manner similar to Section 72(u).

Treaty provisions override the 30 percent withholding tax imposed under Section 871. These overrides may apply even if it is determined that an annuity is not a valid annuity under U.S. tax law but is nonetheless a valid annuity under the definition stated within the applicable tax treaty. Effec¬ tively, the treaty deinition of an annuity supersedes the Section 72 deinition of an annuity. The IRS has issued a favorable private letter ruling examining this issue.[29] As a practical matter, it is nonetheless advisable to create a GAC that complies with the requirements of U.S. tax law.

Can a Foreign Government Entity Use an Annuity to Invest in U.S. Real Estate? Section 892 provides an income tax exemption to for¬ eign governments that invest in domestic stocks, bonds, and "other domes¬ tic securities." This income tax exemption does not extend to investment in commercial activities including real estate.

However, Regulation Section 1.892-3T(3) deines "other domestic securities" to include annuity contracts. Therefore, a properly structured annuity with a real estate investment option will not be subject to the normal taxation and withholding requirements for U.S. real estate investments or FIRPTA withholding requirements. The character of the income is converted to annuity income, which is exempt income for the foreign government under Section 892.

Example 3 shows how a GAC might be used by a foreign investor or an independent real estate investment advisor targeting foreign investors.

> Example 3: The government of Country Z has investment ofices in New York City and San Francisco that focus on U.S. investment opportunities. The Country Z government is looking to make sig¬ niicant investments in multi-family housing. Taurus Investments, an independent investment specialist in multi-family housing, will manage the investments. Taurus will have discretionary authority over all investment decisions.

29 PLR 9806012 (Nov. 10, 1997). A pivate letter ruling is not authoity for all purposes, but it does provide an indication of the IRS's views.

Planning Solution: Taurus creates a new fund that is exclusively offered through the purchase of a Deleware Financial Life Assurance (DFLAC) GAC that is a U.S. tax qualiied annuity contract. The GAC is issued in New Jersey, which has favorable insurance regulation regarding GACs. DFLAC is not licensed to issue the GAC in Country Z. The policy is issued through a U.S. bank custodian that owns the insurance contract for County Z's beneit. The custodian structure eliminates any argument regarding solicitation by a non-admitted carrier. The custodian, which serves as a custodian for many of Country Z's other investments, has business operations in New Jersey.

What Other Investment Categories Are Suitable for the Foreign Investor? Generally, any investment that is subject to any U.S. taxation or withholding is a prime candidate for investment within the GAC. Investments in agriculture, oil and gas, co-generation, and real estate, or a leveraged buyout would generate effectively connected income—which, as previously noted, is subject to a 35 percent withholding tax. Section 871 provides for a 30 percent withholding tax on ixed and determinate income. While many tax treaties reduce these rates substantially (interest income is generally subject to a 10 percent withholding tax, and dividend income to a 15 percent withholding tax), the GAC converts the income into "annuity" income that simply is not subject to U.S. taxation and withholding pursuant to tax treaties. That is, the GAC eliminates taxation and withholding.

Life settlement contracts have become an interesting investment to a number of foreign investors.[31] Life settlements are the purchase of life insurance policies in the secondary market. From an investment perspective, these are investment grade bonds (assuming the underlying life insurer has an investment grade rating) with junk bond returns. As the investment is mortality driven—i.e., the insured must die sooner or later—these investments are non-correlated investments to the bond and equities markets. Revenue Rulings 2009-13[32] and 2009-14[33] now subject the investment returns to a 30 percent withholding tax. Again, the GAC can overcome this tax treatment,

[31] Lite settlements are politically sensitive investments, and U.S. institutional investors have yet to become active investors in the this market. For a college endowment, e.g., the public and alumni may look unfavorably at investment in life settlements, despite favorable investment attributes. That said, structuring such an investment within a GAC may completely mask the issue. The GAC itself would be recorded on the investor's balance sheet, rather than the annuity's underlying investment in a life settlement fund.

[32] 2009-1 CB 1029.

[33] 2009-1 CB 1031.

converting the character of the income to annuity income that falls within the favorable tax treatment of a tax treaty.

Summary

The GAC is an excellent tax structuing vehicle for both tax exempts and foreign institutional investors, but while some of the best known institutional investors have utilized GACs, the structure remains largely under the radar. Investors' and advisors' lack of familiarity with insurance products in general has not helped the matter. This article sets out in a straightforward manner the tax rules and tax treatment that apply, and provides a variety of possibilities for structuring institutional investment in a wide range of alternative GAC-based investments. Experience will demonstrate to fund promoters and investors alike that the cost and process for utilizing the GAC is far easier than the tax structuring track along which they have been traveling.