

# Financial Advisor

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## U.S. premium excise tax

U.S. citizens living in Canada face many taxes that Canadian citizens don't. One is the premium excise tax – 1% of the premiums paid for a life or health insurance policy, or annuity issued by a foreign life insurance company. For many years this tax appears to have been ignored.

But Canada and the United States have entered into an agreement implementing many parts of the U.S. Foreign Account Tax Compliance Act (FATCA). U.S. citizens must identify themselves to their Canadian financial institutions, like life insurance companies. Those institutions must report information on their U.S. clients to the Canada Revenue Agency (CRA), which in turn must share that information with the Internal Revenue Service (IRS). Once it has this information, the IRS can take steps to collect the tax it's owed, including the premium excise tax.

Since the premium excise tax may gain greater prominence in the future, it's worth exploring what it is and how it works.

## The premium excise tax

Internal Revenue Code (IRC) §§4371 – 4374 and Treasury Regulations 46.4371 and 46.4374 impose an excise tax on the premiums paid for any life insurance policy, sickness or accident insurance policy, or annuity policy that is issued on the life or health of a U.S. person, but purchased from a foreign insurer.<sup>1</sup> The tax is 1% of the gross premiums paid, and applies to all U.S. citizens wherever they live.

A foreign insurer is “an insurer ... who is a nonresident alien individual, or a foreign partnership, or a foreign corporation.” (IRC §4372(a)) Most Canadian life insurance companies would be treated as foreign corporations under this Code section.

The tax must be paid by “any person who makes, signs, issues or sells any of the documents and instruments subject to the tax, or for whose use or benefit the same are made, signed, issued, or sold.” (IRC §4374) In its audit manual the IRS interprets IRC §4374 as holding the following jointly and severally liable for paying the excise tax:

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<sup>1</sup> Casualty and indemnity bonds, and reinsurance are also subject to the tax, but a discussion of them is beyond the scope of this article.

- The insured,
- The policyholder, if different from the insured,
- The insurance company, or
- The broker obtaining the insurance.

The IRS says that it will pursue the policyholder for the tax first. But it does not have to, and could hold the life insurance company and brokerage that sold the policy responsible for paying the tax.

Treasury Regulation 46.4371-3(b) defines the premium subject to tax:

For purposes of this subpart, the term “premium payment” means the consideration paid for assuming and carrying the risk or obligation, and includes any additional assessment or charge paid under the contract, whether payable in one sum or installments.

The IRS’ audit manual further says:

The excise tax is based on the gross amount of premiums paid to the foreign insurer or reinsurer for an insurance policy, annuity contract or indemnity bond. This amount includes any additional assessments, charge, or call, paid pursuant to the agreement of the parties. The whole amount is taxed whether payable in one lump sum or installments.

Nothing in the Code, Regulations or IRS guidance says that it makes any difference whether the policy is a term or permanent policy, and if a permanent policy, what kind of policy (universal life, or participating or non-participating whole life insurance). Nor is there anything to suggest that you could carve out a portion of the premiums paid to the foreign insurer as not subject to the excise tax.

The tax is calculated and reported on [IRS Form 720](#) and is due quarterly. Additional information on the tax is found in the [instructions to IRS Form 720](#) and in [IRS Publication 510](#).

Although FATCA may make it easier for the IRS to identify U.S. citizens who own Canadian life insurance policies, there are limits. Under the Intergovernmental Agreement that Canada and the United States have signed to implement FATCA, the following types of life insurance policies are not reportable:

- A cash value insurance contract with a balance or value of \$250,000 or less as of June 30, 2014.
- A cash value insurance contract held by an individual on or after July 1, 2014 with a balance or value exceeding \$50,000 at the end of any calendar year or other appropriate reporting period.

It follows that term life insurance policies would also be non-reportable since they have no cash value. Still, just because a policy is not a reportable asset does not mean that a U.S. person will not have to comply with their obligations under the Code.

## **“Buy American” won’t solve the problem**

One solution to the excise tax could be for a U.S. citizen living in Canada to buy a U.S. life or health insurance policy, or annuity, from a U.S. life insurance company. If the U.S. citizen owned a U.S. policy, they would not have to pay the excise tax. But Canadian and American licensing and tax laws make that very difficult. Here are two of the obstacles:

Life insurance agents and brokers, and life insurance companies, must be licensed in each province or state where they do business, and must comply with the laws and regulations of that province or state. In both countries you generally can’t buy a life or health insurance policy, or an annuity, directly from a life insurance company. You must buy through a licensed agent or broker.

- In both countries, a condition for a life insurance company doing business in the province or state is that it must maintain sufficient assets in the country where it does business to support its liabilities. If a life insurance company makes the investment necessary to sell policies in a country, it will sell policies to citizens and residents of that country. Those policies will comply with the laws of that country, not necessarily the laws of the country where the company has its head office.

