PROPOSED TREASURY REGULATION TO AFFECT INVESTMENTS BY VARIABLE INSURANCE CONTRACTS IN HEDGE FUNDS

The holder of a universal life or variable annuity policy is not taxed on increases in the value of the policy if (a) the policyholder is not the common law owner of the assets supporting the policy and (b) those assets are sufficiently "diversified." In general, there are two different structures whereby these assets may be invested in a hedge fund partnership:

a. The "**fund-of-funds**." The partnership is open only to insurance companies and their segregated accounts and the fund-of-funds is invested in two or more investment partnerships that are generally available to accredited investors or qualified purchasers under the federal securities laws. Under current law, a fund-of-funds meets the tax requirements if the partnership's manager retains, and actually exercises, the discretion to change the allocation of the fund's assets among the lower-tier partnerships.

b. The "**clone fund**." A separate partnership is open only to insurance companies and their segregated asset accounts and the clone fund pursues the same investment strategy as a commonly managed investment partnership that is open to accredited investors or qualified purchasers. Frequently, the policy permits the holder to allocate (and reallocate) his investment among a menu of clone funds.

<u>If</u> the recently proposed Treasury Regulation is ultimately adopted in its current form:

- **A general partner of these funds cannot continue to receive an incentive allocation of profits, but instead must recast his incentive compensation as a fee.** The costs are that the fee will be subject to the 2.9% Medicare tax, while the allocation is not, and the fee will be ordinary income, while the allocation may pass through some long-term capital gains.

- **A fund-of-funds must be restructured, as the diversification requirements can no longer be satisfied by "looking through" partnerships that are open to accredited or qualified investors.**

Technical Discussion. Under Section 817 of the Internal Revenue Code, an insurance policy is disqualified if the segregated asset account supporting it is not sufficiently "diversified." The current Treasury Regulations provide that "partnership interests that were not registered under a Federal or State law regulating the offering or sale of securities" are "looked-through" and investments by these partnerships are counted for purposes of the diversification tests. Treas. Reg. §1.817-5(f)(2)(ii). The Proposed Regulation is to repeal this look-through rule. If the Proposed Regulation is adopted, the only partnerships that would be looked-through would be those that were available only to insurance companies and their segregated asset accounts.

In determining whether a partnership is open to investors other than insurance companies and their segregated asset accounts, the general partner's interest is disregarded only if the return to the general partner "is computed in the same manner as the return on an interest held by a segregated asset account." Treas. Reg. §1.817-5(f)(3)(ii). An incentive allocation would fail this test. Under current law, failing this test is not a problem as the partnership is looked-through in any event because it is available only to qualified purchasers or accredited investors.

Proposed Effective Date. The Treasury proposes that the new rules be applied retroactively to all policies from the date of final adoption of the Proposed Regulation. Existing arrangements that comply with current law will have two months from final adoption to come into compliance with the new regulation.

Possible Outcomes and Consequences

a. **The Proposed Regulation is modified prior to adoption.** Because the Proposed Regulation will prohibit currently accepted business practices, undoubtedly someone will request a hearing. Thus, the regulation will not be adopted until after a hearing and a review of comments submitted on behalf of affected partnerships. Arguments probably will be submitted that the final regulation should not apply retroactively to existing policies. Further, one of the issues upon which the Treasury solicited comments appears to be the consequences of incentive payments. The response should be that no tax policy is served by turning a tax consequence to a policyholder on the difference between an incentive allocation and an incentive fee.

   Traditionally, the primary tax issue with insurance products that wrap investment assets has been framed as whether the policyholder has sufficient indicia of ownership and control to be considered the tax law owner of the assets. If the fund-of-funds manager exercises discretion as to the allocation of the investment among various partnerships, the policyholder has no indicia of ownership over the assets in the segregated asset account for his policy. In many cases, the amount each policyholder has indirectly invested in a lower-tier partnership is less than the minimum required to invest in that partnership. Thus, the investment in the lower-tier partnership is only available to the policyholder through his insurance policy.

b. **The fund-of-funds becomes diversified by investing in (i) additional partnerships, (ii) managed accounts, (iii) wholly owned LLCs and/or (iv) clone funds**.

   If the Proposed Regulation is adopted, the costs of compliance to a fund-of-funds will be:

   - limitations on the amounts that the fund-of-funds manager can allocate to his favorite strategies conducted by his favorite lower-tier partnerships; and

   - to obtain concentration in a strategy and a particular lower-tier manager, the investment must be made through a clone fund or in a managed account or other form whereby the lower-tier manager receives an incentive fee rather than an allocation of profits.

As discussed above, a fee is generally not as attractive as an allocation because an allocation may pass through long-term capital gains and, in any event, will not be subject to the 2.9% Medicare tax that would be imposed on a fee.

The diversification requirement can be met in several different ways. Technical compliance with the various standards is beyond the scope of this memorandum. The simplest test is that there is diversification if:

- No more than 55% of the total assets is represented by any one investment;
- No more than 70% of the total assets is represented by any two investments;
- No more than 80% of the total assets is represented by any three investments; and
- No more than 90% of the total assets is represented by any four investments.

Thus, the minimum number of lower-tier partnerships would be 5, each of which holds 20% of the fund-of-fund's assets. However, the common law ownership rules require that the fund-of-fund's manager exercise discretion and move money periodically among the funds. Therefore, the minimum safe number is probably 8 to 10 lower-tier partnerships.

However, if the fund-of-funds wants to put more than, say, 55% of its assets with one lower-tier manager, it can do so in a managed account or in a wholly-owned LLC in which the lower-tier manager may be the managing member without an equity interest. In these structures, the investments made by the lower-tier manager for the fund-of-funds would be counted for purposes of the diversification tests. Because these structures would take up one of the 14 client "slots" available to a manager registered under the Investment Advisor Act, such a lower-tier manager's willingness to implement these structures may depend in part upon the amount of assets involved and the number of his open slots.

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