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FATCA AND INSURANCE

FUNDAMENTAL QUESTIONS REMAIN UNANSWERED AS COMPLIANCE DEADLINE APPROACHES

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Doctor: *I think you might have a FATCA. Please meet me at the hospital.*
Patient: *That sounds serious. What is it?*
Doctor: *It is a large building with beds in it.*
Patient: *No, what's a FATCA? And how do I know if I have it?*
Doctor: *Kinda' hard to explain. But, we are going to have to probe around a bit. There are a lot of areas we need to look into.*
Patient: *Will it hurt?*
Doctor: *Probably.*
Patient: *Surely you can't be serious about all this. I have a business to run.*
Doctor: *Hopefully, getting it under control will not be too expensive. And please, don't call me Shirley!*
Patient: *Does insurance cover FATCA?*
Doctor: *It should, but you ask the wrong thing. The real question is whether FATCA should cover insurance!*

INTRODUCTION

In March 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act of 2010[1] ("HIRE"), section 501(a) of which added a new chapter to the Internal Revenue Code ("chapter 4").[2] The purpose of chapter 4 is to prevent U.S. persons from evading U.S. tax by holding income-producing assets through (1) accounts in foreign financial institutions ("FFIs") or (2) through other foreign entities (non-financial foreign entities, or "NFFEs)".[3] The law does so by imposing new withholding tax requirements on "withholdable payments" made to FFIs by U.S. persons, and expanding the information reporting requirements imposed on FFIs with respect to certain "U.S. accounts,"[4] and by imposing withholding, documentation and reporting requirements relating to certain payments made to NFFEs.

There are, however, certain exceptions for FFIs that enter into agreements ("FFI Agreements") with the IRS to identify and report on their "U.S. accounts," and for NFFEs that provide information about their "substantial U.S. owners." In order to avoid the new withholding requirements, those foreign entities subject to the new withholding regime will have to satisfy the significant reporting and documentation requirements in the new chapter 4.

With a Jan. 1, 2013 effective date, the impact of FATCA has been felt globally, as companies located around the world are seeking to understand and prepare for the potentially significant compliance burdens it could involve. In many cases, implementation of FATCA will necessitate the development of major new systems, processes and protocols in order to capture and report the required information. This is particularly true for those companies whose situations are complicated by multiple locations, businesses and business types.

For the insurance industry specifically, this means that U.S. insurers may be required to withhold on payments to non-U.S. payees, and non-U.S. insurers who are the recipients of payments from U.S. entities may be required to collect information from their policyholders that is not only difficult to receive, but which may also be impermissible to request in certain jurisdictions.

There is no official legislative history to FATCA, but there is a Joint Committee Explanation from which taxpayers and the government can take guidance with respect to these significant and new requirements. Treasury and the Internal Revenue Service ("IRS") have indicated an intention to issue prompt and significant guidance to assist those entities subject to the various withholding and reporting rules to enable them to come into compliance prior to the effective date. Foreign financial entities subject to the rules of FATCA, however, have generally found small comfort in these promises by Treasury and the IRS. Several FFIs, domestic entities that may be withholding agents under FATCA, industry groups, and even some foreign governments have submitted thoughtful and practical comments to Treasury and the IRS regarding the effective date and applicability of the FATCA provisions to specific financial interests.

Among the comments sent to Treasury and the IRS are several from insurance companies, both domestic and foreign, insurance associations and governmental groups. These comments have raised several issues from the essential clarification of who exactly qualifies as an FFI and what qualifies as a "U.S. account," to effective dates and exclusion provisions specific to the insurance industry, as well as broader issues of the compliance burden being imposed vis-à-vis the potential for tax evasion.

To its credit, the Treasury and IRS have issued two notices providing interpretative guidance on FATCA, Notices 2010-60 and 2011-34. [Author's Note: Notice 2011-53, providing some transitional guidance, was released subsequent to the drafting of this article.] Many questions remain, however, with respect to the scope and implementation of the reporting, documentation and withholding rules and both domestic and foreign entities, associations and governmental groups continue to submit comments in response to the notices.

