



STEP CLE PROGRAM

Osgoode Hall, Donald Lamont Learning Centre,
130 Queen St. West, Toronto

US TAX ISSUES WITH LIFE INSURANCE POLICIES 13th February 2013

Edward C. Northwood, Esq.
Of Counsel
THE RUCHELMAN LAW FIRM

Exchange Tower, Suite 2300, 130 King Street West, P.O. Box 233, Toronto, Ontario Canada M5X 1C8

T: 416.350.2026 or 416.367.6874; E: northwood@ruchelaw.com

Foreign Legal Consultant

Practice Restricted to U.S. Law

155 Summer Street, Buffalo, New York 14222-2205

Tel: 716.332.3456; F: 716. 332.3457 E: ed@ednorthwood.com



OVERVIEW OF CROSS BORDER PROBLEMS FOR CANADIANS WITH U.S. CONNECTIONS

☐ U.S. Gift and Estate Taxes

- ☐ On transfer of worldwide assets of U.S. citizens or domiciliaries
- ☐ On transfer of U.S. situs assets (vacation homes, real property interests, stocks, options, business interests, etc.) of noncitizens/nondomiciliaries

☐ Expansive Reach of U.S. income tax regimes on U.S. income tax residents or citizens

- ☐ Worldwide income (may be different than Canadian), including as to insurance products
- ☐ Beneficial interests in non-U.S. estates and trusts
- ☐ Anti-deferral regime for non-U.S. companies (resulting in deemed, or phantom, income)



INDIVIDUALS SUBJECT TO U.S. INCOME TAX

☐ Tax on Worldwide Income

☐ U.S. citizen (no matter where resident or domiciled)

☐ U.S. resident

☐ “Green card” holder; or

☐ Satisfy “days test”

☐ $1/6$ days yr-2 + $1/3$ days yr-1 + days current yr > 182
+ 31 or more days present in U.S. in current year

☐ Closer connection exception (Form 8840)

☐ Tax treaty rules (centre of vital interests—election on Form 8833 required)



U.S. PERSONAL TAX SUMMARY FOLLOWING FISCAL CLIFFHANGER





PRIMARY INDIVIDUAL INCOME TAX CHANGES

- ▣ Top federal rate now 39.6% on ordinary income over \$400K (\$450K joint) for US taxpayers
- ▣ Long term capital gains and qualifying dividends tax rate now increased to 20% for same classes of taxpayers (which will apply to Canadians who sell US real properties)
- ▣ Itemized deductions and personal exemptions phased out or limited for those with income over \$250K (\$300K joint)
- ▣ NB – 3.8% additional tax on net investment income for US taxpayers with income over \$200K (\$300K Joint) now in effect (under “Obamacare” law); this does not apply to NRAs



THE GIFT AND ESTATE TAX SURPRISES





CHANGES EFFECTIVE FOR 2013 UNTIL.....

- ☐ US Gift, Estate and GST Tax Exemption all = \$5M, Indexed for Inflation
[2012 = \$5.12M; 2013 \$5.25M]
- ☐ Tax Rate for transfers over \$1M = 40%
- ☐ Portability for U.S. spouses
 - ☐ Essentially, unused exemption on first death may be used on second death
- ☐ All permanent (that is, no “sunset”)
- ☐ Many States still impose a separate estate tax



ILLUSTRATION OF PORTABILITY

- ▣ 2 US citizen spouses
- ▣ H dies, owning \$1M personally and \$9M jointly

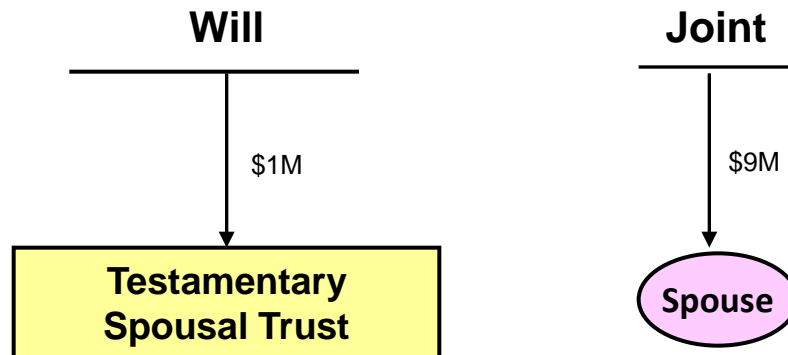




ILLUSTRATION OF PORTABILITY...Contd.

