

## Defining Qualified Business Income In Life Settlement Industry

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Among the many other income tax relief provisions provided by the Tax Cuts and Jobs Act,[1] one of the key ones is new Internal Revenue Code Section 199A's 20 percent deduction from taxable (not gross) income for "qualified business income" derived from the direct performance of certain types of professional services or that flow through from fiscally transparent entities. On Aug. 16, 2018, the Internal Revenue Service published its proposed regulations for implementing this code section, which includes good news for insurance agents and brokers. This article examines whether that good news will carry over to participants in the life settlement industry, the secondary life insurance policy investment and trading business. Read our prior three TCJA's impact on the life settlement industry articles [here](#), [here](#) and [here](#).

Code Section 199A generally provides a taxpayer, other than a Subchapter C corporation,[2] with an income tax deduction[3] for a certain amount of its qualified business income. Qualified business income is defined to include income derived from a "qualified trade or business," which means any type of trade or business except a "specified trade or business" or services rendered as an employee.[4]

The specified trade or business concept serves to exclude the Code Section 199A deduction for certain types of professional services income which encompass those professions described in Code Section 1202(e)(3)(A)[5] as well as services consisting of investing and investment management, trading or dealing in securities,[6] partnership interests or commodities.[7] The following types of professions do not receive the Code Section 199A deduction: accounting, actuarial science, architecture, athletics, brokerage services, consulting, engineering, financial services, health, law, performing arts or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.[8]

Following the TCJA's adoption but before the IRS published its proposed Code Section 199A regulations, the insurance agent and brokerage community proactively sought to have the IRS clarify and confirm that income derived from insurance agents' and



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brokers' services does not constitute disqualified business income by arguing to the IRS that Congress did not intend to include insurance agents' and brokers' services as Code Section 199A "brokerage services," particularly because "insurance business" is listed in Code Section 1202(e)(3)(B), and not Code Section 1202(e)(3)(A) which is the specified code section referenced in Code Section 199.[9] On Aug. 8, 2018, the IRS rewarded these efforts by interpreting "brokerage services" as used in Code Section 1202(e)(3)(A) to exclude insurance agents' and brokers' services, thus making their income qualified business income. Specifically, the IRS' Proposed Treasury Regulation §1.199A-5(b)(2)(x) states that "...the performance of services in the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities" (as defined in section 475(c)(2) (and which definition of securities does not include nonvariable life insurance policies) for a commission or fee. "This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers." [10] The IRS' proposed regulations make clear state licensing laws do not control the determination of whether a profession is or is not a qualifying field.[11] By excluding insurance agents' and brokers' services from Code Section 199A brokerage services, arguably the IRS has implicitly said that the principal asset of an insurance agency or brokerage is not the reputation or skill of its employees and this is bolstered by the IRS' proposed regulations that further define what it means for a business to have as a principal asset the reputation or skill of its employees, which is limited to a business where fees are paid it for endorsing products or services, payment to it for the utilization of an individual's name, likeness, trademark or other symbol associated with his or her identity; and where payment to it is made for radio, television or other media appearances.

The question for life settlement industry participants is where do they end up in light of the IRS' proposed regulations' favorable treatment of insurance agents and brokers services as nonbrokerage services. These participants are (1) life settlement brokers, (2) life settlement providers, (3) life expectancy evaluation providers and (4) life settlement policies servicers.

### **Life Settlement Brokers' Services and Income**

Life settlement brokers negotiate, on behalf of original policyholders, their sales of in-force life insurance policies to life settlement providers. Forty-three states now regulate the life settlement business and require that (1) life settlement brokers be licensed as life insurance agents (or in some states hold a separate life settlement broker license) to render life settlement brokerage services and (2) life settlement providers, the purchasers for life insurance policies in secondary market transactions, must be licensed by state insurance departments. Life settlement brokers receive compensation (usually articulated as a commission, typically ranging from 1 to 3 percent of a life insurance policy's death benefit amount) payable from the gross life settlement proceeds. Usually life settlement brokers solicit purchase bids from multiple life settlement providers, making a market for a policy and seeking to obtain the highest purchase bid for selling policyholders. Oftentimes life settlement brokers split their commissions with a downstream life insurance agent that has the policyholder customer relationship (and sometimes is the agent of record that originally sold the policy to the policyholder seeking a life settlement of the policy).

