

[TEXT OF THE FATCA COMMENT LETTER SUBMITTED BY
CANADIAN LIFE AND HEALTH INSURANCE ASSOCIATION]

February 1, 2011

Internal Revenue Service
CC:PA:LPD:PR (NOT-121556-10)
Courier's Desk
1111 Constitution Avenue, NW
Washington, DC 20224

Re: ***Notice 2010-60*** - Notice and Request for Comments Regarding Implementation of Information Reporting and Withholding Under Chapter 4 of the Code

Dear Sirs or Madams:

Pursuant to *Notice 2010-60*, 2010-37 I.R.B. (the "Notice"), the Canadian Life and Health Insurance Association (the "CLHIA") hereby provides additional comments on the appropriate treatment of life insurance companies and life insurance and annuity contractsⁿ¹ under Chapter 4 of Subtitle A ("Chapter 4") of the Internal Revenue Code of 1986 (the "Code").ⁿ² We previously submitted comments on the application of Chapter 4 to Canadian life insurance companies, their affiliates, and their policies and annuities in letters dated June 15, 2010, and November 1, 2010 (the "Prior Submissions"). Our November 1, 2010 submission (i) identified certain types of policies and annuities that we recommended be excluded from the application of Chapter 4 and (ii) discussed the potential application of the documentation rules contained in Section III.B. of the Notice to existing policies and annuities. This letter recommends that small life policies and annuities not otherwise exempted from the application of Chapter 4 and reinsurance contracts also be excluded from the application of *section 1471* and urges that the implementation of the documentation rules under Chapter 4 to existing policies and annuities be significantly limited from the proposal outlined in the Notice.

I. Exemption of Small Life Policies and Annuities

A. Background

In our Prior Submissions, we discussed at length why we believe that no United States person logically would acquire policies or annuities from Canadian life insurance companies in order to evade United States tax. We also advised you that United States persons represent no more than a miniscule percentage of our members' policyholder base and described the difficulties that Canadian life insurance companies would face in attempting to comply with Chapter 4.

In addition, we noted in those submissions that life insurance companies are not included in the definitions of "foreign financial institution" ("FFI") or "financial institution" contained in *sections 1471(d)(4)* and *1471(d)(5)*ⁿ³ and that life insurance policies and annuity contracts are not included in the definitions of "United States account" ("United States Account") or "financial account" contained

in sections 1471(d)(1) and 1471(d)(2).ⁿ⁴ Although we acknowledged that the legislative history of section 1471 includes language stating that the Treasury “may prescribe” rules pursuant to which insurance companies will be treated as FFIs and “certain [insurance] contracts or policies,” such as annuities or cash value life policies, will be treated as United States Accounts for purposes of that provision, we also stated that the lack of any express designation of life insurance companies as FFIs and of life policies and annuities as United States Accounts, when combined with the “may prescribe” language of the Technical Explanation, gave the Treasury great discretion as to whether, and to what extent, life insurance companies and their products should be subject to section 1471.

In our Prior Submission dated November 1, 2010, we identified several types of policies and annuities that we urged the Treasury to exempt from treatment as United States Accounts due to the very low tax-evasion potential associated with those contracts. Those insurance products include (i) policies or annuities that constitute government-registered retirement or savings plans or that are held by such plans, (ii) policies that lack cash value, and (iii) group insurance policies that have cash values if the policies do not permit or provide for the cash value to be paid to, or otherwise benefit, the individual group members.

In considering these issues further, and after reviewing the full spectrum of the types of policies and annuities issued by our members, we now urge the Treasury also to exclude from treatment as United States Accounts other types of life policies and annuities that present a very low risk of being used to evade United States tax. We discuss those particular types of policies and annuities in more detail below.

B. Small Life Policies

The first additional category of insurance products that we believe should be excluded from the scope of section 1471(d)(1) are life policies that have some cash value, but that, by virtue of their terms, clearly are acquired principally for life protection purposes, not for the purpose of generating investment returns.

