

# JOB WELL DONE: PREVENTING THE USE OF PRIVATE PLACEMENT LIFE INSURANCE TO WRAP HEDGE FUND INVESTMENTS

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## I. INTRODUCTION

As the economy continues to see a significant rise in hedge fund activity, investors continue to look for

mechanisms that will mitigate the tax burden on their hedge fund investments.<sup>1</sup> Hedge funds are lightly regulated investment pools that actively trade shares in short periods of time, generating substantial short term gains that are taxed at up to 35%.<sup>2</sup> In an attempt to avoid the harsh ordinary income tax, taxpayers may wrap the hedge fund interest within a private placement life insurance contract.<sup>3</sup> An insurance wrapper is a life insurance contract in which a portion of the policyholder's premium payment is invested in a hedge fund.<sup>4</sup> Because the hedge fund interests are held within an insurance policy,<sup>5</sup> gains on the investments are shielded from tax.<sup>6</sup> Policyholders may also be able to access their money during their lifetimes by withdrawing or

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<sup>1</sup> "Over the last decade, the growth of hedge funds has accelerated dramatically, in terms of both assets under management and number of funds." FRANÇOIS-SERGE LHABITANT, HANDBOOK OF HEDGE FUNDS 20 (2006). Although precise figures are difficult to obtain, recent industry reports estimate hedge funds manage a total wealth of more than a trillion dollars, compared to less than \$40 billion in 1990. *Id.*; see also Daisy Maxey, *Hedge Managers See Consolidation Coming*, WALL ST. J., Sept. 10, 2007, at C11 (noting that hedge funds expect to keep growing).

<sup>2</sup> David M. Schizer, *Balance in the Taxation of Derivative Securities: An Agenda for Reform*, 104 COLUM. L. REV. 1886, 1935 (2004); I.R.C. § 1 (short term gains are taxed as ordinary income; the applicable tax rate for taxpayers in the highest tax bracket is 35%).

<sup>3</sup> Charlene D. Luke, *Beating the "Wrap": The Agency Effort to Control Wraparound Insurance Tax Shelters*, 25 VA. TAX REV. 129, 132 (2005) (explaining that life insurance wrappers were used primarily to convert ordinary income into tax-sheltered income).

<sup>4</sup> GRANT R. MARKUSON, PRIVATE PLACEMENT LIFE INSURANCE: NEW INSIGHTS FOR AN ENDURING TECHNIQUE 1 (2002), available at <http://www.mnlaw.com/t&egrant.pdf>.

<sup>5</sup> See *infra* Part II.

<sup>6</sup> Rachel E. Silverman, *The Search For a Safe Tax Shelter - As IRS Steps Up Scrutiny, Advisers Shift To Conservative Tactics, but Some Still Test Limits*, WALL ST. J., Oct. 13, 2005, at D1 ("Assets inside a life insurance policy can grow tax-free . . .").

borrowing funds from the policy, tax-free.<sup>7</sup> While the use of private placement life insurance contracts gives wealthy investors the prospect of huge tax savings on hedge fund investments, the transaction also gives rise to the question of whether the practice is a bona fide tax planning device or an improper tax shelter.

Under current law, taxpayers are able to take advantage of inconsistencies or gaps in the tax rules to reduce their tax liabilities.<sup>8</sup> However, there is often a blurry line between an improper tax shelter and more legitimate strategies that take advantage of the intricacies of the tax code.<sup>9</sup> Improper tax shelters arise because of the difficulty in perfectly specifying or defining the tax base.<sup>10</sup> Through revenue rulings, private letter rulings, and treasury regulations, the Treasury Department and the Internal Revenue Service ("IRS" or "Service") convey their position and offer guidance to practitioners and taxpayers regarding the relevant transaction.<sup>11</sup> This Note analyzes the effectiveness of these rulings and regulations in the context of private placement life insurance wrappers. Ultimately, the rulings and regulations have succeeded in preventing the use of life

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<sup>7</sup> Allison B. Colter, *Insurers Provide Investors Access to Hedge Funds*, WALL ST. J., Oct. 2, 2001, at B7.

<sup>8</sup> David A. Weisbach, *An Economic Analysis of Anti-Tax-Avoidance Doctrines*, 4 AM. L. & ECON. REV. 88, 89 (2002) (noting that "taxpayers have what is termed a 'right' to alter their affairs to minimize taxes").

<sup>9</sup> See generally Silverman, *supra* note 6 (comparing legitimate strategies that are composed of "well-established, legal building blocks" with strategies that lack any real economic purpose other than to avoid taxes).

<sup>10</sup> See Weisbach, *supra* note 8, at 93 (explaining that tax shelters are effectively "inadvertent omissions from the tax base"). The tax base is the total amount to which the appropriate tax rate is applied. WILLIAM A. KLEIN ET AL., *FEDERAL INCOME TAXATION* 22 (14th ed. 2006).

<sup>11</sup> See Rachel E. Silverman, *Insuring Against Hedge-Fund Taxes – 'Private Placement' Policies Draw More Wealthy Investors Despite Fees, Limited Control*, WALL ST. J., Oct. 18, 2006, at D1 (explaining how recent rulings and regulations have laid out more clearly what is allowable in private placement life insurance, which in turn, has removed uncertainty among insurers and investors).

insurance as a tax shelter for hedge fund investments, leaving no cause for Congressional concern today.

Part II introduces private placement life insurance contracts and explains how they are used to invest in hedge funds. Part III delineates the current law restricting private placement life insurance policies and the tax agencies' most recent reform efforts to curb the use of hedge funds in life insurance wrappers. Part IV outlines two methods for analyzing the effectiveness of tax reform measures. Finally, Part V applies these methods to examine the effectiveness of the tax agencies' latest targeted reforms, concluding that these reforms were successful in deterring the use of private placement life insurance policies primarily as an investment vehicle for hedge funds.

## II. PRIVATE PLACEMENT LIFE INSURANCE CONTRACTS

Life insurance enables individuals to make economic preparations for retirement and death.<sup>12</sup> Life insurance products may be viewed along a continuum, ranging from pure insurance products to products used solely for investment purposes.<sup>13</sup> Term life insurance is characterized as "pure" insurance, where the face amount of the policy is paid to the named beneficiary upon the death of the insured.<sup>14</sup> A whole life insurance contract combines a term policy with an investment component, where a portion of the policyholder's premium is invested in a separate investment account like a hedge fund.<sup>15</sup> A private placement life insurance contract is a type of variable universal life

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<sup>12</sup> Charlene D. Luke, *Taxing Risk: An Approach to Variable Insurance Reform*, 55 BUFF. L. REV. 251, 258 (2007).

<sup>13</sup> *Id.*

<sup>14</sup> See SmartMoney.com, Term or Whole Life?, <http://www.smartmoney.com/insurance/life/index.cfm?story=lifeterm> (last visited Feb. 11, 2008) (explaining that term insurance can be purchased for periods of one year to thirty years).

