United States: Like Oil and Water - Using Private Placement Variable Deferred Annuity (PPVA) Contracts To Enhance the Investment Return Of Foreign Investors In MLPs

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Overview

Master Limited Partnerships are publicly traded partnerships. The MLP universe -- which in 2000 had 18 companies with a collective $14 billion in market value -- now has 113 companies with some $460 billion. MLP investment returns have beaten the Standard & Poor's 500 for 12 straight years. For the ten year period ending in December 2013, the total return for MLPs was 15.03 percent. Not bad!

These publicly traded partnerships invest primarily in energy and associated commodities - natural gas, propane, marine transportation, asphalt, coal, crude petroleum product chain, timber et al. MLPs are well positioned to generate high-single-digit to low-double-digit total returns over time consisting of a tax-advantaged average yield of 5.7 percent and annual distribution growth of 3-5%.

MLPs typically deliver a tax advantaged distribution to investors. Approximately 80 percent of the quarterly distribution is treated as a non-taxable return of capital. Approximately 20 percent of the distribution is treated as income. In the early years, the income is heavily sheltered by equipment depreciation and the depletion allowance. Since the publicly traded MLPs are treated as a partnership for tax purposes, the basis of the investor's unit is a key measure for taxation when units are sold. Once the units are sold, a portion received capital gains treatment and a portion is subject to taxation as ordinary income for recapture of any depreciation and depletion allowance.

What is a private placement variable annuity?

An annuity contract is a contract between the policyholder and insurance company to pay an annuity to the policyholder. Insurance companies offer two types of annuities – immediate and deferred. Immediate annuities provide a stream of payments at fixed intervals (monthly/quarterly/semi-annually or annually). The annuity is paid for a term of years or based on a life contingency such as "life only" or "joint and survivor." The payments end at the end of the fixed term or death of the annuitant (measuring life).

A deferred annuity is a deferral of that promise to make a series of payments to the policyholder. The deferral may be set for a fixed period of time. Many contracts list a maximum age of 85 or 90 for the deferral period. The account value in a "fixed" annuity is based upon the crediting rate based upon the insurer's investment performance on general account assets. Most insurance general account investments are in investment grade bonds.

A fixed deferred annuity provides the policyholder with a 'fixed' crediting rate declared by the life insurance company based upon the investment return of its general account assets. Most life insurers invest their general account assets in long-term investment grade bonds.

In a variable deferred annuity contract, the investment performance is based upon the investment performance of the life insurance company's separate account funds. These funds are segregated from the insurer's general account assets as a matter of state insurance law. Traditionally, these funds within retail variable annuity contracts are mutual fund clones or sub-accounts managed by investment management firms in the mutual fund industry. The investment performance for these accounts is a direct pass-through to the policyholder.

The private placement version of this product is for accredited investors and qualified purchasers based upon the definition under federal securities law. The products are institutionally priced with no surrender charges. Retail variable annuities frequently have back end surrender charges on a declining basis over a five-year period. The investment options within the private placement version are sophisticated and flexible including hedge fund, private equity and real estate options as well as traditional mutual fund-like options. Why not MLPs?

The MLP Problem for Foreign Investors

Foreign investors and their investment advisors have a high degree of interest in tax structuring for investments in U.S. real estate and income that is effectively connected to a U.S. trade or business (ECI).

Many of the tax structures currently used are very complicated and deliver limited results with a moderate to high degree of tax leakage. The PPVA has the potential to deliver very compelling results to the foreign investor private or sovereign wealth fund.

The PPVA has the unique ability to convert the character of ECI for tax purposes into an "annuity" which is not subject to U.S. income and withholding under virtually all of the double tax treaties with the United States. No other tax structure is without any tax leakage, low administrative cost and technical simplicity, e.g. once you understand what a variable annuity is and how and why it works.

The MLP is generally a very tax-advantaged alternative investment that generates a high degree of cash flow. Most data on MLPs seems to suggest that 70-90 percent of MLP distributions are treated as a non-taxable return of capital with approximately 20 percent of distributions being treated as income.

MLPs also use an accelerated 15-year depreciation schedule which shelters income distributions. The trade-off is that distributions reduce the investor's tax basis and upon sale, a portion of the gain is treated as ordinary income due to recapture.

The PPVA is able to capture and convert all of this taxable income into non-taxable "annuity" income. A life insurer is taxable on all of its investment income within the separate account and is able to take a reserves deduction for all of its investment income within the separate account.

Foreign investors that do not have the benefit of a favorable income tax treaty can also take advantage of PPVA purchasing from a non-U.S. based insurer that has not made an election under IRC Sec 953(d) to be treated as a U.S. taxpayer. The company should be a controlled foreign corporation (CFC) owned by a U.S. parent. Effectively, a combination of the tax treatment of life insurance companies for the reserves deduction on investment income in the life insurer's separate account and the offshore CFC status and ownership by its U.S. based parent life insurer, allow the offshore life insurer to receive a full tax refund of all of the withholding for effectively connected income (ECI).

A foreign investor is taxable in theory on annuity distributions or surrender of the annuity contract. Without the benefit of a tax treaty, a foreign policyholder would be subject to a 30 percent withholding tax under IRC Sec 871(a). Virtually all of the double tax treaties exempt annuity income from income and withholding tax treatment for U.S. purposes. The policyholder without the benefit of a tax treaty is able to take distributions from the policy without the thirty percent withholding tax under IRC 871(a).

