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Selected Insurance and International Tax Considerations for Investors in Life Settlement Businesses

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The life settlement industry continues to evolve. Certainly, for life insurance contract owners who have an immediate need for cash or no longer have a reason to maintain their policies, selling their policies to investors who are willing to pay more than a contract's cash value represents an alternative to surrendering a contract or taking out policy loans.[1] And, for investors who can develop reliable actuarial models and establish long-term business processes, this option presents a means of diversifying a portfolio with noncorrelated assets.

At the same time, the nature of this business, in which investors seek to profit purely from the poor mortality experience of selected insureds, has caused some to question whether the underlying concept of the life settlement industry comports with notions of insurable interest. Even though the industry responds to an identified need, some of these concerns have been exacerbated as the result of practices that have developed in which some investors seek to "create inventory" by facilitating the initial purchase of life insurance contracts by unrelated parties. In those cases, the general expectation is that the unrelated insured will transfer the policy to the investor when the contract contestability period terminates.[2]

In addition, the secondary market for life insurance has not yet matured, resulting in instances of inefficient pricing. Moreover, while pricing will typically reflect the investor's desired return, selling policyholders often will not factor in the intangible value of a policy to his or her beneficiaries. Both of these factors have resulted in concerns that, in some circumstances, policyholders may sell their contracts for less than their true value.

Industry participants reconcile many of these concerns about the business itself by relying on state licensing and other regulatory oversight that seek to ensure consumer protection. So, even though issues continue to be raised in this arena, and there remain several practical barriers to entry, it is a business that has been growing exponentially. In fact, billions of dollars continue to be made available by investors from all over the world who are looking to acquire existing U.S. life insurance contracts.[3]

Despite the number of willing investors and the frequency with which these transactions are occurring, no "cookie cutter" transaction type, or business structure, is predominant in the industry. That is, there is a variety of participants in terms of form of entity, domestic and foreign locale, degrees of active participation in the operation of the "business," sophistication and needs as to actuarial and business modeling, and expectations regarding buying and holding and securitizing the policies.

Among the more significant drivers of the variation in the structuring, however, is a given investor's identification and understanding of the numerous tax issues that are potentially involved.

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A Round Business in a Square Tax Code

Many of these issues surface because the Internal Revenue Code arguably was not crafted in contemplation of a business involving the trading of existing life insurance policies. That is, there are rules in place that are designed to prevent perceived abuses relative to the original purchase and ownership of life insurance policies by individuals and businesses that are generally able to defer or otherwise exclude income from their contracts; *e.g.*, the interest deduction limitation rules set forth in section 264.[4] Yet, it is questionable how, if not whether, many of these rules should be applied in the context of a business operating in a secondary market in which the income from death benefits is generally subject to tax.

For example, the general rules governing the purchase, holding and maturity of a life insurance contract provide for the deferral of income attributable to cash value buildup in a policy. Lifetime distributions of cash value are subject to tax only to the extent that the amount actually received by the policyholder under the contract exceeds the amount paid for the contract.[5] Amounts received upon the death of the insured are excludable from income altogether,[6] unless the contract had previously been the subject of a transfer for value.[7] In the latter case, only the portion of the death benefit that reflects the "cost" of the contract to the policyholder would be excluded from taxable income.[8]

Premiums paid for a contract generally may not be deducted from taxable income.[9] Moreover, except in some very limited circumstances, policyholders may not deduct interest paid in connection with a loan incurred with respect to the policy.[10] These rules reflect an attempt by Congress to limit taxpayers' ability to deduct amounts incurred in connection with the generation of tax-deferred or tax-free income.

In the case of a life settlement business, all the policies are acquired in a purchase transaction that is subject to the above transfer for value rule.[11] Hence, all the income in excess of the cost of the policies is includible in taxable income. In addition, the policies acquired in a life settlement transaction are typically managed in such a way as to keep the cash values in the policies as low as possible without causing the contract to lapse. That being the case, the rationale for the above rules limiting the deductibility of interest is arguably diminished in this context. Nevertheless, one could likely anticipate that there would be a challenge to a position that the interest deduction limitation rules do not apply. Contrast this with a business involving some other form of taxable investment, in which case there would be no general prohibition on the deductibility of interest.