<sup>15</sup> KENNETH BLACK, JR. & HAROLD SKIPPER, JR., LIFE & HEALTH INSURANCE 127 (13th ed. 2000).

insurance contract<sup>16</sup> that is tied to the investment performance of accounts that are segregated from the general accounts of the issuing company.<sup>17</sup> Policyholders can invest in a wide range of underlying products, including hedge funds.<sup>18</sup> Compared to traditional retail contracts, private placement life insurance has substantially reduced costs and increased investment choices.<sup>19</sup> These contracts also typically have minimum annual premiums of at least \$1 million and are most often a planning tool for wealthier individuals.<sup>20</sup> An investor must meet the definition of a “qualified purchaser”<sup>21</sup> and an “accredited investor”<sup>22</sup> in order to purchase a private placement life insurance product.

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<sup>16</sup> Variable life insurance policies allow policyholders to invest a portion of their premiums in separate investment accounts, allowing the policyholder to obtain risk based returns. *Id.* The amount of the cash value and death benefit varies with the performance of the underlying assets. *Id.* Universal life insurance policies give the policyholder the flexibility to adjust the amount of premium payments. *Id.* at 114.

<sup>17</sup> See Markuson, *supra* note 4, at 3.

<sup>18</sup> See Silverman, *supra* note 6 (noting that private placement products allow investors to utilize a range of options, including hedge funds, derivatives, and real estate investment trusts).

<sup>19</sup> See Markuson, *supra* note 4, at 1 (“[Private placement life insurance] is a variable universal life contract that has stripped out all of the retail pricing and markups, while at the same time allowing policy owners to choose and/or suggest the use of specific investment managers, subject to normal due diligence and investor control issues.”).

<sup>20</sup> *Id.* (noting that only very affluent investors will be able to afford the high premiums of private placement products); see also David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1384 (2001) (“While variable contracts based on bonds and mutual funds are a staple of middle class tax planning, contracts based on hedge fund returns are available only in private transactions for very wealthy taxpayers.”).

<sup>21</sup> A qualified purchaser is a natural person with at least \$5 million in investable assets or a corporation or trust with at least \$25 million in investments, excluding pension and employee benefit plans. 17 C.F.R. § 270.2(a)(51) (2008).

<sup>22</sup> An accredited investor is any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$ 1,000,000 or any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those

Private placement life insurance initially developed as a way to provide low-cost insurance to companies that needed to fund benefit programs for senior executives.<sup>23</sup> It was not until such policies were pitched to wealthy individuals in the mid- to late-1990s that people began recognizing the potential tax benefits for hedge fund investors.<sup>24</sup> As a general rule, the investment return<sup>25</sup> accrued within life insurance policies is free from current inclusion in gross income to the policyholder.<sup>26</sup> Private placement life insurance contracts therefore offer investors an opportunity for substantial tax-free buildup of investment benefits, while still allowing for life insurance distributions and loans.<sup>27</sup> In essence, a private placement wrapper combines sought-after investment results with the tax advantages of a life insurance policy.<sup>28</sup> Following the discovery of private

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years and has a reasonable expectation of reaching the same income level in the current year. 17 C.F.R. § 230.501 (2008).

<sup>23</sup> See Markuson, *supra* note 4, at 2 (noting that senior executives often desired “greater investment options, lower fees, and greater overall customization”); see also Colter, *supra* note 7 (explaining that private placement life insurance developed from the need to fund executive-benefit programs).

<sup>24</sup> See Colter, *supra* note 7.

<sup>25</sup> Luke, *supra* note 3, at 130 (explaining that the investment return earned on the premiums paid for qualifying cash value life insurance is often referred to as “inside buildup”).

<sup>26</sup> See I.R.C. § 7702(g) (providing that “[i]f at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year.”).

<sup>27</sup> Michael J. Goldberg, *Tax Clinic Practical Advice on Current Issues: Gains & Losses - How to Use a Life Insurance Wrapper to Minimize Taxes on Securities Investments*, THE TAX ADVISER, 2-01 T.T.A. 90 (2001); see I.R.C. § 72(e)(5) (providing that distributions from life insurance shall be included in gross income, but only to the extent they exceed the investment in the contract); see generally I.R.C. § 72(e) (stating that loans tied to the cash surrender value are not treated as distributions).

<sup>28</sup> See Goldberg, *supra* note 27 (explaining that a private placement life insurance wrapper offers substantial tax-free buildup of gains of investments).

placement life insurance tax benefits and fueled by the hedge fund industry's growth, many life insurance products were developed specifically for hedge fund investments.<sup>29</sup>

Life insurance contracts that are primarily investment motivated cut against legitimate mortality planning and are mechanisms for tax avoidance.<sup>30</sup> Life insurance products provide for two significant tax benefits: deferral of tax on buildup on investments inside the policy and exclusion from gross income of proceeds received under the life insurance upon death of the insured.<sup>31</sup> Life insurance policies that are purchased purely for investment to reap the tax benefits may be considered a tax shelter. While not all tax shelters are illegal,<sup>32</sup> the aim of every tax shelter is to create a tax benefit in the form of a loss, expense, or exclusion from gross income that has no economic significance and is simply the consequence of rule manipulation.<sup>33</sup> Therefore, life insurance policies that are in serious contemplation of death are legitimate planning devices, while insurance policies purchased strictly for investment and tax benefits are tax shelters that compel government action.

A short example will illustrate how much is at stake if a taxpayer successfully uses private placement life insurance

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<sup>29</sup> Grant R. Markuson, *Private Placement Life Insurance: New Insights for an Enduring Technique*, TRUSTS & ESTATES, ADVERTISING SUPPLEMENT, Dec. 2002, at 2 (describing that the growth of the hedge fund industry in the 1990s led to products being tailored specifically for hedge fund investments), available at <http://www.m-nlaw.com/t&egrant.pdf>.

<sup>30</sup> See Luke, *supra* note 12, at 257 (explaining that Congress has acted to prevent insurance products from becoming overly investment oriented or overly prone to use in tax shelters).

<sup>31</sup> See I.R.C. § 61(a) (stating that gains on investments within life insurance policies are not realized income); see also I.R.C. § 7702(g); I.R.C. § 101(a) ("[G]ross income does not include amounts received . . . under a life insurance contract, if such amounts are paid by reason of the death of the insured.").

<sup>32</sup> See Editorial, *The IRS Out of Control*, WALL ST. J., July 17, 2002, at A16 (arguing that it is not against the law to minimize one's tax burden and it is common sense to do so).

<sup>33</sup> See Marvin A. Chirelstein & Lawrence A. Zelenak, *Essay: Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1942 (2005).

as a tax avoidance mechanism. Suppose B wants to invest in a hedge fund interest that will generate \$100,000 of ordinary income this year. If B invests in the hedge fund directly, the accrued interest may be taxed either at the 35% ordinary income tax rate<sup>34</sup> or the more forgiving 15% long term capital gain rate<sup>35</sup> subjecting B to a current tax of \$35,000 or a capital gain tax of \$15,000. In contrast, if B instead purchases a private placement life insurance contract in which a portion of the premium payment is invested in the underlying hedge fund, the \$100,000 of gain will accrue in the life insurance policy tax-free.<sup>36</sup>

The IRS also has a significant stake in preventing taxpayers from avoiding taxes on their hedge fund gains. As of the summer of 2006, the total amount invested in hedge funds was approximately \$1.23 trillion.<sup>37</sup> With \$1.23 trillion invested in hedge funds and assuming an 11% annual return,<sup>38</sup> investors paying tax at the 15% long term capital gain rate are collectively paying just under \$20 billion in taxes each year.<sup>39</sup> Therefore, if all investors were using private placement life insurance contracts, the government would lose \$20 billion in revenue each year. According to the Internal Revenue Service, the individual income tax revenue for the national government was \$1.24 trillion for the 2006

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<sup>34</sup> I.R.C. § 1 (imposing tax based on specific thresholds of taxable income within a particular calendar year. For taxpayers in the highest tax bracket, ordinary income for the year will be taxed at 35%).

