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Understanding the New IRS Tax Rulings on Life Settlements

March 14, 2009

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Panelists

- Luc Moritz, tax partner, O'Melveny & Myers
- Peter Ritter, tax partner, O'Melveny & Myers
- Kirk Van Brunt, tax partner,
Locke, Lord, Bissell & Liddell

- Moderator: Larry Simon, president and CEO,
Life Settlement Solutions, Inc.



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Overview of Revenue Rulings 2009-13 and 2009-14

- The rulings are the culmination of work begun by the IRS last year.
- The rulings respond to ongoing requests for guidance by industry groups and Congress
- What is a “revenue ruling?”



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Rev. Rul. 2009-13

Addresses Three Scenarios

- SITUATION 1: Surrender of a cash value life insurance policy
- SITUATION 2: Sale of a cash value life insurance policy
- SITUATION 3: Sale of a term life insurance policy



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SITUATION 1 – Policy Surrender

- Primary purchaser surrenders a life insurance policy:
 - Cash value = \$78,000
 - Premiums paid to date = \$64,000
- Gain = \$14,000 ($\$78,000 - \$64,000$)
 - See section 72(e)
- Gain is ordinary income, not capital gain
 - Section 1234A does not apply



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SITUATION 2 – Policy Sold in Settlement Market


- Primary purchaser sells policy:
 - Sales price = \$80,000
 - Cash value = \$78,000
 - Premiums paid to date = \$64,000
 - COI = \$10,000
- Gain
 - Basis (Adj. for COI): $64,000 - 10,000 = 54,000$
 - Gain: $80,000 - 54,000 = 26,000$
 - Ordinary income: $78,000 - 64,000 = 14,000$
 - Capital Gain = 12,000 (remainder)



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Rev. Ruling 2009-13

Focusing on COIs

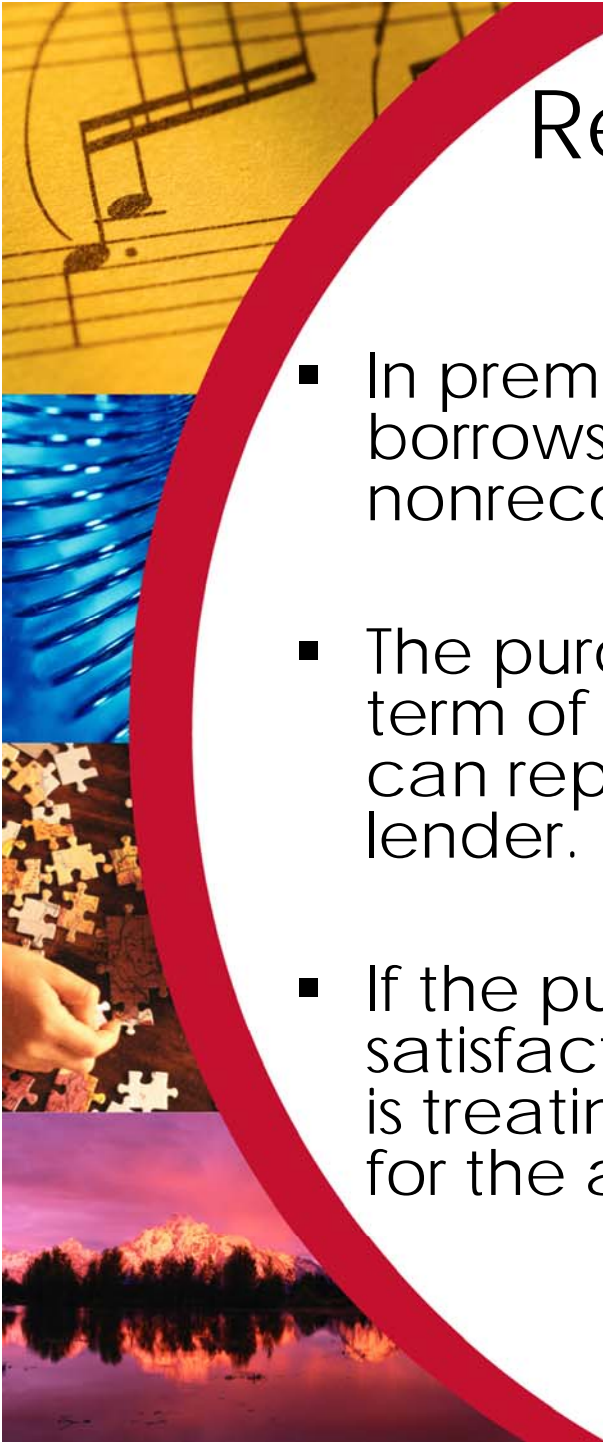
- Under Rev. Rul. 2009-13, the primary purchaser calculates his tax basis by subtracting the cost of insurance (COI) charges assessed under the policy to date.
- Most policies provide a guaranteed maximum COI charge. This means that the actual COIs will not exceed this amount, but this maximum charge normally should not be treated as the COI charge for purposes of Rev. Rul. 2009-13.
- For UL policies, actual COIs generally are separately stated and reported to the policyholder.
- For traditional whole life policies, actual COIs may not be separately stated and they may not be easily determined.
- For term insurance, Rev. Rul. 2009-13 indicates that absent other proof, the term premium is treated as the COI charge for the period it covers.
- More guidance on COIs to come?



