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Family Offices

Investments by Family Offices in Hedge Funds through Variable Insurance Policies: Tax-Advantaged Structures, Diversification and Investor Control Rules and Restructuring Strategies

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Variable insurance policies are an often utilized structure through which family offices and other high net worth investors invest in hedge funds and other private investment funds. One of the primary advantages of investing in hedge funds and other private investment funds through variable insurance policies is the deferral of income taxes. However, policy holders must first satisfy two important tests – the "diversification rules" and the "investor control" rules – in order for the policies to qualify for favorable income tax treatment.

This article describes the mechanics of investing in an insurance dedicated fund ("IDF") through variable insurance policies and offers a roadmap for satisfying the two tests to ensure the variable insurance policies maintain their tax-advantaged status. Moreover, this article describes in detail a recent restructuring transaction in which the authors participated (the "Transaction") and provides the key terms in the Transaction documents applicable to the diversification and investor control rules.

"Diversification Rules"

Income from variable life insurance policies is generally taxable at ordinary income rates because there is no exchange of a capital asset; however, there are several exceptions to this rule. In particular, in the event of the death of a policy owner, the proceeds from such policies would be distributable to the beneficiary tax-free. In order to qualify for such treatment, the insurance company, on behalf of its policy owner, may only invest in private investment funds that: (1) admit certain qualified investors; and (2) meet the diversification rules under Section 817(h) of the Internal Revenue Code of 1986, as amended (the "Code").

The diversification rules provide that the investments made by an insurance company through a segregated asset account will be diversified only if the following conditions are met: (1) no one investment constitutes more than 55% of the value of the total assets of the account; (2) no two investments constitute more than 70% of the value of the total assets of the account; (3) no three investments constitute more than 80% of the value of the total assets of the account; and (4) no four investments constitute more than 90% of the value of the total assets of the account.[1] An investment in a private investment fund will be sufficiently diversified for purposes of qualifying for the favorable tax treatment only if the policy owner can "look-through" the private investment fund or other investment vehicle to its underlying securities portfolio, whereby such private investment fund is ignored for purposes of diversification testing. Without a look-through rule, a segregated asset account that invests all of its assets into a private investment fund would be treated as having only one asset – the private investment fund. With a look-through rule, an interest in the private investment fund would not be treated as a single investment, but rather as holding a pro-rata portion of each security held by the private investment fund. Section 817(h)

(4) of the Code allows this "look-through" treatment, but such treatment is available only if: (1) insurance companies (or other similar entities) are the only entities holding the beneficial interests in the private investment fund (other than the investment manager); and (2) public access to the private investment fund is available exclusively (except as otherwise permitted by Treasury Regulations Section 1.817-5(f)(3)) through the purchase of a variable insurance policy.[2] Most private investment funds will not satisfy the first requirement since they are traditionally open to investment by investors that are "accredited investors," as that term is defined under Rule 501(a) of Regulation D under the Securities Act of 1933, as amended. Insurance companies now comply with the diversification rules by requiring hedge fund managers to establish separate clone funds open to only insurance companies and other similarly qualified private investment funds.

However, the IRS has taken the position, in certain instances, that assets held in segregated asset accounts underlying variable life insurance contracts would be viewed for federal income tax purposes as owned by the policy owner and not the insurance company that issued the contract. As a result, income derived from the assets underlying the contract would be deemed "controlled" by the policy owner and currently taxable to the policy owner as income in the year in which the income was earned.

"Investor Control" Doctrine

In addition to the diversification rules, the policy owner must comply with the "investor control" doctrine. The doctrine was developed in a series of revenue rulings issued as a response to the marketing of variable life insurance products allowing the contract owner too much discretion over the underlying investment assets. Under the investor control doctrine, if the owner of a variable policy has "direct investment control and can exercise other incidents of ownership" over the assets underlying its policy, the policy owner, instead of the insurance company, is deemed the owner of the assets. The net result of such deemed ownership is the policy owner losing the tax-deferral treatment for the income attributable to the private investment fund assets, and the inclusion of such income in the policy owner's gross income.

