Is Increasing Hedge Fund After-Tax Returns Using Private Placement Life Insurance and Annuities Still Viable?

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In the process of helping to create and advise many hedge funds over more than 25 years, we have seen some important trends develop. In the beginning, funds generally reported their investment returns before investment management fees. Then, as investors became more aware, it became essential to report returns, net of all fees. In recent years, U.S. taxable investors, who still constitute the largest segment of hedge fund investors, frequently want to know investment return, net of all fees, and *net of income tax*. "It's not what you make, it's what you keep."

Most hedge funds are tax inefficient. They produce mostly short-term capital gains and ordinary income, taxed at rates (including state and local tax) up to 50%. Although we doubt that there is an average hedge fund and we have never met an average hedge fund manager, for the purposes of this article we are assuming that the tax on an average hedge fund's income is 35%, consisting of mostly short gain and ordinary income (or significant long-term capital gain but subject to substantial state or local tax). If you are a hedge fund investor or manager, the real income tax rate you or your investors pay on hedge fund income is probably higher.

How can this ugly tax picture be improved?

HEDGE FUND LIFE INSURANCE AND ANNUITIES

The cash value build-up within a life insurance or annuity policy is not subject to income tax, so long as the investment remains within the policy. The death benefit of a life insurance policy is income tax free. These tax benefits can be made available for hedge fund investments by the use of private placement life insurance and annuities.

Under an annuity policy, the investment goes to a separate account managed for the insurance company by an investment advisor (not necessarily an RIA). The purchaser makes his or her investment as a premium payment which, after policy costs, is invested by the investment advisor either directly or through one or more hedge funds or separate accounts. When the policy owner withdraws funds from the policy, he or she pays tax on the income at ordinary rates (plus an excise tax of 10% of the gain, if he or she is under 59½).

The life insurance policy works in the same way, except that to qualify as a life insurance policy for tax purposes, a certain amount of essentially term life insurance must be purchased, determined by the age of the investor and the type of policy. For example, for a 50-year-old who is investing $5 million, the pure insurance purchase would need to be about $10 million (a $15 million policy), so the insurance needs to be a little more than twice the cash. At age 60, the life insurance roughly equals the cash. The amount of life insurance relative to the cash value keeps going down, until, at age 90, it more or less disappears.

The pure insurance portion is essentially low-cost term life insurance, which allows the entire investment, including the cash, to qualify as life insurance. The charges 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 the amount of pure (term) insurance then in place, as required by the policy, plus whatever is in the cash account, to the beneficiary, 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 of the policy withdraws the cash before the death of the insured, the income generally is taxed at ordinary rates (plus an excise tax of 10% of the gain, if he or she is under 59½). Under certain policies, so long as the policy is not terminated, a substantial portion of the cash can be withdrawn as a loan, on an income tax free basis.

BENEFITS

The Exhibit 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 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.

In our experience in working with these policies over the last 10 years, generally investors purchase these life insurance policies when they are already investors in hedge funds but would like to make the least tax efficient portion of those investments more tax efficient. On occasion, the purchaser also wants and needs life insurance coverage, and for that person the policy is even more beneficial.

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.

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

One of the key elements of effective estate planning is to make gifts of assets in trust, so that the assets in the trust will not be subject to estate tax in the estate of the person who makes the gift (the "donor"). The beneficiaries of the trust are often the donor's spouse and issue (children, grandchildren, etc.). So long as the donor's spouse is living and friendly with the donor, if the assets in the trust are really needed, they can be "recaptured" by distribution to the spouse. Since 1995, under a Treasury Ruling, it is possible for the donor to keep substantial control over the trust by retaining the right to fire and replace the trustee. (The replacement trustee can be anyone the donor selects except a close relative or subordinate employee.)

The best assets to give to such a trust are assets that will grow substantially over time. A number of our wealthy, estate planning clients have felt that the best class of assets to select would be hedge fund investments within a life insurance policy, so the trust assets grow at hedge fund rates, free of income tax.

For example, suppose a donor creates such a trust in December 2003, when he or she is 50 years old, and gives it $2 million. If the donor and the donor's spouse have not used any of their gift tax exemption, this gift would be U.S. gift tax free. Then, the donor loans the trust $3 million at the lowest interest rate for a long-term loan allowed without the loan's being treated as a gift for gift tax purposes (these rates, announced by the IRS, change monthly). For December 2003, that rate, assuming annual compounding, is 5.12%. Assume that the loan is kept in place for 40 years, until the donor dies at age 90. At that point, the trust owes the donor's estate about $21.1 million on the loan.

