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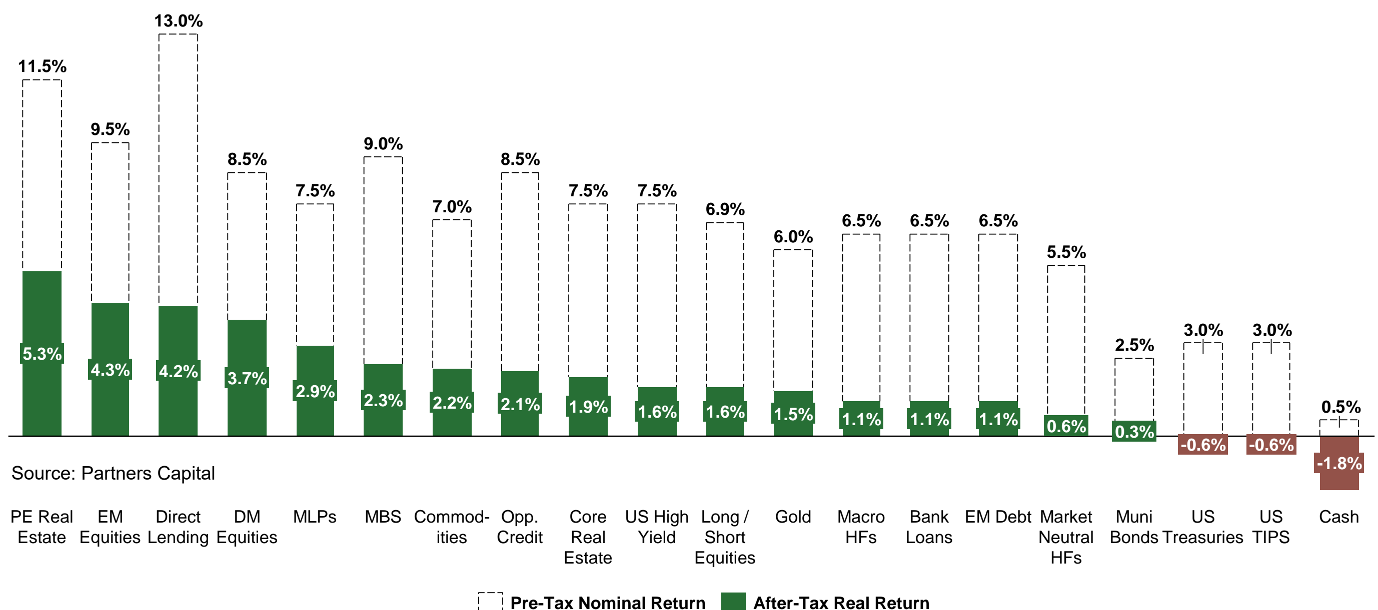
Tax-Advantaged Investing for Private Equity Managing Directors In this quarter's issue, we explore how the right investment structures and portfolio construction can materially reduce tax drag and improve long-term investment returns. Since publishing our last issue of *Personal Account Investing*, the January 2nd budget bill has taken the maximum federal ordinary income tax rate up from 35.0% to 43.4% and long-term capital gains taxes from 15.0% to 23.8% including the Medicare tax increase to 3.8%. State and local taxes are also expected to rise as states and municipalities face their own fiscal challenges. Overlaying these changes are lower expected investment returns, putting tax-advantaged investment structures and tax-sensitive portfolio construction back on center stage. Exhibit 1 is an updated version of our estimates of after-tax asset class returns reflecting the new tax regime in place today.

Exhibit 1. Three-Year Annual Return Forecast by Asset Class (Sorted By Projected After-Tax Real Return)



Notes: After-tax real returns for a New York state resident assuming top marginal federal tax rate of 43.4% and 23.8% tax on long-term capital gains (based on legislated rates from American Tax Relief Act of 2012). Assumed state tax rates for New York are current 8.8% rate on income and long-term capital gains. Real returns based on expected annual inflation of 2.0%.

