A Whiter Shade of Pale

Building a Private Label Investment Program with Private Placement Life Insurance and Annuities

Overview

Poor John Paulsen! Now that's an oxymoron! He has to be the most radioactive man on the Planet when it comes to tax planning. Everything he touches in business seems to be couched in subversive tax planning to break the national treasury.

The financial press has become more like the Hollywood Paparazzi when it comes to his tax planning. When he went to Puerto Rico, it was "John Paulsen is trying to buy the Island of Puerto Rico from the U.S. Government in order to turn it into his own personal tax haven." Never mind, the Puerto Rican government adopted cutting-edge economic incentives that our own federal government could learn a thing or two from.

Next, it was John Paulsen's reinsurance company in Bermuda. The Press was all over that from the standpoint of Paulsen's personal tax benefits. Can't a rich man like John Paulsen start an insurance company in a top jurisdiction for insurance. This plan seems to have worked well for the Oracle of Omaha, Warren Buffet.

Lastly, the Press has gone crazy over the latest, Paulsen and Company's creation of an insurance dedicated fund that it will manage one of Paulsen's strategies within the insurance fund. Like many hedge fund strategies , the strategy is tax inefficient. Most of the income is short term capital gain income taxed at ordinary rates. The irony in this case is the length that Paulsen and carrier went to avoid the perception of promoting anything that might be construed as a tax shelter, to end up in the crossfire of the Press.

The moral of the story might be that in spite of any legal authority and justification of the tax law, if you are promoting a tax planning solution that John Paulsen is considering, you are going to get plenty of bad press. How does George Soros get a pass? These gentlemen could probably cover the federal deficit by themselves!

Unfortunately, this strategy is a perfectly legal strategy (just like the other strategies) and is a perfectly good idea for investment management firms with tax inefficient strategies to consider.

This article will focus on the creation of an insurance dedicated fund as a strategy to hedge fund managers to consider not only for high net worth investors but also tax exempt investors.

Background on Variable Insurance Products

In case you did not know, the assets of variable life insurance and annuities in the U.S. life insurance industry exceed two and a half trillion dollars. The Pareto Rule applies here. Eighty percent of these assets are held by twenty percent of the life insurers. The majority of the assets are held in retail variable life and annuity products sold by insurance agents.

The majority of the assets are part of variable annuity arrangements. Life insurers have managed to squeeze out $150 billion in variable annuity sales in 2011 and preceding years never missing a beat during the economic and market downturn by adding relatively high guaranteed returns to the contracts.

The marketplace for private placement life insurance and annuities easily exceeds $100 billion. High net worth assets account for approximately $15 billion while corporate and bank owned life insurance programs account for $100 plus million.

Private Placement Life Insurance (aka PPLI)?

PPPLI is a form of variable universal life insurance. The policy is strictly available for accredited investors and qualified purchasers as defined under federal securities law. The policy is institutionally priced and is virtually a “no load” product. The insurer provides the policyholder with the ability policyholder to customize the investment options within the policy. The range of investment options can include a customized fund managed by the client’s existing investment advisor as well as a range of asset classes including hedge funds, real estate and private equity.

The assets supporting the policy cash value are separate or segregated from the life insurer’s general account asset and its creditors. The policyholder is able to select these funds within the life insurance policy with the carrier’s fund election form.

Private Placement Variable Deferred Annuities?

A deferred annuity is a deferral of that promise to make a series of payments to the policyholder. The deferral may be set for a fixed period of time. Many contracts list a maximum age of 85 or 90 for the deferral period. The account value in a “fixed” annuity is based upon the crediting rate based upon the

insurer's investment performance on general account assets. Most insurance general account investments are in investment grade bonds.

In a variable annuity the investment performance is based upon the on investment performance of separate account funds. These funds are segregated from the insurer's general account assets Traditionally, these funds are mutual fund clones or sub-accounts managed by investment management firms in the mutual fund industry. The investment performance for these accounts is a direct pass-through to the policyholder.

The private placement version of this product is for accredited investors and qualified purchasers based upon the definition under federal securities law. Like PPLI, the products are institutionally priced with no surrender charges. The investment options include hedge fund, private equity and real estate options as well as traditional mutual fund-like options.

Tax Advantages of Life Insurance and Annuities

Deferred annuities provide for tax deferral. At the death of the policyholder, the account value must be distributed to the beneficiaries within five years of the policyholder's death unless the beneficiary is the policyholder's spouse. In that case, the spouse is treated as the new owner and policy benefits may continue to be deferred until the spouse's death.

Income taken "other than as an annuity" during the policyholder's lifetime is treated as taxable income (at ordinary rates) to the extent of investment income within the policy. Income that is taken in the form of an annuity is partly taxable and partly treated as a return of principal based on a formula known as the exclusion ratio. The big point here is annuities are not as tax advantaged as life insurance.

The tax advantages of life insurance are well known. Life insurance enjoys the tax-free buildup of the policy cash value, tax-free death benefit and the ability to take tax-free distributions from the policy during lifetime through a partial surrender of the cash value and low cost policy loans. Said another way, the money grows tax-free; you take it out during your lifetime tax-free and when you die it is tax-free.

