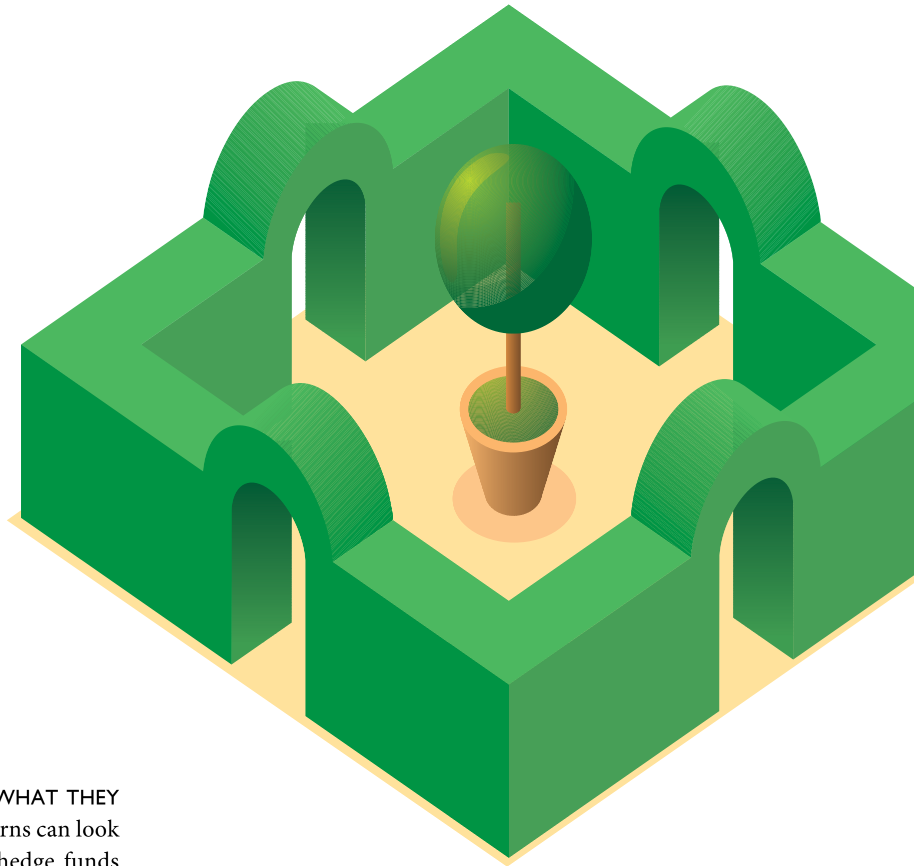
Edward A. Renn and Frank W. Seneco



Keeping What You Make

INVESTORS CARE ABOUT WHAT THEY KEEP, NOT WHAT THEY earn. That's why many hedge funds that post big returns can look quite ordinary after taxes are figured. With many hedge funds generating ordinary income and short-term capital gain, federal income tax rates of 39.6% will be the norm for most hedge fund investors in 2013. The Obama health care tax will impose an additional 3.8% tax burden on returns. Income taxes in high-tax states such as New York and California could impose at least an additional 12%, meaning the combination of state and federal taxes for hedge fund investors could easily exceed 50%.

There is, however, at least one way for investors to dampen the tax hit.

For over two decades, one of the best-kept secrets in tax planning has been private placement life insurance (PPLI), which makes it possible for a hedge fund investor to capture return tax-free. PPLI is a variable universal life insurance policy that provides cash value appreciation based on a segregated investment account and a life insurance benefit.

PPLI is designed to maximize savings and minimize the death benefit. The investment account can be invested in tax-inefficient hedge fund strategies via an insurance dedicated account. The death benefit is typically the minimum amount allowed to qualify as insurance under the Internal Revenue Code.

The cost of PPLI averages 1% to 1.5% of the amount invested annually. Assuming the PPLI policy is purchased over three or four years, the policy owner has tax-free access to the PPLI policy's value through loans. If held to the insured person's death, the investment account and the insurance coverage are paid out as a death benefit, free of income tax. Depending on local law and the entity that owns the policy, PPLI policies allow significant creditor protection from tort, contract and marital creditors.

PPLI policies typically require a $3 million to $5 million investment spread out over three to four years. Gradual funding of the policy avoids modified endowment contract (MEC) status and enables non-taxable loans to be taken from the policy. Although it is possible to put money into a PPLI policy as a single premium, this would result in the PPLI policy being treated as an MEC, which limits tax-free access to the policy cash values during the insured person's life.

Ideally, the PPLI would be held until the insured person's death, but investment options can be changed along the way. PPLI policies are not liquid capital that the owner may redeploy in a few years. It is shelf money that may be available to the owner if necessary, but is really intended to grow tax-free for the benefit of future generations. PPLI is a terrific option for pre-existing multigenerational trusts. Mass market customers buy life policies in part for their income tax benefits, which can also be achieved with off-the-shelf variable products, but PPLI investment options can be tailored to a high-end client's needs and the cost of insurance per dollar of coverage is much reduced.

