

OFFSHORE GROUP OF INSURANCE SUPERVISORS

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**REGULATORY ISSUES FOR VARIABLE LIFE AND VARIABLE
ANNUITY PRODUCTS**

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1. Introduction

1.1 Purpose of Paper

The purpose of the paper is to examine the structure of variable life and variable annuity products and the regulatory issues that arise, including the impact of the US tax environment where products are sold to US purchasers.

The areas that should concern the regulator when examining an application for a company offering variable life and annuity products should include the potential exposure to money-laundering due to the high level of premiums, the complex tax environment, whether the provider is fit and proper and the strength of the reinsurance programme. Since policies are issued to independent third parties, there is potential exposure to fraud and mismanagement by the issuer and other parties.

The regulator should be aware of all these areas when an application is received and a critical assessment of each area should be made.

1.2 Market for Offshore Variable Annuities

Offshore variable annuities may offer a cheaper and less complex method of holding assets than certain offshore trust structures. Typically they are purchased by (1) US citizens interested in holding assets offshore and benefiting from income tax deferral on the earnings on those assets as well as from investment structures not generally available under US annuities, and (2) US residents who are not US citizens desiring to defer or eliminate taxation of their non-US assets. They are often purchased as part of a “pre-immigration strategy” before taking up US residence. They also are attractive to US citizens working outside the US who wish to defer tax on their assets built up whilst abroad. For such income tax deferral to be achieved, the annuities must meet certain requirements imposed by US tax laws.

1.3 Market for Offshore Variable Life Insurance Policies

Like offshore variable annuities, offshore variable life insurance policies may offer a cheaper and less complex method of holding assets than certain offshore trust structures. Typically they are purchased by US citizens interested in holding assets offshore and benefiting from income tax deferral and, with respect to death benefits, income tax exclusion on the earnings on those assets as well as from investment structures not generally available under US life insurance contracts. They may also be of interest to US residents who are not US citizens desiring to defer or eliminate taxation of their non-US assets. For such income tax treatment to be achieved, the life policies must meet certain requirements imposed by US tax laws.

2. Deferred Variable Annuities

2.1 Introduction

A Deferred Variable Annuity (DVA) is a form of annuity contract issued by a life insurance company that can be, but need not be, designed to comply with US taxation rules. If designed to comply with US taxation rules (see below), the product allows for personal taxation on investment returns to be deferred in the hands of a US taxpayer. Under a DVA, the amount of money available to provide a stream of annuity payments at a scheduled retirement date or to be received in a lump sum surrender at any time depends upon the investment performance of the assets, in contrast to a deferred fixed annuity where such amounts are subject to guarantees of principal and interest. A DVA can have both variable and fixed components.

Annuity payments can be guaranteed to be payable for the lifetime of an annuitant, the joint lifetimes of an annuitant and joint annuitant, a fixed period, or the longer of a lifetime(s) and a fixed period. If the annuitant dies after receiving some, but not all, of the fixed period annuity payments due, the remaining payments would be paid to his or her survivors either as a lump sum or a continuing annuity. (See below for death benefits where the annuitant dies before annuity payments begin.)

DVAs have become more popular than fixed products as they are felt to give the potential for a greater return in the long term.

2.2 US Taxation Treatment

A variety of rules must be satisfied for a DVA to be treated as an “annuity” for US tax purposes, apart from compliance with the actuarial definition of “annuity.” These US tax rules differ for annuities that are part of a tax qualified retirement plan and for annuities that are not part of such a plan (*i.e.*, “nonqualified” DVAs). For example, a nonqualified DVA must include certain language mandated by, and be administered in accordance with the requirements of, section 72(s) of the US tax code (relating to post-death distributions). The discussion herein of the US tax treatment of nonqualified DVAs assumes that this and other applicable requirements are met.

If a DVA is taken as part of a tax qualified retirement plan, premiums generally are paid from pre-tax income and the full amount of the annuity is taxable as income when received. As a general matter, the indicia of ownership of tax qualified retirement plan assets must be subject to the jurisdiction of US courts. There are no additional taxation benefits resulting from the DVA within the tax qualified retirement plan, as investment income arising in such a plan already is tax deferred.

If the DVA is nonqualified, there is a tax benefit relative to other forms of investment in that tax on investment income is deferred until money is withdrawn from the contract through annuity payments, withdrawals, or distributions after death. The US tax treatment of distributions from a nonqualified annuity depends upon whether the

distributions are in the form of annuity payments (where each payment includes a portion that is a non-taxable return of the investment) or in the form of lump sum withdrawals before annuity payments begin (where payments are taxed as income-first until all income has been withdrawn and only the investment remains). If any payments are taken before age 59.5, a 10% penalty may apply.

Under US taxation rules, in order for income tax deferral to be achieved, investments under a DVA cannot be made at the direction of the contract owner in specific assets or, more broadly, in any funds that are available to the general public; this means that special funds need to be established for variable annuity contracts. There are also asset diversification rules that restrict the maximum amount that can be invested in any single investment, i.e., no more than 55% of total assets may be invested in any single investment, 70% of total assets in any two investments, 80% in any three investments and 90% in any four investments. This means that, at a minimum, there must be at least five separate investments in a DVA, and the investments cannot be pre-arranged or otherwise influenced by the contract owner.

