

# INVESTING IN HEDGE FUNDS THROUGH PRIVATE PLACEMENT LIFE INSURANCE

*Leslie C. Giordani, J.D.*

*Amy P. Jetel, J.D.*

## Introduction

This article examines the use of private placement life insurance (PPLI) to manage the tax inefficiency of hedge funds and hedge funds of funds within a high-net-worth investor's taxable portfolio. PPLI can improve the tax efficiency of a portfolio because life insurance enjoys favorable tax treatment. This favorable tax treatment allows investment consultants to strategically allocate assets in a PPLI portfolio to hedge funds and hedge funds of funds (which are generally tax-inefficient investments) without worrying about the negative tax consequences that would occur in a traditional investment portfolio.

Life insurance has a long history as a tax-advantaged investment vehicle with minimal legislative risk, thanks to the powerful lobbying influence of the life insurance industry and other groups. Certain established carriers, both inside and outside the United States, offer "private placement" policies that are priced institutionally and comply fully with U.S. tax rules and therefore receive the preferential tax treatment of life insurance. These private placement products offer investment platform choices that include hedge funds and hedge funds of funds.

Unlike traditional life insurance, an investor buys a PPLI policy not for its life insurance component but as a tax-free investment vehicle. Such a purchase, if priced and structured correctly, can improve a portfolio's overall risk-adjusted return by increasing allocations to tax-inef-

ficient asset classes and accessing the broadest possible selection of high-quality investment managers, including managers of hedge funds and hedge funds of funds.

This article concentrates on the tax treatment of PPLI and then addresses practical matters for purchasers and investment consultants.

## Tax Advantages

Life insurance has the following three well-known tax advantages:

1. The cash value of a life insurance policy grows faster than a taxable investment portfolio because earnings, including dividends, interest, and capital gains, aren't taxable as they accumulate within the policy.<sup>1</sup>
2. The policyholder can generally make tax-free withdrawals and loans against the policy's assets during the insured's lifetime.<sup>2</sup>
3. The proceeds payable upon the death of the insured aren't taxable income of the beneficiary.<sup>3</sup>

## Asset Protection Advantages

Life insurance provides excellent protection against future creditor risk because of its preferred status under certain state exemption statutes. This protection increases when life insurance is coupled with sophisticated offshore planning. Because carriers typically do business in states or offshore jurisdictions that provide separate-account protection, an

insurance company must segregate the assets inside a private placement policy from its general account, thereby protecting assets from the life insurance company's creditors. Some states also exempt the debtor's interest in a policy's cash surrender value as well as the death proceeds.<sup>4</sup> But domestic exemption statutes vary widely, and in some states the exemption statute is inadequate or restrictive as to the allowable exemption amount or the class of persons entitled to the exemption.<sup>5</sup>

In contrast, many offshore jurisdictions' laws treat insurance contracts as well as—or better than—state laws. Offshore legislation may include specific exemption language and a pro-debtor protection regime. A PPLI buyer typically accesses benefits of a U.S.-tax-compliant policy issued by an offshore company by establishing a foreign situs trust or company to own the policy. Offshore, the client then also enjoys the additional investor confidentiality that is generally not the norm in the United States.

### Insurance Product Issues

**F**ew PPLI investors regard the life insurance component—that is, the death benefit payable in excess of cash value—as an important feature. The life insurance component, however, is critical to PPLI's tax treatment, because the tax benefits are lost if the product fails to qualify as life insurance under tax rules. Moreover, if the cost of insurance and other fees is too high, the tax benefit is diminished as a practical matter because of poor net investment performance.<sup>6</sup>

Planners generally design PPLI policies to maximize cash-value accumulation and to reduce the death benefit so that cost has the least effect on cash value. In other words, the policy design provides for the largest up-front infusion of cash with the smallest death benefit amount possible under Internal Revenue Code guidelines.

### Internal Revenue Code Section 7702 Compliance

**T**o qualify for tax advantages, life insurance policies issued after December 31, 1984, must meet the def-

*Few PPLI investors regard the life insurance component—that is, the death benefit payable in excess of cash value—as an important feature.*

inition of “life insurance” under Internal Revenue Code Section 7702. IRC Section 7702 states that the policy must be a life insurance contract under applicable law that meets the cash-value accumulation test (CVAT) or the guideline premium test (GPT) plus the cash-value corridor test (CVCT). These tests disqualify policies created solely as investment vehicles,

without regard to the relationship between cash value and the death benefit. A determination must be made at least once every twelve months that a variable life insurance contract satisfies either the CVAT or the GPT/CVCT.<sup>7</sup> The two tests will give different results for any given client. Some carriers have products that meet both tests; others have products that meet only one. An experienced insurance professional should determine which test works best for a particular case.