Immediately following is an overview of the some of the basic provisions of FATCA and the initial guidance released by Treasury and the IRS. The article then highlights some of the concerns expressed by the insurance industry through comment letters, and some of the key questions on which the industry is awaiting guidance.

FATCA—OVERVIEW OF BASIC PROVISIONS AND INITIAL GUIDANCE

FATCA imposes a broad expansion of reporting, documentation and withholding rules in order to obtain information about foreign accounts maintained by U.S. persons and prevent perceived tax evasion by those U.S. persons. Section 1471 imposes a mandatory 30 percent withholding tax on "withholdable payments"[5] made to an FFI unless the FFI enters into, and complies with, an agreement ("FFI Agreement") with Treasury.

This provision is a marked change from prior law in that it imposes withholding requirements on amounts that previously were specifically *not* required to be withheld on such as portfolio interest.[6] Section 1471(b) describes the requirements of an FFI Agreement between Treasury and any FFI. The FFI must agree to:

(1) gather certain information about account holders of each account maintained by the FFI as is necessary to determine which (if any) accounts are U.S. accounts;

(2) comply with such verification and due diligence procedures as the Secretary may require with respect to the identification of U.S. accounts;

(3) report on an annual basis specific information with respect to all U.S. accounts identified;

(4) deduct and withhold 30 percent of any passthru payment made to a "recalcitrant account holder" and payments made to an FFI that has made an election to be withheld upon;[7]

(5) comply with requests by the Secretary of the Treasury for additional information with respect to any U.S. accounts; and

(6) in cases where foreign law precludes the reporting of any information required by these provisions, the FFI must agree to attempt to obtain a valid and effective waiver of such law from each holder of a U.S. account, and if a waiver is not obtained within a reasonable period of time, to close any non-waivered U.S. accounts.

Section 1471(b)(2) provides that certain FFIs may be treated as meeting the requirements of the FATCA provisions if such FFI complies with procedures prescribed by the Secretary to ensure that such FFI does not maintain U.S. accounts, and if such FFI meets other requirements as the Secretary may prescribe with respect to accounts of other FFIs maintained by such FFI; or such FFI is a member of a class of institutions with respect to which the Secretary has determined that the application of section 1471 is not necessary to carry out the purposes of the section.

Section 1471(c) provides the information FFIs seeking to avoid the withholding requirement must report on U.S. accounts. This information includes the name, address and taxpayer identification number of each account holder that is a specified U.S. person and in the case of a U.S. foreign-owned entity that is an account holder, the name, address and taxpayer identification number of each "substantial United States owner" of such entity. The FFI must also provide the account number of any U.S. accounts, the account balance or value (determined at such time and in such manner as the Secretary may provide), and, except to the extent provided by the Secretary, the gross receipts and gross withdrawals or payments from the account (determined for such period and in such manner as the Secretary may provide). If this seems burdensome, the statute provides an election to be subject to the same reporting requirements as U.S. financial institutions in certain circumstances.

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Section 1472 of the Code imposes a mandatory 30 percent withholding tax on "withholdable payments" made to an NFFE unless the NFFE certifies that it has no "substantial U.S. owners" or provides information about those U.S. owners. This legislation applies to all FFIs and NFFEs that receive withholdable payments (discussed below) and do not meet the reporting requirements of section 1471(b) and (c) or the waiver or exception requirements of section 1472(b) and (c).

NOTICE 2010-60

On Aug. 27, 2010, Treasury and the IRS issued Notice 2010-60,[8] providing initial guidance on sections 1471–1474, eagerly anticipated by U.S. payors as well as affected foreign payees. Notice 2010-60 explains in detail the terms that will be imposed by FFI Agreements and the types of foreign entities that can receive payments without chapter 4 withholding. The Notice also states that, in future guidance, the Treasury and IRS intend to publish a draft FFI Agreement and draft information reporting and certification forms. In addition to guiding foreign entities through the process of deciding whether or not they must enter FFI Agreements in order to avoid chapter 4 withholding, and understanding what such an agreement entails, the notice provides guidance for U.S. financial institutions ("USFIs") to determine whether or not they are free to refrain from withholding on withholdable payments.

