Domestic Private Placement Life Insurance and Annuities Can Substantially Increase Hedge Fund After-Tax Returns

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Many hedge funds have impressive before-tax returns. However, for many hedge funds whose returns are based on short-term trading, their returns may not be as impressive on an after-tax basis. Income taxes on such returns can be as high as 40% to 50% (depending on the investor's state and local tax rate). Although tax planning for hedge funds can often improve after-tax returns (such as by deferring gains), recent changes in the tax law, such as the constructive sales rules, have made tax deferral more difficult.

Although many hedge fund investors believe that there is little that can be done about "death or taxes," hedge fund life insurance has the potential of eliminating income tax on hedge fund earnings and, as discussed below, with proper estate planning, eliminating estate tax as well. Unfortunately, even hedge fund life insurance cannot provide immortality but it generally provides a large tax-free death benefit for a cost much less than the tax savings.

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 may be invested in a hedge fund, a group of hedge funds or a separate account managed for the insurance company by a hedge fund manager. At the death of the insured, the policy pays the value of the separately managed account plus an amount of life insurance (in effect, a kind of term insurance) which is paid to the beneficiary. The policy can be cashed in, prior to death, at the value of the separately invested account. There are a few insurance companies (both in the U.S. and offshore) which offer such private placement variable hedge fund life insurance to high net worth individuals and families (or their trusts).

The hedge funds' returns increase the cash value of the policy, without suffering any reduction for income tax. The cost of setting up the policy, including the cost of the insurance agent's commission and taxes, generally average between 3.5% and 5% of the initial cash invested. Annual charges, including the cost of the "term" insurance, average 1% to 3% per year. Assuming the insurance policy is respected for tax purposes, all the "inside build up" will not be subject to current income tax, and if the policy is maintained until the death of the insured, the entire death benefit (including all the earnings from the hedge fund) will be received by the beneficiary free of all income tax.

Benefits

The chart below 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. The taxable account column assumes a 35% tax rate (a rate lower than most hedge fund investors' highest marginal tax rate on ordinary income but higher than the long-term capital gain rate, so it assumes that the investments produce mostly but not entirely ordinary income and short term gains).

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 rate.

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. tax purposes. Although annuities generally cost less than life insurance, annuities defer but do not eliminate U.S. income tax.

Asset Protection

An additional benefit of the insurance policy is that insurance is generally 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

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

other operations, and the separate account is generally protected from the claims of creditors of the policy owner.

Domestic Versus Offshore Policies

For U.S. policyholders, the same rules concerning tax deferment or elimination apply to domestic and offshore policies. However, an annuity or life insurance policy issued by an offshore foreign company is subject to a 1% U.S. excise tax. Such foreign companies do not pay state premium taxes or federal DAC tax to which domestic policies are subject. By comparison, the total tax on insurance of a domestic life insurance policy is about 3% and a fraction of a percent on the issuance of domestic annuity. Thus, in terms of tax on issuance, it costs about 2% less to issue a foreign life insurance policy and almost 1% more to issue foreign annuity.

U.S. insurance companies provide the protection of U.S. regulation and U.S. law. Although foreign laws protecting the cash value from insurance companies' creditors may be similar to U.S. laws, most U.S. investors feel more comfortable with an insurance company that is subject to U.S. law and regulation. Most investors do not have as much confidence in tax haven countries' laws, courts, legal systems or political stability as compared to U.S. jurisdictions. Furthermore, many offshore insurance companies have insignificant assets or business, are recently formed, and, in some instances, may ignore U.S. securities law and/or state insurance law requirements. In addition, domestic policies can legally be sold and marketed in the U.S. For foreign insurance companies, the policies generally must be applied for and solicited from outside the U.S.

Although the fear may not be realistic, some investors have a concern that these small offshore insurance companies will run off with their money. Although the "money" will generally be under the control of an asset allocator in whom the investor has confidence, and possibly a custodian as well, the investments will be in the name of the insurance company separate account. Although legal protections can be imposed, the protections often increase the tax risks, and there will always be some risk that the principals or employees of the offshore insurance company could take the money. Although this is also possible for U.S. insurance companies, U.S. insurance companies are highly regulated, and the risk is significantly reduced.

Offshore insurance companies marketing in the U.S. (or otherwise subjecting themselves for U.S. jurisdiction) may be violating U.S. securities or insurance laws. Although this is primarily a concern for the insurance companies (and not policyholders), it is obviously preferable not to place substantial assets with a company that may be violating U.S. law. It may also be more likely that the IRS would disallow the advantages of a policy that is issued by an insurance company that is not "real" or substantial.

On the other hand, offshore insurance companies may be less likely to be discovered by the IRS, may be better for asset protection, and may allow investment in offshore investments not open to a U.S. insurance company.[1] As discussed below, offshore insurance policies may give investors greater control of their own investments, but this benefit may carry additional tax risks.

With respect to offshore annuities, until the tax law is clarified, there is a risk, probably not a very large risk, that an annuity issued to a U.S. person by an offshore company would be considered a debt instrument subject to the original issue discount ("OID") rules resulting in current U.S. income taxation. To avoid OID treatment, annuities rely on Code Section 1275(a)(1)(B)(ii) which requires that the annuity be "issued by an insurance company subject to tax under subchapter L." Since foreign insurers not doing business in the U.S. would not be subject to U.S. tax, they arguably do not qualify, and there is therefore a risk that this exception does not apply. The final regulations issued on January 7, 1998 did not give any guidance on this issue.