The Bottom Line on PPLI and PPVA

I have outlined a hypothetical purchase of a PPLI contract. A high net worth investor, age 50, invests a single premium of $10 million into a contact issued by a domestic life insurer. The policy is a modified endowment contract (MEC). The initial death benefit is $35 million. The cash value is invested into a customized hedge fund managed account managed by the client's multi-family office.

The policy is invested at an assumed rate of 15 percent per year (I know-wishful thinking!). The comparison demonstrates the difference between a taxable account (far left column in red) and a tax-advantaged column (second and third columns in green). The taxable account is taxed at a combined rate of 47 percent.

The long-term results in favor of PPLI are staggering.

PPLI

	$10 MillionDeposit					
Year	**Net Taxable Investment Value ($)**	**End of Year PolicyCash Valu**	**Death Benefit ($)**	**Net Taxable Investment IRR (%)**	**PolicyCash Value IRR (%)**	**Death Benefit IRR (%)**
1	10,795,000	11,362,510	35,943,930	7.95	**13.62**	**259.44%**
2	11,653,203	12,912,620	35,943,930	7.95	**13.62**	**89.60**
3	12,579,632	14,684,290	35,943,930	7.95	**13.65**	**53.18**
4	13,579,713	16,710,230	35,943,930	7.95	**13.69**	**37.68**
5	14,659,300	19,019,330	35,943,930	7.95	**13.75**	**29.15**
10	21,489,508	36,525,140	48,943,680	7.95	**13.84**	**17.24**
15	31,502,114	70,617,360	86,153,180	7.95	**13.91**	**15.44**
20	46,179,894	136,575,200	158,427,200	7.95	**13.95**	**14.82**
30	99,238,319	525,828,200	552,119,600	7.95	**14.13**	**14.32%**
40	213,258,263	2,004,725,000	2,104,961,000	7.95	**14.17**	**14.31%**

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The advantage of tax deferral within annuities is frequently taken for granted particularly with investments that are taxed as ordinary income. The hypothetical illustration compares a $10 million investment into a PPVA contract against the same investment in a taxable account. The hedge fund managed account is taxed as ordinary income at a combined rate of 53.4 percent. The assumed investment return is ten percent in all years (net of fees). As you can see, the results are dramatic.

PPVA

	MaleAge50- $10.0MillionDeposit				
	PPVA HYPOTHETICALILLUSTRATION				
Year	Net Taxable Investment Value @ 53.4%	PPVA End of Year PolicyCash Value	PPVA Death Benefit	Net Taxable Investment IRR	Death Benefit IRR
1	10,466,000	10,950,000	10,950,000	4.66%	**9.5%**
10	15,769,141	25,009.530	25,009.530	4.66%	9.5%
20	24,866,497	61,461, 121	61,461, 121	4.66%	9.6%
30	39,212,263	152,203,127	152,203,127	4.66%	9.7%
40	61,834,267	377,193,992	377,193,992	4.66%	9.7%
50	61,834,267	1,024,074,091	1,024,074,091	4.66%	**9.7%**
60	97,507,163	2,584,625,676	2,584,625,67	4.66%	**9.7%**
80	**382,347,656**	**16,463,804,711**	**16,463,804,71**	**4.66%**	**9.7%**

Creating the Insurance Dedicated Fund (IDF)

The IDF is a separate and standalone fund that is separate from the hedge fund manager's domestic and offshore funds. The IDF will not investment in the master feeder fund. that the domestic and offshore funds of the hedge fund invest in. The tax requirements of IRC Sec 817(h) and Treasury Regulation 1.817-5 specify that the only permissible investors in the IDF are insurance company separate accounts.

Insurance company separate accounts are the insurance company assets that are segregated from the insurer's general account assets. The insurance company's subscribes to the IDF for the benefit of the separate account. The policyholder makes a fund election as part of the application process and decides to allocate premium to the IDF. The investment performance net of any policy or management fees flows to the separate account and is allocated to the policyholder's account value.

One strategy to mimic the returns of the non-insurance fund is for the IDF to invest in one or more of the Manager's non-insurance funds. The strategy provides good investment diversification and allows the insurance fund to track the investment returns of the non-insurance funds.

In the marketing of an IDF, the role of the investment manager of the IDF is to focus on the investment aspects of the IDF. The investment manager should work with a

consultant that knows a thing or two about PPVA or PPLI . Collectively, this covers both sides of the equation in the marketing of PPLI or PPVA.

One additional point, if the manager is uncertain about the ultimate marketing of the IDF and is reluctant to incur large expenses in the creation of the IDF, there are some solutions that mitigate the upfront cost of the IDF and provide more of a "pay as you go" approach. As a result, the decision to create and market and IDF does not have to be complicated or expensive.

Summary

For high net worth investors that invest in tax inefficient hedge funds, you have to ask yourself and your advisors why you aren't already utilizing PPLI and PPVA. Californian resident in the top marginal tax bracket will pay taxes on short term capital gain income of approximately, 56-57 percent and long term capital gain income of approximately 36-37 percent which is almost equal to the top federal bracket for ordinary income.

These tools are under-utilized. If you asked me (and nobody is!!!), every hedge fund of fund should have an IDF version of its fund. Operators are standing by for your call!