
Applying FATCA to captive insurance arrangements: Surprising results may occur

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In brief

FATCA was enacted in March 2010 as part of the Hiring Incentives to Restore Employment Act as an administrative tool to prevent and detect offshore tax evasion and improve taxpayer compliance. The provisions of FATCA were intentionally broad and significantly expanded the existing US information reporting regime by imposing additional documentation, withholding, and reporting requirements on payments to US accounts, foreign financial institutions (FFIs), and certain non-financial foreign entities (NFFE) with substantial US owners. While final regulations released in January 2013 provided additional clarity and details regarding the impact of FATCA, the definition of a financial institution still remains broad and includes a number of entities not normally considered as vehicles for tax evasion.

A captive insurance company is an example of an entity that can produce surprising results when the FATCA rules are applied - affecting both the captive and other entities involved in the arrangement. This may occur notwithstanding that captive insurance companies provide a variety of financial and business benefits relating to insuring risks for many multinational enterprises. One surprising result is that some captives may fall under the definition of an FFI thereby triggering various reporting and withholding obligations. Other foreign asset reporting requirements of the US owners of captive insurance companies may also arise.

In detail

Domestic or foreign entity

Enterprises may choose to insure their US business risk with a captive insurance company that is incorporated in either the United States or a foreign jurisdiction. Could this captive insurance entity constitute an FFI and therefore be subject to various obligations under FATCA? An important first step is determining whether such entity is foreign or

domestic for FATCA purposes. Foreign captive insurance companies often make an election under Internal Revenue Code Section 953(d) to be treated as domestic entities for US federal tax purposes. But the final FATCA regulations have specific definitions - the term 'US person' under Treasury Regulation Section 1.1471-1(b)(132) explicitly excludes a company that makes a Section 953(d) election unless

such entity is licensed to do business in a particular state.

Definition of financial institution

A foreign captive insurance company must also meet the definition of a 'financial institution' under the final regulations (or an intergovernmental agreement or IGA if applicable) in order to qualify as an FFI. The term 'FFI' includes a specified

insurance company that issues or is obligated to make payments with respect to certain cash value insurance or annuity contracts.

Observation: *In practice, captive insurance companies are seldom licensed to transact insurance business in a particular state within the United States and will generally be treated as a foreign entity for FATCA purposes. Fortunately, the majority of foreign captive insurance companies will not be considered to be FFI's under the definition of a specified insurance company for FATCA purposes because they do not have any cash value insurance policies. However, such captives should still evaluate their business operations to determine if they qualify as another category of FFI. These other categories include: (1) depository institutions, (2) custodial institutions, (3) investment entities, and (4) certain holding companies and treasury centers.*

Status as an NFFE

Since many captives will not be considered to be FFI's under FATCA, they will be NFFEs. As an NFFE, any US source insurance or reinsurance premiums (premiums attributable to US business risk) should be considered withholdable payments under FATCA and subject to 30% withholding absent a valid withholding certificate (such as Form W-8BEN-E). As a result, US withholding agents still need to collect certain tax documentation from the captive and will now have to report such premium payments on Form 1042 and Form 1042-S. If the withholding agent does not withhold as required, it will be liable for the withheld tax, interest, and penalties.

Observation: *In order to avoid any unnecessary withholding on investments or accounts with*

financial institutions, captive insurance companies should be ready to provide the appropriate documentation to counterparties before receiving a withholdable payment.

Form 8938 - Foreign asset reporting

New Section 6038D, which was also enacted as part of FATCA, requires certain US taxpayers holding specified foreign financial assets (SFFAs) to report those assets to the IRS using Form 8938, *Statement of Specified Foreign Financial Accounts*, with their annual income tax return if certain thresholds are met. SFFAs generally include:

- financial accounts maintained by an FFI (that is not a US payor)
- the following SFFAs if they are held for investment and not held in an account maintained by a financial institution:
 - stock or securities issued by a non-US person
 - any interest in a *foreign entity*
 - any financial instrument or contract that has an issuer or counterparty that is not a US person.

A 'foreign entity' is defined as an entity that is not a US person. The term 'US person' under Section 6038D refers to the definition in the FATCA regulations and includes those captive insurance entities that have made a Section 953(d) election, provided such captive is not licensed to do business within a particular state.

Observation: *The clarification of the Section 953(d) rule under the FATCA final regulations will likely have an impact on the requirement to file a Form 8938. The majority of*

foreign captive insurance companies that have made a Section 953(d) election are not licensed to do business in a particular state. As a result, any interest in such a captive entity would likely be considered an SFFA that may need to be reported.

Although Section 6038D imposes requirements to disclose on US individuals and specified domestic entities, only individuals are currently required to file. Filing obligations for specific domestic entities will arise when the IRS issues additional regulations. Notice 2013-10 also provides that certain domestic entities will not need to report for years prior to those beginning after December 31, 2012.

The takeaway

Organizations that use captive insurance company arrangements should review their situation now in anticipation of the various upcoming FATCA deadlines. FATCA may impose reporting, withholding, and other obligations depending upon the specific taxpayer circumstances. The FATCA rules are broadly written. Companies should not assume that they are not otherwise affected but instead take a proactive approach to analyze the status of captive entities for FATCA purposes. They should also map out current and expected payment flows both within their related group of entities as well as payments made outside the group (e.g., to foreign reinsurers.)

Most notably, if the captive meets the definition of an FFI, it will need to evaluate various decisions about how to comply, such as entering into an FFI agreement with the IRS so as to avoid FATCA withholding on US source payments. Should the entity register this agreement by October 25, 2013 in order to be published on the IRS December List of participating

entities? Who should be named as the responsible officer?

Even if the foreign captive is not an FFI, it will be considered an NFFE. Payments made to it by a related entity involving US source income may be subject to FATCA withholding, which generally begins January 1, 2014. What internal processes should

be in place to ensure that proper documentation and reporting occurs and the 30% FATCA withholding is avoided? What existing processes may be leveraged?

Additional background

For additional background, please see the [Global IRW Newsbrief archive](#).

[Access our FATCA IGA Website Monitor](#) for a high-level overview of the IGAs promulgated so far and the latest IGA developments.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Global Leader, Global Information Reporting Network

Stuart Finkel
(646) 471-0616
stuart.finkel@us.pwc.com

United States

Steve Chapman
(646) 471-5809
stephen.chapman@us.pwc.com

Iris Goldman
(646) 471-3992
iris.goldman@us.pwc.com

John Ernest
(614) 227-3217
john.ernest@us.pwc.com

Dominick Dell'Imperio
(646) 471-2386
dominick.dellimperio@us.pwc.com

Jon Lakritz
(646) 471-2259
jon.w.lakritz@us.pwc.com

Candace Ewell
(202) 312-7694
candace.b.ewell@us.pwc.com

Haskell Garfinkel
(312) 298-2647
haskell.garfinkel@us.pwc.com

Rob Limerick
(646) 471-7012
robert.limerick@us.pwc.com

Bermuda

Rick Irvine
(441) 299-7136
richard.irvine@bm.pwc.com