<sup>35</sup> I.R.C. § 1(h) (imposing a 15% tax on adjusted net capital gain); I.R.C. § 1222 (defining long-term capital gains as “gains from the sale or exchange of a capital asset held for more than 1 year”).

<sup>36</sup> See I.R.C. § 72.

<sup>37</sup> See Silverman, *supra* note 11.

<sup>38</sup> According to the CS/Tremont Hedge Fund Index, the annual return over the period from January 1994 to December 2005 was 10.69%. The CS/Tremont Hedge Fund Index is a capitalization-weighted index, and uses only funds that have at least \$10 million of assets and can provide audited performance figures. L'HABITANT, *supra* note 1, at 518.

<sup>39</sup> See I.R.C. §§ 1(h), 1222.



fiscal year.<sup>40</sup> Therefore, the loss of \$20 billion would account for more than a 1.5% drop in individual income tax revenue each year.

### III. CURRENT LAW

Recently, the IRS released rulings and changes in regulations regarding the use of private placement life insurance policies as a mechanism to avoid the tax imposed on hedge fund gains.<sup>41</sup> These rulings have not completely prohibited such products from being offered, but instead allow investors to purchase such policies, if the product remains compliant with the rulings and regulations.<sup>42</sup> Investing in hedge funds through private placement life insurance remains a viable planning tool, and the recent developments in the law affect only the design of these products.<sup>43</sup> The question remains, if sophisticated taxpayers can continue to use life insurance products as a tax shelter for hedge fund gains, are the anti-avoidance regulations to stop such insurance wrappers an effective tax reform measure?

#### A. Diversification Requirement

On July 18, 1984, Congress enacted the diversification requirement of section 817(h) to reduce the use of life

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<sup>40</sup> Internal Revenue Serv., Tax Stats at a Glance, <http://www.irs.gov/taxstats/article/0,,id=102886,00.html> (last visited Feb. 25, 2008).

<sup>41</sup> See I.R.S. Priv. Ltr. Rul. 2002-44-001 (May 2, 2002); Rev. Rul. 2003-92; Rev. Rul. 2003-91; see also Internal Revenue Serv., *Regs Target use of Annuity Contracts, Life Insurance as Tax Avoidance Vehicles*, 2003 TAX NOTES 146-11 (2003) (announcing that the Service has issued proposed regulations to curb the use of tax-preferred life insurance and annuity contracts for tax avoidance on investment earnings).

<sup>42</sup> David S. Neufeld, *New Guidance on Investor Control Rule: Road Map or Roadblock?*, 100 TAX NOTES 1191, 1191 (2003) (explaining that the recent reforms delineate "how insurance policies can own hedge funds and who can make investment decisions").

<sup>43</sup> *Id.*

insurance policies as investment vehicles.<sup>44</sup> Under section 817(h), to qualify as life insurance and receive the attendant tax benefits, variable life insurance policies must be “adequately diversified.”<sup>45</sup> In its simplest form, this means that each “segregated asset account” must contain at least five investments, and no one investment may represent more than 55% of the value of a separate account’s assets, no two investments may constitute more than 70%, no three investments may comprise more than 80%, and no four investments may make up more than 90% of the separate account’s value.<sup>46</sup> In the case of a nonregistered limited partnership like a hedge fund, as long as only insurance companies may invest in the hedge fund, the hedge fund can be looked through and its underlying investments counted in computing diversification.<sup>47</sup> Failure to meet the diversification requirements under section 817(h) will result in taxation of the cash value accumulation of the life insurance policy as ordinary income to the policy owner.<sup>48</sup>

## B. Investor Control Doctrine

Before the enactment of section 817, the Service was concerned that taxpayers were avoiding income tax by wrapping their investments in certain annuity or life insurance contracts.<sup>49</sup> In response, the tax agencies released

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<sup>44</sup> H.R. Conf. Rep. No. 98-861, at 1055 (1984) (noting that the diversification requirement was intended to “discourage the use of tax-preferred variable annuity and variable life insurance primarily as investment vehicles”).

<sup>45</sup> I.R.C. § 817(h)(1) (“[A] variable contract . . . which is otherwise described in this section and which based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract for any period . . . for which the investments made by such account are not, in accordance with regulations prescribed by the Secretary, adequately diversified.”).

<sup>46</sup> *Id.*

<sup>47</sup> *Id.* § 817(h)(4); Treas. Reg. § 1.817-5(f)(2)(i).

<sup>48</sup> See I.R.C. § 7702(g).

<sup>49</sup> Leslie C. Giordani, *Recent Developments Affecting Hedge Fund Investing through Private Placement Life Insurance*, 25 INS. TAX REV. 579, 579 (2003).

four revenue rulings articulating two guiding principles: (1) the policyholder may not possess significant control or ownership over the underlying assets and (2) access to the investments must be exclusively through the purchase of a variable contract.<sup>50</sup> These rulings formed the bedrock of what became known as the investor control doctrine. In 1984, the United States Court of Appeals for the Eighth Circuit adopted the investor control doctrine.<sup>51</sup> However, because the diversification requirements of section 817 were enacted after the rulings that established the investor control doctrine and addressed many of the same issues, practitioners in the insurance industry assumed that section 817 superseded the investor control doctrine.<sup>52</sup> Nevertheless, the IRS has maintained in recent rulings and reforms that

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<sup>50</sup> See generally Rev. Rul. 77-85; Rev. Rul. 80-274; Rev. Rul. 81-225; Rev. Rul. 82-54 (expressing the principles that (1) if the investor possesses significant incidents control and ownership over the asset, the person is treated as the owner of an asset, regardless of who holds legal title to it and (2) an investor may not invest in a fund that is also available for investment by the general public). If the investor maintains a prohibited interest under the investor control doctrine, the contract holder must then include any interest, dividends, or other income derived from the partnership interests in his or her gross income. I.R.C. § 61(a).

<sup>51</sup> *Christofferson v. United States*, 749 F.2d 513 (8th Cir. 1984). In *Christofferson*, the taxpayer purchased a variable annuity contract in which he had the power to direct the investment of premiums, to reallocate their investment among the funds at any time, to make withdrawals, to surrender the contract, and to apply the contract's accumulated value to provide annuity payments. *Id.* The court held that because the taxpayers had surrendered few of the rights of ownership or control over the assets of the separate account, it must conclude that the taxpayers, and not the insurance company, effectively owned the separate account assets. *Id.*

<sup>52</sup> See Giordani, *supra* note 49, at 579 (arguing that "if the investor control doctrine still applies to cause the assets of the segregated account to be owned by the policy owner for federal income tax purposes if investment in the partnership is available to public investors, then there was no point in applying look-through to determine diversification in the first place"); see also David S. Neufeld, *The Keyport Ruling and the Investor Control Rule: Might Makes Right?*, 98 TAX NOTES 403, 405 (2003) (arguing that the approach of applying both the investor control doctrine and diversification test is "implicitly unworkable, confused, and confusing").

