

# FRENCH LIFE INSURANCE POLICIES: A U.S. INCOME TAX PERSPECTIVE

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## Tags

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The world of available insurance policies on an individual's life is broad and complex within the context of the tax law in the insured individual's country of residence. Add a foreign element, and one is faced with a legal and tax labyrinth. Certain important terms are lost in legal translation, and the task of applying the policy's term in another country is not easy.

For a U.S. tax adviser, the mere use of the label "life insurance" is not itself sufficient to cause a non-U.S. life insurance contract to be characterized as life insurance for U.S. income tax purposes. Rather, accurate characterization requires a thorough analysis of the terms of the policy based on an understanding of the foreign and U.S. tax regimes. This is because a non-U.S. policy is crafted to meet non-U.S. tax rules, unless drafted specifically for U.S. tax purposes.

This article aims at summarizing the U.S. and French tax regimes applicable to life insurance policies during the insured individual's lifetime and analyzing the U.S. tax implications for a U.S. citizen or tax resident holding a French life insurance policy designed for French residents. Applicable tax regimes triggered by the death of the insured will be the subject of a companion article, which will appear in a later edition of *Insights*.

## FRENCH LIFE INSURANCE

The starting point is a summary of the more important tax consequences for a French resident setting up a French life insurance policy.<sup>1</sup> For purposes of illustration, we focus on a popular and typically-encountered life insurance policy.

The individual subscriber is the insured individual who is the lifetime beneficiary of the life insurance policy. The policy guarantees a certain payout at the earlier of (i) the time of death of the insured individual or (ii) an agreed upon date. The life insurance policy has a cash surrender value, and the subscriber has identified beneficiaries in the event of death.

The subscription of a life insurance policy by an individual triggers the potential application of two types of taxes during lifetime: income tax and wealth tax.<sup>2</sup> French social charges (comparable to social security tax or net investment income tax under U.S. law) are also taken into account.

<sup>1</sup> Although specific French tax provisions apply to French residents who subscribe to non-French life insurance policies, those provisions are outside the scope of the present article.

<sup>2</sup> At the time of the death, two additional taxes, borne by the beneficiaries, may apply. A discussion of those taxes is outside the scope of this article. Note that life insurance companies frequently act as withholding agents for collection of applicable taxes at death.

## **French Life Insurance for French Tax Purposes**

In order to benefit from the favorable tax regime currently applicable to French life insurance policies, the life insurance company must be established in France<sup>3</sup> and the policy must be taken out after December 31, 1982.<sup>4</sup> As previously mentioned, the policy generally has a cash surrender value or a guaranteed payout at the end of the contract – generally equivalent to the cash surrender value at the time of death.<sup>5</sup> In addition, certain life insurance policies are set up to meet specific underlying investment requirements in order to benefit from even more favorable tax treatment.<sup>6</sup>

## **General Income Tax Rules Applicable to French Life Insurance Proceeds**

Once the basic criteria are met, life insurance proceeds are subject to French income taxation only upon withdrawal or the maturity date of the policy. Thus, barring early withdrawal, the insured subscriber will not incur taxation throughout the contract. This means that all reinvestment of income and gains within the policy is made on a pre-tax basis, thereby increasing the effective yield. The taxable amount equals the withdrawn or received amount, less the paid-in premiums. In other words, the increase in value over the paid-in premiums is subject to French income tax.

French income tax is levied at the following rates:<sup>7</sup>

<b>Net Taxable Income Bracket</b>	<b>Applicable Tax Rate</b>
Up to €9,700	0%
€9,700 – €26,791	14%
€26,791 – €71,826	30%
€71,826 – €152,108	41%
More than €152,108	45%

However, at the election of the taxpayer, withholding tax can be levied by the insurance company issuing the policy. The election must be made not later than at the time proceeds are received. The withholding of tax discharges the taxpayer from any further income tax liability with respect to the proceeds received under the policy.

