Life Settlements: Using Irish Vehicles to minimise US Taxes on Life Settlement Payments

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Introduction

We have seen life settlements (in particular, relating to life policies insured on US citizens residing in the US) become an increasingly popular asset class. As a result of a US ruling issued by the Internal Revenue Service (Revenue Ruling 2009-14) on 1 May 2009, there now exists potentially negative US tax consequences for non-US investors who acquire life policies and receive death benefits from a US insurance company on the death of a US citizen residing in the US. As a result we have seen Ireland increasingly being examined and used as a jurisdiction to locate the offshore investment vehicle to acquire such life policies so as to avail of the benefits of the Ireland/US Double Taxation Convention (the "Ireland/US Treaty") to avoid the potential negative US tax issues arising from the above ruling.

IRS Ruling 2009-14

Revenue Ruling 2009-14 (which is specifically limited to term policies) found that death benefit proceeds payable by a US insurance company to a non-US investor not engaged in a US trade or business, upon the death of an insured who is a US citizen residing in the US would be US-source income. As a result, such US-source proceeds, less the purchase price and additional premiums paid by the investor to maintain the contract after the purchase, potentially would be subject to US withholding tax (currently at 30%).

Irish Vehicles

Offshore investors have used either Irish regulated funds or Irish SPVs in an attempt to avoid such US withholding taxes. Which vehicle they have used has depended on a combination of different factors.

Irish regulated funds

It is possible to establish an Irish regulated fund for investing in life settlements. Typically the regulated fund is established as a Qualifying Investor Fund (QIF). QIFs have no borrowing or leverage restrictions which are a matter for disclosure only, have virtually no other investment restrictions, and benefit from a lighter touch regulation than other Irish regulated funds. QIFs are authorised by the Central bank of Ireland on a filing only basis. In practical terms, this means that once the QIF meets with certain requirements (including that the parties involved in the operation of the QIF meet certain criteria) the Central Bank does not formally review the fund documentation prior to launch. As such, provided that the Central Bank receives a completed application for the authorisation of the QIF before 3.00pm on a particular business day, the QIF will be authorised the following business day.

Irish regulated funds are exempt from Irish taxation on their income and gains and distributions may be made free of Irish withholding taxes to all non-Irish resident investors and also to certain categories of Irish investors.

SPVs (Section 110 Vehicles)

Section 110 of the Taxes Consolidation Act, 1997 prescribes a very favourable tax regime for companies that satisfy its conditions (commonly referred to as “Section 110” companies).

Unlike regulated funds, Section 110 companies are not exempt from Irish tax on their profits but instead are liable to tax at a rate of 25%. However, they are permitted to issue hybrid debt which has the characteristics of equity but the return on such debt is tax deductible. As Ireland has no thin capitalisation rules, it is possible to finance such companies 100% in such manner and reduce taxable profits to zero. In summary, it is possible to structure such companies to pay as little or as much tax on their profits as desired.

Ireland/US Treaty

Under the Ireland/US Treaty both regulated funds and Section 110 companies can potentially benefit. It is worth noting that for Luxembourg (another potential jurisdiction for life settlement funds), regulated funds (unlike Ireland) cannot benefit under the Luxembourg/US Double Tax Convention.

In order to benefit from a treaty with the US, the resident of the other Contracting State must satisfy a Limitation on Benefits (“LoB”) article in their treaty with the US. The Ireland/US Treaty is no different and also contains a LoB article. The LoB article in each treaty negotiated by the US is typically different albeit the thrust of the LoB article is the same in each treaty; which is to limit the benefits of the treaty to only certain categories of residents of the other Contracting State. The US LoB article is to combat what the US sees as inappropriate use of double tax treaties. Essentially, the LoB article in a treaty with the US will require a resident of the other Contracting State to pass various tests to satisfy the US that the relevant treaty with the US is not being used inappropriately. Only residents of the other Contracting State (e.g. Ireland) who satisfy the LoB article may claim the benefits of their treaty with the US.

The LoB article in all of the US's double tax treaties is relatively complex and close attention must be paid to ensure that the relevant resident satisfies the article. The LoB article in the Ireland/US Treaty is no different in its complexity but, ultimately, it contains fewer limitations (than many treaties with the US) on accessing the benefits of the treaty.

