



Private Placement Life Insurance: The Foreign Account Tax Compliance Act (FATCA) and the Future for U.S. Persons

Non-U.S. insurance companies with U.S. connections may incur significant costs to comply with the Foreign Account Tax Compliance Act (FATCA). By electing to be treated as a U.S. taxpayer, non-U.S. insurance companies can avoid FATCA reporting requirements, achieve transparency, and avert withholding taxes.

1. INTRODUCTION AND BENEFITS OF INSURANCE STRUCTURES

The Foreign Account Tax Compliance Act (FATCA) will be progressively phased in over the next several years, creating large costs for everyone involved and even more bad will for the U.S. government. Much of its impact will be focused in the area of brokerage. In this article, we focus on life insurance solutions where there is a U.S. connection (i.e., the policyholder or beneficiary is a U.S. person). The benefits and advantages of private placement life insurance (PPLI) or variable unit-linked (VUL) life insurance are now well known and have become an integral part of wealth planning for advisers globally. The main benefits are the following:

- Tax optimization and planning,
- Asset protection (ownership transfer of any premium to the insurer),
- Investment flexibility, in particular for U.S. persons, and
- Estate, inheritance, and succession planning (tax-free death benefits and tax-free loans).

The business has matured enormously over the last several years, with a very professional industry emerging that serves the upper end of the market. In the pioneer and growth phases, however, some parts of the business unfortunately acquired a somewhat dubious reputation. When transacting with any offshore insurance carrier, the adviser should watch out for the following:

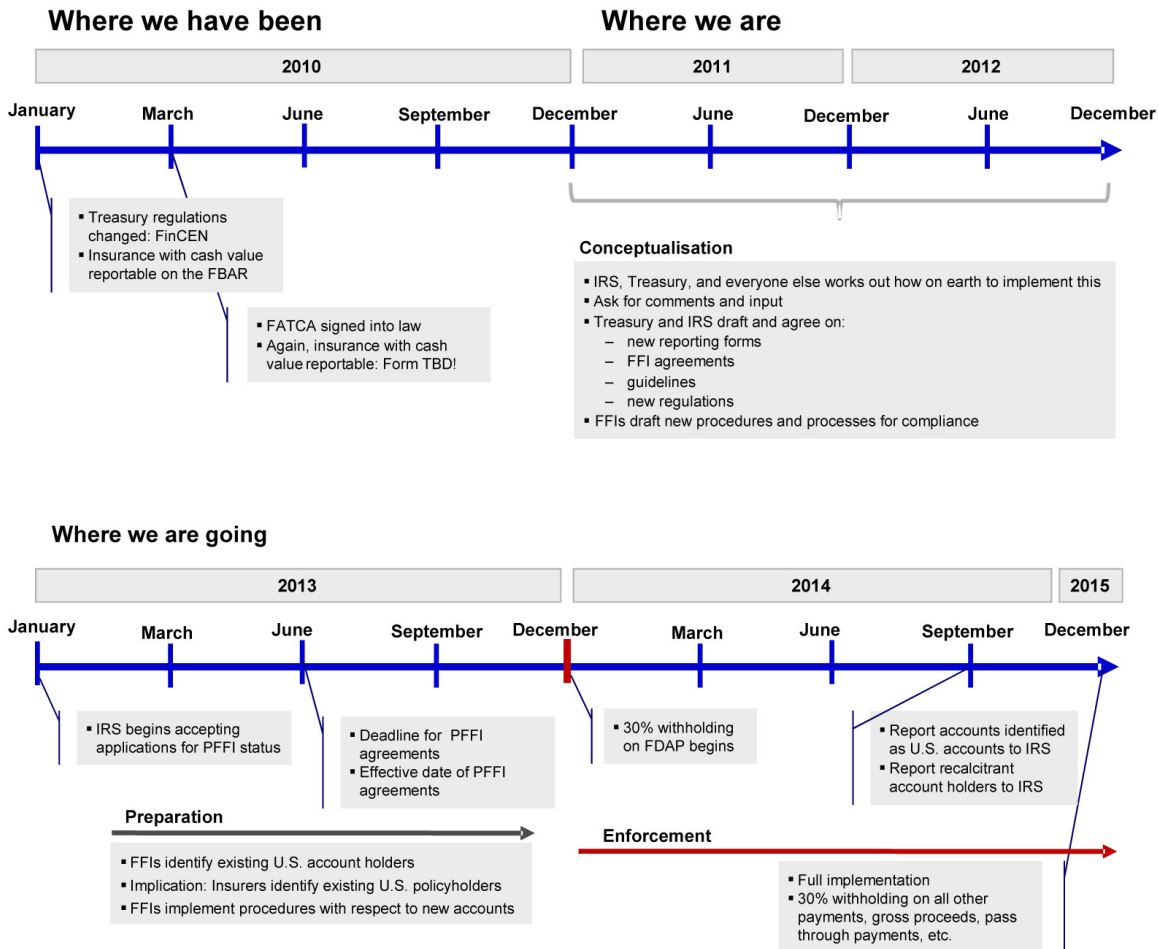
- Inappropriate or poorly set up structures: Verify the structure with an attorney and/or CPA.
- Expensive and opaque cost structures: Ensure all fees are fully disclosed, particularly investments, structured products, and mutual fund structures.
- Investment management issues.
- Policy compliance: Verify the policy is compliant with tax and regulatory laws.
- Fiduciary duty issues (for example, oversight of the asset manager).

