Tax-Efficient Investing Using Private Placement Variable Life Insurance and Annuities

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Many hedge funds and managed accounts have impressive before-tax returns. After tax, however, returns of many hedge funds and investments with returns based on short-term trading may not be as impressive. 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 and other investments can often improve after-tax returns (deferring gains, for example), recent changes in the tax law, including the constructive sales rules, have made tax deferral more difficult. One method to defer hedge fund taxable income and convert it to long-term capital gain (investing through a derivative such as a total return swap) has significant tax risks of being disallowed and is the target of proposed legislation in Congress.

While many investors believe there is little that can be done about "death and taxes," private placement variable life insurance has the potential of eliminating income tax on hedge fund and other earnings and, with proper estate planning, estate tax as well. Although this relatively new life insurance product cannot provide immortality, it generally provides a large tax-free death benefit at a cost much lower than the tax savings. A related financial product, the private placement variable annuity, does not eliminate income tax but does provide substantial tax deferral.

In this article, we discuss private placement variable life insurance and annuities, income tax savings, asset protection, and the estate planning benefits of such policies. We indicate how the insurance can be used as part of an overall long-term investment strategy and which investors should consider the polices, and we compare United States and offshore policies.

WHAT IS PRIVATE PLACEMENT VARIABLE LIFE INSURANCE?

Private placement variable life insurance (PPVL insurance) is life insurance with a separately invested account for that policy's cash value that may be invested in a hedge fund, a group of hedge funds, or a separate account managed for the insurance company by an investment manager. The separate account can be invested in any diverse portfolio of liquid assets (not necessarily a hedge fund).

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. A few insurance companies (both in the U.S. and offshore) offer PPVL insurance to high net worth individuals and families (or their trusts).

The investment returns of the hedge funds and/or managed accounts increase the cash value of the policy, without reduction by

income tax. The cost of setting up the policy, including the cost of the insurance agent's commission and taxes, varies greatly but generally averages between 3.5% and 5% of the initial cash invested. Annual charges, including the cost of the "term" insurance, average 1% to 2% per year.

Properly created and administered, PPVL insurance achieves income tax-free investing — none of the "inside buildup" is 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 or managed accounts) will be received by the beneficiary free of all income tax.

Benefits

Exhibit 1 compares the return on a sample PPVL 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 investment. The taxable account column assumes a 35% tax rate (a rate lower than most investors' highest marginal tax rate on ordinary income but higher than the long-term capital gains rate).

The ultimate results will depend on, among other things, the actual charges imposed by the insurance company, the actual investment performance achieved by the managers selected, and the investor's actual marginal rate. (The higher the assumed tax rate and investment return, the greater the projected tax benefits of the insurance product).

Private Placement Variable Annuities

Private placement variable annuities are similar to PPVL insurance, but do not provide a sufficient death benefit to be considered life insurance for U.S. tax purposes. Annuities generally cost substantially less than life insurance. Costs vary greatly, but are generally up to 3% to set up the policy and up to 1% a year to maintain it. 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 other operations, and the separate account is generally protected from the claims of creditors of the policyowner.

Estate Planning

Another advantage of PPVL insurance is that it is an extremely useful estate planning tool. Hedge fund and managed account assets work particularly well in estate and gift tax planning structures because these assets tend to grow quickly. PPVL insurance tends to be even more useful in estate planning because it combines the estate and gift tax planning benefits of income tax-free hedge fund and managed account 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 and/or managed accounts, can escape estate tax on the death of the insured (and his or her spouse) and possibly escape a generation-skipping tax (on the death of the insured's children). With federal tax rates of up to 55%, the tax savings could be very substantial.

EXHIBIT 1
Return Examples

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

If an irrevocable trust with sufficient assets to purchase the PPVL insurance does not 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 that 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 buildup, is much lower than the estate tax that would be due at the insured's death, after the buildup. Also, 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 loss of control over the 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" to the grantor (basically not a close relative or employee). This ruling potentially gives grantors substantial practical control of trust assets.

