Private Placement Life Insurance Planning (Part 2)

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Part 1 of this outline appeared in the June issue and covered private placement variable universal life insurance.

11. *Practical Realities*

    a. *Solicitation*. If an offshore life insurance company or its agents have solicited an offshore life insurance contract within the United States, 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 United States. The client should travel outside the United States 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.

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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*

a. 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 United States, 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.

b. 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*

a. 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.

b. *Legal Advisor*

i. 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.

ii. 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.

c. *Insurance Broker*

i. 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.

ii. 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.

iii. 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., 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.

iv. 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 policy holder. 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?*

a. 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 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.

i. "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 forgoes the possibility of receiving a higher price.

b. 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.

2. *Benefits And Risks Of Hedge Funds*

a. 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." R. McFall Lamm, Jr. & Tanya E. Ghaleb-Harter, *Do Hedge Funds Belong in Taxable Portfolios?*, 4 J. of Wealth Mgt. 58 (Summer 2001). Third, hedge funds can improve returns and reduce risk particularly well at times when markets are excessively volatile.

b. 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. 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*

a. 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 pro-

duced 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. Lamm, *supra*.

Asset Class	Return	Volatility
Hedge Funds	14.6%	4.4%
Stocks	17.2%	13.7%
Bonds	7.5%	4.4%

b. 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 that indicates that a 50 percent allocation to hedge funds may be appropriate. *See* Lamm, *supra*.

4. *Types Of Hedge Funds And How They Produce Investment Returns*

a. 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.

i. *Long/Short Equity Market Neutral*

(1) 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. 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 bor-

rowed securities. This deposit may be increased or decreased in response to changes in the market price of the borrowed securities.

ii. *Merger Arbitrage*

(1) 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.

iii. *Convertible Arbitrage*

(1) 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 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.

iv. *Relative Value Arbitrage*

(1) 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.

v. *Event Driven*

(1) 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.

vi. *Regulation D*

(1) 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.

vii. *Fixed Income Arbitrage*

(1) 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.

viii. *Distressed Securities*

(1) 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.

ix. *Long/Short Equity Directional*

(1) 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.

x. *Emerging Markets*

(1) 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.

xi. *Macro*

(1) 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*

a. 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 generally is 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.

b. 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.

i. In the case of a CRT, 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. Comm'r*, 104 T.C. 236, 241-45 (1995), *aff'd*, 105 F.3d 482 (9th Cir. 1997). Private foundations, on the other hand, are taxed only on their UBTI.

c. 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 regulations. *See also* Pvt. Letter Ruls. 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.

6. *SEC Issues*

a. 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.

i. *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."

ii. *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).

b. 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.

c. 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.

d. 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.

e. 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*

a. 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.

b. 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.

c. Hedge funds or hedge funds of funds as an investment of a PPVUL insurance contract should not pose diversification concerns under Internal Revenue Code section 817(h) as long as the investment structure of the fund is a limited partnership. This is because limited partnerships are "looked through" to their underlying investments for purposes of applying the diversification test. Investor control is a significant consideration, however, especially in light of recent rulings issued by the IRS. *See, e.g.,* Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Pvt. Letter Rul. 200244001. Many hedge fund managers have responded to these rulings, however, by creating insurance-dedicated funds or funds of funds, which should reduce the risk of an IRS finding of investor control.

d. 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.

e. 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*

a. 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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