- ☐ Under old rule, spousal trust would use up \$1M of exemption and other \$4.25M of unused exemption would be lost
- ☐ Under Portability, survivor may add unused \$4.25M exemption to his/her own \$5.25M exemption, for a total of \$9.5M exemption
- ☐ Not available to NRA decedents



WHAT DID NOT CHANGE

- ☐ Valuation discounts for Family LP's and Companies remain
- ☐ QDOT Laws still apply
- ☐ Canada/US Treaty applies to Increased Estate Tax Exemption and Death Tax Credits
- ☐ DOD Basis Bump remains applicable to all Decedents' Assets [both US citizens, US domiciliaries and NRA's]
- ☐ State estate taxes remain a deduction for federal purposes (there used to be a credit)



RECOMMENDED STRATEGIES

- ▣ Inheritance Trusts for US Children remain important (possible reduction in exemption; creditor protection)
- ▣ US citizen with non-citizen spouse should make annual exclusion gifts (\$143,000; \$14,000)
- ▣ Consider large gift to asset protection or other dynasty trust with retained beneficial interest (but excluded from estate) or with no retained interest



TYPICAL INSURANCE PLANNING DISCUSSION

- ▣ Who or what should own a policy
- ▣ What type of policy
- ▣ Who is insured
- ▣ Who is beneficiary
- ▣ Decisions can be affected by cross border implications



DEMOGRAPHIC PATTERNS AT ISSUE

- ▣ US citizen insured, resident of Canada
 - ▣ Owns policy personally
 - ▣ Owns CanCo that owns policy
 - ▣ Settles ILIT that owns policy
 - ▣ NRA spouse owns policy



DEMOGRAPHIC PATTERNS AT ISSUE...CONTD.

- ▣ Canadian resident (NRA) insured, with US beneficiaries
 - ▣ Owns policy personally
 - ▣ Owns CanCo that owns policy
 - ▣ Settles ILIT that owns policy
- ▣ Canadian resident insured, moves to the US



U.S. TAX CONSIDERATIONS FOR LIFE INSURANCE

☐ Gift Tax (U.S. citizens or Domiciliaries)

- ☐ What is the policy worth?

☐ Estate Tax (U.S. Citizens or Domiciliaries)

- ☐ Death benefit includible if insured possesses “incidents of ownership”

- ☐ Also a factor for NRAs who own US assets because it is includable in denominator of fraction that applies for Treaty and deduction purposes

☐ COLI

- ☐ If owned by and payable to company, company valuation issues

- ☐ If owned by company + insured is majority owner, if payable to others, fully includible



U.S. TAX CONSIDERATIONS FOR LIFE INSURANCE, Contd....

☐ Income Tax Treatment

☐ During Life:

☐ I: policy earnings tax exempt? (Is it life insurance? IRC 7702)

☐ I: Policy dividends tax-free?

☐ I: withdrawals, loans, partial or full redemptions tax-free? If MEC, first out taxable; if not, recover basis tax-free first

☐ I: premiums deductible? (rarely)