For purposes of this article, the dispositive points of Notice 2010-60 are those specifically addressing insurance companies. The notice points out that the definition of financial institution in section 1471(d)(5)[9] is broad enough to include certain insurance companies, and that the statute grants the Secretary regulatory authority to exclude or include insurance companies and certain products sold by insurance companies within the definition of "financial institution" and "financial account." Treasury and the IRS do not view the issuance of insurance or reinsurance contracts without cash value as implicating the tax evasion concerns of chapter 4. The notice states that Treasury and the IRS intend to issue regulations treating entities whose business consists solely of issuing such contracts as non-financial institutions for purposes of FATCA. This appears to let nonlife insurance companies and life insurance companies that only issue term life policies off the hook for the withholding and compliance requirements.

Notice 2010-60 distinguishes insurance contracts that have a cash value associated with the contract such as annuity contracts that frequently combine insurance protection with an investment component, and identifies such contracts as possibly presenting the risk of U.S. tax evasion that chapter 4 is designed to prevent. The notice does not provide guidance, but rather requested comments.

Notice 2010-60 also addresses retirement plans, which may be held by insurance companies. The notice states that pursuant to section 1471(f), withholding does not apply to any payment to the extent that the beneficial owner of such payment is part of a class of persons identified by the Secretary as posing a low risk of tax evasion. Although a retirement plan may qualify as a financial institution under the broad definition in chapter 4, Treasury and the IRS intend to issue guidance providing that certain foreign retirement plans pose a low risk of tax evasion for chapter 4 purposes, and therefore payments beneficially owned by such retirement plans will be exempt from withholding. The notice provides further guidance stating that a foreign retirement plan will be identified as posing a low risk of tax evasion only if the retirement plan (1) qualifies as a retirement plan under the law of the country in which it is established, (2) is sponsored by a foreign employer, (3) does not allow U.S. participants or beneficiaries other than employees that worked for the foreign employer in the country in which such retirement plan is established during the period in which benefits accrued. The notice then requests comments on the definition of a retirement plan for this purpose and on how such a plan could appropriately identify or document itself to a withholding agent to verify its compliance with any such definitional requirements.

Notice 2010-60 also deals with U.S. branches of FFIs and controlled foreign corporations, requesting comments on basically everything of interest to affected taxpayers.

Notice 2011-34 provides modified procedures for a participating FFI to identify U.S. accounts among its preexisting individual accounts and describes a new procedure for participating FFIs to certify their completion of the requirements for determining the status of their preexisting individual accounts, with a strong emphasis on private banking and the FFI Agreements to come; and how to identify U.S. accounts among existing accounts. These procedures are detailed and exhaustive and the notice requests comments concerning whether other FFIs, and **in particular insurance companies,** should perform procedures similar to those described with respect to holders of preexisting individual accounts, including private placement life insurance.

TAXPAYER, INDUSTRY AND GOVERNMENTAL COMMENTS

Property and Casualty Insurance

The insurance industry as a whole was forthcoming with comments after the promulgation of Notice 2010-60. These comments requested clarification of the definition of an FFI, noting that property and casualty insurance companies do not generally hold financial assets for the accounts of others, and that, generally, investments supporting contracts are owned by the insurer and not its policyholders. Other comments note that property and casualty insurers have occasion to make non-claim payments to their policyholders, but that none of these situations should be considered as holding financial assets for the accounts of others. These occasions include property and casualty contracts with return premium provisions or retrospective rating provisions; payments to policyholders due to commutations of contracts; and the payment of policyholder dividends or similar items. Commentators pointed out that none of these situations give rise to opportunity for tax evasion as contemplated by chapter 4.

