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Recent Developments Could Increase the Attractiveness of Hedge Fund Life Insurance And Annuities

By James R. Cohen, Esq. and Jeffrey S. Bortnick, Esq.

MANY HEDGE FUNDS and other investments whose returns are based on short-term trading are tax inefficient. Good gross returns can be reduced by 40% or more by income taxes (including state and local taxes). For over a decade, hedge fund investors have used private placement life insurance (PPLI) to eliminate or defer income tax on hedge fund and other tax inefficient earnings and, with proper estate planning, reduce or eliminate the estate tax as well. PPLI can provide a large tax-free death benefit for a cost that is often much less than the tax savings gained.

Despite the significant wealth accumulation benefits for certain hedge fund investors, in the past, many conservative taxpayers were unwilling to seriously consider PPLI invested in hedge funds, fearing that the IRS would not allow the expected tax benefits. In recent years, the IRS has issued rulings and changed the regulations ("Recent IRS Guidance") to prevent the tax benefits on certain PPLI invested in hedge funds. Tax advisors experienced in PPLI are advising that the Recent IRS Guidance helps to chart a course, as long as certain rules are followed, to achieve substantial tax benefits through PPLI. The Recent IRS Guidance has resulted in increased activity and innovations concerning PPLI, thereby making PPLI more attractive to more hedge fund investors.

What is Hedge Fund Life Insurance?

Hedge fund life insurance is life insurance with a separately invested account for that policy's cash value, which is invested in a hedge fund or a group of hedge funds.
The pure insurance portion is essentially low-cost term life insurance, which allows the entire investment, including the cash value, to qualify as life insurance. For example, for a 50-year old who is investing $5 million, the pure insurance would need to be about $10 million (a $15 million policy), so the pure insurance needs to be a little more than twice the premium invested. At age 60, the life insurance roughly equals the cash value. The amount of life insurance relative to the cash value keeps going down, until, at age 90, it more or less disappears. The costs of setting up and maintaining the policy are charged to the account, and the account grows (or shrinks) depending upon the success of the investment.

The life insurance is placed on someone's life (the insured), and at that person's death, the policy pays to the beneficiary the amount of pure (term) insurance then in place, plus whatever is in the cash account – free of income tax. The entire death benefit (including all the earnings from the hedge funds and/or separate accounts) is received by the beneficiary free of all income tax. If the owner surrenders the policy before the death of the insured, the income generally is taxed at ordinary rates (plus possibly an excise tax of 10 percent of the gain, if he or she is under age 59½). Under certain policies (that is, policies that are not modifed endowment contracts), the excise tax does not apply and as long as the contract is not terminated, a substantial portion of the cash can be withdrawn as a policy loan, income tax-free.

Benefits

The chart on the bottom of page 3 compares the return on a sample hedge fund life insurance policy purchased at age 50 for $5 million against a taxable investment of $5 million. The chart assumes a 12% return per year on the hedge fund investment and uses the costs of an actual policy. The taxable account column assumes a

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35% tax rate. Of course, the chart simply shows illustrated results. The ultimate results will depend, among other things, upon the actual charges imposed by the particular insurance company, the actual investment performance achieved by the hedge funds selected and the investor's actual marginal income tax rate.

Under the assumptions of the chart at the bottom of this page, the tax benefits are very substantial. After 40 years, the End of Year Cash Value within the policy and Death Benefit are each over $240 million more than (or over 300% of) the amount remaining if a 35% income tax rate (which is less than the federal and state or local combined tax rate for many taxpayers on ordinary income or short term capital gain) were payable each year.

Hedge Fund Annuities

Hedge fund annuities are similar to hedge fund life insurance, but do not provide a sufficient death benefit to be considered life insurance for U.S. income tax purposes. Although annuities generally cost less than life insurance, annuities defer but do not eliminate U.S. income tax. The tax benefits of annuities (from tax deferral) are much less than PPLI, but if the deferral is long enough at a high enough rate of return, it can be worthwhile. Hedge fund annuities are often considered by investors for whom life insurance is not appropriate, such as someone who is not insurable or insurable only at high costs, someone who does not want to undergo insurance underwriting and medical exams, or for an investor who does not have an insurable interest or wants to invest so much in the product that the insurer can not write enough life insurance (i.e. the amount exceeds the insurer's capacity).

Asset Protection

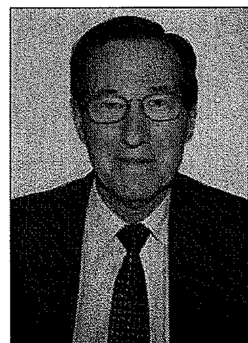
An additional benefit of the life insurance or annuity policy is that it generally is a good form of asset protection. The funds in the separate account of the insurance company are generally not exposed to creditors' claims against the insurer arising out of any of the insurer's other operations, and the separate account is generally protected from the claims of creditors of the policy owner.

