IRS ruling on insurance wrappers and hedge funds

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A November 1 private letter ruling by the United States Internal Revenue Service (the IRS) may limit the use of insurance contracts to invest in hedge funds and other private investment partnerships.

The ruling deals with variable contracts, which are insurance contracts with payments or benefits that are tied, in some way, to the market value or investment return of securities or other assets.

If properly structured, the insurance company will be treated as owning the securities or other assets in order to meet its obligations under the policy, and the policy holder will enjoy the generally beneficial tax treatment that goes with owning an insurance contract. (Taxation of the market value or investment return of the securities or other assets will generally be deferred with an insurance contract as compared to the taxation with a direct investment in those assets.)

However, under prior IRS rulings, if the policy holder has too much control over the underlying assets, the IRS will treat the policy holder, and not the insurance company, as the owner of the underlying assets. Then the policy holder will be subject to current tax on any income or gain from those assets (such as an interest in a hedge fund).

When will a policy holder be considered to have too great a degree of control over the underlying assets; Prior IRS published guidance indicates that, where the underlying assets consist of shares in a mutual fund, the mutual fund shares must be available exclusively through the purchase of variable contracts from the insurance company. If the mutual fund shares are also available to the general public, then holders of the variable contracts will be treated as direct owners of the mutual fund shares.

The idea is that a direct investment in the fund and the purchase of the variable contract will be economically equivalent investments, and the taxpayer should not be able to elect the beneficial tax treatment that is afforded to insurance products by "wrapping" the mutual fund shares in an insurance contract.

The November 1 private letter ruling considers a variable life insurance contract where assets supporting the contract are invested in a number of private investment partnerships. Although not mentioned in the ruling, these private investment partnerships could be hedge funds.

The policy holder specifies the allocation of premium among the various funds when the policy is purchased, and may change the allocation for subsequent premiums at any time. Because interests in the private investment partnerships are also sold to other qualified purchasers or accredited investors, the IRS concludes that each policy holder is the direct owner of the interests in the private investment partnerships.

Thus, the policy holder is currently taxed on any income or gain from the private investment partnerships, just as a taxable investor with a direct interest in a partnership would be.

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One question the ruling leaves open is whether a hedge fund manager could set up a parallel fund that is open only to investments by insurance companies. Insurance companies have taken a similar approach with mutual funds, investing in "cloned" funds that are open only to insurance companies but that make investments similar to those in publicly available funds.

For insurance companies that have already set up variable contracts with investment options like the one described in the ruling, unwinding the transaction could be expensive. If the IRS position were to prevail, each policy holder would be liable for the tax on the income from the private investment partnerships. Query whether the insurance company might agree to pay this tax as part of a settlement with the IRS.

A private letter ruling from the IRS is binding only on the taxpayer that requested it, although it can reflect the general approach of the IRS to an issue. The taxpayer that requested this ruling has reportedly asked for reconsideration.

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