### Modified Endowment Contract (MEC) Testing

**P**PLI policies frequently are designed to maximize cash-value growth without jeopardizing the policy owner's tax-free access to cash value during the insured's lifetime. But a policy owner who funds a policy so heavily that it is defined as a modified endowment contract (MEC) will pay tax at ordinary income rates on policy value gains that are accessed during the insured's lifetime, which are accessed before policy basis in the case of a MEC.

Under IRC Section 7702A, a contract is a MEC if it was entered into after June 21, 1988, and it fails to meet the seven-pay test; that is, if the accumulated amount that the policy owner pays during the first seven contract years exceeds the sum of the net level premiums that the policy owner would have paid if the contract provided for paid-up future benefits after the payment of seven level annual premiums. Generally speaking, non-MEC premiums are paid over four or five years and MEC premiums are a one-time, up-front payment. Of course, if the purpose is to pass wealth from one generation to the next without requiring access to policy cash value, MEC status is inconsequential, and a MEC structure is preferable because of the superior tax-free com-

pounding effect achieved by a one-time, up-front premium payment.

### **IRC Section 817(h) Testing and the Investor Control Doctrine**

Press releases and news articles<sup>8</sup> about recent revenue rulings<sup>9</sup> concerning the investor control doctrine and proposed changes to the IRC Section 817(h) diversification rules<sup>10</sup> have labeled PPLI investing as a “tax-avoidance investment scheme” that puts “legitimate products at risk.”<sup>11</sup> These authors ignore the fact that the recent rulings merely narrow one small aspect of the law affecting life insurance and do not prohibit PPLI as a tax-preferred investment vehicle or the investment of policy assets in hedge funds. The life insurance arrangements affected by the recent legislative changes were not inherently wrong when put into place. To the contrary, they were designed in compliance with the Treasury Regulations under IRC Section 817(h). Thus, investing in hedge funds through PPLI remains a viable planning tool, and the recent legal developments affect only the way the insurance industry must design these products from now on.

A brief history of the investor control doctrine and IRC Section 817(h) explains why these changes are occurring and how PPLI policies should be structured in light of the new developments.

#### ***The Investor Control Doctrine***

In the 1970s, the IRS grew concerned that taxpayers were avoiding income tax by “wrapping” their investments in “investment annuity contracts,” which created “the possibility of major tax shelter abuse.”<sup>12</sup> These “potentially abusive” investments were structured as follows: Each investment annuity contract paid an annuity based on the investment return and market value of the contract’s segregated-asset account. A third-party custodian, typically a bank, held and invested the contract’s assets according to the annuity owner’s directions.<sup>13</sup> In response, the IRS issued four revenue rulings between 1977 and 1982 describing circumstances in which owners of variable annuity or variable life insurance contracts would be treated and taxed as owners of the underlying assets because of their control of the investments. In *Christoffersen v. United States*,<sup>14</sup> the

United States Court of Appeals for the Eighth Circuit adopted the IRS’s position. These “investor control” authorities, detailed below, applied to variable annuity and variable life insurance contracts the well-established federal income tax principle that a person is treated as the owner of an asset if he possesses significant control and ownership over that asset, regardless of who holds legal title to it.

#### ***Revenue Ruling 77-85***

The IRS’s first response, Revenue Ruling 77-85,<sup>15</sup> concludes that the annuity owner is, for federal income tax purposes, the owner of the separate-account assets under the following conditions:

1. the annuity owner controls the investment of the separate-account assets;
2. the annuity owner has the power to vote any securities in the account; and
3. the annuity owner can withdraw any or all of the assets at any time.

#### ***Revenue Ruling 80-274***

The second ruling, Revenue Ruling 80-274,<sup>16</sup> similarly concludes that a savings-and-loan-association depositor is taxed as the owner of a certificate of deposit (CD) underlying a variable annuity contract when the depositor transfers the CD to a life insurance company in exchange for a variable annuity contract and the insurance company is expected to hold the transferred CD for the depositor’s benefit.

#### ***Revenue Ruling 81-225***

The centerpiece of the investor control authorities is the third ruling, Revenue Ruling 81-225,<sup>17</sup> which applies the investor control principle to five different situations. In four of the situations, the annuity owner—not the insurance company—is considered the owner of the mutual-fund investments underlying the annuity contracts because the investments are available for purchase by the general public. In the fifth situation, the insurance company—not the annuity owner—is considered the owner of those investments because the shares are not available to the general public; they are available only through the purchase of a variable contract. Revenue Ruling 81-225 concludes that when the under-

lying shares are directly or indirectly available to the public, the annuity owners enjoy sufficient control and other indicia of ownership to be considered owners of the underlying shares for tax purposes and the insurance company is “little more than a conduit between the policyholders and their mutual fund shares.”

