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Insuring Against Hedge-Fund Taxes

'Private Placement' Policies Draw More Wealthy Investors Despite Fees, Limited Control
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[from page D1]

A small but growing number of wealthy investors have discovered a legal way to invest in **hedge funds** without paying income taxes on the gains.

It's called "private placement" life insurance. These special insurance contracts allow policyholders to invest in a wide range of products, including hedge funds. The main attraction: Because the investments are held within an insurance wrapper, gains inside the policy are shielded from income taxes -- as is the payout upon death. What's more, policyholders may be able to access their money during their lifetimes by withdrawing or borrowing funds, tax-free, from the policy, depending on how it's set up.

Private-placement insurance policies are essentially variable insurance policies, which allow policyholders to invest a portion of their premiums in separate investment accounts. Though the policyholder can typically choose among a variety of investment options, there are no guarantees when it comes to performance. The strategy's chief advantage is the tax benefits that all life-insurance policies offer: Assets inside a life insurance policy can grow tax-free, and the death benefit can also be paid out free of income tax. Depending on how a policy is structured, the payout may also escape estate taxes.

Investors have long used the tax benefits of plain-vanilla variable life-insurance policies and annuities to invest in mutual funds. But private-placement policies allow users to invest in a far-wider range of options, including hedge funds, derivatives, real estate investment trusts and timber.

Private-placement policies are typically restricted to individuals paying at least $1 million in total premiums. They are offered by both domestic and offshore insurers, including American International Group Inc., Phoenix Cos.'s AGL Life Assurance Co., Sun Life Financial Inc., Massachusetts Mutual Life Insurance Co. and New York Life Insurance Co., among others.

The policies' tax advantages are particularly attractive for **hedge funds**. Because they trade frequently and often hold shares for very short periods, hedge funds -- lightly regulated investment pools for institutions and the wealthy that often employ risky strategies -- can generate a lot of short-term gains, which are taxed at up to 35% federally, rather than the 15% long-term federal capital-gains rate, plus state taxes. Another benefit: Assets in insurance policies may be off-limits to creditors, depending on the state or jurisdiction governing the policy.

John A. Anderson, managing principal of **Tempewick Wealth Management LLC**, a Mendham, N.J., wealth-management firm, says that he has set up twice as many private-placement insurance and annuity contracts this year than last year. Leslie Giordani, an Austin, Texas, lawyer, says that her private-placement legal work is growing about 30% a year. Sun Life's new private-placement business has more than doubled in

each of the past three years, the company says. AGL Life Assurance says that its private-placement insurance and annuity premiums have been growing about 40% a year. "The buzz is growing more and more," says John Hillman, president and chief executive officer of AGL.

One big reason for the growth: In recent years, the Internal Revenue Service has issued a series of rulings and regulations that have laid out more clearly what's allowable and what's not in private-placement life insurance and annuities. That, in turn, has removed uncertainty among insurers and investors.

The regulations have "given us fenceposts," says Bob Chesner, vice president of AIG Life in Houston. "You know what you can and cannot do."

In issuing these guidelines, the IRS hoped to "shut down abusive transactions" in which investors would, say, buy a publicly available hedge fund and then stick it in an insurance policy solely to avoid taxes, says one IRS lawyer. The rulings were also designed so that insurance companies and investors "could have a clearer example of what's acceptable and what's not," he adds. The IRS says that it may issue further guidance on private-placement life insurance in the future.

Giving Up Control

One major downside: Investing through a **private-placement life insurance** policy means you'll have to give up a good deal of control and choice over your investments in order to satisfy tax rules. "The IRS has very strict rules about investor control and diversification," says New York lawyer Gideon Rothschild. "Many high-net-worth people are control freaks and they don't really want to give up control. For many people it just isn't the right thing."

Meanwhile, if the funds within your policy have any losses, tax rules say you can't use investment losses within a policy to offset gains outside a policy.

Interest in private-placement life insurance comes as the **hedge-fund** market has ballooned in recent years -- although recent troubles at funds such as Amaranth Advisors and less-then-stellar returns are taking some of the luster out of the sector. As of this summer, some $1.23 trillion was invested in nearly 9,000 hedge funds and funds of funds -- which pool various hedge funds together -- more than double the amount five years ago, according to Hedge Fund Research in Chicago.

The private-placement life insurance market represents only a tiny fraction of the total hedge-fund market. Industry watchers estimate that the total onshore individual private-placement life insurance and annuity market is currently about $4 billion to $5 billion.

"I'm always amazed that no matter how popular it gets, it's not more popular," says David Neufeld, a partner with law firm Markuson & Neufeld, in Princeton, N.J,, which advises on private-placement transactions. "I can't understand why anyone who is invested in hedge funds -- highly tax-inefficient instruments -- would invest without this. There's a huge amount of untapped potential." Still, Mr. Neufeld acknowledges that the policies are complicated to set up. And since they are life-insurance policies, you'll have to take a medical exam to qualify. (Tax-deferred private-placement annuities, however, typically require no medical underwriting.)

There are also charges beyond investment-management fees when you invest in a private-placement policy -- though they are likely to be more than offset by the tax savings. These typically include upfront sales charges, as well as state premium taxes or offshore excise taxes, which can total about 2.5% to 4% of initial premiums. In addition, insurance companies charge recurring fees, which can take a 0.25% to 0.60% annual bite out of the cash value of the policy. Overall, you can expect annual fees to average about 0.75% to 1.25% of the policy's cash value over the policy's life, insurance advisers say. (Because the premiums for these

policies are so large -- generally starting at $1 million -- policyholders often have lots of leeway to negotiate. These charges are on top of any investment fees. Hedge funds typically charge management fees of 2% aand performance-based incentive fees of as much as 20% or more; funds of funds generally charge an extra layer of fees on top of that. In addition, it can cost from $10,000 to well over $20,000 in legal or advisory fees to set up a policy.

Private-placement policies have to be structured very carefully in order to pass muster with the IRS. There are two chief ways to do this: The simplest is to invest in so-called insurance-dedicated funds. These are special funds -- including hedge funds, mutual funds or other types of investments -- that aren't available to the public at large.

Currently, there are an estimated 75 to 100 **insurance-dedicated hedge funds**, funds of funds and other alternative investments available through private-placement policies. They span a wide variety of strategies, and are often sponsored by established hedge-fund managers such as Tremont Capital Management.

Each insurance company offers its own choice of insurance-dedicated funds. You're allowed to pick and choose among those options and move in and out of the investments. However, you can't make any direct investment recommendations to the fund managers themselves.

Hedge-Fund Choices

Insurance companies say they do extensive due diligence on the funds they choose, and the number of choices they offer is growing. AIG, for instance, offers about 40 insurance-dedicated funds, up from about 30 a year ago, while AGL has about 50 insurance-dedicated funds, adding about 15 in the past 18 months.

Policyholders who seek a wider range of investment options beyond the small menu of **insurance-dedicated funds** can use what's called a "managed account." In these, the insurance company hires an investment manager who can choose any investment or hedge fund -- not just insurance-dedicated ones -- based on guidelines you provide. In a managed account, though, there must generally be at least five different investments. And you can't directly choose which funds the investment manager invests in; you can only give broad investment guidelines.

Michael Sonnenfeldt, the found er of Tiger 21, a New York-based group of more than 100 **wealthy investors** who get together to exchange advice and ideas, says he plans to eventually purchase a private-placement life insurance policy as a tax-efficient way to invest in **hedge funds** and other alternative investments, but hasn't gotten around to it yet. "It's a dynamite tool," he says, "but the negative thing is that it adds complexity and inflexibility."