For purposes of Code Section 199A, because a life settlement broker is usually also licensed as a life insurance agent, a life settlement broker's services should be treated no differently than a life insurance agent's services given that a life settlement broker's service is a brokerage service and involves the same life insurance policy the original sales commission for which now constitutes qualified business income of the life insurance producer of record, which producer, as indicated above, may also receive compensation from the life settlement transaction's sales proceeds from the policy seller. The

treatment of life settlement brokers' income as qualified business income is qualitatively consistent with their life insurance agent brethren's sales commission income. The only differences between the brokerage services performed by a life insurance agent and a life settlement broker and the compensation respectively paid for those services are (a) the timing of performance of these services, one at the front end for the original sale and issuance of the life insurance policy and the other for the disposition of the life insurance policy, generally after (and oftentimes, many years after) expiration of its contestability period, in its secondary market sale, and (b) the identity of the payor of the compensation for performance of the brokerage services, a life insurance company for the producer of record's original sale and issuance of the life insurance policy and the selling policyholder for the life settlement broker's sourcing a life settlement provider's secondary market purchase of the life insurance policy.

There is some uncertainty whether life settlement brokerage commission splits paid by the life settlement brokers to downstream life insurance agents or other finders of life insurance policy sellers in connection with life settlement transactions are qualified business income for the downstream agents or finders. It is not clear that these agents/finders render brokerage services that can be classified under the "insurance agent and broker" exclusion from "brokerage services" because generally what they do, in effect, is engage a life settlement broker on behalf of the agent's selling policyholder customer and function as a conduit for the flow of transaction information between the selling policyholder customer and the life settlement broker, and often they do not interface with the life settlement providers that make purchase offers for a policy or the one that ultimately buys the policy. Arguably, this activity could fall under the umbrella of an insurance agent or broker since the underlying asset being transferred is an insurance policy. However, even if a life insurance agent that secures the services of a life settlement broker for the agent's policyholder client is not itself engaged in the nonbrokerage services rendered by the life settlement broker, the agent's commission-split income may still be qualified business income as the agent's services are arguably not those described in Code Section 1202(e)(3)(A), unless perhaps they are "financial services" of some referral sort, which would seem to be contradictory to the life settlement broker's services not being characterized as brokerage services for Code Section 199A purposes.

### **Life Settlement Providers' Services and Income**

Most life settlement providers buy life insurance policies from their original owners and immediately resell them to investors, effectively in a "table-funding" transaction where the investor escrows the purchase money funds which the life settlement provider, through an escrow agent, uses to pay the purchase price for the policy to the selling policyholder along with commissions due to the life settlement broker and, where applicable, the commission-split due to the life insurance agent of record for the policy. The life settlement provider earns a fee for its service of buying and reselling the policy paid by the investor which typically is a fixed percentage of the policy's face amount of death benefit, usually in the range of 2 percent to 3 percent. In most cases, however, the life settlement provider does not become the subsequent, interim policy owner of record, but rather, record and beneficial ownership of the policy is transferred directly from the selling policyholder to the investor using policy change forms filed with the life insurance company that has issued the policy in lieu of a two-step process of first recording the life settlement provider as policy owner of record and then recording the investor as the transferee of the policy from the life settlement provider.

Accordingly, most life settlement providers treat the nature of their income as commission or brokerage income, even though in reality they are a buyer and reseller of intangible personal property, i.e., life insurance policies. There is a minority school of thought that a life settlement provider should treat its

income as short-term capital gain on the sale of a capital asset because it buys and then resells the life insurance policy, a capital asset. However, whether the life settlement provider's income is treated as commission income or short-term capital gain, both before and after the TCJA, there was and is no U.S. income tax distinction, because both types of income were and are taxed at ordinary income tax rates. Nevertheless, short-term capital gains are not qualified business income,[12] and if the IRS were to determine that a life settlement provider's income is short term capital gain from its purchase and resale of a life insurance policy, the twenty percent (20 percent) qualified business income deduction would not be available to life settlement providers.

In substance, a life settlement provider's transactions in buying and immediately reselling policies to investors are brokerage services, except in some cases where a life settlement provider uses its own capital to buy policies and hold them for its own account; but, even in those situations, usually such a life settlement provider would transfer policy ownership to an affiliated investment holding entity, a life settlements investment fund managed by an affiliate of the life settlement provider, retaining the brokerage nature of the provider's activity. Members or partners of life settlement providers that are organized as pass-through entities should also be able to treat their allocable shares of the flow-through brokerage income as qualified business income. However, to the extent the IRS were to determine that a life settlement provider's income is, as described above, short-term capital gain, then a life settlement provider's income would not be accorded qualified business income treatment.