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not reliable indicator of future performance.

Broadly, there are three ways to reduce tax drag on investment returns: (1) avoid asset classes and strategies that are inherently tax-inefficient – generally those that predominantly generate ordinary income or short-term capital gains like most credit, hedged equity and absolute return strategies, (2) allocate to tax-favored strategies such as energy master limited partnerships, or (3) invest in tax-inefficient strategies via structures that allow for the avoidance of taxes, such as Insurance Dedicated Funds ("IDFs"), which are funds that accept subscriptions only from life insurance carriers). The challenge with the first and second courses of action is that they can result in a failure to capture the full benefits of a well-balanced diversification across asset classes that takes into account each asset class's stand-alone attractiveness and such factors as correlation with other asset classes and strategies. The third alternative, using an IDF structure, enables the investor to build more efficiently diversified portfolios without the tax drag that would otherwise outweigh the diversification benefits.

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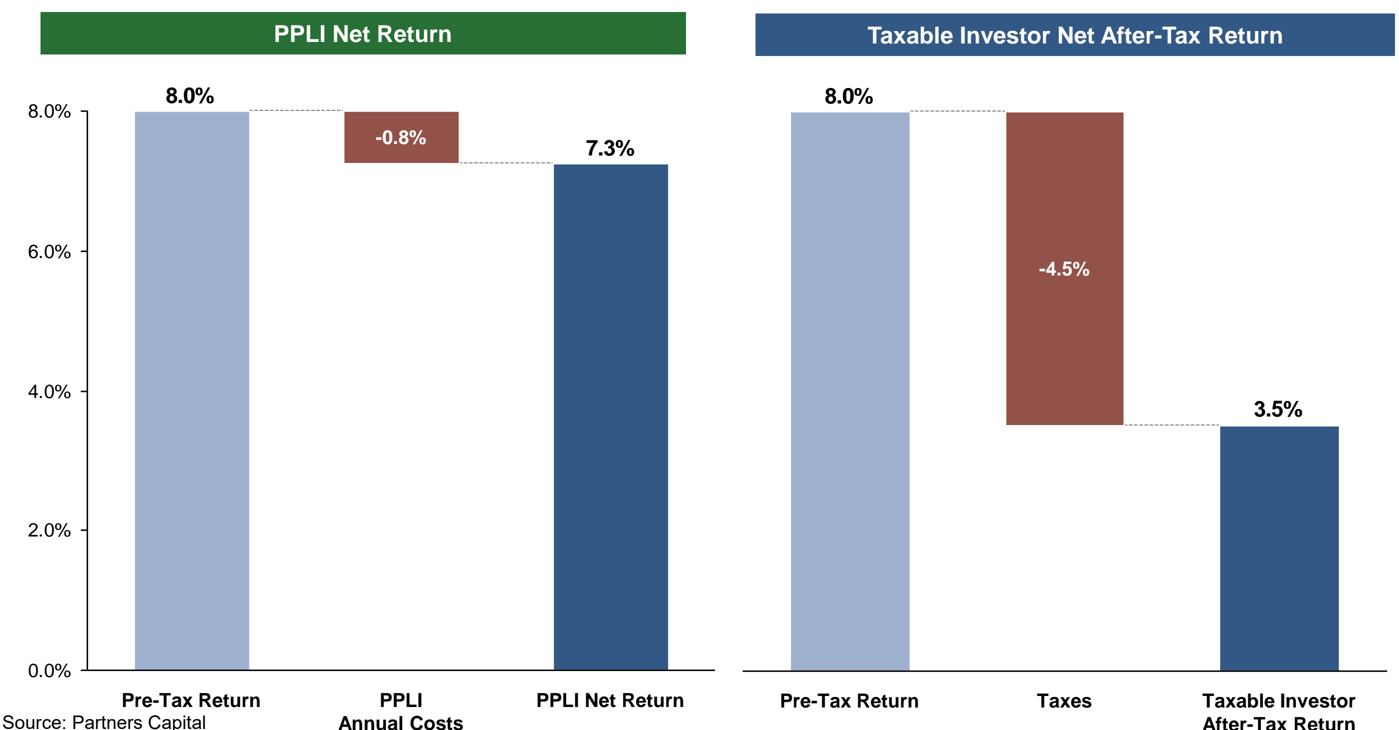
There are two primary insurance products for investing in IDFs: Private Placement Life Insurance (PPLI) and Private Placement Annuities (PPA). PPLI is, in essence, an investment program wrapped with life insurance with the end result of allowing your investments to compound free of taxes on capital gains and income and then to be distributed to your beneficiaries free of these taxes upon death. If properly structured with a trust owning the policy, the value of this account may be distributed free of estate taxes as well. PPLI provides a life insurance pay-out on death. There is an upward limit on funding a PPLI policy which depends on how much mortality risk the carrier and re-insurers are prepared to assume. IDF managers seek to optimize the favorable tax impact of IDF structures by allocating to less tax-efficient strategies. Hence PPLI (and PPA) policies can be viewed as asset allocation tools through which an insured investor gains desired exposure to attractive but tax inefficient strategies via the IDF in which the policy is invested.