Ownership Test

For regulated funds and Section 110 companies resident in Ireland who wish to satisfy the LoB article, their options for satisfying the LoB article can typically be narrowed down to 3 different tests (although they are by no means the only possibilities). They are as follows:

(1) The principal class of shares/units of the regulated fund are substantially and regularly traded on a recognised stock exchange. Obviously Exchange Traded Funds (ETFs) have satisfied this test. However, it may be possible to create a scenario outside of the ETF arena, of funds satisfying the substantially and regularly traded test.

or

(2) At least 50% of the shareholders/unit holders of a regulated fund or at least 50% of those holding the equity of a Section 110 company are qualifying residents of the US and/or Ireland. As such, if the Irish investment vehicle can control the number of non-US and non-Irish investors investing (directly or indirectly) in the vehicle (by limiting such investors to no more than 50%), the vehicle will satisfy the ownership test in the LoB article. The 50% ownership test also provides an opportunity for a Section 110 company to structure its financing in a manner in respect of which its debt (remains debt for Irish tax purposes) while also qualifying as either equity or debt for US tax purposes depending on the desired result arising from the geographic spread of its likely investor base.

or

(3) No less than 95% of the shareholders of a regulated fund (whose legal form is a company), or no more than 95% of those holding the equity (as defined under US tax laws) of a Section 110 company, is held by seven or fewer persons who are either tax resident in an EU member state and/or a country who is party to NAFTA and who qualify for the benefits of their respective treaties with the US. This test is known as the Derivative Benefits test and because of other conditions that must be satisfied it is not commonly used. However, for those regulated funds (corporate form only) or Section 110 companies designed to primarily raise monies from a small group of investors (ideally located in small number of countries) it can and has been successfully used to obtain treaty benefits under the Ireland/US Treaty.

Base Erosion Test

There is an additional test, known as the “base erosion” test, which residents of Ireland who fall into categories (2) and (3) above must also satisfy. The purpose of the base erosion test is to ensure that a company which satisfies one of the ownership tests is not used as a mere conduit through which payments, potentially liable to withholding tax at full rates, are passed so that they end up in the hands of persons who are not entitled to treaty benefits. Briefly, the test is that certain tax deductible payments must not exceed 50% of the gross income of the company claiming to be a qualified person for the purposes of treaty benefits. Effectively, all tax deductible payments are split into three categories: (i) certain excluded payments (such as professional fees, salaries, rent etc), (ii) payments not included in (i) that are made to “good” persons; and (iii) payments not included in (i) that are made to “bad” persons. Good and bad payments are determined, inter alia, on the basis of where the recipient resides.

While the base erosion test is not without its complexities, Section 110 companies with the appropriate ownership have and are satisfying the test (including life settlement vehicles). It should be noted that the LoB article test has to be satisfied each fiscal year to obtain treaty benefits for the relevant fiscal year under consideration.

As for regulated funds, the base erosion test should not be applicable because under Irish tax rules any payments made by such a fund are not tax deductible. While gross income is calculated under US tax rules, tax deductible payments are calculated under Irish tax rules. Regulated funds as tax-exempt vehicles should therefore not have to satisfy the base erosion test.

Using an Irish Section 110 company together with an Irish Regulated Fund to satisfy the LoB provisions of the Ireland/US Treaty

It is common to use a Section 110 company and a regulated fund in tandem to satisfy the LoB article of the Ireland/US Treaty. By using both vehicles together (investors invest in the Section 110 company which in turn invests in the regulated fund and the regulated fund in turn invests in the life settlements) the base erosion test can be disregarded and more than 50% of the monies can effectively be sourced from non-US/Irish investors while still satisfying the LoB provision of the Ireland/US Treaty.

Conclusion

The question of accessing any treaty with the US is often complex because of the LoB article in all treaties with the US; however, the LoB article in the Ireland/US Treaty is not as limiting as many other LoB articles. Consequently, Irish regulated funds and Section 110 vehicles with the right fact pattern can, and regularly do, satisfy the test. Such investment vehicles are obtaining treaty benefits under the Ireland/US Treaty to avoid US withholding taxes.

Accessing the Ireland/US Treaty is no different where the Irish regulated fund or Section 110 vehicle is investing in life settlements and, because of Revenue Ruling 2009-14, the ability of such Irish vehicles to access the Ireland/US Treaty to avoid US withholding taxes on life settlements payouts, combined with a very attractive tax regime in Ireland, puts Ireland at the top of any list for promoters of life settlement funds looking for a jurisdiction to locate their offshore investment vehicle.

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