

# Alternative Investing Through Private Placement Life Insurance and Variable Annuities

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Highlights from Wells Fargo Prime Services' *On the Horizon* conference series held on February 24, 2016

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*Investing in alternative asset managers through Private Placement Insurance products – PPLI (Life Insurance) or PPVA (Variable Annuities) – through Insurance Dedicated Funds (“IDFs”) is a growing trend in tax-sensitive investing. Managers have found that these fund structures may help attract incremental AUM due to certain tax features and may provide clients with investment returns that accumulate on a tax-deferred basis (through variable annuities) or are fully exempt from income tax (via life insurance).*

The following summary is based on February's *On the Horizon* conference featuring:

- **Henry Bregstein**, New York Partner & Global Co-Chair of Financial Services, Katten Muchin Rosenman LLP
- **Richard Coffin**, Managing Director, SALI Fund Services
- **David Friezo**, Founder and President, Frisa Family Office and Lydian Advisory Group
- **Richard Jacobson**, Managing Director, Golub Capital
- **Labib Mahfouz**, President and COO, Axonic Capital

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## What is an Insurance Dedicated Fund?

IDFs are hedge funds linked to a variable annuity or life insurance policies. The structure of an IDF allows for taxable investors to invest in hedge funds through insurance carriers on a tax-deferred or tax-free basis through Private Placement Life Insurance (“PPLI”) or Private Placement Annuities (“PPVA”). Insurance Dedicated Funds enable hedge funds to manage a separate fund that follows the same strategy as the flagship fund. Unlike traditional life insurance, an investor would buy a PPLI policy principally as an income tax free investment vehicle.

## Why are Managers and Investors Interested in Insurance Dedicated Funds?

### **IDF from the fund manager’s standpoint:**

IDFs are viewed as a way to diversify investor bases with tax-sensitive investors.

- Labib Mahfouz, Axonic: *“The IDF was a great addition to the platform, particularly in the current environment.”*
- According to Katten, the IDF investment universe tends to be stickier than the ordinary hedge fund investment base.

### **IDF from the investor’s standpoint:**

Tax sensitive investors are familiar with the features of life insurance as an investment vehicle:

- *The investment portfolio accrues on a tax deferred basis*
- *The policyholder can generally make tax-free withdrawals and loans against the policy’s assets during the insured’s lifetime*
- *The proceeds payable upon death of the insured aren’t subject to income tax*
- *For annuity: tax is deferred until time of withdrawal (every withdrawal is treated as a partial recovery of investment in the insurance contract so the rate of tax is reduced until entire investment is withdrawn)*

## Timeline and Structure of an Insurance Dedicated Fund

According to the panelists, it is a short timeline to create an IDF. Generally it will take 8-10 weeks to establish an IDF attached to an existing platform, and approximately 3-4 months to establish a stand-alone IDF.

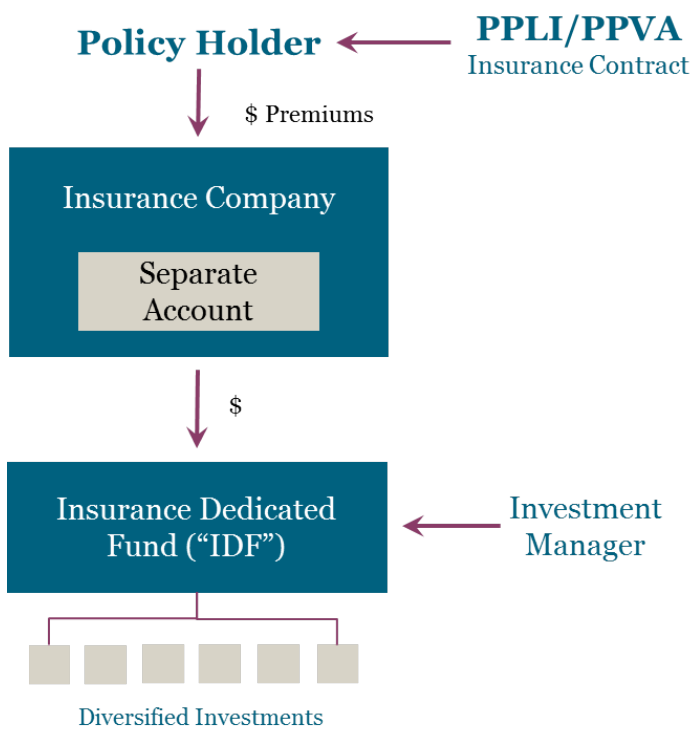
- **Labib Mahfouz** said that Axonic chose to set up an IDF on its own platform rather than attaching itself to an established platform for greater flexibility and control. In its case, Axonic already had the infrastructure so there was not much additional work needed to add the IDF, and the annual fees, once set up, were materially lower.
- **Rich Jacobson** explained that for Golub, it was easier to attach to an established platform (SALI Fund Services) which has established relationships with the major insurance carriers. Platforms such as SALI offer a “plug-and-play” model which handles much of the administrative burden. He felt it was important for his fund to present investors with a taxable and tax-efficient investment strategy.