Estate Planning

One of the advantages of hedge fund life insurance is that it is an extremely useful estate planning tool. Hedge fund assets work particularly well in estate and gift tax planning structures because these assets tend to grow quickly. Hedge fund life insurance tends to be even more useful in estate planning because it combines the estate and gift tax planning benefits of hedge fund returns with life insurance. Life insurance is frequently purchased by irrevocable trusts, either existing or created in connection with the purchase of the life insurance. Properly structured, the death benefit, including all the income tax free earnings on the cash value invested in hedge funds, can escape estate tax on the death of the insured (and his or her spouse) and possibly generation-skipping tax (on the death of the insured's children). Since each of these taxes is at federal tax rates of up to 55%, the tax savings could be very substantial. If such an irrevocable trust with sufficient assets to purchase the hedge fund life insurance does not already exist, gift tax obligations may have

to be incurred to receive the estate and generation-skipping tax advantages. Proper estate planning may minimize the gift tax incurred in setting up such a trust. To the extent gift tax must be paid to create the trust structure, it is important to remember that any gift tax paid at the outset, before the tax free build up, is much less than the estate tax that would be due at the insured's death, after the build up, and, because the gift tax paid is removed from the estate, it is generally one-third less expensive than the estate tax that would be due.

One factor that has kept some investors from using life insurance trusts has essentially been eliminated. Some investors prefer to avoid placing assets in trust because of the loss of control of those assets. In a 1995 Revenue Ruling, the IRS conceded that the creator of a trust (the "grantor") can retain the power to fire the trustee and appoint a new one, so long as the new trustee is not "related or subordinate" (basically a close relative or employee) of the grantor. This ruling potentially gives grantors substantial practical control of trust assets.

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

Hedge fund life insurance is not for everyone. Since insurance companies often require very high minimum premiums (often $20 million to open a separate account and $1 million in premiums for each policy), it is generally appropriate only for wealthy individuals or families. Hedge fund life insurance is generally appropriate for someone who expects not to withdraw the cash value from the insurance prior to the insured's death (or at least not for a long time). Although the cash value of such policies can be withdrawn at any time and the earnings on the separate account are tax deferred until a cash withdrawal, the earnings on the cash withdrawal generally are taxed as ordinary income at the time of cash withdrawal and may be subject to a 10% excise tax.[2] Although if the policy is held long enough, the tax benefit of the deferral of income tax, even if subject to an excise tax, is likely to make the purchase of the life insurance or annuity policy beneficial, the benefit of a tax deferral subject to an excise tax is certainly not nearly as great as the benefit of complete exemption from income tax (which results from keeping the assets in the policy until the death of the insured).

Generally, only investors who really want to invest in and like the returns of hedge funds would purchase hedge fund life insurance or annuities. 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 (whom the investor may have suggested to the insurance company) can generally change investments or reallocate among hedge funds whenever he or she wants to, the policyholder cannot hire and 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 with a different investment account. 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.

Although the lack of investor control may be a problem, the degree of control permitted varies from policy to policy and the tax-free build up with a successful hedge fund manager, and the income tax free, and possibly estate tax free, payout at death, make hedge fund life insurance very attractive to certain wealthy investors. While certain offshore policies may allow greater investor control than domestic policies, the greater investor control is, in effect, purchased with increased tax risk. The costs of "term" life insurance coverage in most hedge fund life insurance policies are sufficiently low to make the policy attractive to any wealthy hedge fund investor. If the investor already has or needs term life insurance, then the hedge fund life insurance could replace other life insurance coverage and make the hedge fund life insurance even more attractive.

Benefits for Hedge Fund Managers

Hedge fund life insurance provides potential benefits for hedge funds and their managers. Hedge fund insurance may be a good marketing device for a hedge fund manager. The insurance provides a way for an investor to increase his or her after-tax returns substantially. Therefore, investors may be more likely to put more money into the fund through insurance, and the funds placed in the insurance policy are likely to grow faster (since income tax does not have to be paid) and to be more stable (less likely to be withdrawn or switched to another hedge fund or other investment). As indicated in the above chart, the cash value invested in hedge funds under the policy is always higher than the amount invested in hedge funds in the taxable account.

Hedge fund managers may also be interested in investing in the hedge fund life insurance themselves. However, there are some limitations on investments by a hedge fund manager in a policy for which that manager will control the investment of the cash values.

Conclusion

Although hedge fund life insurance and annuities are not for everyone, in the right circumstances, they can provide very significant benefits to both policyholder investors and hedge fund managers. Although the benefits are often achievable through domestic or offshore insurance companies, many investors and hedge fund managers prefer to deal with domestic insurers. However, offshore insurance is feasible for some investors, especially those willing to take greater tax risks in order to achieve more flexibility or lower costs. ■

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[1] However the offshore company may be subject to U.S. withholding tax on U.S. source income (such as the 30% tax on U.S. dividends) and would not be entitled to U.S. tax treaty benefits, both of which might significantly reduce investment returns.

[2] It may be possible, in some circumstances, to structure the life insurance policy so up to about 80% of the cash value can be borrowed out income-tax and excise-tax free.