As an example of the potential estate tax savings, assume that a fifty-year-old investor creates an insurance trust and transfers $5 million to it as a gift, paying gift tax of about $2.5 million. (The exact amount will depend upon the extent to which unified credit has been previously used and the state of residence.) The investor dies at age eighty. Using the insurance trust, the beneficiaries or trusts for their benefit receive about $124 million, using the same assumptions as in Exhibit 1. If the investor had not created the trust, but rather personally invested the $7.5 million on the same assumptions, the investor's estate would have amounted to about $71 million. After a 55% estate tax, the beneficiaries would have received about $32 million.

Thus, the beneficiaries receive almost four times as much through the use of PPVL insurance in an insurance trust than if the investor had simply invested directly with the same investment managers.

ENHANCEMENT OF LONG-TERM INVESTMENT STRATEGY

Investing income tax-free through PPVL insurance is a crucial advantage in the case of hedge funds, which are notoriously tax-inefficient. Investors who would otherwise hold hedge funds in their investment portfolios can, by purchasing insurance, "have their cake and eat it, too."

To capture maximum benefits from investing tax-free, the PPVL policyholder should always integrate the insurance-wrapped portion of the investment program into the overall long-term investment strategy. In other words, both sets of investments should be chosen to optimize the investor's overall expected after-tax return depending on risk. In practice, this generally means placing hedge funds and similarly tax-inefficient liquid strategies (such as managed futures and high-yield bonds, to the extent they have a role in the overall strategy) in the insurance policy, and placing more traditional stocks and bonds, in the non-insurance portfolio.

An example illustrates how this "joint optimization" of the overall portfolio would work. The example also quantifies the long-term benefits of hedge fund life insurance versus investing without insurance. Assume a New York City-based family with $100 million of liquid assets, of which $10 million is proposed to be placed in an insurance policy. The $100 million is initially in cash. The patriarch of the family, Adam Smith, is considering insuring his own life, setting up an irrevocable insurance trust and giving the policy to his children, and paying the 55% gift tax up-front on the policy's initial $10 million premium. He pays income taxes at the top marginal New York City and federal tax rates. If he purchases the insurance, he will have $85 million to invest outside the policy and $10 million to invest inside the policy after payment of the gift tax. If he does not purchase the insurance, he will have the full $100 million to invest.

The costs of Mr. Smith's proposed insurance policy are assumed to average 75 basis points on the total market value of the insurance policy assets per year over a twenty- to thirty-year investment planning horizon. A 55% gift tax is paid on the insurance policy at the start of the investment period, a tax subtracted from the asset value of the combined family investment portfolio. (If the family does not purchase insurance, the gift tax is not paid, and the full $100 million is available for investment.) An estate tax is applied and paid at a 55% rate for the entire non-insurance portion of the assets at the time of Mr. Smith's death, which is assumed to occur either in twenty years or in thirty years.

Thus, two investment planning horizons are considered: a thirty-year time horizon, and a twenty-year time horizon. For simplicity, we assume Mr. Smith spends nothing from the investment portfolio over the planning horizon.

The asset classes used in the example, their historical returns, risks and correlations based on monthly data from January 1, 1990, through March 31, 1999, are shown in Exhibits 2 and 3. Constraints applied in the after-tax asset optimization process are shown in Exhibit 2.

The family wishes to hold a combined portfolio — including insurance-wrapped assets as well as non-insurance wrapped assets — that maximizes after-tax return, given the level of after-tax risk they seek over the investment planning horizon. The results of an after-tax combined portfolio optimization for a twenty-year investment horizon are shown in Exhibit 4.[1] Similar results for a thirty-year investment horizon are shown in Exhibit 5.