Thus, to the extent that a life settlement business model involves the use of debt to fund the purchase and maintenance of policies, which many of them do, the associated interest expense will likely not be deductible. On the other hand, the transfer for value rule, referred to above, permits the policyholder to include in the cost of the policy that may be excluded from income, interest expense that was otherwise disallowed as a current deduction. In effect, the policyholder may capitalize, rather than currently deduct, this otherwise disallowed interest expense for the purpose of measuring the taxable portion of death proceeds.

This capitalization-type rule for interest expense is specifically available with respect to contracts issued after June 8, 1996.

It should also be noted that, in the event a death benefit is received under a contract, it would be reasonable to assume that the portion of the overall interest expense that may be included in the cost of the contract is limited to the amount of interest paid in connection with that particular policy. As such, in the event that an entity receives taxable income upon the death of an insured, and covenants in a loan agreement require payments of cash receipts to be applied first towards the paydown of loan principal (which is a fairly common requirement), it is possible that the entity will have taxable income, but no cash to pay the tax.

Another practical issue here is how the entity's aggregate debt should be allocated to each policy, particularly if borrowed funds are used to finance other aspects of the business.

Uncertainty also reigns in this arena as a result of what it appears the Internal Revenue Service (IRS or Service) believes to be a difference between the concepts of investment in the contract and basis. As noted above, investment in the contract is essentially equal to the premiums and other consideration paid for a contract less amounts received under the contract that were not included in taxable income.[12] This concept is used for measuring the portion of lifetime distributions from a contract that are excludable from taxable income; and hence, gains that must be included.

The transfer for value rules base the cost that may be excluded from income upon the receipt of taxable death benefits on the consideration, premiums, and other amounts paid for a contract.

In LTR 9443020, however, the IRS took the position that the adjusted basis of a life insurance contract sold by an individual insured to a viatical settlement company[13] must be reduced by the sum of the cost of insurance protection provided under the contract.[14] It is unclear whether the IRS would require a similar reduction in basis for a life settlement company as it mandated in LTR 9443020 for an original purchaser. In any event, it would appear that such position is not consistent with the "basis-type" notions set forth under the Code provisions for measuring gain from a contract that do not require any reduction for incurred costs of insurance. It also appears to be a tenuous position in light of several judicial authorities that arguably rebut the early 1900s case law on which the IRS relied in rendering LTR 9443020.

This issue is less important for a life settlement company that intends to hold all of its contracts until maturity, but it is meaningful for those entities that re-sell policies. To that end, it is also important to note that the rule that deals with the capitalization of disallowed interest under the transfer for value rule applies in the case of amounts received upon the death of an insured.

The provision, however, does not state that it also applies in the case of a sale of a contract. In the 1994 letter ruling, the IRS recognized a distinction between amounts received upon the death of an insured and the proceeds of a sale. To sustain an argument that the disallowed interest should be capitalized in a future sale, one would likely need to develop a position based on general tax principles, as opposed to the specific insurance tax rules.

Another key issue for investors is whether amounts received upon the death of an insured, as well as amounts received upon the re-sale of a policy, should be treated as ordinary or capital income. The weight of authority would appear to suggest that amounts received upon the death of an insured is ordinary income. Capital treatment would require the sale or exchange of a capital asset. Although an insurance policy represents a capital asset, one would nevertheless need to demonstrate that a payment of a death claim via operation of the contract is a sale or exchange.[15]

In the event of the sale of a contract, assignment-of-income theorists might posit that at least a portion of the sales price is for the cash value account that transfers with the policy. The portion of the cash value that exceeds the policyholder's investment in the contract, if withdrawn from the policy, would be subject to tax as ordinary income. On the other hand, it may be possible to support capital gain treatment for the portion of the re-sale price that exceeds the cash value.

To sustain an argument that the disallowed interest should be capitalized in a future sale, one would likely need to develop a position based on general tax principles, as opposed to the specific insurance tax rules.