<sup>3</sup> Article 125-0 A of the French Tax Code, as currently in effect.

<sup>4</sup> BOI-RPPM-RCM-10-10, June 30, 2014, no. 80.

<sup>5</sup> BOI-RPPM-RCM-10-10, June 30, 2014, no. 40.

<sup>6</sup> Article 125-0 A of the French Tax Code, as currently in effect.

<sup>7</sup> Please note that high income taxpayers are subject to an additional income tax levy at a marginal rate of 4%.

The rate of withholding tax varies depending on the age of the policy. The following table summarizes the applicable withholding rates:

Taxpayer Reporting	Age of the Policy <sup>8</sup>	Withholding Tax Rate
<b>Taxpayers disclosing identity &amp; residence to the tax authorities</b>	< 2 years	45% or 35% (for policies subscribed to as of January 1, 1990)
	≥ 2 years < 4 years	25% or 35% (for policies subscribed to as of January 1, 1990)
	4 years	15%
	≥ 6 years (for policies subscribed to between January 1, 1983, and December 31, 1989) or ≥ 8 years (for policies subscribed to as of January 1, 1990)	7.5% (unless the policies are otherwise exempt) <sup>9</sup>
<b>Taxpayers not disclosing identity &amp; residence to the tax authorities</b>	N/A	60% <sup>10</sup>
<b>Taxpayers residing in deemed non-cooperative countries</b>	N/A	75% <sup>11</sup>

*“The withholding of tax discharges the taxpayer from any further income tax liability with respect to the proceeds received under the policy.”*

<sup>8</sup> The age is calculated as of the setting up of the policy (BOI-RPPM-RCM-30-10-20-20, June 30, 2014, no. 70) or as of the first premium payment (BOI-RPPM-RCM-30-10-20-20, June 30, 2014, no. 70).

<sup>9</sup> BOI-RPPM-RCM-30-10-20-20, June 30 2014, no. 110 &130

<sup>10</sup> Article 125, II, 2 of the French Tax Code, as currently in effect.

<sup>11</sup> Article 125, II bis of the French Tax Code, as currently in effect.

When the taxpayer is not a French resident for French income tax purposes, the withholding tax obligation is mandatory for the financial institution issuing the life insurance policy.<sup>12</sup>

### **Available Deductions for French Income Tax Purposes**

The taxable life insurance proceeds are decreased annually, provided the taxpayer did not elect to be subject to withholding on taxable distributions. If the policy has been in existence for at least eight years (or six years for policies subscribed to between January 1, 1983, and December 31, 1989), taxable proceeds are decreased by the following amounts:<sup>13</sup>

- €9,200 for married individuals and civil unions
- €4,600 in all other scenarios<sup>14</sup>

The foregoing deductions are only available to French tax residents.<sup>15</sup>

### **Available Exemptions for French Income Tax Purposes**

Exemptions are available for those who qualify under French tax law. Qualification is generally linked to the holding period of the policy, the underlying investments, or certain life events. Broadly speaking, the following factors are key elements of qualification:

- The life insurance policy was subscribed to before or after specific dates and was held for six or eight years, depending on the applicable regime.<sup>16</sup>
- The life insurance premiums were paid prior to specific dates or the proceeds were received prior to specific dates, and the policy was held for six or eight years.<sup>17</sup>
- Withdrawals are made as a result of<sup>18</sup>
  - employment termination,<sup>19</sup>
  - early forced retirement, or<sup>20</sup>
  - disability.<sup>21</sup>

*“When the taxpayer is not a French resident for French income tax purposes, the withholding tax obligation is mandatory for the financial institution.”*

<sup>12</sup> Article 125, II bis of the French Tax Code, as currently in effect.

<sup>13</sup> BOI-RPPM-RCM-20-10-20-50-20140211, no. 330.

<sup>14</sup> Article 125-0 A, I, 1 of the French Tax Code, as currently in effect.