The analysis yields results as follows:

- Even after payment of a gift tax up-front, the purchase of "hedge fund insurance" increases investment returns substantially, regardless of one's investment objectives and independent of potential estate tax reductions. Among portfolios with virtually identical asset mixes, efficiently diversified portfolios that include insurance average an additional 100 basis points a year or more in after-tax return over a twenty-year horizon, and more than 200 basis points a year over a thirty-year horizon, compared to taxable portfolios that exclude insurance.
- When estate tax benefits are additionally considered, the benefits of insurance are even greater. In the example, if the insured dies in twenty years, the after-estate tax liquidation asset value of insurance-included portfolios is more than twice the after-estate tax liquidation asset value of taxable portfolios that exclude insurance. If the insured dies in thirty years, the differential value of the portfolio including insurance exceeds three times the value of the insurance-excluded portfolios.
- The existence of an insurance policy within a family's investment portfolio does not materially affect the family's overall asset mix. To the extent that aggressive tax-inefficient strategies have a place in the asset mix, however, these strategies appear disproportionately in the insurance portion. Thus, the primary effect of "hedge fund insurance" is to reduce the family's effective overall tax rate, not to make it invest any differently. This is as it should be: The tax "tail" is not wagging the dog.

WHICH INVESTORS SHOULD CONSIDER PPVL INSURANCE OR ANNUITIES?

PPVL insurance and annuities are not for everyone. Since insurance companies often require very high minimum premiums (generally between $5 million and $30 million to open a separate account and $1 million in premiums for each policy), this strategy is generally appropriate only for wealthy individuals or families.

PPVL 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 withdrawal and may be subject to a 10% excise tax. It may be possible, in some circumstances, to structure the life insurance policy so that it is not a modified endowment contract so that up to about 80% of the cash value can be borrowed income tax and excise tax-free.

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 a life insurance policy until the death of the insured).

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 (who may be someone the investor recommended to the insurance company) can generally change investments or reallocate among hedge funds or other investment managers 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 (often allowing quarterly reallocation among different types of investments or investment strategies). Furthermore, 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.

EXHIBIT 2

Smith Family Asset Mix Returns, Risks and Optimization Constraints (%)

No.	Asset Class	Annualized (1/1/90 to 3/31/99) Net Pre-Tax Return[1]	Current Yield[2]	Ann. Mgmt Fee[5]	Est. Ann. Turnover	Pct LT Gains	Ann. Pre-Tax Risk[3]	Constraints Min Percent	Max Percent	Group Constrain
				Traditional Asset Classes						
1	Cash (90-Day T-Bills)	6.55	6.55	0.30	100	0	0.76	0	100	None
2	Fixed Income (Merrill Lynch 3-7 Yr Muni)	6.77	6.77	0.35	40	0	3.33	0	100	None
3	Fixed Income (Lehman Aggregate)	8.17	8.17	0.35	40	0	3.98	0	100	None
4	U.S. Core Managed Equity (Russell 3000)	17.10	2.00	0.50	40	50	15.29	0	50	None
5	Non-U.S. Core Managed Equity (EAFE)	13.32	2.00	1.00	40	50	16.94	0	25	None
	Hedge Funds									
6	Convertible Arbitrage (HFR Convert.)	10.69	0.00	N/A	100	0	5.00	0	10	Hedge fund
7	Distressed Securities (HFR Distressed)	16.50	0.00	N/A	50	50	15.00	0	10	strategies
8	Long-Biased Equity Hedge (HFR Eq Hedge)	20.03	0.00	N/A	75	25	16.25	0	40	collectively
9	Merger Arbitrage (HFR Merger Arb)	11.92	0.00	N/A	100	25	9.00	0	10	must not ex-
10	Relative Value Arbitrage (HFR Rel Val)	13.61	0.00	N/A	100	25	8.50	0	10	ceed 50% of
11	Dedicated Short Selling[4] (HFR Short)	3.03	0.00	N/A	100	25	25.00	0	10	total portfolio.

Asset Class Returns and Risks Based on Monthly Historical Returns, January 1990 through March 1999.
Data Source: Ibbotson Associates & HFR, Inc.

[1]This is the arithmetic annual average return of the indicated HFR index or market benchmark. Returns on hedge funds have been netted of incentive fees and management fees; others are gross of management fees. If any asset is invested in through the PPVUL policy, its expected return is reduced by 75 basis points annually from what is shown in the table.