A Private Placement Annuity (PPA) is a contract between the policyholder and insurance company to pay an annuity to the policyholder. With PPA, your investment compounds free of taxes on capital gains and income; however, investment gains are taxed as ordinary income upon withdrawal of the annuity unless a charitable organization is designated as the beneficiary of the annuity, in which case the investment value of the policy should be transferrable to the charitable organization income tax-free. Unlike PPLI, PPA does not have any life insurance component, and there is no upward limit on how much funding can be placed in the policy. While a PPA policy does not provide a death benefit, it is simpler to set up and less expensive (no cost of mortality risk) than a PPLI policy.

We estimate that the after-tax return of a PPLI account can exceed a taxable portfolio return by 2-4% annually assuming 8-10% average annual net returns. Exhibit 2 shows the tax savings that can be captured with a PPLI policy.

Exhibit 2. Comparison of Annual Net Returns Inside a PPLI Policy vs. Traditional Taxable Investing.



Source: Partners Capital

Notes: Taxable portfolio assumes the investor is a NYC resident (~56% tax rate) with all short term capital gains and 75% portfolio turnover. Annual costs for PPLI are estimated and do not include upfront costs. This material contains hypothetical or simulated performance results which have certain inherent limitations.

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not reliable indicator of future performance.

When setting-up a PPLI policy the insured is both procuring life insurance and establishing a separate investment account within the policy. At death, the insured's beneficiaries receive both the insurance

