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# How do the final FATCA regulations impact insurers?

January 25, 2013

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## In brief

The [final regulations](#) relating to the provisions of the Foreign Account Tax Compliance Act (FATCA) were issued along with a [press release](#) on January 17, 2013.

The final regulations contain over 500 pages of guidance that will undoubtedly consume a significant amount of time as stakeholders including banks, investment funds, insurance companies, and their clients, study their content. As it relates to the insurance industry, these final regulations contain a number of significant differences from the proposed regulations.

PwC released an [earlier newsbrief](#) on January 18, 2013 highlighting many of the distinctions between the proposed and final regulations, which potentially apply to all industries. To supplement the earlier newsbrief, this newsbrief describes the most notable differences between the proposed and final FATCA regulations that will impact insurers.

**Observation:** *The three previously released notices in 2010 and 2011 provided initial guidance on FATCA generally, but provided very little insight with respect to the impact and applicability of FATCA to insurers. The proposed regulations attempted to address insurance products and operations; however, they left a number of unanswered questions. Under the final regulations, there are wins and losses for the insurance industry. The regulations answer many previously open questions and provide confirmation and clarity on other points of interest. Based on what we know, and the time remaining to implement, the time for action is now for insurers who have not yet started their FATCA compliance programs.*

### Please join us for the following webcasts:

- 1) A general overview of the final regulations from 9:30 to 11:00 am EST on January 29, 2013. [Click here for more information and to register.](#)
- 2) A specific discussion regarding insurance industry issues arising from the final regulations from 10:00 to 11:30 am EST on February 15, 2013. A link to the registration site can be found at <http://www.pwc.com/us/fatca> starting on January 31, 2013.

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## In detail

### What's different?

*Insurance company definition – including specified insurance company*

The final regulations have defined an insurance company as an entity that: (1) is a company regulated as an insurance company in its

country of operation, (2) has gross income arising from insurance, reinsurance, and annuity contracts that exceeds 50 percent of gross income, or

(3) has assets associated with insurance, reinsurance, and annuity contracts that exceeds 50 percent of gross assets.

In addition to the definition of an insurance company, the definition of a financial institution was expanded to include a "specified insurance company." A specified insurance company is defined as "an insurance company or a holding company (as described in the final regulations) that is a member of an expanded affiliated group (EAG) that includes an insurance company, and the insurance company or holding company issues, or is obligated to make payments with respect to, a cash value insurance or annuity contract."

**Observation:** The revised definition of an insurance company and the definition of a specified insurance company are generally favorable. The proposed regulations defined a foreign insurance company with "a financial account" as a Foreign Financial Institution (FFI). The possibility that a single account held by an insurer would require the entity to be classified as an FFI was troublesome. Therefore, insurers should be pleased that the definition has been altered, and the single account scenario no longer burdens the entity with the FFI requirements. In addition, the condition that the entity must be regulated under local law provides clarity as to when a foreign entity will qualify as an insurance company, instead of determining whether the entity is an insurance company under US criteria.

#### Definition of financial account

The definition of a financial account has been modified to include cash value insurance contracts with a cash value greater than \$50,000. However, the \$50,000 value exclusion does not apply to annuity contracts.

This differs from the prior definition, which included all cash value insurance and annuity contracts without a limitation to the contract's value.

**Observation:** The definition of financial account will impact a foreign insurer's status and requirement to register as a FFI or be identified as a non-financial foreign entity. This change, while it only applies to cash value insurance contracts, should benefit the insurance industry by excluding a number of insurance contracts from the definition of a financial account. However, the rule requires foreign insurance companies to determine the aggregate cash value of a contract at "any time during the calendar year." This may pose an operational burden because regular maintenance or tracking of these balances is required to identify contracts that surpass the threshold. A participating FFI may elect to report all cash value insurance contracts with a balance greater than zero, which may be a practical solution for those participating FFIs that do not want to create a monitoring process.

#### Alignment with local law for certain definitions

In response to industry comments, the final regulations do not reference US tax law in the definition of "insurance company," "annuity contract," or "life insurance contract," instead the definitions rely upon local law.

**Observation:** This change is certainly beneficial for global insurance companies; it permits reliance on local law designations when considering whether their products are an "annuity" or "life insurance" contract, or whether their companies qualify as an "insurance company". While recognizing the positive aspects of this change, it is

important to highlight the operational challenges some insurers may face in applying different definitions across jurisdictions. For instance, a UK business unit which is part of a multinational insurance organization is now permitted to apply its local law to determine which of its products are in scope, while separate rules will be applied in the US and other geographically disparate business units. Managing the results of this local analysis and the ultimate application of FATCA may be more difficult than applying one standard.

