Taxing Life Settlements Investment Funds Under The TCJA

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This is the third article in our series of three articles addressing the most significant impacts of the Tax Cuts and Jobs Act on the U.S. life settlements industry. Life settlements investment funds, like hedge funds and private equity funds, usually have general partners whose compensation for managing the fund oftentimes includes a so-called "carried interest" profit participation element. Among its many other changes, the TCJA materially altered the taxation of carried interests generally, but not, for the most part, for life settlements investment funds.

Prior to the TCJA, the profits realized from these carried interests by general partners were taxed at the capital tax gain tax rate and received long term capital gains treatment if a general partner held the carried interest for more than one year. While the TCJA did not, in the end, eliminate capital gains treatment for carried interest profits, as some parties had advocated in attacking carried interests taxation for many years, the TCJA's changes now provide that carried interests only receive long term capital gains treatment if a general partner holds the carried interest for more than three years. The TCJA implemented the new carried interest taxation rule through new Section 1061, Partnership Interests Held In Connection With Performance Of Services, of the Internal Revenue Code of 1986, as amended.

From a technical perspective, now any carried profits interest which, directly or indirectly, is transferred to or is held by a taxpayer in connection with the performance of substantial services by the taxpayer, or any a related person, in any "applicable trade or business" is defined as an "applicable partnership interest".[1] However, an "applicable partnership interest" does not include a partnership interest owned, directly or indirectly, by a corporation or any capital interest in a partnership in respect of which the partner makes an actual contribution to capital which provides the partner with a right to share in partnership capital commensurate with the amount of capital contributed.[2] An "applicable trade or business" is any activity conducted on a regular, continuous and substantial basis consisting of (1) raising or returning capital and (2) either (a) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition) or (b) developing specified assets.[3] Thus, the TCJA's new carried interest taxation rules are built around defining the targeted businesses (hedge funds and private equity funds) as those investing in "specified assets."

In turn, specified assets are defined as the following types of assets: securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of its interest in any of these assets.[4] For life settlements investment funds, usually the vast majority of their assets consist of in-force life insurance policies, which generally do not constitute specified assets. However, there are three exceptions where these funds do hold specified assets.

First, putting aside broker-dealer compliance matters under the Securities Exchange Act of 1934, as amended, and investment company compliance matters under the Investment Company Act of 1940, as amended, associated with the acquisition of variable life insurance policies (which in addition to being life insurance policies are also securities under the federal securities laws), some life settlements investment funds buy, hold and resell variable life insurance policies, which are specified assets. Second, most, if not all, life settlements investment funds hold some amount of specified assets in the form of cash reserves, which may be invested in cash equivalents or short-term maturity securities, for funding payments of future premiums due for their portfolio of life insurance policies. Third, to the extent a life settlements investment fund engages in hedging transactions, such as purchasing derivative contracts to mitigate the longevity risks of the individuals insured under its life insurance policies portfolio, the fund would also likely have specified assets.

Thus, overall, the result may actually be good news for life settlements investment funds which, for the most part, normally do not hold specified assets or hold only a small percentage of specified assets compared to their other asset holdings. However, it is not clear to what extent holding a small percentage of specified assets will affect the "applicable partnership interest" determination or how carried profits interests will be taxed where a fund holds a de minimis amount of specified assets such as cash reserves, which is a matter for which Internal Revenue Service guidance is needed.

Under new Code Section 1061, capital gain recognized for an applicable partnership interest derived from the disposition of such applicable partnership interest or otherwise from the portion of a partnership's capital gain with respect to such applicable partnership interest on the disposition of any underlying capital assets will be treated as long-term capital only if the partnership interest or underlying capital asset, as applicable, has been held by the partner or the partnership, as applicable, for at least three years,[5] regardless of any election made under Code Section 83(b).[6] Short-term capital gains recognized on or with respect to carried profits interests are taxed at ordinary income tax rates for individuals.

In summary, the TCJA's new rule requiring a three-year holding period for long-term capital gain taxation of a carried profits interest may, depending on the facts, not apply to an investment manager's carried interest in a life settlements investment fund. However, it is not clear how such a carried profits interests will be taxed where the fund holds a de minimis amount of cash reserve specified assets, which is a matter for which Internal Revenue Service guidance is needed. Nevertheless, the bottom line for life settlements investments funds is that their managers holding carried profits interests therein should be able to continue to receive long term capital gains treatment in many situations as long as the relevant interest is held for a minimum period of one year, subject to a longer term of three years to the extent the fund holds specified assets.

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