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CROSS-BORDER LIFE INSURANCE: DIFFERING DEFINITIONS IN AN AGE OF INTERNATIONAL TAX REPORTING

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INTRODUCTION

We wrote several articles in 2004-2005 that dealt with the tax consequences relating to life insurance policies owned by individuals when they moved across the Canadian-U.S. border.[1] Since that time and until recently, much of the current Canadian[2] and the U.S.[3] tax legislation as it relates to the taxation of holders of life insurance policies has basically remained unchanged.

However, the 2013 Canadian Federal Budget proposed changes in the rules applicable to leveraged insured annuity arrangements and so called 10/8 policies that are now law. In addition, draft legislation released in 2013 proposes significant changes to the exempt policy rules for policies issued after 2015.[4] Also, at the time we wrote our original articles, the Canadian Department of Finance had announced draft legislation relating to the taxation of foreign investment entities that contained specific provisions with respect to foreign insurance policies held by residents. The government did not proceed with those proposals.

Despite the absence of much substantive change in the insurance tax rules (thus far), there has been a significant development over the past few years where policyholder taxation is concerned: the greatly expanded reporting requirements for foreign financial assets. This topic will be dealt with towards the end of this article.

Using two simple fact patterns involving individuals, we will briefly review some of the current Canadian and U.S. income tax implications relating to life insurance when a resident of Canada emigrates to the U.S. and a U.S. citizen moves to Canada. In the first case, a Canadian resident (who is not a U.S. citizen) emigrates to the U.S. holding two policies issued on his or her life while resident in Canada by Canadian life insurers – a universal life insurance policy (the "Cdn UL Policy") and a ten-year level premium renewable term policy that has no cash value (the "Cdn Term Policy"). Each of these policies is an "exempt policy"[5] and is not registered as a deferred income plan. Since each policy is an exempt policy, income will only arise on the disposition of the interest in the policy.[6] In the second case, a U.S. citizen moves to Canada owning and being the life insured under a fixed, non-variable UL policy (the "US UL Policy") and a ten-year level premium renewable term policy issued by a U.S. carrier (again, with no cash value) (the "US Term Policy"). Neither policy is connected with a tax-qualified retirement plan.

CANADIAN TAX TREATMENT OF THE MOVE SOUTH

A Canadian resident is taxed on the person's worldwide income.[7] A non-resident of Canada is taxable under the ITA on the non-resident's taxable income earned in Canada which includes the income arising on the disposition of taxable Canadian property ("TCP").[8] TCP is defined to include various types of property including a life insurance policy in Canada ("LIPC").[9] An LIPC includes a life insurance policy issued by an insurer on the life of a person or resident in Canada at the time the policy was issued or effected.[10] In general, if a Canadian resident individual ceases to be resident in Canada, the ITA contains provisions that cause accrued gains and losses to be realized in the year of departure.[11] However, these rules do not apply to the Cdn UL Policy and the Cdn Term Policy because each policy is an LIPC.[12] Each of the policies is TCP and the non-resident holder will continue to be liable for income tax arising under the ITA on a disposition in respect of the policy, such as a surrender. In such event, certain procedures are imposed under the ITA and must be followed in the event of a disposition so that payment of the Canadian income tax is ensured.[13] In the event of the death of the life insured under these policies, the insurance proceeds will be tax-free under the ITA.

U.S. TAX TREATMENT OF THE NEW RESIDENT

The United States imposes tax on the worldwide income of its citizens wherever they reside, and it taxes its non-citizen

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residents on generally the same basis. The scope of the U.S. taxing regime, including its extra-territorial reach, is central in examining the tax treatment of life insurance policyholders who cross the U.S. border, the key consideration being the U.S. tax definition of "life insurance contract."[14] Very generally, this definition restricts the amount of cash value that a life insurance policy can provide in relation to its death benefit at any time, thus distinguishing it from annuities and investment products for tax purposes. The definition specifically recognizes a financial instrument as life insurance only if it is treated as such under the applicable law where it is issued (i.e., state law in the U.S., or the law of the non-U.S. issuing jurisdiction) and either (1) the policy's cash value at any time cannot exceed the net single premium for its death benefit at that time,[15] viewing that death benefit as a level amount,[16] or (2) the gross premiums paid for it do not exceed a "guideline premium limitation" based on its death benefit,[17] and that benefit at any time is at least a statutory multiple of the policy's cash value at that time.[18] Very broadly speaking, the rules allow life insurance treatment for a policy that is not more investment-oriented than a single premium, level-face endowment at age 95.[19]