the investor control doctrine remains an independent theoretical basis for denying deferral on gains earned within variable life insurance policies.<sup>53</sup>

### 1. The First Prong—Control by the Investor

Revenue Ruling 2003-91 reaffirms the first prong of the investor control doctrine, holding that even if a wrapped investment satisfies the diversification requirements of section 817(h), the IRS may still disregard the form of the transaction when the policyholder retains dominion and control over the investments held within the policy.<sup>54</sup> The IRS has made it clear that all investment decisions must be made by the insurance company or its investment advisor in their sole and absolute discretion, without arrangement or agreement between the policyholder and the insurance company regarding the specific investments or investment objectives of a specific investment vehicle.<sup>55</sup> The Service has explained that the policyholder cannot select, manage, or control the investments of the segregated account.<sup>56</sup>

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<sup>53</sup> Andrew W. Needham & Christian Brause, 736 T.M., Hedge Funds, at A-101 ("For example, if the policyholder retains the right to vote, to direct investment, or to otherwise act on behalf of the insurance company investors in the fund, the IRS may assert that the insurance company is acting as an agent of the policyholder."); see also Neufeld, *supra* note 52, at 404 (explaining that the investor control doctrine is violated when either (1) an insurance policy owner possesses too many rights to control the actual investments held within the variable contract, or (2) the segregated account of the variable contract is invested in funds in which the general public may also invest).

<sup>54</sup> See Needham & Brause, *supra* note 53 (stating that if the investor asserts control over the underlying investments, the IRS will treat the policyholder as the owner of the wrapped investment without regard to whether the contract satisfies the section 817(h) diversification requirements).

<sup>55</sup> David S. Neufeld, *To IDF or Not to IDF: Can Insurance Companies Allocate to Public Available Hedge Funds?*, MFA REPORTER, Dec. 2004, at 10 (explaining that policy owners cannot direct the investments within their policies beyond giving basic guidance to the insurance company).

<sup>56</sup> See Markuson, *supra* note 4, at 5 (noting that the policyholder cannot possess sufficient incidents of ownership of the segregated assets or else will risk forfeiting the tax advantages of the policy).

In Revenue Ruling 2003-91, the IRS respected the insurance company as the owner of the underlying investment because the policyholder did not make particular investment decisions regarding investments in the sub-accounts.<sup>57</sup> The ruling further states that whether a contract holder has sufficient ownership to cause him to be the owner of the assets for federal income tax purposes depends on all of the relevant facts and circumstances.<sup>58</sup> The IRS ruled that that the policyholder did not have direct or indirect control over the separate account or any sub-account asset.<sup>59</sup> The ruling also confirmed the second principle of the investor control doctrine, indicating that owners of variable life insurance may allocate investments among a limited number of insurance-dedicated<sup>60</sup> funds without being the owner of the contract for federal income tax purposes.<sup>61</sup>

## 2. The Second Prong—Insurance-Dedicated Funds Only

The second prong of the investor control doctrine reflected the Service's position that underlying investments in the separate accounts must be accessed only through the

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<sup>57</sup> See Needham & Brause, *supra* note 53, at A-100.

<sup>58</sup> Rev. Rul. 2003-91.

<sup>59</sup> The IRS noted that the investment strategies of the sub-accounts are sufficiently broad to prevent the policyholder from making particular investment decisions; that no arrangement, plan, contract, or agreement exists between the policyholder and the fund advisor; and that the policy holder may not communicate directly or indirectly with the advisor or any investment officers concerning the selection, quality, or rate of return of any specific investment or group of investments held by the separate account or in a sub-account. *Id.* Thus, all investment decisions concerning the separate account and the sub-accounts are made by the insurance company or the advisor "in their sole and absolute discretion." *Id.*

<sup>60</sup> Insurance-dedicated signifies that the underlying investment or hedge fund may be invested in only through the purchase of a life insurance policy.

<sup>61</sup> Rev. Rul. 2003-91 (indicating that investment sub-accounts are available solely through the purchase of a contract and thus the sub-accounts are not publicly available).

purchase of an annuity or life insurance contract.<sup>62</sup> However, Treasury Regulation section 1.817-5(f)(2)(ii), which was enacted with section 817, made an exception for nonregistered partnerships like hedge funds, allowing look-through treatment even if the hedge fund investment was not insurance-dedicated.<sup>63</sup> Yet, Private Letter Ruling 2002-44-001, the later removal of regulation section 1.817-5(f)(2)(ii), and Revenue Ruling 2003-02 extend the second prong of the investor control doctrine to hedge funds as well.<sup>64</sup> Thus, due to recent reform efforts, a hedge fund is accessible only through an insurance-dedicated fund and any investment by a variable contract in a fund that is also open to the general public is absolutely forbidden.<sup>65</sup>

#### a. Private Letter Ruling 2002-44-001

In Private Letter Ruling 2002-44-001 ("PLR 2002-44-001"), the Service ruled that life insurance companies that offer hedge funds as an investment choice for variable contracts are restricted to offering hedge funds in which only life insurance companies can participate.<sup>66</sup> Insurance

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<sup>62</sup> See Rev. Rul. 81-225 (ruling that investment in a fund that is open to the general public is prohibited because the policyholder's positions are substantially identical to what his or her position would have been had the fund been purchased directly).

<sup>63</sup> Treas. Reg. § 1.817-5(f)(2)(ii) (repealed March 1, 2005).

<sup>64</sup> See I.R.S. Priv. Ltr. Rul. 2002-44-001 (May 2, 2002); Internal Revenue Serv., *IRS Publishes Final Regs on Look-Through for Nonregistered Partnerships*, 2005 TAX NOTES 39-10 (2005) (effectively repealing § 1.817-5(f)(2)(ii)); Rev. Rul. 2003-92. In Revenue Ruling 2003-92, a separate asset account of an insurance company had 10 sub-accounts, each of which invested in a private investment partnership. Investment in the partnership was available to investors other than insurance companies. The IRS ruled that the policyholder, not the insurance company, was the owner of the underlying investment. The net effect of Revenue Ruling 2003-92 is that the assets within variable contracts may be invested in hedge funds and funds-of-funds, but only if the fund is insurance-dedicated.

<sup>65</sup> See Neufeld, *supra* note 52, at 405.

<sup>66</sup> I.R.S. Priv. Ltr. Rul. 2002-44-001 (May 2, 2002) (concluding that the ruling is consistent with Congressional intent to deny annuity or life

company accounts cannot invest side-by-side in hedge funds with wealthy investors from the general public.<sup>67</sup> According to the ruling, a hedge fund with investors other than investors buying insurance policies is too public, so that the policyholder would be considered the direct owner of the hedge fund interest; that is, taxable currently on the fund's undistributed income.<sup>68</sup>

The Service made its ruling in PLR 2002-44-001 notwithstanding treasury regulation section 1.817-5(f)(2)(ii), which specifically permitted investors other than insurance-only investors in nonregistered partnerships.<sup>69</sup> Hedge funds are typically structured as nonregistered partnerships and, therefore, under section 1.817-5(f)(2)(ii), qualified for look-through treatment for purposes of applying the diversification tests of section 817(h).<sup>70</sup> Nonetheless, the Service's ruling contradicted the explicit permission granted in regulation section 1.817-5(f)(2)(ii), causing industry confusion and requiring further government action.

