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Assurance, Advisory & Tax

Insurance Dedicated Fund (IDF) Structure for Tax Efficiency

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Introduction

- **Insurance Dedicated Funds**, or "**IDFs**," are commingled fund structures managed by 3rd party asset managers, and made available for investment through insurance companies. Clients allocate to IDFs by first funding a variable life insurance or annuity contract, called **Private Placement Life Insurance** ("PPLI") or **Private Placement Variable Annuity** ("PPVA"). To purchase a PPLI or PPVA contract, a client must meet the definition of Accredited Investor and Qualified Purchaser.
- For tax-sensitive investors, IDFs allow them to invest in certain strategies on a long term, income-tax deferred (and if structured properly, both income and estate tax-eliminated) basis. For investment managers who oversee tax-inefficient strategies, an IDF can function as a more tax "**friendly**" access point for their wealthy clients, improving net-of-tax returns, and enabling the asset manager to attract and retain additional investor capital.

How is an Insurance Dedicated Fund formed?

- The process of creating an **IDF** is very similar to that of launching a traditional fund structure. Most **IDFs** are traditional **LP** or **LLC** structures. Further, the **IDF** should have its own set of legal documents including a PPM, LPA (or equivalent), and subscription documents. Similar to other traditional funds structures, the IDF will engage with service providers – including one or more custodians, a NAV administrator, and auditor. Oftentimes IDFs are structured to 'mimic' or invest parallel a manager's existing or flagship fund strategy.

- Because eligible investors in the **IDF** are limited to insurance companies (investing on behalf of individual policyholders), the IDF must be onboarded and "**approved**" onto one or more insurance carrier investment platforms initially, and made available for investment through the carrier. Each carrier maintains its own investment menu of approved IDFs for policyholders to choose from. Practically speaking, a manager needs $10mm or more in initial seed capital to launch an IDF with a carrier.

POLLING QUESTION

What is a prerequisite for a client to purchase a Private Placement Life Insurance (PPLI) or Private Placement Variable Annuity (PPVA) contract and invest in an Insurance Dedicated Fund (IDF)?

A) Being a Qualified Purchaser only

B) Meeting the definition of Accredited Investor only

C) Both Accredited Investor and Qualified Purchaser

Pros of Insurance Dedicated Fund Structure

1. Tax-Advantaged Asset Location
2. Elimination of K-1s
3. Varying Applications for Different Investor Types

Tax-Advantaged Asset Location

For clients who desire tax-inefficient asset classes, including some hedge funds, private credit, private equity, and other opportunistic strategies, an investment through an IDF can potentially allow the client to compound their investment dollars much more efficiently over the long term, by deferring and/or eliminating the dilutive effects of income tax.

In effect, the client trades income taxes for insurance fees associated with their PPLI or PPVA contract. Because these contracts are institutionally priced, there is often a meaningful arbitrage that clients can realize by allocating to a manager's IDF.

Contd.

Elimination of K-1s

K-1s associated with investments held within the PPLI or PPVA contract are sent to the insurance company, which is treated as the owner of the IDF. Hence, policyowners never receive K-1s associated with the policy's underlying investments (these are sent to the carrier). Rather, policyholders receive statements from the carrier, indicating the value of their policy's segregated investment account, which fluctuates depending on the performance of the IDF(s) held within the contract.

Varying Applications for Different Investor Types

While **IDFs** are perhaps most well-known as a solution for UHNW and Family Office clients, they can also be utilized by a wide variety of investors:

- Foundations, Endowments, and Pensions
- Sovereign Wealth Funds
- Insurance Companies, Corporations, and Banks

POLLING QUESTION

What is a potential advantage of Tax-Advantaged Asset Location through Insurance Dedicated Funds (IDFs)?

A) Reduction of insurance fees

B) Simplification of legal documentation

C) Deferring and/or eliminating the dilutive effects of income tax(if properly structure through a PPLI or PPVA contract)

Cons of Insurance Dedicated Fund Structure

1. Investor Control
1) 817(h) Diversification
2) Segregated Asset Base

Investor Control

While the policyholders are allowed to select the manager of the IDF, and agree upon a more broad investment mandate for the IDF, clients are not allowed to influence the specific buying or selling of securities held within the IDF. In that regard, the investment manager to the IDF must maintain 100% discretion as it relates to any investment decisions made within the IDF. Similarly, the manager must provide scheduled attestations to the carrier that Investor Control has not been breached.