#### Valuation of insurance contracts

The proposed regulations did not provide a methodology to value cash value or annuity contracts, the final regulations prescribe the account value or balance of the contract to be determined based upon either the year-end balance or at each contract anniversary date. In instances where there is no reporting of a value to the account holder, the final regulations indicate that the value is determined by using the discount interest rate and mortality tables that are either (1) the rates and tables prescribed under Internal Revenue Code Section 7520 and the regulations thereunder, or (2) those used by the FFI to determine the amounts payable under the contract."

**Observation:** This clarification was highly anticipated by the insurance industry. All prior guidance indicated that foreign insurance companies would need to value insurance contracts. However, there was much confusion about when (e.g. at year end, at contract anniversary date, on a final regulation prescribed date) and how (e.g. use cash value, surrender value, etc.) to value these contracts. Under the final regulations, foreign insurers can choose when and how to value their insurance contracts based on what

makes the most sense for their organization.

#### **IRC Section 953(d) election**

Under the definition of a US person in the final FATCA regulations, foreign insurance companies that make an IRC Section 953(d) election<sup>1</sup> to be taxed as a US company will continue to be treated as a foreign insurance company unless such company is licensed to do business in a particular state within the US. However, it should be noted that this definition is inconsistent with the language contained in IRC Section 953(d), causing an apparent conflict between the definitions.

**Observation:** Should the definition under the final regulations prevail, this provision could have a significant impact on the insurance industry because it is common for captive insurance companies to make the IRC Section 953(d) election; however, they do not take the next step to be licensed to do business in a particular state. As such, the entities treated as foreign will need to determine if they are a FFI and must consider whether to become a participating FFI. In the event that an insurance company makes the IRC Section 953(d) election and also is licensed to do business in a particular state, then it is considered a US person and will be a US withholding agent (USWA) subject to reporting on its life insurance and annuity contracts under IRC Section 6047(d). Furthermore, following the proposed regulations, many insurance companies believed that in

the absence of guidance to the contrary, an IRC Section 953(d) election was justification for classifying the entity as a USWA. Since the final regulations provide contrary guidance, insurers should re-evaluate their legal entity classification assumptions. Insurers may find additional foreign entities that require FATCA analysis.

#### **Defining grandfathered obligations**

The final regulations provide some additional guidance on the types of insurance contracts which can be considered an obligation as well as those that are excluded. Whether the contract is grandfathered remains an issue of when the contract was originated:

- Insurance contracts which can be considered an obligation - A life insurance contract payable no later than upon the death of the insured individual may qualify as an obligation or immediate annuity contract payable for a period certain or for the life of the annuitant. This final definition alters the proposed regulations, which was simply a life insurance contract payable no later than the death of the insured, or a term certain annuity.
- Insurance contracts which cannot be considered an obligation - Consistent with the proposed regulations, the final regulations note that a legal agreement or instrument without a stated expiration or term will not be considered an obligation. Consequently, the following types of agreements would not seem to be an obligation: a deferred annuity contract, variable life or annuity contracts, or a life insurance or annuity contract that permits substitution of a new

individual as the insured or as the annuitant under the contract.

**Observation:** This clarity adds significant burden for insurers operationally, because the definition of an obligation in the proposed regulations was much simpler from an insurance perspective. Insurance companies must determine when a contract is opened, and confirm on a product by product basis whether the grandfathered obligation definition applies. As an alternative, insurers may decide not to apply the grandfathered rule and simply impose withholding on all obligations if required.

#### **Many things just stayed the same**

##### **Material modifications of grandfathered obligations**

No additional clarity was provided for material modifications of grandfathered obligations beyond what was provided in the proposed regulations. As a result, for all obligations outside of debt, the determination of whether there has been a material modification will be a facts and circumstances test.

**Observation:** The lack of guidance on material modifications, requires companies to develop clear guidelines for identifying changes that will be a material modification and controls to monitor all changes. Some insurance companies may decide to treat all modifications as material or they may decide not to apply the grandfathering provisions due to the uncertainty around material modifications.

##### **Insurance and reinsurance premiums as withholdable payments**

As expected, insurance and reinsurance premiums remained in scope and are included in the definition of withholdable payment.