2. FATCA: IMPLEMENTATION AND CONSEQUENCES

The costs of FATCA compliance to Foreign Financial Institutions (FFIs) have been estimated at 5 to 10 times that of the additional tax revenue. Under FATCA, FFIs have the choice of entering into a reporting agreement with the United States in relation to their U.S. clients or being subject to a 30 percent nonrecoverable withholding tax penalty on virtually all U.S. source income, including gains, investment returns, returns on capital, and so on, whether or not that withholdable payment flows to a U.S. client or any other account at the FFI.

Figure 1 shows the implementation time line with the most important dates, which suggest that it is critical to secure compliance of clients and start conversations now.

Figure 1. Time Line for FATCA Implementation



Both clients and advisers must realize that insurance policies with a cash value now need to be included on the report of foreign bank and financial accounts (FBAR) and that there will be penalties for failing to report. In the past, the IRS and Treasury were ambiguous on this point, with most legal opinions agreeing that insurance policies were not reportable. In January 2010, the Treasury (FinCEN) promulgated new regulations coming into force 28 March 2011 that require reporting for fiscal year 2010 onwards. The guidance states that “any account that is an insurance policy with a cash value or annuity policy” is reportable. In an indication of the Treasury’s enthusiasm to improve insurance-related reporting, FATCA’s requirement to report “Foreign

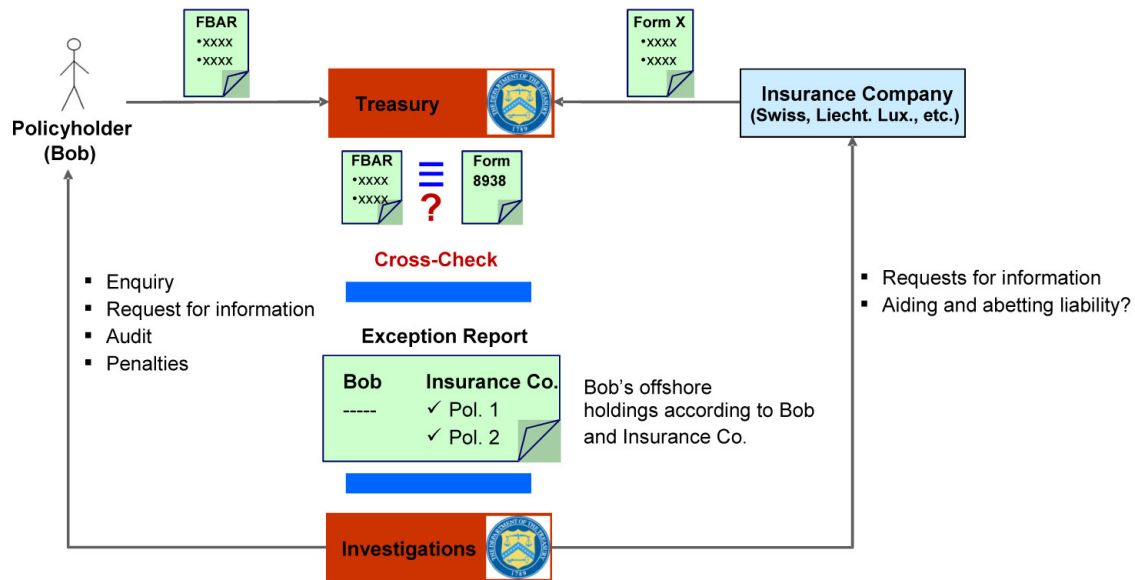
Assets” (different from the FBAR and a separate form) will also require reporting of foreign policies.

Moving to the life insurance and annuity carriers, those treated as FFIs under FATCA (all the big ones) will be subject to the 30 percent withholding tax on U.S. assets. They will, therefore, have to become participating FFIs (PFFIs) to avoid the withholding tax. It is reasonable to expect that if a carrier becomes a PFFI, it will be required to disclose all details of U.S. policyholders, including custodian banks, account details, balances, and so on. This would not just include policyholders with U.S. assets but rather all policyholders with U.S. person indicia if evidence of non-U.S. status cannot be obtained.