One of the most significant investor control rulings, Rev. Rul. 81-225, 1981-2 C.B. 12, described four situations in which investments in mutual funds pursuant to annuity contracts would be considered to be owned by (and taxable to) the policy owner rather than the insurance company investor. Revenue Rulings 2003-91, 2003-2 C.B. 347, and 2003-92, 2003-2 C.B. 350, clarify and expand Rev. Rul. 81-225 with respect to hedge funds. In Rev. Rul. 2003-91, the IRS addressed two nearly identical situations; one situation involved a variable life contract while the other involved a variable annuity contract. In both scenarios, the policy was supported by a separate account with various sub-accounts. Interests in the sub-accounts were available only through the purchase of a life insurance or annuity contract. Each sub-account was managed by an investment adviser hired by the insurance company and each sub-account represented a different investment strategy. The insurance company retained the right to increase or decrease the number and type of sub-accounts. The contract owner had the right to allocate premiums across various sub-accounts and was permitted to transfer cash values across sub-accounts.

There was no arrangement, plan, contract or agreement between the policy owner and either the investment adviser or the insurance company regarding the availability of a sub-account, the investment strategy of each sub-account or the assets held by each sub-account. All investment decisions for each sub-account were made by the investment adviser. The policy owner was not able to communicate directly or indirectly with the investment adviser or with the insurance company regarding the selection of specific investments. The ruling held that these arrangements satisfied the investor control doctrine and that the insurance company, and not the policy owner, was the owner, for federal income tax purposes, of the variable contract assets. Accordingly, the income attributable to those assets would not be included in the policy owner's gross income.

Rev. Rul. 2003-92 examined three scenarios; in both scenarios 1 and 2, the account supporting the purchased insurance products was segregated into sub-accounts and each sub-account invested in private investment funds that were sold in private placements to qualified purchasers who were accredited investors. An investor was not required to purchase a variable insurance product to obtain an interest in the underlying private investment funds. The third scenario provided that interests in the private investment fund were only available through the purchase of an annuity, life insurance or other variable contract offered by an insurance company. With respect to the first two scenarios, the IRS ruled that the arrangements violated the investor control doctrine because the private investment fund's equity interests were publicly available. In scenario 3, interests in the private investment fund were only available for purchase by the purchaser of an annuity, life insurance or other variable contract issued by an insurance company. Therefore, the private investment fund was an insurance-only partnership and for federal income tax purposes, the insurance company, and not the policy owner, was the owner of the interests.

Insurers may also utilize a fund of funds arrangement in which the insurance company invests in an insurance dedicated fund of funds (offered only to variable account holders), which in turn invests in underlying hedge funds, all of which may be publicly available to accredited investors. The diversification rules would be satisfied without having to comply with additional look-through requirements at the underlying hedge fund investment level so long as the insurance dedicated fund of funds invested in at least five different hedge funds; each such fund is counted as an investment in and of itself.[3]

Section 817(h)(5) permits the use of an independent investment adviser for variable contracts. However, under the investor control rulings, an issue could arise if the policy owner specifically insists on the use of a specific investment adviser or may remove or object to the removal of such adviser. IRS rulings provide, among other things, that a policy owner may recommend an investment adviser from a list of investment advisers approved in advance by the insurer (but the insurer is under no obligation to approve such recommendation), the investment adviser must report only to the insurer, the policy owner must have no communication with the adviser concerning investment performance and the insurer will be responsible for compensating the investment adviser for its services rendered to the segregated account.[4]

IDF Restructuring and Investment Transaction

Shipman & Goodwin LLP was engaged by a newly-formed limited partnership series (the "Series") of a multi-series IDF (the "Issuer Fund") to structure, and then negotiate the terms of, the Transaction. The Issuer Fund was created to offer limited partnership interests (the "Interests") to (i) separate accounts of life insurance companies that fund variable life insurance policies, variable annuity policies and other variable