1. Low Death Benefit Policies

In this regard, and in order to focus section 1471(d)(1) only on policies that potentially could be acquired for purposes of evading United States taxation, we recommend that you exclude from the definition of a United States Account any policy that does not provide for an excessive death benefit (e.g., a traditional whole life policy with a typical face amount). Due to the comparatively small size of such policies and the fact that life policies cannot have a cash value in excess of the amount of their death benefit, this class of policies is highly unlikely to be used for tax evasion purposes. The type of such policy that presents the clearest case for exclusion is a life policy with a death benefit of \$ 500,000 or less.ⁿ⁵ Under actuarial principles, the \$ 500,000 death benefit is approximately the amount of death benefit that a 40-year old male nonsmoker could obtain if he paid a single premium of \$ 50,000.ⁿ⁶ ,ⁿ⁷ Thus, the size of such policies is substantially consistent with the \$ 50,000 cap that applies to depository accounts that are excluded from treatment as United States Accounts under section 1471(d)(1)(B) (the “Depository Account Cap”).

In establishing this “small policy” exception, we do not believe that it should matter whether any such policy is variable or non-variable in nature. Although it might be argued that variable policies have a more significant imbedded investment component than non-variable policies, the exclusion we are recommending is not based on the method by which the policy accrues inside build-up. Rather, it is based on the facts that the overwhelming majority of the policies issued by our members are acquired for life protection purposes and that policies with a comparatively low death benefit (and therefore a correspondingly low cash value) are, by their very nature, not policies that have any realistic likelihood for being acquired for United States tax evasion purposes. Even in the case of variable life policies, the cash value of such a policy could never exceed the amount of its death benefit, and the death benefit cap therefore provides an easily administrable way of identifying life policies that have no significant risk of being used for tax evasion purposes.

Use of a policy’s death benefit as the measuring amount for excluding that policy from characterization as a United States Account would eliminate the need for the issuing insurance company to monitor the policy’s cash value in order to determine whether the policy was a small policy that should be excluded from the application of *section 1471*.ⁿ⁸ Instead, the company could make an initial determination of whether the policy was or was not a United States Account and only monitor and report on the policy if its death benefit exceeded the cut-off amount. In fact, insurance companies might create a specific form of contract that would have a death benefit that could not exceed the cut-off amount, allowing them to exclude completely from the reporting requirements of Chapter 4 an entire class of contracts.

Excluding life policies with a death benefit of \$ 500,000 or less from treatment as United States Accounts (together with the exclusions for “no cash value,” registered, and group contracts recommended in our Prior Submissions) would remove approximately 90 percent of the policies issued by our members from the scope of Chapter 4, significantly reducing the burden on our members in producing information with respect to their policies. In addition, requiring insurance companies to produce information on only their larger policies would focus that reporting on the very types of policies that have the greatest potential for being used for tax evasion purposes, thereby allowing the Internal Revenue Service to devote particular attention to those contracts.

2. Low Periodic-Premium Policies

In addition, we recommend that an exclusion from treatment as a United States Account be provided for any life policy that has an aggregate annual premium that does not exceed \$ 10,000.ⁿ⁹ Due to the slow incremental accretion to cash value that would occur in respect of any such policy, these policies also present no realistic risk of being acquired for tax evasion purposes. Moreover, these traditional life policies represent the vast majority of the policies issued by our members (and other life insurers), and the proposed exception from *section 1471(d)(1)* therefore would substantially reduce the burden on both our members and the Internal Revenue Service in respect of the application of Chapter 4 to life policies.

C. Small Annuities

We also urge the Treasury to adopt regulations that would exclude from the treatment as United States Accounts small annuities issued by insurance companies. As is the case with respect to small life policies, we do not believe it is reasonable to believe that any United States person would acquire a small annuity contract from a non-United States insurer in order to evade United States taxation. Even if it were possible for a United States person to acquire such a contract under the relevant regulatory rules and the issuing insurer's business practices, such annuities typically have surrender and other charges that would apply if a policyholder cashed out the annuity, significantly reducing the economic benefit of such a contract. Moreover, at least in the case of annuities issued by Canadian life insurance companies, earnings credited to non-registered annuities (*i.e.*, annuities other than the retirement-based annuities that we recommend be excluded from treatment as United States Accounts for the reasons set forth in our Prior Submission dated November 1, 2010) generally would be subject to tax in Canada on a current basis at rates comparable to those in the United States. Those facts make such small annuities particularly ill suited to use for tax evasion purposes.

