Ease the estate tax bite on hedge fund investments

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By David Y. Choi

High net-worth individuals invest in hedge funds to generate lucrative returns and diversify their portfolios. However, hedge fund investors can find the after-tax rates of return to be disappointing, even if the pre-tax rates of return are higher. In addition, since hedge funds are structured as partnerships, investments in hedge funds are currently taxable, often at ordinary income rates; and hedge funds do not distribute the cash to cover the income tax liabilities.

Enter the private placement variable life insurance (PPVLI), a variable universal life insurance product that can hold hedge funds as investments. For many high-net-worth individuals, PPVLIs provide a solution for long-term investing, asset protection and estate planning, while providing income tax-free access to investment growth. While not for everyone, the use of PPVLIs as part of an overall estate plan is an option worth considering.

Many think of life insurance as a backstop against an untimely death or as a means to pay one's estate taxes. However, the income earned on investments held by insurance policies is deferred for income tax purposes. Like retirement accounts, the growth in the investment portion of the life insurance policy is not subject to income taxes unless and until it is distributed to the policy owner. But unlike retirement accounts, PPVLI owners may not only withdraw what they have paid as premiums, they can also borrow up to 90 percent of the tax-deferred growth without having to pay any income taxes. A properly structured PPVLI product can be the financial equivalent of eating one's cake and having it, too.

PPVLIs also can be used to help preserve wealth for the next generation. Sophisticated estate planning techniques, such as generational split-dollar agreements, discretionary dynasty trusts, spousal access irrevocable life insurance trusts and increasing annuity charitable lead trusts, can substantially eliminate federal and state estate, gift and generation skipping transfer taxes that may otherwise take away significant portions of one's wealth. The combination of PPVLI products with one or more sophisticated estate planning vehicles can provide an all-in-one solution for a high-net-worth individual and his or her family.

For example, Michael is a high-net-worth individual in his mid-forties who has substantial liquid assets and is seeking a long-term investment vehicle that can also work for his estate planning. Michael wants to provide for his family and protect what he has, but he does not want to be cash poor as a result of any estate planning. One option for Michael may be to create an irrevocable life insurance trust (ILIT) for the benefit of Michael's spouse and descendants. Michael can fund the ILIT with Michael's lifetime gift exemption (up to $10,640,000, including his spouse's exemption). Michael's ILIT can then buy a PPVLI product from among many different insurance carriers. The terms of Michael's ILIT can be drafted to conform to Michael's specific family objectives and the ILIT can reach the assets in the PPVLI investment accounts should Michael's family ever require them. As the PPVLI investments grow tax-free, the ILIT can take policy loans without income tax consequence, and if needed, the ILIT Trustee can distribute the cash to Michael's spouse. Finally, if Michael dies prematurely, the life insurance proceeds will pass to Michael's family free of any estate or income taxes.

Unfortunately, PPVLIs are not available to everyone. PPVLI investors must be "qualified purchasers" or "accredited investors." Qualified purchasers must have $5 million or more in

investments and accreditors investors must have an individual net worth in excess of $1 million and meet certain earning thresholds. These restrictions limit the class of investors to high-net-worth individuals who can tolerate some risk.

In addition, federal tax rules limit PPVLI investments in two important ways. First, PPVLIs can only offer hedge funds that are available to insurance companies and not to the general public. Second, owners of PPVLIs cannot control the choice of hedge fund investments within the policy. As with all investments, there is no guarantee of positive results, and all investments should be chosen to meet an investor's short- and long-term objectives, risk tolerance, and overall diversified investment portfolio. Be sure to consult with your attorney and your wealth manager when considering PPVLIs as part of your estate plan.

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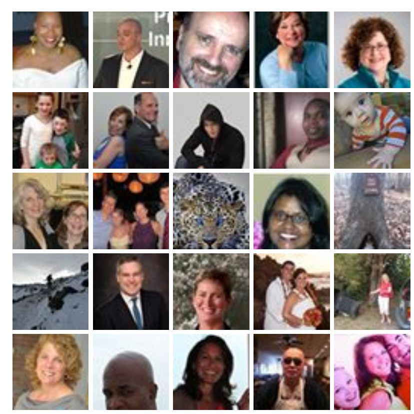

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