[2]The yield is modeled as zero for hedge funds. Though hedge funds generate income that we have treated as being taxed at ordinary tax rates, they tend not to distribute income to limited partners; hence, the yield available for reallocation within the portfolio is just part of the overall total return.

[3]Annualized Standard Deviation of benchmark or HFR index. In the case of HFR Indexes, standard deviation has been adjusted by Windermere Investment Associates to reflect the risk of a single manager. Windermere Investment Associates to reflect the risk of a single manager.

[4]Short selling has been disallowed from the insurance portfolio. Must be held in the taxable portfolio.

[5]Applicable only to traditional asset classes (fixed income and equities). Hedge funds returns are already shown net of management fees.

EXHIBIT 3
The Smith Family Correlation Matrix

Asset No.	Asset Class	Cash 1	ML Muni 2	LB Agg 3	R3000 4	EAFE 5	Conv Arb 6	Distrs 7	Eq Hdg 8	Mgr Arb 9	Rel Val 10	Short 11	S&P 500 Reference
1	Cash Equivalents	1.00	0.15	0.16	(0.09)	(0.09)	(0.09)	(0.12)	0.02	(0.09)	(0.11)	0.06	0.00
2	M-L 3-7 Year Muni		1.00	0.71	0.41	0.32	0.12	0.07	0.21	0.05	0.11	(0.23)	0.41
3	Lehman Aggregate			1.00	0.41	0.22	0.25	0.10	0.22	0.14	0.04	(0.14)	0.44
4	Russell 3000				1.00	0.49	0.43	0.49	0.38	0.56	0.39	(0.78)	0.99
5	EAFE					1.00	0.28	0.25	0.71	0.32	0.28	(0.45)	0.53
6	Convertible Arbitrage						1.00	0.56	0.56	0.49	0.55	(0.46)	0.41
7	Distressed Securities							1.00	0.61	0.61	0.55	(0.50)	0.44
8	Equity Hedge								1.00	0.51	0.55	(0.71)	0.66
9	Merger Arbitrage									1.00	0.40	(0.48)	0.53
10	Relative Value Arbitrage										1.00	(0.44)	0.35
11	Short Selling											1.00	(0.74)

Based on historical monthly total returns from January 1, 1990 through March 31, 1999.
Data Source: Ibbotson Associates and HFR, Inc.

The investor control issue is one of the trickiest issues related to this type of policy. 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 for some investors, we have found that the degree of control permitted is acceptable to many investors. Moreover, the tax-free buildup with successful investment managers, and the income tax-free and possibly estate tax-free payout at death, make PPVL insurance very attractive to certain wealthy investors. The costs of the "term" life insurance coverage in most PPVL insurance policies are sufficiently low to make the policy attractive to any wealthy hedge fund or other private capital investor. If the investor already has or needs term life insurance, the PPVL insurance could replace other life insurance coverage and make the strategy even more attractive.

For both the life insurance and annuity policies, the ability to add high-yield and short-term trading strategies to one's overall investment mix without adding tax-inefficiency can be very attractive.

DOMESTIC VERSUS OFFSHORE POLICIES

Private placement life insurance and annuities can be purchased from U.S. or offshore insurance companies. For U.S. policyholders, the same rules concerning tax deferral or elimination apply to domestic and offshore policies. An annuity or life insurance policy issued by an offshore foreign company, however, is generally subject to a 1% U.S. excise tax. Such foreign companies generally do not pay state premium taxes or federal DAC tax to which domestic policies are subject (which typically amounts to a one-time 3% cost for life insurance).

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. 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.

