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PPLI Makes Hedge Funds Less Taxing

Planning considerations when using private placement life insurance

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For affluent investors, hedge funds can be a powerful wealth management tool, offering attractive returns and broad diversification. However, hedge funds can be extremely tax inefficient. Typically, hedge fund earnings are taxed as ordinary income or short-term capital gain, at federal rates as high as 43.4 percent. Add in state taxes and the combined rate approaches 50 percent.

Investors who have an appetite for hedge fund returns, but find the potential tax bite distasteful, should consider private placement life insurance (PPLI) and private placement variable annuities (PPVA). Still a relatively underused strategy, PPLI has grown in popularity in recent years among affluent investors seeking greater tax efficiency

A Tax Favored Insurance Structure

PPLI is a variable universal life insurance product designed to hold interests in various asset classes, including hedge funds, hedge funds of funds and other "alternative" investments. By covering these assets in an "insurance structure," PPLI has the power to convert highly inefficient taxable assets into favorable tax-efficient investments.

Life insurance offers significant tax advantages. So long as a policy remains in force, investments grow and compound income-tax-free. Although withdrawals or surrenders can generate ordinary income if structured improperly, there are two ways you can tap a policy's cash value tax-free: 1) take withdrawals up to the amount of your investment in the contract, or 2) take low-cost loans from the policy.

If your clients hold a policy for life and the investments perform well, they'll accumulate significant cash value without paying tax along the way. This cash value can provide your clients with a variety of benefits, including tax-free withdrawals, enhanced death benefits and funding for children's education. In addition, when your clients hold the policy for life, the death benefit transfers to their heirs income-tax-free. And by placing a policy in a properly structured irrevocable life insurance trust (ILIT), it's possible to avoid estate taxes as well.

A Flexible Investment Tool

PPLI combines the powerful tax benefits of life insurance with the flexibility to invest in hedge funds and other sophisticated asset management offerings. Other benefits include:

- Lower costs — Typically, PPLI offers lower fees, commissions and other costs than retail insurance products.
- No surrender charges— Policies can be surrendered at any time without incurring surrender charges often found in retail life insurance policies.
- Simplified tax reporting — PPLI eliminates many of the annual reporting burdens associated with hedge funds, including K-1s.
- Avoidance of "phantom income" — Because earnings accumulate in a tax-free environment, investors avoid paying taxes on income that's not distributed to them.
- Opportunities to enhance the benefits of wealth transfer and charitable planning strategies.
- Ability to transfer existing life insurance policies into a PPLI using a tax-free Internal Revenue Code Section 1035 exchange.
- Enhanced creditor protection, if structured properly.

PPLI offerings are unregistered securities, so they're available only to investors who meet the SEC's "accredited investor" and "qualified purchaser" standards. Accredited investors are those with either: 1) a net worth of at least $1 million (excluding their primary residence), or 2) income of at least $200,000 ($300,000 for married couples) in each of the preceding two years. Generally, qualified purchasers are individuals (and certain trusts) with at least $5 million in net investments and entities with at least $25 million in net investments.

Planning Considerations

Typically, PPLI policies are designed to maximize cash value growth and minimize death benefits. This allows the owner to keep the costs as low as possible and to participate in more of the investments' potential gains. These arrangements must be structured carefully to ensure that the relationship between cash values and death benefits satisfies the IRC's definition of "life insurance."

In addition, to preserve tax-deferred treatment, policies must meet certain diversification requirements, must hold investments that aren't available to the general public and comply with investor control prohibitions. Generally, the best way to meet all of these requirements is by selecting one of the insurance dedicated funds (IDFs) now offered by many investment firms. The funds available include hedge funds, hedge funds of funds, master limited partnerships (MLPs) and other alternative strategies. The list of available funds is growing at a rapid pace, and investors often find that funds they're already invested in are available inside a tax-efficient PPLI structure.

Keep in mind that deferred gains within a life insurance policy are taxed as ordinary income if not managed properly. So, while PPLI offers advantages for tax-inefficient investments, it's generally not appropriate for tax-efficient assets. For example, placing an investment that generates long-term capital gains into a PPLI policy would effectively convert those gains into ordinary income if the owner chooses to surrender the policy.

Structured Alpha in Action

One reason PPLI is so attractive is its ability to take advantage of "structural alpha." Unlike alpha, which measures an investment's performance on a risk-adjusted basis, structural alpha measures a particular asset structure's ability to boost returns without adding risk.

By enhancing a fund's after-tax returns, PPLI maximizes structural alpha.

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