



Introduction

May first of 2009, the Internal Revenue Service issued two Revenue Rulings that constitute the official position of the IRS on certain key tax issues in the life settlement arena. Uncertainty in this area had plagued taxpayers and tax practitioners for years. Many feared that this ruling would act as a deterrent from the asset class; however we have received increased interest from many institutional investors which had not considered life settlements as an investment option due to tax treatment ambiguity. These investors now feel comfortable that the situation is finally clear and are beginning to invest.

Most life settlement vehicles were set up prior to this clarification, and are set up in off-shore centers or via investment vehicles that cannot utilize double income tax treaties. For funds set up in this fashion, the tax clarification causes a 30% Non Resident Alien (NRA Tax) withholding tax on all maturity proceeds from policies as well the requirement to file a tax return and pay a US Federal Corporate Tax rate. This tax is not only a tremendous effect into performance, but it also creates extremely complicated issues that a fund manager must deal with. These issues include, withholding agents, actual withholding, tax returns, corporate tax payments, tax refunds, and tax credits to investors. All these actions, are not only a weight on the fund's performance, but also add significant costs in legal, tax, accounting, and simply the time value of money.

There are a couple of potential solutions to avoid the withholding of the NRA tax:

- Access to tax treaties with "Other Income" article
- Make use of a tax transparent vehicle for pooling investor's funds to invest in Life Settlements, whereby the investor will claim the treaty benefits
- In certain circumstances the investment vehicle itself may claim treaty benefits

Tax transparency

A tax transparent entity is an entity which is not taxed either in representative capacity or in its own capacity as a tax paying entity, but the tax is levied on the investors, in their domicile, on their share of income in the entity.

Aside from being considered tax transparent from the country where the transparent entity is domiciled, care should be given to the acknowledgement of the tax transparency of the entity by respectively:

1. The tax authorities of the investor's home jurisdiction (domicile);
2. The tax authorities of investment country (USA), which may levy withholding taxes on income and/or gains arising on investments held by the entity.



Indeed, investors in the transparent entity should be no worse off as a result of pooling their investments than if they had invested directly in the relevant investments held by the transparent entity on their behalf. This can be achieved by the tax authorities of the investor's domicile and the tax authorities where investments are located (USA) agreeing to apply tax treaty benefits (double taxation treaty) as if the transparent entity did not exist i.e. considering it as tax transparent. An investor in a transparent vehicle can then claim treaty benefits under an existing double income tax treaty between the investor's country of domicile and the USA.

Currently the Luxembourg Fond Commun de Placement ("FCP") is the most widely used tax transparent vehicle as it is a proven vehicle recognised as being transparent by many tax authorities. The US Internal Revenue Service regards the FCP as being tax transparent. The FCP has no legal personality and must be managed by a Luxembourg based management company regulated by the Commission de Surveillance du Secteur Financier (CSSF). The FCP may be set up as an umbrella fund with multiple compartments.

Tax treaties

A key factor for applying treaty benefits for life settlements is that the treaty of the investor's home jurisdiction should contain an "other income" article. Another key factor of a tax treaty is the Limitation on Benefits clause ("LOB"). The purpose of the LOB clause is to prevent the application of the benefits of the treaties to treaty shopping structures. Although the LOB clauses differ in most tax treaties, the following common LOB test in treaties for companies can be found.

- A company resident in one country is eligible for treaty benefits under a tax treaty between that country and the US if the company's shares are actively traded on a recognized stock exchange
- A company may also be eligible for treaty benefits if 50% (or more than 50%) of its shares are owned by persons otherwise eligible for treaty benefits and a "base erosion" test is satisfied.
- A company may also be eligible for treaty benefits if 95% of its shares are held by 7 or fewer residents of EU or NAFTA countries, and a special "base erosion" test is satisfied.

The LOB requirement is where the fault lies with many solutions that the previously mentioned off shore funds have sought. They have made use of securitization vehicles which will claim the treaty benefits that is overlooking the LOB requirements. Furthermore, these structures are on the radar of the Organization for Economic Cooperation and Development ("OECD") and if challenged by tax authorities they will not pass the test and will leave the vehicle with a huge tax burden and quite possibly fines that will vaporize the returns for the investors.

