Structuring Life Settlements Investment Funds After TCJA

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May 3, 2018, 3:49 PM EDT

This is the second of our three part series of articles regarding the key impacts of the recent federal tax legislative reform now commonly known as the Tax Cuts and Jobs Act on the U.S. life settlements industry. Read the first part, discussing new reporting rules for life settlement transactions, here. This article focuses on the TCJA's changes affecting life settlements investment fund tax structuring.


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The TCJA has ushered in many important changes to the federal income taxation of various types of U.S.-based business entities as well as for U.S. resident individual taxpayers. Before the TCJA, certain offshore life settlements investment funds[1] having U.S. resident investors enjoyed significantly favorable income tax treatment on their receipts of a fund's distributions of death benefits paid upon the maturity of U.S. issued life insurance policies owned by the fund. Now, however, the TCJA has drastically altered the ability of certain 10 percent or greater U.S. resident investors in offshore investment funds classified as controlled foreign corporations to achieve those pre-TCJA U.S. income tax advantages.

Historically, the offshore life settlements investment fund industry has principally used Ireland and Luxembourg as jurisdictions for fund formation for a few reasons, tax- and nontax-related. From an investment fund regulation perspective, these two countries' investment management regulatory regimes are generally fairly easy to operate in, and European and other non-U.S. investors prefer those jurisdictions over a U.S. domiciled fund entity based on those investors' familiarity with Irish/Lux fund structures from having made prior fund investments. From an income tax perspective, Ireland and Luxembourg based funds that are taxed as corporations in their domiciliary jurisdiction pay minimal domestic corporate taxes as their distributions to equity holders[2] were (and still should be) tax deductible payments. Of course, fund sponsors also have structured their Irish and Luxembourg funds to qualify for benefits provided under the applicable tax treaty with the United

States, namely the avoidance of the 30 percent U.S. “Fixed, Determinable, Annual, Periodical” withholding tax on U.S.-sourced income derived from death benefits paid on life insurance policies originally issued in the U.S. and acquired by funds in the secondary life insurance market. The U.S. tax treaties with these two countries exempt this death benefits income from the 30 percent U.S. withholding tax because this type of income qualifies as “other income” which is not subject to the tax.[3]

In the pre-TCJA world, for life settlement investment funds having U.S. resident persons as a majority of their investors there were two primary U.S. income tax advantages to domiciling a fund, treated as a corporation for U.S. federal income tax purposes and qualified as a treaty eligible resident, in a jurisdiction having an “other income” treaty provision granting this U.S. withholding tax exemption. First, this type of fund, even though it may have technically met the definition of a controlled foreign corporation, or CFC, under Section 957(a) of the Internal Revenue Code of 1986, as amended by virtue of it having U.S. resident Subpart F shareholders collectively owning more that 50 percent of the total vote and value of the fund’s equity interests, it could defend a position that it did not recognize Subpart F income upon receipt of U.S. sourced death benefit payments because death benefits did not constitute any of the defined types of passive income (e.g., dividends, interest, interest equivalents, rents and royalties) which are classified as Subpart F income under Code Section 952.[4] Thus, a Subpart F “U.S. shareholder” investor — historically defined as a U.S. person with a direct, indirect or by attribution 10 percent or more equity interest in a CFC but now, post-TCJA, defined as a 10 percent or more vote or value interest — in the fund did not recognize deemed dividends, or phantom income, under the prior Subchapter F regime and were only taxed in the United States when the fund actually distributed its death benefits income to its investors.[5] This ability to defer U.S. income taxation until the fund’s payment to its U.S. investors is important because normally, in the earlier years of a fund, it uses funds received from death benefit payments to pay premiums due for other life insurance policies held by the fund that have not yet matured, before distributing death benefit income to investors under the fund’s profit participating notes. In addition to the timing element, avoiding Subpart F income characterization is important in these structures since Subpart F distributions are not eligible for U.S. “qualified dividend” treatment. Thus, when distributed by the fund to U.S. individual investors, the death benefits were taxed as “qualified dividend” income at the 20 percent capital gains tax rate, not as ordinary dividends at the pre-TCJA ordinary income tax rate applicable to a particular U.S. resident investor. In sum, U.S. resident individual level investors in this type of fund structure obtained the potential for income recognition deferral (no death benefit phantom income) but more importantly, by avoiding Subpart F classification on the death benefit income, they enjoyed the ability to convert ordinary death benefit income into qualified dividend income taxable at the capital gains tax rates. The TCJA has radically changed all the foregoing for fund structures that are CFCs with Subpart F shareholders.