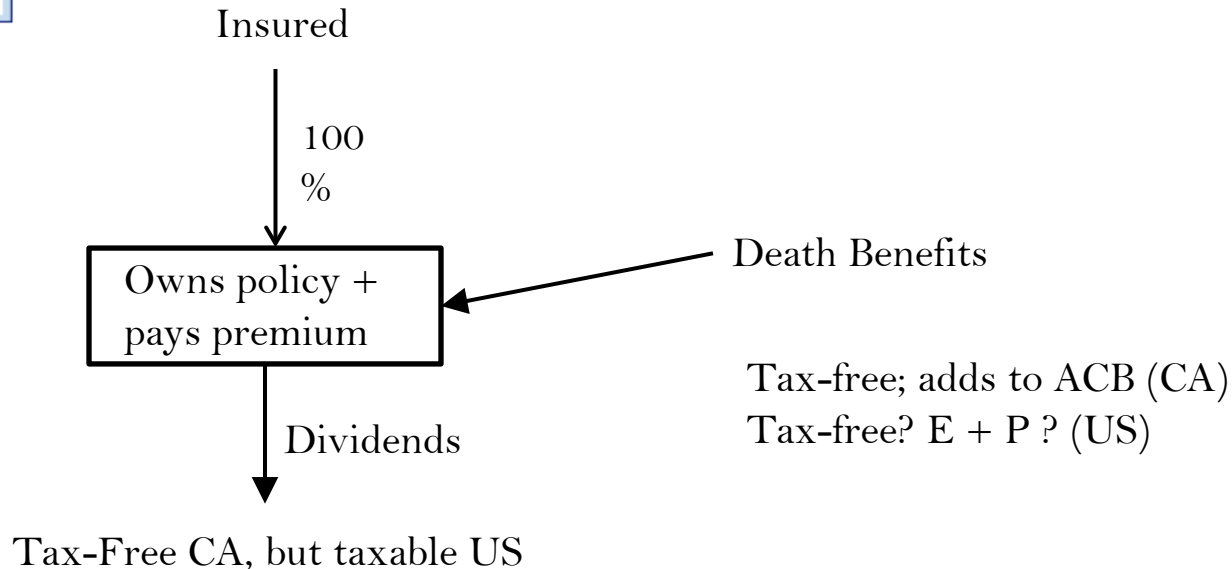
☐ On death:

☐ I: death benefit tax-free?

[beware transfer for value rules]



CANCo OWNERSHIP



- ☐ US estate tax valuation issue if CanCo owner is US
- ☐ Consider liquidating CanCo immediately after death (tax-free US)

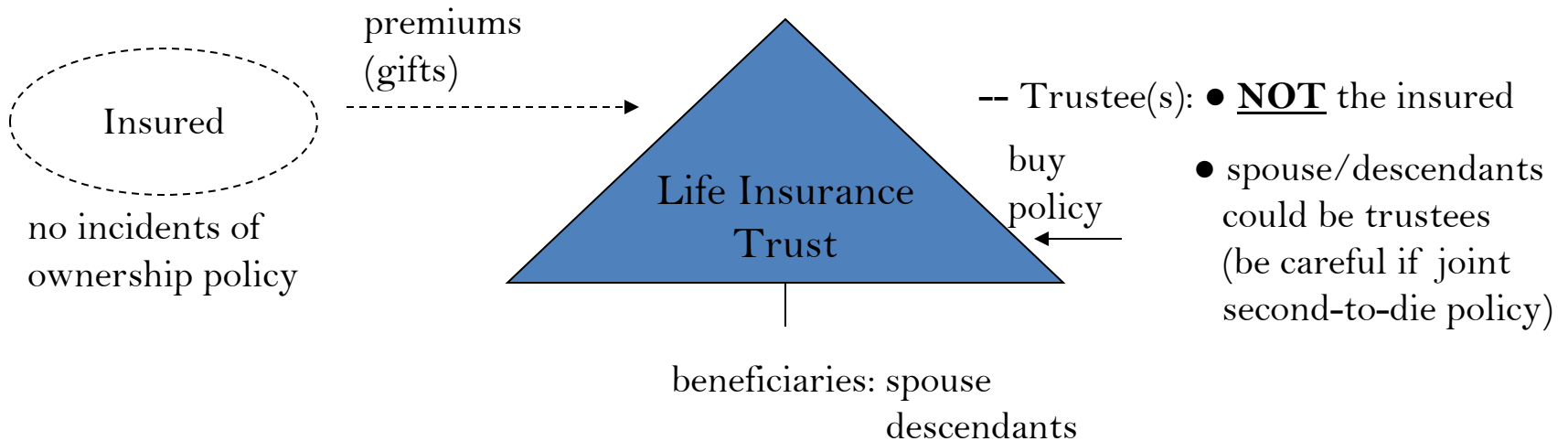


USE OF ILIT

- ▣ Estate Tax Solution for US citizen insured or NRA with US assets
 - ▣ Create Irrevocable Trust (ILIT)
 - ▣ Settled and funded by insured
 - ▣ Discretionary for family
 - ▣ Insured is neither a beneficiary nor Trustee
 - ▣ Trust acquires (or is assigned) policy
 - ▣ Premium payments (and assigned policy) are gifts
 - ▣ If non-citizen spouse owns policy, then such spouse either creates ILIT or her/his Will must pass policy to children (or trust for children) if insured survives



LIFE INSURANCE TRUST





ISSUES FOR U.S. BENEFICIARIES OF FOREIGN TRUSTS

- ▣ If US Citizen insured/grantor
 - ▣ FGT during insured's lifetime
 - ▣ If not US qualified, personal income inclusion
 - ▣ FNGT at death
 - ▣ If not US qualified, part of death benefit will be US taxable income [distribute in first year]



ISSUES FOR U.S. BENEFICIARIES OF FOREIGN TRUSTS

- ▣ If Canadian resident NRA
insured/grantor
 - ▣ FNGT during life and on death
 - ▣ But no cash to distribute until death!