Important Facts

Investors in Life Settlement structures need to ensure that the following factors have been properly managed:



- An investor must ask for clarification of the double income tax treaty of the investor's home jurisdiction (domicile) with the USA. It is reasonable to ask the fund manager for an opinion as to the tax efficiency of the vehicle they manage.
- The investor must also ensure that the vehicle they invest in is indeed considered transparent by the investor's home jurisdiction. This is very important, because if such vehicle is not considered transparent for tax purposes, the investor will not be able to claim treaty benefits under a double income tax treaty with the USA.
- Understand the composition of the fund's investors: In order for a fund to completely represent tax efficiency, it must not have any investor that could potentially pollute the tax treatment of the investment vehicle. This is a key issue that a fund manager must explain. Investments into a transparent vehicle from off shore centers may create a tax liability for the whole fund.

Since the analysis as provided above on the tax issues at stake is complex and requires proper professional tax advice, it is crucial for investors to ensure that the fund vehicle they are contemplating an investment in, has retained adequate tax advisers. These advisers should be able to provide the investor with a third party opinion as to the validity of the investment's tax efficiency.

Examples of Improper structures

- Life Settlements investments have been set up under different structures, from closed end funds, to Notes or Fund of Funds of Life Settlements. Some of these vehicles, although developed under the proper legal structures to hold the assets, have not taken into consideration the consequences of Taxation, and have thus may develop an inherent tax liability which will adversely affect investors. **Off-shore Funds** – Most offshore funds (funds set up in off shore locations), even though they claim to be regulated, often lack a lot of supervision. Many of them are able to advertise or make statements about their investment vehicle that poorly reflect actual facts. There is no off-shore center, where there is no or very low taxation, in the world that has a double income tax treaty with the USA, hence all off-shore funds will be liable for a 30% NRA withholding tax, and the investment's performance shall be adversely affected.
- **Funds of Funds** - There are many well developed fund of funds vehicles that invest in life settlements, however one must look at the transparency of the investment all the way through. So even if you invest in a fully regulated fund of funds vehicle that has been developed properly, if this vehicle invests in other structures without the proper tax architecture, then the investment will be liable for NRA tax in the United States.
- **Funds with US vertical structures** – Some funds advertise that they mitigate the tax liability risk by setting up US structures in the form of trusts or limited liability companies. It is important to note that even though such vehicle may help minimize the withholding tax liability and make tax transactions simpler, this fund is still liable for a 35% corporate income tax in the USA, which again will adversely affect investment performance, not to mention add an additional layer of costs and entities, that may make the system less transparent and harder to perform due diligence.



- **Debt Instruments** – Many firms are issuing notes and other debt instruments, which technically switch the investment from income to long term capital gain for the investors. However, it is commonly known that repackaging an investment product solely for the purpose of avoiding tax, is not legal. It is important that in this structure, the debt issuing vehicle may still be liable for tax in the domicile it is incorporated, and furthermore, may still be liable for withholding tax. The issuing entity cannot claim treaty benefits unless it pays taxes somewhere, hence the IRS may very well still have a claim to withhold NRA tax.

Therefore it is critical not only to understand the structure you are investing in, but also the underlying legal structures of how the fund will be holding its assets. It is important to note that most funds set up prior to 2009 investment in life settlements, have not managed their tax liability properly and hence an investor must perform proper due diligence to ensure tax efficiency.

Life Settlements is a very attractive investment opportunity in today's environment. The purpose of this paper is not to deter investors from investing into this asset class, but to rather help them understand the complexities of international tax treatments that may affect their investment. Many other asset classes are adversely affected by international tax laws, however, an investor can take advantage of investing in life settlements if the proper vehicle with the correct structure is chosen. For life settlements, the tax efficient way to invest is, from a domicile jurisdiction that has a double income tax treaty with USA and through a transparent fund vehicle. Finally, always ask your fund manager for a third party opinion.