**Observation:** This provision will have a significant impact on insurance brokers because premium

<sup>1</sup> Under Section 953(d), a foreign insurance company, that is a controlled foreign corporation for US tax purposes can make an election to be treated as a US corporation for tax purposes.

payments are common within insurance brokers. It will also impact insurance companies broadly (beyond life insurance companies) who pay reinsurance premiums on US risks to foreign reinsurance companies. As a result, all insurance companies and insurance brokers that pay reinsurance premiums will have new documentation and reporting requirements as of January 1, 2014. It is also important to highlight that the regulations focus on insurance and reinsurance premiums in the context of withholdable payments, foreign insurance companies will be impacted by this provision and should consider their FATCA status. If they (including members of the EAG) are determined to be a FFI, they should consider becoming a participating FFI to avoid being subject to FATCA withholding on their reinsurance premium payments.

#### **Clarifications**

##### **Premium prepayments**

The final regulations clarify that a depository account does not include an advance premium or premium deposit received by an insurance company. In order to be excluded, such premium must be payable annually and the amount of the advance premium or premium deposit must not exceed the annual premium required under the contract.

**Observation:** Insurance companies that receive premium prepayments that exceed the exclusion parameters (annual and advance premium payment not to exceed one year's premium requirement) will have depository accounts. As such, these insurers could be considered a FFI and thus will be required to conduct all applicable due diligence procedures required for depository accounts. This clarification in the final regulations requires insurance companies to assess their current

premium prepayment policy and potentially implement tracking processes. Insurance companies need to either implement a process to track premium prepayments to ensure they are within the regulatory limits or implement a policy to prohibit premium prepayments. One possible procedure could be returning to the account holder any premium prepayments received that exceed the exclusion parameters.

##### **Indemnity reinsurance**

An indemnity reinsurance contract between two or more insurance companies is excluded from treatment as a financial account based on the definition of a cash value insurance contract. In these types of contracts, the ceding company maintains contractual relationship and liability with each insured (account holder).

**Observation:** Although indemnity reinsurance was explicitly excluded by the final regulations, it is notable that reinsurance premiums are still considered to be withholdable payments. In addition, other items requested by the industry were not removed from scope (e.g., assumption reinsurance, P&C insurance, term insurance, etc.). Moreover, the clarity regarding indemnity reinsurance contracts seems to be inconsistent with the Intergovernmental Agreements (IGAs).

##### **Term life insurance**

The final regulations provide additional guidance regarding term life insurance contracts to prevent the front-loading of premiums. To be excluded, the final regulations require that the premium on a term life insurance contract be payable annually during the term of the contract or until the insured attains age 90 and that the premiums cannot decrease over time.

**Observation:** Following the release of the proposed regulations term life

insurance contracts appeared to be out of scope for FATCA; however, the final regulations indicate that term life insurance contracts are conditionally excluded if (1) the premium is an annual premium received during the contract term or until the insured is 90; and (2) the premiums do not decrease. It is important to note that these contracts, irrespective of the stated criteria, will not be financial accounts. Rather, the concern is that these contracts could give rise to withholdable payments in the future, such as interest on a death benefit. Insurance companies must look at the characteristics of their term life policies to assess whether or not they are excluded. Depending on the number of policies to be evaluated this may have a significant impact. Additionally, depending on the size of each insurer's term life book of business, insurers may want to modify their term life product contracts going forward to meet these exclusion requirements.

##### **Reserves**

There was some concern raised that a foreign insurance company's reserve activities could cause the insurance company to be considered a custodial or investment entity financial institution. The final regulations explicitly state that reserving activities of an insurance company will not cause such insurance company to be considered a depository institution, custodial institution, or investment entity.

**Observation:** This provision clarifies that an insurance company does not take into account its reserve activities when determining whether it qualifies as a depository institution, a custodial institution or an investment entity. However, as discussed in the definition of an insurance company, this rule continues to require focus on whether the entities meet the definition of an



insurance company. Most notably, should a company cease to be a regulated insurance company, it must meet the annual income or asset test in order to qualify. Absent such a qualification, entities need to consider each of the financial institutional tests, including reserve activity.

### ***The takeaway***

The long awaited final FATCA regulations arrived. The insurance industry as a whole remains diversified in its approach and progress on FATCA. However, given the clarity, confirmation, and

additional guidance provided in the final regulations (as well as the IGAs), all insurers should be assessing the impact to their organization, making business decisions to mitigate some of the impact and taking steps toward implementing operational solutions that enable timely FATCA compliance.

For additional background on the final [regulations](#), as well as recent FATCA developments, please see the [Global IRW Newsbrief archive](#).

### ***Let's talk***

If you would like to discuss FATCA in more detail please call your local PwC contact or alternatively any of the FATCA team members listed below :

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