Although we recognize that even these small annuities will have some cash value and that Chapter 4 does not have any specific exception for small financial instruments, we believe that the unique discretion provided to the Treasury with respect to the application of Chapter 4 to life insurance companies and their products provides a strong basis for excluding small annuity contracts from the definition of United States Accounts. Annuities issued by life insurers ordinarily have imbedded life contingencies (*e.g.*, the annuity is payable until the death of the annuitant or it contains a permanent purchase rate guarantee under which the policyholder can elect to take a lifetime payout stream based on actuarial principles). That characteristic differentiates such annuities from other types of investment products and is the basis for the permitted tax-deferred inside build-up accorded such contracts under United States tax principles. Moreover, if the proposed exception applies only to small annuity contracts, there is no significant likelihood that those contracts would be acquired by United States persons in order to evade United States tax.

Because annuities issued by life insurance companies do not have an associated specified death benefit, we recommend that the cut-off for treating such annuities as non-United States Accounts be based on the aggregate amount of premiums paid for the annuities. (Use of aggregate premiums as the measuring amount to determine whether an annuity is "small" or not would be easier for insurance companies to monitor than cash value, which could vary day to day and the amount of which would not be within the control of the policyholder.) In this regard, one possibility would be to exclude annuities for which the aggregate premium is \$ 50,000 or less, again by reference to the Depository Account Cap. However, that cut-off amount would exclude only a very small portion of the annuities issued by our members, and even much larger annuities would not present the tax evasion potential with which Chapter 4 is concerned. It would be more reasonable to use an aggregate premium amount of \$ 350,000, which would exclude approximately 97 percent of the annuities issued by our members and which (as in the case of small life policies) would focus both the insurance companies and the Internal Revenue Service on annuities that have a greater likelihood of being used for tax evasion purposes.

II. Exemption of Reinsurance Contracts

Neither Chapter 4 nor its legislative history suggests that reinsurance contracts between insurance companies should be treated as United States Accounts. Indeed, given the nature of such contracts and the purposes of Chapter 4, we see no reason why reinsurance contracts should give rise to the documentation and reporting requirements of Chapter 4.

The Notice also does not provide that reinsurance contracts will be treated as United States Accounts. However, the Notice does state that “Treasury and the IRS do not view the issuance of . . . reinsurance contracts without cash value as implicating the concerns of chapter 4. This would include, for example, most . . . reinsurance contracts . . .” Notice at II.B.2. That language could be read to suggest that there may be some reinsurance contracts that will be considered United States Accounts.

To the extent that inference is correct, we disagree with the implication that any reinsurance contract should be considered a United States Account. In our view, reinsurance contracts do not have “cash value” within the assumed meaning of that term. Reinsurance is a means of shifting risk among insurance companies. A reinsurance agreement does not have an investment component that is analogous to the cash value that may exist in the case of a directly written life policy or annuity. Reinsurance contracts do not permit withdrawals of amounts by the ceding companies during the terms of the contracts, and the net positive economic amount, if any, that a ceding company may obtain in the event of the termination of a reinsurance contract is a function of the amount and nature of the risk recaptured by the ceding company, the economic or contractual premium for that recapture, and the surrender and other charges imposed by the reinsurer with respect to the recapture. There is no basis for equating the consequences of such a recapture with the payment of cash value under an insurance policy or annuity contract.