What if there is a loss? Over the years, IRS employees have made public statements—though not in formal guidance—that one cannot recognize a loss with respect to a life insurance contract. In their comments, they stated that the position assumes that the acquisition of a life insurance contract is a personal expense. A life settlement company could suffer a loss on a contract as the result of a re-sale, a contract surrender or an insured who lives beyond his or her life expectancy. It is not clear whether the IRS would seek to deny a life settlement company the ability to recognize a loss under any of these circumstances.

The above items represent just a few of the many domestic tax issues that add an element of uncertainty to the life settlement arena. Because, in many cases, these items could have a significant impact on the economics of a life settlement business, many domestic and foreign investors seek to set up structures in offshore jurisdictions where the computation of taxable income is less complex and does not involve limitations on the current deductibility of interest, premiums, and other expenditures that may be disallowed or capitalized under U.S. tax law.

Sailing Away

Certainly, as is the case with investments in any type of asset in an offshore vehicle, among the biggest considerations of foreign investors, as well as domestic investors setting up offshore entities, are their exposure to U.S. and foreign withholding taxes, and, depending on the ju-

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risdiction, different treaty and other rules that might be involved; as well as differing tax rates and means of determining taxable income.

Foreign Investors

In conducting this type of planning, foreign investors will first need to determine which tax regime will apply. For example, if the income to be generated is deemed to be business income, and the business is conducted in the United States, tax will be imposed on net income that is sourced in the United States and will be calculated under the same general tax rules that are applicable to domestic taxpayers on their U.S. income.

More precisely, a foreign entity doing business in the United States is subject to U.S. tax on net income effectively connected with the conduct of this trade or business in the United States. The effectively connected net income will be subject to tax at graduated rates up to the highest federal corporate tax rate of 35 percent.[16]

If the business income is foreign source, it would generally not be taxable under U.S. tax rules.[17]

If the business is not conducted in the United States, but the income has a U.S. source, then there could be a 30 percent withholding tax on amounts distributed from the United States to a foreign jurisdiction.[18] Similarly, if the income is deemed to be investment income, as opposed to business income, the income would be subject to a 30 percent withholding tax if the income is considered to be "fixed or determinable annual or periodical gains, profits and income" (FDAP) and the income is considered U.S. source.[19]

The presence of a tax treaty between the United States and the foreign jurisdiction, and the terms of that treaty, could also have an impact on the taxation of the income; *i.e.*, whether the U.S. tax rules will apply to the calculation of income and, if not, whether the income will be subject to withholding.

If the income is investment income, it could qualify for lower withholding rates under the relevant treaty. In the context of a life settlement transaction, this could occur, for example, if the death benefits fit within a treaty's "other income" article. In many (but not all) cases, only the residence country is allowed to tax income not otherwise covered by the treaty.

To summarize, among the key factors in determining the taxation of a life settlement business involving foreign investors are: where the income is sourced; whether the income is business income or investment income; and whether the structure involves payments into a jurisdiction with which the United States has a tax treaty and, if so, whether that treaty provides relief from the normal U.S. tax rules.

A taxpayer is concerned about these issues as they will determine the tax rates, if any, that the income will be subject to, the manner in which taxable income will be determined, the timing in which the income will be includible in taxable income, and whether distributions of cash will be subject to withholding.

Several books can be written on each of the above concepts—and many already have been—but there are a number of additional issues that must be managed in the context of a life settlement arrangement involving a foreign entity.

For example, the question of where income is sourced is not so simple as merely looking at where a life insurance policy or the issuing insurance company is located. Rather, one may be required to look at the type of income that is being paid. For example, the source may be deemed to be different depending on whether the subject income involves the payment of a death benefit, a distribution during the lifetime of the insured, or the proceeds of a re-sale. Of these types of income, most pertinent in the case of life settlement companies is the characterization of death benefits for this purpose.