ISSUES FOR U.S. GRANTORS AND BENEFICIARIES OF FOREIGN TRUSTS

Complex reporting requirements for U.S. Grantor or beneficiary (whether FNGT or FGT)

- ☐ 35% penalty to beneficiary for failure to comply with reporting obligation (Form 3520)
- ☐ All distributions deemed to be accumulation distributions unless proven otherwise
- ☐ Retirement and savings plans (RRSPs, RESPs, RDSPs, TFSAs) in Canada
- ☐ 5% penalty to grantor for failure to comply with reporting obligation (Form 3520-A)





ISSUES FOR U.S. BENEFICIARIES OF FOREIGN TRUSTS

- ▣ Distributions from foreign non-grantor trust (“FNGT”) of prior year income are subject to accumulation distribution rules: taxed at ordinary income rates (up to 35%), plus interest is imposed to reflect deferral
 - ▣ What was capital gains in year earned is taxed as ordinary income when distributed in a later year
 - ▣ Interest charge may become punitive



FOREIGN INSURANCE EXCISE TAX (IRC 4371)

☐ Applicable if:

- ☐ Policy of Insurance, reinsurance, indemnity bond, or annuity contract
- ☐ U.S. citizen or resident insured (or U.S. business for casualty insurance); and
- ☐ Policy issued by foreign insurer (for which no special Treaty exists – and none does for Canada)



FOREIGN INSURANCE EXCISE TAX ...Contd...

- ▣ Rate on life insurance is 1% of premium
- ▣ Liability is joint & several
 - ▣ Primary is premium payer
 - ▣ Others liable: insured; policy holder; insurance company; banker
- ▣ Form 720
- ▣ No Treaty with Canada



TRANSFERS OF A POLICY

- ▣ From parent to child, from corporation to individual, cross insurance
- ▣ Deemed disposition (unless ss.148(7) applies) with proceeds equal to FMV, not CSV
- ▣ Gifts, bequests or transfers from a person to a non arm's length person result in deemed proceeds equal to CSV and gift tax event if from a US person
- ▣ Transfers to a child or spouse/partner tax-free in Canada (attribution rules still apply), but gift tax event for US citizen in Canada