The Code Section 965 Transition Tax

First, for the most recent taxable year of a "specified foreign corporation," which includes any CFC, that began operations before 2018, there is a mandatory deemed Subpart F distribution to U.S. shareholders by the CFC of its accumulated post 1986 earnings and profits. In essence, this means that, to the extent an offshore fund (1) was a CFC in 2017 and (2) had accumulated earnings and profits at the end of 2017 (the higher of the amounts tested on Nov. 2, 2017, or Dec. 31, 2017), then the U.S. shareholders of the fund are deemed to receive their allocable shares of these accumulated fund profits as a Code Section 965 inclusion amount in 2017 and likely at the 15.5 percent income tax rate. This Code Section 965 transition tax is a one-time event in 2017 and acts as a transition step for the new hybrid exterritorial income tax system for domestic C corporations.

GILTI Tax

Second, for taxable years after Dec. 31, 2017, new Section 951A of the code, one of the TCJA's most significant anti-deferral/anti-tax abuse measures, imposes a new form of U.S. income tax on "global intangible low-taxed income," or GILTI. While not technically a Subpart F income category, GILTI borrows from the U.S. Subpart F regime in many respects and is intended to require some minimal level of U.S. income tax be paid currently by U.S. shareholders of CFCs that have net profits and that utilize minimal depreciable assets in their businesses. Importantly, Code Section 951A's GILTI inclusions are not eligible for qualified dividend treatment.

As noted above, TCJA also revised the test for what constitutes a "U.S. Shareholder" of a CFC to mean a U.S. resident person that owns 10 percent of more of either the total vote or value of the CFC's share equity, whereas the pre-TCJA test meant a U.S. resident person that owned 10 percent or more of only the CFC's share equity.[6] A U.S. flow-through entity, such as a LLC or partnership, that is an investor in an offshore fund can also be classified as a U.S. shareholder for Subpart F purposes if it owns 10 percent or more of either of the offshore fund's vote or value.

At a high level, a U.S. shareholder's annual GILTI inclusion amount will be its allocable share of the CFC's total annual net income, with some adjustments, to the extent that the CFC's net income exceeds an annual permissible "run rate." The Congress defined this run rate as 10 percent of the total adjusted income tax basis of a CFC in its depreciable, tangible personal property, of which there would normally be none in the case of a life settlements investment fund. Since death benefits that are U.S.-sourced income are included in the computation of GILTI inclusions, for life settlements investment funds that are CFCs, GILTI may act to eradicate both the ability of (a) the fund's U.S. Shareholders to avoid recognition of at least some U.S. income in the year death benefits are paid to the fund as well as (b) any U.S. Shareholder to obtain qualified dividend treatment of such GILTI distributions from the fund.

It should be noted that these potential negative results from the application of Code Sections 965 and 951A only would apply to U.S. investors that are classified as U.S. shareholders under Subpart F. For U.S. investors that are not so classified and which also do not hold their interests through a pass-through entity that is classified as a U.S. shareholder, the Code Section 965 transition tax and the GILTI income inclusion rules will not have any direct impact on these investors.

Code Section 962 Elections

The U.S. top tier individual ordinary tax rate, which will likely apply to GILTI inclusions, unless a Code Section 962 election is made, is 37 percent versus the 20 percent rate for qualified dividend income, not taking into account any state and local taxes nor the 3.8 percent net investment tax imposed by Code Section 1411. On the other hand, the effective federal tax rate for domestic U.S. “C” corporations on GILTI inclusions is 21 percent. In addition, domestic C corporations, but not individuals, enjoy an 80 percent credit for any foreign income taxes paid on the CFC's net test income for GILTI. On top of both of these advantages, domestic C corporations receive a 50 percent GILTI deduction under Code Section 250. Thus, the individual income tax rates on GILTI inclusions is significantly higher than the effective U.S. GILTI income tax rates for domestic corporations on GILTI inclusions.

