

Hedge Fund

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Increasing Hedge Fund After-Tax Returns Through Private Placement Life Insurance

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Many hedge funds have impressive before-tax returns. However, since the returns of many hedge funds are based on short-term trading, income taxes on such returns can be as high as 40% to 50% (depending on the investor's state and local tax rate). Therefore, a 20% before-tax return may be only a 10-12% after-tax return and a 12% before-tax return may be only 6-7% after tax. Since other forms of investment may provide more favorable tax results (such as tax deferral or long-term capital gain treatment), hedge fund returns may not be as impressive on an after-tax basis as other investments.¹ In any case, even if a hedge fund's after-tax return is very impressive, investors may need to withdraw funds from the hedge fund to pay their income taxes, and such investors would save substantial sums if the income taxes could be eliminated.

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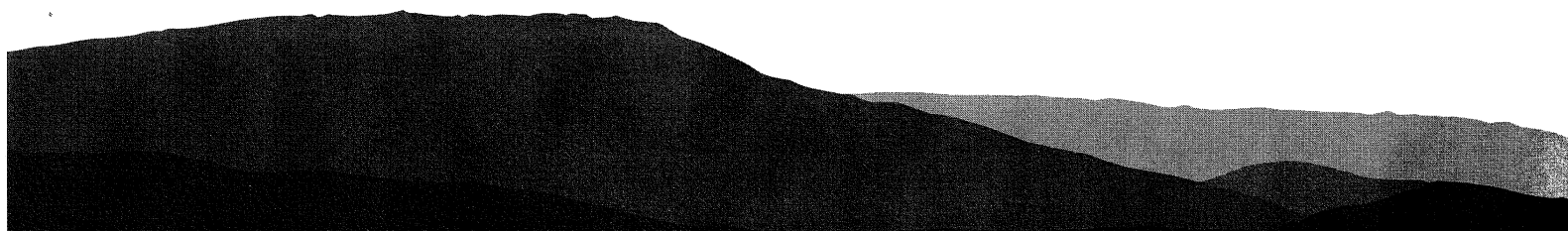
that there is little that can be done about "death or taxes," hedge fund life insurance has the potential of eliminating income tax on hedge fund earnings and, as discussed below, with proper estate planning, eliminating estate tax on the death of the insured. Unfortunately, even hedge fund life insurance cannot guarantee 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. A few insurance companies (both in the U.S. and offshore) offer such private placement variable hedge fund life insurance to high net worth individuals and families (or their trusts). The purchaser makes the "investment" as a premium payment (usually a single, upfront premium). Most (or almost all) of the premium

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¹ Although tax planning for hedge funds can often improve after tax returns (such as by deferring gains), hedge fund life insurance may be the only way to eliminate income tax on hedge fund returns.



is placed in the separate account managed by the designated manager (the "hedge fund manager"). The hedge fund manager invests the separate account directly or through one or more hedge funds. Part of the "premium" pays for the insurance broker's compensation (generally at least 2% of the premium) and the applicable taxes (generally a state premium tax and DAC tax for U.S. carriers or a 1% excise tax if the insurance is purchased on a U.S. insured from an offshore carrier). In addition, annual mortality and expense charges are made against the separate account. The cost of the at-risk insurance (low cost term insurance which provides a death benefit above the value of the separate account) is also charged against the account.

The overall effect is that an investor can purchase an insurance policy with a single premium in which the cash value is invested in one or more hedge funds. The hedge funds' returns increase the cash value, without any reduction for income tax. The cost, including the cost for the purchase of at-risk insurance, is in some policies as low as 1% to 2% of cash value each year. The cost will vary depending on the insurance company, the age and health of the insured, and the amount invested. The cost (as a percentage of cash value) is generally highest during the initial years of the policy and decreases as the cash value increases. 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) is received by the beneficiary free of all income tax.

Example of Benefits

To demonstrate the benefit of eliminating income tax on hedge fund investments, assume a \$5 million investment in a policy insuring the life of a fifty-year-old non-smoking, healthy male, and that the hedge fund returns an average of 12% per year. If the insured dies thirty years later, as indicated in the chart below, the death benefit would exceed \$123.8 million. If the same \$5 million were invested by a fifty-year-old in the same hedge fund directly, but he withdrew 35% of the earnings each year to pay his income tax,

thirty years later he would have only about \$47.6 million. Although the \$47.6 million is an excellent return on the \$5 million investment, it is only about 38% percent of the proceeds of the insurance policy. In addition, as discussed below, with proper planning, the beneficiaries can receive the insurance proceeds free of estate taxes, and possibly generation-skipping taxes. After a 55% estate tax, only \$21.4 million of the \$47.6 million would be left for the beneficiaries of the estate. The projected death benefit is over \$100 million more than the \$21.4 million. The chart below

