Private Placement Life Insurance, the Foreign Account Tax Compliance Act and a Solution for U.S. Persons

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Introduction: Fatca
The Foreign Account Tax Compliance Act (Fatca) will be progressively phased in over the next several years. The cost of compliance to Foreign Financial Institutions (FFIs) has been estimated at 5 to 10 times estimated additional U.S. tax revenue. Foreign financial institutions have effectively been told that they will have to pay for the privilege to become tax collectors serving the IRS.

Under Fatca, FFIs have the choice of becoming a Participating Foreign Financial Intermediary (PFFI) by entering into a reporting agreement with the United States in relation to their U.S. clients or be subject to a 30% nonrecoverable withholding tax penalty on virtually all U.S. source income, including gains, investment returns, returns on capital etc.

Life insurance structures as a wealth planning tool
Private Placement Life Insurance (PPLI) or Variable Unit Linked Life Insurance (VUL) has become a well known, accepted component of wealth planning over the last 10 years. The benefits and advantages of PPLI include: tax reduction and optimization, asset protection, investment flexibility, estate, inheritance and succession planning. Done correctly, insurance solutions can provide tax-free death benefits, tax-free loans and full asset protection for the client.

Caution as always is advised. In the pioneer and growth phases some parts of the business unfortunately acquired a somewhat dubious reputation. When examining existing structures or setting up new ones, advisors should watch out for the following:

- Inappropriate or poorly set up structures – verify the structure with an attorney or CPA.
- High, intransparent cost structures – ensure all fees are fully disclosed, particularly structured products and investment fund structures.
- Investment management issues – ensure that policy investments are monitored and the asset manager audited.
- Policy compliance – verify the policy is compliant with tax and regulatory laws.
- Fiduciary duty issues – e.g. oversight of the asset manager.

Implications for life insurance structures
For U.S. persons, insurance policies with a cash value now need to be reported on the FBAR (Report on Foreign Bank and Financial Accounts) and there will be penalties for non-reporting. In the past, IRS and Treasury were ambiguous on this point with most legal opinions agreeing that insurance policies were not reportable. In January 2010 Treasury (FinCEN) changed the game with new regulations coming into force March 28, 2011, requiring reporting for fiscal year 2010 onwards. For the first time clarifying the definition of "other financial account", the guidance states that reportable is: "Any account that is an insurance policy with a cash value or annuity policy." This is now crystal clear: Variable universal life policies with a cash value (or frozen cash value) and deferred variable annuity policies are now required reporting on the FBAR. Treasury has clarified that reporting on the FBAR is the policyholders' responsibility, not the beneficiaries'. In an indication of Treasury's enthusiasm to improve insurance-related reporting, Fatca introduces a requirement to report "Foreign Assets" on the new separate Form 8938. This is complementary to the FBAR and will also require reporting of foreign policies, specifying that "insurance contracts with a cash value" must be reported.

With regard to the insurance companies themselves, insurers treated as FFIs (all the big ones) will be subject to the 30% withholding tax on U.S. assets and, theoretically at least, on "pass-thru" payments from PFFIs. They will therefore have to become participating FFIs (PFFI) to avoid the withholding tax. If an insurer becomes a PFFI, it will be required to disclose all details of U.S. policyholders with all account details: balances, asset manager, custodian bank etc. This will apply to all policyholders with U.S. person indicia.

Fatca is going to cause some major shake-ups over the next few years. For insurance reporting, we expect Treasury to electronically cross-check what policyholders are reporting against what the companies are reporting. I.e., the policyholder reports the cash value of his policy(s) on the FBAR and Form 8938. The insurer reports the policyholder's policy(s) on its own form. Obviously if what is reported on the FBAR and 8938 equals what the insurance company is reporting there is no problem. If they don't equal, we expect discrepancies over a certain value to be investigated.

Effect on the insurance industry

Fatca may turn out to be a game changer for PPLI, particularly for insurers dealing with any U.S. connection. It is true that many U.S. persons taking out PPLI policies are doing it to get access to offshore investments without running into PFIC (Passive Foreign Investment Company) tax problems, hence the investments are not U.S. situs. This is missing the point however; the larger carriers all have U.S. investments and/or receive payments from U.S. sources. Worse, as Fatca currently stands, PFFIs will be required to withhold on payments made to non-participating FFIs. This means either comply, become a PFFI or have 30% deducted from all incoming payments from both U.S. sources *and non-U.S. PFFIs.*

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. Even if those policies do not contain any U.S. investments, the insurance company will still be required to identify and report that U.S. person as a policyholder. Given the amount of PPLI business done with U.S. persons over the last 15 years, to state the obvious, we think it highly unlikely that all is compliant. We think this will lead to increased voluntary disclosure as people seek to regularise their affairs and to a certain amount of capital flight out of some larger insurers as some U.S. persons surrender and move the money elsewhere or exchange their policies.

A solution for U.S. clients and clients with a U.S. connection

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, both to serve the client best and to make sure both he and his advisor stay on the sunny side of the law. Over the last few years a niche model has emerged for U.S. persons and the "U.S. connection": the "953(d)" insurance company.

953(d) refers to Section 953(d) of the U.S. Internal Revenue Code (IRC). This allows a non-U.S. insurance company to make the election to be treated as a U.S. taxpayer. This provides some very material benefits to insurance company, policyholders and beneficiaries. We believe this model will become much more popular over the next few years. The 953(d) carrier should not be subject to Fatca as it is already a U.S. taxpayer, compliant and transparent. It cannot be treated as an FFI, because it is not foreign in terms of the Internal Revenue Code.

The 953(d) offshore carrier can invest in assets anywhere in the world. Through the policy, the policyholder can legally defer income tax and capital gains tax and mitigate estate tax on assets within the policy, regardless of the location of those assets: U.S., Europe, Asia etc. Moreover, the 953(d) carrier is not subject to U.S. state or federal insurance laws as it does not engage in trade and business in the U.S.

The 953(d) election elegantly addresses a number of the issues with Fatca, it is fully tax-transparent and a viable alternative to the Liechtenstein- or Luxembourg-based carrier. A big benefit is for non-U.S. persons with U.S.-situs assets or U.S. person dependents. The U.S. taxpayer status solves the withholding tax issues, the structure is fully tax transparent for U.S. beneficiaries while at the same time retains the tax advantages of PPLI. In particular, it provides benefits to clients with U.S. beneficiaries in their trust structures. In combination with an irrevocable life insurance trust it also avoids the Generation Skipping Tax (GST).

We believe that the issues arising with Fatca may drive increased popularity of the 953(d) carrier. E.g., the client may still have a Swiss asset manager, the assets may still be located with a Swiss custodian, but compliance, reporting, payments and investing is made easier and more cost effective using the 953(d) carrier.

Conclusion

Fatca is going to have wide-reaching consequences for the insurance industry. In the early wild west days of the offshore insurance industry some rather interesting policies were written. Some of these are known to have issues, giving rise to a need for restructuring. We think likely a movement of some policies with offshore insurers to 953(d) carriers by means of exchange. With penalties for non-compliance increasing going forward, we expect the movement underway to greater compliance while retaining the insurance structure to continue.

If a client has a policy that is older than eight years or so and is issued by a Swiss/Liechteinstein/Luxembourg or other offshore carrier, we recommend getting that policy checked. If the client has a questionable structure or there are compliance issues, now really is the time to get it looked at.

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Clients with a U.S. connection looking to benefit from offshore private placement life insurance solutions should seek out providers with the specialized knowledge to guide them through the complexities of U.S. tax and regulatory oversight to achieve optimal solutions.