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**OPINION BRIEF ON WHETHER IRREVOCABLE INVESTMENT-LINKED LIFE
INSURANCE POLICIES ARE IN SCOPE OF THE COMMON REPORTING
STANDARD**

**I. IRREVOCABLE INSURANCE
BACKGROUND**

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This brief explains why investment linked irrevocable insurance policies are either not exempt from the exclusion of Cash Value insurance as defined in the Common Reporting Standard or in scope due to the Standard's general anti-avoidance provisions.

Furthermore the standard will be refined which will include identified loopholes. The permanent lock-in of assets prohibits the use of policy assets to for regularization. There is also reputation risk for FI. A trust or foundation holding such a policy will have to report in any event.

I. Irrevocable insurance background

Specialist opinion is sought for a non-EU based bank contemplating if a related insurance company providing irrevocable investment-linked insurance is exempt from Common Reporting Standard (“CRS”) reporting.

A priority goal of the CRS is to include structures where a client irrevocably hands his assets to a legal arrangement or entity for the ultimate benefit of others. This is referred to as an irrevocable trust. The CRS requires these irrevocable structures to report on the identified beneficiaries as well as the initial contributor of assets, even if the settlor / founder has no equitable rights to the income or assets.

Several offshore insurance companies propose a new type of policy that has never existed prior the CRS. They advocate an irrevocable investment-linked insurance where the policyholder can never access the policy assets and the only payable amount is a death benefit. This new type of insurance product is promoted as having no Cash Value and hence is not reportable under the CRS. In substance over form, these types of insurance policies serve virtually the same functions as irrevocable trusts. It thus seems unlikely the drafters of the CRS would categorically exempt irrevocable investment-linked insurance policies.

II. Irrevocable investment-linked insurance is excluded from the exemption from definition of Cash Value insurance

Insurance policies defined as a financial accounts and in scope of the CRS are policies with a Cash Value and some types of pensions. The CRS defines Cash Value¹ as the amount a policyholder is entitled to receive upon surrender, termination or pledge as a loan. Therefore if an insurance policy cannot be terminated, surrendered or pledged for a loan, it does not have a Cash Value. It would seem logical that this type of policy would be out scope of the CRS. However there is an obscure clause in the CRS commentary that brings irrevocable investment-linked insurance policies into the definition of Cash Value.

The CRS lists several exemptions to the definition of Cash Value insurance. Notwithstanding the foregoing, i.e. in despite of the previous definition of Cash Value, they list amounts that are payable under any insurance contract that are not considered as having a Cash Value. These are where amounts are payable solely as a death benefit, refunds of premiums and policyholder dividends. Also excluded from the definition of Cash Value is an amount payable for injury, sickness or other benefit providing indemnification of an economic loss upon the incurrence of the event insured against. Critically, the CRS commentary excludes from the exemption of Cash Value “**other benefits**” payable under an investment-linked insurance contract². An investment-linked insurance contract means an

¹ Standard for exchange of financial account information in tax matters - Section III Defined Terms - (C) Financial Account (7) Definition of Cash Value insurance contract

² Standard for exchange of financial account information in tax matters – Commentary on Section III Defined Terms – Point 76

1 insurance contract under which benefits, premiums, or the period of coverage, are adjusted to
2 reflect the investment return or market value of assets associated with the contact.

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4 In effect the CRS commentary clarifies that despite the definition of Cash
5 Value insurance being a policy where the policyholder can access the assets via a surrender,
6 termination or loan, a policy where an amount is payable for any type of benefit, including
7 death benefit, is a Cash Value **policy if the payment is linked to performance of**
8 **investment returns, i.e. “any benefit” including death benefit**, from an investment-linked
9 policy. A unit-linked irrevocable insurance policy is an investment-linked policy whose death
10 benefit is linked to performance of investments.

11
12 This double negative exemption of excluding the exemption from Cash Value
13 definition, means death benefits payable which are linked to investment performance is
14 indeed a Cash Value.

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16 The payment of a death benefit from an investment-linked insurance policy
17 being a Cash Value policy conflicts with the exemption of death benefits being exempt from
18 Cash Value³. However, it is assumed that the death benefits exempted from Cash Value are
19 not investment-linked and consists of mortality risk which the insurer bears.

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25 ³ Standard for exchange of financial account information in tax matters - Section III Defined Terms - (C)
Financial Account (8) Definition of the term Cash Value. Does not include any amount payable under an
insurance contract solely by reason of death of an individual insured under a life insurance contract.

Argument that indemnity benefits are not life insurance benefits

There are two types of insurance (a) indemnity and (b) non-indemnity.