The simplest and most common way to invest in a PPLI policy is through "insurance dedicated funds," or IDFs. An IDF is a hedge fund that is open only to investors who are buying the investment through insurance or annuity products. To qualify as insurance under the Internal Revenue Code, a policy must be diversified, with at least five separate investments that do not exceed certain concentrations. It is not a difficult hurdle, and it is usually easily achieved in a fund of funds, which is the most common class of IDF. An IDF is a "look-through" entity, so a single IDF with several underlying investments can satisfy diversification by itself. Non-IDFs do not receive

Figure 1

PPLI VS. HEDGE FUND RETURNS

AGE	INVESTMENT	PPLI END-OF-YEAR CASH VALUE	DEATH BENEFIT (INCLUDING CASH VALUE)	HEDGE FUND TAXABLE (53% TAX)
50	$10,000,000	$10,583,149	$41,162,000	$10,376,000
55		13,862,975	41,162,000	12,026,792
60		19,365,400	41,162,000	14,464,374
70		39,085,869	45,339,608	20,921,810
80		80,302,482	84,317,606	30,262,088
90		163,260,398	171,423,418	43,772,215

look-through treatment and count as a single investment, so multiple non-IDF funds must be purchased to satisfy diversification.

One other investment restriction is that the owner of a PPLI policy cannot control the purchase and sale of underlying investments in the segregated account. For example, a hedge fund manager cannot form an IDF and purchase a policy that holds his or her own IDF. This should not be confused with the ability of a PPLI owner to switch the funds invested in the PPLI contract's investment account. If performance of one IDF disappoints, it is easy to request that the insurance company switch to a different and better-performing IDF, so long as the owner does not control the underlying investments in the new IDF.

Let's look at an example. John Jones is a successful businessman with $50 million of investable assets. John loves his hedge fund investments but realizes more than half of his 2013 profits will benefit federal and state government. To compare the benefits of PPLI, he asks his agent to illustrate a $10 million single premium PPLI policy and compare it to a $10 million taxable hedge fund investment (see Figure 1).

Assuming there is a net annual 8% return, PPLI generates $4.9 million more than a taxable hedge fund investment after 10 years. After 20 years, PPLI has outperformed by over $18 million. Held for 40 years, the PPLI policy will produce $120 million more than a taxable account. The outperformance will only increase if the investment returns are higher. Some commentators believe tax rates are likely to increase, which also would help the PPLI product outperform.

PPLI is available from mainstream domestic insurance carriers and offshore insurance companies. Sometimes, given a client's unique needs, a foreign policy is the best solution. But for the majority of Americans looking at PPLI for tax-free growth, a domestic carrier will be simpler, more straightforward, and provide the name recognition people look for when transferring millions of dollars.

PPLI is a complicated product and requires an insurance agent who understands its moving parts and how to best utilize it in an overall tax plan. Traditional life insurance agents prefer conventional products that pay all of the first-year premiums to the agent as a commission. In PPLI, agent commissions are adjustable, typically measured in basis points and paid annually.

PPLI is especially useful as a component of more complicated tax strategies. If a client has a significant windfall that results in a large infusion of ordinary income in a particular year, such as the recognition of offshore deferrals for a hedge fund manager or a large bonus for an executive or business owner, PPLI, in conjunction with a charitable lead annuity trust (CLAT), can offset the tax while supporting charities, including private foundations. At the end of a successful long-term CLAT, wealth that is significantly greater than the original contribution can pass, free of gift taxes, to children or other loved ones.

PPLI can address many cross-border tax problems faced by international families. PPLI provides a partial solution to foreign non-grantor trusts with accumulation problems, as it prevents the trust from realizing additional income on an annual basis. PPLI, or more likely a private placement annuity, can temporarily shelter non-U.S. investments from the U.S. tax system for a foreign executive who intends to return to his or her home country eventually, but who is assuming a post in the U.S. and therefore will be a tax resident in the U.S. and temporarily subject to U.S. income tax on worldwide income.

PPLI is income-tax efficient, while providing the owner with tax-free access to the policy cash values. With proper planning, the cash value appreciation and insurance coverage can also escape gift, estate and GST tax. It can be structured to provide world-class creditor protection. PPLI owners are also often pleasantly surprised to find that they no longer need to chase fund K-1s to complete their personal tax returns. PPLI is legitimate, bright-line tax planning. It is a perfect solution for patient investors who desire exposure to tax-inefficient hedge funds without paying confiscatory income taxes.

Non-IDFs do not receive look-through treatment and count as a single investment, so multiple non-IDF funds must be purchased to satisfy diversification.

Edward A. Renn is a partner in the private client department of Withers Bergman LLP, an international law firm. He can be reached at edward.renn@withers.us.com.

Frank W. Seneco is an advanced planning life insurance specialist. He is the president of Seneco & Associates Inc., a boutique advanced planning firm in Connecticut.