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insurance treatment for investments that are publicly available to investors).

<sup>67</sup> Lee A. Sheppard, *Hedge Fund Wrapper Ruling Makes Getting Smaller Investors Harder*, 23 INS. TAX REV. 794, 794 (2002) (insurance companies cannot "wrap" hedge fund interests in insurance products if they want investors in their variable contracts to have the benefit of the tax shelter for inside buildup).

<sup>68</sup> I.R.S. Priv. Ltr. Rul. 2002-44-001. *See also* I.R.C. § 61(a) (defining gross income as "all income from whatever source derived").

<sup>69</sup> *See* Neufeld, *supra* note 42, at 1192; Giordani, *supra* note 49 (noting that despite the explicit language regarding the exception for non-registered partnerships in relation to the insurance-only requirement of the investor control doctrine, the Service has ruled as though the exception does not exist); *see also* I.R.S. Priv. Ltr. Rul. 2002-44-001 (holding any investment by an insurance company through a variable policy into a mutual fund or a hedge fund, even one established as a nonregistered limited partnership, would violate the investor control rule's prohibition on integrating public investors with insurance company investors).

<sup>70</sup> *See* Giordani, *supra* note 49.

b. Removal of Regulation Section 1.817-5(f)(2)(ii)

After the IRS's ruling in PLR 2002-44-001, where the IRS explicitly ignored section 1.817-5(f)(2)(ii), the IRS issued a notice repealing the regulation.<sup>71</sup> The notice explained that section 1.817-5(f)(2)(ii) was not consistent with Congressional intent because it was not explicitly subject to the public availability limitation of section 817(h).<sup>72</sup> The Treasury Department and the IRS believed that removal of section 1.817-5(f)(2)(ii) would eliminate any possible confusion regarding the prohibition on ownership of interests by the public in a non-registered partnership funding a variable contract.<sup>73</sup> The removal of section 1.817-5(f)(2)(ii) put to rest any debate over whether investment in a nonregistered partnership like a hedge fund interest must be restricted to insurance-dedicated funds.

Section 1.817-5(f)(2)(i) was unchanged by the removal of section 1.817-5(f)(2)(ii).<sup>74</sup> Look-through treatment is available for interest in a nonregistered partnership if: (a) all the beneficial interests in the nonregistered partnership are held by one or more segregated accounts of one or more insurance companies; and (b) public access to such nonregistered partnership is available exclusively through the purchase of a variable contract.<sup>75</sup> Therefore, hedge fund insurance wrappers continue to be offered in two forms: (1) fund of funds—a hedge fund available only to insurance company investors that invest in other hedge funds and (2)

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<sup>71</sup> See I.R.S. Priv. Ltr. Rul. 2002-44-001, *supra* note 66; Internal Revenue Serv., *Regs Target Use of Annuity Contracts, Life Insurance as Tax Avoidance Vehicles*, 2003 TAX NOTES 146-11 (2003) ("The proposed regs, effective on publication of the final regs, would revoke reg. section 1.817-5(f)(2)(ii).").

<sup>72</sup> Internal Revenue Serv., *supra* note 71.

<sup>73</sup> *Id.* (explaining that Congress intended to treat subject contracts invested in nonregistered partnerships to the insurance-dedicated limitation).

<sup>74</sup> *Id.* (allowing access only to nonregistered partnerships that are not available to the general public).

<sup>75</sup> Treas. Reg. § 1.817-5(f)(2)(i).



clone of funds—a hedge fund offered only to insurance companies with investment objectives and strategies that mimic those of a hedge fund managed by the same portfolio manager and available to eligible investors.<sup>76</sup>

#### IV. METHODS OF ANALYSIS

The efficiency of reform measures in addressing tax avoidance mechanisms can be analyzed by examining the change in taxpayer behavior and the consequent change in revenue. The primary purpose of anti-avoidance doctrines is to prevent taxpayers from shifting their activity into other tax shelters.<sup>77</sup> By preventing taxpayers from engaging in the same tax shelter or shifting into other shelters, the IRS is able to capture additional revenue.<sup>78</sup> In some cases, however, taxpayers tweak the deal just enough to sidestep the reform.<sup>79</sup> These avoidable measures do not raise revenue or increase the tax burden on sophisticated and wealthy taxpayers.<sup>80</sup> Thus, anti-avoidance doctrines that merely induce taxpayers to shift their behavior toward worse shelters without raising significant revenue are inefficient.<sup>81</sup> In contrast, anti-avoidance doctrines that cause taxpayers to return to non-avoidance behavior and, therefore, raise significant revenue, are more efficient.<sup>82</sup> Therefore, successful anti-avoidance reforms will decrease the

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<sup>76</sup> See Needham & Brause, *supra* note 53, at A-100.

<sup>77</sup> See Weisbach, *supra* note 8, at 99 (arguing that, by limiting tax shelters, “the hope [is] that decisions will be based less on taxes and more on other considerations,” such as a business purpose or non-tax economics).

<sup>78</sup> See *id.* at 102-03 (“If taxpayers can easily restructure transactions to avoid the anti-avoidance doctrines, there will be . . . little change in revenue. If, on the other hand, a taxpayer cannot readily avoid the anti-avoidance doctrines, there will be a larger effect on revenue.”).

<sup>79</sup> See Schizer, *supra* note 20, at 1315.

<sup>80</sup> *Id.*

<sup>81</sup> See Weisbach, *supra* note 8, at 103 (explaining that failing to cause taxpayers to shift toward non-avoidance behavior will generate insignificant revenue).

<sup>82</sup> See *id.*

taxpayer's elasticity of taxable income, limit the distortionary effect, and produce effective frictions that constrain tax planning.

#### A. Elasticity of Taxable Income and the Distortionary Effect

Anti-avoidance doctrines affect the ability of taxpayers to shift into shelters and, therefore, are a policy tool that affects the elasticity of taxable income and the efficiency of the tax system.<sup>83</sup> The goal of efficient tax reform is to enforce anti-avoidance doctrines at an optimal level, reducing the taxpayer's elasticity of taxable income, while at the same time limiting the distortionary effect.<sup>84</sup> The elasticity of taxable income defines the ability or relative inability of taxpayers to shift their activities into other tax shelters.<sup>85</sup> Stronger anti-avoidance doctrines reduce the elasticity of taxable income because they make it more difficult to shift into shelters.<sup>86</sup> The distortionary effect occurs when taxpayers respond to an anti-avoidance doctrine by wasting more resources through engaging in more costly shelters.<sup>87</sup>

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<sup>83</sup> See *id.* at 93.

<sup>84</sup> *Id.*

<sup>85</sup> Weisbach gives an example of two commodities that can be consumed, apples and pears: "[S]uppose that we currently impose a tax just on apples. The individual will shift some of his apple consumption to pears because of the tax and may also reduce overall consumption. These shifts—to pears and to less consumption—create the elasticity of taxable income . . . ." *Id.* at 97. The elasticity of taxable income measures the amount by which taxable income changes when the tax rate is increased. *Id.*

<sup>86</sup> See Weisbach, *supra* note 8, at 93.