Insurance practitioners argue that indemnification policies do not include life insurance. So the CRS commentary excluding indemnification payments from the exemption from Cash Value does not apply to life insurance and hence does not apply to irrevocable investment-linked life insurance. There are several problems with this “indemnification argument”. The two types of insurance mention in the commentary regarding indemnification payments relate to sickness and injury benefits. Sickness, accident and injury insurance is not only classified in insurance licenses under long-term or life insurance business, but that sickness and injury are non-indemnity insurance!⁴ Therefore the commentary seems to be pointing at any type of benefit from an investment-linked insurance, including death benefits, are not exempt from the definition of Cash Value.

The other problem against arguing that life insurance death benefits from an investment linked insurance should not be exempt from the exclusion of Cash Value is if you look at the big picture. The CRS wants to include any amount payable from an insurance policy which compensates loss if that compensation comes from a unit-linked insurance policy. So, for instance an insured house burns down and policyholder can claim for compensation from a unit-linked policy, that policy will be in scope as a Cash Value policy. Logically it follows the CRS will also want to include insurance policies that pay death benefits if the compensation comes from an investment-linked policy.

⁴ See point 3 - http://www.b-h.co.za/downloads/Insurable_Interest_&_Non-Indemnity_Policies.pdf

Miscellaneous commentary reinforces irrevocable insurance is Cash Value

The notion that an irrevocable investment-linked insurance policy is a Cash Value policy is further reinforced where the CRS states that if no person can access the Cash Value, the Account Holder is any person named as the owner in the contract and any person with a vested entitlement to payment under the terms of the contract⁵. The Cash Value not accessible by any person would be the death benefit of an irrevocable investment-linked insurance policy.

⁵ Standard for exchange of financial account information in tax matters - Section VIII (E) Miscellaneous (1) The term Account Holder

III. CRS anti-avoidance provisions

There may be an argument over the ambiguity that the death benefits exemption of Cash Value exemption takes priority over other benefits of investment-linked insurance and hence irrevocable insurance is not a Cash Value. Consequently, irrevocable insurance would not be a financial account and thus not be reportable.

However, the anti-avoidance provisions⁶ ensure that this newly created irrevocable insurance product will either be in scope, or that the authorities must rule it is in scope if it has been created with the purpose of circumventing the CRS.

Furthermore, the effective implementation guidelines state that jurisdictions must have rules and administrative procedures in place to ensure effective implementation of and compliance with, the reporting and due diligence procedures including rules to prevent any Financial Institutions, persons or intermediaries from adopting practices intended to circumvent the reporting and due diligence.⁷ The CRS states that the form of the anti-avoidance rules itself is not important as long as it is effective to prevent circumvention of reporting requirements.

The CRS anti-avoidance rules have a general wide-ranging impact. It is important to note that a Financial Institution (“FI”) may have implemented methods to avoid

⁶ Standard for exchange of financial account information in tax matters - Section IX Effective implementation guidelines

⁷ Standard for exchange of financial account information in tax matters Section IX

1 the EU Savings Tax Directive (“EUSTD”). The same FI may now consider utilising similar
2 methods to circumvent the CRS, e.g. the use of insurance policies. However, it is critical to
3 note that the EUSTD had no anti-avoidance provisions, but the CRS includes broad anti-
4 avoidance provisions.

5 6 7 **Shift maintenance of account**

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9 An insurance company which does not issue Cash Value insurance policies is
10 a non-specified insurance company. A non-specified insurance company is not a reporting FI
11 and therefore does not report or undertake due diligence on its policyholders. The CRS anti-
12 avoidance examples reflect that a FI, such as a bank, shifting accounts to a related non-
13 reporting FI (such as a non-specified insurance company), would mean the FI remains the
14 reporting FI. “A reporting FI advises customer to maintain account with a related Entity in a
15 non-participating Jurisdiction that enables the Reporting FI to avoid reporting while offering
16 to provide services and maintain customer relations as if the account was maintained by the
17 Reporting FI itself. In such a case the Reporting FI should be considered to maintain the
18 account and have the resulting reporting and due diligence requirements”⁸. This strongly
19 indicates a bank moving accounts to a related non-reporting insurer and maintains
20 relationship with customer, would be considered the FI maintaining the account. This means
21 the bank would have to report on the policyholders as if they were the account holders.

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⁸ Standard for exchange of financial account information in tax matters – Commentary on Section IX - Point 5 - Example 1

1 Creating a product that does not exist before CRS, which is clearly intended to
2 circumvent the reporting requirements would fall foul of the anti-avoidance guidelines. The
3 only purpose to utilise an irrevocable unit-linked life insurance policy is to circumvent
4 automatic reporting.

