

## Private Placement Life Insurance Planning

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# Private Placement Life Insurance Planning<sup>+</sup>

## A. Introduction: “Big Picture” Estate and Tax Planning

This article will examine two strategies that fall outside the bounds of a traditional estate planning framework, although they are well within the “big picture” that clients wish their estate planners to address; and in many ways, these two strategies go hand-in-hand. The first is *private placement variable universal life insurance (“PPVUL”)*, an investment-oriented strategy that can dramatically improve the tax efficiency of a client’s investment portfolio. The second is *hedge fund investing*, an investment strategy that has rapidly gained popularity among taxable investors in today’s equity market environment due to its ability to deliver superior risk-adjusted returns in both bull and bear markets.

## B. Private Placement Variable Universal Life Insurance

### 1. Introduction

As the investment power of high-net-worth individuals continues to grow, legal and financial advisors are frequently asked about tax-advantaged structures for passive investments. A life insurance policy that is U.S.-tax compliant, especially one offered by an established carrier, presents a conservative and cost-effective investment opportunity. By virtue of the substantial lobbying influence of powerful interest groups, including the U.S. life insurance industry, life insurance as a financial product has had a long history in the United States as a tax-advantaged investment vehicle with minimal legislative risk. Certain carriers with well-established operations both inside and outside of the U.S. offer “private placement” (or, more appropriately, “customized”) policies that are fully compliant with U.S. tax rules and are, therefore, fully entitled to the preferential tax treatment that life insurance enjoys. With proper policy design, an investor can place wealth in a tax-free investment environment at a low cost, achieve protection against future creditor risk and local economic risk, gain financial privacy, and enjoy superior flexibility with regard to the policy’s underlying investments.

Despite the long-standing availability of variable universal life insurance products in the retail market, the PPVUL market is still in its growth and development phase, and there are significant traps for the unwary. Accordingly, it is important for the advisor who counsels high-net-worth clients for whom private placement life insurance planning is advantageous to understand the tax, investment, and pricing aspects of life insurance generally, and to be able to weigh the advantages and disadvantages of an offshore private placement policy against a domestic private placement policy or a domestic

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retail policy. It is equally important for the advisor to be attuned to jurisdictional issues when planning the life insurance ownership structure and for the advisor to engage the services of a knowledgeable intermediary, such as an experienced insurance broker that dedicates itself to the private placement marketplace, to be involved in the design of the product, the selection of the carrier (and the attention to related due diligence issues), and the ongoing service and compliance matters related to the policy itself.

## **2. What PPVUL is Not**

There are currently two insurance structures other than PPVUL on the market that have recently come under a significant amount of scrutiny by the Internal Revenue Service (the “Service” or “IRS”). These structures are Internal Revenue Code (“IRC”) § 501(c)(15) insurance companies and equity acquisitions of offshore insurance company stock. It is essential to understand that these structures are unrelated to the PPVUL structure discussed in this article.

The first structure mentioned, an IRC § 501(c)(15) insurance company, is statutorily defined in the Internal Revenue Code. IRC § 501(c)(15) was originally passed as a way to assist farmers who lacked easy access to the insurance market. The goal of IRC § 501(c)(15) was to allow these farmers to set up small insurance companies that would be considered tax-exempt, provided that they collected less than \$350,000 in premiums a year and did not underwrite life insurance. Recently, however, ultra-high-net-worth investors, seeking to shelter assets from income taxation, have availed themselves of the tax benefits available to IRC § 501(c)(15) insurance companies. That is, as long as such an insurance company does not collect more than the \$350,000 premium limit per year, it is allowed under IRC § 501(c)(15) to accumulate earnings on its investments income tax-free. Moreover, appreciated assets may be transferred to the corporation in exchange for stock when the company is initially capitalized. These insurance companies are legal under the letter of the law, and several of them have accumulated millions of dollars of tax-free earnings for their investors. However, the IRS apparently now perceives the use of IRC § 501(c)(15) insurance companies to be investor abuse in some cases. Accordingly, the IRS issued Notice 2003-35 in May 2004 to remind the public that an IRC § 501(c)(15) insurance company’s primary purpose is to provide insurance, not investment opportunities.<sup>1</sup> Notice 2003-35 also advises that the IRS will begin active investigation of these entities in the near future.

The other insurance structure attracting the IRS’s attention has as its purpose the conversion of hedge fund earnings from ordinary income and short-term capital gain income into long-term capital gain income. As mentioned above, hedge funds have become increasingly popular over the last several years due to their consistent outperformance of other investment strategies. This performance has driven investors to seek ways to avoid paying the high level of income tax typically attributed to hedge fund returns. The strategy involving the acquisition of offshore insurance company

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<sup>1</sup> IRS Notice 2003-35, I.R.B. 2003-23, May 9, 2003.

stock, sometimes referred to as the “equity transaction,” involves a hedge fund manager or other investment service provider setting up an offshore insurance company. The organizer then seeks equity investors for the insurance company (i.e., investors interested in hedge funds), promising to allocate the investor’s equity to a specified investment account, typically the investor’s preferred hedge fund(s). The primary argument made by the IRS in connection with this structure is that the insurance company is not actually taking on insurance risk and therefore does not meet the definition of an insurance company.<sup>2</sup>

Both IRC § 501(c)(15) insurance companies and the equity transaction differ greatly, in design and purpose, from a PPVUL structure. Potential PPVUL purchasers may hear the buzzwords “offshore insurance company” and “hedge fund” and immediately worry that PPVUL policies issued by offshore carriers are subject to the IRS scrutiny they have read about in recent newspaper articles.<sup>3</sup> This, however, is not the case.

### **3. The U.S. Client**

PPVUL insurance offers to U.S. qualified investors<sup>4</sup> the ability to select asset management beyond the limited asset-management choices offered in retail variable life insurance products. This is attractive to high-net-worth clients who may have investment mandates that involve more sophisticated strategies such as hedge funds. Due to the expense associated with regulatory pressures imposed by federal and state securities laws and by state insurance boards, some domestic companies have more limited investment platforms than their offshore counterparts. Because offshore insurance companies are not subject to the same bureaucracy and regulations imposed within the U.S., they are able to engage investment managers with greater ease.

Generally, the client’s motivations for investing in a PPVUL policy differ quite a bit from the reasons that U.S. persons typically purchase life insurance. Its value in the high-net-worth market is as an investment vehicle, optimally used for the most tax-inefficient asset classes in an investor’s portfolio. The purchase of death benefit is secondary. Usually, therefore, the core goals for acquiring a PPVUL insurance product are to take advantage of the income-tax and possible estate-tax savings, to maximize investment choices, and to incur as little cost as possible in doing so. There are

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<sup>2</sup> See IRS Notice 2003-34, I.R.B. 2003-23, May 9, 2003.

<sup>3</sup> See, e.g., Johnston, David Cay, *Insurance Loophole Helps Rich*, N.Y. TIMES, April 1, 2003; McKinnon, John D., *U.S. May Curtail Hedge-Tax Haven Tied to Insurance*, WALL S. J., September 12, 2002.

<sup>4</sup> Many offering memoranda for offshore PPVUL policies reference “qualified purchaser” or “accredited investor” standards, as used in U.S. securities law, to describe suitable investors. In the offshore context, this should be considered merely a guideline and not a strict requirement because offshore policies are not actually subject to SEC regulations. However, if the premiums of an offshore PPVUL policy are to be invested in funds that do require investors to be “qualified purchasers,” then the policy owner must be a “qualified purchaser” for that purpose. In the domestic context, because private placement products in the U.S. are subject to SEC regulations, each purchaser generally must be a “qualified purchaser” under section 2(a)(51) of the Investment Company Act of 1940, 15 U.S.C. §80a-2(a)(51), and an “accredited investor” under section 501(a) of Regulation D of the 1933 Act, 17 C.F.R. 230.501(a).

additional advantages of investing in a PPVUL insurance policy issued offshore that will be discussed in detail below.

#### **4. Foreign Trusts with U.S. Beneficiaries**

Private placement life insurance products offered by offshore carriers are also beneficial for other types of clients, such as foreign persons who have created foreign trusts with U.S. beneficiaries. Prior to the enactment of the Small Business Job Protection Act of 1996 (the “1996 Act”),<sup>5</sup> a foreign person could, with relative ease, establish a grantor trust with one or more U.S. beneficiaries. As with all grantor trusts, the foreign grantor was essentially treated as the owner of the trust for U.S. federal income tax purposes.<sup>6</sup> This was advantageous for several reasons. First, as long as the trust’s assets were invested in property producing income from foreign sources or capital gain income from domestic or foreign sources, the income derived by the trust would generally be treated, for U.S. income tax purposes, as that of the foreign person who was the grantor and would not be subject to U.S. federal income tax. Second, distributions from the trust to U.S. beneficiaries were classified as distributions from a grantor trust, so U.S. beneficiaries who received distributions from the trust were not subject to U.S. federal income taxation on such distributions. Finally, under the terms of the trust, there was usually no requirement for trust income to be distributed each year, so monies could accumulate in foreign grantor trusts as long as desired and be distributed to the beneficiaries income-tax-free at some later time.