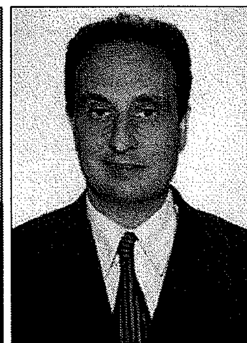
Estate Planning

Hedge fund insurance works particularly well in estate and gift planning structures because it combines the benefits of long-term income-tax free hedge fund returns with life insurance. Most investors consider this product as a remedy for tax inefficient hedge fund returns, and consider any life insurance as an unintended byproduct or cost of the income tax benefit. However, the life insurance is often useful for estate planning and this product can be a catalyst to discuss effective estate planning. By arranging for a trust to own the hedge fund life insurance, very large estate tax savings are possible. The estate tax savings through trusts, combined with income tax-free hedge funds returns and large death benefit, can greatly increase after-tax returns.

Which Hedge Fund Investors Should Consider These Life Insurance Policies or Annuities?

Hedge fund life insurance is not for everyone. Since insurance companies often require high minimum premiums (often at least $1 million in premiums for each policy), it is generally appropriate for only wealthy individuals or families.





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The biggest problem for a potential investor (other than the high minimum) is generally that there is some loss of investor control. Although the investment manager of the insurance company's separate account can generally change investments or reallocate among hedge funds whenever he or she wants to do so, the policyholder cannot hire or fire the investment manager, or move or reallocate assets whenever he or she wants to do so. The insurance company ultimately has the power to hire or fire the investment manager. Some policies give policyholders some choice concerning the investment of the separate account, and, of course, the policyholder can always surrender the policy (with negative tax consequences) or move the policy to a different insurance company (incurring brokerage commissions and other costs). The investor control issue is one of the trickiest issues related to this type of policy since, if the policyholder has too much investor control, the IRS might be able to claim that the investor should be taxed on the earnings currently. Recent developments have increased the availability of insurance dedicated investment choices within hedge fund insurance policies, thereby reducing some policyholders' concerns about loss of investor control.

Recent IRS Guidance

The government last year finalized a regulation[1] and in 2003 issued two revenue rulings[2] (together in this article called the "Recent IRS Guidance") which place some restrictions on the tax advantages of hedge fund insurance. The Recent IRS Guidance does not

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Age	Single Premium	End of Year Cash Value	Death Benefit (including cash value)	Taxable Account (at 35% tax)
50	$5,000,000	$5,398,996	$17,782,027	$5,390,000
53		6,561,573	17,782,027	6,263,632
60		13,594,803	18,217,036	10,596,382
70		39,928,676	46,317,264	22,456,663
80		117,942,390	123,839,720	47,591,877
90		343,582,426	360,761,548	100,860,340

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prevent such policies from investing in hedge funds, nor change the income tax deferral and elimination (or estate tax planning) benefits of such policies. In order to meet the diversification requirement so that the policyholder will not be taxed on hedge fund earnings, the regulation requires that the insurance policies either: (1) invest in a hedge fund which is open to insurance companies only, or (2) invest in a diversified portfolio of at least five hedge funds, if the hedge fund investments are open to non-insurance investors. The revenue rulings also place restrictions on the insurance policyholder's ability to choose the underlying hedge fund investments (especially if the hedge fund allows non-insurance investors).

The new Recent IRS Guidance eliminates the ability for an investor to choose to invest in a policy whose cash value is invested in a single hedge fund which is open to any investor other than through insurance policies. Although this requirement limits choice, it has also allowed many investors, hedge funds and insurance companies to feel more comfortable that their expected tax benefits are achievable, in particular if the cash value is invested in a hedge fund open only to insurance companies.

As a result, many hedge funds or funds of funds have formed or are forming insurance dedicated funds, open to insurance companies only. An insurance dedicated fund (sometimes called a "cloned fund") often invests similarly and receives the same or similar investment returns as the same manager's existing hedge fund or fund of funds. Some insurance companies are issuing policies which allow investors to choose among many such insurance dedicated funds. Properly structured, the IRS guidelines allow such investments, including the investor's right to periodically reallocate the investment among a number of cloned funds. In recent years, more and more insurance policies are being issued with more and more choices of so called "cloned funds." The increased choices and perceived lower tax risk have sparked increased interest in hedge fund insurance.

Example of Hedge Fund Insurance With Choices

As an example, a hedge fund insurance policy with investor choice might give the investor the ability to choose to allocate the cash value of the policy among seven insurance dedicated hedge fund choices.