If these requirements are met, the undistributed gain accruing in the cash value of a life insurance policy – the "inside buildup" – grows tax-deferred and there is no income tax on the policy's death proceeds.[20] If not, there is accrual taxation of the inside buildup, assuming that the policy is not part of a tax-qualified retirement plan.[21]

When a former Canadian resident takes up U.S. residence, the individual will be taxed by the U.S. on his or her worldwide income, subject to the rules of the Canada-U.S. Income Tax Convention (1980)[22] and any applicable foreign tax credits. It will thus be necessary for the life insurance policies owned by the new resident to meet the requirements of the IRC in order to be treated as life insurance under the tax law. The Cdn Term Policy should comply with section 7702, since it was recognized as life insurance in Canada and its (zero) cash value cannot exceed the net single premium for its death benefit. The Cdn UL policy is more problematic, since its cash value may exceed the net single premium for its death benefit, and so to comply with the IRC, the past and future gross premiums paid for it must not exceed the guideline premium limitation for its death benefit. That benefit also must be at least the multiple of the contract's cash value that is specified in section 7702.[23] The Cdn UL Policy could meet these requirements, but this is not guaranteed, and making this determination would require actuarial testing. Second, the typical Cdn UL Policy may contain provisions not found in U.S.-issued life insurance, rendering their treatment uncertain.

If the Cdn UL Policy does not comply with IRC section 7702, accrual taxation of its inside buildup results, although, if the non-compliance occurred before the move to the U.S., it appears that only the income arising after residence was established should be taxable by the U.S. In the absence of actuarial testing, the best answer under U.S. tax law likely will be for the Cdn UL Policy to be exchanged for a U.S.-issued policy. This can be done tax-free under U.S. law, although such an exchange would be treated as a surrender of the existing policy and the acquisition of a new one under the ITA, resulting in a taxable event. This of course may not be feasible if there was a change in the insurability of the life insured.

U.S. TAX TREATMENT OF THE MOVE NORTH

Even though a U.S. citizen takes up residency in Canada, the Code views the citizen as remaining subject to its provisions. Thus, with respect to life insurance policies owned by a citizen, the usual rules will apply from a U.S. tax standpoint.

In planning for the move to Canada, a U.S. citizen should beware of acquiring *new* life insurance policies unless they comply with both the Canadian exempt test and the U.S. tax definition of life insurance (none are known to be issued by U.S. or Canadian insurers at this time). One practical option may be to try to ascertain if the US UL Policy perchance complies with the Canadian exempt test, and if it does, to learn how that status may be maintained (the US Term Policy will likely comply with the exempt test). If no other solution is found, consideration should be given to terminating the US UL Policy for otherwise it may be subject to accrual tax reporting in Canada.[24]

CANADIAN TAX TREATMENT OF THE NEW RESIDENT

Once resident in Canada, the holder of the U.S. policies will be subject to the rules in the ITA applicable to owners of life insurance policies, provided that each of the U.S. policies is a "life insurance policy"[25] under the ITA. If it is assumed that each of the U.S. policies would be regarded as a "life insurance policy" under the ITA, then when the U.S. citizen moves to Canada, he or she will be treated as having disposed of and reacquired the U.S. policies at fair market value and will be subject to the rules under the ITA that apply to Canadian resident owners of life insurance policies.[26]

As a first step, therefore, it will be necessary to determine if each U.S. policy is an "exempt policy" under the ITA. In order to apply the test, the U.S. dollar denominated policies must be converted into Canadian dollars. The ITA and the regulations made thereunder do not contain any specific rules for determining whether either of these policies is an "exempt policy" in this situation. It will thus be difficult to apply the "exempt test" to the policy, even with actuarial assistance. It is very likely that the US Term Policy qualifies as an exempt policy. However, with the US UL Policy, this is uncertain. If it cannot be determined whether the latter policy is an exempt policy, consideration should be given to surrendering it before the move to Canada as noted above.

