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FUND STRUCTURES

Overview of How Insurance Dedicated Funds Offer the Returns of Private Funds With the Favorable Tax Treatment of Insurance Products

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Private funds employ innumerable different strategies. Some of those strategies can result in significant U.S. federal income tax burdens, however, either for the funds themselves or for their investors. Although those inherent inefficiencies have been ameliorated in some cases by decades of iteratively refined structures and thoughtful planning, insurance products often remain more tax efficient than private funds for their respective investors.

As a result, there are a number of situations in which investors may prefer to access investment strategies through an insurance product, rather than a private fund. Those privately offered insurance products, typically either life insurance policies or variable annuities, invest in turn in private insurance dedicated funds (IDFs). This article provides an overview of the architecture of an IDF; the tax and regulatory considerations arising from its creation; and the various circumstances where an IDF can be attractive.

For more on IDFs, see "Alternative Private Credit Structures: Adopting Insurance Dedicated Funds for Favorable Tax Treatment (Part Two of Two)" (Oct. 20, 2020); and "Direct Lending Funds: Five Structures to Mitigate Tax Burdens for Various Investor Types (Part Two of Two)" (Dec. 10, 2019).

Overview

IDFs are meant to combine investment returns typically available only through private funds with tax treatment available only to insurance products. To achieve that goal, IDFs must ensure the resulting product in the hands of the ultimate holder is respected as an insurance product rather than treated as, and taxed as, ownership of the underlying assets.

Investor Base

Early IDFs often provided access to portfolios of hedge funds, in essence, operating as funds of funds. Those IDFs were largely deployed as part of estate planning strategies for U.S. ultra high net worth (UHNW) policy owners. Since then, however, IDFs have been launched in conjunction with a wide range of both liquid and illiquid investment strategies.

The insurance products that allocate capital to IDFs include private placement variable life insurance and variable annuities, with holders now including banks and corporate entities, often through corporate- or bank-owned life insurance, as well as the historic UHNW investor base.[1] Notably, IDF investments made through insurance products such as corporate-owned life insurance (COLI) and bank-owned life insurance (BOLI) policies tend to be attractive to corporate owners.

Investment Structure

To obtain investment returns from a private fund, an investor invests directly in that fund. By contrast, the ultimate beneficiary of the investment returns from an IDF does not hold an interest in the IDF itself. Instead, the party wishing to obtain investment returns "linked" to (*i.e.*, based on) an IDF can only access the IDF through the purchase of an insurance product with variable components, one of which is the IDF.

The issuer of the insurance product places part of the premiums paid for the insurance product in a segregated account and then invests the segregated account in one or more IDFs in accordance with investment options elected by the holder. Critically, only life insurance companies may invest in IDFs.[2] Specifically, the only eligible investors are U.S. life insurance companies and foreign life insurance companies electing to be treated as insurance companies for U.S. tax purposes.

The life insurance company investing in an IDF through a segregated account receives the entirety of the gain or loss attributable to its investment, for both financial statement and tax purposes.[3] If the diversification, investor control and other applicable IDF rules are satisfied, the holders of the insurance policy or variable annuity receive the economic benefit of the segregated account's IDF returns without being treated as the owner of the assets of the segregated account.

Tax Treatment

A holder of an insurance product with a variable component is typically not subject to income tax on the increase in value of the variable component (known as "inside build-up") unless that value is withdrawn by the holder. As death benefits are not taxable income to the beneficiary of a life insurance policy, an IDF investment made through a life insurance policy and paid to the beneficiary of the policy as part of the policy's death benefit is entirely exempt from income tax. For that reason, variable products are often used to manage estate tax liability, among other uses.

If the holder of an insurance product borrows against the "cash value" of the product – determined in part by the performance of the underlying investments – then the proceeds of the borrowing are also not taxable to the holder. The insurance product itself serves as collateral for the loan. In effect, the holder can borrow on a nonrecourse basis against the value of the product's underlying investments.

By contrast, private funds often preclude investors from borrowing against their fund interests. If permissible, investors typically borrow from third parties, and the costs of the borrowing and related loan-to-value restrictions make that borrowing relatively less attractive.

Criteria for Tax Qualifications

For policy holders to avoid being treated as owning the assets in the segregated account for income tax purposes, variable insurance products must meet two primary requirements:

1. the investments in the segregated account underlying the insurance product must meet diversification requirements (or, if the insurance product is invested in a single IDF, the IDF must meet the diversification requirements)[4]; and
2. the holder of the product must not "control" the product's investments, although the holder may be permitted to elect between available investment options.

For other contexts where excessive control can increase risks for sponsors, see "Parental Liability in the E.U.: Rebuttable Presumption of Decisive Influence and Four Misconceptions About Avoiding Liability (Part Two of Three)" (Jun. 4, 2019); and "Recent Developments Affect Classifications of Control Groups and Fiduciaries Under ERISA" (Apr. 14, 2016).