817(h) Diversification

Technically speaking, the IDF must hold at least 5 underlying assets or “line items” within the portfolio, as referenced under Section 817(h) of the IRC. These could be individual stocks/bonds/ETFs, private funds, or other direct deals. No one asset can represent more than 55% of the overall IDF portfolio, no two can represent more than 70%, no three can represent more than 80%, and no four can represent more than 90%. Insurance carriers require that each IDF manager deliver detailed reports to the carrier, attesting that diversification is monitored and maintained.

Contd.

Segregated Asset Base

The IDF can only accept investments from insurance companies, and an IDF cannot be a share class of an existing fund (it must be its own stand-alone structure). Hence, its applicability with investors is limited to clients who either already own, or intend to fund a new PPLI or PPVA contract.

POLLING QUESTION

What is a requirement under Section 817(h) of the Internal Revenue Code (IRC) for the 817(h) Diversification aspect of Insurance Dedicated Fund (IDF) structures?

A) The IDF must hold a minimum of 5 underlying assets

B) No single asset can represent more than 70% of the overall IDF portfolio

C) At least 10 underlying assets are required for diversification

Taxable Investment vs IDF Investment

Federal, state, and local taxes may hinder a client's ability to compound their wealth efficiently when investing in certain tax-inefficient asset classes

Income taxes can greatly affect a client's ability to compound their wealth on a net-of-tax basis

Assumptions	Taxable Investment (CA resident)	Taxable Investment (NYC resident)	Taxable Investment (FL resident)	IDF Investment via PPLI
Net Investment Return	12.00%	12.00%	12.00%	12.00%
Blended Federal Tax Rate	-4.69%	-4.69%	-4.69%	-0.00%
State / City Income Tax	-1.60%	-1.52%	0.00%	-0.00%
Annual Insurance Costs	-0.00%	-0.00%	-0.00%	-0.80%
Net Investment Return	**5.71%**	**5.79%**	**7.31%**	**11.20%**

Additional assumptions:

- Federal Income Tax: 37%
- CA State Income Tax: 13.30%
- New York State / City Income Tax: 12.7%
- Long Term Capital Gains Tax: 20.0%
- Net Investment Income Tax: 3.8%
- Anticipated Tax Profile: 90% Ordinary Income/STCG & 10% LTCG
- Note: Assumed 12% net investment return is based on historical track record and there is no assurance this target will be met.

Please note: 1) Applying a reduced or negative investment return assumption, the PPLI investment may under-perform vs. a similarly-made taxable investment; further, 2) if client decides to surrender the PPLI contract, client may realize additional adverse tax consequences (including payment of ordinary income tax applicable to any profits accumulated within the contract), 3) insurance costs of 80 bps per annum associated with PPLI structure represent estimated long term normalized cost of structure and may vary depending on a variety of factors, including the PPLI insured individual's age, gender, and medical underwriting, as well as situs-determined premium taxes, insurance carrier product pricing, and placement fees incurred; 4) modeled 12% return assumption is based upon hypothetical returns of investment manager, and actual investment returns of the IDF may not reflect the return assumptions used here; 5) above tax assumptions are based upon historic as well as anticipated tax profile assumptions employed through a sample direct lending strategy, and individual tax rates of individual client may differ depending on that client's tax residency, income tax bracket, as well as performance and ultimate tax profile of underlying investment strategy employed. Net investment return assumptions are not guarantees, forecasts or predictions and there can be no assurance that these targets will be met.

Conclusion

There are definite pros and cons to the IDF structure. For certain investors, an IDF can help them to maximize their net-of-tax returns tremendously over the long term. That said, creating an IDF also requires an investment in time and resources by the asset manager to both build the structure, as well as educate potential investors as to its benefits. Managers who are exploring this space are encouraged to build relationships with experienced insurance carriers, service providers, and insurance producers who can help them navigate the ins and outs of this marketplace.

POLLING QUESTION

What is a potential advantage of IDF Investment via PPLI compared to Taxable Investment in different locations?

A) Investor has full control over the IDF’s investment allocation

B) Income tax-deferral (and potential income tax elimination, if PPLI held until death)

C) No insurance costs

THANKS FOR LISTENING

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