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Rev. Rul. 2009-13 – Effect on Premium Financing?

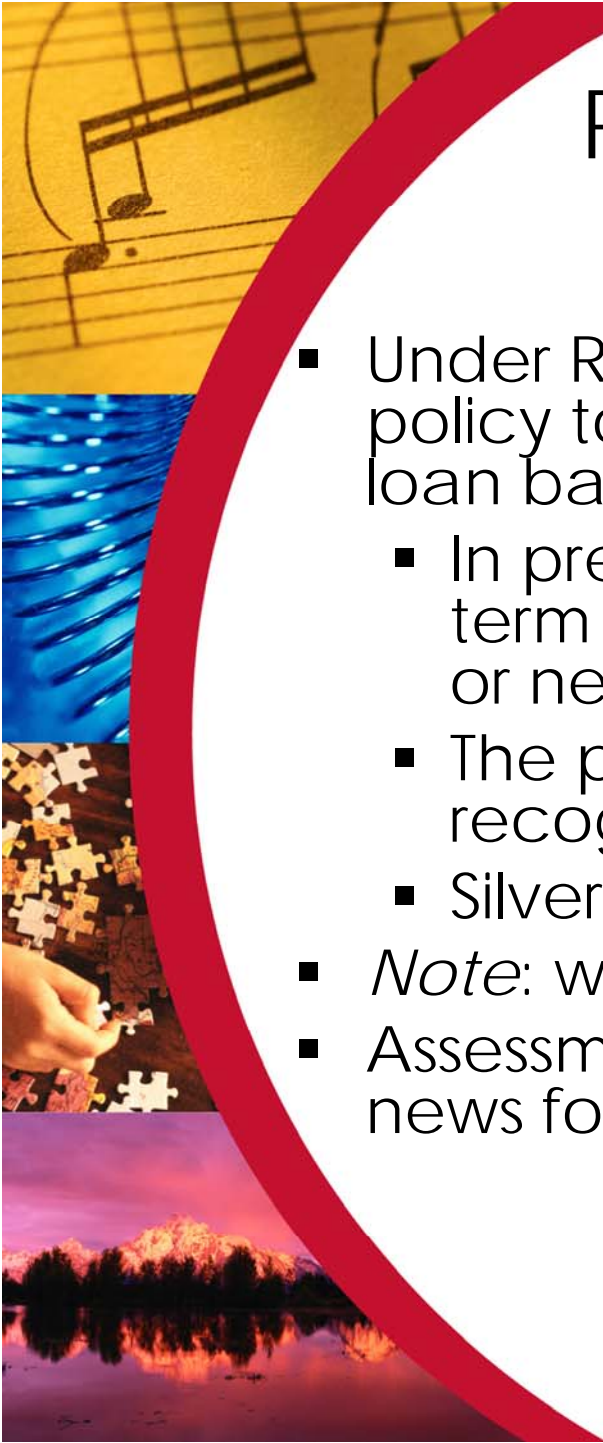
- In premium financing, the primary purchaser borrows to buy life insurance, usually on a nonrecourse (or limited recourse) basis.
- The purchaser incurs interest expense over the term of the loan, and at the end of the term he can repay the loan or “put” the policy to the lender.
- If the purchaser puts the policy to the lender in satisfaction of a nonrecourse loan, the purchaser is treating as having sold the policy to the lender for the amount of the loan.



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Rev. Rul. 2009-13 – Premium Financing cont'd

- Under Rev. Rul. 2009-13, the purchaser that puts a policy to the lender recognizes gain equal to the loan balance less his tax basis.
 - In premium financing, the policy is typically term with no cash value, so tax basis will be \$0 or near \$0.
 - The purchaser, thus, typically will have to recognize the entire loan balance as income.
 - Silver lining: the income will be capital gain.
- *Note:* what about interest expense and tax basis?
- Assessment: Rev. Rul. 2009-13 is probably grim news for premium financing.



