Beware the life insurance tax trap

New US residents – or citizens who have been living abroad – may be losing out on taxable benefits if their life insurance policies aren't compliant

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As many new residents discover – sometimes the hard way – US taxpayers with foreign bank accounts and other offshore assets are subject to a raft of special reporting requirements, as well as additional tax charges on foreign investment funds and certain other holdings. Failure to report these assets can result in steep monetary fines, open an individual's tax return to audit indefinitely and even expose him or her to criminal prosecution – a worry for many as the US Treasury and Justice departments continue their investigations into offshore assets. Many practitioners are wondering if foreign insurance products could be the next target.

Life insurance policies with cash surrender values are reportable assets if the issuer is a non-US insurance company. A US taxpayer who owns a non-US policy, purchased abroad, may be unaware that many foreign policies do not qualify as life insurance for US tax purposes. The consequences of owning a non-compliant policy can be quite serious.

Tax benefits

Qualifying life insurance policies are afforded many tax benefits in the US. The proceeds paid at death are not taxed to the beneficiaries and the policy may be excludable from the policyholder's estate, depending on how ownership is structured. Moreover, there is no federal income tax on the inside buildup in value, and distributions during the insured's lifetime generally are tax-free until the policyholder has recovered his or her adjusted costs (with certain exceptions). In the case of a variable life insurance policy that allows policyholders to track the performance of one or more investment portfolios, the tax result is not unlike owning a tax-sheltered mutual fund or retirement account.

Failure to qualify

Most of these tax benefits are lost if the policy does not meet the tax requirements for life insurance in the US. For example, if a policy fails certain actuarial tests at any point during the life of the insured, the policyholder will be taxed on the inside buildup in the policy, possibly with interest and penalties. Moreover, the death benefits may become taxable to the beneficiaries.

Variable life insurance policies present additional challenges because they are also subject to diversification requirements and prohibitions against investor control. This puts some of the more customized policies offered by foreign insurers at risk because many of these policies give policyholders a level of control over investment decisions that would be impermissible in the US. This can cause policyholders to be treated as the true owners of the underlying assets for US tax purposes and taxed currently on the earnings, whether or not the earnings are actually distributed.

> The policyholder could be subject to penalties for failing to report the underlying (foreign) investments

This could be compounded by the likelihood that many of the underlying assets of a non-US policy will be foreign investment funds subject to the passive foreign investment company rules. A policyholder potentially could be taxed at top marginal rates and subject to additional tax charges whenever one of the foreign investment funds pays a dividend or is sold from the associated asset account. The policyholder also could be subject to penalties and other sanctions, including tax returns opened to audit indefinitely, for failing to properly report the underlying (foreign) investments – assets which the policyholder never had reason to believe that they 'owned' at all.

Offshore insurance companies and brokers are already required to report policyholder information to the US Treasury Department or their local tax authorities in many cases. They would be a logical starting point for any future investigation into non-US insurance products. ⬢