In sum, brokerage fee type income earned by both life settlement brokers and life settlement providers should be qualified business income under of the IRS' recently proposed Code Section 199A Proposed Treasury Regulations, which exclude insurance agents' and brokers' services from being brokerage services that do not obtain the qualified business income deduction.

### **Life Expectancy Evaluation Provider Services**

Life expectancy providers produce and sell mortality or life expectancy estimates for the life settlement industry. Both life settlement brokers and life settlement providers buy these estimates to evaluate the fair market value of a life insurance policy, which, in large part, drives the discounted cash flow analysis, using an assumed internal rate of investment return, to arrive at the purchase price of a policy, and life insurance policy investors rely heavily on the quality of life expectancy reports. Life expectancy providers create life expectancy estimates using a combination of employees who are mortality underwriters, health care professionals like doctors and nurses and life actuaries,[13] which generally are highly trained and skilled professionals. However, the IRS' Code Section 199A Proposed Regulations narrowly definition of what it is a business having as a principal asset the reputation or skill of its employees does not include a life expectancy provider. Thus, life expectancy providers' income should also constitute qualified business income.

### **Life Settlement Investment Funds' and Fund Managers' Income**

Life settlement investment funds' returns earned from life insurance policy death benefits payments or gains realized from reselling purchased life insurance policies, like other types of investment businesses, are not likely qualified business income given that a specified trade or business includes an investing business.[14] Similarly, a life settlement investment fund manager's management fees are not likely qualified business income for the same reason.

## Life Settlement Asset Servicers' Services and Income

Life settlement asset servicers render services to life insurance policy investors, usually life settlement investment funds. These services include assisting investors with “optimizing” premium payments due for life insurance policies to keep them in-force (determining the lowest amount to pay for the pure cost of insurance for this negative cash flow asset), tracking the health and life status of insureds to ascertain when deaths occur and death benefits can be collected and filing death benefit claims with life insurance companies and otherwise assisting in the collecting of death benefit payments. Servicing fees paid to life settlement asset servicers are likely qualified business income because their services should not fall within any of the disqualified services enumerated in Code Section 1202(e)(3)(A), including the limited scope of “financial services” under the Code Section 199A Proposed Regulations and also due to the absence of having as a principal asset the reputation and skill of its employees as the services of life settlement asset servicers do not fall under the enumerated types of services/payment categories that the IRS has designated to fall under this category.

In summary, most of the life settlement industry’s participants’ income should likely constitute qualified business income under the Code Section 199A Proposed Treasury Regulations, namely life settlement brokers, life settlement providers, life expectancy evaluation providers and life settlement asset servicers, but likely not life settlement investment funds or their managers. Therefore, life settlement brokers, life settlement providers, life expectancy evaluation providers and life settlement asset servicers that are Subchapter C corporations should evaluate whether their conversion to a Subchapter S corporation, partnership or disregarded entity for federal income tax purposes is desirable. The comment period for the Code Section 199A Proposed Treasury Regulations expired on Sept. 22, 2018, and the IRS plans to hold a hearing on them on Oct. 16, 2018.

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[1] PUB. L 115-97.

[2] 26 U.S.C. §199A does not apply to Sub-Chapter C corporations because they already benefit from the lowered corporate income tax rate provided in the TCJA.

[3] 26 U.S.C. §199A.

[4] 26 U.S.C. §199A(d)(1).

[5] But without regard to the words “engineering” and “architecture.”

[6] As defined in 26 U.S.C. §475(c)(2).

[7] As defined in 26 U.S.C. §475(e)(2).

[8] 26 U.S.C. §1202(e)(3)(A). This code section provides for the exclusion from gross income of

noncorporate taxpayers of 50 percent of gain realized on the sale or exchange of qualified small business stock.

[9] See e.g., Lockton's email dated July, 2018, to IRS, The Underwriters Group letter dated July 11, 2018 to IRS, and ABD Insurance Finance Services letter dated July 16, 2018 to IRS.

[10] Prop. Treas. Reg. §1.199A-5(b)(2)(x).

[11] 83 Fed. Reg. 159 (August 16, 2018), p.40897.

[12] 26 U.S.C. §199A(d)(1)(B).

[13] Although life expectancy providers often employ life actuaries, they are not engaged in rendering actuarial services within the meaning of Code Section 1202(e)(3)(A).

[14] 26 U.S.C. §199A(c)(3)(B)(i).