#### **Revenue Ruling 82-54**

In the final of the four “investor control” rulings, Revenue Ruling 82-54,<sup>18</sup> the annuity owners direct the insurance company to invest in shares of any or all of three mutual funds that are not available to the public. One mutual fund invests primarily in common stocks, another in bonds, and a third in money market instruments. Annuity owners allocate their premium payments among the three funds and have an unlimited right to reallocate before the annuity contract’s maturity date. The ruling concludes that the owners’ ability to choose the contract’s investments does not constitute sufficient control to cause them to be treated as owners of the underlying mutual-fund shares. In its analysis, the IRS reiterated its position from Revenue Ruling 81-225 that public availability of investments will cause annuity owners to be treated as owners of the underlying investments for income tax purposes. Specifically, the IRS explained:

“In each of the four situations [in Revenue Ruling 81-225] the mutual fund shares were available for purchase not only by the prospective purchasers of the annuity contracts, but also by other members of the general public. The policyholders’ position in each situation was substantially identical to what it would have been had the mutual fund shares been purchased directly by the policyholders.”

#### ***Christoffersen v. United States***

In 1984, the United States Court of Appeals for the Eighth Circuit upheld the investor control theory of Revenue Ruling 81-225 in *Christoffersen v. United States*.<sup>19</sup> The taxpayers in *Christoffersen* purchased a variable annuity contract that reflected the investment return and market value of separate-account assets. The taxpayers had the power to direct the investment of premiums in any one or all of six publicly traded mutual funds, to reallocate their investment among the funds at any time, to make withdrawals, to surrender the contract, and to

apply the contract’s accumulated value to provide annuity payments. These facts indicated to the court that the taxpayers effectively owned the separate-account assets. The court therefore held that “[u]nder the long recognized doctrine of constructive receipt, the income generated by the account assets should be taxed to the [annuity holders and not to the issuing insurance company] in the year earned, not at some later time when the [annuity holders] choose to receive it. This is the essence of Revenue Ruling 81-225, which we find persuasive.”<sup>20</sup>

#### **IRC Section 817(h)**

After the IRS issued these four revenue rulings and the Eighth Circuit decided *Christoffersen*, Congress enacted IRC Section 817, which aims to discourage the use of variable annuities and life insurance primarily as investment vehicles.<sup>21</sup> Because IRC Section 817(h) and its regulations were enacted after the investor control authorities, and because they address some of the same issues as those authorities, many in the insurance industry concluded that this statute superceded the investor control doctrine.<sup>22</sup> The discussion below will reveal why this conclusion was a logical one.

To qualify as life insurance, variable life insurance policies must comply with IRC Section 817(h), which requires diversification of variable life insurance separate accounts. In its simplest form, each “segregated asset account” must contain at least five investments, and no one investment may represent more than 55 percent of the value of a separate account’s assets, no two investments may constitute more than 70 percent, no three investments may comprise more than 80 percent, and no four investments may make up more than 90 percent of the separate account’s value. An “investment” for purposes of the diversification test is any single investment (for example, a security, cash, etc.) or any investment vehicle that is not looked through to its underlying investments, as discussed in detail below. Failure to meet the diversification requirements under IRC Section 817(h) will result in taxation of the cash-value accumulation as ordinary income to the policy owner.

The diversification rules also cover the case in which the investments of the underlying separate account(s) are hedge funds or hedge funds of funds. Most notably, IRC Section 817(h) regulations permit

“look-through” treatment for certain investment structures, such as private investment partnerships. In other words, if the partnership meets certain requirements, the separate account will be treated as being invested in the various investments of the partnership, rather than being invested in the partnership itself. Generally, the IRC Section 817(h) regulations allow look-through treatment for hedge fund investments that meet the following two-part test for an “insurance-dedicated fund”:<sup>23</sup>

1. all the beneficial interests in the partnership (or other investment vehicle) must be held by one or more segregated asset accounts of one or more insurance companies (subject to certain limited exceptions); and
2. access to the partnership (or other investment) must be exclusively through the purchase of a variable contract.

But the regulations further provide that “non-registered partnerships”—those that are not registered under a federal or state law regulating the offering or sale of securities—receive look-through treatment without meeting the above two requirements.<sup>24</sup> In short, a segregated account may be invested in a non-registered partnership alongside “public investors” without causing the cash-value accumulation to be taxed as ordinary income. U.S. hedge funds and hedge funds of funds are typically non-registered investment partnerships and therefore may be looked through to their underlying assets for purposes of applying the diversification tests of IRC Section 817(h). This non-registered partnership exception to the two-part test generated controversy recently because, despite explicit regulations, the IRS has ruled as though the exception does not exist.