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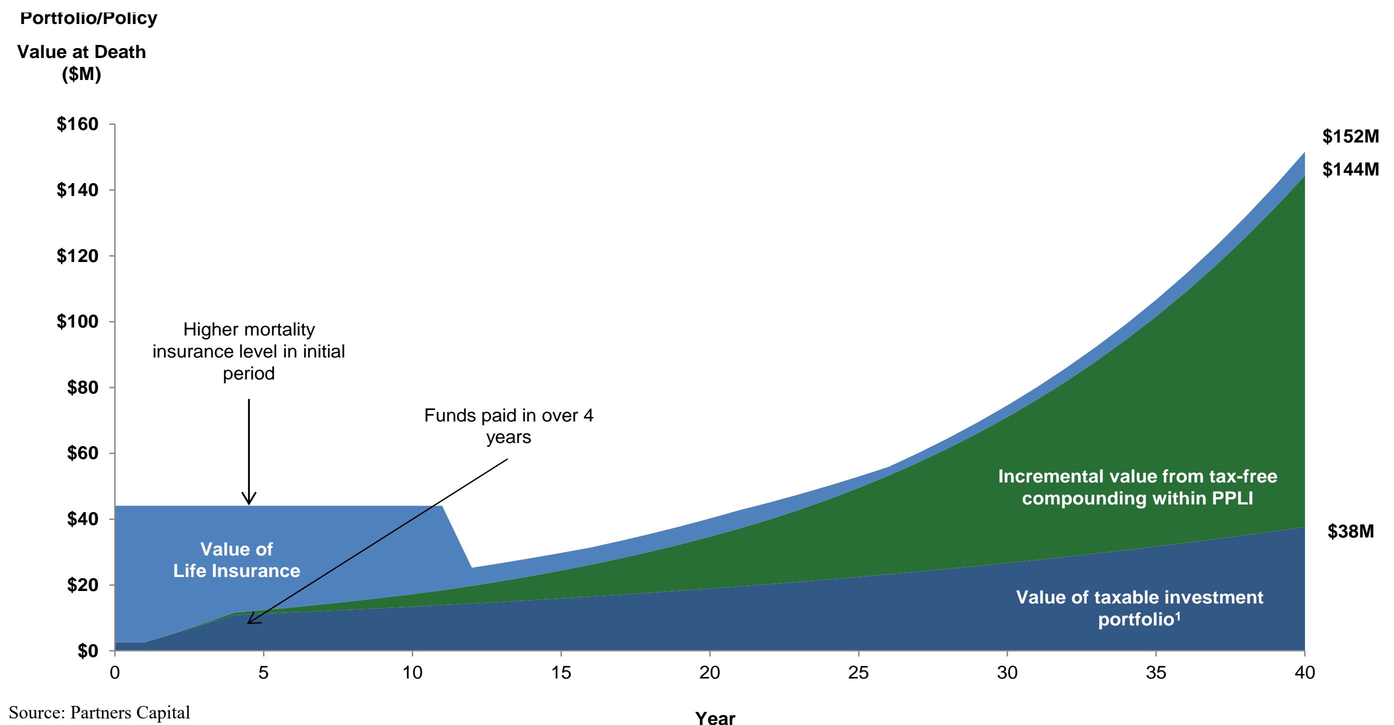
proceeds (death benefit) and the balance in the investment account. The death benefit will be larger in the earlier years and, assuming accumulation of investment returns in the separate account over time, the investment account balance will be the larger source of funds to the beneficiaries in later years.

In most PPLI policies, the life insurance component is deliberately reduced over time as the investment account becomes the larger source of benefits at the insured's death. See Exhibit 3 for an illustration of the relationship between the value of the life insurance component and the investment account component in a PPLI policy.

Exhibit 3. Illustrative Long-Term Returns From Investing Through An IDF.



Source: Partners Capital

Notes: Illustrative returns based on Partners Capital model, which contains hypothetical or simulated performance results which have certain inherent limitations. Assumes $10 million in premium paid over four years by a 50 year old male preferred non-smoker. +8.0% net investment return; estimated ~56% New York City resident tax bracket. Taxable portfolio assumes all capital gains are short term and 75% turnover.

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not reliable indicator of future performance.

IDF structures have been available for a many years through various insurance carriers and brokers. However, they have been of limited interest to sophisticated investors because the insurance-related costs have been prohibitive and the quality of underlying investment offerings has often been mediocre. More recently, both of these concerns have been largely addressed. At sufficient scale, insurance carriers and brokers now offer institutional pricing for PPLI and PPA, and carriers will place IDFs managed by independent investment managers on their platforms, improving the quality of available investment offerings.

PPLI and PPA policies are set up as separately managed investment accounts, and are therefore shielded from the carrier's credit risk. Carriers now typically offer several independently managed IDFs and the policy holder chooses the IDF to which his or her policy premiums are allocated and should have visibility on the managers within the IDF. It is important to note that the key constraint imposed by the IRS on PPLI and PPA policies is that the investor/insured cannot control or influence the selection of investments inside the IDF. Accordingly, partners in an investment firm should not utilize an IDF which is managed by their own firm.