Life Insurance, Annuities and Retirement Plans

Some life insurance industry comments argue that all life insurance should be exempted from the definition of financial institution because life insurance offers protection against uncertain events such as death or disability; but commend Treasury and the IRS for recognizing in Notice 2010-60, that at least those life contracts without a cash value should be excluded from the withholding and reporting requirements. Non-U.S. commentators raised several issues regarding the unattractiveness of their life products to U.S. policyholders due to the tax and regulatory rules of the company's country of incorporation and the low risk of using a life insurance product for tax evasion purposes due to the limitations on withdrawals, loans and other means of effectively accessing cash value. Other commentators recommended that contracts existing as of Dec. 31, 2012 be excluded from the definition of financial account.

These commentators point out, as do all of the non-U.S. commentators generally, that the information gathering and reporting requirements are onerous, and particularly so for the insurance industry. Unlike the banking industry, insurance companies do not often have frequent contact with their policyholders. In fact, several life insurance products are single premium products and the insurer may not have current information on the policyholder. They suggest, therefore, that the insurance industry needs additional time to come into compliance. (Generally, in the case of life insurance, it is the policyholder's beneficiary who seeks out the insurance company in the event of death to seek death benefits, not the insurance company that goes out looking for an opportunity to pay, especially when the premiums are all paid up on a policy.) As one commentator pointed out,

> [c]ompliance with the search requirements would be extraordinarily difficult, costly, and, in some cases, almost impossible, requiring a manual search of files that long preceded any anti-money laundering or know-your-customer rules. Insurance companies simply have not had the same data collection requirements and procedures as banks have had and cannot comply in the same manner as banks with respect to existing contracts.[10]

An additional impediment to timely compliance by the insurance industry is the issue of local privacy laws where insurance companies are resident. For example, the EU Data Protection Directive of 1995 (EU Directive) required member states to enact local laws providing a harmonized level of data protection among members. Under the EU Directive, the United States is considered as failing to offer an adequate level of data protection. However, a self-certification safe harbor system was established shortly after the adoption of the EU Directive to permit the transfer of data from the EU to a U.S. company that self-certified itself as a safe harbor entity. The consequence is that insurers in EU member states may be prohibited by law from providing the information required by chapter 4 absent the intended recipient agreeing to be a safe harbor entity. Chapter 4 provides an opportunity for such

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companies to obtain a waiver from local data and information protection laws, but the same issues with respect to timeliness arise as well as questions of the waivers being provided under duress, which would render the waivers invalid under the EU Directive. Several commentators noted that a later effective date would provide time for non-U.S. insurers to work on possible exceptions to, or exemptions from, local privacy laws. Non-U.S. commentators have also suggested that treaty partners with exchange of information agreements already have sufficient protections in place for the IRS to request information as required, and, thus, it is not necessary or appropriate to impose additional information gathering and reporting requirements on non-U.S. entities.

Other recommendations made by the insurance industry include an exclusion for insurance contracts with a cash value of less than $50,000.[11] Several commentators noted that retirement plans and pension plans are frequently regulated; investment in a retirement pension plan to effect tax evasion is generally not a very wise choice since the possibility of any tax evasion is minimal and, therefore, any contract issued with respect to a government-regulated pension plan or government-sanctioned private retirement account should be excluded from the definition of financial account. Recommendations to exclude any group annuity contracts or group cash value insurance contracts were made for the same reason; i.e., nominal if any opportunity for tax evasion. Similar rationale was expressed in comments to exclude any cash value contract where the cash value cannot be accessed or can be accessed but only with substantial charges, penalties, fees or taxation in the jurisdiction where the contract was issued—there is simply no opportunity for tax evasion.