### **There are two basic IRS rules managers follow when establishing an IDF:**

In order for the PPLI/PPVA to qualify for the deferral of income taxes, the legal format must meet the formation structure specified by the IRS – it must be a separate legal entity attached to, but distinct from, the insurance company’s separate asset account. The IDF must also satisfy the diversification rules and the investment control rules under the Internal Revenue Code.

1. The diversification rules provide that:
  - a. No one investment can constitute more than 55% of the total assets of the account;
  - b. No two investments can constitute more than 70% of the value of the total assets of the account;

- c. No three investments can constitute more than 80% of the value of the total assets of the account;
  - d. No four investments can constitute more than 90% of the value of the total assets of the account
2. According to a limited amount of case law and rule interpretations, the Investor Control Doctrine means that the IDF must be managed on an independent discretionary basis. No PPVA or PPLI account owner can directly or indirectly influence the IDF manager with respect to the selection of funds or securities to fulfill the IDF's investment mandate.



Source: Katten Muchin Rosenman LLP

## PPLI/PPVA Structure

The investments held by an IDF that is treated as a partnership for tax purposes are measured individually for diversification and will need to follow the diversification rules.

Institutional uses for IDFs include: Corporate Owned Life Insurance (**COLI**), Bank Owned Life Insurance (**BOLI**) and Insurance Company Owned Life Insurance (**ICOLI**). These are institutional investment strategies which can provide a tax-efficient tool to

- offset employee retirement and benefit program liabilities
- provide a balance sheet asset
- provide an efficient asset/liability management tool which may positively impact overall financials

### Investment Manager:

Creates IDF as standalone or on platform.  
 Enters into an investment management agreement with IDF and participation agreement/side letter with insurance company.  
 Manages money on behalf of IDF  
 Certifies 817(h) compliance

### Distributors:

Insurance professionals  
 Bank/Broker-Dealer Private Client Groups  
 RIAs  
 Family Offices  
 Online BD platforms

### Insurance professionals:

Reviews insurance needs  
 Completes application  
 Leads client through the PPLI underwriting process

### Attorneys and Advisors:

Advisor to client  
 Estate/income tax expert  
 Asset protection expert  
 Coordinates policy ownership  
 Insurance expert (reviews and negotiates PPLI/PPVA contract)  
 Advisor to IDF investment manager (separate)

### Insurance Company:

Provides IDF investment options  
 Underwrites PPLI policy  
 Issues policy  
 Reports policy values to client

## *On the Horizon conference series*

As markets move and regulations change, alternative asset managers need to remain at the forefront of issues. Our Business Consulting group hosts “On the Horizon,” a periodic morning conference series during which key industry experts discuss hot-button topics specifically affecting alternative asset managers.

### **About Wells Fargo Prime Services**

Part of the Institutional Investor Services group, Wells Fargo Prime Services offers comprehensive prime brokerage services and solutions for alternative asset managers. Through our multi-asset class platform, we help managers meet their operational and financial goals with:

- Integrated financing solutions
- Technology and operational solutions
- Capital introductions
- Business consulting services
- Risk management solutions

### **About the Business Consulting group**

The Business Consulting group delivers subject matter expertise for alternative asset managers including: business development (from launch to franchise management), best practices, peer analysis and benchmarking, and thought leadership.

We help fund managers focus on their day-to-day investment objectives and improve the efficiency of their operations. By leveraging our knowledge of industry service providers we facilitate key introductions and discussions to achieve the right operational fit for our customers’ business. We offer subject matter expertise across the full spectrum of hedge fund operations including formation and structure, strategic growth, trading workflows, and technology platforms.

To learn more about our thought leadership initiatives:

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