The impact of FATCA on the insurance industry

In our August 2011 edition of Insurance Agenda we outlined how the Foreign Account Tax Compliance Act (FATCA) would potentially impact insurance companies.

Following the release of the FATCA draft regulations in February 2012, this edition of Insurance Agenda confirms what the regulations mean for life and general insurers; what concessions have been granted; and what insurers need to do now in order to become FATCA compliant.

Our key FATCA insurance insights include:

► FATCA can impact insurance companies regardless of whether they have US operations, customers or assets. All insurers should review their business now to determine how FATCA might impact them

► There is still some uncertainty around the product scope for insurance. Guidance suggests that any insurance contract with either a cash value or investment component are within scope of the provisions

► Insurance companies who only offer pure risk-based products should not be considered to be a ‘financial institution’ under the FATCA definition unless they provide other financial services such as issued debt

► The introduction of an exemption for pre-existing life insurance accounts with balances less than USD 250,000 should significantly ease the burden of compliance

► Term life contracts with annual premiums, where the amount payable on termination cannot exceed the premiums paid, are also out of scope. This will remove some products that have a return of premium feature, subject to the specific terms of the policy.
What is FATCA?

On 8 February 2012, the Internal Revenue Service (IRS) and US Treasury released the proposed FATCA provisions of the Hiring Incentive to Restore Employment (HIRE) Act. These proposed regulations now give the IRS new administrative tools in order to identify US persons earning unreported income outside of the US.

It is important to note that a US person is not limited to US citizens and does include any person who has ever held a green card.

FATCA is designed to discourage US persons attempting to avoid tax by opening accounts with foreign institution or investing through foreign vehicles. FATCA prevents this tax abuse through the implementation of new identification, information reporting and withholding obligations for entities that are Foreign (non-US) Financial Institutions (FFIs).

FFIs who choose to enter into agreements with the IRS (known as Participating FFIs or “PFFIs”), are required to classify all individual account holders, new and existing, as:

1. Non-US persons
2. US persons or
3. Recalcitrant account holders

A PFFI is also required to classify all new and existing entity account holders as either Non-Financial Foreign Entities (“NFFEs”), PFFIs or Non-Participating FFIs (“NPFFIs”).

As stated above, PFFIs have significant withholding obligations under FATCA. Specifically, PFFIs are required to withhold 30% on certain direct and indirect US sourced income (including the gross proceeds on the sale of certain US assets) in relation to payments made to accounts where the account holder is either recalcitrant or a NPFFI.

Broadly, recalcitrant account holders include account holders who either fail to comply with reasonable requests for information or fail to provide a waiver of privacy laws. NPFFIs are FFIs who either choose not to or are otherwise unable to enter into a FFI agreement with the IRS.

In addition to the identification and withholding obligations under FATCA, a FFI agreement also imposes annual reporting requirements on a PFFI. These reporting requirements include a certification by the PFI’s Responsible Officer (RO), or another individual in a similar level position, that the PFFI is compliant in relation to the FATCA provisions. This RO would also need to certify that the PFFI, to the best of their knowledge, did not assist account holders in avoiding the application of FATCA.

Will an insurance company be a FFI or NFFE?

As FATCA places significant identification, reporting and withholding obligations on PFFIs, a key step in determining the impact of FATCA on your insurance business is to identify whether the legal entities that make up your business are FFIs or NFFEs.

Whether an insurance company is caught under the definition of a FFI is entirely based on the range of insurance products offered. Insurance companies who issue, or are obliged to make payments in relation to Cash Surrender Value insurance contracts, annuities or certain other financial accounts; are classified as FFIs and therefore need to ensure they meet FFI obligations.

Why should an insurance company become a PFFI?

Where an insurance company is a financial institution for FATCA purposes, it will need to decide whether it chooses to become a PFFI (by entering into a FFI agreement with the IRS) or a NPFFI. As mentioned above, should the insurance company decide to be a NPFFI, it will be subject to the FATCA withholding at 30% on certain direct and indirect US sourced income paid to it by other PFFIs.

In addition, where the insurance company is part of a financial services group, and the group includes other financial institutions which decide to become a PFFI, then the “one in, all in” provisions contained in the FATCA regulations will come into force in order to compel the insurance company to also become a PFFI.

What is a Cash Surrender Value insurance policy?