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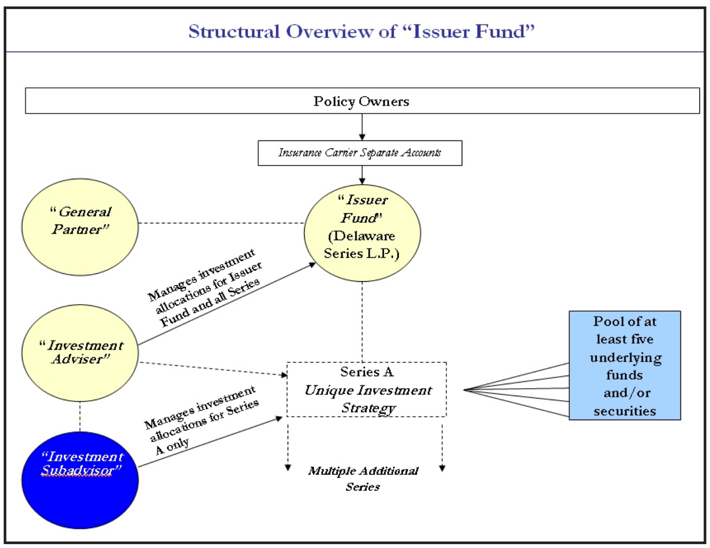
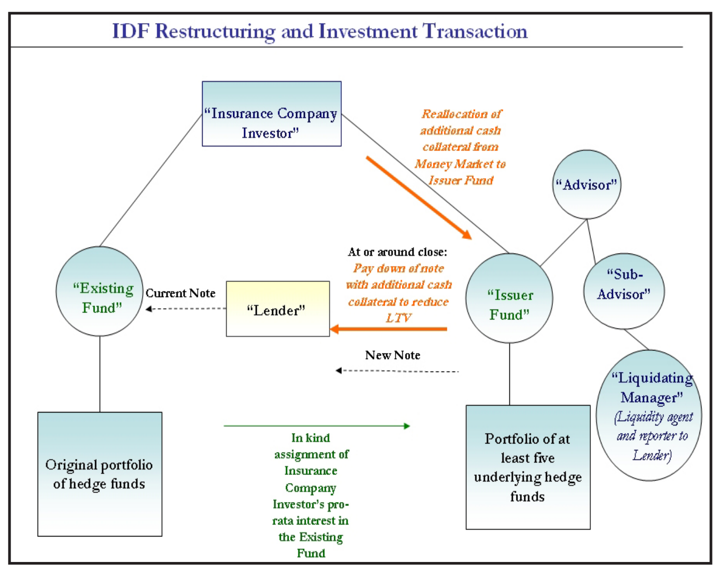
insurance policies, such as the Account (defined below); and (ii) private investment funds that are eligible to purchase and hold the Interests under Section 817(h) of the Internal Revenue Code of 1986, as amended, and corresponding Treasury Regulations Section 1.817-5 and in compliance with Revenue Ruling 2005-7.[5] For purposes of this Article, references herein to the Issuer Fund will be deemed to include the Series. The figure immediately below depicts the structure of the Issuer Fund.



Offshore trusts formed for the benefit of members of a large family office (the "Family Office") were the owners of various policies issued by an offshore affiliate of an international insurance company ("Insurance Company Investor"). The Insurance Company Investor in turn made an investment in an existing insurance dedicated fund (the "Existing Fund"). As a result of a decline in the net asset value of the Insurance Company Investor's capital account with the Existing Fund and the increasing loan to value ratio of the Existing Fund's debt facility, the Insurance Company Investor, in consultation with the Family Office, requested that the Existing Fund redeem a substantial portion of the capital account and transfer the assets to a corresponding capital account with the Issuer Fund.