Background

Figure 1: Illustration of Information Reporting under FATCA and FBAR

FATCA

FBAR

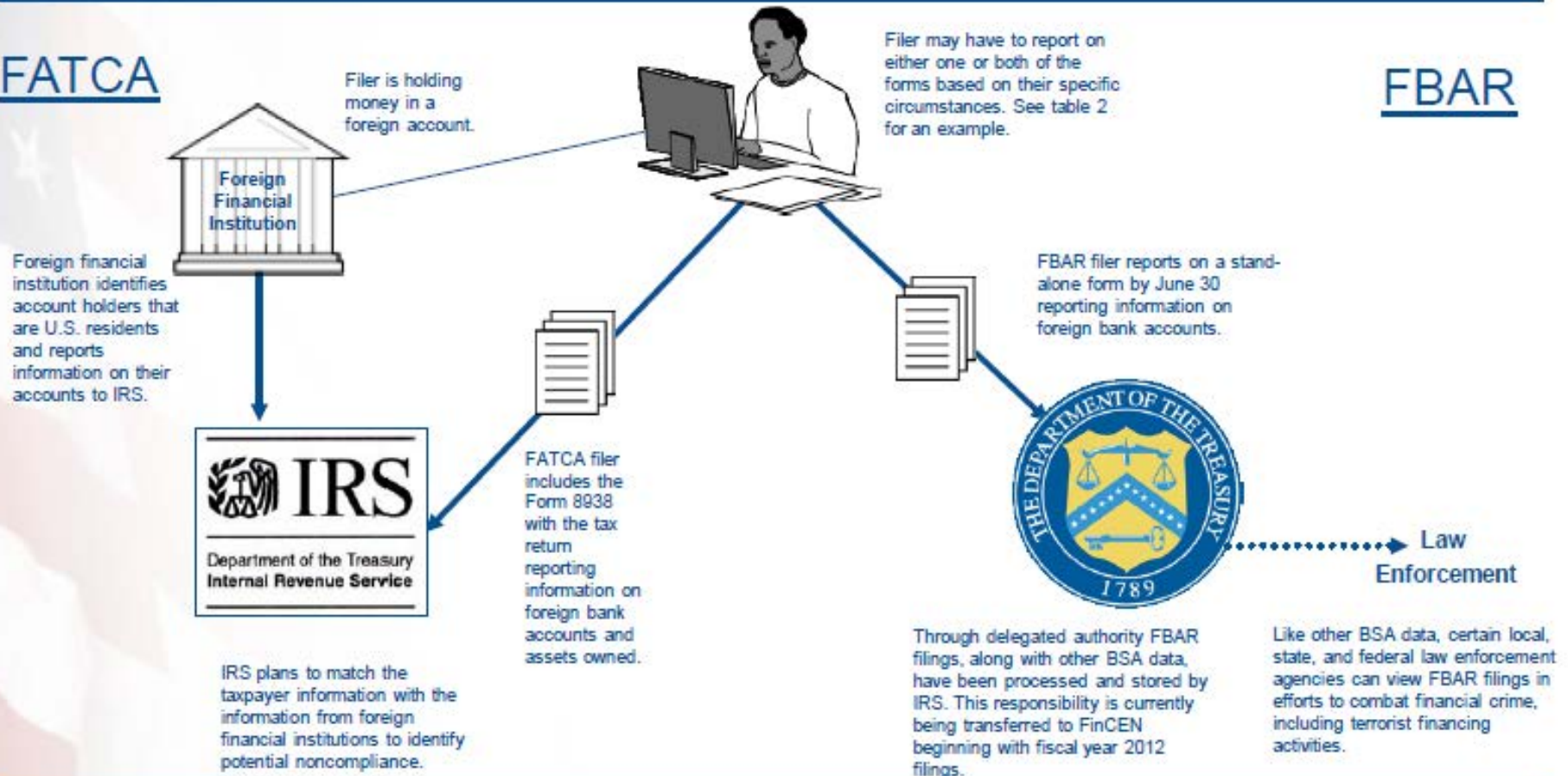


Figure 2: Duplicative or Similar Reporting Requirements



G A O

Accountability • Integrity • Reliability

Form 8938 November 2011 Department of the Treasury Internal Revenue Service	Statement of Specified Foreign Financial Assets	CMB No. 1540-7165 Attachment Sequence No. 475
<p>▶ See separate instructions ▶ Attach to your tax return</p> <p>If you have attached additional sheets, check here <input type="checkbox"/></p>		
Name(s) shown on return		Identifying number
Number, street, and room or suite no. (if a P.O. box, see instructions)		
City or town, province or state, and country (including postal code)		
For tax year beginning 20__ and ending 20__		
<p>Note. All information must be in English. Show all amounts in U.S. dollars. Show currency conversion rates in Part I, line (c), or Part II, line (b).</p>		
<p>Type of filer</p> <p>a. Specified individual (1) <input type="checkbox"/> Married filing a joint return (2) <input type="checkbox"/> Other individual</p> <p>b. Specified domestic entity (1) <input type="checkbox"/> Partnership (2) <input type="checkbox"/> Corporation (3) <input type="checkbox"/> Trust (4) <input type="checkbox"/> Estate</p> <p>Check this box if this is an original, amended, or supplemental Form 8938 for attachment to a previously filed return <input type="checkbox"/></p>		
<p>Part I. Foreign Deposit and Custodial Accounts (see instructions)</p> <p>If you have more than one account to report, attach a continuation sheet with the same information for each additional account (see instructions).</p>		
1. Type of account <input type="checkbox"/> Deposit <input type="checkbox"/> Custodial	2. Account number or other designation	
3. Check all that apply		
<p>a. <input type="checkbox"/> Account opened during tax year b. <input type="checkbox"/> Account closed during tax year</p> <p>c. <input type="checkbox"/> Account jointly owned with spouse d. <input type="checkbox"/> No tax item recorded in Part II with respect to this asset</p>		
4. Maximum value of account during tax year \$		
5. Did you use a foreign currency exchange rate to convert the value of the account into U.S. dollars? <input type="checkbox"/> yes <input type="checkbox"/> no		
6. If you answered "yes" in line 5, complete all that apply.		
(1) Foreign currency in which account is maintained	(2) Foreign currency exchange rate used to convert to U.S. dollars	(3) Source of exchange rate used if not from U.S. Treasury Financial Management Service
7. Name of financial institution in which account is maintained		
8. Mailing address of financial institution in which account is maintained. Number, street, and room or suite no.		
9. City or town, province or state, and country (including postal code)		