<sup>15</sup> BOI-RPPM-RCM-20-10-20-50-20140211, no. 240.

<sup>16</sup> BOI-RPPM-RCM-10-10-80, June 30, 2014, no. 80.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*, no. 100

<sup>19</sup> *Id.*, no. 102.

<sup>20</sup> *Id.*, no. 105.

<sup>21</sup> *Id.*, no. 107.

- The life insurance payout takes the form of a life annuity, rather than a lump-sum payment.<sup>22</sup>
- The policy invests in specified classes of investments at specific ratios, as defined by French tax laws, and the policy was held for eight years.<sup>23</sup>

With regard to the last factor, two different regimes exist under French tax law that provide for a full exemption of the life insurance proceeds, provided the policy invests in specified classes of investments at specific ratios. The first regime is called the “D.S.K.” (Dominique Strauss-Kahn) regime; the second is the “N.S.K.” (Nicolas Sarkozy) regime.

A D.S.K. policy is a life insurance policy subscribed to between January 1, 1998, and December 31, 2004. Among other criteria, the policy’s cash surrender value or the guaranteed amount must be converted into “account units.” Stated simply, every account unit is indexed to the value of specific underlying investments. The insurance company is liable for the number of account units the policy guarantees to the subscriber or other beneficiaries. The insurance company is not liable for the value of the underlying investments.<sup>24</sup> Every account unit is made up of specific investments. The insurance company is the legal owner of these underlying investments.<sup>25</sup> As a general rule, the underlying investments must be one or more O.P.C.V.M.’s (*Organisme de Placement Collectif en Valeurs Mobilières*) or certain similar European investment funds. O.P.C.V.M.’s essentially constitute investment funds, thus generating passive income. In order to be a qualifying O.P.C.V.M. for purposes of this specific life insurance regime, the O.P.C.V.M. must invest in certain types of investments, at specific ratios, as listed by French law.

An N.S.K. policy is a life insurance policy subscribed to between January 1, 2005, and December 31, 2013. Under this type of life insurance policy, either all or some of the premiums must be converted into account units. If only some of the premiums are converted, the balance must be directly invested.<sup>26</sup> Here again, a certain ratio of account units must be invested in certain O.P.C.V.M.’s meeting investment ratios proscribed by French law.

### **French Social Charges**

French social charges apply to French life insurance proceeds. Depending on the nature of the life insurance policy, these social charges are levied at a 15.5% rate (i) throughout the life of the policy or (ii) upon withdrawal.

The 15.5% rate is the aggregate amount of a multitude of social charges that generally apply to French passive income, and the following breakdown highlights its various components:

<sup>22</sup> *Id.*, no. 90.

<sup>23</sup> BOI-RPPM-RCM-10-10-90, June 30, 2014.

<sup>24</sup> BOI-RPPM-RCM-10-10-90-10-20120912, no. 20.

<sup>25</sup> *Id.*

<sup>26</sup> BOI-RPPM-RCM-10-10-100-10-20130107, no. 10.

Social Charge	Rate
C.S.G.	8.2% (5.1% is tax deductible)
C.R.D.S.	0.5%
<i>Prélèvement Social</i>	4.5%
<i>Contribution Additionnelle au Prélève-ment Social</i>	0.3%
<i>Prélèvement de Solidarité</i>	2.0%
<b>Aggregate Amount</b>	<b>15.5%</b>

### **French Wealth Tax**

A French tax resident can be subject to French wealth tax if, on January 1 of the applicable tax year, his or her worldwide net assets have a fair market value exceeding a certain threshold. For the 2016 tax year, this threshold equals €1.3 million.<sup>27</sup>

If a French resident's worldwide net assets exceed the threshold, the fair market value is taxed at the following rate:

Asset Valuation Bracket	Applicable Tax Rate
< €800,000	Exempt
€800,000 – €1,300,000	0.50%
€1,300,000 – €2,570,000	0.50%
€2,570,000 – €5,000,000	1.00%
€5,000,000 – €10,000,000	1.25%
> €10,000,000	1.50%

<sup>27</sup> Article 885 A of the French Tax Code, as currently in effect.