Diversification

In general, the holder of a variable product will not be taxed on any inside buildup of assets in a separate account that supports the variable product if the separate account is "adequately diversified" within the meaning of Section 817(h) of the U.S. Internal Revenue Code of 1986. The investments of a separate account are considered adequately diversified as long as no more than:

1. 55% of the value of the total assets of the account is represented by any one investment;
2. 70% of the value of the total assets of the account is represented by any two investments;
3. 80% of the value of the total assets of the account is represented by any three investments; and
4. 90% of the value of the total assets of the account is represented by any four investments.

The applicable regulations provide exceptions to those diversification requirements during the ramp-up and liquidation of an IDF.

Investor Control

Even if the segregated account is adequately diversified, the holder of a variable insurance product will be treated as the owner of the assets in which the account is invested if the holder has too much control over the product or over the IDF within the product. Known as the "investor control doctrine," that principle is the product of a series of court cases and IRS revenue rulings dating back to 1977, most significantly applied in 2015 in *Webber v. Commissioner*.

Although the contours of the investor control doctrine are imprecise, it is clear that holders of variable products may not select or recommend, or, critically from a compliance perspective for IDF sponsors, communicate with investment officers about the selection of, particular investments of or investment strategies for the separate account underlying the variable product. In addition, the holders of variable products may not have any legal, equitable, direct or indirect interest in the underlying assets held by the separate account.

In *Webber*, the Tax Court noted several additional actions that violate the investor control doctrine, including, among others:

1. having, and using, the power to vote shares or exercise other rights attached to the segregated account's investments;
2. extracting cash from the account for the holder's own purposes, rather than by borrowing against the cash value of the account; and
3. deriving "effective benefit" from the separate account's investments.

Failure to adhere to the investor control doctrine has dire consequences for both the investor and the sponsor. In addition to reputational and perhaps regulatory downsides, the risks are shared between the sponsor, an insurance company and the holder of an insurance product through a series of carefully crafted, and often overlapping, contractual arrangements.

Platform IDFs

The diversification and investor control requirements impose substantial compliance burdens on sponsors seeking to launch an IDF. Some sponsors may be well equipped, however, to comply with those requirements and may launch standalone IDFs. In particular, that includes asset management affiliates of insurance companies or large sponsors launching an IDF as part of a broader product lineup.

For many sponsors, however – and especially sponsors considering their first IDFs – the burden of complying with those requirements may be beyond their internal capabilities or may require the inefficient allocation of scarce resources. As a result, many sponsors work with third-party IDF platforms.

An IDF offered through a platform is formed as a separate series of a Delaware series limited partnership (LP) or LLC, with its own offering and governing documents prepared by the sponsor (and subject to review by the platform provider). Separately, the sponsor enters into a sub-advisory agreement with the platform provider's investment adviser, pursuant to which, among other things, the sponsor agrees to comply with tax and insurance requirements. The platform provider is typically compensated through an administrative fee charged against the IDF's assets.

See "Beyond the Master-Feeder: Managing Liquidity Demands in More Flexible Fund Structures" (May 25, 2017).

IDF Vehicle Structure

Where the IDF is a standalone vehicle, the sponsor acts as GP (in the case of an LP) or the manager or managing member (in the case of an LLC), as well as the IDF's investment manager.

Alternatively, where the sponsor uses a preexisting platform IDF, then it can be structured as a series of an existing Delaware LP or LLC. The platform provider acts as GP or manager and as investment manager of the series LP or LLC, as applicable. The sponsor acts as sub-adviser to the investment manager for the series housing the IDF.

See our two-part series: "Using Delaware Statutory Series LLCs to Offer Customization to Investors" (Apr. 20, 2021); and "Uncertainty Surrounding Liability Shields and Cost Savings of Series LLCs" (Apr. 27, 2021).

Securities Regulatory Treatment of IDFs

IDF Analysis

In addition to the tax and insurance regulatory components peculiar to IDFs, sponsors must also consider the typical securities law issues in launching a new fund. IDF interests are offered in private placements under the Securities Act of 1933 (Securities Act), typically using the safe harbor provided by Regulation D.

The IDF will likely fall within the definition of "investment company" under Section 3 of the Investment Company Act of 1940 (Investment Company Act), so it must qualify for an exemption from registration thereunder. As the investors in an IDF are solely separate accounts of life insurance companies, IDFs generally qualify for the exemption from registration in Section 3(c)(7) of the Investment Company Act for investment companies whose investors are all "qualified purchasers" as defined in Section 2(a)(51) of the Investment Company Act.[5]

Separate Account Analysis

Assets of the issuing insurance company's general account are available to satisfy the claims and expenses of the insurance company generally, including claims under policies. By contrast, the separate account through which an investor indirectly invests in an IDF is segregated from, and protected from claims against, that general account. That segregation ensures the IDF investor, and not the other creditors of the insurance company (including other policyholders), bears the IDF's investment risk, and that the IDF investor's interest in the IDF is not at risk of claims of other creditors of the insurance company.

