Committee Report: Insurance

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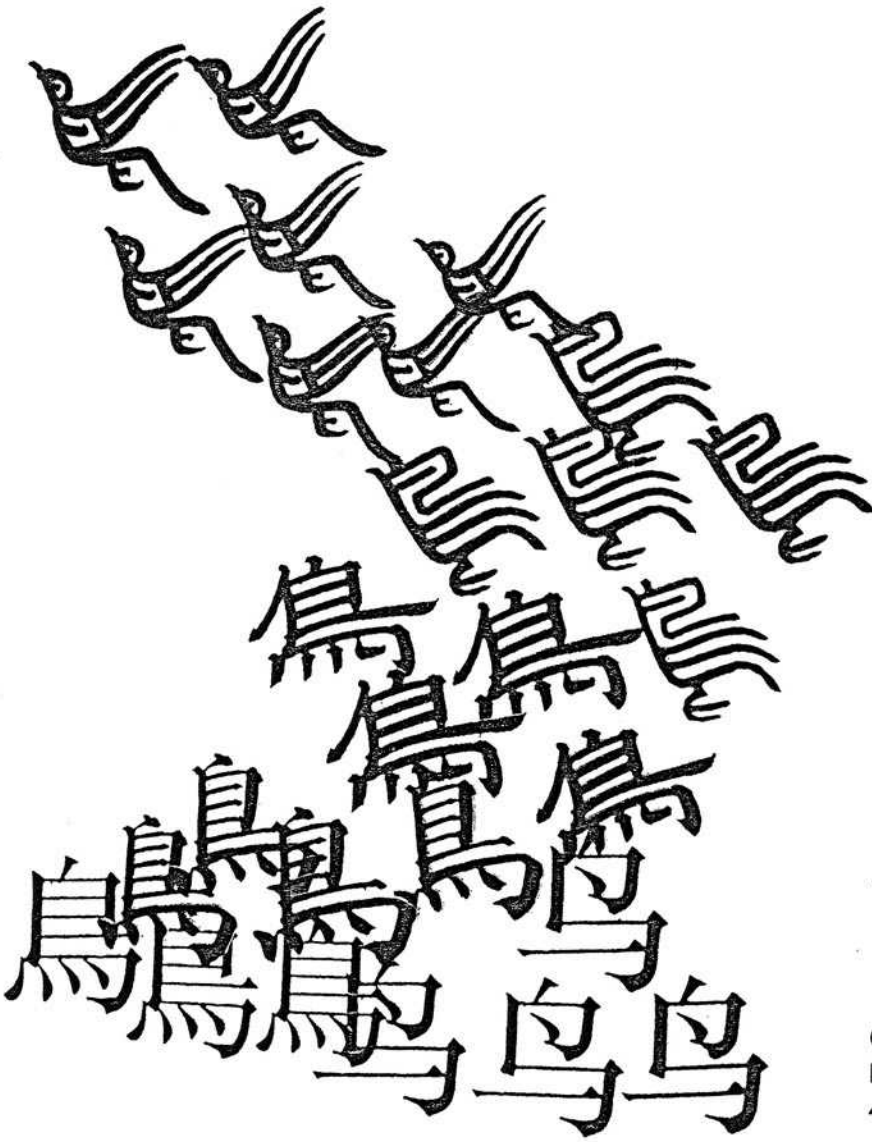

Asian art sold for record prices during Sotheby's "Asia Week" auctions, p.6.

BRIEFING

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INSURANCE

PPLI Invested In Hedge Funds

Recent developments increase the attractiveness and chart a course for hedge fund life insurance and annuities

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For more than 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. With proper estate planning, they've been able to use it to reduce or eliminate the estate tax as well. PPLI can even provide a large tax-free death benefit for a cost that is often much less than the tax savings gained.