The 1996 Act effectively eliminated the grantor trust status of these foreign trusts by treating a person as owning assets of a trust only if that person is a U.S. citizen, U.S. resident, or domestic U.S. corporation.<sup>7</sup> As a result, a foreign person who creates a trust is no longer considered the owner of the trust’s assets, and the trust is classified as a non-grantor trust for U.S. federal income tax purposes.<sup>8</sup> When a trust has been classified as a foreign non-grantor trust, it is possible for the trust to defer U.S. federal income taxation because, ordinarily, the earnings of such a trust would not be taxed directly by the U.S., with certain exceptions.<sup>9</sup> However, when income is distributed from the trust to a U.S. beneficiary, it is taxable to such U.S. beneficiary. Specifically, a U.S. beneficiary is taxable on amounts of income currently distributed from the trust’s

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<sup>5</sup> The Small Business Job Protection Act was signed by President Clinton on August 20, 1996. The 1996 Act changed income tax law and reporting related to foreign trusts in two significant areas: (1) for U.S. beneficiaries who receive distributions from trusts created by foreign persons, and (2) for U.S. persons who create foreign trusts.

<sup>6</sup> If a trust is classified as a grantor trust, the trust is essentially viewed as a pass-through entity, because the grantor is deemed to be the owner of part or all of the trust for U.S. federal income tax purposes. See IRC §§ 671-679.

<sup>7</sup> Any foreign grantor trust that was in existence prior to September 20, 1995, is “grandfathered” and will continue to be a grantor trust as to any property transferred to it prior to such date provided that the trust continues to be a grantor trust under the normal grantor trust rules. Separate accounting is required for amounts transferred to the trust after September 19, 1995, together with all income and gains thereof.

<sup>8</sup> There are exceptions to this rule that are beyond the scope of this article. See Treas. Reg. § 1.672(f)-3.

<sup>9</sup> Exceptions include certain income, dividends, rents, royalties, salaries, wages, premiums, annuities, compensations, remunerations, and endowments or other “fixed or determinable annual or periodic gains, profits, and income” (“FDAP” income) derived from the U.S. and income that is effectively connected with the conduct of a U.S. trade or business.

worldwide distributable net income (“DNI”).<sup>10</sup> The character of the income on trust assets when distributed to the U.S. beneficiary is determined at the trust level, even though the trust itself may not pay U.S. income tax on such income or gain.<sup>11</sup>

Furthermore, distributions from foreign non-grantor trusts of undistributed net income (“UNI”) are classified as accumulation distributions and taxed according to the “throwback” rules. In general, the throwback rules tax accumulation distributions to a U.S. beneficiary at the tax rate that would have been paid if the income had been distributed in the year that the trust originally earned such income. The net result is that, at the time of distribution, a U.S. beneficiary would be subject to tax first on the trust’s current year DNI and, if current year distributions exceed DNI, then on the trust’s UNI. Additionally, when a distribution is made that is classified as UNI, an interest penalty is assessed and applied to the tax on the accumulation distribution. The effect of the interest charge can cause an effective tax rate of 100 percent to apply after several years of accumulation.

Despite the effective elimination of foreign grantor trusts (created by foreign persons) and all of the attendant benefits, all is not lost. When planning on behalf of a trust to which these rules apply, the goal is to reclassify trust income as something that is exempt from income tax in order to mirror the structure of the old foreign grantor trusts. Life insurance achieves this goal because income earned inside the policy is not taxed currently to the owner of the policy. Moreover, income distributed from the policy during the life of the insured is generally nontaxable under current law, if properly structured.<sup>12</sup> Finally, all amounts paid out of the policy to the policy beneficiary as death benefit proceeds are not subject to U.S. income tax.

For existing foreign non-grantor trusts with undistributed net income (and previously classified foreign grantor trusts with income accumulated after the 1996 Act), offshore PPVUL insurance can be an effective tool to stem the ever-increasing accumulation of taxable income inside these trusts. In a typical situation, trust assets are used to pay life insurance premiums. As trust assets are gradually depleted by annual premium payments, the further accumulation of distributable net income ceases. Note that the trust may still contain pre-existing undistributed net income that is taxable to the U.S. beneficiary (and subject to the interest penalty) whenever the trustee makes a distribution in excess of DNI. Over time, however, cumulative distributions to the beneficiaries may exhaust this pre-existing UNI. Thereafter, the trustee may generally withdraw or borrow funds from the policy on a tax-free basis and then distribute those proceeds (also on a tax-free basis) to the U.S. beneficiary.

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<sup>10</sup> This situation applies to discretionary distributions from foreign complex trusts; the situation would be somewhat different for U.S. beneficiaries of foreign simple trusts or foreign complex trusts with mandatory distribution provisions.

<sup>11</sup> Capital gain income is included in determining DNI, and retains its character in the hands of the U.S. beneficiary if distributed in the year that it was earned by the trust.

<sup>12</sup> In general, this means making withdrawals from a non-modified endowment life insurance policy up to the policy basis, then switching to policy loans. See note 14, *infra*.

## 5. Tax Considerations

### a. **U.S. Federal Income Tax Benefits**

The U.S. federal income tax advantages of life insurance are the same whether the policy is acquired onshore or offshore. First, earnings on policy cash values, including dividends, interest, and capital gains, are not taxable to the policy owner as they accumulate within the policy.<sup>13</sup> Because earnings on policy cash values are generally not taxable, the policy's cash value grows much quicker than when compared to a taxable investment portfolio. Consider the following example of a taxed investment versus accumulation inside a private placement life insurance policy. The hypothetical example assumes single-life coverage on a 45-year-old male, with a \$2.5 million annual premium for four years, a 10 percent rate of return net of investment management fees (all of which is taxed as ordinary income [at 40 percent, which represents a hypothetical federal-plus-state income-tax rate] in the taxed scenario, as would be the case with a hedge fund investment).

<b><u>End of Year</u></b>	<b><u>Taxed Investment</u></b>	<b><u>Life Insurance Cash Value</u></b>	<b><u>Life Insurance Death Benefit</u></b>
1	2,650,000	2,681,609	44,251,900
5	12,288,296	13,459,717	44,251,900
10	16,444,512	20,820,235	44,251,900
20	29,449,617	50,682,027	61,832,073
30	52,739,779	127,259,381	136,167,537
40	94,448,912	319,917,484	335,913,358

In addition to the tax-free accumulation of the policy's cash value, withdrawals and policy loans by the policyholder can be used to access policy assets during the lifetime of the insured. Generally, such withdrawals and loans are received income-tax-free.<sup>14</sup> Finally, the proceeds payable at the death of the insured are excluded from the taxable income of the beneficiary,<sup>15</sup> and with proper structuring, may also be excluded from the taxable estate of the owner insured.<sup>16</sup>

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<sup>13</sup> See IRC § 72; IRC § 7702(g)(1)(A). Some income (*e.g.*, dividends) attributable to policy assets may nevertheless be subject to taxation (*e.g.*, by source withholding).

<sup>14</sup> Note that if a policy is a modified endowment contract ("MEC") as defined by IRC § 7702A, proceeds of a loan or withdrawal are taxed as ordinary income to the extent of any gain in the policy cash value before the loan or withdrawal. To avoid this taxation, therefore, it is crucial that MEC status be avoided when it is intended that the policy cash value be accessible during the insured's lifetime through loans or withdrawals. On the other hand, due to the higher insurance-related costs of non-MECs, MEC status does not need to be avoided when a policy is designed to pass wealth from one generation to the next without a need to access policy cash value during the insured's lifetime. Generally, non-MECs are characterized by a premium paid over five or six years, while MECs are characterized by a one-time, up-front premium payment.

<sup>15</sup> See IRC § 101(a)(1).

<sup>16</sup> See IRC § 2042. Generally, as long as the premium payor does not retain "incidents of ownership," the policy proceeds will be excluded from his or her estate for estate tax purposes.

## **b. Other Potential Tax Benefits**

Enhanced tax advantages are available to a client who, by completing all aspects of the transaction offshore,<sup>17</sup> acquires a PPVUL policy issued by an offshore carrier. First, no state premium tax is payable when a PPVUL insurance policy is issued offshore. This results in a savings, in most states, of approximately two to three percent of the premium. Second, the federal deferred acquisition cost (“DAC”) tax and/or federal excise tax that is assessed on the premium of a policy issued by a foreign company will be less than the DAC tax paid on a similar policy issued onshore. The DAC tax on a policy issued onshore is generally about one to one and a half percent of premiums paid. The overall tax paid on a policy issued offshore will be less; however, the actual amount of the tax will depend on whether the policy is issued by a company that has elected to be taxed under IRC § 953(d) as a domestic corporation (the “953(d) election”). If the insurance company has made the 953(d) election, a reduced DAC tax of less than one percent of premium will normally apply. If the insurance company has not made the 953(d) election, no DAC tax will apply; however, a one percent U.S. federal excise tax on premium payments will be payable.<sup>18</sup> Overall, the absence of the state premium tax and reduced or no federal DAC tax offshore, along with no or low premium sales loads, contributes to the substantially improved yields compared to taxable investments, as illustrated above.