*“If a life insurance policy meets the statutory definition, its yearly increase in value is not subject to income tax.”*

Life insurance policies are subject to French wealth tax according to the following rules throughout the term of the policy:<sup>28</sup>

- If the policy has no cash surrender value, only the premiums paid after the taxpayer has reached the age of 70 must be included in the taxable base.
- If the policy has a cash surrender value, this cash surrender value, as determined on January 1 of the applicable year, must be included in the taxable base.
- If the policy temporarily prevents the taxpayer from an early cash-out, the policy must still be included in the taxable base.

## U.S. LIFE INSURANCE

Section 7702 of the Internal Revenue Code of 1986, as currently in effect, (the “Code”) defines life insurance for purposes of U.S. income taxation. It defines a life insurance contract to mean any contract that is a life insurance contract under the applicable law, but only if such contract meets the following requirements:

- **Cash Value Accumulation Test:** Under this test the cash surrender value of the contract may not at any time exceed the net single premium that would have to be paid at that time to fund future death benefits under the contract, assuming that the contract matures no earlier than the policyholder’s 95th birthday and no later than the day the insured attains age 100. This test is intended to permit traditional whole-life insurance contracts to qualify as life insurance contracts, even though cash values accumulate at reasonable interest rates.
- **Guideline Premium Requirement with Regard to Premiums Paid Under the Contract and Specified Cash Value Corridor:** The guideline premium limitation as of any date is the greater of (i) the guideline single premium or (ii) the sum of the guideline level premiums to that date. The former is the premium that is necessary at the date the policy is issued, and certain other times to fund the future benefits under the contract, plus charges for any of four qualified additional benefits. The calculation must be based on reasonable mortality and expense charges. The guideline level premium is the level annual amount payable over a period of time, not ending before the insured person attains age 95 years, that is necessary to fund future benefits under the contract. The cash value corridor test ensures that the contract contains at least a minimum amount of pure insurance protection at all times, as specified by certain tables. To illustrate, for an insured person with an attained age of 40 years, the death benefit must be 250% of the cash value. For attained ages from 41 to 45 years, the required percentage decreases ratably to 215%.

In addition, specific diversification rules exist that must be respected in order to qualify for owner-directed investments.<sup>29</sup>

<sup>28</sup> *Id.*

<sup>29</sup> Code §817(h).

The purpose of the provision is to counter a general concern over the proliferation of investment-oriented life insurance products.<sup>30</sup> If a life insurance policy meets the statutory definition, its yearly increase in value is not subject to income tax.<sup>31</sup> In addition, upon a payout before death, the investment in the contract – viz., the aggregate amount of premiums paid into the policy reduced by the aggregate amount received under the contract that was excluded from gross income – is not subject to income tax, leaving only the amount in excess of the investment in the contract as amounts of a payout that would be taxed.<sup>32</sup>

Upon the death of the insured, proceeds attributable to the death benefit of the life insurance contract are generally not subject to income tax in the hands of the estate or heirs receiving the payment.<sup>33</sup> However, where a life insurance contract has been transferred for valuable consideration to a third party, the contract resembles an investment product and amounts in excess of the value paid for the policy plus the premiums paid after the transfer are fully taxable in the hands of the recipient.<sup>34</sup> This rule does not apply in certain business circumstances, such as upon the retirement of the insured in relation to a contract owned by his or her employer.<sup>35</sup>

## U.S. TAXATION OF FRENCH LIFE INSURANCE

The first step in analyzing the status of the French life insurance policy involves reading the document, which is typically written in French. The goal is to analyze the general conditions of the contract and the special conditions applicable to the insured. The second step is to understand the foreign tax regime generally applicable to the documents. Finally, the foreign document must be analyzed in light of applicable U.S. tax law.



