

Taxation of life settlements

The publication of the Internal Revenue Services' ("IRS") rulings 2009-13 and 2009-14 in May brought to the forefront a tax issue that many professional investors and asset managers have known about for years, and have either chosen to ignore or have spent much time and energy implementing various tax structures to help mitigate against.

The IRS rulings imply that the death benefit received by an investor from a life insurance policy issued by a US-domiciled insurance company is fully taxable as income, although gains from the sale of a life insurance policy would be treated as capital gains. This results in two distinctly different tax rates with the rate on capital gains being considerably lower than that of income.

In an ideal world, foreign investors, excluding resident aliens, would sell a life insurance policy just prior to its maturity, hence any gains would be deemed as capital gains, as clarified by the new ruling. However, the key issue is that death is a prediction at best and not a certainty, and with the necessity of registering changes to policy ownership at the insurance carrier level prior to death, there is no legal means of doing this after the event. One solution, as introduced by investment banks, is to use synthetic policies where the bank retains ownership of the policy but the premium liability and the death benefit are the investors' responsibilities, hence bypassing and eliminating any taxable event for investors.

Key tax issues

Contrary to what many in the industry believed in the early days, the death benefit received from a US-issued life insurance policy is taxable as US sourced income and not as capital gains for non-US investors. To be exempt from US taxes, investors need to complete a form known as W8-BEN which indicates to the entity paying the death benefit to apply for an exemption and not to withhold the tax. This form requires investors to state their tax residency and depending on the tax treaty that exists between the US and this jurisdiction, if any, a partial or total exemption from US taxes is granted. For jurisdictions where there is no tax treaty, a maximum tax rate of 30% is applied. For investors or investment funds domiciled in offshore jurisdictions, there is no tax treaty, so the maximum withholding tax rate would therefore be applied, unless a specific tax structure is utilised to



For the fund manager who wants to attract investment capital worldwide, a robust legal and tax structure in a favourable jurisdiction is needed

mitigate such an event. Below is an example of how the withholding tax would work:

A policy with a face value of \$1,000,000 with a life expectancy of 8 years was purchased for \$200,000. Assuming that the insured passes away in year 4 at which point \$148,500 of premiums have been paid and \$6,000 of costs have been incurred in servicing this policy, the total costs would be \$354,500. The taxable amount would therefore be 30% of the difference between the face value and the total costs incurred which in this case is 30% of \$645,500 or \$193,650. The net death benefit received would be \$806,350 or 19% less than the face value of the policy. Given that the policy matured prior to the estimated life expectancy, the impact of the withholding tax in this case is merely to reduce the "super profit" thus giving a net annualised return of 30% instead of 38% should there be no withholding tax. However, if death were to occur after the life expectancy say by an additional 2 years, then the expected return to investors in this example would be reduced from 12% to 5%.

Tax solutions for life settlement funds

To the extent that all investors in a fund are from one jurisdiction and this jurisdiction has a tax treaty with the US, this makes for an easy life for the fund's tax advisors as there is no US withholding tax and the fund pays on

behalf of the investors any tax liability to the tax authority of the investors' residence. Such a structure was used successfully for German-domiciled funds in the early part of this decade with the added advantage that German tax law enabled investors to have very little German tax liability – some even received after tax returns.

The situation is more complex if investors are multi-jurisdictional (e.g. pan-European). The attractiveness of the steady returns of this asset class will depend largely on how each jurisdiction will tax the gains and proceeds in the hands of investors. Whilst some jurisdictions, assuming a qualifying tax treaty, may view gains as capital gain, others such as the United Kingdom may tax it as income.

For the fund manager who wants to attract investment capital worldwide, a robust legal and tax structure in a favourable jurisdiction is required not only to qualify for exemption from US withholding tax (or to greatly minimise it) but also to allow for investment funds to invest in unquoted assets such as life settlements.



In the ideal world, investors in this asset class would only be subject to tax in their country of residence and at the lower capital gains or income tax rate

Selecting a tax structure

Investment managers in the life settlement space have tried to grapple with this issue for many years. For institutional shareholders, the simplest approach is a fund structure that is tax transparent for US tax purposes and allows for investments into this type of assets. Two jurisdictions have worked well for European investors: Ireland and Luxembourg with the Luxembourg SIF FCP being the more favoured option as it is a structure that suits big institutions and banks although it has the twin disadvantages of not being suitable for non-US tax treaty investors and of being extremely costly to run.

Other managers with European investors have gone down the route of an Irish professional investors' fund or a Luxembourg SICAV SIF - another form of professional investors' fund. However, these structures are not tax-transparent for US tax purposes and therefore would need to rely on applying tax treaty benefits to the fund, and not to investors.

To illustrate further how this structure work, we have taken the example of a Luxembourg SICAV SIF. In order to qualify for tax treaty benefits, the Luxembourg company needs to be Luxembourg resident. This is defined ultimately as the residency of the controlling shareholders and needs to be either in the US or in Luxembourg in order to allow the company, and therefore the fund, to qualify for exemption from withholding tax. These structures are usually set up using swaps or are dependent on Luxembourg tax rulings such that investors in the fund are deemed to hold a type of debt, known as Preferred Equity Certificate ("PEC") that effectively means little or no Luxembourg tax is due as Luxembourg allows for interest deduction on debt and exemption from Luxembourg withholding tax. The distinct disadvantage of such an approach is that tax treaties are renegotiated from time to time and such structures may come under scrutiny under what is known as Limitation on Benefits clauses as being excessively liberal in their interpretation on the provisions of the double tax treaty.