EXHIBIT 4

Summary of Smith Family Efficient Portfolio Alternatives, with and without Hedge Fund Insurance

	Portfolio with Insurance, After Initial Gift Tax Paid				Portfolio without Insurance, No Gift Tax Applicable			
Portfolio Characteristic	Portfolio (1-A)	Portfolio (1-B)	Portfolio (1-C)	Portfolio (1-D)	Portfolio (2-A)	Portfolio (2-B)	Portfolio (2-C)	Portfolio (2-D)
Initial Market Value—Combined Assets ($MM)	$95	$95	$95	$95	$100	$100	$100	$100
Taxable Portfolio	$85	$85	$85	$85	$100	$100	$100	$100
Insurance Portfolio	$10	$10	$10	$10	$0	$0	$0	$0
Optimized Asset Mix—Initial Year	100%	100%	100%	100%	100%	100%	100%	100%
Cash								
Tax-Exempt Fix Inc (M-L 3-7 Yr Muni)			5%	16%			7%	21%
Taxable Fix Inc (Lehman Aggregate)								
U.S. Core Managed Equities (Russell 3000)	50%	50%	45%	34%	50%	43%	28%	14%
Non-U.S. Core Managed Equities (EAFE)			0%					
Convertible Arbitrage								
Distressed Securities	10%	10%	10%	10%	10%	10%	10%	10%
Long-Biased (Directional) Equity Hedge	40%	38%	31%	27%	40%	40%	40%	40%
Merger (Risk) Arbitrage								
Relative Value Arbitrage			4%	8%		2%	10%	10%
Short Selling		2%	5%	5%		5%	5%	5%
One-Year Combined Portfolio Statistics								
5th Percentile One-Yr After-Tax Return	-3.50%	-3.04%	-1.63%	-0.36%	-3.36%	-2.05%	-0.77%	0.34%
95th Percentile One-Yr After-Tax Return	33.96%	32.82%	28.93%	25.29%	32.52%	29.43%	25.76%	22.35%
Median One-Yr After-Tax Rate of Return	13.70%	13.48%	12.62%	11.73%	13.17%	12.60%	11.71%	10.80%
20 Year Investment Horizon (No Spending)								
Average Pre-Tax Return	17.82%	16.86%	15.74%	14.51%	17.96%	17.23%	16.25%	14.84%
Average Pre-Tax Risk	14.02%	12.20%	10.59%	8.98%	14.02%	12.17%	10.57%	8.96%
Average After-Tax Return	12.97%	12.32%	11.44%	10.65%	11.60%	11.05%	10.40%	9.73%
Average After-Tax Risk	11.80%	10.54%	9.07%	7.64%	10.94%	9.59%	8.07%	6.70%
After-Tax Sharpe Ratio (6%)	0.79	0.83	0.86	0.92	0.73	0.77	0.84	0.91
			Percentiles of Pre-Estate Tax Wealth—Yr 20					
95th Percentile	$2,050	$1,734	$1,392	$1,129	$1,638	$1,401	$1,162	$960
Mean	$1,090	$970	$829	$719	$898	$813	$724	$640
5th Percentile	$475	$461	$436	$418	$413	$411	$407	$397
			Derived Percentiles of Post-Estate Tax Wealth —Yr 20					
95th Percentile	$1,325	$1,123	$852	$674	$737	$630	$523	$432
Mean	$677	$602	$494	$419	$404	$366	$326	$288
5th Percentile	$277	$268	$250	$236	$186	$185	$183	$179

EXHIBIT 5

Summary of Smith Family Efficient Portfolio Alternatives, with and without Hedge Fund Insurance