One choice might be an insurance dedicated "clone" managed by a hedge fund manager specializing in Asian investments.

Another choice may be an insurance dedicated fund managed by a fund of funds manager.

A third choice may be an insurance dedicated clone of a distressed securities hedge fund.

A fourth choice might be an insurance dedicated clone of a convertible arbitrage hedge fund.

A fifth choice may be an insurance dedicated clone of an equity long/short hedge fund.

A sixth choice may be an insurance dedicated clone of a global macro hedge fund.

A seventh choice might be an insurance dedicated clone of an event driven hedge fund.

The policyholder/investor can choose the percentage of the cash value allocated to each choice, and periodically change the allocation. The hedge fund insurance investor does not have the right to invest in any hedge fund it chooses. The choice is limited to the seven choices, although the insurance company may add or eliminate choices. However, if the hedge fund choices available within the policy are attractive, this degree of investment control may well be sufficient to satisfy the investor. Since hedge fund insurance is often purchased to achieve tax-free hedge fund returns, it is necessary that the investor is happy with the investment choices and the potential economic returns expected. One of the key recent developments is that insurance companies are offering more investment choices. As a result of the recent IRS guidance and rulings, more managers are forming insurance dedicated funds. Therefore, potentially more attractive investment choices are available through hedge fund insurance.

Insurance Product Chassis

Another recent innovation concerns the insurance product chassis. PPLI has traditionally been sold as other life insurance through illustrations based upon specific assumptions. The assumptions involve a separate current and guaranteed set of charges from the insurance company. The difference between the current and guaranteed rates can have a huge effect on the after tax returns under the illustrations. The illustrations are time consuming to produce and often hard for clients and their advisors to understand. Furthermore, many investors have had unfavorable experiences with insurance illustrations. In the low-interest environment of recent years, the actual performance of many policies have been much worse than the original illustrations used when the policies were purchased. Some hedge fund investors have been unwilling to make a large investment expected to last over 25 years in which the insurance company can raise its charges (even within specified guaranteed maximums) without the investor's consent. At least one recent insurance product tries to solve these concerns by bundling insurance company costs and expenses and guaranteeing them over the life of the insurance contract. This eliminates the need for illustrations, simply a flat charge and a death benefit factor page, making the product easier for the investor's advisor to explain, and for the investor to understand.

The availability of insurance dedicated funds, pricing innovations, and the tax-free build up with successful hedge fund or investment managers, and the income tax deferral or the income tax-free, and possibly estate tax-free, payout at death, make these policies very attractive to certain wealthy investors.

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Hedge fund insurance as part of an overall portfolio

The greatest tax benefits from hedge fund insurance result when the policy is held until the death of the insured, because the death benefit is received free of income tax and possibly estate tax. Therefore, hedge fund insurance is often purchased with only a portion of a wealthy investor's assets – the portion not expected to be needed before the death of the insured.

Most wealthy investors have a diversified portfolio of investments consisting of different investment strategies. In deciding the investment strategy for hedge fund insurance, the policy owner's overall investment mix should be considered. Diversifying a portfolio with high-yield, short-term trading, or other tax-inefficient strategies, is often considered beneficial for minimizing risk and increasing returns. Hedge fund insurance often allows high-yield and short-term trading strategies to be added to one's investment mix without adding tax inefficiency.

Because a tax deduction to the policy owner is not available for losses on returns inside the policy, assets expected to produce high, consistent, absolute returns are good candidates for PPLI. Investments that are either highly tax efficient or so speculative that losses are contemplated are generally not the best candidates for PPLI investments.

Conclusion

Although hedge fund life insurance and annuities are not for everyone, in the right circumstances, they can provide very significant benefits. Recent developments have restricted some forms of hedge fund life insurance and annuities, but have not limited the very significant tax advantages of properly structured policies. The Recent IRS Guidance may increase the popularity of private placement life insurance and annuities invested in insurance dedicated hedge funds. It is often difficult to market a financial product in the absence of tax clarity. The Recent IRS Guidance increases the tax safety of some of these policies and, in any event, makes the position of the IRS clearer. This clarity, together with increased insurance dedicated fund investment choices and insurance chassis innovations, should make hedge fund insurance more attractive to certain hedge fund investors and their advisors

[1] *Reg. Section 1.817-5(f) was amended by revoking Reg. Section 1.817-5(f)(2)(ii), TD 9185, 70 FR 9869, March 1, 2005.*

[2] *Revenue Ruling 2003-91 and Revenue Ruling 2003-92.*

* *Portions of this article were adapted from an article in the May 2006 Trust and Estates, "PPLI Invested in Hedge Funds."*

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