Reinsurance

Comments submitted by the reinsurance industry and associations generally agreed with the language in Notice 2010-60 that the issuance of reinsurance contracts without cash value does not implicate the concerns of chapter 4 and unanimously encouraged Treasury and the IRS to exclude reinsurance companies from the definition of financial institution. Commentators pointed out that reinsurance transactions are entered into for the purpose of freeing up capital in order to increase underwriting capacity, and spread risk at a global level. Reinsurance transactions are between insurance companies; they are exclusively business-to-business transactions and do not affect individual policyholders, much less present the tax evasion potential that underlies the provisions of chapter 4. Comments, again unanimously, recommend that Treasury and the IRS exclude both property and casualty as well as life reinsurers from the definition of financial institution because reinsurance transactions do not affect individual policyholders; and, hence, no tax evasion as contemplated by chapter 4 is effected by reinsurance. Nor does reinsurance of life or annuity business create a cash value, and reinsurance recoveries are not available to individuals.[12] Payments made under reinsurance contracts are made to the ceding company and are based on the loss experience of the ceding company on the underlying contracts. Because some reinsurers are authorized to reinsure both life and property and casualty business, exempting only property and casualty reinsurers may leave some reinsurance companies in limbo with respect to whether or not they had to meet the reporting and documentation requirements of chapter 4. Comments go on to suggest that exempting all reinsurance companies is consistent with the policy goals of chapter 4. There are some companies that enter into both direct insurance and reinsurance, but these are more typically property and casualty companies that generally do not issue cash value life insurance policies. Thus, comments have requested a more precise definition of a financial institution to exclude reinsurance companies and a more complete definition of a cash value policy that will be treated as a U.S. account.

Holding Companies

Several insurance commentators addressed Notice 2010-60's reference to holding companies. The notice states that Treasury and the IRS intend to issue regulations that will create an exemption from FFI status to a holding company whose subsidiaries are not treated as FFIs under chapter 4. If the subsidiaries include FFIs, however, the holding company will presumably be treated as an FFI subject to chapter 4's information reporting and withholding requirements. The consensus of the comments was that because holding companies do not have "financial accounts" or "U.S. account holders," the compliance and administrative burden of the IRS receiving a large number of reports showing no accounts would be excessive relative to any tax evasion prevention, therefore the commentators recommend that holding companies be excluded from the definition of financial institution.

BUT QUESTIONS REMAIN

Treasury and the IRS stated in Notice 2010-60 that proposed regulations will be issued with sufficient time for affected parties to implement the systems and processes necessary

to fully comply with the withholding, information gathering and reporting requirements imposed by chapter 4. However, comments and recommendations from the insurance industry have gone unaddressed with the second round of guidance provided in Notice 2011-34, and the effective date of Jan. 1, 2013 is rapidly approaching.

Generally, it is in the best interest of the insurance industry that Treasury and the IRS reach the answers and solutions most appropriate for its special circumstances. Hence, potentially affected parties are hopeful that the questions raised and recommendations made by the insurance industry are still percolating through Treasury and the IRS, but with the effective date rapidly approaching, it is difficult to sit quietly with so many issues unanswered. For their part, Treasury and the IRS continue to seek further comment from the insurance industry. On May 6, at the Insurance Companies session at the ABA Tax section meeting, Treasury representatives urged the industry to submit additional comments on how to define an "active trade or business,"[13] and how to define cash value and cash surrender value, the latter being on the IRS priority guidance list this year, and how those definitions might apply to FATCA requirements.

While Treasury and the IRS keep asking taxpayers to provide comments, numerous questions remain for Treasury and IRS determination, such as the following:

The Questions Are Fundamental

The requested guidance goes to issues as basic as seeking clarification around, "When will an insurance company be an FFI and when will it be exempted?" and "Which insurance products will be deemed to be U.S. accounts?"

Speculation around what the final rules might look like has resulted from inquiries as to, "How much cash value will be deemed to be too much cash value?" and, "Will the IRS exempt certain contracts that preclude loans or withdrawals prior to death?"

From a policy perspective, many have asked, "Is there really any potential for tax evasion in a retirement or pension fund?"

The Questions Are Practical

What will be the implications of chapter 4 for insurance companies resident in treaty jurisdictions? Will chapter 4 "trump" the treaty provisions for pensions and annuities?

What policies will be subject to FATCA? How will the term "cash value" be defined? For example, will a policy that provides for return of premium have cash value for purposes of FATCA? Will some form of low cash value exception be provided, such as the $50,000 exception noted above? What about the suggested exemption from FATCA for policies with level premiums under $10,000, or values under $500,000? What is meant by the term, "private placement"?