Whether the investor control doctrine survived the enactment of IRC Section 817 has been a long-standing debate in the insurance tax community. Recall that the investor control doctrine declared that annuity owners will be taxed as direct owners of a separate account’s

investments if those investments are available to the general public. But because IRC Section 817’s non-registered partnership exception took effect after the investor control doctrine, one may conclude that IRC Section 817 has sole authority over the question of whether a segregated account may invest alongside public investors in a non-registered partnership and still qualify as life insurance. As one commentator put it, if the investor control doctrine survived enactment of IRC Section 817, then the statute

must have been a “nullity the day it was enacted” because application of both tests is “implicitly unworkable, confused, and confusing.”<sup>25</sup> After all, Treasury Regulation Section 1.817-5(f)(2)(ii) explicitly allows a non-registered partnership to be looked through to determine diversification—regardless of whether investment in the partnership is available to public investors. If the “public availability” aspect of the investor control doctrine still applies to non-registered partnerships despite this explicit exception, then there is no point in applying look-through to determine diversification. Therefore, although the reg-

ulation incorporates by reference certain aspects of the earlier investor control revenue rulings,<sup>26</sup> the seeming incompatibility of the two tests leads to the conclusion that the investor control doctrine—at least as to non-registered partnerships—did not survive the enactment of IRC Section 817(h).

However, IRS private letter rulings have held that IRC Section 817(h) did not supersede the four investor control revenue rulings or *Christoffersen*—and have ignored Treasury Regulation Section 1.817-5(f)(2)(ii).<sup>27</sup> And recently, the IRS, keeping with its position in these private letter rulings, issued two revenue rulings<sup>28</sup> that further solidified the IRS’s stance on this issue. These two rulings are discussed below.

**Revenue Ruling 2003-91**

This ruling, issued on July 24, 2003, confirms the principle that an owner of variable life insurance

*As one commentator put it, if the investor control doctrine survived enactment of IRC Section 817, then the statute must have been a “nullity the day it was enacted” because application of both tests is “implicitly unworkable, confused, and confusing.”*

and annuity contracts may allocate investments among a limited number of insurance-dedicated funds without being deemed the owner of the contract for federal income tax purposes. Revenue Ruling 2003-91 describes the purchase of either a variable life insurance or variable annuity contract, the investments of which may be allocated by the contract holder among various sub-accounts, and it states that whether a contract holder has sufficient ownership to be the owner of the assets for federal income tax purposes “depends on all of the relevant facts and circumstances.” The IRS cites that investment in the sub-accounts “is available solely through the purchase of a [variable c]ontract” as a relevant fact and circumstance in determining investor control, and it also cites the early investor control rulings.

**Revenue Ruling 2003-92**

This ruling, also issued on July 24, 2003, deals specifically with non-registered partnership investment. It describes three situations in which variable contracts are not registered under federal securities laws and are sold only to “qualified purchasers” that are “accredited investors.”<sup>29</sup> The assets supporting the contracts are held in a segregated asset account that invests in interests of a non-registered partnership. In the first two situations, partnership interests are available for purchase by the public, and in the third situation partnership interests are available only through the purchase of a variable annuity or life insurance contract. The IRS held that in the first two situations, because partnership interests are available to the public, the contract holder is the owner of the assets for federal income tax purposes. But because the partnership interests in the third situation are available only through the purchase of a variable contract, the contract holder is not the owner of the segregated account. While the IRS does discuss IRC Section 817 and its regulations, it does not mention the Treasury Regulation Section 1.817-5(f)(2)(ii) look-through rule for non-registered partnerships.<sup>30</sup>

*The IRS’s position in these rulings and in the prior letter rulings, which completely ignores the existence of Treasury Regulation Section 1.817-5(f)(2)(ii), has been the subject of much criticism.*

The IRS’s position in these rulings and in the prior letter rulings, which completely ignores the existence of Treasury Regulation Section 1.817-5(f)(2)(ii), has been the subject of much criticism.<sup>31</sup> Because these authorities were contrary to the plain language of the Treasury Regulation, it was doubtful that the Service’s reasoning would withstand a court challenge. Now, however, the Treasury Department and the IRS have stated their intent to eliminate the controversial non-registered partnership exception to the look-through rules.

**Proposed Changes to IRC Section 817 Regulations**

On July 29, 2003, less than one week after the IRS issued the two revenue rulings just discussed, the Treasury Department and the IRS proposed the repeal of Treasury Regulation Section 1.817-5(f)(2)(ii). This action would mandate the use of insurance-dedicated hedge funds (that is, funds that are available only through the purchase of a variable life insurance or annuity contract)

and prohibit the use of non-insurance-dedicated funds as direct investments of separate accounts. Consistent with statements made in a prior private letter ruling<sup>32</sup> and the reasoning adopted in Revenue Ruling 2003-92, the notice proposing the repeal states the following:

“The Treasury Department and the IRS are concerned that § 1.817-5(f)(2)(ii) is not consistent with Congressional intent because it is not explicitly subject to the public availability limitation of section 817(h). The Treasury Department and the IRS believe that removal of § 1.817-5(f)(2)(ii) will eliminate any possible confusion regarding the prohibition on ownership of interests by the public in a non-registered partnership funding a variable contract.”<sup>33</sup>

In light of the fact that the IRS ignored the existence of Treasury Regulation Section 1.817-5(f)(2)(ii) in Revenue Ruling 2003-92 and Private Letter Ruling 200244001, it’s interesting to note that the Treasury and the IRS concede in the notice that, “[u]nlike § 1.817-5(f)(2)(i), satisfaction of the non-registered partnership

look-through rule of § 1.817-5(f)(2)(ii) is not explicitly conditioned on limiting the ownership of interests in the partnership to certain specified holders.<sup>34</sup> And the notice provides for a grace period for arrangements to be brought into compliance with the new law as long as those arrangements were “adequately diversified within the meaning of section 817(h) prior to the revocation of § 1.817-5(f)(2)(ii).”<sup>34</sup> One could wonder how an arrangement could be considered adequately diversified under a regulation that the IRS completely ignored in enforcing the diversification rules in the first place, but these ponderings may be best left to the academic realm. In practice, it is unlikely that the IRS will not allow an otherwise satisfactory variable contract, the separate account of which invests in a non-insurance-dedicated non-registered partnership, and that brings itself into timely compliance after the repeal of Section 1.817-5(f)(2)(ii), to receive the benefit of the grace period.

### ***Lingering Issue: Is the Asset Allocator Model Viable?***

Many PPLI and annuity contracts are structured to permit the policy owner to select from a group of asset-management choices. Among these choices is one or more independent “asset allocators” who constructs and manages one or more separate accounts consisting of non-insurance-dedicated hedge funds that meet the IRC Section 817(h) diversification test (without regard to the exception under Treasury Regulation Section 1.817-5(f)(2)(ii)). The account managed by this asset allocator is available only to insurance companies in connection with their variable contracts, making such an account “insurance dedicated” albeit not a “fund.” This arrangement is generally known as a privately managed separate account, or “the allocator model.” In Revenue Ruling 2003-91, the IRS appeared to confirm the validity of the allocator model, but the statement of facts provided that the contract holder “may not communicate directly or indirectly with [the insurance company] concerning the selection or substitution of [the independent investment adviser].” Adequate diversification of the separate account does not prevent the IRS from finding that the contract holder should still be treated as the owner of the assets in the account due to his control over the investments;<sup>35</sup> therefore, because

policy owners or their advisers might bring an allocator to the insurance carrier’s attention, this language in Revenue Ruling 2003-91 has caused some concern about whether the policy owner’s selection of an allocator might give rise to a finding of investor control.

The IRS consistently has held that a contract holder may allocate the investments of the separate account among the insurance company’s available choices without being deemed the owner of the separate account for federal income tax purposes.<sup>36</sup> If the contract holder instead selects an independent party approved by the insurance company to make investment decisions, the IRS likely wouldn’t find that the selection of an allocator is a form of control unless there is an “arrangement, plan, contract, or agreement” between the contract holder and the allocator with regard to the investments of the separate account.<sup>37</sup> Therefore, the allocator should be selected from a list provided and approved by the insurance company, and the contract holder should not mandate the use of his or her own allocator. The IRS has provided guidance on this issue by approving an arrangement in which the contract holder’s “influence over the way the investments are managed will be limited to selecting an investment manager from a pool of investment managers whose credentials have been evaluated and approved by [the insurance company]. These investment managers may be recommended to [the insurance company] by one or more [contract holders]. [The insurance company] will be under no obligation to approve any such recommendations. Moreover, once [the contract holder] makes an initial selection, the investment manager can only be changed by [the insurance company] and not by [the contract holder].”<sup>38</sup> Presumably, however, a policy owner can change from one investment manager approved by the insurance company to another investment manager approved by the insurance company under authority of the line of rulings previously discussed.<sup>39</sup>

A final note of caution, however. It is possible that, due to the IRS’s apparent policy of limiting wealthy taxpayers’ ability to invest in hedge funds within life insurance contracts, the IRS could absolutely prohibit insurance carrier subscriptions to hedge funds that are not “insurance-dedicated.” Under the allocator model—even though the policy owner selects only the allocator

and does not select the underlying noninsurance-dedicated hedge funds—the IRS might find that investor control exists under Revenue Ruling 2003-92 simply because the insurance company has subscribed to a non-insurance-dedicated hedge fund. Therefore, despite adequate diversification among the non-insurance-dedicated funds, the IRS could view the policy owner as having *indirect* investor control merely because the separate account holds a fund that is not available exclusively through the purchase of a variable contract. Although the IRS has not made this argument, the possibility—however remote—that the IRS could attempt to use it underscores the fact that the asset allocator model remains a gray area.