UK tax considerations

For UK resident investors, the issue of investing in life settlements is whether the gains will be taxed as gains or income as in the US. Non-UK domiciled funds can apply for Distributor Status which enables them - subject to certain rules - to treat any gains made due to the buying and selling of assets as Capital Gains Tax ("CGT") versus income generated from interest, dividends or bonds which is taxed as income. When CGT rates were identical to the income tax rate, little was done to differentiate between the two when investing in life settlements.

This changed in the 2007 budget when the CGT rate was reduced from 40% to 18% whilst the income tax rate remained at 40%. This benefit was short lived as the 2008 budget incorporated wording such that non-domiciled funds would be treated as corporations for UK tax purposes and the receipt of death benefits would be treated as income. Whilst non-domiciled funds can still

apply for UK Distributor Status, there is little benefit in doing so as the proceeds will be taxed as income.

Options for non-tax treaty investors investing in life settlements

Many of the original life settlement funds were domiciled offshore - mainly in the Cayman Islands, the Isle of Man, the British Virgin Islands and Guernsey. Many of these funds ignored the tax issues or used an underlying tax structure. In the current market, there are several popular tax structures being used, some more watertight than others. Two popular tax structures that have been used are the Section 110 of the Irish Tax and Consolidation Act coupled with its double tax treaty and the US IRS’s Internal Revenue Code Section 865. The Irish solution uses a Special Purpose Vehicle (“SPV”) as a securitisation vehicle which allows for the deduction of expenses including interest, thus making it tax neutral. The IRS’s Section 865 relies on the tax residency of the taxpayer’s domiciliation in taxing the death benefit proceeds. Whilst some institutional investors use either of these options, others opt for the safer route of a transparent entity such as a Luxembourg FCP.

The ideal world

In the ideal tax world, investors in this asset class would only be subject to tax in their country of residence and at the lower capital gains or income tax rate.

In the case of life settlements, the maturity of a policy is not set in stone – some mature early and others late. For each policy underwritten, an average life expectancy (known as “LE”) is given which signifies that on average, the median of the population will have passed away by LE. However, this predicates on having a sufficiently large portfolio say of 1,000 or more insured lives.

Without a tax structure or some form of double tax treaty, non-US domiciled investors in this asset class will need to pay tax on those policies that mature early and are left with the burden of potentially making a loss on those that mature past the average LE. Investors entering into a fund that is not exponentially increasing in size may potentially be left subsidising the tax bill of those investors who went in first, unless the fund is valued using some sort of “equalisation” method where early investors do not participate in all the gains from the early mortality experiences. An investment fund in this asset class that is equitable to shareholder would need to have a tax structure with an appropriate equalisation valuation methodology in order to balance out the timing issue not only in terms of investments but also in terms of asset maturity. A more detailed discussion on our equalisation valuation methodology can be found in the article “Valuation Methodologies for Life Settlements”.**

At Centurion, we recognised in 2002 the tax issues in investing in life settlements. By using the Cayman Islands as our funds’ jurisdiction and choosing a master-feeder structure, we were able to utilise a tax structure which allows experienced investors from all jurisdictions - be they an Isle of Man life company or a Middle-Eastern institutional investor - to benefit from the attractive returns offered by this asset class. Our valuation methodology also enables us to be fair to all shareholders irrespective of the timing of their investment into our funds.

**For more articles and presentations on longevity please go to: www.centurionfundmanagers.com.

About Centurion: Centurion’s current fund range includes one of the first micro-longevity funds in the market, established in 2002, which consists of physical (or cash) policies, a micro-longevity fund established in 2006 which combines both physical and synthetic policies, a micro-longevity fund of funds launched in 2003 and a macro/micro longevity fund of funds launched in 2009.

Fund name	Type of fund	Domicile	Quoted
Defined Return Fund plc	Micro longevity with physical policies only	Cayman Islands	
Life Settlement Strategy Fund SPC	Micro longevity with physical and synthetic policies	Cayman Islands	Channel Islands Stock Exchange
Argent Fund SPC	Micro longevity fund of funds	Cayman Island	Luxembourg Euro MTF
Centurion SICAV SIF — Longevity Fund	Macro/Micro longevity fund of funds	Luxembourg	

Website	Telephone	Email
www.centurionfundmanagers.com	+44 (0) 207 079 5850	info@centurionfundmanagers.com

This fact sheet offers information about funds managed by Centurion Fund Managers Ltd and promoted by Centurion Portfolio Managers Limited. Centurion Portfolio Managers Limited is authorised and regulated by the Financial Services Authority (FSA). The information in this document should not be construed as investment advice or an offer, invitation, inducement or solicitation to sell, issue, purchase, subscribe for or otherwise acquire shares. No reliance may be placed upon the information or opinions contained in this document. Past performance is not indicative of future returns. The information in this document and any further information provided by or on behalf of Centurion Fund Managers, has not been verified and is liable to change at any time. The information in this document is for information purposes only and is confidential. It is not directed at or intended for distribution to or use by any person or entity in any jurisdiction where (by reason of that jurisdiction’s applicable securities laws, person or entity’s residence or otherwise) such distribution, publication or use would be contrary to applicable law or regulation. It may not be reproduced or further distributed to any other person or entity or published, in whole or in part, for any purpose. Furthermore this document is strictly only for persons who are investment professionals within the meaning of Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (SI2005/5129), as amended (the “FPO”), or persons falling within paragraph 49 of the FPO (high net worth companies, unincorporated associations etc.) or persons to whom it may otherwise be unlawful for these materials to be communicated without approval of the same for the purposes of section 21, Financial Services and Markets Act 2000. © Centurion Fund Managers Ltd 2009