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Domestic and International Tax Consultant:
Tax Planning for High Net-Worth Individuals Investing in Hedge Funds

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Background

Hedge funds are often used by wealthy individuals and institutions for their promise of high returns in any economic climate. Since their introduction in 1990, assets managed in hedge funds have increased from a low of $39 billion to a high of $1.93 trillion in 2008. This article focuses on tax issues faced by high net worth individuals in the U.S. that invest in hedge funds, and explores tax planning strategies that may help reduce their capital gains taxes.

High net worth individuals that fall into the highest U.S. federal, state, and local income tax rates may lose up to 50% of their income to taxes. Similarly, if hedge fund buy and sell transactions produce capital gains for their investors within one year of being invested, then these gains will receive short-term capital gains (STCG) tax treatment, which may expose all such gains to the highest U.S. federal, state, and local income tax rates. However, if hedge fund buy and sell transactions produce capital gains for their investors beyond one year of being invested, then these gains will receive long-term capital gains (LTCG) tax treatment, which may subject all such gains to the lower U.S. federal long-term capital gains tax of 15%, as well as other state and local income tax rates. Irrespective of the capital gains tax treatment received, high net worth individuals may lose between 25% and 50% of their hedge fund gains to taxes.

Common Tax Planning Solution

In recent years, many hedge fund investors have turned to life insurance as an investment vehicle for the tax benefits it provides. A properly structured life insurance contract may allow high net worth individuals in the U.S. the ability to invest in hedge funds without suffering any tax consequences on their capital gains, and the ability to access their gains tax free through properly structured insurance contract loan provisions. Obviously, if capital gains taxes are no longer an issue to hedge fund investors, then their capital gains will remain invested, which will allow for much more aggressive compounded growth over time.

To illustrate the substantial difference in financial results that a hedge fund investor may experience as a result of favorable U.S. tax treatment applicable to life insurance, please observe the following example. No life insurance costs are included.

	Hedge Fund Investor Gains without Life Insurance	*Hedge Fund Investor Gains with Life Insurance*
Fund Return	+30%	+30%
Fund Fee	-6%	-6%
Taxes (STCG)	**-12%**	**0%**
Remainder	+12%	+24%

In practice, a life insurance company is used to structure and issue a private placement life insurance contract (PPLI) to a hedge fund investor. Since it is a life insurance contract, there are expenses and taxes to consider. The most obvious expense is the cost of insurance. U.S. life insurance companies typically charge a substantial cost of insurance because of their enormous overhead, which includes the following: (i) costly and extensive corporate distribution networks for their products, (ii) enormous commissions paid to sales agents, (iii) costly and complex state regulatory requirements, and (iv) a life insurance structure that is commonly designed to maximize the net amount at risk, which is the difference between a life insurance contract's death benefit and its cash value, thereby maximizing the cost of insurance being carried.

In addition to the cost of insurance, state premium taxes are assessed on premiums paid to a life insurance company usually in the range of 2% to 5%. Moreover, a federal DAC tax of 1% to 1.5% of premiums paid is typically assessed on U.S. insurance companies and passed to the investor. It is not uncommon for the investor to lose 10% or more of the initial premium paid after all costs and taxes. However, once the money is in the life insurance contract, the cost of insurance remains the principal expense over time.

To illustrate the substantial difference in financial results that

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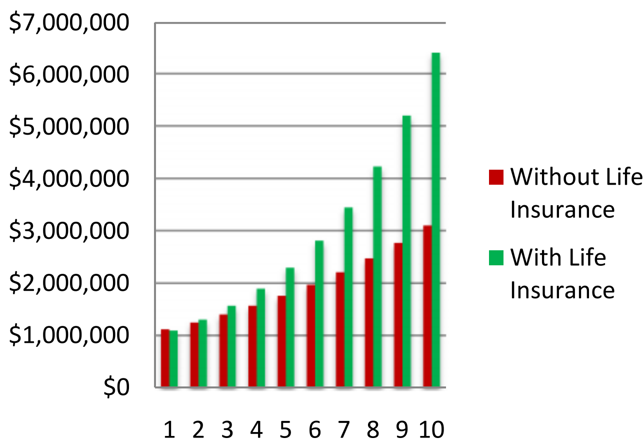
a hedge fund investor may experience as a result of favorable U.S. tax treatment applicable to life insurance, please observe the following example. The following example assumes that a U.S. male of age 50 makes a lump sum investment of $1,000,000 into a U.S. hedge fund via a private placement life insurance contract issued by a U.S. life insurance company. The U.S. hedge fund is assumed to have a constant rate of return of 30% annually for 10 consecutive years. All U.S. life insurance costs are included.



Years 2 - 10	*Hedge Fund Investor Gains without Life Insurance*	*Hedge Fund Investor Gains with Life Insurance*
Fund Return	+30%	+30%
Fund Fee	-6%	-6%
Cost of Insurance	**0%**	**-5%**
Taxes (STCG)	-12%	0%
Remainder	+12%	+19%

State Regulatory Considerations

A U.S. investor's ability to choose a hedge fund is heavily influenced by state regulations imposed on U.S. life insurance companies and U.S. tax law. Costly state regulatory requirements may require hedge fund investors to invest premiums in the range of $20,000,000 or higher to have the flexibility to select their own hedge fund. Even if this requirement is met, a U.S. insurance company may not allow the flexibility to add on more hedge funds to the investor's portfolio due to the prohibitive state regulatory costs involved. Moreover, if a single hedge fund is selected, it will still be required to meet the diversification requirements of Rule 817(h) of the IRC, which basically outlines that a hedge fund must have at least 5 different company holdings in order to qualify to receive all of the premiums paid to an insurance company. Consequently, these additional considerations may be significant barriers for U.S. hedge fund investors interested in pursuing a life insurance tax planning solution.