### **Typical Fact Pattern**

In a typically-encountered fact pattern, a French national and resident moves to the U.S. for work-related reasons. The individual may hold an H-1B or an L-1 visa, but not a green card – a term commonly used to describe a permanent resident visa. The individual is a U.S. resident for income tax purposes, under the substantial presence test of Code §7701(b). The individual may hold several assets in his or her estate, including a French life insurance policy. The terms of the policy provide that the individual is the beneficiary of the policy, entitled to a payout during life that is capped at the cash surrender value. At death, the death benefit must be paid to the surviving spouse or children.

Typically, a French contract is not designed to provide a death benefit. Instead, the French life insurance policy serve as an investment tool for French residents.

<sup>30</sup> Staff of the Joint Committee on Taxation, “[General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984](#),” December 31, 1984, p. 646.

<sup>31</sup> Code §7702(e)(5). This treatment is also subject to the provision that (i) the policy does not constitute a modified endowment contract as defined by Code §7702A and (ii) no annuities have been paid under the contract.

<sup>32</sup> Code §§72(e)(2)(B) and 72(e)(5)

<sup>33</sup> Code §101(a).

<sup>34</sup> Code §101(a)(2)

<sup>35</sup> Code §101(a)(2)(B).



Viewed in this light, French life insurance policies generally do not meet the Code §7702 tests mentioned above. The premium payment is front loaded so as to accelerate tax savings on the investment feature.

### **U.S. Income Tax Regime Applicable to Non-Qualifying Life Insurance Policies**

As previously stated, Code §7702 has a two-pronged test. For a life insurance policy to qualify, the policy must

- be designated as a life insurance contract under the applicable law, and
- meet either (i) the cash value accumulation test or (ii) the guideline premium requirement and the specified cash value corridor.

Regarding the first test, which requires the contract to be a life insurance contract under the applicable law, the Code does not specify whether that law can be foreign law. However, the “General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984,” published by the Joint Committee of Taxation (“J.C.T.”), states that the law may be foreign law:

A life insurance contract is defined as any contract, which is a life insurance contract under the applicable State *or foreign law*, but only if the contract meets either of two alternatives: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. [emphasis added]

Thus, a French life insurance contract is a life insurance contract for U.S. tax purposes. However, it cannot meet either of the tests in the second prong. Consequently, Code §7702(g)(1)(A) becomes applicable. It provides for the tax regime applicable to non-qualifying policies, in the following terms:

If at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract . . . the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year.

In our example, the French life insurance policy would be taxed on a current basis in the hands of the expat French individual who resides in the U.S. The yearly income on the contract will be treated as ordinary income of that individual. The income on the contract is the increase in the net surrender value of the contract during the taxable year, as increased by the cost of life insurance protection provided under the contract during the taxable year and reduced by the premiums paid under the contract during the taxable year.

### **Avoiding Double Taxation**

As mentioned above, French life insurance companies must withhold French income tax on life insurance distributions when the distributions are made for the benefit of individuals who are not considered to be French residents for French income tax purposes. In our scenario, this would result in taxation in France at maturity, in addition to the tax paid in the U.S. during the premium’s buildup period.

*“The Treaty allows policies issued by a French insurer or reinsurer that is a French resident to be exempt from the excise tax.”*

To prevent double taxation from occurring, the France-U.S. Income Tax Treaty (the “Treaty”) contains a provision designed to allow the tax authorities of the two countries to agree, between themselves, as to the country having the primary right to tax.<sup>36</sup> Regrettably, the Treaty is silent as to the specific tax treatment applicable to life insurance proceeds. Faced with growing concerns from the French expat community, the French government published a statement declaring that only the U.S. has the right to tax life insurance proceeds. The declaration is premised upon the view that income from payments under a life insurance policy is akin to interest and that, pursuant to Article 11 (Interest) of the Treaty, this income is taxed only in the country of residence of the recipient.<sup>37</sup> The same result would be reached under Article 22 (Other Income) if the payment is not defined to be interest for U.S. tax purposes. Article 22 allocates, to the country of residence, the exclusive right to tax income not covered by other provisions of the Treaty.