Sovereign wealth funds are taxed under IRC Sec 892. IRC Sec 892 treats an annuity contract as a domestic security whose income is tax exempt. As a result, the PPVA has the ability to convert MLP income that might be taxed as ECI into tax exempt income. Equally as important from a non-tax standpoint, the use of the PPVA eliminates the need to file a federal and state tax return and also eliminates K-1 reporting to the foreign investor.

a) MLPs

Foreign investors are fully responsible for federal income tax liabilities stemming from effectively connected income (ECI), or income derived from a U.S. trade or business. Foreign owners of MLP units will have all of their distributions subject to withholding at the highest marginal tax rate under IRC Sec 1446 - 35 percent for corporations and 39.6 percent for individuals. Additionally, MLP sponsors must withhold at the state level for foreign investors.

Foreign owners of MLP units will have all of their distributions subject to withholding at the highest marginal tax rate. This differs from a U.S. investor who is subject to taxes (payable after the fact) on their allocated net income, which is typically substantially less than the distributions earned.

The result of this excess withholding is that a foreign investor is subject to more taxes than a domestic investor is on an annual basis, and must file a U.S. federal tax return to get a credit back on the excess withholding. This credit goes towards paying the foreign investor'staxes on gains, resulting in an after-tax return equivalent to his U.S.based MLP investor. The bigger problem is that most foreign investors are loathe to be in the position of having to file a federal return, let alone multiple state level returns.

The PPVA is a complete solution to this problem. The life insurance company separate account is considered the legal owner of the investments and as a U.S. taxpayer, is not subject to any of the foreign withholding taxes under IRC Sec 1446. The quarterly distributions paid by the MLP to the insurance company separate account are not subject to any withholding taxation. No taxation on capital gains or depreciation or depletion recapture is applicable.

The life insurer is technically taxable on this income but receives a reserves deduction equal to its investment income within the separate account. Furthermore, the foreign investor does not have a need to file a federal or state level tax return. The only K-1 in this scenario is a K-1 sent by the MLP sponsor to the life insurer.

b) Tax Treatment of Annuity Income under U.S. Tax Treaties

The annuity provisions of the Model Income Tax Treaty have been incorporated in the majority of existing tax treaties. Article 18 of the Model Income Tax Treaty provides favorable treatment for annuity income.

The Model Treaty provides that annuity income is only taxed in the home jurisdiction and 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.

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

Treaty provisions override the 30 percent withholding tax imposed under IRC Sec. 871. These overrides may apply even if it is determined that the annuity is not a valid annuity under U.S. tax law but nonetheless a valid "annuity" under the definition within the tax treaty.

Effectively, the Treaty definition of an annuity supersedes the tax law definition of an annuity in IRC Sec. 72. The IRS has issued a favorable Private Letter Ruling (PLR 980612) examining this issue. A Private Letter Ruling is not law, and may not be relied upon by a taxpayer, but provides an indication of the IRS' position on different tax issues.

As a practical matter, I believe that it is nonetheless advisable to issue a PPVA that complies with the requirements of U.S. tax law. For a high net worth investor, the policy should be issued by an offshore carrier that has made an IRC Sec 953(d) election. This carrier level election treats the offshore carrier as a U.S. taxpayer eliminating any withholding obligation for ECI.

Additionally, the annuity contract is not considered a U.S. sitused asset for federal estate tax purposes eliminating any potential estate tax exposure for the foreign investor.

c) Tax Treatment of Annuity Income for Sovereign Wealth Funds

IRC Sec. 892 provides an income tax exemption to foreign governments, which invest in domestic stocks, bonds, and "other domestic securities". This income tax exemption does not extend to investment in MLPs and commercial activities including real estate.

However, Reg.1.892-3T(3) defines "other domestic securities" to include annuity contracts. Therefore, a properly structured annuity with a MLP investment option will not be subject to the normal taxation and withholding requirements for ECI and 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 IRC Sec. 892. Additionally, the foreign government will not a tax filing income at the federal or state level.

Summary

MLPs are very attractive investments in general. MLPs provide high cash flow distributions and total returns that are heavily tax sheltered in the early year of the investment. Nevertheless, MLP withholding on MLP distributions for foreign investors is confiscatory. Eventually, these tax benefits come back to "bite" the investor in recapture when the investment is sold. MLPs are the investment version of "Buy now and pay later".

The tax treatment for foreign investors for the foreign investor is subject to withholding taxation at the highest federal level and state level. The favorable tax treatment of annuity income under most tax treaties can avert these problems and produce an investment return that is exempt for tax purposes. The PPVA solution can be equally effective even where the foreign investor does not have access to the benefit of a tax treaty.

MLPs within PPVA provide for high cash flow, high total returns, high liquidity, and no U.S. income and withholding taxation.

The planning technology of PPVA provides a creative and exciting method to enhance the tax and withholding treatment for foreign investment in MLP by high net worth and institutional investors. The result is a much higher net investment return. PPVA is equally effective as a tax structuring vehicle for other investments that are subject to ECI tax treatment including real estate.