A Cash Surrender Value insurance policy includes any insurance policy under which the policy holder is entitled to receive money upon redemption or termination of the policy - unless that money represents a refund of previously paid premiums. The key test here is whether the policy holder is entitled to receive money upon termination or surrender of the policy, not whether the policy holder actually does. For example, a policy holder may not receive any money upon the termination of a policy because of surrender fees or if the money is applied against the outstanding value of any loans.

In Australia, the broad product groups that are likely to be Cash Surrender Value insurance policies are both investment-linked contracts and bundled insurance/savings products with surrender values (for example, whole of life and endowment contracts).
To recognise that some life insurance policies may be risk-based but still have a cash surrender value, the draft FATCA regulations introduce the concept of “term life insurance contracts”. Term life insurance contracts are defined as insurance contracts where the payout upon termination does not exceed total premiums paid (less certain expenses) and that require equal periodic premiums to be paid at least annually.

Given the requirement that premiums must be periodic and paid at least annually, not all risk based life insurance policies will satisfy this exemption. For example, single premium death benefit policies (that have a Cash Surrender Value – such as a cash back policy) may fall within FATCA provisions as they are unlikely to satisfy the term life insurance policy requirement. Consequently, a life insurance company may be a FFI even though all its policies are risk based.

The fact that some risk based insurance policies will be considered Cash Surrender Value policies, highlights that a close inspection of a life insurance company’s policies is required in order to determine if that insurance company is a FFI.

Furthermore, life insurance companies that are currently not FFIs but are in the process of developing new types of insurance policies will need to reassess their FATCA status in light of those new policies.

Is there any relief from a PFFI’s obligations under FATCA?

Notwithstanding that an insurance company may be a FFI, relief from the potentially onerous identification, reporting and withholding obligations required from a PFFI may be available if the PFFI is eligible to be a ‘deemed compliant FFI’.

For example, an insurance company which is not part of a larger group that undertakes an insurance business solely in Australia with 98% of its cash value insurance contracts and annuities held by Australian residents may be able to access concessions from identification, reporting and withholding obligations available to registered deemed complaint FFIs if it implements policies and procedures to ensure it does not acquire any future US customers.

Are there any obligations for NFFEs under FATCA?

Even if the legal entities that make up an insurance business are not FFIs, insurance companies that are NFFEs will still be required to provide documentation to the FFIs that they deal with (for example, their bank). Providing incorrect documentation may lead to delays in payments or further requests for information and so accurate and timely delivery of information is recommended.

The level of documentation required will partially depend on the proportion of income derived from premiums as opposed from passive sources, such as interest and dividends. Where an insurance company earns the majority of its income from passive sources, additional documentation supporting that the FFI is not owned by certain specified US persons may be required.

In summary, all insurers will need to determine whether they are FFIs or NFFEs to determine their potential obligations under FATCA and act accordingly.

Key lessons learnt from our FATCA engagements

<table>
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<th>Clear ownership is key - both centrally and within the local business units</th>
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<td>The emotional journey is important: clear &amp; effective communications are important right from the start</td>
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<td>Quickly scope the problem and focus the assessment effort</td>
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<td>Centrally manage the interpretation of FATCA rules</td>
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<tr>
<td>Assess the problem quickly then pace the implementation to manage risk</td>
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<td>Compliance needs to be delivered across the group</td>
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> FATCA is a strategic issue for the business requiring significant and widespread change. Typically it starts as a ‘turf issue’ but execution impacts across IT, AMLKYC, operations, sales, distribution and relationship management.

> Realistically assessing the problem requires a concerted education and communication initiative across all the affected areas within the business.

> People’s reactions in often one of anger then denial. Plans need to allow for this response and give people the time to make the emotional journey.

> FATCA impacts different business lines and geographies in different ways. An informed top-down analysis can quickly identify business units and products which may be prudently de-prioritised.

> The FATCA regulations are not intuitive and need to be translated into terms which the operational teams can understand.

> Aspects remain uncertain unless a clear central view of the resulting assumptions is established, the programme will not perform consistently across the group.

> A group-wide view of the impact of FATCA is needed to inform prioritisation decisions.

> These should identify what should be progressed now (where this is efficient or required due to long lead times) and what can be prudently delayed.

> Mechanisms need to be put in place to ensure local business units are delivering an effective and compliant solution.
How will FATCA affect the insurance industry?