Need for Unique Tax Planning Solution

In light of the substantial costs, taxes, and restrictions involved in pursuing a hedge fund investment strategy via life insurance in the U.S., high net worth individuals are demanding a much more cost efficient and flexible tax planning solution. In response to their demands, offshore life insurance as an alternative may significantly alleviate many of the costs, taxes, and restrictions discussed above. An off-shore life insurance contract that qualifies as a life insurance contract for U.S. tax purposes may provide the same tax benefits as a life insurance contract issued by an insurance company in the U.S.

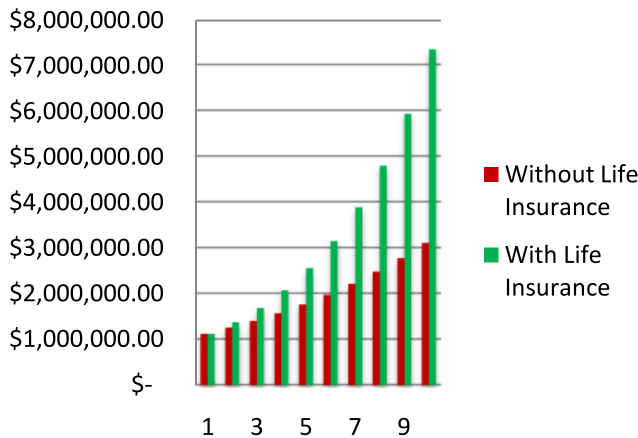
Off-Shore PPLI Tax Planning Solution

In practice, an off-shore insurance company is used to structure and issue a private placement life insurance contract (PPLI) to an off-shore entity acting as purchaser on behalf of a U.S. investor. Since it is a life insurance contract, as is the case with a life insurance contract issued in the U.S., there are expenses and taxes to consider. Off-shore life insurance companies typically charge a substantially reduced cost of insurance because of their lower overhead with respect to U.S. insurance companies. Off-shore insurance companies typically have far less costly corporate distribution networks for their products, pay substantially less in commissions to sales agents, are far less regulated, and provide a life insurance structure that is designed to minimize the net amount at risk, thereby minimizing the cost of insurance being carried.

Since the life insurance contract is purchased by an off-shore entity on behalf of a U.S. investor from an off-shore insurance company, which places the issuer and the purchaser outside the jurisdiction of the U.S. federal and state tax authorities, state premium taxes and the U.S. federal DAC tax do not apply. However, a U.S. federal excise tax of 1% may be assessed on premium payments leaving the country on behalf of a U.S investor. In addition, there is an insurance transaction fee charged by advisors facilitating the purchase

of an off-shore life insurance contract on behalf of a U.S. investor, which is usually assessed in the range of 2% to 5% of premiums paid. Moreover, there are also additional insurance underwriting costs and other professional fees to consider when pursuing this tax planning solution. It is not uncommon for the investor to lose up to 10% of the initial premium paid after all costs, fees, and taxes. However, once the money is in the life insurance contract, the cost of insurance remains the principal expense over time.

To illustrate the substantial difference in financial results that a hedge fund investor may experience as a result of favorable U.S. tax treatment applicable to off-shore life insurance, please observe the following example. The following example assumes that a U.S. male of age 50 makes a lump sum investment of $1,000,000 into an off-shore hedge fund via a private placement life insurance policy issued by an off-shore life insurance company. The off-shore hedge fund is assumed to have a constant rate of return of 30% annually for 10 consecutive years.



Years 2 - 10	*Hedge Fund Investor Gains with U.S. Life Insurance*	*Hedge Fund Investor Gains with Off-Shore Life Insurance*
Fund Return	+30%	+30%
Fund Fee	-6%	-6%
Cost of Insurance	**-5%**	**-1%**
Taxes (STCG)	0%	0%
Remainder	+19%	+23%

Year	*Without Life Insurance*	*With U.S. Life Insurance*	*With Off-Shore Life Insurance*
1	$1,120,000	$1,097,153	$1,118,592
2	$1,254,400	$1,305,079	$1,373,017
5	$1,762,342	$2,300,020	$2,553,451
10	$3,105,848	$6,406,350	$7,331,900

Off-Shore Regulatory Considerations

Off-shore life insurance regulations allow hedge fund investors much more flexibility in the selection of and the number of hedge funds that may be selected. If a single hedge fund is selected, the diversification requirements of Rule 817(h) of the IRC must still be met. Since off-shore life insurance regulations are far more flexible and favorable, only a $1,000,000 premium commitment is typically required to pursue an off-shore PPLI tax planning solution. Consequently, many of the barriers that may have been encountered by a U.S. investor attempting a U.S. PPLI tax planning solution are no longer an issue with an off-shore PPLI tax planning solution.

Is the off-shore PPLI tax planning solution right for you?

As illustrated, the difference in financial results that a U.S. hedge fund investor may experience over time by using a life insurance tax planning solution is staggering and is strongly in favor of an off-shore PPLI tax planning solution. A U.S. interested person must meet the definition of an accredited investor as outlined in the U.S. Securities Act of 1933 in order to pursue this strategy. A U.S. interested person must be looking to or is willing to invest in an off-shore hedge fund. This solution is ideal for hedge fund investors whose gains are typically subject to short-term capital gains (STCG) taxes, and is still applicable to investors subject to long-term capital gains (LTCG) taxes.

Note: Please be advised that the information contained in this article may be used for informational purposes only, and is not meant to be and should not be taken for a solicitation for either a U.S. private placement life insurance contract, or an off-shore private placement life insurance contract.