THE LATEST TREND – REPORTING ON FOREIGN FINANCIAL ASSETS

Taxpayer reporting of foreign financial assets. Taxpayers resident in Canada (with certain exceptions not relevant to this article) and certain partnerships are required to annually file an information return in respect of certain foreign property that they own.[27] Reporting is generally required where the person or partnership holds at any time in the year "specified foreign property" the total cost of which exceeds Cdn$100,000.[28] Specified foreign property includes a variety of foreign property such as funds or intangible property deposited or held outside of Canada and shares of a non-resident corporation (other than a foreign affiliate) but does not include, among various types of property, personal-use property. Life insurance is not specifically listed as being specified foreign property.[29] The form to be filed is the T1135, "Foreign Income Verification Statement".

As a result of the 2013 Canadian Federal Budget which reflected the federal government's renewed focus on combating international tax evasion,[30] a revised T1135 form has been released by the Canada Revenue Agency which requires much more information than the old form. The instructions accompanying the form state that specified foreign property includes an interest in a foreign insurance policy.

U.S. persons also have reporting obligations on foreign financial accounts and assets. FinCen Form 114[31] must be filed to disclose interests in accounts maintained with foreign financial institutions where the aggregate value exceeds US$10,000. Such interests include life insurance and annuity contracts. In addition, IRS Form 8938 must be filed with the annual income tax return to disclose foreign financial assets – the instructions expressly include life insurance and annuity contracts in this – where the aggregate value exceeds US$50,000 at the tax year-end or US$75,000 at any time during the year. These thresholds rise to US$100,000 and US$150,000 for spouses filing jointly, and are reduced for individuals residing outside the U.S.

Financial institution reporting of foreign financial accounts. The required reporting by honest and diligent taxpayers does not, of course, remedy the problem of tax evasion by those who would hide assets offshore. In 2010, the U.S. Congress took a dramatic step to address this problem by enacting a group of Code provisions collectively known as "FATCA" – the Foreign Account Tax Compliance Act.[32] FATCA effectively forces non-U.S. financial institutions ("foreign financial institutions" or "FFIs") worldwide to report to the IRS on the financial accounts of "U.S. persons" (i.e., taxpayers) by threatening the institutions with a 30 percent withholding tax on U.S.-source income. Many governments around the world have entered into "inter-governmental agreements" ("IGAs") with the U.S.[33] to enable this reporting by their resident finan-

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cial institutions, often with a pledge from the U.S. that its own institutions would engage in reporting on those governments' nationals. Given the increasing focus of fiscal authorities on the problem of income tax evasion and the need for enhanced enforcement efforts across national boundaries, this is not surprising.

The regulations under FATCA (and the applicable IGAs) treat cash value life insurance (and annuity) contracts as financial accounts subject to reporting by "participating" FFIs, i.e., those that agree to report to the IRS and thereby avoid the withholding tax. The report is to show the U.S. person's name, address, account number, tax I.D. number, account value – meaning the cash value in the case of a life insurance contract – as of the annual reporting date, and any distributions made during the reporting period. As a result, in the case of life insurance contracts issued by carriers outside of the U.S. that are participating FFIs, the IRS will be apprised of the cash values of contracts owned by or for the benefit of U.S. persons.[34] The IRS will not know whether the contracts in question meet or do not meet the requirements of IRC section 7702; the FATCA regulations and the IGAs do not impose on participating FFIs the need to make such a judgment. But reports of significant cash values under contracts issued outside of the U.S. almost certainly will, in time, attract the attention of IRS auditors. As and when that occurs, the question of section 7702 compliance can readily be raised by auditors armed with the FATCA-generated reports.

And there is no reason to believe this would not work the other way. Canada certainly has as much official desire, if not need, to enforce its revenue laws as does the U.S. The 2013 Canadian Federal Budget stated that the federal government was negotiating with the U.S. for an agreement to enhance information exchange under the Canada-U.S. Tax Treaty, that the agreement would include information exchange provisions in support of FATCA, and that under the agreement information exchange would be improved on a reciprocal basis to facilitate tax compliance in both countries.[35] Apparently, Canada and the U.S. may be close to an agreement on this matter. As reciprocal reporting on the financial accounts of resident "foreign nationals" by local financial institutions becomes the international norm, Canadian revenue authorities will have access to information on persons with foreign-issued life insurance (among other foreign-based assets) who have become Canadian residents. Such information would enable tax auditors in Canada to inquire about, and challenge, the exempt test compliance (or not) of a US UL Policy.