Another obstacle is the differing tax treatment that policies and annuities receive in each country. A life or health insurance policy, or an annuity, owned by a U.S. citizen living in Canada would be subject to both countries' tax rules, even though the issuing insurance company would issue tax reporting slips only for those events that were taxable under its own country's rules. Here are some of the differences:

- Under U.S. tax law a life insurance policy's adjusted cost basis (ACB) is not reduced each year by an amount equal to the net cost of pure insurance (NCPI), as it is under Canadian law.
- In the United States, life insurance policy withdrawals are treated as coming from tax-free ACB first, then from taxable policy gains. In Canada, withdrawals are treated as coming from ACB and taxable gains in the same proportion as those amounts bear to the policy as a whole.
- Life insurance policy loans are tax-free in the United States, unless the policy ends in a way other than the life insured's death (such as a policy surrender). If that happens the outstanding policy loan is treated as a withdrawal, and only that part of the loan exceeding the policy's ACB is taxable. In Canada, policy loans are tax-free only to the extent that they do not exceed the policy's ACB.
- Non-qualified deferred annuities benefit from tax-deferred growth in the United States, whereas non-registered annuity contract gains are taxable each year in Canada.
- Non-qualified deferred annuity withdrawals are treated as coming from taxable gains first, then from annuity contract basis. In Canada, a withdrawal from a non-registered deferred annuity is not a taxable event, although the contract's annual growth is still taxable.
- Different rules govern how much cash a life insurance policy may have before it must be treated as an investment contract. A U.S. policy owned by a U.S. citizen living in Canada will be subject to Canadian rules, even though the U.S. insurance company will monitor the policy for compliance only with U.S. rules.

Travelling to the United States to buy a policy through a U.S. based broker or agent is also problematic. Under most U.S. states' laws, a life insurance agent may not solicit business in a state other than where they are licensed. One interpretation of this rule says that an agent is soliciting business in the state where the prospect is physically present when the first solicitation is made, and therefore needs to be licensed in that state. It won't be enough to later have the application form signed in the state where the agent is licensed.

There are other problems. The policy will need to be delivered to the policyholder in the state where the agent is licensed. Any medical tests will need to be carried out according to the U.S. insurance company's rules, which may preclude Canadian testing facilities. Finally, U.S. state regulators are serious about making sure that life insurance companies respect the law. In 2014 MetLife agreed to pay a \$50 million fine for violating New York state insurance law by selling life insurance to New York based companies without being licensed to sell in New York State.<sup>2</sup>

As a practical matter, therefore, an American life insurance company wanting to do business in Canada would likely create a subsidiary company that complies with Canada's licensing, regulatory and capital sufficiency requirements. It would then sell products appropriate to Canada's legal and tax rules through agents or brokers licensed in the appropriate Canadian province. The same would apply to a Canadian company wanting to do business in the United States. Neither company would sell products in the foreign market developed for sale in their home market, nor would they permit those licensed to do business with them to sell their products in a province or state in which they were not licensed to sell.

### **Irrevocable life insurance trusts (ILITs) and the premium excise tax**

If a U.S. citizen or resident owns a life insurance policy on their own life, the death benefit is included in their estate at death. It's not an issue if the taxable estate is expected to be less than US\$5.45 million (2016 exemption equivalent limit, indexed annually for inflation), or if both spouses in a married couple are U.S. citizens and their combined estate value is expected to be less than US\$10.9 million.

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<sup>2</sup> Robert B. Shapiro and Scott C. Shine, of Carlton Fields Jordan Burt, LLP, "[Considerations for insurers in the aftermath of the MetLife Consent Decree](#)".

For those whose wealth exceeds those thresholds, or who are concerned that the current exemption equivalent limits will be reduced in the future, an irrevocable life insurance trust (ILIT) provides a way to exclude the death benefit from the insured's taxable estate. The details of creating and administering an ILIT are beyond the scope of this article. However, generally the trust is structured to make sure that the insured has no rights to the trust assets during life. The IRS therefore won't be able to say that the insured owned the life insurance policy at death, and won't be able to include the death benefit in the insured's taxable estate.

However, an ILIT does not help a U.S. citizen or resident avoid the premium excise tax because the tax applies to insureds, even if the insured does not own the policy. The IRS will still expect the insured to file IRS Form 720 and pay the tax.

## Conclusion

Although the premium excise tax has been part of the IRC for many years, the IRS has not aggressively enforced it. That may change now that FATCA reporting requirements may make it easier for the IRS to determine who should pay the tax.

A U.S. citizen living in Canada can do very little to avoid the tax. U.S. citizen clients should structure ownership of their policies in as tax-efficient a way as possible, and be aware that even if they take legitimate steps to avoid U.S. taxes they may still have to file an excise tax return and pay the premium excise tax.

***Every effort has been made to ensure the accuracy and currency of the information provided. However, any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of the tax and legal situation with their own professional advisors after the facts of the specific case are considered.***

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