Clearly, FATCA is going to cause some major shake-ups. We would reasonably expect the Treasury to electronically cross-check what participants are reporting on the FBAR, the report of foreign assets form still to come under FATCA, and the form the PFFI insurance companies will use to report, “Form 8938.”

Obviously, if what is reported on the FBAR, the report of foreign assets form, and the insurance company’s “Form 8938” is the same, there is no problem. If they are not the same, we expect large discrepancies to be investigated. Figure 2 illustrates what we think the likely process will be.

Figure 2. Treasury Cross-Checking Process



3. EFFECT ON THE INDUSTRY

FATCA may turn out to be a game changer for PPLIs, particularly for large insurers dealing with any U.S. connection. It is true that many U.S. persons taking out PPLI policies do so to get access to offshore investments without running into the passive foreign investment company (PFIC) tax problems. This fact, however, misses the point: The larger carriers all have U.S. investments and/or receive payments from U.S. sources. We believe this means they must either comply, become a PFFI, or pay 30 percent on all incoming payments from U.S. sources. A PFFI is required to identify all U.S. person account holders and report all details on U.S. person account holders to the IRS. For insurance companies, this will apply to policyholders holding policies with a cash value. Given the amount of PPLI business done with U.S. persons over the last 15 years, we think it highly unlikely that all are compliant. We think these requirements will drive increased voluntary disclosure as people regularize

their affairs and as some U.S. persons surrender or exchange their policies, moving the money elsewhere, which may well result in capital flight.

4. POTENTIAL SOLUTION FOR SOME CLIENTS

All clients are special, some clients are more special than others, and clients with a U.S. connection have now become truly special. Special solutions are required to serve the client best and to make sure both the client and you as adviser stay on the sunny side of the law. Over the last few years, a niche model has emerged for U.S. persons and those with “U.S. connections”: the “953(d)” insurance company.

Section 953(d) of the U.S. Internal Revenue Code (IRC) allows a non-U.S. insurance company to make the election to be treated as a U.S. taxpayer, which may provide material benefits to the insurance company, policyholders, and beneficiaries. With FATCA looming on the horizon, we think this model will become much

more popular over the next few years. The 953(d) carrier should not be subject to FATCA because it is already a U.S. taxpayer and is compliant and transparent. It cannot be treated as an FFI because it is not foreign in terms of the IRC. Moreover, it would not imply an obligation to register with the SEC as an asset manager. **Figure 3** summarizes the distinction between a U.S. person to the IRS and a U.S. person to the SEC and what it means for the participants.

As an offshore insurance carrier, the 953(d) carrier can invest in assets located anywhere in the world, including the United States and Europe. Through the policy

structure, the policyholder can legally defer income tax and capital gains tax and mitigate estate tax on the assets within the policy, regardless of the location of those assets: United States, Europe, Asia, and so on. Like a Liechtenstein or Luxemburg insurance company, the 953(d) carrier is not subject to U.S. state or federal insurance laws because it does not engage in trade and business in the United States.

The 953(d) election elegantly addresses a number of the issues with FATCA. As a U.S. taxpayer, the FATCA regime does not affect the 953(d) carrier. It is, in any case, tax transparent. This election results in a big benefit for

Figure 3. Who U.S. Persons Are and What It Means for the Participants

U.S. person/company in:

| | America | Offshore¹ |
|-------------------|----------------|-----------------------------|
| To the IRS | ✓ U.S. person | ✓ U.S. person |
| To the SEC | ✓ U.S. person | ✗ U.S. person |

¹ e.g., Bahamas, Bermuda, Cayman Islands



non-U.S. persons with U.S.-situs assets and/or U.S. person dependents. The U.S. taxpayer status solves the withhold tax issues. The structure is fully tax transparent for U.S. beneficiaries but at the same time retains the tax advantages of PPLI. In particular, it provides benefits to those clients with U.S. beneficiaries in their trust structures. In combination with an irrevocable life insurance trust (ILIT), it also avoids the generation skipping tax (GST).

5. CONCLUSION

FATCA is going to have wide-reaching consequences for the insurance industry. In the early days of the offshore insurance industry, some rather interesting policies with known issues were written, giving rise to a need for restructuring. We think some policies with offshore

insurers will likely move to 953(d) carriers by means of exchange. With penalties for noncompliance increasing in the future, we expect the movement underway to greater compliance will continue, with the insurance structure being retained. If a client has a policy that is older than eight years or so and issued by a Swiss/Liechtenstein/Luxembourg or other offshore carrier, we recommend getting that policy checked. If your client has a questionable structure or there are compliance issues, now is the time to get it looked at.

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