<sup>87</sup> "The distortionary effect means that an increase in the strength of anti-avoidance doctrines makes shelters worse." *Id.* at 100. For example, consider a small increase in the strength of an anti-avoidance doctrine. "[Prior] to the increase, taxpayers would have entered into tax avoidance transactions until the cost of avoidance exactly equaled the taxes saved." *Id.* When the anti-avoidance measure is increased, "some taxpayers who previously avoided tax, those on the margin, will stop avoiding taxes because avoidance has become too expensive." *Id.* Other taxpayers, however, will continue to avoid tax, but now it is more costly to do so they

For example, suppose a taxpayer must pay \$50 to attain a \$100 tax benefit. Congress subsequently enacts a tax rule that causes the taxpayer to incur \$70 to remain in the tax shelter and attain the same \$100 tax benefit. Because the taxpayer is still receiving a benefit from the transaction, he will pay the extra \$20 to sidestep the anti-avoidance rule. Although the taxpayer is paying more for the relevant tax shelter, the IRS has not increased its tax revenue. Therefore, effective anti-avoidance doctrines reduce the taxpayer's elasticity of taxable income and limit the number of taxpayers that incur higher costs from remaining in the targeted shelter.

## B. Frictions

The term frictions characterize constraints on tax planning outside the tax rules.<sup>88</sup> A "discontinuous" friction is defined as one that imposes unavoidable and significant costs when taxpayers depart from the transaction covered by the reform.<sup>89</sup> In contrast, a "continuous" friction is an inadequate deterrent that has a minimal or modest effect on taxpayer welfare, allowing the taxpayer to sidestep the reform while still engaging in tax planning.<sup>90</sup> Four factors determine whether frictions will be effective in the prevention of tax avoidance. First, the size of the benefit that tax planning provides.<sup>91</sup> When the benefit is larger, the

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must engage in more elaborate shelters to avoid tax, incurring additional costs. *Id.*

<sup>88</sup> See Schizer, *supra* note 20, at 1315 (noting that frictions "describe constraints on tax planning external to the tax law").

<sup>89</sup> *Id.* at 1325 (explaining that avoidance is unlikely if, "in changing the transaction to avoid the reform, the taxpayer or an irreplaceable counterparty would suffer a dramatic and unavoidable decline in utility, and this cost would exceed the tax benefit at issue").

<sup>90</sup> *Id.* at 1326 (explaining that a "continuous" friction will have only a modest effect on taxpayer welfare and is less likely to prevent avoidance of a tax rule).

<sup>91</sup> If a larger tax benefit is at issue, a more persuasive friction is required in order for the rule to be effective. Furthermore, the applicable tax rate and the amount of income at stake are pertinent questions in determining whether frictions may be effective. *Id.* at 1323-24.

friction will need to be stronger.<sup>92</sup> Second, the “strength” of the friction measures the inconvenience to the taxpayer.<sup>93</sup> For example, if a taxpayer incurs a cost that is still less than the tax planning benefit, the friction is weak and the taxpayer will continue to engage in the targeted transaction.<sup>94</sup> Third, the “malleability” or “rigidity” of the friction examines the ability of taxpayers to tweak the deal just enough to attain the tax benefit. Taxpayers must be forced to choose between the friction and the tax benefit.<sup>95</sup> Fourth, frictions that make it more difficult for practitioners and other tax accommodation parties such as advisors or potential counterparties to aid the taxpayer in planning are more effective in curtailing the relevant planning mechanism.<sup>96</sup> Ultimately, effective frictions demonstrate that an anti-avoidance doctrine efficiently constrains the use of a tax planning device.

## V. EFFICIENCY ANALYSIS

The Treasury regulations and recent IRS rulings are aimed at preventing sophisticated investors from using life insurance to turn taxable investments in hedge funds into tax-deferred or tax-free investments.<sup>97</sup> Instead of prohibiting

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<sup>92</sup> *Id.*

<sup>93</sup> *Id.* at 1324.

<sup>94</sup> *Id.* at 1325 (showing that if an increased cost is less than the tax savings, the friction is too weak to stop the targeted tax planning).

<sup>95</sup> *Id.* at 1324-25 (explaining that malleability relates to “how difficult it is for the taxpayer to attain the benefits of the friction, or to avoid the costs it imposes, while still achieving the tax objective”).

<sup>96</sup> For example, “if the taxpayer must have a legal opinion in order to avoid penalties, frictions that discourage counsel from rendering the opinion will impede planning.” *Id.* at 1325. In addition, “if the taxpayer needs a securities dealer for a planning strategy,” effective frictions will prevent the dealer from supplying the requisite security. *Id.*

<sup>97</sup> Rob Wells, *Treasury Curbs Tax-Deferral Strategy – New Regulations Limit Use of Insurance, Annuities By Sophisticated Investors*, WALL ST. J., Mar. 1, 2005, at D2 (discussing the Treasury Department’s release of final rules limiting the use of life insurance and annuities to avoid current taxes on investment earnings in hedge funds and other private placement investments).

these transactions, the recent changes provide a roadmap to the industry and investors, enabling them to proceed confidently with private placement products as long as they are structured within the Service's prescripts.<sup>98</sup> It is clear that the tax agencies have given their blessing to life insurance policies that remain compliant with the diversification requirement of section 817(h) and the investor control doctrine.<sup>99</sup> Thus, private placement life insurance policies shielding hedge fund gains from taxes remain prominently available. Private placement life insurance policies continue to be offered by both domestic and offshore insurers, including American International Group, Inc., The Phoenix Companies, Inc., Sun Life Financial, Inc., and Massachusetts Mutual Life Insurance Co.<sup>100</sup>

Despite this initial observation, further analysis illustrates that the recent changes significantly increase the costs of such transactions. Furthermore, the reforms have increased constraints on control and the need for bothersome compliance.<sup>101</sup> These high costs and increased burdens are insurmountable for most investors, evidenced by a small market share of total hedge fund investment in private placement life insurance contracts.<sup>102</sup> Therefore, the practical effects of the reforms have been to successfully deter taxpayers from using private placement products.

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<sup>98</sup> See Neufeld, *supra* note 42, at 1191 (noting that the guidance provided by the IRS and Treasury allow the industry and investors to proceed with variable life insurance programs involving hedge funds more confidently than anytime in the last twenty years).

<sup>99</sup> See *supra* Part III.

<sup>100</sup> See Silverman, *supra* note 11; see also Sun Life Financial, Variable Universal Life Insurance, [http://www.sunlife-usa.com/indiv/ind\\_11.cfm](http://www.sunlife-usa.com/indiv/ind_11.cfm) (last visited Feb. 25, 2008); The Phoenix Companies, Inc., Private Placement Life Insurance and Annuities, <https://www.phoenixwm.phl.com/public/products/pp/index.jsp> (last visited Feb. 25, 2008).

<sup>101</sup> See *infra* Part V.A.

<sup>102</sup> See *infra* Part V.B.

## A. Having to Follow the Rules

### 1. Loss of Control

The loss of control caused by the first prong of the investor control doctrine increases effective frictions and efficiently reduces the taxpayer's elasticity of taxable income. While practitioners and life insurance companies are still able to structure policies as a tax avoidance mechanism, the investor control doctrine deters investors who prefer direct involvement with the policy's underlying investments. Policyholders lose a substantial amount of control by purchasing a private placement life insurance contract instead of directly investing in a hedge fund. When investing directly into a hedge fund, the investor may assert actual control over the investment decisions of the sub-accounts.<sup>103</sup> With direct investments, the investor can hire a single hedge fund manager or a combination of hedge fund managers to tailor the portfolio to the investor's needs and desires.<sup>104</sup> However, in an insurance-dedicated fund, because the investor's assets are pooled with those of many other policyholders, managers of funds cannot offer any alteration to their product in order to accommodate individual needs.<sup>105</sup> Consequently, an investor who does not approve of a certain strategy is powerless to change that allocation, short of bailing out of the fund altogether.<sup>106</sup> Thus, investing through a private placement life insurance policy signifies the giving

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<sup>103</sup> L'HABITANT, *supra* note 1, at 515.