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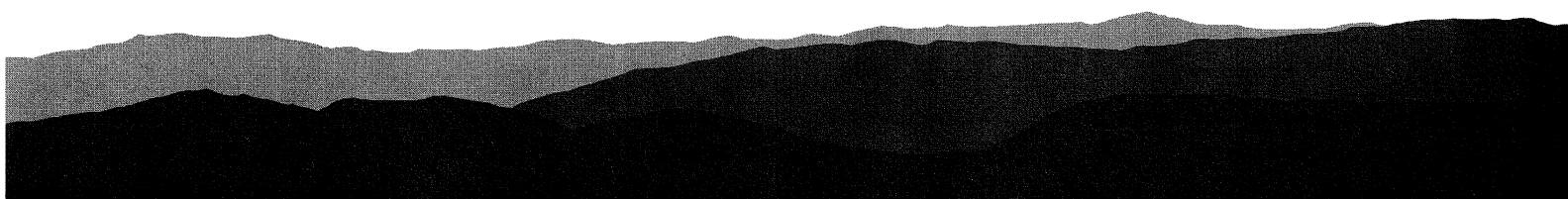
compares the return on a hedge fund life insurance policy (indicating both end-of-year cash value and death benefit) against a taxable investment at various ages. The chart assumes a 12% return per annum on the hedge fund investment. The taxable account column assumes a 35% tax rate (a blended rate assuming part ordinary and short-term

capital gain and part long-term capital gain). The chart is a hypothetical illustration of such policies; actual policy terms, returns and costs vary.

Age	Single Premium	End of Year Cash Value	Death Benefit (including cash value)	Taxable Account (at 35% rate)
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

The death benefit greatly exceeds the taxable account value at all ages. Obviously, the after-tax benefit of the insurance policy would be substantially higher if the average returns on the hedge fund investment substantially exceeded 12% (and would be much lower if the average returns were much less than 12%). The tax benefit would also be substantially higher if the investor's assumed tax rate were more than 35% (many hedge fund investors' marginal tax rates are between 40% and 50%).

If the policy is maintained until the death of the insured, the entire death benefit (including all the earnings from the hedge fund) is received by the beneficiary free of all 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 other operations, and the separate account is generally protected from the claims of creditors of the policy owner.

Estate Planning

As mentioned previously, one of the advantages of hedge fund life insurance is that it is an extremely useful estate planning tool. Jim Cohen's April 15, 1994 article in this publication, entitled "Hedge Funds in Estate Planning," discussed estate planning for both hedge fund investors and hedge fund managers. Hedge fund assets work particularly well in estate and gift tax planning structures because their 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, it is important to remember that any gift tax paid before the tax free build up is much less than the gift or estate tax after the build up and that gift tax is generally one-third less expensive than estate tax.

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Hedge fund assets work particularly well in estate and gift tax planning structures because their assets tend to grow quickly.

Which Hedge Fund Investors Should Consider Hedge Fund Life Insurance?

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 premi-

ums for each policy), it is generally appropriate only for very 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 are taxed as ordinary income at the time of cash withdrawal and may be subject to a 10% excise tax. Although if the policy is held long enough, the tax benefit of the deferral of

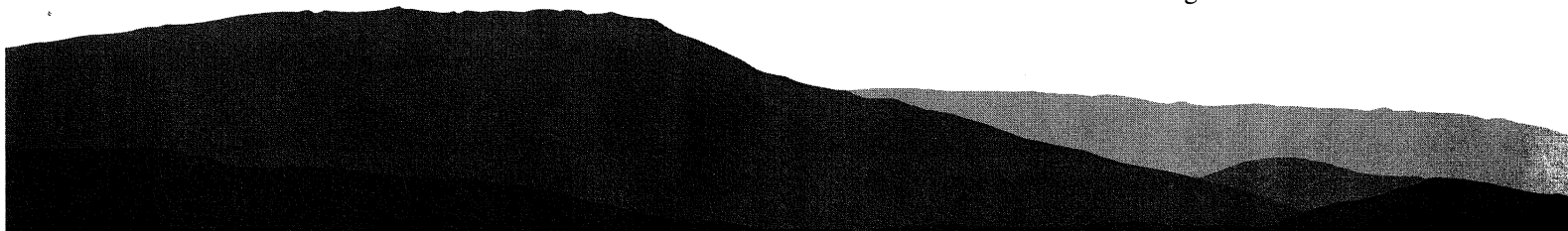
income tax, even if subject to an excise tax, is likely to make the purchase of the life insurance policy (or of a similar, variable annuity policy) beneficial, the benefit of a tax deferral subject to an excise tax is certainly not nearly as great as the benefit of complete

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. Because the costs of maintaining the policy (including the cost of the at-risk life insurance) averages approximately 1% to 2% per annum, the return on the cash value invested in the hedge fund should average at least 5% for the after-tax return to be better than a direct investment in the hedge fund. (In fact, if the cost of the at-risk life insurance is not considered a cost, as it should not be since it is purchasing something of value - term life insurance at a low cost - even returns on the hedge fund investment of less than 3% may result in a better after-tax return than a direct investment in the hedge fund).

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the hedge fund manager 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 (especially those with life insurance needs).

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 substantially his or her after-tax returns. 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 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. At age 90, the cash value is over 340% of the taxable account (over \$240 million more would be invested in the hedge funds).

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The hedge fund insurance product potentially provides a way for up to one hundred additional

investors (who may not individually be able to meet the minimums of a hedge fund) to invest in the fund. Many hedge funds take the position that a separate account of an insurance company takes up only one slot, even if the separate account consists of the cash values of one hundred different insurance policies. Therefore, the insurance policy structure may be used to open up an additional one hundred slots.

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

Conclusion

Although hedge fund life insurance is not for everyone, in the right circumstances, it can provide very significant benefits to both policyholder investors and hedge fund managers. **HF**

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