As discussed above, FATCA will have significantly different impacts on an insurance company depending on whether the company is classified as a FFI or a NFFE. A key determinant in whether an insurance company will be a FFI will be whether the company issues insurance with a cash surrender value, such as a life insurer.

Outlined below is our assessment on how FATCA will impact life and general insurers:

Life insurers

Any insurer who issues Cash Surrender Value insurance or annuity contracts will fall within the definition of a FFI. Most Australian life insurers either have some legacy conventional business or investment linked business on their books, and so, we would expect most life insurers to be FFIs.

A key decision therefore for most life insurance companies is whether to become a PFFI - by agreeing with the IRS to comply with the identification, reporting and withholding obligations required from all PFFIs. While the requirements for fulfilling a PFFI agreement are significant, if an insurance company is a FFI and does not enter into an agreement with the IRS, a tax withholding at a rate of 30% will need to be applied to payments made to the company by other PFFIs that are directly or indirectly sourced from the US. Note also the “one in, all in” provisions contained within the FATCA regulations.

If a life insurance company chooses to become a PFFI, they are agreeing to comply with the identification, reporting and withholding obligations required under a PFFI agreement.

While these obligations are significant, the recently released draft FATCA regulations provide some concessions from these obligations. For example, a life insurance company who had agreed to become a PFFI is not be required to identify the holder of pre-existing Cash Surrender Value insurance policies or annuity contracts if the aggregate balance of the holder’s accounts does not exceed USD 250,000 as at the start date of their FFI agreement. Instead, these accounts holders will be deemed to be non-US persons and no further identification procedures are required unless the aggregate balance of the account exceeds USD 1,000,000 at the end of any subsequent calendar year. This means that insurance companies that are PFFIs must monitor the account balances of policyholders at the end of each calendar year to determine whether further identification obligations are required. This is likely to provide operational challenges.

General insurance companies

An insurance company that does not issue Cash Surrender Value insurance policies or annuity contracts should not be a FFI. Accordingly, we would expect most general insurers to be NFFEs.

What you can do to prepare for FATCA?

As a life insurance company, you should undertake a legal entity analysis to determine whether your legal entities are FFIs. A key element of ascertaining FATCA status is to do a review of all of the types of policies issued by your insurance company to determine whether any of these policies are within the application of FATCA. To the extent that certain legal entities are FFIs, a key first step in becoming FATCA compliant is to conduct an impact assessment on your business.

An impact assessment should include identification of entities that may satisfy the requirements for deemed compliance as well as performing an analysis between current client information gathering and reporting systems capabilities. This assessment may outline system changes required for you to comply with your FATCA reporting requirements. This analysis will help identify resource requirements for a successful FATCA implementation project and how and where these scarce resources should be allocated.

Furthermore, by conducting this analysis and identifying existing customer data and information aggregation and reporting systems, the impact of FATCA on your business and customers may be significantly reduced. Minimising the impact of these rules on customers will be critical in managing the customer experience.

For life insurance companies that are not FFIs, policies and procedures should be developed to help ensure that future policies do not change the FATCA status of the company from a NFFE to a FFI.

General insurance companies should also conduct a review of their policies to confirm the assumption that they should not be a FFI under FATCA.
Next Steps

If you are a life insurance company, we recommend you undertake the following first steps to help ensure you are FATCA compliant:

► Undertake a legal entity analysis to determine whether the legal entities in your insurance business are non-US financial institutions (“FFIs”).

► Review all of your policies to determine whether any policies are in scope

► If your business includes legal entities that are FFIs, identify whether any of these entities satisfies the requirements for reduced obligations under FATCA while still remaining compliant

► For all life insurance companies that are not FFIs, implement policies and procedures to help ensure any policies issued in the future do not cause the company to become a FFI

► For all FFIs, conduct an impact assessment on your business to identify the gap between your current capabilities and the required capabilities to become FATCA compliant.

As FATCA becomes effective from 1 July 2013 for entities that enter into agreements with the IRS to satisfy certain identification, reporting and withholding obligations, we recommend life insurance companies undertake these critical first steps to ascertain their potential FATCA compliance burden and identify ways to reduce this burden as much as possible.

While it is important to understand FATCA and its impact, it is critical that the requirements be operationalised to minimise its impact on the business and manage the customer experience. The timeframes before commencement of the rules require insurance companies to start their FATCA programs now.
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