The requested restructuring involved three separate, but simultaneous transactions: (i) an investment in the Issuer Fund by the separate account (the "Account") of the Insurance Company Investor of (A) cash and (B) an in-kind contribution of hedge fund and hedge fund of fund ("FOF") interests; (ii) the transfer from the Existing Fund to the Issuer Fund of a portfolio of hedge fund and FOF interests held for the benefit of the Account; and (iii) the establishment of a new debt facility provided by an international financial institution (the "Lender") to the Issuer Fund containing similar terms and conditions to the Lender's existing debt facility with the Existing Fund. The Issuer Fund was managed by an investment adviser (the "Adviser") and the Series was managed by both the Adviser and an unaffiliated sub-adviser (the "Sub-Adviser"). The Existing Fund was managed by an investment manager (the "Liquidating Manager"). The Sub-Adviser engaged the Liquidating Manager to assist it with complying with certain reporting requirements of the Lender as well as providing advice to the Sub-Adviser on liquidating the underlying funds of the Issuer Fund. An illustration of the Transaction is set forth in the figure immediately below.



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The Transaction in a series of steps accomplished three goals: (A) establish a new secured variable funding note financing between the Lender and the Issuer Fund; (B) avoid a default under the Existing Fund debt facility with the Lender; and (C) terminate the Account of the Insurance Company Investor with the Existing Fund. In furtherance of such goals, a substantial portion of the assets of the Existing Fund had to be transferred to the Issuer Fund to form part of the collateral for the new note financing. The Transaction was completed in the following order:

1. The Existing Fund redeemed the Insurance Company Investor's interest in the Existing Fund, part in cash and part in kind (such interest representing a substantial portion of the assets of the Existing Fund and related liabilities).
2. The Insurance Company Investor contributed the assets and related liabilities to the Issuer Fund.
3. The Insurance Company Investor directed that the above two steps be accomplished by a direct transfer of the assets and liabilities from the Existing Fund to the Issuer Fund.
4. The Lender required that the Insurance Company Investor raise and contribute to the Issuer Fund a substantial amount of cash collateral to partially secure, along with the assets, the new variable funding note financing.

The Lender imposed several requirements on the parties prior to consummating the Transaction described above. The new secured variable note issued by the Issuer Fund was required to be on substantially similar terms as the Existing Fund's existing secured note, *mutatis mutandis*. In addition, the Lender required that the Liquidating Manager remain in place as a sub-adviser to the Issuer Fund with respect to the liquidation of the collateral held at the Existing Fund after the consummation of the Transaction.

In addition to the foregoing, the Transaction was structured to comply with the requirements of the diversification rules and investor control doctrine in order to preserve the integrity of the tax deferred status of the insurance policies held by the Family Office trusts.

Since the Existing Fund and the Issuer Fund were both IDFs with investments in at least five separate hedge funds, for purposes of complying with Section 817(h), the Insurance Company Investor was entitled to "look through" the Issuer Fund and the Existing Fund to each fund's underlying investments to ensure diversification of investments. Therefore, the diversification rules set forth in Section 817(h) of the Code were satisfied with respect to both funds.

IDF Agreement

In addition to the issues raised by the investor control doctrine in the Transaction, several additional issues were raised during the negotiation of the principal documents implementing the Transaction. A discussion of these issues follows.

Participation Agreement

The participation agreement by and among the Insurance Company Investor, the Issuer Fund, its general partner (the "General Partner") and the Adviser (the "Participation Agreement") was the main operative document governing the purchase and sale of the Interests by the Insurance Company Investor on behalf of its separate accounts and subaccounts that own variable life insurance policies, variable annuity

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policies and other variable insurance policies (the "Variable Contracts").

In order to ensure the "look through" treatment accorded to IDFs under Section 817(h)(4) of the Code would be available (i.e., "looking-through" a private investment fund to its underlying securities portfolio to satisfy the diversification requirements of Section 817(h) of the Code), the Insurance Company Investor required that the Issuer Fund limit all offers and sales of Interests to the following types of investors: (1) participating insurance companies (i.e., only those insurance companies that fund Variable Contracts) ("Participating Insurance Companies") and (2) participating insurance funds (i.e., registered investment companies, real estate investment trusts, partnerships or trusts that (i) were eligible to purchase and hold Interests under Section 817(h) of the Code and corresponding Treasury Regulations Section 1.817-5 (including, without limitation, satisfying the "look-through" requirements of Treasury Regulations Section 1.817-5(f)) and complied with Revenue Ruling 2005-7; (ii) invested a portion of their respective assets in the Issuer Fund and (iii) entered into an agreement concerning the purchase and redemption of Interests ("Participating Insurance Funds")). The Issuer Fund was also required to represent that the Issuer Fund's other Participating Insurance Funds and Participating Insurance Company investors had represented and warranted to the Issuer Fund that such investors had met certain suitability requirements and would purchase and hold Interests only for the benefit of policy owners that they believed met such suitability requirements. Further, the Issuer Fund was prohibited from issuing or selling Interests to any Participating Insurance Funds or Participating Insurance Companies unless their respective participation agreements with the Issuer Fund contained provisions substantially similar to the provisions described above as well as certain other provisions contained in the Participation Agreement, which include, but are not limited to, the following:

- Suitability requirements relating to the underlying insurance company account investors;
- Suitability requirements relating to the Participating Insurance Funds and Participating Insurance Companies;
- Certain typical redemption provisions (e.g., gates, redemption suspension, and mandatory redemption);
- Certain special redemption provisions to override gates and redemption suspensions (e.g., redemptions for the payment of any insurance charges and or charges for Variable Contracts, redemptions required for the payment of a death benefit and redemptions for the occurrence of certain events (e.g., the Issuer Fund is no longer exempt from registration under the Investment Company Act of 1940, as amended, the Issuer Fund is no longer holding assets in compliance with the requirements of Section 817(h) and Treasury Regulations Section 1.817-5 and there is a violation of the "investor control" doctrine, each, a "Redemption Event"). With respect to certain Redemption Events, the Participation Agreement provided a cure period for certain violations;
- All contracts held by account investors were required to be Variable Contracts;
- The Issuer Fund must invest, dispose of and hold assets in compliance with Section 817(h) and Treasury Regulations Section 1.817-5 and notify the Participating Insurance Fund or Participating Insurance Company investor of any non-compliance and cure such noncompliance within the cure period

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afforded under Treasury Regulations Section 1.817-5;

- The Issuer Fund and its affiliates must conduct their business at all times so that no account owner will have incidents of control which cause the Issuer Fund's income and gains to be currently taxable to the account owner as a result of the application of the investor control doctrine; and
- The Issuer Fund and its affiliates agree (i) to not accept any investment recommendation or any investment decisions regarding the direct or indirect investment of its assets based, in whole or in part, on information received from an account owner or its representative; (ii) no policy owner will have any right, or be permitted, to select or identify any particular investment to be made with any assets of the Issuer Fund; and (iii) except for the general description of the investment objectives and policies of the Issuer Fund, there is no pre-arranged plan or agreement between any account owner or its representative, known to the Issuer Fund or its affiliates, with respect to investments to be made by the Issuer Fund.

The Insurance Company Investor required the Issuer Fund and its affiliates to provide a special indemnity with respect to (i) compliance with Section 817(h) and Treasury Regulations 1.817-5 and any amendments or modifications or successor provisions to such section or regulation, subject to the cure provision in (a)(2) of Treasury Regulations Section 1.817-5; and (ii) any failure to comply with the terms of the Participation Agreement resulting in the policy owner or its representative having incidents of control.

The indemnity section of the Participation Agreement was heavily negotiated by the parties; counsel should pay particular attention to conflict provisions in the agreement which would override the indemnification and exculpation provisions under the constitutive documents of a private investment fund or any other contract or document to which the private investment fund, its general partner or investment manager are party. Further, of particular importance, practitioners should be wary of prohibitions by insurance company investors against indemnification of certain unaffiliated service providers of the private investment fund (e.g., administrators, sub-investment advisers, prime brokers and other lenders) which could frustrate the private investment fund's ability to conduct its business.

Subadviser Agreement between Sub-Adviser and Liquidating Manager

As part of the Transaction, the Liquidating Manager was engaged by the Sub-Adviser pursuant to the terms of a subadviser agreement (the "Subadviser Agreement"). Pursuant to the Subadviser Agreement, the Liquidating Manager was responsible for the orderly liquidation of certain existing hedge fund and FOF interests held (but not redeemed) by the Issuer Fund in consideration for the payment of certain asset-based fees (the "Liquidation Fees").