## **c. Transfer Tax Planning**

In addition to the considerable income tax benefits of life insurance planning, many clients also desire a flexible framework for transferring wealth to their children or multiple future generations in a transfer-tax-efficient manner. For example, a senior generation can pass assets in a leveraged manner to the next generation with minimal transfer-tax liability by creating an irrevocable life insurance trust and by funding the insurance purchase through an alternative premium-paying arrangement, such as an intrafamily loan.<sup>19</sup> When a client’s net worth suggests the need for removing substantial assets from the estate tax base, private placement life insurance, a traditional irrevocable life insurance trust, and an alternative premium-paying arrangement can be a very effective combination.

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<sup>17</sup> Most states in the U.S. impose a premium tax on life insurance policies. However, as long as the policy is negotiated, applied for, issued, and delivered offshore, state insurance taxes should not apply to an offshore PPVUL purchase. Nevertheless, state laws applicable to the policy owner, insured, and beneficiary must be carefully examined on a case-by-case basis. Furthermore, although the constitutionality of such statutory provisions might be questionable, some states impose a “direct procurement tax” to collect the premium tax for transactions on the lives of state residents that take place out-of-state. Domestic producers have tried to capitalize on the fact that Alaska and South Dakota assess very low levels of premium tax, and thus offer prospective purchasers a low-cost alternative to offshore PPVUL. Recently, however, a major carrier reported that the Texas insurance authorities assessed a premium tax on premiums paid for an Alaska PPVUL policy issued on the life of a Texas insured and then successfully collected that assessment. As a result, the tax-savings opportunity offered by Alaska and South Dakota PPVUL policies has already been limited in Texas and is likely to see further limitation in other states.

<sup>18</sup> See IRC § 4371.

<sup>19</sup> A number of other transfer tax planning opportunities exist utilizing life insurance, but a full discussion of all of such opportunities is beyond the scope of this article.

#### d. Irrevocable Life Insurance Trust

An irrevocable life insurance trust (“ILIT”) is a commonly used estate planning technique. When the ILIT will receive completed gifts which are in turn invested in an offshore private placement policy, the trust should be a foreign trust for legal purposes (because it is important that the policy have a foreign owner due to state regulatory concerns). Also, it may be best to structure the trust as one that is domestic for tax purposes in order to avoid the onerous foreign trust reporting requirements, and more importantly, to avoid the potential negative application of IRC § 684.<sup>20</sup> The classification of a trust as domestic for tax purposes can be accomplished by satisfying the definitional requirements set forth in IRC § 7701.<sup>21</sup>

Because it is important for the settlor’s gift to the irrevocable life insurance trust to be a completed gift for gift tax purposes, the settlor should not retain a testamentary power of appointment.<sup>22</sup> In addition, the settlor should retain no powers under the trust agreement that would cause the trust assets to be includible in the settlor’s estate for estate tax purposes.<sup>23</sup> Moreover, the allocation of generation-skipping transfer (“GST”)<sup>24</sup> tax exemption (if available) to the initial funding (as well as ensuring that additional assets contributed to the trust also are GST tax exempt) permits the policy proceeds to be received and passed free of GST tax as well.<sup>25</sup> This planning effectively removes the death proceeds from the estate of the settlor/insured and exempts the assets in the trust from the GST tax as well.

As noted above, it is important that the trust, as owner of an offshore life policy, be foreign for ownership purposes to reduce the nexus between the policy and the U.S.

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<sup>20</sup> Under some circumstances, a U.S. person transferring property to a trust that is considered a foreign trust for tax purposes may be required to pay income tax on the transferred property. Specifically, IRC § 684 treats a transfer of property by a U.S. person to a foreign trust as a sale or exchange for an amount equal to the fair market value of the property transferred. Thus, the transferor is required to recognize gain on the difference between the fair market value of the transferred property and its basis. The rules set forth in IRC § 684 do not apply to the extent that the transferor or any other person is treated as the owner of the trust under section 671, which will typically be the case with a foreign trust with U.S. beneficiaries. See IRC § 679. However, upon the *death* of a U.S. person who was treated as the owner of a foreign trust during that person’s lifetime, gain will be recognized under IRC § 684 (unless that foreign grantor trust’s assets receive a step-up in basis under IRC § 1014(a), which would not be the case in a traditionally structured irrevocable life insurance trust to which completed gifts have been made.) See Treas. Reg. §1.684-3(c).

<sup>21</sup> Under the regulations to IRC § 7701(a)(31), a trust is a foreign trust unless both of the following conditions are satisfied: (a) a court or courts within the U.S. must be able to exercise primary supervision of the administration of the trust; and (b) one or more U.S. persons have authority to control all substantial decisions of the trust. See Treas. Reg. § 301.7701-7.

<sup>22</sup> See Treas. Reg. § 25.2511-2(b).

<sup>23</sup> See IRC § 2036 to 2041.

<sup>24</sup> The GST tax is a transfer tax (in addition to the estate tax) that is imposed on transfers that skip a generation and at a rate equal to the highest marginal estate tax rate. The purpose of this tax is to prevent the avoidance of estate tax at the skipped generation. That is, in the absence of GST tax, clients could, for example, leave property directly to their grandchildren, without subjecting that property to a transfer tax at their children’s generation.

<sup>25</sup> See IRC § 2642.

jurisdiction where the client resides. This should negate an argument that the policy was acquired onshore and could possibly therefore be subject to state premium tax.

## **6. Investment Considerations**

As mentioned above, policy owners purchasing PPVUL are typically offered investment platforms by the issuing carrier that include a wide array of typical equity and bond fund choices. Many carriers also offer extensive alternative investment choices such as hedge funds, hedge funds of funds, private equity, commodity funds, etc. Once premiums have been contributed to the policy, a policy owner may later shift part or all of the cash value to another investment choice without tax consequences. Generally, the investment fund must be managed by a professional investment advisor, and the insurance company will perform due diligence to determine the fund's suitability as a selection available to policy owners. Note that some carriers may charge a fee over and above their normal administrative fee against the policy cash value for the administrative work required to establish a new relationship with an investment manager.

In some part due to reduced industry regulation in the offshore insurance market, a very broad universe of managers and investment styles is available to investors who purchase offshore PPVUL insurance. The variety of investment choices and flexibility to add managers have also improved recently in the domestic market. Currently, hedge fund and fund of fund strategies are the most frequently selected investment vehicles in the PPVUL market because they have had consistent returns in up and down markets and are usually tax-inefficient due to the investment strategies they employ.<sup>26</sup> Investors find that these investment choices work extremely well in a life insurance policy because of the policy's tax-advantaged nature. Moreover, policy owners receive protection of their investments through separate account legislation that exists in jurisdictions where offshore carriers typically reside as well as within the U.S.<sup>27</sup>

## **7. Pricing Considerations**

Generally speaking, there are three principal insurance-related fees associated with PPVUL insurance products: the premium load, the mortality and expense (or administration) charge ("M&E"), and the cost of insurance charge ("COI"). The non-insurance-related fees are asset management and, if applicable, custodial fees.

One of the deterrents to using domestic life insurance as a tax-advantaged investment vehicle for large premium amounts is the high level of fees associated with

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<sup>26</sup> For more detail on hedge funds see Section C, *infra*.

<sup>27</sup> In the event of a company default, the policy's cash values generally are not subject to the claims of the insurance company's creditors. In Bermuda, for example, the Segregated Accounts Companies Act permits any company to apply to operate segregated accounts, thereby enjoying statutory division between accounts. The effect of such statutory division is to protect the assets of one account from the liabilities of other accounts. Thus, the accounts will be self-dependent, with the result that only the assets of a particular account may be applied to the liabilities of such account.

insurance products in the U.S. retail market, and in some cases, this remains true for domestic private placements. Although commissions vary greatly throughout the industry, purchasers can be charged sales commissions of greater than 10 percent of their premium commitment.<sup>28</sup> Ongoing charges against a policy's cash value also vary, but often exceed charges against cash value in the offshore market due (in part) to the asset management fee component, which is generally higher for domestic private placements. Finally, domestic policyholders usually incur a surrender fee if they surrender a policy within a certain time-frame. Many offshore carriers do not assess such a fee.

The premium load in the offshore market is typically modest, approximately one percent of premiums paid or less. The M&E charge varies widely among carriers, depending on the carrier's pricing and profit strategy. The insurer also assesses the COI charge against the policy's cash value. This COI charge varies from year to year based on the "net amount at risk," and on the age, gender, and health status of the insured at the time of medical underwriting. On average, over the life expectancy of the insured and depending on the earnings of the separate account, the *combination* of the M&E and COI loads on a single life product should be less than one percent per year. Generally, cost efficiencies exist offshore because carriers can offer lower administrative charges than domestic carriers due to lower overhead and franchise costs, lower or nonexistent entity-level taxes, and reduced operating costs due to less governmental regulation.

Because the federal tax advantages of life insurance are the same onshore and offshore, it is the increased investment flexibility, the reduction in costs resulting from state-premium-tax savings and lower sales loads and administrative charges, and opportunities for enhanced asset protection that set offshore PPVUL transactions apart from their domestic counterparts.