The Questions Ask How Far Insurance Companies Will Need to Go to Comply

What are the implications for existing contracts? Insurance contracts are not deposit accounts or custodial accounts; they are contracts entered into by unrelated parties (excluding some which are related party reinsurance transactions). How will Treasury and the IRS address the concerns of non-U.S. life insurers with regard to the potential need to research old files on preexisting life insurance contracts? Will Treasury and the IRS expand the exceptions for older contracts and low cash value contracts?

The Questions Ask How to Put a Square Peg in a Round Hole

How will Treasury and the IRS address the issue of withholding on recalcitrant policyholders when the contract does not provide for any withholding by the insurer, or if such withholding is prohibited by local regulation? What happens when FATCA requires an account to be closed, but local regulations do not permit an insurance company to cancel a contract? How will Treasury and the IRS define pass-thru payments in the insurance context, where all assets belong to the insurance company and there is a separate liability to the insured?

THE INDUSTRY NEEDS ANSWERS

The statute contains highly specific requirements, but it also leaves much to the discretion of the Secretary. Without final guidance, and with the effective date looming, foreign

How will Treasury and the IRS address the issue of withholding on recalcitrant policyholders when the contract does not provide for any withholding by the insurer, or if such withholding is prohibited by local regulation?

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financial institutions are unsure as to whether they are subject to FATCA's compliance rules, and, if so, how to come into compliance; whether they will be in a class exempted by Treasury; whether to make an election; whether they should begin to establish processes by which they can acquire the required information not already in their databases; whether to identify U.S. account holders and request waivers; and what to do if they are in treaty partner countries.

Given the relatively short amount of time to get into compliance, it has become incumbent upon companies to begin the process of undertaking comprehensive, resource-intensive assessments of their businesses, and prepare to institute potentially significant change processes across their organizations. In many cases, they may be granted an exemption, or otherwise find compliance to be less burdensome than anticipated; but absent guidance, it is necessary to do so given the potential consequences of being in noncompliance.

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END NOTES

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1. P.L. 111-147.
2. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended. Chapter 4 includes sections 1471–1474.
3. Section 501(a) is a revised version of provisions in a bill titled the "Foreign Account Tax Compliance Act of 2009," H.R. 3933, S. 1934 (introduced on Oct. 27, 2009), and is sometimes referred to as FATCA.
4. FFIs can enter into Agreements with the IRS that establish the reporting requirements. As discussed in further detail below, Notice 2010-34 sets out guidelines and Treasury has indicated it intends to publish a form FFI Agreement prior to the effective date of the new chapter 4 provisions.
5. The term "withholdable payment" is defined in section 1473(1)(A) to include: (i) any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, or periodical gains, profits and income, if such income is from sources within the United States, and (ii) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States.
6. Sections 871(h), (i) and 881(c) and (d).
7. Section 1471(b)(3) permits certain FFIs to make elections to be withheld upon. This has become an issue as the U.S. entity does not have the ability to say "no."
8. 2010-37 I.R.B. 329.
9. Section 1471(d)(5) defines "financial institution" (hereinafter, "FI") by reference to three alternative activities: (A) deposit-taking in a banking or similar business; (B) the holding of financial assets for the account of others; and (C) engaging primarily in the business of investing, reinvesting or trading in financial assets including securities, partnership interests and commodities, and derivative interests therein.
10. Comments of Allianz SE, dated Nov. 11, 2010, Doc 2010-24092.
11. This provision is consistent with the definition of a U.S. account in section 1471(d)(1)(A), which excepts accounts held by a natural person with an aggregate value of less than $50,000.
12. Except in the rare case of assumption reinsurance wherein the reinsurer steps into the shoes of the ceding company and enters into a direct insurance relationship with the insured. It would be very easy, if necessary, to make an exclusion for assumption reinsurance transactions.
13. This is relevant, for example, with respect to the ability to exclude payments to NFFEs.