**Practical Issues in Purchasing PPLI**

In addition to the tax issues discussed above, PPLI purchasers and investment consultants must consider a number of purely practical issues, described below.

**Investment Choices**

Now that the IRS has provided more clarity about the rules for hedge funds as separate-account choices, many managers of hedge funds and hedge funds of funds have moved to establish insurance-dedicated funds to serve the growing demand for PPLI. The number of hedge funds and hedge funds of funds that have established insurance dedicated funds is still small compared with the overall number of hedge funds.<sup>40</sup> Interestingly, a number of the most successful fund of funds managers—measured by overall size, track record, longevity, and industry ranking—including some whose flagship funds are closed to new investors, are among those who have established insurance-dedicated funds.<sup>41</sup> Moreover, fund of funds managers often allocate a significant portion of their insurance-dedicated fund to their flagship funds of funds on a no-fee basis, so that insurance-dedicated-fund investors participate in the managers’ underlying

positions that are closed to new investors. Despite the early entry of several high-quality fund managers to the insurance-dedicated-fund market, struggling fund managers with poorer track records may see the insurance-dedicated-fund market as an under-occupied niche. This possibility underscores the importance of the investment consultant’s role in manager selection and due diligence.

**Solicitation**

Transactions with offshore PPLI issuers or their agents may inadvertently be subject to state premium taxes, which typically run from 1 percent to 3 percent if solicitation of the policy occurs in the United States. Some offshore carriers are more permissive than others in what they believe is allowable activity. The conservative approach is for the carrier and its agents to have no contact whatsoever with the client in the United States. The client should travel outside the United States to negotiate the contract, take a physical exam, complete other aspects of underwriting such as the inspection report, and sign applications. Once the policy is issued, the insurer should deliver it to its owner offshore. Finally, the offshore owner of the policy (typically a trust), and not the U.S. client funding the purchase, should pay the premiums.

*Despite the early entry of several high-quality fund managers to the insurance-dedicated-fund market, struggling fund managers with poorer track records may see the insurance-dedicated-fund market as an under-occupied niche.*

**Underwriting**

PPLI purchasers must pay careful attention to the “insurance” nature of the life insurance contract, despite its tax and investment purposes. The insurance company must assume risk in the transaction, and the client must go through financial and medical underwriting that allows the carrier to assess that risk. Carriers typically require clients to divulge enough financial information to establish the need for insurance and an insurable interest. Clients also must submit detailed medical information and undergo an insurance-specific medical examination by a qualified physi-

cian, typically a board-certified internist. After these disclosures, a client could have medical or financial issues that will prohibit economical acquisition of the contract. An experienced life insurance professional can add tremendous value in the underwriting process.

### **Professional Involvement: Investment Consultant**

When an investment consultant generates the idea to use PPLI to mitigate tax impacts, the consultant's role beyond the allocation decision typically includes explaining PPLI to the client, considering and evaluating the investment choices, and referring non-investment components to appropriate legal and insurance professionals. When the investor suggests PPLI to the investment consultant, the role generally will be the same, except that legal and insurance professionals already may be on board. In any case, the limited role of the investment consultant in the insurance aspects of the transaction should not require additional licensure.

### **Professional Involvement: Lawyer**

The lawyer's role in PPLI acquisition is fairly broad. The lawyer first will educate the client about PPLI planning, including the relative merits of domestic versus offshore PPLI, and may recommend further estate planning such as an irrevocable life insurance trust. The lawyer will act as tax counsel, analyzing the structure with an eye toward tax compliance; negotiate contract points with prospective carriers; and work with the insurance broker to implement the policy while ensuring that the client's financial, medical, and personal information are processed with the highest degree of confidentiality. Finally, it should be the lawyer who confirms the financial solvency of the client prior to any transfers into a private placement policy.<sup>42</sup>

### **Professional Involvement: Broker**

A knowledgeable insurance broker should ensure tax compliance and competitive pricing of the policy. The broker also makes product recommendations, selects the appropriate carrier, and assists with negotiating the contract and associated fees. Keeping jurisdictional issues in mind, the broker should perform extensive due diligence on carrier candidates to ensure

that the carrier is capable of performing its obligations over the policy term.

The broker also should understand and assess the reinsurance treaties between carrier candidates and their reinsurers. Reinsurance treaties are contractual arrangements in which the carrier places some or all of the policy "at risk" amount (that is, the death benefit in excess of cash value) with other insurance companies or reinsurers. Because most private placement policies have relatively large face amounts, most if not all of the death benefit will be covered by reinsurance. A skilled broker must evaluate this issue to ensure that the carrier has the capacity to issue the death benefit required in a particular case and that the carrier has competitive reinsurance rates.