Despite these significant benefits for appropriate hedge fund investors, many conservative taxpayers have been unwilling to seriously consider PPLI invested in hedge funds, for fear that the Internal Revenue Service would not allow the tax benefits. It is true that in recent years, the IRS has issued rulings and changed the regulations to prevent the tax benefits on certain PPLI invested in hedge funds. But these very same rulings constitute a form of IRS guidance that many advisors who are experienced in PPLI say now helps them chart a course to achieving significant tax benefits when PPLI cash values are invested in hedge funds. This clarity has led more hedge fund investors to embrace PPLI, sparking innovations, which in turn makes PPLI attractive to more hedge fund investors.

It's important, therefore, to understand hedge fund life insurance, hedge fund annuities, their potential benefits for income tax, estate tax and asset protection, their investor-control issues, and the latest innovations for these products. It's also useful to know which clients would most be interested in PPLI, and how such an investment would fit into their investment portfolios and estate plans. Although the underlying investment of the cash value of PPLI does not have to be hedge funds—it could be in a managed account that employs a tax inefficient strategy or in other investments—we will refer to the product as hedge fund life insurance (HFLI) or annuities.

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's investing $5 million, the pure insurance would need to be about $10 million (a $15 million policy), so the pure insurance will have to be a little over twice the premium being 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 insured's death, the income generally is taxed at ordinary rates (plus possibly an excise tax of 10 percent of the gain, if the insured is under age 59 1/2). Under certain policies (that is, a policy that is not a modified endowment contract, called a "Non-MEC"), 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, free of income tax.

BENEFITS

What are the benefits?

Let's look at the return on a representative HFLI policy. Let's say it's purchased at age 50 for $5 million and compare it to a taxable investment of $5 million; let's assume a 12 percent return per year on the hedge fund investment. Let's also plug in the costs of an actual policy and suppose a tax rate (a blended rate on capital gains and ordinary income, including state and/or local tax) of 35 percent.

Of course, returns, costs and tax rates vary in real life. But, under our assumptions, the tax benefits are substantial: After 40 years, the end-of-year cash value within the policy and the death benefit are each over $240 million more than (that's over 300 percent of) the remaining amount if a 35 percent income tax were payable each year. Since the investments placed in the policy are generally selected as the investor's least tax-efficient investments, the real rate of tax applicable to taxable investment is likely to be well above 35 percent. We have found that real life comparisons have turned out to be even more favorable.

An added benefit, not only of the life insurance but also the hedge fund annuity policy, is that they generally are good forms 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.

> An added benefit of hedge fund life insurance and annuities: they're generally good forms of asset protection.

ANNUITIES

Hedge fund annuities are similar to hedge fund life insurance, with this important exception: they 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, they defer but do not eliminate U.S. income tax. Thus, the tax benefits of annuities are generally less than the tax benefits of PPLI, but if the deferral is long enough at a high enough rate of return, annuities can be worthwhile. Hedge fund annuities are often considered by investors for whom life insurance is not appropriate. That includes people who are not insurable or insurable only at high costs, those who do not want to undergo insurance underwriting and medical exams, or investors who do not have an insurable interest or want to invest so much in the product that the insurer cannot write enough life insurance (that is to say, the amount exceeds the insurer's capacity).

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. But 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 HFLI, very large estate tax savings are possible. The estate tax savings through trusts, combined with income tax-free hedge fund returns and large death benefits, can greatly increase after-tax returns.

Certainly, life insurance and life insurance trusts are parts of estate planning. HFLI is generally marketed as a way to achieve efficient hedge fund investing. That's fine, as far as it goes, but the cost of the pure insurance inside HFLI policies is generally low when compared to other life insurance choices. So a wealthy client who wants life insurance coverage to provide liquidity, pay estate taxes (or for whatever reason), especially if he is an active hedge fund investor, should look at HFLI as part of his estate-planning process.

For example, a client creates an irrevocable life insurance trust, gives the trust $2 million (assuming the client and spouse have not previously used their gift tax exemptions), and loans the trust $3 million at the applicable federal rate (AFR), which was 4.79 percent in April 2006 on long-term loans. The trust purchases $5 million of HFLI. The after-tax death proceeds payable to the trust or its beneficiaries (free of income and estate taxes) will likely be substantially larger than other alternatives.