The trust invested the $5 million in hedge fund insurance. At the donor's death (*see Exhibit*), assuming a 12% return, the trust (or donor's beneficiaries) would receive an insurance death benefit of about $360.8 mil-

EXHIBIT

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

lion, which is about $350 million after paying the estate tax on the loan. This trust benefit would be free of income, estate, and generation skipping tax. In a number of states (including Delaware and New Jersey) which have repealed the rule against perpetuities, the trust could continue forever, free of estate and generation skipping tax.

Compare three much less favorable alternatives. For purposes of this comparison, we assume that the donor dies at age 90 (in the year 2043) and that donor's estate will be subject to a 50% estate tax. (Of course, the rate or even the existence of the estate tax far into the future is speculative, but we think it is very likely that there will continue to be an estate tax on very large estates, taxed at 50% or more.) The first alternative is a direct investment in the hedge fund (not through the insurance policy) without any trust. If the donor invested the $5 million in the hedge fund directly, he or she would have ended up with about $100 million (see the "Taxable Account" column in the Exhibit) and the investor's beneficiaries would end up with about $50 million after the 50% estate tax, about a seventh of where they end up with the optimal planning discussed above. Under the second alternative, the donor would set up the trust, the trust would invest in the hedge fund directly, and the beneficiaries would end up with about $100 million. Under the third alternative, the donor would buy hedge fund insurance but not in a trust. Under this alternative, the beneficiaries would end up with about $180 million (the $360 million death benefit less a 50% estate tax). Under these assumptions, all three alternatives are much worse than the optimal planning (using the trust as the owner and hedge fund insurance).

In any event, this exercise shows that hedge fund life insurance can add substantial value in estate planning.

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 $5 million to open a separate account and $1 million in premiums for each policy, requiring, for example, five $1 million dollar policies or one $5 million policy to get started), it is generally appropriate only for wealthy individuals or families.

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 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 (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

In 2003, the IRS released a proposed regulation[1] and two revenue rulings[2] which place some restrictions on the tax advantages of private placement variable life insurance invested in hedge funds. The proposed regulation does *not* 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 proposed regulation (which is not yet effective) 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).

As a result of these recent developments, many hedge funds or funds of funds 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 periodically to reallocate the investment among a number of cloned funds.

Alternatively, the policyholder can allow an independent manager appointed by the insurance company to allocate the insurance account among five or more hedge funds which are open to investors who are not insurance companies.

Although the lack of investor control and other limitations may be a problem, the degree of control permitted varies from policy to policy 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.

BENEFITS FOR HEDGE FUND MANAGERS

Hedge fund life insurance and annuity policies also provide potential benefits for hedge funds and their managers. These policies are often good marketing devices for hedge fund managers since the insurance provides a way for an investor to increase his or her after-tax returns substantially, a point worth making to a wealthy potential hedge fund investor. The funds placed in the policy are likely to grow faster (since, with income tax on the investment deferred or eliminated, the investor will not need to withdraw money from the fund to pay tax on his or her share of the fund's income). In addition, the investment is less likely to be withdrawn or switched to another hedge fund or other investment, because of the tax or commission costs of making a switch. It may be possible, through these policies, for hedge fund managers to defer fees with respect to domestic investors.

Based on the recent developments discussed above, many insurance companies and potential policyholders prefer that the insurance or annuity's cash value be invested in an insurance dedicated or cloned fund. Since most hedge fund managers do not run insurance dedicated hedge funds, hedge funds willing to form such funds may have a significant marketing advantage. Some hedge fund managers are unwilling to form an insurance dedicated fund. Other hedge fund managers believe that the extra administrative difficulty of running an additional fund (or separate account for an insurance company) and "splitting tickets" is not a significant burden, or is worth the trouble for the additional insurance funds which can be raised.

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. 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 rulings and proposed regulation 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 rulings and proposed regulation increase the tax safety of some of these policies and, in any event, make the position of the IRS clearer. This clarity should make a number of these policies attractive to investors.

ENDNOTES

[1]*Reg – 16394-02, revoking reg. section 1.817-5(f)(2)(ii).*
[2]*Revenue Ruling 2003-91 and Revenue Ruling 2003-92.*