Section 865(a) provides that gain from the sale of personal property by a nonresident shall be sourced outside the United States. The term "sale" includes "an exchange or *any other disposition*."[20] Thus, if a life insurance policy is deemed to constitute personal property, [21] the payment of death benefits on a life insurance policy is a "disposition" of personal property. And, if section 865(e)[22] is inapplicable, then one could argue that the gain ought to be treated as foreign-source income in the hands of a foreign entity.

Support for treatment of the payment of death benefits as a disposition of a policy can potentially be found in various authorities interpreting section 1001, which provides rules for computing gain from the sale, exchange, or other disposition of property,[23] as well as common definitions of the term "disposition." A counterargument could be made, however, that relies on one of two revenue rulings that considered payments out of insurance contracts to be FDAP that is subject to 30 percent withholding.

As a preliminary matter, it should be noted that the domestic trade or business concept is roughly parallel to the treaty trade or business concept.

The first of the rulings, Revenue Ruling 64-51, did not deal with the section 865 source question, as that section had not yet been enacted. In any event, the facts set forth in the ruling contained an assumption that the income was U.S. source.

The second ruling, Revenue Ruling 2004-75, found that payments of cash value on surrender were FDAP for withholding purposes. It did not, however, address payments of death benefits.

In reaching its conclusion, the ruling analogized the cash value surrender payments to interest and dividends, and hence arguably reached the correct result. Mortality payments, however, are not as closely aligned to the investment nature of distributed cash value.

Even if the above rulings had addressed the issue, it is not certain that they would have concluded that death benefits constituted FDAP. That is, regulations provide a description of items of income that are not FDAP.[24] This provision states that "Gains derived from the sale of property" are not FDAP. The preamble to these regulations provides that "the IRS and the Treasury believe that the statute contemplates very few exceptions to the concept of FDAP, and the only clear exception is for gain from the disposition of property."[25]

For reasons similar to those discussed above relative to section 865, one could also argue that the payment of death proceeds is a disposition and hence is not included in the definition of FDAP. In light of the holding in Revenue Ruling 2004-75, however, it is less clear whether one could sustain such an argument relative to the portion of a death benefit payment that reflects the cash value at the time of the death claim.

As discussed above, another key issue is whether the activities are an investment activity or a business. As further discussed, if it is an investment activity, regardless of how actively it must be managed, the withholding tax regime would apply. This is significant in this context, as the operation of a life settlement business requires active participation in the identification, acquisition, and administration of each individual contract.

If it is a business activity, then the question is whether the income is effectively connected with the conduct of a U.S. trade or business and whether it qualifies as business profits under a treaty.

A foreign entity will be subject to U.S. tax, as though it were a domestic company, on income that is effectively connected with the conduct of its U.S. trade or business.[26] Thus, the initial question becomes whether the entity is engaged in the conduct of a U.S. trade or business. Adding to the complexity is the fact that there is no comprehensive definition of the term "trade or business," even in the domestic context. The relevant concepts have evolved judicially in the course of cases with many different fact patterns. In general, however, a trade or business entails a profit-oriented, non-investment activity that is regular, continuous, and considerable.[27]

Under this vague standard, various cases and rulings have held that even sporadic or isolated activity in the United States is sufficient to cause a foreign entity to be treated as conducting a U.S. trade or business.[28] This is particularly true when the foreign entity is engaged in a trade or business outside the United States.

As a preliminary matter, it should be noted that the domestic trade or business concept is roughly parallel to the treaty trade or business concept. In a non-treaty scenario, however, U.S. tax is only imposed if the income is effectively connected to a U.S. trade or business. In the treaty context, it is imposed only if the income is attributable to a permanent establishment. [29]

Domestic Investors

Domestic investors will generally be able to defer their recognition of income from an investment in an offshore vehicle unless the entity is characterized as a controlled foreign corporation (CFC). A CFC is an entity in which more than 50 percent of either the combined voting power of all classes of stock or the total value of the stock is held by U.S. shareholders for one or more days during the taxable year. If the entity is a CFC, then each of the U.S. shareholders that owns 10 percent or more of the CFC

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stock will be subject to current tax on its share of "Subpart F income" regardless of whether the income is distributed. The amount to be recognized will be characterized as a deemed dividend.