## **8. Legal Considerations: Asset Protection**

High-net-worth clients in the U.S. often desire to globalize their holdings in a manner that protects them from future creditor risk as well as local political and economic turmoil. By virtue of its preferred status under certain state exemption statutes, life insurance presents an excellent asset-protective vehicle for the high-net-worth client, especially when coupled with sophisticated offshore planning. As a consequence of the separate account protection that typically exists in the jurisdictions where carriers reside, the insurance company must segregate the assets inside a private placement policy from its general account, which then protects the policy assets from the claims of the creditors of the life insurance company.<sup>29</sup> In addition, some U.S. states exempt not only the debtor's interest in a life insurance policy's cash surrender value, but also the death proceeds themselves from the claims of creditors.<sup>30</sup> However,

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<sup>28</sup> Onshore, additional loads against premiums are state premium tax and a 1 to 1.5% federal DAC "tax."

<sup>29</sup> See note 27, *supra*.

<sup>30</sup> Premiums paid with express or implied intent to defraud creditors, however, generally are not protected. Such

the exemption statutes vary from state to state, and in some cases, the domestic exemption statute is inadequate or restrictive as to the allowable exemption amount or the class of persons entitled to benefit from the exemption.<sup>31</sup>

Many offshore jurisdictions offer legislation related to life insurance contracts that is comparable to, or better than, similar legislation under U.S. state law. Such offshore legislation may include specific exemption language and a pro-debtor protection regime. In addition, the laws of an offshore jurisdiction might allow the inclusion of spendthrift provisions in the policy itself, which limit the policy owner's rights in the policy, thereby affording another level of asset protection to the policy. If invested with an offshore manager, the assets inside the separate account of the policy will not only receive protection from creditors by virtue of the exemption statute, but it will also be harder for a U.S. creditor to reach the policy's assets because they are located offshore. The client will also enjoy investor confidentiality and financial privacy under the laws of many offshore jurisdictions, to which similar laws in the U.S. generally do not compare.

## **9. Other Considerations**

The PPVUL life insurance market, and in particular the offshore PPVUL market, is marked by the absence of high-pressure marketing that plagues the domestic retail life insurance market. In addition, offshore companies in smaller markets enjoy lower regulatory oversight and reporting obligations. Generally, offshore insurers pass on their reduced marketing costs, regulatory compliance, and reporting requirements to the policy purchaser in the form of lower fees. When insuring their risks, offshore carriers have the choice of contracting with any one or more of the world-class reinsurers participating in the worldwide life insurance market. Finally, offshore life insurance carriers should be able to offer a wider variety of products and a greater death benefit capacity as the client market expands.

Although U.S. clients typically draw from existing pools of cash or easily liquidated investments to fund a private placement policy, unique planning opportunities exist in the offshore market due to the absence of regulatory oversight. For example, clients usually can make in-kind premium payments of property other than cash when a client prefers to invest noncash assets. Additionally, it is possible for a client to exchange an underperforming domestic or foreign policy for a more cost- and tax-efficient policy on a tax-free basis.<sup>32</sup>

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premiums, plus interest, are usually recoverable by a defrauded creditor out of insurance proceeds.

<sup>31</sup> For a complete state-by-state treatment of the exemption statutes relating to life insurance and annuities, see DUNCAN E. OSBORNE AND ELIZABETH M. SCHURIG, *ASSET PROTECTION: DOMESTIC AND INTERNATIONAL LAW AND TACTICS*, Ch. 8 (four volumes, West Group, updated quarterly, 1995).

<sup>32</sup> In the foreign context, the rules governing such an exchange under IRC § 1035 should be closely examined due to statutory uncertainty in some circumstances.

## 10. Product Design Issues

Although some investors regard the life insurance component (i.e., the death benefit payable in excess of cash value) as an independently important feature, most investors are drawn to PPVUL insurance for its tax benefits, investment flexibility, and price structure. Nevertheless, the life insurance component of the product is absolutely critical with regard to its tax treatment—if the product fails to qualify as life insurance under applicable U.S. tax rules, the U.S. tax benefits are lost completely. Moreover, if the cost of insurance and other fees assessed against the assets within the policy are too high, the client loses the tax benefit as a practical matter by virtue of poor performance over time attributable to those high costs and fees.

Generally, planners design PPVUL insurance policies in a way that maximizes cash accumulation and also reduces the death benefit, so that the cost of insurance affects the cash value to the smallest extent possible. In other words, the policy design provides for the largest up-front infusion of cash with the correspondingly smallest death benefit purchase possible. There are also certain other product design issues that must be addressed in each case.

### a. **IRC § 7702 Compliance**

In order to receive the U.S. tax advantages afforded to life insurance products, any policy issued by a carrier (including a foreign carrier) after December 31, 1984, must meet the definition of life insurance under IRC § 7702; that is, the policy must be a contract which is a life insurance contract under the applicable law, but only if such contract meets the cash value accumulation test (the “CVAT”) or the two-pronged test composed of the guideline premium test (“GPT”) and the cash value corridor test (“CVCT”). The purpose of these tests is to disqualify policies created for their investment component without regard to the actual relationship between the cash value and the contractual death benefit. The two methods of testing for IRC § 7702 compliance will have significantly different results in any given client situation. The availability of actuarially tested products using both tests varies from carrier to carrier. Some carriers have products that meet both tests; others have products that meet only one of the tests. It is important for an experienced insurance professional or actuary to determine which test works best for a particular case.

**CVAT.** Under IRC § 7702(b), a contract qualifies as a “life insurance policy” if the cash surrender value, at any time, does not exceed the net single premium that a policyholder would have to pay at such time to fund future benefits under the contract assuming a maturity no earlier than the insured’s age 95 and no later than the insured’s age 100. The CVAT is generally applied to test whole life contracts.

**GPT and CVCT.** IRC § 7702(c) sets forth the guideline premium test and IRC § 7702(d) describes the cash value corridor test. If the policy design implicates this alternative over the CVAT, it must satisfy both tests. A policy will satisfy the GPT if the sum of the premiums paid under the contract does not at any time exceed the “guideline

premium limitation” at that time. A contract falls within the cash value corridor if the death benefit at any time is not less than the applicable percentage of the cash surrender value. At age 40, the applicable percentage is 250 percent, decreasing in increments to 100 percent at age 95.

**MEC Testing.** Frequently, the design of life insurance planning is to maximize the growth of policy cash values without jeopardizing the policy owner’s ability to have tax-free access to those values during the insured’s lifetime. If the policy owner funds the policy too heavily, thereby causing it to be classified as a modified endowment contract (“MEC”), he or she will pay tax on policy values that she accesses during the insured’s lifetime at ordinary income rates to the extent of any gain in the policy assets before the loan or withdrawal.

Pursuant to IRC § 7702A, a contract is a MEC if it was entered into after June 21, 1988, and it fails to meet the 7-pay test under IRC § 7702A(b). A contract fails to meet the 7-pay test if the accumulated amount the policy owner pays under the contract at any time during the first seven contract years exceeds the sum of the net level premiums that the policy owner would have paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums. Generally speaking, non-MECs are characterized by a premium paid over four or five years and MECs are characterized by a one-time, up-front premium payment. Of course, if the purpose of the policy is to pass wealth from one generation to the next without requiring access to policy cash values, MEC status is inconsequential, and a MEC structure is therefore preferable due to the superior tax-free compounding effect achieved by a one-time, up-front premium payment.

**b. Diversification under IRC § 817(h) and the Investor Control Doctrine**

In addition to IRC § 7702 compliance, *variable* life insurance policies must also comply with the diversification requirements of IRC § 817(h), which requires that they be invested in an “adequately diversified” mix of investments. “Adequately diversified” means that a life insurance separate 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. Failure to meet these diversification requirements will cause the separate account to not be considered “life insurance,” and consequently, the “policy” owner will be deemed to directly own all of the policy’s assets, making the policy owner currently taxable on the policy’s income.

Before 2003, the Treasury Regulations allowed a life insurance separate account to “look through” a nonregistered investment partnership (such as a hedge fund or fund of funds) to its underlying investments to determine whether it met the diversification rules outlined above. In other words, the nonregistered partnership was not treated as a single investment, but as an investment in the various funds in which the partnership

itself was invested, thereby making it easier for the separate account to satisfy the diversification requirements. By contrast, for a registered partnership (or other investment company or trust) to have received the same “look-through” treatment of nonregistered partnerships, it had to meet both of the following requirements:

- (i) all of the beneficial interests in the partnership must be held by one or more segregated asset accounts of one or more insurance companies; and
- (ii) access to the partnership must be exclusively through the purchase of a variable contract.

In other words, a registered partnership had to be an “insurance-dedicated fund” (or “IDF”) to receive look-through treatment, but a nonregistered partnership did not. An amendment to the Treasury Regulations, proposed in 2003 and effective March 1, 2005, removed this “special” treatment for nonregistered partnerships. This means that a nonregistered partnership must now meet the above two requirements of an insurance-dedicated fund to be looked through to its underlying investments for purposes of the diversification rules.