Also, separate accounts are subject to state insurance regulation, which can affect an IDF's operations in certain situations.[6] For example, IDFs generally need to provide for periodic valuations to permit compliance with state valuation requirements applicable to separate accounts or allow liquidity if an insured under a policy invested in the IDF dies. Moreover, the offering of the variable contract associated with the separate account must comply with the applicable exemptions from registration under the Securities Act and the Investment Company Act.

Types of Policyholders

There are three types of variable contract holders for whom investing through an IDF can be particularly attractive:

1. UHNW individuals;
2. corporations, through COLI or BOLI policies; and
3. non-U.S. investors in jurisdictions that have tax treaties with the U.S.[7]

UHNW Individuals

IDFs are attractive to UHNW individuals because, if the IDF is deployed properly, the IDF is taxed as insurance and not as an investment product. That results in the general deferral of federal income taxation, as well as potential estate tax benefits. It may be especially useful where, for example, the investor plans to move from a high-tax jurisdiction to a lower-tax jurisdiction, further reducing the investor's tax liability for his or her IDF investment.

In addition, investors seeking to leave assets to a public charity or private foundation may make their gifts (by naming the charity or foundation the beneficiary of the relevant contract) inter vivos while retaining control of the contract. Further, the investor's estate can take an unlimited charitable deduction for the fully accreted value of the contract at death.

Companies and Banks

COLI or BOLI policies indexed to private IDFs can be attractive to employers with large workforces where the insurance policy, and thus the underlying investment allocations, can be optimized based on actuarial models.

In COLI/BOLI arrangements, the employer pays for, and retains the value of, life insurance on a defined pool of employees. COLI/BOLI policies are part of the general assets of the employer, and their establishment generally requires notice to, and consent from, the applicable employees. The policies often offer a superior after-tax yield to other alternatives, match the long-term nature of benefit plan expenses and can serve as an effective hedge against those expenses.

Based on informal surveys, more than 75% of the Fortune 1000 – and more than 80% of the largest banking institutions – have COLI and BOLI arrangements in place.

Non-U.S. Persons

Several common investment strategies with attractive risk-adjusted returns also have tax characteristics that, for non-U.S. investors, require complex structural solutions or suffer from tax drag on the structure (or both). For example, a non-U.S. investor in a fund that receives "effectively connected income" (ECI) from originating loans may have U.S. tax filing obligations, and be subject to U.S. tax with respect to that income, absent the use of a separate blocker entity.

As an investor in a properly deployed IDF is not treated as the beneficial owner of the IDF's assets, IDFs avoid negative tax effects for non-U.S. policyholders from the receipt of ECI as well as income subject to tax under the Foreign Investment in Real Property Tax Act (FIRPTA). Moreover, non-U.S. persons in jurisdictions with tax treaties with the U.S. may be able to avoid U.S. withholding or income tax on returns during their lifetimes from the IDF pursuant to the applicable treaty.

For more on FIRPTA, see "Alternative Private Credit Structures: Using REITs to Address Foreign Investor Tax Challenges (Part One of Two)" (Oct. 13, 2020); and "PE Real Estate Funds: Structuring by Investor Type and Distinct Statutory Considerations (Part One of Three)" (Aug. 13, 2019).

Conclusion

IDFs are an increasingly popular item on the menu of investment vehicles offered by sophisticated investment management firms. Although they are complex to establish and operate, they offer many benefits to both sponsors and the holders of insurance products invested in the IDFs.

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[1] IDFs are entirely distinct from the non-U.S. "captive" insurers (and re-insurers) related to certain U.S.-based hedge fund sponsors.

[2] There are other applicable limitations for holders of insurance products. For instance, the holder of the insurance product cannot exercise control over the investments an IDF makes.

[3] The insurance company also receives a corresponding deduction for amounts payable from the segregated account to the holder of the insurance product.

[4] Separate accounts are often divided into sub-accounts, with the sub-accounts invested in IDFs. Diversification requirements apply separately to each such sub-account. For ease of presentation, this article refers to separate accounts, rather than separate accounts and sub-accounts.

[5] This article assumes the variable contracts through which investors invest in the IDF are offered solely to sophisticated investors in private placements. Where the variable contracts are issued in a registered public offering, the securities law analysis and requirements for the IDF are more complex.

[6] It should be noted that, in the U.S., as a result of the McCarran-Ferguson Act of 1945, insurance regulation is, with few exceptions, a matter of state law rather than federal law.

[7] IDFs may also be attractive to sovereign wealth funds, but their use in that context is complex and beyond the scope of this article.