In addition, we do not believe that treating reinsurance contracts as United States Accounts would serve any useful purpose. In the event that the ceding company that wrote the reinsured policy is an FFI for purposes of Chapter 4 and has United States Accounts, it would already be subject to the requirements of Chapter 4 and there would be no reason also to subject the reinsurer to those requirements. Likewise, in the event that the ceding company that wrote the reinsured policy is a United States person, it would already be subject to United States reporting rules with respect to its policyholders. Thus, there would be no reason to impose the Chapter 4 requirements on the reinsurer. Accordingly, we urge you to specifically exclude all reinsurance contracts from the definition of a United States Account. n11

III. Documentation on Existing Policies and Annuities

Section III.B. of the Notice proposes that, in order to determine whether an existing account in an FFI is a United States Account, each FFI obtain specific detailed residency and other documentation from each of the holders of its existing accounts within two years or five years after the date on which the FFI’s “FFI Agreement” enters into effect, depending on the amount of the “average monthly balance” of the relevant Account. The Notice is framed in terms of banks and similar financial institutions, not insurance companies, and there is nothing in Section III.B. that discusses insurance companies or insurance “accounts” in particular.

Our November 1, 2010 Prior Submission discussed in detail the problems that our members would have in complying with any requirement that they obtain from their existing policyholders the information described in the Notice, including both practical limitations on their ability to solicit such information and legal limitations (including Canadian federal and provincial privacy laws) on their ability to use that information to provide data to the Internal Revenue Service. There have been no developments in these areas since the date of that submission, and we accordingly again urge you to grandfather all existing policies and annuities from the application of the documentation requirements set forth in the Notice.

In the event, however, that you determine that you cannot provide a broad grandfathering of all existing life policies and annuities, we recommend that you take notice of the fact that the vast majority of insurance products are acquired for life protection or other non-tax evasion purposes and that you exercise your unique discretion under Chapter 4 with respect to life insurance companies and their products to exclude from the documentation requirements set forth in the Notice all policies and annuities that do not possess the attributes of a tax-evasion financial instrument. In this regard, we recommend that you completely exclude from the documentation requirements all existing life policies that do not constitute private placement life insurance and all other existing life policies and annuities with a cash value of \$ 1,000,000 or less. The policies and annuities that would be excluded under this approach represent more than 99 percent of the existing policies and annuities issued by our members, and making this change would substantially reduce the burdens on our members in contacting and attempting to obtain disclosable residency information from their existing policyholders.

It is important to note, however, that, even with respect to this much smaller group of existing policyholders, our members would still have the problems discussed in our Prior Submissions regarding complying with the documentation requirements of the Notice. As noted in those submissions, our members would have no way of requiring existing policyholders to provide the required information and no legal right to cancel existing policies or annuities because of a refusal to provide the information. In addition, Canadian privacy laws may preclude our members from sharing any information with respect to existing policies (or annuities) or policyholders with the Internal Revenue Service absent the consent of the affected policyholders. Accordingly, we continue to strongly urge the Treasury to attempt to ameliorate those problems by recourse to the information exchange provisions of the United States-Canada income tax convention or otherwise. In the event that the regulations would still require our members to provide the requested information with regard to this smaller group of policyholders, we think it is essential that you waive compliance with that requirement during the period that our members are unable to provide the information without the policyholders' consent (after having made reasonable efforts to obtain that consent) and legally prohibited from cancelling or otherwise terminating the relevant policies or annuities.

In applying the \$ 1,000,000 floor amount suggested above, we also recommend that you do not require insurers to aggregate policies or annuities owned by a single policyholder. There was no reason prior to the enactment of Chapter 4 for United States persons to attempt to avoid the application of the Chapter 4 requirements by entering into multiple insurance policies or annuities. Thus, we do not believe that aggregation is necessary as an anti-abuse rule in implementing the floor amount with respect to existing policies or annuities. In addition, we note that it is not uncommon for parents or

grandparents to have multiple policies or annuities to provide life protection to their children or grandchildren. Requiring aggregation of those policies would reduce the effectiveness of the recommended floor approach, without a corresponding benefit to the Internal Revenue Service.

IV. Conclusion

The CLHIA appreciates the opportunity to provide these comments and would be interested in meeting with the Internal Revenue Service or the Treasury to discuss our comments in more detail. Please contact the undersigned or our counsel (Michael Miles or Carol Tello, Sutherland Asbill & Brennan, 202/383-0100) if you have any questions about this letter or would be willing to meet with us.