Thus, under current Treasury Regulations, as long as a nonregistered partnership is organized as an IDF (and as long as that IDF is invested in an adequately diversified mix of investments), a separate account invested only in that partnership will be considered “adequately diversified,” and thereby maintain its status as a tax-advantaged investment vehicle.<sup>33</sup>

**“Double Look-Through” Allowed for Second-Tier IDFs.** During the period in which those Regulations were proposed, the IRS extended the principles of those Regulations to fairly common real-world structures involving IDFs. In Revenue Ruling 2005-7, the IRS allowed a separate account to not only look through an IDF that is its direct investment, but also to look through any other IDFs in which the first IDF is invested. In other words, if IDF #1 holds an investment in IDF #2 that makes up more than 55 percent of IDF #1’s investments (and would, therefore, seem to cause the separate account to fail the diversification rules), the separate account can still look through IDF #2 to its underlying investments to determine whether it is adequately diversified (and presumably any IDFs in which IDF #2 is invested, and so on). Thus, this favorable ruling allows a life insurance separate account to look through multiple levels of IDFs to determine whether it is adequately diversified under IRC § 817(h).

**IDF May Invest in Non-IDFs.** Although the preceding conclusion seems to be a fairly obvious extension of the final Regulations, many insurance professionals remained concerned about an IDF’s diversification when it invested not in other IDFs

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<sup>33</sup> Although the amendment became effective March 1, 2005, nonregistered partnerships in existence at that time that were not IDFs but otherwise complied with IRC § 817(h) had until December 31, 2005, to comply with the new rules.

but in one or more non-IDFs. This was of particular concern for insurance-dedicated hedge funds of funds. The source of these professionals' concerns was their interpretation of the IRS's activity in this area as eventually leading to a complete disallowance of a separate account's direct or indirect investment in publicly available funds.

In Private Letter Ruling 200420017, the IRS alleviated at least some of those concerns by confirming that an IDF established as a fund of funds may, in fact, invest in one or more non-IDFs as long as it meets the requirements listed below.

(i) Although the owner of the life insurance contract may direct the separate account to be invested in one of the IDFs offered by the insurance company, the owner may not direct the IDF's investment in any particular underlying fund, and there must be no investment agreement or plan between the contract owner and the life insurance company or the investment manager.

(ii) All decisions regarding the IDF's investment in the underlying non-IDFs must be made by the insurance company's investment manager in its sole and absolute discretion.

(iii) The IDF's investment strategies must be defined broadly (such as "conservative," "moderate," or "aggressive") so that the contract owner is unable to make specific investment decisions by directing the separate account to be invested in one of the available IDFs.

(iv) Only the life insurance company may add or remove investment options under the life insurance contract.

Note that these requirements address the contract owner's actual control over the separate account's investment, rather than mandating that the separate account have no direct or indirect contact with a non-IDF.

**Lingering Issues: Can a PPVUL Separate Account Invest in an Adequately Diversified Mix of Non-IDFs?** As outlined above, the final regulations have now made it clear that a life insurance separate account may invest in a single insurance-dedicated fund and be allowed to look through that fund to its underlying investments to determine whether it is adequately diversified. But the question that remains in the minds of some practitioners is whether a PPVUL separate account may directly invest in an adequately diversified mix of non-IDFs (i.e., at least five non-IDFs in the right proportions). The logical answer to this question is yes. However, many practitioners are not confident that the IRS would take the logical position when it comes to this issue.

This lack of confidence in the IRS's reasoning abilities stems from a long history of apparent IRS hostility toward life insurance separate accounts. It has consistently been the IRS's view that, when a separate account is invested in funds that are available to the public, it allows the account holder to exhibit control over the separate

account because he could effectively dictate an investment strategy for the separate account in the same way that he could choose investments for himself personally, but in a tax-free environment. Or, in the words of the IRS, account holders make the insurance company “little more than a conduit between [themselves] and their mutual fund shares,” and their “position [is] substantially identical to what it would have been had the mutual fund shares been purchased directly.”<sup>34</sup>

In short, although the logical interpretation of the statutes and regulations would lead to a conclusion that a PPLI separate account may invest directly in an adequately diversified mix of non-IDFs, a more conservative approach would be to avoid non-IDFs as direct investments of separate accounts until such an investment strategy is formally blessed by the IRS.

**Can Foreign Policy Owners Invest in IDFs?** As stated above, in order for a fund to qualify as insurance-dedicated, it must restrict access to owners of variable contracts. IRC § 817(d) defines a “variable contract” as one: (1) that provides for the allocation of all or part of the amounts received under the contract to an account segregated from the insurance company’s general asset accounts; (2) that either provides for the payment of annuities or is a life insurance contract; and (3) whose contract benefits—whether annuity payments or policy death benefit—reflect, or vary based upon, the investment return and the market value of the segregated account. For owners of contracts issued by certain foreign insurance companies, their ability to invest account assets in IDFs is subject to some uncertainty because IRC § 817(d)(1) requires that the account be segregated “pursuant to *State* law or regulation.”<sup>35</sup>

In a 2002 private letter ruling dealing with issues unrelated to IRC § 817(h) or investor control, the IRS raised this definitional issue with respect to the segregated accounts of a foreign insurance company that had elected, under IRC § 953(d), to be taxed as a domestic insurance company.<sup>36</sup> After interpreting the word “State” to refer only to the 50 states and the District of Columbia for purposes of IRC § 817(d), the IRS stated that, had the insurance company not made the 953(d) election, then contracts issued by the company would not have qualified as variable contracts under IRC § 817(d), notwithstanding that the contracts otherwise met its definition. By interpreting “State” in this manner, the IRS has called into question whether the owner of a contract issued by a non-953(d) company may avail itself of the apparent investor control safe harbor offered by IDFs and whether an IDF manager may accept investments from such foreign-contract owners without jeopardizing both its fund’s continuing qualification as an IDF and, theoretically, the continuing life insurance status of its existing investors’ variable policies.

**Is the Asset Allocator Model Viable?** Many private placement variable life insurance and annuity contracts are structured to permit the policy owner to select from

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<sup>34</sup> Rev. Rul. 81-225.

<sup>35</sup> Emphasis added.

<sup>36</sup> PLR 200246022 (August 13, 2002).

a group of asset management choices, among which is one or more independent “asset allocators” who have an account management agreement with the insurance company to construct and manage with full discretion one or more separate accounts consisting of non-insurance dedicated hedge funds, and in which the number and proportion of funds meet the IRC § 817(h) diversification test. The account managed by the manager (*i.e.*, allocator) is available only to insurance companies in connection with their variable contracts. This arrangement is generally known as a privately managed separate account, or “the allocator model.” In Rev. Rul. 2003-91, the Service appeared to confirm generally the validity of this model, but the statement of facts in the ruling provided that the contract holder in that situation “may not communicate directly or indirectly with [the insurance company] concerning the selection or substitution of [the independent investment advisor].” Because an allocator might sometimes be brought to the attention of an insurance carrier by a policy owner or a policy owner’s advisor, this language in the ruling has caused some practitioners to become a bit concerned about whether the policy owner’s selection of an allocator might give rise to a finding of investor control. Adequate diversification of the separate account does not prevent the Service 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>37</sup>

The Service has consistently held that a contract holder may freely 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>38</sup> If the contract holder instead selects an independent party that has been approved by the insurance company as a separate account management option to make investment decisions, it seems unlikely that the Service would 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>39</sup> One qualification, therefore, is that the allocator (*i.e.*, investment advisor) should be selected from a list of available allocators provided and previously approved by the insurance company, and the contract holder should not mandate that his or her own allocator be used. The Service has provided guidance on this issue by approving an arrangement under 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>40</sup>

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<sup>37</sup> Rev. Proc. 99-44, 1999-48 I.R.B. 598 (“[s]atisfying the diversification requirements does not prevent a contract holder’s control of the investments of a segregated account from causing the contract holder, rather than the insurance company, to be treated as the owner of the assets in the account”).

<sup>38</sup> See, *e.g.*, Rev. Rul. 2003-92; Rev. Rul. 2003-91; PLR 200244001; PLR 9752061.

<sup>39</sup> Rev. Rul. 2003-91, I.R.B. 2003-33 (July 23, 2003).

<sup>40</sup> PLR 9752061 (Sep. 30, 1997).

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>41</sup>

In summary, a finding of investor control depends on “all of the relevant facts and circumstances.”<sup>42</sup> The recommendation of an allocator by a policy owner or her advisor to the insurance company, without other factors, arguably should not support a finding of investor control. It seems that, as long as the contract holder has no actual control over the allocator’s investment decisions and the allocator may be selected by other policy owners to manage their separate accounts, the allocator model should not run afoul of the investor control doctrine.

