GLOBAL PENSIONS

Shifting ground

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Andrew Walters

Andrew Walters of Assured Fund explains how the solidification of US tax laws for life settlement funds has wrong-footed fund managers

Seismic changes in the way the US tax authorities intend to tax the returns on American senior-citizen-based life settlement funds have caught many fund managers on the hop.

On May 1, the US Internal Revenue Service (IRS) issued two rulings clarifying its position on the purchase and sale of life settlements.

IRS Ruling 2009-13 discusses the tax implications for US insured’s disposing of their policies, either by surrendering them back to the issuing life office or selling them into the second-hand market.

IRS Ruling 2009-14, on the other hand, raises the issue of tax implications for purchasers of life settlement policies, who receive a benefit when the insured dies.

Background

Life settlements are second-hand life insurance policies that are sold into the second-hand market by US senior citizens for more than the surrender value but less than the face value.

Buyers of the life settlement will typically pay between 20% and 30% of the face value to the insured and then maintain the ongoing premium payments to keep the policy in force until the death of the insured – when the buyer gets the full death benefit.

The life settlement market emerged in the 1990s and has grown to be a multi-billion-dollar industry, attracting investment from the likes of Berkshire Hathaway, Deutsche Bank, Credit Suisse, JP Morgan and Goldman Sachs.

In 2007, the transaction volume was estimated at $12bn and while this may have declined of late due to the economic climate, the virtue of this alternative asset that is uncorrelated to the traditional markets has been established.

Given the large value of the policies and the need to diversify away the life expectancy risk, access to this investment is normally through offshore funds, which typically offer a return of 8% to 11% pa. However, this return has invariably been calculated as a 'mark-to-model' return – which has not taken into account the spectre of US taxation.

Previously, the tax issue was largely ignored, with many funds playing on the ambiguous nature of the tax opinions from legal counsel at the time. It would be argued that the returns from life settlements were not fixed, or determinable, or annual or periodic gains and as such did not constitute US sourced income and thus were not subject to US Withholding Tax legislation.

In May, as a result of IRS ruling 2009-14, all ambiguity was swept aside. The IRS clearly stated that where the investor is a non-US Corporation, which is not engaged in a US trade or business, purchases a life insurance policy issued by a US insurance company on a US citizen residing in the US and receives the benefit on the death of the insured, that income is US source income.

As US source income it is subject to US withholding tax at 30% on the gain made on the policy. Thus, if the face value of the policy was $100,000, for which the fund paid $20,000 to the insured to acquire the policy followed by $9,000 in premiums to keep the policy in force until the death of the insured, then $71,000 would be classified as taxable income and would be subject to US tax at 30%.

Previously the biggest risk to the return was the life expectancy of the insured. If the insured should pass away ahead of his anticipated life expectancy then the investor would receive a greater return than anticipated. If the insured lived beyond his life expectancy then there are more premium payments to be made and the returns are less than anticipated.

Now suddenly, if an insured should live longer than the quoted life expectancy the returns could very well go negative. Faced with the threat of losing their returns, there is now of course a real urgency to complete effective tax planning to protect investor interests.

The US has a number of double tax treaties with various countries, under which the US authorities will not levy any tax as the income will be taxed in foreign investors' own jurisdictions.

Thus, if a life settlement fund had investors from only one jurisdiction that had a double tax treaty with America, then there would be no US withholding tax but the fund would have to settle any local tax on that income.

However, life settlement funds are promoted worldwide and have investors from countries with double tax treaties with America and from countries that do not have such agreements.

In such a circumstance, would it be practical for the fund administrator to encourage each investor to complete a W8 BEN form declaring his residency?

Looking ahead

Following the process forward, suddenly, the US insurance company clerk is faced with the predicament of splitting the returns between taxable and non-taxable. How does the clerk know what the fund paid the insured by way of purchase price for the policy? Inevitably, he will not take that responsibility but will tax the whole face value, leaving it to the fund to argue its case later with the IRS, threatening the returns and delaying payment.

Sensibly, many funds are structuring around the problem. Their first stepping stone must be to remove the responsibility for the collection of tax away from the clerk at the insurance company to their appointees, usually a grantor trust within the US.

The trustees will receive the proceeds on any maturity on behalf of the beneficial owners that will be located within a double tax treaty territory, popular ones being Ireland or Luxembourg. The proceeds will thus be remitted from the US gross of tax.

The structuring process is not simple and must withstand scrutiny. Double-tax treaties are written to prevent clear fabrications to evade tax and thus structuring a solution can take time and money but ultimately a vehicle that leaks no tax is achievable.

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