<sup>104</sup> *Id.* (noting that to determine an optimal portfolio for each investor, "it is necessary to take into account the investor's time horizon, his risk appetite, his overall objectives, his age, his available income and the rest of the assets of his portfolio (including, if relevant, his liabilities, as well as any constraints, tax status, etc.)").

<sup>105</sup> *Id.* at 516 (explaining that a drawback of funds of funds from the investor's perspective is the lack of control).

<sup>106</sup> *Id.* at 587.

up of a good deal of control and choice over investments in order to satisfy relevant tax rules.<sup>107</sup>

In effect, the friction of relinquishing control is very strong. The loss of control over underlying investments is a substantial inconvenience to sophisticated investors who often have the knowledge and competence to make direct investment decisions. With the exception that there will be cash accumulation deferral if the investor can keep his hands off, the reforms shut down the use of private placement life insurance wrappers if the investor exerts too much control.<sup>108</sup> In addition, the loss of control is a rigid friction, forcing investors to either relinquish control or to refrain from investing in hedge funds using life insurance products. The taxpayer cannot make any alteration to the deal to sidestep the first prong of the investor control doctrine.<sup>109</sup>

Similarly, the loss of control reduces the taxpayer's elasticity of taxable income. If the taxpayer desires to direct investments in the sub-accounts, the policyholder must abandon all private placement life insurance products in order to do so. The reforms make it impossible for an investor to maintain the power to make investment decisions or premium allocations and use insurance wrappers as a tax planning mechanism. The investor must choose between investment control and the tax benefit. Thus, the loss of control both increases frictions and reduces the elasticity of taxable income, indicating that the tax reforms have been efficient.

## 2. Reluctance

The diversification requirement of section 817(h) and the regulations under the look-through doctrine increase frictions against tax accommodation parties like insurance companies and hedge funds, making it more difficult for

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<sup>107</sup> See Silverman, *supra* note 11 (indicating that wealthy investors must give up control over their investments).

<sup>108</sup> See Rev. Rul. 2003-91; see also I.R.C. §§ 61, 7702(g).

<sup>109</sup> See *supra* Part III.B.1.

them to market compliant products.<sup>110</sup> For example, insurance companies may be unwilling to create their own hedge fund for investment or to clone someone else's hedge fund.<sup>111</sup> Insurance companies may also be unwilling to persuade hedge fund managers to set up special funds specifically for insurance contracts.<sup>112</sup> In addition, life insurance companies want to be able to put their customers in hedge funds that are offered to other investors, not just hedge funds that are offered to separate accounts for insurers.<sup>113</sup> Hedge fund alternatives like clones of funds are often inferior to generally available hedge funds.<sup>114</sup>

Hedge funds are also reluctant to engage in private placement products due to the recent reforms. Hedge funds may be unwilling to set up insurance-dedicated funds specifically for insurance companies.<sup>115</sup> Furthermore, even if funds are willing to set up special funds, they may fail to gather a sufficient number of insurance-dedicated hedge funds to become or remain viable. Hedge funds may also be deterred from entering the market after witnessing the failure of other funds to comply with the relevant tax rules. Lastly, the diversification requirements require disclosure of

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<sup>110</sup> See Luke, *supra* note 3, at 185 (explaining that the tax agencies have asserted that the investor control doctrine and diversification requirement are "strong weapons in their war on tax shelters").

<sup>111</sup> See Sheppard, *supra* note 67.

<sup>112</sup> See *id.* (arguing that the investor control doctrine requires hedge fund managers to form funds that limit access to annuity or life insurance contracts).

<sup>113</sup> See *id.* (stating that life insurance companies want to place policyholders in funds that are open to investors of the general public).

<sup>114</sup> See Houman B. Shadab, *The Definition of Accredited Investors in Certain Private Investment Vehicles* 19 (Working Paper, 2007), available at <http://ssrn.com/abstract=980751> (explaining that hedge fund alternatives have not matched the performance of the best hedge funds which rely more directly on human skill).

<sup>115</sup> See Sheppard, *supra* note 67 (commenting that hedge funds may be unwilling to set up special funds specifically for insurers).



each fund's major positions, if not all positions, and this is something fund managers are reluctant to do.<sup>116</sup>

The tax reforms therefore create effective frictions that discourage tax accommodation parties from providing tax planning assistance to the taxpayer. The reforms have made it more difficult for insurance companies and hedge funds to provide compliant private placement life insurance policies as a tax planning device. Insurance companies still offer a menu of investment options to policyholders, but the number of available options is significantly reduced because of the need to find insurance-dedicated hedge funds.<sup>117</sup> Thus, requiring investors to persuade hedge fund managers to set up special funds for them is precisely the type of annoyance intended by the tax agencies.<sup>118</sup>

### 3. Costs of Compliance

The costs of having to comply with the tax rules increase deterrent frictions, reduce the taxpayer's elasticity of taxable income, and minimize the distortionary effect. While the diversification rule does not directly affect the ability to use hedge fund wrappers, it does raise the costs of all variable contracts because insurance companies must monitor compliance.<sup>119</sup> In order to adhere to the tax rules, insurance companies must perform expensive and complicated compliance testing.<sup>120</sup> For example, although insurance companies may offer hedge funds that are clones of publicly available hedge funds, these funds come at an increased cost.<sup>121</sup> It may cost from \$10,000 to \$20,000 in legal or

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<sup>116</sup> See Neufeld, *supra* note 42, at 1194 (arguing that the diversification requirement requires each fund to disclose positions, thereby revealing private investment decisions and strategies).

<sup>117</sup> See *supra* Part III.B.

<sup>118</sup> See Neufeld, *supra* note 42, at 1194.

<sup>119</sup> See Luke, *supra* note 3, at 187-88.

<sup>120</sup> See Neufeld, *supra* note 42, at 1194 (explaining that elaborate diversification testing is required of all assets underlying each fund owned by the variable contract).

<sup>121</sup> See Luke, *supra* note 12, at 282 (explaining that while it is clearly impermissible to enclose a publicly available hedge fund interest inside a

advisory fees to set up a policy.<sup>122</sup> Consequently, these increased costs are passed on to the taxpayer investor. Therefore, private placement life insurance policies have costs that will deter investors from using private placement life insurance as a tax planning mechanism.