A final note of caution in connection with the allocator model may be warranted, however. It is entirely possible that, due to the Service’s apparent public policy stance of limiting (wealthy) taxpayers’ ability to invest in hedge funds within life insurance contracts, the IRS could take a very inflexible approach when it comes to allocations to hedge funds. This approach would involve an absolute prohibition of subscriptions by insurance carriers to hedge funds that are not “insurance-dedicated.” Thus, under the allocator model, even though the policy owner selects only the allocator, and does not select the underlying non-insurance-dedicated hedge funds among which the allocator invests separate account assets, the IRS might nonetheless find that investor control exists under the rationale of Rev. Rul. 2003-92 simply because the insurance company (albeit at the direction of the allocator) has subscribed to a non-insurance-dedicated hedge fund. Therefore (the IRS’s argument would go), despite the fact that the separate account is adequately diversified within the meaning of IRC § 817(h) among the non-insurance dedicated funds, the policy owner has *indirect* investor control for the mere fact that the separate account holds as one or more of its investments a fund that is not available exclusively through the purchase of a variable contract, and access to which is not limited to insurance company segregated accounts. Although the IRS has not made this argument—and it is a weak argument at best—the possibility, however remote, that the Service will attempt to use it underscores the fact that the tax consequences of using the asset allocator model remain unclear.

**Conclusion.** Hedge funds or hedge funds of funds as an investment of a private placement life insurance contract should not pose investor control concerns (assuming the funds are independently selected by the insurance company) as long as the investment structure of the fund is a limited partnership that meets the following two-part test:

(i) all the beneficial interests in the partnership must be held by one or more segregated asset accounts of one or more insurance companies; and

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<sup>41</sup> Rev. Rul. 2003-92; Rev. Rul. 2003-91; Rev. Rul. 81-225; Rev. Rul. 82-54.

<sup>42</sup> Rev. Rul. 2003-91.

(ii) access to the partnership must be exclusively through the purchase of a variable contract.

If the partnership meets these requirements, it will be “looked through” to its underlying investments for purposes of applying the IRC § 817(h) diversification test, and investor control will not be a concern due to the absence of public availability. *De facto* investor control, however, is still a significant consideration in the design, implementation, and administration of any private placement life insurance structure, and practitioners should carefully monitor their clients’ actions to prevent a scenario that could lead to a finding of investor control. The hedge fund industry has responded to the IRS’s recent activity by creating many insurance-dedicated funds and funds of funds. The continuation of this trend will sustain the viability of private placement life insurance as an attractive planning tool for high-net-worth investors who desire the superior risk-adjusted return characteristics of hedge funds and funds of funds.

### **c. Insured Lives**

It is important in the illustration process to determine whether it is better from a planning perspective to purchase a single-life or joint and survivor product. Joint and survivor coverage is less frequently available in the offshore market, but availability should increase with market demand. The life being insured and the person funding the policy can be different persons, depending on age and health concerns, and assuming always that there is an “insurable interest” relationship as defined under applicable law.

### **d. Loan Spread and Loan Provisions**

A sometimes overlooked detail in policy design is the client’s ability to access policy cash values on a cost-advantageous basis. Many carriers offer competitive charges for the accumulation of values inside the contract, but then charge a high spread on loan values. As mentioned previously, careful attention should be given to non-MEC qualification if a client desires access to policy cash values through withdrawals up to basis or loans.

### **e. Extended Maturity Option**

As life expectancies gradually increase, it is important to understand what happens to the policy beyond the normal policy maturity age of 95 or 100. Some private placement life insurance contracts omit provisions related to this possibility. A forced return of cash values at an advanced age before death would result in a disastrous income-tax liability.

### **f. Cost of Insurance**

Competitive COI rates are essential to good policy performance but are often not a clearly identified cost. As discussed above, COI rates vary depending on the age, gender, and health of the insured. In general, U.S. insureds can expect significantly

lower COI rates than non-U.S. insureds. Some offshore carriers have obtained reinsurance based on a blend of U.S. and non-U.S. lives, which results in higher costs. Other carriers (both domestic and offshore) mark up the reinsurance cost of their COI rates to provide a higher profit margin, especially in early policy years, in what they hope will be an overlooked cost item. Finally, the bargaining power of the carrier in the global reinsurance market often will be reflected in COI pricing, with superior pricing being obtained by larger carriers that can promise their reinsurers higher volume.

#### **g. Investment Return Issues (“Force-Outs”)**

One of the most important nontax design issues relates to whether a carrier will warrant against “force-outs” of cash value when the cash value grows more quickly than expected, thereby pushing up the required net amount at risk. Policyholders must pay tax at ordinary income rates on force-outs of cash. Accordingly, the optimal result is for the carrier to negotiate with the reinsurer to guarantee that the “at risk” portion will always remain sufficiently ahead of the cash value without the need to force cash out of the policy. If this is not possible, the insurance broker must pay careful attention to policy performance each year and pre-plan against this result.

### **11. Practical Realities**

#### **a. Solicitation**

If an offshore life insurance company or its agents have solicited an offshore life insurance contract within the U.S., such solicitation may subject the transaction to a potential claim by the government of the state where the client resides for a state premium-tax payment. 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 U.S. The client should travel outside the U.S. to negotiate the contract, take a physical examination, complete other aspects of the underwriting process (such as the inspection report), and sign applications. Once the policy has been issued, the insurer should deliver the policy to its owner offshore. Finally, premiums should be paid by the offshore owner of the policy (typically a trust) and not directly by the U.S. person who is funding the purchase of the policy.

#### **b. Underwriting**

Planners must pay careful attention to the “insurance” nature of the life insurance contract, despite its desirable 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 such risk. Carriers typically require clients to divulge enough financial information to establish an insurable interest as well as the need for insurance. Clients also must submit detailed medical information and undergo an insurance-specific medical examination by a qualified physician, typically a board-certified internist. Even after these disclosures are made, a

client could have medical or financial issues that will prevent her from acquiring the contract on an economical basis. An experienced life insurance professional can add tremendous value to the underwriting process.

### **c. Policy Servicing**

Affluent clients are not accustomed to dealing directly with insurance carriers, and some of the companies that offer PPVUL insurance contracts do not have personnel with the experience in the high-net-worth market to provide client service at the desired level. For these reasons, it is preferable for a qualified professional who does have such experience to work as an intermediary between the client and the carrier to provide annual policy servicing, to explain and confirm information received from the insurance company, and to evaluate the continued and long-term market competitiveness of the carrier and the product that the client has selected.

## **12. Selection of Jurisdiction and Carrier Due Diligence**

In addition to policy design, it is imperative that advisors think about issues related to the jurisdiction that will govern the life insurance policy and its issuer. Countries where offshore carriers are resident, such as Bermuda, the Bahamas, the Cayman Islands, and Guernsey, have separate account legislation that protects policy assets from claims against the carrier, whereas the Isle of Man and Liechtenstein (countries that also have resident carriers there) do not have such statutes. As is evident among the various state jurisdictions in the U.S., some of the offshore jurisdictions have specific creditor exemptions for life insurance while others do not. Additional jurisdictional issues include the level of regulatory oversight that the jurisdiction's governing bodies have over the insurance industry, the relative political and economic stability of the jurisdiction, the jurisdiction's international reputation, and the availability of professional resources in that jurisdiction.

In addition to jurisdictional issues, there are several carrier-related issues that a client's advisors should analyze as part of the due diligence process. Because this endeavor is properly undertaken by a qualified insurance broker, it will be discussed in the section related to brokers below.

## **13. Professional Involvement**

Although reduced regulatory controls and taxation offshore provide a wonderful environment for creative insurance structures, it is also this lack of regulatory oversight that demands the involvement of knowledgeable professional advisors in every offshore PPVUL insurance transaction. Similarly, in the case of a domestic private placement transaction, the carrier's ability to discriminate between policyholders and the unique nature of each transaction also suggests the advisability of engaging third-party legal and insurance advisors. The legal advisor will work with the client to plan and implement the life insurance structure in relation to the client's overall tax and estate

plan, and the insurance broker will oversee product design, pricing issues, and carrier selection.

**a. Legal Advisor**

The legal advisor's role is fairly broad. The advisor will first educate the client on the various aspects of the life insurance planning and may recommend further estate-planning vehicles such as an irrevocable life insurance trust structure. In addition, the advisor will analyze 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. The legal advisor will also typically act as a communications liaison between the client and the insurance professionals. Finally, it should be the legal advisor who confirms the financial solvency of the client before any transfers are made into a private placement policy.<sup>43</sup>

**b. Insurance Broker**

A knowledgeable insurance broker should ensure tax compliance and competitive pricing of the policy. It is also the broker's responsibility to make product recommendations, to select the appropriate carrier, and to assist with negotiating the contract and associated fees. Keeping jurisdictional issues in mind, the broker should perform extensive due diligence on carrier candidates. Careful examination of the carrier helps ensure that it will be capable of fulfilling its obligations over the term contemplated by the policy.

Although carrier due diligence is important in the case of any private placement transaction, it is particularly critical when contemplating an offshore transaction. The offshore market is a mixed bag of smaller, newer carriers with very little capital on one hand, and wholly-owned subsidiaries of large U.S. or multinational companies on the other. The carrier, its parent, and/or its principal reinsurer should have a good credit rating from A.M. Best, Moody's, Standard & Poor's, and/or Duff & Phelps. If the carrier is not substantial in its own right, it should have a guarantee from a parent corporation with regard to satisfying any carrier claims. The financial condition of the company (and its parent, if applicable) should be examined carefully. In the case of a subsidiary, the broker should evaluate the parent company's commitment to the offshore market, as some large U.S. carriers have aborted their recent attempts to enter the offshore marketplace.