In order to ensure the Issuer Fund's compliance with the representations, warranties and covenants made to the Insurance Company Investor in the Participation Agreement, the Liquidating Manager was required to make similar representations, warranties and covenants regarding compliance with Section 817(h) and Treasury Regulations Section 1.817-5 as well as the investor control doctrine. The Liquidating Manager in turn required a provision declaring it had no responsibility for Sub-Adviser's and Issuer Fund's own compliance with Section 817(h) and Treasury Regulations Section 1.817-5.

In addition to the specific requirements mandated by the Insurance Company Investor in the Participation Agreement, the Insurance Company Investor further required in the Subadviser Agreement that all Liquidation Fees as well as any account trading fees and/or extraordinary litigation expenses incurred on behalf of the Issuer Fund by the Liquidating Manager be paid out of the operating account of the Issuer Fund and not from any other assets of the Issuer Fund. The foregoing provision was consistent with the thinking behind the restrictive indemnification provisions contained in the Participation Agreement; ultimately, the Insurance Company Investor's main objective during the Transaction was to: (1) limit all parties' (and their respective affiliates) and any service providers' rights to indemnification by the Issuer Fund; and (2) limit the fees which could be charged against assets held by the Issuer Fund and contributed by the Insurance Company Investor on behalf of the Account. For the reasons previously stated, practitioners should resist this draconian restriction on indemnification which will likely jeopardize the IDF's ability to enter into agreements with its key service providers.

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The authors would like to thank Margaret Solis, an Associate at Shipman & Goodwin LLP, resident in the firm's Hartford, Connecticut office, for her contributions to this article.

1.Treas. Reg. § 1.817-5(b)(1). An investment would include all securities of the same issuer.

2. In Rev. Rul. 2007-7, 2007-1 C.B. 468, the Internal Revenue Service ("IRS") issued guidance that certain investors (other than a purchaser of a variable contract) in a regulated investment company that are described in Treasury Regulations Section 1.817-5(f)(3) are not deemed members of the "general public," as that term is used in Rev. Rul. 2003-92 and Rev. Rul. 81-225, and accordingly, holders of a variable annuity or life insurance policy will not be treated as the owner of an interest in the investment company that funds the variable contract solely because interests in the same investment company are also available to investors described in Treasury Regulations Section 1.817-5(f)(3) (e.g., the general account of a life insurance company (if certain requirements are met); certain managers and corporations related to the manager of an investment company, partnership or trust; a trustee of a qualified pension or retirement plan; and investors in certain grandfathered contracts).

3. See PLR 9851044 (Sept. 22, 1998) and Rev. Rul. 2005-7. An IDF could also invest solely in lower tier insurance dedicated funds. In that case, the IRS permits a "double look-through" – so the assets of the lower tier insurance dedicated funds are counted as separate investments for purposes of the diversification rules. See PLR 9847017 (August 21, 1998). It remains unclear as to what extent lower tier fund investments must be different in character from one another with respect to their underlying assets in order to qualify as "diversified."

4. See PLR 9752061 (Sept. 30, 1997) (ruling on such facts that the holder of a retiree medical policy did not have sufficient control over the policy investments to become owner of the policy); see also Rev. Rul. 2003-91, 2003-2 C.B. 347, and Rev. Rul. 2003-92, 2003-2 C.B. 350 (describing contacts between investment managers, insurance companies and policyholders which would be deemed by the IRS to violate the investor control doctrine).

5. Rev. Rul. 2005-7 clarifies the look-through rules for purposes of the diversification requirement under Section 817(h). Specifically, the ruling provides that look-through treatment is permitted at multiple levels of regulated investment companies, provided that all beneficial interests in each regulated investment company are held directly by one or more segregated insurance company accounts (except as otherwise permitted by Treasury Regulations Section 1.817-5(f)(3)) or by other regulated investment companies, all the beneficial interests of which are ultimately owned by one or more segregated insurance company accounts.