The broker will determine from the carrier its process and requirements for underwriting. The broker also will analyze the carrier's mortality costs and assumptions and the carrier's servicing and administration capabilities. The carrier should have in-force illustration capability and resources for adequate ongoing reporting to the policyholder. The broker also will participate in annual reviews and oversee the policy for tax compliance.

### **Conclusion**

Investment consultants may perceive that the compelling benefits that hedge funds and hedge funds of funds bring to the risk-adjusted return of a taxable investor's portfolio are undercut by the tax inefficiency of hedge fund earnings. Using PPLI products as the investment chassis for an allocation to hedge funds can successfully meet the otherwise conflicting goals of investing in hedge funds and investing tax-efficiently. In other words, with proper policy planning and carefully chosen hedge funds, an investor can enjoy the "best of both worlds"—tax efficiency and superior risk-adjusted investment returns.

### **ENDNOTES**

1. IRC Sec. 72; IRC Sec. 7702(g)(1)(A).
2. Please refer to the discussion of MEC testing below.
3. IRC Sec. 101(a)(1).
4. Premiums paid with express or implied intent to defraud creditors, however, generally are not protected. A

defrauded creditor can recover such premiums, plus interest, out of insurance proceeds.

5. For a state-by-state treatment of exemption statutes relating to life insurance and annuities, see Duncan E. Osborne and Elizabeth M. Schurig, *Asset Protection: Domestic and International Law and Tactics*, Eagan, West Group, 1995 and updated quarterly, chapter 8.

6. A full financial analysis of the cost structures of various PPLI products is beyond the scope of this article. As a general rule, however, the *base* Cost of Insurance (COI) and Mortality and Expense (M&E) charges assessed by life insurance companies that participate in the PPLI market are generally competitive. The COI and M&E charges together make up the bulk of the annual assessment against cash value. Few, if any, PPLI insurance carriers assess premium loads themselves, but they allow their agents or multi-carrier brokers to add on such loads. Premium charges assessed by the insurance carrier usually will be limited to state premium tax and the federal Deferred Acquisition Cost (DAC) tax charges. Those two tax charges vary depending on the state of issuance for the state premium tax (roughly from less than 1 percent to around 3 percent) and on the insurance carrier for the DAC tax (roughly from 0.3 percent to 1.5 percent).

However, insurance companies typically offer fairly wide latitude with regard to the amount of up-front premium load and annual trail commission that they permit agents or brokers to add on to the companies' base pricing. Overly aggressive pricing by an insurance agent or broker can undermine the benefits of PPLI. Accordingly, conservative, competitive overall pricing of a policy to which an investor commits at least \$5 million of premium typically carries a premium charge of no more than 1 percent of premium (that is, \$50,000 in the case of \$5 million in premium commitment). The total charges (insurance carrier charges plus agent/broker charges) should not reduce the internal rate of return (IRR) of the policy below the assumed net-investment return of the policy's underlying assets (for example, hedge funds) by more than 100 basis points by the tenth to fifteenth policy year. This is in the case of a non-MEC that assumes an 8- to 10-percent net investment return and preferred, non-smoker underwriting on a forty-five to fifty year-old male. The IRR reduction will be higher in early years, perhaps as much as 350 basis points in the first year, taking into account premium loads and taxes, but it declines quickly and, over the life of the policy, the average annual cost should be well under 100 basis points of cash value. For the hedge fund investor who expects a 10-percent net return and pays combined federal and state income tax at a 40-percent marginal rate on ordinary income and short term capital gains, this represents an overall improvement in the "after-tax" return on the hedge fund of at least 3 percent (that is, the investor receives a 6 percent return in a taxable environment versus 9 percent in the insurance environment).

7. IRC Sec. 7702(f)(9).

8. See, for example, Tom Herman, "Tax-Avoidance Device Is Attacked," *The Wall Street Journal Online* (July 17, 2003) available on the World Wide Web at <http://online.wsj.com>; Treasury Press Release JS-591, "Treasury Works to Stem the Inappropriate Use of Life Insurance and Annuity Contracts," July 23, 2003; and Treasury Press Release JS-605, "Treasury and IRS Continue Crackdown on Abuse of Life Insurance and Annuity Contracts," July 29, 2003.

9. Revenue Ruling 2003-91, Internal Revenue Bulletin 2003-33; Rev. Rul. 2003-92, Int. Rev. Bull. 2003-33.

10. Internal Revenue Service, "Diversification Requirements for Variable Annuity, Endowment, and Life Insurance Contracts, REG-163974-02, notice of proposed rulemaking," *Federal Register* 68, no. 146 (July 30, 2003): 44689.

