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INVESTMENT MANAGEMENT & ESTATE PLANNING

Why Make Your Next Venture Capital Investment Through a Life Insurance Policy?

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For more than a decade, clients have been "wrapping" hedge fund investments inside of Private Placement Life Insurance ("PPLI") policies as a way to take advantage of the tax free build up of investment income and gains inside of a life insurance policy. Similar products have targeted other kinds of investment assets, such as private equity transactions. What many planners have overlooked is that the same tax concepts which permit the wrapping of these investments also apply to other income generating activities, including successful venture capital investments. For years high level insurance brokerages firms, working with major U.S. life insurance companies, have negotiated tailored policies to permit the client's investment advisors to choose and manage the investments, including targeted, client specific investments, such as venture capital opportunities favored by the client. As the market has become more competitive, the overall insurance "drag" to the client is approaching 1.25% per year of the policy asset value.

A common situation involves young, wealthy clients who have made their first fortune, and have enough existing wealth that any newly created wealth need not be available for their consumption. These clients have done the range of traditional income and estate planning, but are left with a still growing estate, a distaste for more taxes, and most importantly, a continuing urge to create new wealth – but this time through targeted venture capital investments. The untapped investment features of PPLI policies now become attractive.

Carefully structured and implemented, a PPLI policy can make that venture capital investment which pursues the client's new ideas while generating tax free growth inside the PPLI policy. The client can layer the traditional estate tax planning for life insurance policies over the imbedded income tax planning.

If a U.S. business will be involved, a U.S. life insurance company (or a foreign life insurance company that has made a 953(d) election to be taxed as a U.S. life insurance company) can be used to design and implement a PPLI policy. A foreign life insurance carrier can be used for foreign businesses.

In a typical structure, the client creates and funds an Irrevocable Life Insurance Trust ("ILIT") designed for the client's estate planning goals, and the ILIT then purchases a variable life insurance policy on a targeted life – which could be the client, their spouse, both of them, their children, their parents, etc. The ILIT trustee and their legal counsel then work with the insurance company to structure a properly diversified segregated asset account which permits investments into new business opportunities selected by the independent investment advisor of the policy (who is appointed by the ILIT trustee). The amount of, and mechanisms for, the ILIT funding, whether by gifts, loans or otherwise, involve the same analysis as with any other ILIT funding.

Once the PPLI policy is in place, the investment advisor examines and chooses to invest a portion of the policy assets into one or more venture capital ideas. For example, the investment might be made into a start up technology company which focuses on concepts familiar to the client and brings together the same or similar talent that the client would have invested in outside the PPLI policy. Once there is sufficient policy liquidity and equity (whether by funding or internal build up), a PPLI policy could broaden its investments into quasi-captive casualty insurance companies that underwrite the business insurance risks, perhaps on an excess risk basis, of these venture capital businesses and maybe other businesses.

Care needs to be taken to avoid the presence of "investor control" and in many cases this is a stumbling block given the control desires of wealthy clients. But, in many situations

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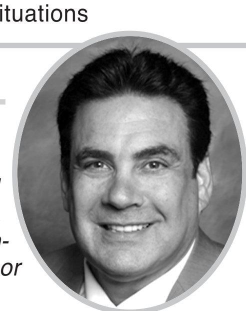

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these days, an independent team separate and apart from the client is much more important to the success of the venture than the particular involvement of the client. In this sense, the client is already functioning as an angel investor instead of as an investor, and these activities can be conducted through a PPLI policy without the need for client control.

The types of venture capital businesses that can be owned inside a PPLI policy are virtually unlimited. The practical limits are the client's willingness to follow the investor control rules, and the income and gift tax issues associated with funding the policy.

Multiple PPLI policies on various lives can be used to own different businesses, to diversify the ownership of a particular business, and to stagger the roll out of the eventual death benefits among the family and trusts. Carefully planned, the client's adult children can become involved in the PPLI policy owned businesses.

The complications to be expected with implementing venture capital business ownership inside a PPLI policy include demonstrating to the insurance company that the business will be a validly operated business independent from the client, that the business is capable of being both valued regularly and liquidated in the event the insured dies, and that the business will be properly operated and segregated from the insurance company for legal liability purposes. Each of these issues presents significant hurdles but with a motivated client who is willing to take the time and follow the rules, all of these can be resolved.

As one might imagine, the venture capital ideas of our clients have and will continue to generate long and sizable cash flow streams all of which could build up tax free inside a PPLI policy. Better yet, if the business strikes it rich, or an exit strategy is realized, all of the gain could be realized tax free inside by the PPLI policy. Time to expand horizons?