The Aver Advisory

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presented by Aver Associates Estate Planners & Trustees

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IRS ISSUES TWO RULINGS ON US LIFE SETTLEMENTS

Life settlements—sales by the owners of life insurance policies to third parties—have become popular as a way to dispose of unneeded policies for amounts greater than their cash surrender value.

On May 1, 2009, the Internal Revenue Service issued two revenue rulings intended to clarify the proper income tax treatment relating to the surrender, sale, and purchase of life insurance policies.

The first ruling, Rev. Rul. 2009-13, addresses the seller's tax situation and discusses scenarios regarding the surrender or sale of a policy by the owner/insured. The second ruling, Rev. Rul. 2009-14, addresses the buyer's tax situation and provides guidance to investors who purchase life insurance contracts.

The second ruling, in particular, discusses some of the issues related to source and taxability for non-US investors who purchase insurance written by US companies over the lives of US insureds.

Treatment for Foreign Investors

Source of income. Based on analogous references to classes of income that are specified in the *Internal Revenue Code*, the IRS concludes that income, received by a foreign investor from the payment of death benefits pursuant to a life insurance policy, would be "from sources within the United States" because the insured was a US citizen and the insurer was a US domestic corporation.

Taxability. The ruling concludes that the net amount of income received as death benefits by the foreign investor is subject to US withholding tax. The income is characterized as "fixed or determinable annual or periodical income" (FDAP) under IRC 881(a)(1).

The ruling requires that any US withholding agent—the life insurance carrier or its paying agent—withhold 30% of the amount of the death benefit in excess of the foreign holder's tax basis in the contract.

Comments

We finally note that no guidance is provided in Rev. Rul. 2009-14 on the treatment of a foreign person not engaged in the conduct of a trade or business in the United States who sells a life insurance policy on the life of a US person.

Further, no guidance on the application of the impact of any tax treaty is offered. It is important to note that life settlement funds offered to non-US investors may qualify for exemption from withholding taxes on FDAP under US tax treaties with Ireland and Luxembourg. ■

SAMPLE SCENARIO

Fact pattern: P is a US resident who purchased a life insurance contract on his own life from a US-based insurance company on January 1, 2001.

On June 15, 2008, P sold his life insurance contract to a foreign investor for an amount of $20,000. The remaining term was seven years and six months.

The monthly premium was $500. As the contract owner, the foreign investor named itself as beneficiary.

On December 31, 2009, P died, and the insurance company paid $100,000 under the contract to the foreign investor. The foreign investor had paid monthly premiums totaling $9,000 until the date of death.

Holding: The IRS ruling holds that the foreign investor realized $71,000 of ordinary income from sources within the US; that is, $100,000 less $20,000 less $9,000.

Although the source of income in this type of situation is not identified by statute or by regulation, the ruling explains that the source is determined by analogy to the income classes that are specified within the statute.

Citing IRC § 861(a)(1), (a)(7), and 865, the IRS would rule that since P was a US resident and the insurance company is a US domestic corporation, the foreign investor's income is from sources within the United States and is therefore subject to the 30% withholding tax.

Source: *US Internal Revenue Service Revenue Ruling 2009-14*

Conflict of Laws

Governing law of trust is central to trustee's responsibilities and critical to determination of trust's domicile

González Gómez v. Gómez-Monche Vives [2008] ITELR 422 (UK High Court)

Facts. At the centre of the dispute was a defendant beneficiary being sued by another beneficiary who alleged that the trustees, in breach of trust, had made distributions to which the defendant was not entitled.

The defendant made an application challenging the jurisdiction of the English court on the grounds that there was insufficient connection to the United Kingdom. In particular,

- The principal asset of the trust were shares in a Cayman Islands company.
- The Cayman company owned the family business which was located in Spain.
- The settlor was domiciled in Spain.
- All the beneficiaries, including the defendant, were domiciled in Spain.
- The trust was administered in Liechtenstein.
- The trustees were based in Liechtenstein and the B.V.I.

The only connection to the UK was a clause in the trust agreement stating that the governing law of the trust was the law of England.

Jurisdiction was disputed under art 5(6) of the European Commission *Judgment Regulation*, a precondition of which is that the relevant trust be domiciled in England and Wales.

Analysis. The fact that the trust was administered in Liechtenstein did not automatically mean that the trust was domiciled there.

A trust would be domiciled in part of the UK, if the system of law of that part is the system of law with which the trust has its closest and most real connection.

The UK High Court found that unlike parties to a commercial contract, trustees had to be intimately aware of their responsibilities under the general law applicable to the trust. Reference to the law governing the trust was central to the trustee's responsibilities.

It was held that although a choice of English law as the proper law of the trust is not conclusive as to the question of domicile, it is very difficult to see what other circumstances would outweigh the choice of English law so that another system of law had a closer and more real connection to the trust than English law.

The fact that the proper law of the trust was the law of England made the trust "domiciled" in England for the purpose of art. 5(6).

Commentary. The scope of art. 5(6) of the *Judgements Regulation*, which allows service abroad in most of Europe without permission, is crucial for the enforcement of such trusts.