Those U.S. shareholders that own less than 10 percent of the stock will also be subject to tax if the foreign entity is a passive foreign investment company (PFIC).

Subpart F income is comprised of two broad classes: income from the insurance of U.S. risks and foreign base company income. In the case of a life settlement business, the first category does not apply, but the latter category may. Foreign base company income is further categorized into five different general classes, with the only potentially relevant class being foreign personal holding company income (FPHCI). FPHCI is composed of several specifically identified types of passive income; *e.g.*, rents, dividends, interest, royalties, annuities, and a number of other listed items, including "income equivalent to interest."

Regulations under these rules state that income equivalent to interest includes investments in which the return predominantly reflects the time value of money; arrangements that involve compensation for the use or forbearance of money but that are not treated as interest; and other items.

Death benefits from an insurance contract are not one of the listed items of FPHCI, and they have not been specified in the items listed in the regulations. The question has been raised, however, as to whether a death benefit is "income equivalent to interest."

A death benefit is a payment based on the mortality of the covered individual. Although premium amounts paid to an insurance company may reflect, to an extent, the insurance company's investment return based on a time horizon that considers the insured's life expectancy, they represent only one component of the "return" that is promised to the policyholder.

The IRS addressed this issue, as well as the question of whether amounts received upon a surrender of a contract constitute income equivalent to interest. In Field Service Advice Memorandum (FSA) 199950006, the IRS said that neither death benefits nor amounts received upon a surrender are income equivalent to interest. As set forth in the FSA:

> Death benefits are not compensation for the use or forbearance of money and do not reflect the time value of money. Consequently, they are not interest income;…
>
> [S]urrender withdrawals are not interest income (or the equivalent thereof) . . . because they were not compensation for the use or forbearance of money…

Death benefits do not appear to fit within any of the other categories of FPHCI, unless they are gain from the sale of property that does not give rise to any income. The regulations are quite broad, covering the sale or exchange of any property unless excluded (and life insurance policies are not excluded). This regulation is arguably too broad, and, even if applicable to a sale of the policy prior to death, it may not apply to the payment of death benefits at death. Therefore, it would appear that absent further guidance to the contrary, one could reasonably argue that death benefits will not result in the creation of foreign base company income.

If at least 75 percent or more of a foreign entity's income is passive income, or 50 percent or more of its assets are held for the product of passive income, a company will be characterized as a passive foreign investment company. The determination as to whether income will be deemed to be passive for this purpose depends on whether the income would be FPHCI. As set forth in section 1297, "passive income" is "any income which is of a type which would be foreign passive holding company income."

As such, if death benefits, or even cash value build-up, are not characterized as FPHCI, then the entity will not likely be treated as a PFIC provided the policies are intended to be held to maturity (although it could be if the policies are held for sale).

Conclusion

Because the life settlement industry is relatively new, there has likely been little of the IRS audit activity that would cause a brighter light to shine on many of the issues discussed above. There are indications, however, that the IRS has recently been studying the various types of life settlement transactions and structures. Perhaps, in the not too distant future, taxpayers will be able to see IRS guidance on at least some of these issues.

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End Notes

[1] Investors are willing to pay more than cash value, as the return they expect is based on assumptions regarding a contract's maturity that were not reflected in the initial pricing of the policy. The price they are willing to pay is typically based on a discounted value of the death benefit claim that is expected to occur earlier than was originally anticipated by the issuing life insurance company. This circumstance might occur, for example, if an insured suffers a health issue that did not exist at the time the policy was issued by the insurance company.

[2] This outgrowth of the life settlement industry is often referred to as "stranger-owned life insurance." While there is no uniform use of the term, the practice described above is sometimes referred to as "premium financing."

[3] U.S. contracts are particularly attractive because of the requirement that such contracts contain a meaningful net amount at risk above the amount of the contract's cash value. This net amount at risk is the subject of the "arbitrage" that the investors attempt to undertake through their purchase of the policies.

[4] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (Code).