### **U.S. Excise Tax on Foreign Life Insurance Premiums**

Code §4371 provides for an excise tax of 1% applicable to insurance premiums paid to foreign life insurers or reinsurers, unless the premiums are taxed as income effectively connected with the conduct of a U.S. trade or business.

The insurance excise tax must be paid by any person who makes, signs, issues, or sells any of the documents and instruments subject to the excise tax, or for whose use or benefit documents and instruments are made, signed, issued, or sold.<sup>38</sup> Generally, the person making a premium payment to a foreign insurer or reinsurer must file Form 720, *Quarterly Federal Excise Tax Return*, and remit the excise tax to the I.R.S.<sup>39</sup>

The Treaty allows policies issued by a French insurer or reinsurer that is a French resident to be exempt from the excise tax.<sup>40</sup> In order to qualify for the exemption, the foreign life insurer to whom the premiums are paid (i) must have entered into a closing agreement with the I.R.S., (ii) must not reinsure the risks with a person not qualifying for Treaty benefits, (iii) must be a resident of France, and (iv) must qualify under the applicable L.O.B. (Limitation on Benefits) provision of the Treaty.<sup>41</sup> The I.R.S. publishes a list of foreign life insurance companies that have entered into qualifying closing agreements.<sup>42</sup> Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, may have to be filed in order to claim the Treaty exemption.<sup>43</sup>

Here again, although the Treaty grants an exemption from the excise tax, the analysis remains factual and the appropriate path forward depends on the specific policy

<sup>36</sup> Article 26 (Mutual Agreement Procedure) of the France-U.S. Income Tax Treaty (in effect as of the June 1, 2016).

<sup>37</sup> [“Réponse du Ministère des finances et des comptes publics publiée dans le JO Sénat du 02/07/2015,”](#) p. 159.

<sup>38</sup> Code §4374.

<sup>39</sup> Treas. Reg. §46.4374-1(c).

<sup>40</sup> Articles 2 and 30 of the France-U.S. Income Tax Treaty.

<sup>41</sup> Rev. Proc. 2003-78, November 10, 2003.

<sup>42</sup> I.R.S., [“Exemption from Section 4371 Excise Tax.”](#) last reviewed or modified June 14, 2016.

<sup>43</sup> Code §6114.

and the issuing insurer. However, this type of scenario is seldom seen, given that generally the premium payments are made prior to moving to the U.S. and no subsequent payments are made.

**Treatment of French Life Insurance for F.B.A.R. and F.A.T.C.A. Purposes**

Every U.S. tax resident and every U.S. citizen must annually report all interests held in all foreign financial accounts. The report is made to the Financial Crimes Enforcement Network (“FinCEN”) of the I.R.S. on a yearly basis, using FinCEN Form 114, *Report of Foreign Bank and Financial Accounts (F.B.A.R.)*.<sup>44</sup> The definition of “foreign financial accounts” includes an account that is an insurance or annuity policy with a cash surrender value.<sup>45</sup> Under this definition, a French life insurance policy constitutes a foreign financial account for F.B.A.R. purposes and is subject to annual reporting.