5
6 A-Reporting FI and Excluded Accounts in domestic law continue to have a
7 low risk of being used to evade tax⁹. These procedures should include a periodic review of
8 such status. Once a jurisdiction determines an account, such as irrevocable insurance policies,
9 no longer meet requirements posing a low risk for evading tax then the jurisdictions must rule
10 that such accounts are in scope.

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12 One issue worth noting is that the foreword of the CRS states that the CRS is a
13 minimum standard and that jurisdictions may choose to exchange information beyond the
14 minimum standard. If a partner countries becomes aware that irrevocable investment-linked
15 insurance is being used to circumvent reporting, it may request that information be exchanged
16 on these accounts.

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⁹ Standard for exchange of financial account information in tax matters – Commentary on Section IX - Point 15

IV. CRS will be refined

In the EU the CRS is implemented via an amendment to the EU Directive Administrative Assistance (“DAC”)¹⁰. There are five extra categories of income over and above the CRS that remain in DAC. This includes life insurance products not covered by other Union legal instruments on exchange of information and other similar measures. This clearly includes non-Cash Value insurance.

Refining of the CRS to close loopholes

DAC only applies to EU Members. Although the extra category of all life insurance will not immediately affect insurers situated outside the EU providing non-Cash Value policies, the EU and OECD work closely together to align automatic exchange of information. Therefore all life insurance, including non-Cash Value policies, will likely be included in future refinements to the CRS.

Pascal Saint-Amans, Director Centre for OECD Tax Policy and Administration, in charge of the CRS, states they will be paying close attention to the Tax Justice Networks report on the CRS loopholes as they seek to refine the standard on automatic information exchange¹¹

¹⁰ 2014/107/EU <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0016&from=en>

¹¹ <http://www.internationaltaxreview.com/Article/3319275/EXCLUSIVE-Pascal-Saint-Amans-defends-OECDs-Common-Reporting-Standard-despite-loopholes-identified-by.html>

V. Policyholder cannot utilize irrevocable policy assets for regularisation

When an irrevocable insurance policy is treated as a reportable financial account, or the policyholder wishes to partake in any tax amnesty program, the policyholder will be unable to access their policy assets because by its definition it is an irrevocable policy. The policyholder will thus be unable to utilise policy assets to regularise, remit assets back to country of residence, finance outstanding taxes, penalties and imposed on undeclared assets. Also the assets cannot be remitted back to country of residence which is a common amnesty condition when dealing with tax havens.

VI. Foundation as FI will report

Another issue of concern for irrevocable insurance policies not being reportable is if a professionally managed trust / foundation earns any income (e.g. for payment of trustee fees), the trust / foundation would be an investment entity FI. This FI would have to report on the equity interest of the trust / foundation, i.e. on settlor and identifiable beneficiaries even if the only asset is a non-Cash Value insurance policy. This is because the financial account of the trust is the equity interest, not the policy. This is even more true if the policy is held via an underlying company.

VII. Reputation risk

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4 Already exposed by press¹², irrevocable investment-linked insurance is viewed
5 as a scandalous tax evasion scheme. Public awareness of this product being used by a bank
6 would involve substantial reputation, especially where the insurance company is a related
7 entity.

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¹² <http://www.economist.com/news/finance-and-economics/21645259-making-tax-transparency-standards-watertight-will-be-difficult-leaks-tap>

Summary

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3 It is likely, depending on a jurisdiction's interpretation that irrevocable
4 investment-linked insurance is not exempt from the definition of Cash Value insurance, and
5 is hence a reportable financial account. Even if it is argued this is ambiguous, the irrevocable
6 investment-linked insurance should clearly be in scope due to the anti-avoidance provisions.
7 Furthermore, the OECD states it will refine the CRS based on feedback of loopholes from
8 organisations such as Tax Justice Network.

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10 Also consider the EU Commission impact on the OECD refining the CRS,
11 because the EU version of the CRS, already includes all life insurance not covered by other
12 automatic exchange of information legislation. The irrevocable insurance solution also has
13 significant reputation risk for financial institution advising clients to use such as solution as
14 publically reported in the Economist. The main egregious feature of an irrevocable insurance
15 is that by definition, a policyholder cannot access their assets within a policy if needed to
16 regularise their tax compliance situation. The policy assets cannot be used to finance the
17 back-taxes, penalties, and interest. Also the assets cannot be remitted back to country of
18 residence which is a common amnesty condition when dealing with tax havens.

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20 It should be noted that where a foundation / trust will likely be an investment
21 entity FI and will thus have to report on the equity interest of the investment entity even if the
22 sole asset is an irrevocable investment-linked life insurance policy.

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Mark Morris

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END OF BRIEF
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