The broker should also 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's "at risk" amount (i.e.,

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<sup>43</sup> Owing 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 when funding a policy. This is true irrespective of whether the policy is issued by a domestic or offshore carrier.

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 reporting to the policyholder. The broker will also fulfill an ongoing role in annual reviews and will continue to oversee the policy from a tax-compliance standpoint.

## C. Hedge Funds

### 1. Introduction: Why Hedge Funds?

Although the unprecedented bull market of the 1990s led to tremendous accretions in wealth for many investors, the bursting of the tech bubble brought about an equal measure of lost fortunes. In the investment world, stock market volatility is expected, but the roller-coaster ride that many investors have experienced in recent years has given them a whole new concept (and fear) of "volatility." Although hedging strategies<sup>44</sup> have always been acknowledged as a way to reduce portfolio volatility, recent market conditions have highlighted *market-neutral hedge funds* as a way to achieve positive yearly returns with much less risk and significantly lower correlations to market movements. In particular, market-neutral hedge funds of funds, which are diversified groups of hedge funds overseen and monitored by a "manager of managers," have become the investment product *du jour* for high-net-worth investors.

Although estate planning attorneys will not typically be called upon to recommend hedge funds of funds to their clients or to know their technical intricacies, they may receive questions about their legal structures and tax implications. Moreover, some uninformed advisors, including lawyers, have a knee-jerk reaction to the mention of hedge funds, thinking only that they are terribly risky. Many immediately recall Long Term Capital Management, the grossly over-leveraged fund whose default nearly collapsed financial markets in 1998. At a minimum, legal advisors to the high-net-worth client market should not automatically dismiss hedge funds as risky. In an ideal situation, advisors should understand the role that hedge funds can play in improving the risk/return profile of an investment portfolio, know the various types of hedge funds, and have a general familiarity with how hedge funds produce their investment returns.

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<sup>44</sup> "Hedging" is any investment that is taken in conjunction with another position in order to reduce directional exposure, which is the amount of risk that an unhedged position faces in the market as compared to the net exposure of positions involving long and short hedged relationships. A classic example of hedging is a farmer who enters into a futures contract for grain to lock in a particular price. The farmer removes any uncertainty about the price she will receive for grain, but she foregoes the possibility of receiving a higher price.

## 2. Benefits and Risks of Hedge Funds

The incorporation of market-neutral hedge-fund-of-fund strategies in investment portfolios yields three primary benefits. First, it allows investors to access the highest level of investment management talent in the industry. Many of the most successful investment managers have left larger firms to join (or form their own) smaller firms that offer hedge fund products and embrace a wider array of trading strategies that enable them to deliver superior risk-adjusted returns to their customers. Second, it has been demonstrated in recent studies that “adding hedge funds to traditional stock and bond portfolios significantly improves overall returns at equivalent levels of risk.”<sup>45</sup> Third, hedge funds can improve returns and reduce risk particularly well at times when markets are excessively volatile.

The most commonly cited risk of hedge-fund investing is that hedge-fund products are not typically subject to the high level of regulation associated with mutual funds, for example. Most hedge funds are organized as private investment partnerships and investors must meet minimum net-worth or income criteria to invest.<sup>46</sup> In addition, reporting standards are less stringent for hedge funds than for mutual funds or separately managed accounts. For this reason, many hedge fund investors employ an investment consultant to perform due diligence on prospective hedge-fund managers. Investors also typically will prefer highly diversified hedge-fund-of-fund products over single-manager products to minimize the specific risks associated with a single manager. Another potential risk in hedge-fund investing is the over-use of leverage and derivatives. Again, hedge-fund investors typically will look to their investment consultant to monitor the appropriate use of leverage and derivatives by their hedge-fund-of-fund managers.

## 3. Superior Risk-Adjusted Returns

By far the most compelling benefit of hedge-fund investing is that it produces superior risk-adjusted returns compared to traditional stock and bond asset classes. Over the past decade, hedge funds as an asset class have produced equity-like returns in both rising and declining markets, while maintaining the limited volatility of a bond portfolio. The following chart compares hedge funds to stocks and bonds in the 1990s.<sup>47</sup>

<b>Asset Class</b>	<b>Return</b>	<b>Volatility</b>
Hedge Funds	14.6%	4.4%
Stocks	17.2%	13.7%
Bonds	7.5%	4.4%

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<sup>45</sup> R. McFall Lamm, Jr. & Tanya E. Ghaleb-Harter, *Do Hedge Funds Belong in Taxable Portfolios?*, J. OF WEALTH MGT., 1, 1-16 (Summer 2001).

<sup>46</sup> See Section 6, *infra*.

<sup>47</sup> Lamm, *supra* note 45 at 1-2.

One of the hottest debates among investment consultants is what percentage of a taxable investor's portfolio should be allocated to hedge funds. Although some investment consultants limit their suggested allocations to hedge funds to the traditional 15-20 percent range, others suggest allocations consistent with portfolio optimization research indicating that a 50 percent allocation to hedge funds may be appropriate.<sup>48</sup>

#### **4. Types of Hedge Funds and How They Produce Investment Returns**

There are estimated to be more than 8,000 hedge funds representing more than \$1.0 trillion in assets. The following list of principal categories of hedge funds is ordered from least to most volatile, and from lowest to highest expected returns. The first eight categories are considered "market neutral," while the remaining three categories are not.

##### **a. Long/Short Equity Market Neutral**

This investment strategy seeks to profit by exploiting pricing inefficiencies between related equity securities, neutralizing exposure to market risk by combining long and short positions. One example of this strategy is to build portfolios made up of long positions in the strongest companies in several industries and taking corresponding short positions in those companies showing signs of weakness.<sup>49</sup>

##### **b. Merger Arbitrage**

This strategy is sometimes called "risk arbitrage." It involves investment in event-driven situations such as leveraged buy-outs, mergers, and hostile takeovers. Normally, the stock of an acquisition target appreciates while the acquiring company's stock decreases in value. These strategies generate returns by purchasing stock of the company being acquired, and in some instances, selling short the stock of the acquiring company. Managers may employ the use of equity options as a low-risk alternative to the outright purchase or sale of common stock. Most merger arbitrage funds hedge against market risk by purchasing S&P put options or put option spreads.

##### **c. Convertible Arbitrage**

Convertible arbitrage involves purchasing a portfolio of convertible securities, generally convertible bonds, and hedging a portion of the equity risk by selling short the underlying common stock. Certain managers may also seek to hedge interest rate

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<sup>48</sup> See Lamm, *supra* note 45 at 11.

<sup>49</sup> Short selling involves the sale of a security not owned by the seller and is a technique used to take advantage of an anticipated price decline. To effect a short sale, the seller borrows securities from a third party in order to make delivery to the purchaser. The seller returns the borrowed securities to the lender by purchasing the securities in the open market. If the seller can buy that stock back at a lower price, a profit results. A short seller must generally pledge other securities or cash with the lender in an amount equal to the market price of the borrowed securities. This deposit may be increased or decreased in response to changes in the market price of the borrowed securities.

exposure under some circumstances. Most managers employ some degree of leverage, ranging from zero to 6:1. The equity hedge ratio may range from 30 percent to 100 percent. The average grade of bond in a typical portfolio is BB-, with individual ratings ranging from AA to CCC. However, because the default risk of the company is hedged by shorting the underlying common stock, the risk is considerably better than the rating of the unhedged bond indicates.

#### **d. Relative Value Arbitrage**

This investment strategy attempts to take advantage of relative pricing discrepancies between instruments, including equities, debt, options, and futures. Managers may use mathematical, fundamental, or technical analysis to determine misvaluation. Securities may be mispriced relative to the underlying security, related securities, group of securities, or the overall market. Many of these funds use leverage and seek opportunities globally. Arbitrage strategies include dividend arbitrage, pairs trading, options arbitrage, and yield curve trading.

#### **e. Event Driven**

Event-driven investing is also known as “corporate life cycle” investing. This involves investing in opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, bankruptcy reorganizations, recapitalizations, and share buybacks. The portfolios of some event-driven managers may shift in majority weighting between risk arbitrage and distressed securities, while others may be broader in scope. Instruments include long and short common and preferred stocks, as well as debt securities and options. Some managers may use leverage. Fund managers may hedge against market risk by purchasing S&P put options or put option spreads.

#### **f. Regulation D**

Regulation D managers invest in Regulation D securities, sometimes referred to as “structured discount convertibles.” The securities are privately offered to the investment manager by companies in need of timely financing, and the terms are negotiated. The terms of any particular deal are reflective of the negotiating strength of the issuing company. Once a deal is closed, there is a waiting period for the private share offering to be registered with the SEC. The manager can only convert into private shares and cannot trade them publicly during this period; the investment is therefore illiquid until it becomes registered. Managers will hedge with common stock until the registration becomes effective and then liquidate the position gradually.