Code Section 962, which allows for an obscure tax election that was rarely considered pre-TCJA, should be considered now by U.S. shareholders of existing funds that are classified as CFCs due to the arbitrage between the U.S. domestic corporate income tax rate and the individual income tax rate. Code Section 962 provides the ability for U.S. individual shareholders to make an election to be taxed at corporate income tax rates on their Subpart F income. Post TCJA, U.S. individual shareholders in a CFC should strongly consider making a Code Section 962 election for their Subpart F income as well as any GILTI inclusions so as to be taxed at corporate equivalent income rates on their Subpart F income/GILTI inclusion amounts. Importantly, Code Section 951A specifically authorizes GILTI inclusion amounts to qualify for Code Section 962 election treatment.

A Code Section 962 election should reduce the current effective GILTI inclusion rate to

21 percent. In addition, by making the Code Section 962 election, individual U.S. shareholders should also become eligible for the 80 percent foreign income tax credit available to domestic C corporations, thus reducing the GILTI inclusion amount. Amounts included as gross income under Subpart F are generally treated as previously taxed income, or PTI, under Code Section 959 and not subject to U.S. taxation again when actually paid as a dividend to U.S. shareholders. However, in the case of Code Section 962 elections, only the actual tax liability amount, not the gross income amount, is treated as a PTI. For this reason, when a fund makes an actual distribution of its foreign earnings and profits to a U.S. individual shareholder who has made a Code Section 962 election, the PTI exclusion will be much smaller, resulting in additional U.S. income taxation on the net after tax amount. Presumably the qualified dividend tax rate would apply at this time. However, the total overall effective income tax rate will, when combined with the upfront GILTI tax and the back-end qualified dividend tax, approach an effective 37 percent federal income tax rate.

In sum and post-TCJA, a Code Section 962 election, if properly made, would soften the immediate impact of GILTI to U.S. individual shareholders. However, on an combined overall basis, the effective U.S. income tax rate on the allocable share of the CFC's income to individual U.S. shareholders will approach the effective 37 percent individual income tax rate either as earned by the CFC (no Code Section 962 election) or partially as earned and partially when distributed (with Code Section 962 election). This effective U.S. income tax rate is substantially higher than the pre-TCJA U.S. effective income tax rate.

Fund Structuring Strategies

Therefore, if a foreign life settlements investment fund that is viewed as a corporation from a U.S. federal income tax perspective, is classified as a CFC, the ownership of the fund should be restructured, and for newly a formed fund, it should be structured, in a manner that its U.S. shareholders can avoid recognizing deemed distributions of ordinary dividend income upon the fund's receipt of death benefit payments. There are several manners to achieve this goal, including the following three tax planning techniques.

- *Foreign Investor Control Model* — The first tax planning technique is to limit the amount of the equity investments in the offshore fund, treated as a corporation for U.S. federal income tax purposes and qualified to receive "other income" tax treaty benefits under a U.S. tax treaty, by U.S. tax resident persons such that they collectively own less than 50 percent of the total vote and value of the fund's equity instruments with the balance of the fund's equity instruments being owned by non-U.S. resident persons, obviously requiring a more robust mix of foreign investors which may or may not be viable from a business perspective. In this scenario, there would be no limitation on the total value of the fund's equity instruments that any single U.S. resident investor could own of the portion of the up-to 50 percent of the total vote and value fund's equity instruments which U.S. resident investors could own. However, one major obstacle to this type of planning may be qualifying under the limitation of benefits clause applicable in the treaty. A limitation of benefits, or clause operates to avoid "treaty shopping" by limiting treaty benefits to those residents who meet at least one of a list of prescribed LOB requirements such that treaty benefits are not artificially achieved by residents with nominal ties to a treaty jurisdiction.