[5] Section 72. More precisely, policyholders are not subject to tax on returns of their "investment in the contract." Such amount is essentially equal to the premiums paid into the contract less any distributions that were not included in taxable income. Lifetime distributions from life insurance contracts that are characterized as modified endowment contracts pursuant to section 7702A are subject to a different rule. Such amounts are taxed on an income-first basis.

[6] Section 101(a)(1).

[7] Section 101(a)(2). This general rule also does not apply in the case of an employer-owned life insurance policy that does not fit within one of the exceptions set forth in section 101(j).

[8] *Id.* The amount that is excluded may not exceed the value of the consideration paid for the contract plus premiums and other amounts subsequently paid by the transferee. The "other amounts" include interest payments that are disallowed as a deduction pursuant to section 264(a)(4).

[9] Section 264(a)(1).

[10] Section 264(a)(2) through (4).

[11] Some have attempted to develop a business model intended to avoid application of the transfer for value rule.

[12] Section 72.

[13] A viatical settlement company is analogous to a life settlement company in that it involves the purchase of existing life insurance contracts. The contracts that are the subject of a viatical settlement, however, involve insureds that are terminally or chronically ill.

[14] More precisely, the Service said: "The adjusted basis of Taxpayer's contract is equal to the premiums paid less the sum of (i) the cost of insurance protection provided through the date of sale and (ii) any amounts (*e.g.*, dividends) received under the contract that have not been included in gross income." Note that, although the Service cited the section 72(e) in an apparent attempt to reference the definition of investment in the contract, the ruling did not replicate the language set forth in section 72(e) that includes, in the definition, premiums and "other consideration" paid for the contract.

[15] Alternatively, one could foresee an argument being made under section 1234A that the proceeds are attributable to a "cancellation, lapse, expiration, or other termination" of a right with respect to a capital asset, and hence, subject to capital gain treatment.

[16] In addition, pursuant to section 884, a dividend equivalent branch profits tax of 30 percent can be imposed, in certain circumstances, when the profits are repatriated to the home office for redemptions or other purposes. In general, these branch taxes are intended to replicate the withholding taxes that would be imposed if a U.S. subsidiary paid dividends or interest to its foreign parent.

[17] Section 864(c).

[18] Regulation section 1.1441-2(b).

[19] IRC §881(a).

[20] IRC §865(i)(2).

[21] Life insurance has long been recognized as personal property. *See, e.g., Lucas v. Alexander*, 279 U.S. 573 (1929).

[22] Section 865(e)(2) provides that if a foreign entity maintains an office or other fixed place of business in the U.S., income from the sale of personal property attributable to such office or other fixed place of business shall be sourced in the U.S.

[23] *Helvering v. Roth*, 115 F. 2d 239 (2d Cir., 1940); *Herbert's Estate v. Commissioner*, 139 F. 2d 756 (3d Cir., 1943); *Elverson v. Commissioner*, 122 F.2d 295 (2d Cir. 1941). These cases held that when a lender receives a cash payment in extinguishment of debt, he is treated as having disposed of the property. *See also, Hatch v. Commissioner*, 190 F.2d 254 (2d Cir. 1951), which found that an employer's payment on a claim for a death benefit constituted a disposal of the claim at a profit by the deceased's beneficiary.

[24] See regulation section 1.1441-2(b)(2).

[25] TD8734, 62FR53387, October 14, 1997 at 26.

[26] IRC §864 (c).

[27] *Commissioner v. Groetzinger*, 480 U.S. 23, 27 (1987).

[28] *Johansson v. United States*, 336 F. 2d 809 (5th Cir., 1964); Rev. Rul 67-321, 1967-2. C.B. 470, Rev. Rul 70-543, 1970-2 C.B. 172.

[29] Three different tests are used to determine whether a permanent establishment exists. One test looks at the assets of an entity maintained in the treaty jurisdiction, such as a branch, an office, or a store. A second examines the acts of an agent, broker, partner, or subsidiary. The third analyzes the activities carried on by the enterprise in the treaty country. Among the factors that have been key in making the determination are the active conduct of business and continuity of activities.

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