The same reporting obligation is generally applicable for purposes of F.A.T.C.A. and Form 8938, *Statement of Specified Foreign Financial Assets*, provided the life insurance policy is a cash value insurance policy having a value that exceeds a certain amount, which varies based on the marital status of the individual,<sup>46</sup> and that the policy is not a term life insurance contract.<sup>47</sup>

The following table summarizes the filing thresholds for U.S. tax residents:

Filing Status	Applicable Threshold
Single	> \$50,000 (on the last day of the tax year) or > \$75,000 (at any time during the tax year)
Married Filing Jointly	> \$100,000 (on the last day of the tax year) or > \$150,000 (at any time during the tax year)
Married Filing Separately	> \$50,000 (on the last day of the tax year) or > \$75,000 (at any time during the tax year)

<sup>44</sup> Code §1010.350 of Title 31 of the Code of Federal Regulations.

<sup>45</sup> Code §1010.350(c)(3) of Title 31 of the Code of Federal Regulations.

<sup>46</sup> Treas. Reg. §1.1471-5(b)(2)(ii).

<sup>47</sup> Treas. Reg. §§1.1471-5(b)(1)(iv) and 1.1471-5(b)(3)(vii).

## **Treatment of P.F.I.C. Investments Within the Life Insurance Policy**



Premiums paid into the life insurance policy are used to make investments. If a particular investment takes the form of collective investment vehicles (among which are O.P.C.V.M.'s), the vehicle likely will be categorized as a Passive Foreign Investment Company ("P.F.I.C."). A foreign corporation will be classified as a P.F.I.C. if either (i) 75% or more of the corporation's gross income is passive income (e.g., income from interest, dividends, or capital gains) or (ii) 50% or more of the corporation's assets are held for the production of passive income (e.g., stocks, bonds, or cash).<sup>48</sup> A typical P.F.I.C. is an offshore investment company or mutual fund.

Pursuant to Code §1298 and temporary regulations issued by the I.R.S.,<sup>49</sup> a U.S. shareholder of a P.F.I.C. must generally report the P.F.I.C. interest on Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, on a yearly basis, even if no tax is due with regard to the investment.<sup>50</sup> The question then becomes whether the owner of the policy is considered to be the owner of the P.F.I.C. in which the insurance company invested.

A shareholder is a U.S. person that directly owns stock of a P.F.I.C. (i.e., a direct shareholder) or that is an indirect shareholder.<sup>51</sup> As previously mentioned, certain French life insurance policies must meet mandatory underlying investment requirements in order to qualify for favorable tax treatment. The underlying investments made by French insurance companies with regard to premiums received are often funds that typically meet the definition of a P.F.I.C.

Code §1298(a)(2) provides, in general, that attribution of ownership from a foreign corporation to a shareholder requires ownership of at least 50% of the value of the foreign corporation unless that foreign corporation is itself a P.F.I.C. This is reflected in Temporary Treasury Regulations that provide:<sup>52</sup>

An indirect shareholder of a PFIC is a United States person that indirectly owns stock of a PFIC. A person indirectly owns stock when it is treated as owning stock of a corporation owned by another person, including another United States person, under this paragraph (b)(8). In applying this paragraph (b)(8), the determination of a person's indirect ownership is made on the basis of all the facts and circumstances in each case; the substance rather than the form of ownership is controlling, taking into account the purpose of sections 1291 through 1298.

The temporary regulations then address ownership through a foreign corporation, a partnership or entity treated as a partnership for U.S. tax purposes, an S-corporation, a trust, and an estate. Other regulations that address the disposition of an indirect interest in a P.F.I.C. refer only to transactions in which indirect ownership

<sup>48</sup> Code §1297(a).

<sup>49</sup> Treas. Reg. §1.1298-1T(b)(1)(i).

<sup>50</sup> Exceptions exist for certain P.F.I.C.'s with an aggregate value not exceeding \$25,000. See Treas. Reg. §1.1298-1T(c)(2)(ii).

<sup>51</sup> Treas. Reg. §1.1291-1T(b)(7).

<sup>52</sup> Treas. Reg. §1.1291-1T(b)(8)(i).

is described by the temporary regulations.<sup>53</sup> Hence, if the indirect ownership is not covered by the proposed regulations, presumably there can be no indirect disposition. In that way, the regulations on dispositions are closely linked to the definition of indirect ownership.