#### **g. Fixed Income Arbitrage**

This market-neutral hedging strategy seeks to profit by exploiting pricing inefficiencies between related fixed income securities, while neutralizing exposure to interest rate risk. Fixed income arbitrage is a generic description of a variety of strategies involving investment in fixed-income instruments, which are weighted in an

attempt to eliminate or reduce exposure to changes in the yield curve. Managers attempt to exploit relative mispricing between related sets of fixed income securities. The generic types of fixed-income hedging trades include yield-curve arbitrage, corporate versus Treasury yield spreads, municipal bond versus Treasury yield spreads, and cash versus futures.

#### **h. Distressed Securities**

Managers who strategically invest in distressed securities invest in, and may sell short, the securities of companies in which the security's price has been, or is expected to be, affected by a distressed situation. This may involve reorganizations, bankruptcies, distressed sales, and other corporate restructurings. Depending on the manager's style, investments may be made in bank debt, corporate debt, trade claims, common stock, preferred stock, and warrants. Strategies may be subcategorized as high-yield or "orphan" equities. Some managers may use leverage. Fund managers may also run a market hedge using S&P put options or put options spreads.

#### **i. Long/Short Equity Directional**

These non-market-neutral funds consist predominantly of long equities, although they have the ability to hedge with short sales of stock and/or index options. These funds are commonly known as stock-pickers. Some funds employ leverage to enhance returns. When market conditions warrant, managers may implement a hedge in the portfolio. Funds may also opportunistically short individual stocks. The important distinction between "Long/Short Market Neutral" and "Long/Short Equity Directional" is that equity directional funds do not always have a full hedge in place. In addition to equities, some funds may have limited assets to invest in other types of securities.

#### **j. Emerging Markets**

These non-market-neutral hedge funds invest in securities of companies or the sovereign debt of developing or "emerging" countries. Investments are primarily long. "Emerging Markets" include countries in Latin America, Eastern Europe, the former Soviet Union, Africa, and parts of Asia. Global emerging markets funds will shift their weighting among these regions according to market conditions and manager perspectives. Some managers invest solely in individual regions.

#### **k. Macro**

Macro funds invest by making leveraged bets on anticipated price movements of stock markets, interest rates, foreign exchanges, and physical commodities. Macro managers employ a "top-down" global approach and may invest in any markets using any instruments to participate in expected market movements. These movements may result from forecasted shifts in world economies, political fortunes, or global supply and demand for resources, both physical and financial. Exchange-traded and over-the-

counter derivatives are often used to magnify these price movements. These are the riskiest hedge funds.

## **5. Tax Characteristics of Hedge Funds**

For taxable investors, investing in hedge funds is a mixed blessing. On one hand, the previously discussed improvement that hedge funds bring to the risk/return profile of an investor's portfolio is a positive factor; on the other hand, the impact of hedge-fund investing on an investor's effective tax rate is generally negative. Due to the trading methodologies and types of transactions employed by hedge fund managers to generate their returns, nearly all hedge fund returns are taxable as ordinary income or as short-term capital gain, both of which are subject to the highest income-tax rates. For investors who are also subject to state income tax, this typically results in a tax rate on the investment earnings of hedge funds in excess of 40 percent. There are some hedge funds that produce returns taxable at long-term capital gain rates, but these funds are the exception rather than the rule.

For non-taxable vehicles that may comprise part of a high-net-worth client's estate plan, such as charitable remainder trusts ("CRTs") and private foundations, hedge fund investments can also prove to be problematic from a tax standpoint. Because most hedge funds and hedge funds of funds have as their legal structure a limited partnership, earnings of the fund typically constitute "unrelated business taxable income (UBTI)" to a CRT or private foundation. In the case of either a CRT or private foundation, UBTI can be detrimental to its intended non-taxable status.<sup>50</sup>

The way that CRTs and private foundations can nevertheless invest in hedge funds or hedge funds of funds is by electing to invest through the fund manager's "offshore feeder" fund. Because such funds are typically organized as companies rather than limited partnerships, they do not usually generate UBTI. Hedge fund managers organize these entities under the laws of an offshore jurisdiction in order to avoid the registered investment company rules and their accompanying SEC regulation.<sup>51</sup>

## **6. SEC Issues**

A hedge fund manager is exempt from the provisions of the Investment Company Act of 1940 (the "Act") if the fund can remain outside of the statutory meaning of an investment company subject to registration. These exclusions fall primarily under two sections of the Act.

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<sup>50</sup> In the case of a Charitable Remainder Trust, any amount of UBTI in any taxable year will cause all trust income for that year to be subject to income taxation as if the trust were a regular non-exempt trust. Treas. Reg. § 1.664-1(c). See also, *Leila G. Newhall, Unitrust v. Comr.*, 104 T.C. 236, 241-45 (1995). Private Foundations, on the other hand, are taxed only on their UBTI.

<sup>51</sup> See also PLRs 200315028 (Jan. 13, 2003), 200315032 (Jan. 14, 2003), and 200315035 (Jan. 14, 2003), where four charitable remainder trusts employed a controlled foreign corporation for investing in a leveraged hedge fund.

**Section 3(c)(1):** A fund need not register as an investment company if it has fewer than 100 beneficial owners and they are “Accredited Investors.”

**Section 3(c)(7):** Alternatively, a fund may avoid registration if it has fewer than 500 owners and they are Qualified Purchasers (i.e., “super-accredited” investors with higher net-worth and higher income requirements).

Both Sections 3(c)(1) and 3(c)(7) of the Act also stipulate that the fund must neither make nor intend to make a public offering. There is no exemption if the hedge fund manager holds itself out to the public as an Investment Advisor.

An “Accredited Investor” within the meaning of rule 501(a) of Regulation D promulgated under the U.S. Securities Act of 1933, as amended, is defined as one of the following:

(i) an individual with at least a \$200,000 annual income or a net worth of at least \$1 million; or

(ii) a corporation, partnership, LLC, business trust, or tax-exempt organization not formed for the purpose of investing in the hedge fund and having total assets in excess of \$5 million.

A “Qualified Purchaser” is defined in section 2(a)(51) of the Act as one of the following:

(i) an individual with investable assets of at least \$5 million; or

(ii) a corporation, partnership, LLC, business trust, or tax-exempt organization not formed for the purpose of investing in the hedge fund and having investable assets of at least \$25 million.

As a practical matter, hedge fund investors generally will need to qualify as Qualified Purchasers due to limitations imposed in a fund’s offering documents.

## **7. Coordination with Private Placement Variable Life Insurance**

Investing in hedge funds within a private placement variable life insurance contract enables the investor to have her cake and eat it too. Because of the favorable tax characteristics of life insurance, clients can choose hedge fund investments for their positive risk/return characteristics without fear of the significant income-tax burden they often incur.

Most insurance carriers that offer private placement products not only permit hedge funds as investments of separate accounts, they expect it. Moreover, in the non-SEC regulated environment that exists for offshore PPVUL products, the regulatory hassles that accompany admitting a hedge fund as an investment choice within a domestic policy are a non-issue.

Hedge funds or hedge funds of funds as an investment of a PPVUL insurance contract should not pose diversification concerns under IRC § 817(h) as long as the investment structure of the fund is a limited partnership, since limited partnerships are “looked through” to their underlying investments for purposes of applying the diversification test. Although investor control is still a significant consideration, especially in light of recent rulings issued by the IRS,<sup>52</sup> many hedge fund managers have responded to these rulings by creating insurance-dedicated funds or funds of funds. This should help reduce the risk of an IRS finding of investor control.

Two issues of concern in the context of an investment in a hedge fund within a separate account of a private placement policy are valuation and liquidity. Although offshore carriers typically can administer policies when receiving monthly valuation data, domestic carriers may have problems with this because state insurance regulators may require more frequent valuation of policy assets. Although some hedge funds have systems that would allow them to provide daily valuation, most do not, making the less-regulated offshore insurance environment preferable in such cases.

Liquidity is a more difficult issue. Most hedge funds and hedge funds of funds provide in their organizing documents that part or all of the fund can be liquidated on no more than a quarterly basis. More importantly, many have “lock-up” periods that prevent any liquidation in the first investment year. Insurance carriers have a problem with year-long lock-up periods because if the insured dies, the carrier will want to pay the death benefit in cash. Accordingly, it is normal for a carrier to negotiate with a hedge fund manager in an effort to persuade the fund manager to waive its lock-up requirement in the case of the death of the insured in the first investment year.

## **8. Conclusion**

The compelling risk/return benefits that hedge funds bring to a taxable investor’s portfolio are sometimes perceived to be offset by the tax inefficiency of hedge fund earnings. Using private placement life insurance products as the investment chassis for an investor’s allocation to hedge funds can successfully meet a client’s otherwise seemingly conflicting goals of investing in hedge funds and investing tax-efficiently. That is, with proper policy planning and design and carefully chosen hedge fund products, a client can enjoy the “best of both worlds,” tax efficiency and superior risk-adjusted investment returns.

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<sup>52</sup> See, e.g., Rev. Rul. 2003-92; Rev. Rul. 2003-91; Pvt. Letter Rul. 200244001.