WHICH CLIENTS?

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

Other than the high minimum, the biggest problem for a potential investor is generally that there is some loss of investor control. The investment manager of the insurance company's separate account can generally change investments or reallocate among hedge funds whenever he wants to do so. The policyholder cannot hire and fire the investment manager—or move or reallocate assets whenever he wants. The insurance company ultimately has the power to hire or fire the investment manager. A few 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 because too much investor control might spark an IRS claim that the investor should be taxed on the earnings currently. The recent IRS guidance and resulting increase in the use of "cloned" funds (hedge funds that are open only to insurance companies), have increased the availability of investment choices within hedge fund insurance policies, thereby reducing some policyholders' concerns about loss of investor control.

THE IRS SPEAKS

The government last year finalized a regulation[1] and in 2003 issued two revenue rulings[2] that together placed some restrictions on the tax advantages of HFLI. This recent IRS guidance does not prevent such policies from investing in hedge funds, nor does it change these policies' income tax deferral and elimination (or estate tax-planning) benefits. What it does is narrow the manner in which insurance policies can invest in hedge funds and still preserve their tax advantages. 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 insurance-dedicated funds or cloned funds, or (2) if the hedge fund investments are open to non-insurance investors, it must invest in a diversified portfolio of at least five hedge funds. 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). In addition, the recent IRS guidance eliminates the investor's ability to choose to invest in a policy whose cash value is invested in a single hedge fund that is open to any investor other than through insurance policies.

Although these requirements limit

choice, because the IRS guidance implicitly approves the use of cloned funds and certain other arrangements, it also has 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 fund of funds have formed or are forming insurance-dedicated funds, open to insurance companies only. An insurance-dedicated fund (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 that allow investors to choose among many such insurance-dedicated funds. In recent years, more and more insurance policies are being issued with more choices of cloned funds. Greater choice and perceived lower tax risk have increased interest in hedge fund insurance.

CHOICES

As an example of the kinds of choices available in policies today, one such policy could give the investor the ability to allocate the cash value of the policy among seven insurance-dedicated hedge funds all similar to funds managed by the same managers available to individuals (in short, cloned funds), such as:

- a hedge fund specializing in Asian investments;
- a fund managed by a fund of funds manager;
- a distressed securities hedge fund;
- a convertible arbitrage hedge fund;
- an equity long/short hedge fund;
- a global macro hedge fund; and
- an event-driven hedge fund.

The policyholder/investor is limited to these seven funds, and the insurance company has the right to add or eliminate choices. But the policyholder can determine the percentage of the cash value allocated to each of the available funds, and change that allocation periodically. This degree of control may satisfy the investor—so long as the investor feels that the policy's choices are attractive.

THE CHASSIS

Another recent innovation concerns the insurance product chassis. Private placement life insurance traditionally has been sold like 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. Many investors also 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 illustrations shown when the policies were purchased. Some hedge fund investors have been unwilling to make a large investment, expected to last more than 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. A flat charge and a death benefit factor page is used instead, making the product easier for the investor's advisor to explain, and for the investor to understand.

PORTFOLIO

The greatest tax benefits from HFLI result when the policy is held until the death of the insured, because the death benefit is received free of income tax and, when recieved through an irrevocable life insurance trust, free of 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 after-tax returns. HFLI 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, long-term, absolute returns are good candidates for PPLI. Investments that are either highly tax-efficient or so speculative that net losses over the long term are a real possibility are generally not the best candidates for PPLI investments.

HOW POPULAR?

Will HFLI become more popular? Will any significant portion of the more than $1 trillion reportedly invested in hedge funds be through insurance? That's still unclear. But recent developments certainly do make HFLI and annuities more attractive for a greater number of hedge fund investors. ■

Endnotes

1. Treasury Regulations Section 1.817-5(f) was amended by revoking Treas. Regs. Section 1.817-5(f)(2)(ii), TD 9185, 70 FR 9869, March 1, 2005.
2. Revenue Ruling 2003-91 and Rev. Rul. 2003-92.