- *Direct Investment / No or Limited U.S. Shareholder Model* — Here there would be direct U.S. investors in the offshore fund, but the planning would be to limit the amount of the equity investment in the offshore fund (treated as a corporation for U.S. federal income tax purposes and qualified to receive "other income" tax treaty benefits under a U.S. tax treaty) by each U.S. resident investor to less than 10 percent of the total vote and value (directly, indirectly and by attribution) of the fund's equity instruments. U.S. resident investors who are not classified as U.S. shareholders of the CFC under Subpart F can, in the aggregate, control more than 50 percent of the vote and value of the offshore fund. A variation of this planning methodology could permit some U.S. resident investors to have 10 percent more of the shares/value provided that these U.S. shareholders, in the aggregate, do not control more than 50 percent of the foreign fund entity by vote or value.
- *Foreign Pass-Through Entity Feeder Model* — A third tax planning technique is for U.S. resident investors to invest in an amalgamated fashion into a foreign fiscally transparent entity, treated as a partnership for U.S. federal income tax purposes, which, in turn, would invest in the offshore fund, treated as a corporation for U.S. federal income tax purposes and qualified to receive "other income" tax treaty benefits under a U.S. tax treaty. The foreign pass-through entity would not be classified as a U.S. shareholder, while a U.S. partnership would be. Similar to the direct investment / no or limited U.S. shareholder model, either no single U.S. resident investor, including a U.S. partnership, would control 10 percent of the vote/value of the CFC and hence there would be no U.S. shareholders as defined under Subpart F, or some U.S. shareholder would be allowed but monitored and maintained such that U.S. shareholder ownership in the aggregate never exceeds 50 percent of the foreign entity.

Under all these three scenarios, the offshore fund's distributions of death benefits to its U.S. individual resident investors will continue to constitute qualified dividend payments, and the U.S. effective federal income tax rate on such distributions to U.S. individual resident investors will continue to be 23.8 percent taking into account the Code Section

1411’s 3.8% net investment tax.

Conclusions

The TCJA’s new Code Section 965 inclusion and GILTI provisions should be carefully evaluated by existing and to-be-formed offshore life settlements investment vehicles. If GILTI is applicable to a U.S. shareholder, these TCJA provisions will negatively impact the U.S. income tax consequences to U.S. shareholders. Accordingly, existing offshore funds classified as CFCs under the prior rules or now classified as CFCs due to the expanded definition of U.S. Shareholders should consider the feasibility of and means for restructuring to ameliorate these negative income tax consequences. Newly formed offshore life settlements investment funds should likewise embrace an ownership and entity structure that avoids or minimizes, the adverse U.S. income tax effects caused thereby.

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[1] Life settlements investment funds purchase and either hold until maturity, or sometimes later resell, in-force life insurance policies issued by U.S. domiciled life insurers which the funds acquire from (a) life settlement providers licensed under state insurance codes, which, in turn purchase policies from their original owners as an alternative to lapsing or surrendering a policy, or (b) other secondary life insurance market investors, e.g. other life settlements investment funds.

[2] Irish funds typically issue investment instruments called profit participating notes, which are classified as equity instruments for U.S. federal income tax purposes and thus treated as shares for purposes of a controlled foreign corporation under Subpart F of the Internal Revenue Code of 1986, as amended.

[3] Note that not all U.S. tax treaties contain an “other income” provision, e.g., the U.S. tax treaties with Canada and Mexico.

[4] In most cases, life insurers must pay interest at an annual rate imposed by insurance code statutes on death benefits accrued from the date when a claim for death benefits is filed with the insurer until it pays the claim. Therefore, these offshore life settlements investment funds actually recognized Subpart F income to the extent of such interest payments.

[5] Under U.S. federal income tax law, the owner of a life insurance policy acquired in the secondary life insurance market recognizes ordinary income in an amount equal to the amount of the death benefit paid under a life insurance policy in excess of the owner's income tax basis in the life insurance policy, which is the purchase price paid by the owner for the policy plus all the insurance premiums paid by the owner after purchase of the policy until its maturity.

[6] Subpart F of the Code also contains various ownership attribution rules, which the TCJA also modified, and must be considered in any evaluation of whether a foreign corporation has any U.S. Shareholders and is a CFC.