Sincerely yours,

Peggy McFarland,
Director, Corporate Taxation

FOOTNOTES:

n1

For purposes of this letter, we hereinafter generally refer to annuity contracts as “annuities,” to life insurance contracts as “policies” or “life policies,” and to the owners of both annuities and policies as “policyholders.”

n2

Except as otherwise noted, all section references in this letter are to the Code. Sections 1471-1474 comprise Chapter 4 of Subtitle A of the Code.

n3

Insurance policies and annuities are not depository accounts, custodial accounts, or equity or debt instruments in FFIs. See section 1471(d)(2).

n4

Life insurance companies do not accept deposits in the ordinary course of a banking or similar business, hold financial assets for the account of others, or engage primarily in the business of investing, reinvesting, or trading in securities or similar financial instruments. See section 1471(d)(5).

n5

We recommend that the determination of the size of a policy be based on the applicable currency conversion rate in effect as of the last day of the calendar year preceding the date that the policy is issued. Many policies are sold by agents who would need to determine whether a policy was within or outside the scope of the proposed “small contract” exemption. It would be unnecessarily burdensome for agents to have to monitor currency rates on a daily basis, and requiring recourse to daily currency rates would increase the chance that a policy would be inaccurately characterized as a non-United States Account and that the necessary information therefore would not be obtained by the agent. Allowing insurers to distribute the appropriate conversion rate information for an entire year to all agents and employees at the start of that year would significantly reduce the likelihood of errors or mischaracterizations. In addition, using a set currency conversion rate for an entire year would make it easier for the Internal Revenue Service to monitor compliance with the Chapter 4 requirements. Alternatively, we recommend that the determination of the size of a policy be based on the applicable currency conversion rate in effect on the date the policy is issued, rather than on an ongoing basis during the term of the policy. Requiring that determinations be made during each year that a policy is in effect would create extreme administrative difficulties and could cause policies to fall within and without the “small contract” exclusion as currency rates fluctuated.

n6

Obviously, the precise size of a policy that a potential policyholder could obtain for a single premium of \$ 50,000 would depend on a variety of factors, including the applicant’s sex, age, and health condition and the terms of the policy. However, a 40-year old healthy male nonsmoker is a typical applicant for the policies issued by our members, and applicants in the 35- to 45-year old population segment represent a significant target market for our members.

n7

Due to constraints imposed by Canadian tax law, our members generally do not actually issue single premium policies. Thus, the \$ 50,000/\$ 500,000 relationship referred to in the text is, as noted, an actuarial/economic one, rather than one based on specific policies issued by our members.

n8

Excluding small life policies based on the amount of the policies’ cash value would be another way to exclude from the definition of a United States Account life policies that do not have a significant potential for United States tax evasion. However, we believe that the use of a policy’s specified death benefit as the appropriate measuring amount both would be much simpler for insurance companies to implement and apply and would reflect the reason that most policies actually are acquired by policyholders ~ i.e., to obtain a specific amount of life protection for family members. Excluding small policies based on the amount of a policy’s death benefit would

also make it much easier for the Internal Revenue Service to audit compliance with the Chapter 4 requirements.

n9

Consistent with the discussion above, we recommend that the determination of the amount of a policy's premiums be based on the applicable currency conversion rate in effect as of the last day of the calendar year preceding the date of issuance (or, less helpfully, as of the date of the policy's issuance).

n10

In order to ensure that the annuities covered by the proposed exclusion would relate only to annuities that would be considered insurance-based annuities under United States tax principles, it may be appropriate to require small annuities excepted from the application of *section 1471* to have such associated life contingencies.

n11

In making this recommendation, we do not include assumption reinsurance transactions, in which there is a novation of one insurer's obligations to a policyholder and a substitution of a new insurer. In those cases, the new insurer is directly and solely liable to the underlying insured and should be viewed to "step into the shoes" of the old insurer for Chapter 4 purposes, just as it does for all other legal purposes.