11. Herman, <http://online.wsj.com>.

12. *Investment Annuity, Inc. v. Blumenthal*, 442 F. Supp. 681, 693 (D.D.C. 1977), *rev'd. on procedural grounds*, 609 F.2d 1 (D.C. Cir. 1979), *cert. denied*, 446 U.S. 981 (1980).

13. *Ibid.* 685.

14. *Christoffersen v. United States*, 749 F.2d 513 (8th Cir. 1984), *cert. denied*, 473 U.S. 905 (1985).

15. 1977-1 Cumulative Bulletin 12. The ruling holds that the annuity owner's gross income under IRC Sec. 61 includes interest, dividends and other income from the separate-account assets in the year received by the custodian because the assets are not owned by the insurer for federal income tax purposes and are not subject to exclusion under IRC Sec. 801(g)(1)(B) governing segregated accounts.

16. 1980-2 Cum. Bull. 27.

17. 1981-2 Cum. Bull. 12.

18. 1982-1 Cum. Bull. 11.

19. *Christoffersen v. United States*.

20. *Ibid.* 516.

21. Unlike IRC Sec. 7702, IRC Sec. 817 is aimed at *variable* contracts only.

22. For an excellent analysis of this issue, see David Neufeld, "The 'Keypoint Ruling' and the Investor Control Rule: Might Makes Right?" *The Insurance Tax Review* (March 2003): 383-393.

23. Treasury Regulations Sec. 1.817-5(f)(2)(i).

24. Treas. Reg. Sec. 1.817-5(f)(2)(ii).

25. Neufeld, 383-393.

26. Treas. Reg. Sec. 1.817-5(i)(2) (effective date exceptions referencing Rev. Rul. 81-225 and Rev. Rul. 77-85) and 1.817-5(f)(e)(iv) (application of the look-through rule not prevented by holdings that comply with Rev. Rul. 81-225 and Rev. Rul. 82-55).

27. See, for example, Private Letter Ruling 200244001 (May 2, 2002), in which the IRS rejected the taxpayer's argu-

ment that there is a regulatory exception to the diversification rules for non-registered partnerships. See also Priv. Ltr. Rul. 200010020 (March 10, 2000); but see Priv. Let. Rul. 9847017 (August 21, 1998), in which the IRS implied (but did not state) that a non-registered partnership that is available to investors other than through the purchase of a variable contract may be looked through.

28. Revenue Ruling 2003-91, Internal Revenue Bulletin 2003-33; Revenue Ruling 2003-92, Int. Rev. Bul. 2003-33.

29. These ownership limitations are statutory terms that, if satisfied, allow an investment to avoid federal regulation requirements.

30. This ruling generally follows the reasoning of Private Letter Ruling 200244001, issued on May 2, 2002.

31. See, for example, *Steve Leimberg's Estate Planning Newsletter* no. 564 (July 24, 2003): available on the World Wide Web at [www.leimbergservices.com](http://www.leimbergservices.com); *Association for Advanced Life Underwriting (AALU) Bulletin* no. 03-75 (July 24, 2003): *AALU Bulletin* no. 02-125 (November 4, 2002).

32. Priv. Let. Rul. 200244001 (May 2, 2002).

33. Internal Revenue Service, "Diversification Requirements for Variable Annuity, Endowment, and Life Insurance Contracts."

34. *Ibid.*

35. "[A]rrangements in existence on the effective date of the revocation of §1.817-5(f)(2)(ii) will be considered to be adequately diversified if: (i) those arrangements were adequately diversified within the meaning of section 817(h) prior

to the revocation of § 1.817-5(f)(2)(ii), and (ii) by the end of the last day of the second calendar quarter ending after the effective date of the regulation, the arrangements are brought into compliance with the final regulations."

36. See, for example, Rev. Rul. 2003-92; Rev. Rul. 2003-91; Priv. Let. Rul. 200244001; Priv. Let. Rul. 9752061.

37. Rev. Rul. 2003-91.

38. Priv. Let. Rul. 9752061 (September 30, 1997).

39. Rev. Rul. 2003-92; Rev. Rul. 2003-91; Rev. Rul. 81-225; Rev. Rul. 82-54.

40. Under one hundred dedicated funds and funds of funds are currently available.

41. It may seem counter-intuitive that better managers who have no trouble attracting investors would jump through the additional hoops of setting up an insurance dedicated fund. They may be driven by the opportunity to increase their proportion of high-net-worth to institutional investors because they may perceive that high-net-worth business has greater overall persistency. In addition, they may find it attractive to do so through the establishment of large, focused relationships with insurance carriers as opposed to multiple relationships with each investor, which they may believe will improve their overall profit margins by decreasing per-investor service costs.

42. Due to the asset-protective nature of life insurance and the high dollar amount of the typical premium, it is possible for a client to inadvertently make a fraudulent transfer under applicable state law when funding a policy. This is true irrespective of whether the policy is issued by a domestic or offshore carrier.