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Overview of Revenue Ruling 2009-14



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Rev. Rul. 2009-14

Fact Pattern


- Third party ("B") purchases from A, a U.S. individual, a term life insurance policy (with no cash surrender value) issued by a U.S. life insurance company for \$20x
- B holds the policy as a capital asset (e.g., for investment)
- While B holds the policy it pays \$9x in premiums
- > 1 year later:
 - Situation 1: A dies and B receives a \$100x death benefit
 - Situation 2: B sells the policy to a 3rd party for \$30x



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Rev. Rul. 2009-14

Situation 1


- B must include \$71x in gross income (\$100-\$29X)
 - Unlike the original purchaser of the policy in Rev. Rul. 2009-13, B need not reduce its basis by the “cost of insurance”
- Although the policy is a capital asset in B’s hand, the death benefit income is ordinary income, not a capital gain
- The income is U.S. source “fixed or determinable annual or periodical” income subject to 30% U.S. federal income (and withholding) tax if B is a foreign person
 - NOTE: This conclusion is discussed as “Situation 3” in the Revenue Ruling



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Rev. Rul. 2009-14

Situation 2

- B has \$1x in gain (\$30-\$29x)
 - B does not need to reduce its basis by the cost of insurance
- The gain is taxed as a long-term capital gain (because the policy was held for more than one year)
 - Key assumptions: no cash value and policy not held as part of inventory



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The Foreign Life Settlement Investor After Rev. Rul. 2009-14

- Death benefits are US source “FDAP” income subject to withholding when paid under a policy issued by a US insurer on the life of a US citizen, except as modified by treaty.
- Rev. Rul. 2009-14 concludes that section 865 does not apply.
- Many tax treaties would exempt death benefits from US withholding taxes.



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Tax Treaty Examples

- After Rev. Rul. 2009-14, in order to avoid US withholding taxes, a foreign life settlement investor will need to be able to claim treaty benefits under a favorable tax treaty.
- Some examples of favorable treaties:
 - Ireland
 - Luxembourg
 - Netherlands
 - United Kingdom
 - Germany
- Some examples of unfavorable treaties or no treaty:
 - Canada (unfavorable treaty)
 - The Cayman Islands (no treaty)
 - Isle of Man (no treaty)
 - Guernsey (no treaty)



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Tax Treaties – Example

- How would a Cayman Island life settlement fund be treated with respect to death benefits?
- The US has no tax treaty with the Cayman Islands, so *prima facie* US withholding taxes would apply to death benefits paid to the fund.
- What if an investor in the fund is itself resident in a treaty country (e.g., the UK)?
 - The investor may be able to claim treaty benefits under the UK treaty, if
 - The Cayman fund is “transparent” under both US and UK tax law.
 - Caveat: Transparency can be difficult to achieve.



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Rev. Rul. 2009-14

Open Items

Revenue Ruling 2009-14 does not address:


- Whether interest that cannot be deducted under Section 264 of the Internal Revenue Code can be capitalized into B's basis to determine the amount of gross income in Situation 1 or gain in Situation 2
- The character and source of the inside build up in a universal or whole life policy
 - But see Rev. Rul. 2004-75



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Rev. Rul. 2009-14 Impact & Criticism


- Rev. Rul. 2009-14 provides answers to only a subset of the questions relevant to secondary market purchasers of life insurance policies
- The reasoning behind the ruling regarding the source of death benefit income is very thin
 - This issue is likely to be litigated
- Rev. Rul. 2009-14 will effectively force offshore SPVs that anticipate earning death benefit income to be structured in favorable tax treaty jurisdictions, thereby creating various limitations on their ownership, capital structure and operations
- Failing to know an offshore secondary market purchaser's basis in a policy, withholding agents will tend to withhold on the gross amount of the death benefit, even though only a portion thereof is taxable income



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O'Melveny & Myers LLP Experience

- Attorneys at O'Melveny & Myers LLP, including both O'Melveny & Myers panelists, have been involved in many of the earliest and continue to be involved in many of the largest life settlement and premium financing matters
- Our life settlement clients include originators, lenders, funds and investors, including a number of investment banks
- We are active on deal work, using both onshore and offshore structures
- We are also active on regulatory work and in litigation matters related to the industry



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Locke, Lord, Bissell & Liddell Experience & Capabilities

- LLB&L has a large practice dedicated to the life settlement and premium finance industries, and its attorneys have long been at the forefront of tax, regulatory and other legal developments affecting the industry.
- LLB&L represents clients from all sectors of the life settlement industry, including investors, life settlement providers, lenders and financiers, and fund managers.
- LLB&L has substantial experience and expertise in (i) structuring and implementing life settlement funds, domestic and foreign, (ii) advising on insurance regulatory issues affecting the industry, (iii) advising investors, providers, and fund managers on all legal aspects of life settlements, and (iv) handling litigation matters relating to life settlements and insurance generally.



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Life Settlement Solutions Experience & Capabilities

- Premier originator/provider of life settlements
- Premier servicing capabilities for existing settlement pools/portfolios
- Focus/capabilities geared towards institutional investors
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- Extensive distribution network to efficiently deploy capital with quality assets
- Industry-renowned Legal, compliance & due diligence



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