

and inexpensive blocker of UBTI.

A PPVA investment account eliminates UBTI by changing the character of the underlying IDF investment from UBTI to passive income. IRC Section 72(u)(1) states that the income earned in an annuity owned by a non-natural person won't be tax-deferred, but, instead, will be currently taxable as annuity income. The PPVA investment account should enable tax-exempt entities to invest without penalty in investments that would otherwise introduce UBTI.

The IRS has issued several favorable private letter rulings to tax-exempt organizations, including endowments and foundations, which have supported a PPVA investment account's ability to block UBTI.³

Current UBTI blocker arrangements should be reviewed and compared to a PPVA investment account, particularly offshore arrangements that can be complex, expensive and potentially subject to greater scrutiny.

How It Works

IRC Section 72 states that a PPVA qualifies for tax treatment as an annuity if:

1. It's administered by an insurance company and allows for the systematic distribution of principal over a period of payments;⁴ and
2. Its investment offerings are structured as IDFs that are available only to qualified insurance companies.⁵

PPVA investment account values are treated as separate account assets and, therefore, aren't subject to the claims of an insurance company's creditor.

The reallocation of PPVA account assets from one IDF to another shouldn't be a taxable event, and the PPVA account can be transferred tax-free under IRC Section 1035 from one insurance company's administration platform to another's. Because there are generally no upfront fees relating to PPVA investment accounts, this transfer is a frictionless transaction.

Withdrawals from a PPVA account are taxed on a last-in, first-out basis (with the taxable gain recognized until all that remains is the cost basis), and there's a 10 percent excise tax on gains for withdrawals taken before the owner's age 59½.⁶

Structuring Customized Account

The process of creating a new IDF with an investment manager and an investment mandate that a client finds attractive has become dramatically less expensive.

As the time and cost to create a safe-harbor IDF has declined, more and more top-tier investment management firms have created, or are in the process of creating, IDFs to enable the most tax-inefficient segments of their investment portfolios (alternative asset class investments, such as hedge funds, high-yield bond funds, direct lending credit vehicles and high turnover portfolios) to be managed on a tax-deferred basis through a PPVA investment account.

To qualify for a PPVA investment account, a client must be an accredited investor.

In addition, many leading investment managers manage more traditional multi-asset class portfolios in customized IDFs. In many cases, a customized IDF can be created and attached to an insurance company segregated asset account platform cost effectively with as little as \$25 million.

There are two basic rules that must be followed for an IDF to achieve deferral from current period taxation:

1. **Diversification.** The IDF must be properly diversified. The diversification requirement is defined in IRC Section 817(h) as: no more than 55 percent of the IDF assets may be allocated to one underlying fund or security; no more than 70 percent of the IDF assets may be allocated to any two underlying funds or securities; no more than 80 percent of the IDF assets may be allocated to any three underlying funds or securities; and no more than 90 percent of the IDF assets may be allocated to any four underlying funds or securities. A violation of the diversification requirement can result in the PPVA investment account being subject to current period taxation on all embedded gains in the contract and cause the loss of tax deferral