CONCLUDING THOUGHTS

The existence of the differing tax-based definitions of life insurance, and the absence of relief under the Canada-U.S. tax treaty, pose a dilemma for life insurance policyholders who move across the border. Effectively forcing the surrender of a permanent life insurance policy to assure tax compliance makes little sense. A better solution, of course, would be for the migrating policyholder to obtain a new life insurance policy that complies with both the Canadian exempt test and IRC section 7702. This would provide the policyholder with the greatest protection, both insurance-wise and tax-wise, for at some point the migrant may return to the country of origin. The challenge lies in finding such a "dual-compliant" policy. Unfortunately, the authors are not aware of any U.S. or Canadian insurer that issues such a policy at this time. The prospect of enhanced reporting across the border may change the calculus in this respect. ◂

Note from the Editor: On February 5, 2014, the U.S. and Canada finalized their inter-governmental agreement related to FATCA.

ENDNOTES

1 See for example "Life Insurance on the Move: Cross-Border Tax Implications & Opportunities for Canadian and U.S. Policyholders" published in CALU Report (October 2004)

2 Income Tax Act R.S. C. 1985 (5th Supplement c.1, as amended (referred to herein as the "ITA")).

3 Internal Revenue Code of 1986, as amended (referred to herein as the "IRC" or the "Code"). The Code appears as Title 26 of the United States Code.

4 This draft legislation was released on August 23, 2013.

5 Definition of "exempt policy" in subsections 12.2(11) and 148(9.1) of the ITA and subsection 306(1) of the regulations made under the ITA.

6 Subsection 148(1) of the ITA.

7 Subsection 2(1) of the ITA.

8 Subsection 2(3) of the ITA.

9 Paragraph (1) of the definition of TCP in subsection 248(1) of the ITA.

10 Definition of LIPC in subsections 248(1) and 138(12) of the ITA.

11 Paragraphs 128.1(4)(b) and (c) of the ITA.

12 Definition of an "excluded right or interest" in paragraph 128(1)(10) of the ITA.

13 Subsection 116 of the ITA includes subsections 116(5.2) and (5.4).

14 IRC section 7702.

15 IRC section 7702(a)(1) and (b). This limit is referred to as the "cash value accumulation test."

16 IRC section 7702(e)(1).

17 IRC section 7702(a)(2)(A) and (c).

18 IRC section 7702(a)(2)(B) and (d) (subsection (d) sets forth multiples, known as the "cash value corridor," ranging from 250 percent through the insured's age 40 down to 100 percent when the insured reaches age 95).

19 Section 7702, along with section 7702A discussed below, is addressed in a comprehensive manner in DesRochers, Adney, Hertz, and King, *Life Insurance & Modified Endowments* (Society of Actuaries, 2004).

20 IRC section 101(a)(1). In certain instances, however, the death benefit can be taxable, e.g., where the policy has been transferred for value (see IRC section 101(a)(2), including exceptions provided therein).

21 IRC section 7702(g). Further, even if section 7702 is violated, the net amount at risk still passes to the beneficiary tax-free (see section 7702(g)).

22 Convention Between Canada and the United States of America with Respect to Taxes on Income and Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983; March 28, 1984; March 17, 1995, July 29, 1997 and September 21, 2007. The Convention does not mention life insurance except in Article XVIII, Pensions and Annuities, which deals with the payment of pensions and annuities.

23 IRC section 7702(a)(2)(B) and (d).

24 A non-exempt policy is subject to annual accrual reporting under subsection 12.2(1) of the ITA.

25 "Life insurance policy" is defined in subsection s 248(1) and 138(12) of the ITA.

26 Paragraphs 128.1(1)(b) and (c) of the ITA.

27 Subsection 233.3(3) of the ITA.

28 Definition of "reporting entity" in subsection 233.1(1) of the ITA.

29 Definition of "specified foreign property" 233.1(1) of the ITA.

30 Economic Action Plan 2013, tabled in the House of Commons by the Minister of Finance, March 21, 2013, at pgs. 154-155.

31 Formerly known as Form TD F 90-22.1

32 IRC sections 1471-1474.

33 It is anticipated that Canada will enter into an IGA with the U.S. by early 2014.

34 The IRS may have some information on the policies' existence if the premium payors report on and pay their excise tax liability under IRC section 4371 or if the FinCen Form 114 or the Form 8938 is filed, but apart from FATCA there is no required reporting of cash value amounts by the issuing insurer.

35 See footnote 30 at pgs. 155-156.