The increased costs of compliance resulting from the tax rules are effective frictions against private placement life insurance wrappers. The costs of compliance increase frictions that are both rigid and strong. The costs of compliance are rigid frictions because the taxpayer investor cannot sidestep the costs without exiting the private placement industry. Increased costs are also strong frictions, causing the taxpayer to incur a significant monetary inconvenience. The increased cost of compliance cuts into the tax benefit, lowering the overall value of the investment vehicle. If the tax benefit is clearly greater than the increased costs caused by the tax agencies' reforms, the market would reflect a greater number of investors purchasing private placement products. Experience clearly points to the contrary.<sup>123</sup>

The tax reforms are strong anti-avoidance measures that reduce the taxpayer's elasticity of taxable income by increasing the costs of all life insurance contracts seeking to wrap hedge fund investments. The costs of compliance affect all insurance wrappers, reducing the taxpayer's ability to avoid the reforms by engaging in other life insurance shelters. The reforms prove to be strong anti-avoidance measures because the increased costs prohibit shifting into any form of private placement life insurance as a tax planning scheme. Unfortunately, there will be a number of

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private placement life insurance contract under the current regulations, the tax agencies have not attempted to use the investor control doctrine to go after clones of publicly available hedge funds); see also Michael A. Heimos, *Attorney Critiques Regs Targeting Use of Annuity Contracts, Life Insurance as Tax Avoidance Vehicles*, 2003 TAX NOTES 210-51, Oct. 30, 2003.

<sup>122</sup> *Id.*; see also Silverman, *supra* note 6 (commenting that the recent reforms require lawyers to provide more detailed analyses when drafting a formal legal opinion about certain tax strategies).

<sup>123</sup> See *infra* Part V.B.

taxpayers whose tax benefit continues to outweigh the increased costs of the reforms. These taxpayers that engage in the tax planning device notwithstanding the higher costs of compliance represent the distortionary effect of the targeted reforms. Nevertheless, the lack of market penetration of private placement products shows that distortionary activity is very low. The tax reforms have thus been effective in minimizing the waste of resources caused by taxpayers engaging in a more costly tax planning device. Therefore, the costs of compliance have effectively reduced the taxpayer's elasticity of taxable income to engage in private placement life insurance and have limited the reforms' distortionary effect.

#### 4. External Constraints

Finally, there are also deterrent effects resulting from the nature of private placement life insurance contracts, external to the reforms. For example, if the funds within an investor's policy have any losses, the tax rules prevent investment losses within a policy to offset gains outside of the policy.<sup>124</sup> Direct hedge fund investments can produce short term losses that can be set against short term capital gains from short term investments or passive investments.<sup>125</sup> When the taxpayer has the hedge fund interest wrapped within a life insurance policy, neither gains nor losses can be utilized for tax savings. Furthermore, high fees also contribute to the reason why private placement life insurance contracts constitute such a small share of hedge fund investments. Upfront sales charges, as well as state premium taxes or offshore excise taxes, can total about 2.5% to 4% of initial premiums.<sup>126</sup> Insurance companies also

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<sup>124</sup> See Silverman, *supra* note 11; see generally I.R.C. § 72 (stating that gains or losses inside a life insurance policy have not been realized and cannot be used in taxable income calculations).

<sup>125</sup> I.R.C. § 1211 (providing that "losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges").

<sup>126</sup> See Schizer, *supra* note 20, at 1387.

charge recurring fees, which can take a 0.25% to 0.60% annual bite out of the cash value of the policy.<sup>127</sup> Overall, a policyholder can expect annual fees to average about 0.75% to 1.25% of the policy's cash value over the policy's life.<sup>128</sup> It is worth noting that high fees will cut into the investor's tax benefit and lower the overall yield on the investment.<sup>129</sup>

In addition, the carried interest problem caused by the regulations of section 817 has eliminated the use of some insurance wrappers as alternatives to direct hedge fund investment. Typically, a carried interest in a hedge fund will convey 20% of the portfolio gains to the general partner as compensation for his services.<sup>130</sup> The regulation provides that life insurance companies are permitted to disregard the equity of the portfolio manager as an interest available to the public only if the return on such equity is calculated in the same manner as the return on interests in a segregated asset account.<sup>131</sup> If the fund manager retains a carried interest that differs from the economic terms of the hedge fund interest, look-through treatment under section 817 is denied.<sup>132</sup> However, the fund manager can still participate if he receives the 20% carry as a fee for services rather than as an equity interest in the fund.<sup>133</sup> In this case, the carry will generate taxable compensation income rather than capital gain.<sup>134</sup> It is significant that a fund manager that chooses to retain a 20% equity interest in the fund will preclude the fund from being used in an insurance wrapper. Thus, even if the hedge fund is insurance-dedicated, a hedge fund with a carried interest may not qualify for look-through treatment under the diversification rules.

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<sup>127</sup> See Silverman, *supra* note 11.

<sup>128</sup> *Id.*

<sup>129</sup> See Luke, *supra* note 3, at 186.

<sup>130</sup> See Needham & Brause, *supra* note 53, at A-101.

<sup>131</sup> See Treas. Reg. § 1.817-5(f)(3)(ii) (2003); see also Needham & Brause, *supra* note 53.

<sup>132</sup> See Treas. Reg. § 1.817-5(f)(3)(ii) (2003).

<sup>133</sup> See Needham & Brause, *supra* note 53, at A-101.

<sup>134</sup> See I.R.C. § 61.

## B. Tiny Fraction of the Market

The trend in the market suggests that the increased frictions attributable to the tax rules have been successful in deterring the use of private placement life insurance contracts. While private placement life insurance policies continue to be offered by major insurance companies, these investments represent an insignificant amount of total investment in the hedge fund industry. In 2006, the total amount invested in hedge funds was \$1.23 trillion.<sup>135</sup> Nevertheless, industry watchers estimated that the total onshore individual private placement life insurance and annuity market was about \$4 to \$5 billion in 2006.<sup>136</sup> Therefore, private placement life insurance contracts constituted less than half of one percent of the total value invested in hedge funds. With the private placement life insurance market representing such a small portion of the total value of hedge fund investments, it appears that the IRS's objective of preventing widespread abuse was accomplished.

## VI. CONCLUSION

Investors may use private placement life insurance contracts to wrap hedge fund investments and defer tax on gains held within the insurance policy. In order to "prevent taxpayers from turning otherwise taxable investments in hedge funds . . . into tax-deferred or tax-free investments merely by purchasing the investments through a life insurance . . . contract," the tax agencies implemented specific reforms.<sup>137</sup> By 2005, when the last changes were finalized, investors, life insurance companies, and hedge fund managers had a clear roadmap of how to successfully structure policies to achieve a tax-free investment. The tax reforms that enacted the diversification requirement and established the investor control doctrine, however, proved to

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<sup>135</sup> Silverman, *supra* note 11.

<sup>136</sup> *Id.*

<sup>137</sup> Internal Revenue Serv., *supra* note 71.

be effective measures against private placement life insurance wrappers.

The loss of control over the underlying investments in the life insurance policy, reluctance to set up compliant funds and policies, and the increased costs of compliance with the tax rules have collectively increased the frictions against private placement life insurance as a tax planning mechanism. Having to abide by the tax reforms has caused efficient constraints on tax planning. The tax reforms have also reduced the taxpayer's elasticity of taxable income, forcing the taxpayer investor to either refrain from the use of insurance wrappers or become subject to strict control requirements and substantial compliance costs: Effectively, the taxpayer must choose between obtaining the tax benefit and exiting the life insurance industry altogether for hedge fund investments. Lastly, low market penetration shows that the number of taxpayers who incur the higher costs of the transaction is very small. Thus, the tax reforms have efficiently balanced reducing the elasticity of taxable income and the distortionary effect.