

INCREASING HEDGE FUND RETURNS USING INSURANCE AND ESTATE PLANNING

Residents of many countries avoid most current income taxation on hedge fund profits through investing in a hedge fund organised in a "tax haven" jurisdiction. However, US taxable investors are generally subject to current income taxation on realised hedge fund profits. Sophisticated life insurance and annuity products allow deferral or elimination of US income tax on hedge fund profits and may provide tax benefits, avoidance of currency restrictions, or other benefits in other jurisdictions.

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 or a group of hedge funds or retained by the life insurance company in 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 (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 US 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, 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% to 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 US 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 US income tax.

Benefits

Table 1 compares the return on a sample hedge fund life insurance policy purchased at age 50 for \$5m against a taxable investment of \$5m. The table assumes a 12% return per year 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).

Of course, the table simply shows illustrated results. The ultimate results

Wealthy individuals are increasingly investing in hedge funds. Hedge fund life insurance and annuities can potentially significantly increase after-tax returns for many such investors. Significant sums can also be saved by estate and gift tax planning

By James R Cohen and Jeffrey S Bortnick

Source: Author

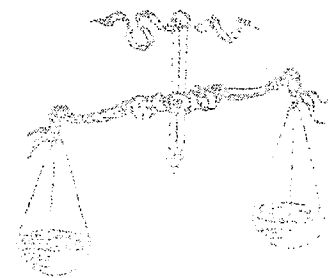
Table 1: The return on a sample hedge fund life insurance policy

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

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 tax rate.

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 insur-



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

Who should consider hedge fund life insurance?

Hedge fund life insurance is not for everyone. It is generally purchased by investors subject to US income tax. Since insurance companies often require very high minimum premiums (often \$20m to open a separate account and \$1m in premiums 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 policy 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 in the US as ordinary income at the time of cash withdrawal and may be subject to a 10% excise tax.

Investor control

The biggest problem for a potential investor (other than the high minimum) generally is that there is some loss of investor control. Although the investment manager can generally change investment or reallocate among hedge funds whenever he or she wants to, in most policies the policyholder cannot hire and fire the investment manager, or move or reallocate assets whenever he or she wants to do so. The investor control issue is one of the trickiest issues related to this type of policy since if the policyholder has too much 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 possible estate tax-free,

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payout at death, make hedge fund life insurance very attractive to certain wealthy investors.

Benefits for hedge fund 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).

Hedge fund annuities

Hedge fund annuities are similar to hedge fund insurance, but do not provide a significant enough death benefit to be considered life insurance for US tax purposes. Although annuities generally cost less than life insurance, annuities defer but do not eliminate US income taxes.

Hedge fund life insurance or annuities from offshore insurance companies are sometimes used by US investors to invest in offshore hedge funds not open to US investors. In addition, a non-US resident might invest in hedge fund annuities or life insurance for benefits under the laws of his or her residence. Such benefits might include tax savings (income, estate or gift), avoiding currency restrictions, or asset protection. Some non-US residents may

also have US tax concerns (such as a non-US resident who is a US tax resident because he or she has a "green card", or a non-US trust or estate with present or contemplated future US beneficiaries).

US estate planning

Estate planning focuses upon the transfer of wealth to the next generation. Frequently, the assets of the "next generation" (children, grandchildren, etc) will be managed in trust. Hedge fund assets in general (and hedge fund life insurance in particular) work out well in gift and estate planning because they tend to grow quickly, so a lot of wealth is transferred to the trust beneficiaries. Life insurance is frequently purchased by an irrevocable trust. Properly structured, the death benefit from hedge fund life insurance, including all the income tax-free earnings on the cash value invested in hedge funds, can escape US estate taxes on the death of the insured and the insured's spouse. With proper planning, the generation-skipping transfer tax on the death of the policy holder's children may also be avoided. Since each of these federal taxes can be as high as 55%, the tax savings could be substantial.

Gift to a GRASP

One of the best tools for accomplishing wealth transfer is a transfer to a grantor sprinkle trust (we call it a GRASP). It is a special type of trust which is treated as complete for gift and estate tax purposes but it is incomplete (a "grantor trust") for US income tax purposes. One of the best investments to put in a GRASP is an interest in a hedge fund or fund of funds.

The transfer to the trust is a gift and the property transferred is removed from the estate of the grantor. (The grantor is the person who creates the trust and transfers property to it. For US income tax purposes, we intentionally flunk one or more tests of being a grantor trust, so the income tax on the trust's income is taxed to the grantor. We (and a number of other tax advisers)

have concluded that when the grantor pays the income tax on the trust's income, it is not an additional taxable gift to the trust's beneficiaries.

Using leverage

Transfers to trusts, including GRASP trusts and trusts which purchase hedge fund life insurance, can be enhanced by the use of borrowed funds. In addition to making a gift to a GRASP or other

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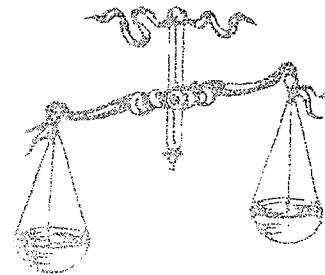
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trust, additional funds can be transferred to a trust by loan without incurring US gift tax. Since many hedge funds out-perform the minimum interest rate that must be charged to avoid a taxable gift, a loan to a trust (including a GRASP), where the trust uses the borrowed funds to invest in hedge funds, may be an excellent estate planning tool.

Competent advice

Because of space limitations, this article merely mentions some aspects of hedge fund insurance and estate planning for hedge fund investors. Potential investors should consult competent advisers for more information concerning investments in hedge fund insurance and for information on domestic and international estate planning involving hedge funds. ♦

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