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Like all investing based on tax policy, there are disadvantages as well as advantages to investing through a PPLI policy. Against the advantages spelled out above, PPLI incurs a 1% up-front federal and additional variable state tax on the insurance premiums paid. The insurance carriers and insurance brokers charge fees and commissions (which have declined in recent years). The full benefits are derived only if the policy is maintained until the insured's death. Exhibit 4 summarises the advantages and disadvantages. Exhibit 5 describes certain risks associated with PPLI and PPA.

The ability to withdraw principal or borrow from or against the policy investment account is a key feature of PPLI. An insured may withdraw his or her premium paid into the PPLI policy tax-free. In addition, the insured may arrange a loan from the policy (up to 90% of the investment account balance) or from a third party secured by the policy (subject to loan-to-value limitations, usually up to 50%). If the insured needs full liquidity, the policy may be surrendered, but at that point gains will be taxed at ordinary rates (which would likely have been the case anyway assuming the assets in the policy generally produce either ordinary income or short-term capital gains) and the life insurance component of the policy will be lost. If the insured has not held the policy for more than 11 years and is under the age of 59 ½, the net investment gains may be subject to a 10% penalty. (In PPA, there is also a 10% penalty on net investment gains withdrawn before the annuitant is 59 ½, but there is no requirement to hold the policy for 11 years.)

Exhibit 4. Selected Advantages & Disadvantages of PPLI

Advantages

- Tax-free compounding of investment returns under current I.R.S. code.
- Income tax-free death benefit (investment value of the policy may transfer to beneficiaries free of 30-50% income tax). If properly structured, the death benefit may also be distributed free of estate taxes.
- Ability to access capital through withdrawal of original premium amount without crystallizing a tax liability.
- Ability to borrow up to 90% of the investment value of the policy from the carrier or, alternatively, ability to borrow up to 50% of the investment value from a third party lender using the policy as collateral.
- Simplification of tax reporting (e.g., no K-1s).

Disadvantages

- Upfront costs (federal and state premium taxes, and any upfront broker commissions).
- Annual costs (cost of insurance, insurance carrier margin and any trailing broker commissions).
- Reduced control for investor - the insured is not permitted to direct the investment program.
- Generally suitable only for investors with a longer-term timeframe - maximum tax benefits come if policy is held until death.

Source: Partners Capital

To set up a PPLI or PPA policy an insured must work with a FINRA (The Financial Industry Regulatory Authority) qualified insurance broker, and select an insurance carrier that offers PPLI and PPA and one or more Insurance Dedicated Funds into which the insured's net premiums can be invested. The broker should facilitate all the arrangements with the carrier. There are several national providers of IDFs and the carrier will advise which IDFs it offers on its platform.

Please let me know if you have any questions, comments or suggested topics for future newsletters.

Best regards.

Paul Dimitruk
Chairman & Partner

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APPENDIX

Exhibit 5. Selected Key Risks of PPLI and PPA

Risk	Details
Change of Law or Regulation Potentially Eliminating Tax Benefits	Congress could eliminate or limit the tax-free treatment of investment returns in PPLI and PPA policies. However, life insurance has always been viewed as a favored means to encourage the middle class to build savings and the life insurance lobby remains exceedingly strong. Moreover, it is unlikely that this change would be given retrospective effect. The IRS could change the tax–free treatment of loans from policies, but similarly this is highly unlikely to penalize pre-existing loans, and the insured could still borrow from a third party using the policy as collateral.
Insolvency of Carrier	In the event of carrier insolvency, the investment value of the policy is not at risk as it is held in a segregated account. The mortality based benefit (life insurance component) is potentially at risk, but this risk can normally be avoided through a IRS Sec. 1035 Insurance Exchange with another carrier.
Investor Control	The key IRS requirement to preserve the tax-advantaged status of PPLI and PPA is that the policyholder does not control or direct the investment program. Evidence of investor control or direction may jeopardize the tax-free status of the policy. For this reason, the investment manager of the IDF must have full discretion over the IDF portfolio.

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