LIFE INSURANCE FOR YOUR HEDGE FUND

Hedge fund life insurance has the potential of eliminating income tax on hedge fund earnings, and with proper estate planning, even eliminating estate taxes at the death of the insured.

WHAT IS HEDGE FUND INSURANCE?

Hedge fund life insurance is life insurance with a separately invested account for that policy's cash value. With hedge fund insurance, the investor can purchase an insurance policy in which the cash value is invested in one or more hedge funds. The hedge fund's returns increase the cash value, without any reduction for income tax. The cost in some policies can average as low as 1% to 2% of cash value each year.

Assuming the insurance policy is respected for tax purposes, the growth in the fund will not be subject to current income tax, and if the policy is maintained until the death of the insured, the entire death benefit with all the earnings from the hedge fund is free of income taxes.

EXAMPLE OF BENEFITS

The hypothetical chart below compares the return on a hedge fund life insurance policy against a taxable investment at various ages. The chart 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).

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 chart shows that the death benefit in the hypothetical case 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 exceeded 12%, and would be lower if the average returns were less than 12%. The tax benefit would be even higher if the investor's tax rate were more than 35%. Marginal tax rates for many hedge fund investors are between 40% and 50%.

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 creditor's claims against the insurer. Also, the separate account is generally protected from the claims of creditors of the policy owner.

ESTATE PLANNING

Hedge fund life insurance 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 an irrevocable trust, 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 taxes on the death of the insured and spouse and possibly the generation-skipping tax on the death of the policy holder's children. Since each of these federal taxes can be as high as 55%, the tax savings could be substantial.

Proper estate planning may minimize the gift tax incurred in setting up such a trust. 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. 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.

HEDGE FUND INSURANCE IS NOT FOR EVERYONE

Since insurance companies often require $20 million to open a separate account and $1 million in premiums for each policy, this strategy is generally appropriate only for very wealthy individuals or families. Hedge fund life insurance is best for someone who expects not to withdraw the cash value from the insurance prior to the policy holder's death or at least is planning not to need it for a long time. Although the cash value of such policies can be withdrawn at any time, the earnings on the cash withdrawal are taxed as ordinary income at the time of the withdrawal. Additionally they also may be subject to a 10% excise tax. 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. But the benefit is certainly not nearly as great as the complete exemption from income tax.

Generally, only investors who really want to invest in hedge funds would purchase hedge fund life insurance. Because the costs of maintaining the policy and the at-risk life insurance, 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. If the cost of the at-risk life insurance is not considered a cost, because the insured needs this insurance coverage anyway for personal or estate planning reasons, 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.

INVESTOR CONTROL

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 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. The tax-free build up, the income tax free death benefit, and the estate tax-free payment 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. Funds placed in the insurance policy are likely to grow faster, since income tax does not have to be paid, and are less likely to be withdrawn or switched to another hedge fund or other investments. Some hedge fund insurance policies provide a way for managers to allow up to one hundred additional investors to invest in the fund as a group.

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.

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

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