	Portfolio with Insurance, After Initial Gift Tax Paid				Portfolio without Insurance, No Gift Tax Applicable			
Portfolio Characteristic	**Portfolio (1-A)**	**Portfolio (1-B)**	**Portfolio (1-C)**	**Portfolio (1-D)**	**Portfolio (2-A)**	**Portfolio (2-B)**	**Portfolio (2-C)**	**Portfolio (2-D)**
Initial Market Value—Combined Assets ($MM)	$95	$95	$95	$95	$100	$100	$100	$100
Taxable Portfolio	$85	$85	$85	$85	$100	$100	$100	$100
Insurance Portfolio	$10	$10	$10	$10	$0	$0	$0	$0
Optimized Asset Mix	100%	100%	100%	100%	100%	100%	100%	100%
Cash								
Tax-Exempt Fix Inc (M-L 3-7 Yr Muni)			5%	16%			7%	21%
Taxable Fix Inc (Lehman Aggregate)								
U.S. Core Managed Equities (Russell 3000)	50%	50%	45%	34%	50%	43%	28%	14%
Non-U.S. Core Managed Equities (EAFE)			0%					
Convertible Arbitrage								
Distressed Securities	10%	10%	10%	10%	10%	10%	10%	10%
Long-Biased (Directional) Equity Hedge	40%	38%	31%	27%	40%	40%	40%	40%
Merger (Risk) Arbitrage								
Relative Value Arbitrage			4%	8%		2%	10%	10%
Short Selling		2%	5%	5%		5%	5%	5%
One-Year Combined Portfolio Statistics								
5th Percentile One-Yr After-Tax Return	-3.50%	-3.04%	-1.63%	-0.36%	-3.36%	-2.05%	-0.77%	0.34%
95th Percentile One-Yr After-Tax Return	33.96%	32.82%	28.93%	25.29%	32.52%	29.43%	25.76%	22.35%
Median One-Yr After-Tax Rate of Return	13.70%	13.48%	12.62%	11.73%	13.17%	12.60%	11.71%	10.80%
30 Year Investment Horizon (No Spending)								
Average Pre-Tax Return	17.62%	15.93%	14.85%	13.69%	17.96%	16.99%	15.58%	14.18%
Average Pre-Tax Risk	14.02%	11.19%	9.67%	8.17%	14.02%	12.13%	10.35%	8.66%
Average After-Tax Return	14.26%	12.76%	11.86%	11.02%	11.53%	10.93%	10.26%	9.59%
Average After-Tax Risk	12.59%	10.12%	8.70%	7.31%	10.94%	9.71%	8.20%	6.76%
After-Tax Sharpe Ratio (6%)	0.84	0.90	0.95	1.01	0.72	0.75	0.81	0.88
			Percentiles of Pre-Estate Tax Wealth ($MM)					
95th	$11,035	$6,722	$4,930	$3,654	$5,322	$4,281	$3,303	$3,303
Mean	$5,160	$3,483	$2,736	$2,185	$2,639	$2,246	$1,872	$1,872
5th	$1,771	$1,453	$1,285	$1,156	$1,015	$958	$910	$910
			Derived Percentiles of Post-Estate Tax Wealth—Yr 20 ($MM)					
95th	$11,579	$7,033	$5,060	$3,753	$2,395	$1,926	$1,486	$1,486
Mean	$5,160	$3,397	$2,669	$2,130	$1,188	$1,011	$842	$842
5th	$1,608	$1,252	$1,152	$1,041	$457	$431	$409	$409

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. While 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, significantly reducing the risk.

Offshore insurance companies marketing in the U.S. (or otherwise subjecting themselves to 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 issued by a questionable insurance company.

At the same time, offshore insurance companies may be less likely to be scrutinized by the IRS, may be better for asset protection, or may allow investment in offshore investments not open to a U.S. insurance company (or available only with higher minimum investments or upon less favorable liquidity terms than available offshore).[2] Offshore insurance policies may give investors greater control of their own investments, although this benefit may carry additional tax risks.

Until the tax law is clarified, there is some risk that an annuity issued to a U.S. resident 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. are not subject to U.S. tax, they arguably do not qualify, in which case there is a risk that this exception does not apply.

CONCLUSION

Private placement variable rate life insurance and annuities can provide very significant benefits for the policyholder investors, greatly increase after-tax returns, provide a particularly good structure for investment strategies that otherwise could be tax-inefficient, and help to reduce the investment risk of a portfolio by adding high-yield and high-turnover strategies without adding tax-inefficiency.

ENDNOTES

[1]This optimization uses PORTAX, a proprietary, multiperiod after-tax optimization software program, that permits subportfolios with varying tax status.

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