This decision defines the scope of the jurisdiction of England to enforce English law trusts even though the defendant is based elsewhere in the European Union. ■

Proper Forum

England and Wales High Court flexes its jurisdictional muscle

Cherney v Deripaska [2008] EWHC 1530

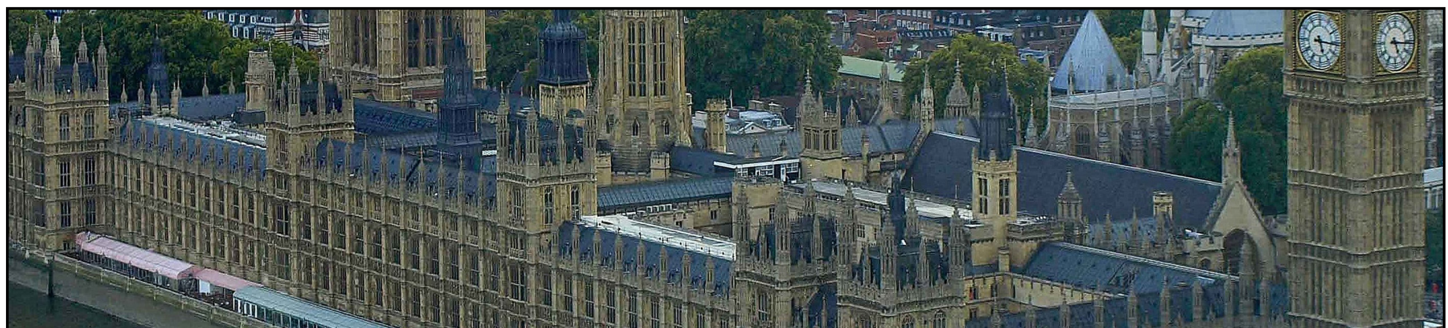
Facts: Oleg Deripaska, Russia's richest man and the ninth-richest in the world, has been sued by his former business partner Michael Cherney for control of a $4 billion stake in aluminum company Rusal, which Deripaska owns with Roman Abramovich.

Deripaska, who is related by marriage to former president Boris Yeltsin, undertook to hold 20% of the shares in Rusal on trust for Cherney pursuant to an agreement made in a London hotel in March 2001.

Analysis: The court had to decide whether to keep the case in England or to send it to Russia. There was little doubt that the jurisdiction most closely connected to the claim was Russia. However, there was a significant chance that the Cherney would not receive a fair trial in Russia and that he may also be at risk of false prosecution. There was also concern about the influence of the government over the Russian courts.

The court decided that Cherney's fears over returning to Russia were justified and that the case should be tried in London. The judge added that there was a significant risk of "improper government influence" in this particular case.

Commentary. Law is about delivering justice, but justice exported abroad is rarely popular. Nonetheless, this highly controversial decision may set new standards for the long arm of the English courts.



Estate Planning

Lessons from the estate of hotel magnate and “Queen of Mean” Leona Helmsley

Facts. After Leona Helmsley died in 2007, it was publicly revealed that she left the bulk of her estate—reportedly worth more than $4 billion—to charity, and more specifically, to the care and welfare of dogs.

In 2003, Helmsley drafted a mission statement to establish goals for a multibillion dollar trust. The administration and management of the Helmsley Charitable Trust was left largely to the discretion of the trustees, with few specific instructions regarding beneficiaries.

Helmsley's mission statement did, however, direct her trustees to make grants from the trust, in their sole discretion, for:

1. The benefit of indigent people.
2. The care of dogs.
3. Such other charitable activities as the trustees shall determine.

In 2004, Helmsley executed a subsequent mission statement, which revoked all prior mission statements. The new mission statement removed the first goal of helping poor people, and stated that it was her intention that the bulk of the trust "provide for the care of dogs."

Since her death, the trustees have given about $1 million—less than 1% of the estate—to dog-related charities. The bulk of grants from the trust have gone to the benefit of human causes such as health care, medical research, human services, and education.

Experts have debated over the enforceability of instructions left by Helmsley in her last mission statement. In February 2009, a New York court answered the question of whether Helmsley really wanted to leave all of her money for dogs alone.

Analysis. The Manhattan Surrogate Court found that the trust and mission statement included enough language to allow the trustees to exercise discretion and use the money for both dog and human charitable purposes.

The court held that "the trustees may apply trust funds for such charitable purposes and in such amounts as they may in their sole discretion determine."

Commentary. In light of this ruling, the trustees could conceivably make all grants from the trust for the benefit of human charitable purposes, and altogether ignore Helmsley's directive to care for dogs.

Without passing judgment on Helmsley's goals, this case raises interesting issues about respecting a person's wishes. While Helmsley truly wanted to help dogs, it does not appear that her specific wishes will be followed.

The lesson to be learned is that if you have specific wishes regarding the distribution of assets from your estate, you must leave clear and specific written instructions to the trustee in an updated and legally binding document.

To the extent that you include discretionary or boilerplate language, it may give the trustee unexpected discretion and the power to distribute your wealth in ways you may not have intended. ■

The estate of The Body Shop founder Anita Roddick

Body shop founder Anita Roddick did not hide the fact that she had no intention of dying rich. Before her death in September 2008, she publicly stated that she intended to spend the last 20 years of her life giving away her fortune to "groups and individuals that show leadership in the areas of global justice, human rights, environmental action and grassroots organising."

Roddick, a human rights activist and environmental campaigner, started The Body Shop as an eco-friendly and ethical cosmetics company with her husband in 1976. In 2005, French cosmetics firm L'Oreal paid £625million for the company, paying Roddick and her husband Gordon more than £100million for their 18% share in the business.

After her sudden death from a brain hemorrhage at the age of 64, it was revealed that Roddick had been true to her word; she had given away the entire value of her estate and left nothing to her children. ■