In general, foreign insurance companies are not considered to be P.F.I.C.'s under an exception carved out in Code §1297(b)(2)(B).<sup>54</sup> Under a relatively recent set of proposed regulations, this exemption does not apply to hedge funds attempting to fit investment operations into an insurance company wrapper.<sup>55</sup> Passive income is carved out only for foreign corporations that actively conduct an insurance business. The standard that appears in Treas. Reg. §1.367(a)-2T(b)(3) is applied to test whether the business is actively carried on:

[A] corporation actively conducts a trade or business only if the officers and employees of the corporation carry out substantial managerial and operational activities. A corporation may be engaged in the active conduct of a trade or business even though incidental activities of the trade or business are carried out on behalf of the corporation by independent contractors. In determining whether the officers and employees of the corporation carry out substantial managerial and operational activities, however, the activities of independent contractors shall be disregarded.

A provision in the §1.367(a)-2T regulations that allows for shared officers and directors is not applicable in the insurance company context.

In these circumstances, it is reasonable to believe that investments made by a French insurance company carrying on an active insurance business are not attributed to the owner of a life insurance policy, even if the income under the contract is currently taxable in the U.S.

This conclusion is consistent with the holding in Rev. Rul 2003-33, which addressed the I.R.S. view of circumstances in which the holder of a variable life insurance contract would be considered to be the owner, for U.S. income tax purposes, of the assets that fund the variable contract. In this ruling, an individual (“Holder”) purchased a life insurance contract under which he retained the right to allocate the premium paid among the available investment accounts. The Holder could change the allocation of premiums at any time within certain limitations, but had no legal or inferred rights regarding the investment strategy of any investment account, or the assets to be held by a particular account. All investment decisions concerning the investment accounts were made by the insurance company and its investment advisor. The I.R.S. concluded that in the facts presented, the Holder did not have any legal, equitable, direct, or indirect interest in any of the assets held by in an investment account, although he had a contractual claim against the insurance company to collect cash in the form of death benefits or cash surrender values under the contract.<sup>56</sup>

<sup>53</sup> Treas. Reg. §1.1291-3(e)(2).

<sup>54</sup> Under proposed regulations,

<sup>55</sup> Prop. Treas. Reg. §1.1297-4.

<sup>56</sup> See also *Christoffersen v. U.S.*, 749 F.2d 513 (8th Cir. 1984); P.L.R. 200601007;

***“If the indirect ownership is not covered by the proposed regulations, presumably there can be no indirect disposition. In that way, the regulations on dispositions are closely linked to the definition of indirect ownership.”***

This conclusion is also consistent with the process followed by the I.R.S. when U.S. persons participate in the Offshore Voluntary Disclosure Program regarding unreported financial accounts. There, the insurance policy is treated as a financial account held by a U.S. person in the insurance company. The assets of the insurance company are not considered to be held by the U.S. individual.

In sum, as long as the policy holder does not have effective control over the investments maintained by the insurance company, the risk to the policy holder should be minimal with regard to P.F.I.C. reporting.

## CONCLUSION

In today's world, one cannot provide solid tax advice without factoring in potential international tax aspects. The present article is a good example for the adverse tax consequences non-internationally-structured tax advice can have on a taxpayer acting in good faith. While life insurance policies benefit from a favorable tax regime under French tax laws, the situation may become quite the opposite when exposed to foreign law. Pre-immigration tax planning thus becomes essential when a taxpayer is suddenly faced with a change in tax residency.

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and P.L.R. 201240018. Private letter rulings issued by the I.R.S. may be relied on only by the taxpayer to whom they are issued. Nonetheless, a private letter ruling can be claimed as authority for purposes of avoiding penalties. It also demonstrates the views of the I.R.S. at the time issued.

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