Form TD F 90-22.1 Rev. January 2011 Department of the Treasury Do not use previous editions of this form.	REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS	CMB No. 1545-2208 File Reports by Calendar Year Aired 1/2011 Do NOT file with your Federal Tax Return
<p>Part I. Filer Information</p> <p>1. Type of filer</p> <p>a. <input type="checkbox"/> Individual b. <input type="checkbox"/> Partnership c. <input type="checkbox"/> Corporation d. <input type="checkbox"/> Consistent e. <input type="checkbox"/> Foreign or Other—Enter type</p> <p>2. U.S. Taxpayer Identification Number 3. Foreign Identification (Complete only if item 2 is not applicable)</p> <p>a. Type <input type="checkbox"/> Passport <input type="checkbox"/> Other b. Individual's Date of Birth (MM/DD/YYYY)</p> <p>If filer has no U.S. Identification Number complete item 4.</p> <p>4. Number 5. Country of Issue</p> <p>6. Last Name or Organization Name 7. First Name 8. Middle Initial</p> <p>9. Address (Number, Street, and Apt. or Suite No.)</p> <p>10. City 11. State 12. Zip/Postal Code 13. Country</p> <p>14. Does the filer have a financial interest in 20 or more financial accounts?</p> <p><input type="checkbox"/> Yes If "Yes" enter total number of accounts _____</p> <p>(If "Yes" is checked, do not complete Part II or Part III, but enter totals at this information)</p> <p><input type="checkbox"/> No</p>		
<p>Part II. Information on Financial Account(s) Owned Separately</p> <p>15. Maximum value of account during calendar year reported \$</p> <p>16. Type of account <input type="checkbox"/> Bank <input type="checkbox"/> Securities <input type="checkbox"/> Other—Enter type below</p> <p>17. Name of financial institution in which account is held</p> <p>18. Account name or other designation 19. Mailing Address (Number, Street, Suite Number, of financial institution in which account is held)</p> <p>20. City 21. State/Province 22. Zip/Postal Code/Postcode 23. Country</p>		

Duplicate identifying information

Similar reporting requirements

Duplicate account information

Source: GAO analysis of the Form 8938 and FBAR.



Supplement 1

Table 3: Comparison of Form 8938 and FATCA Penalty Regimes

	Form 8938	FBAR
Failure to File	\$10,000	Maximum of \$10,000
Continuing Failure to File	After 90 days from notice, an additional \$10,000 for each 30 day period. Maximum additional penalty is \$50,000	not applicable
Reasonable cause exception	Yes	Yes
Accuracy-related penalty	40 percent of the underpaid tax amount	not applicable.
Willful failure to file or willfully causing another to fail to file	not applicable	\$100,000 or 50% of the account balance, whichever is greater
Fraud	75 percent of the underpaid tax amount attributable to fraud	not applicable
Criminal Penalties	Yes	Yes
Statute of Limitations	3 years after the date of filing or from when the information is reported to IRS and 6 years after the return was filed if the taxpayer fails to report over \$5,000 in gross income from foreign assets	6 years to assess penalty and 2 additional years to collect after assessment



DISCLAIMER

Note to Readers

- ❖ *This PowerPoint Presentation is not intended to be legal advice*
- ❖ *Reading the materials does not create an attorney-client relationship*
- ❖ *The outcome of each case stands on its own merits*
- ❖ *Pursuant to I.R.S. regulations, any conclusions or comments contained herein is not intended or written to be used, and cannot be used by the reader, for the purpose of avoiding tax penalties*