The US Treasury Department and Internal Revenue Service have recently announced proposed changes to section 817(h) of the Internal Revenue Code, which will have the effect of preventing holders of variable life and variable annuity contracts from using non-registered partnerships as a means of meeting the diversification rules. This will particularly affect the use of these products as a tax efficient means of investing in hedge funds.

If a variable life or variable annuity policy is used in connection with a “split dollar” arrangement with an employer paying part of the premiums, an employee could be liable to income tax on their accrued share of the policy benefits.

US Federal Excise tax of 1% is charged on premiums payable to non-US insurers, subject to applicable tax treaties.

2.3 Death Benefits

DVAs often have death benefits that typically would guarantee a return of at least the amount of monies invested in the event of death prior to the date annuity payments begin. In such case, section 72(s) of the US tax code may require the death benefit to be paid to the beneficiary in a lump sum (within 5 years of death) or as annuity payments over the beneficiary's life (beginning within 1 year of death).

2.4 Difference Between US Domestic and Offshore Annuities

The main difference between US domestic and offshore variable annuities is that there is generally little or no restriction placed upon the choice of underlying assets by offshore regulations. The lack of such restrictions enables investments to be made at the direction of the contract owner in assets such as hedge funds, private company shares, and other specific assets that are available for investment outside of the annuity contract. It also

enables the contract owner to transfer assets such as shares directly into the annuity contract. Under US taxation rules, however, owner-directed “control” over investments is restricted (see section 2.2), and all contributions and distributions must be made in cash.

Based on recent announcements, it is apparent that US tax authorities are sharply focused on perceived abuses involving “private placement” variable insurance products (i.e., products that are not registered with the US Securities and Exchange Commission pursuant to specific exemptions under US securities laws), particularly those that offer investments in offshore assets such as hedge funds. Thus, such products are likely to be subject to heightened scrutiny by US authorities.

It is also possible to transfer assets such as shares directly into an offshore annuity whilst a domestic annuity provider would require payments to be made in cash. This facility to transfer shares directly into an annuity can, for a non-US taxpayer, often be used to protect the capital gain on the sale of an asset from capital gains tax

Although offshore annuities, if properly structured, can satisfy the requirements of the US tax code that otherwise enable tax deferral to apply, they are potentially subject to treatment as “debt instruments”. If a DVA can be classified as a debt instrument (e.g., due to its guarantees), this would result in immediate tax being payable on investment income despite satisfying the rules of section 72(s) of the US tax code, etc.

It is essential, in view of the complexity of the tax laws, that potential investors be urged to take professional tax advice to reduce the risks of future claims on the companies if the contract owners’ tax treatment turns out to be less favourable than anticipated.

2.5 Location of Companies Offering Deferred Variable Annuity Contracts

The location of companies offering deferred variable annuity contracts include the following jurisdictions:

- Barbados
- Bermuda
- British Virgin Islands
- Cayman
- Guernsey
- Isle Of Man
- Liechtenstein
- Luxembourg
- Switzerland
- Turks and Caicos

3. Variable Life Policies

3.1 Introduction

Variable life insurance policies differ from variable annuities in a number of respects, particularly in that the life policies provide death benefits considerably larger than their cash surrender values (the difference being the “net amount at risk”) and accordingly assess charges for assuming such risk. The life policies also may offer a significant US tax benefit in terms of income and, possibly, inheritance (or estate) taxes and do not involve the conversion of the proceeds of the accumulated investments into an annuity at a chosen retirement age. In order to qualify for favourable US tax treatment, however, the policies must follow strict qualifying rules (described generally below).

If a variable policy qualifies as life insurance under US tax rules but does not meet the “seven pay” test of the US tax code, it is treated as a “modified endowment contract”. Most offshore contracts are purchased with single premiums and therefore fail the test. The “seven-pay test” is defined in the Appendix.

Given the popularity of offshore variable life policies, regulators need to be wary of exaggerated claims that are “too good to be true” (for example, products that claim to comply with US tax rules but that have no net amount of risk, or those that very significantly delay payment of all or a portion of the death benefit).

3.2 Taxation Treatment

- Investment income and gains are not subject to taxation in the US (unless withdrawn from the policy prior to the insured’s death – see below).
- There is no liability to US income tax on death, and estate tax may be avoided with certain tax planning.
- Lifetime distributions (*e.g.*, partial withdrawals) generally are treated as a non-taxable return of basis to the extent there is “investment in the contract,” and treated as income after all basis has been recovered.
- Loans generally are not treated as distributions, and thus not subject to tax. Special rules apply with respect to loans under life policies owned by or for businesses.
- If the policy is treated as a modified endowment contract, any distribution from the policy is includible in income (to the extent there is any gain in the contract at the time of the distribution), and generally results in a 10% tax penalty unless the distribution is made after the policyholder attains age 59.5 (or unless another exception applies). Loans under modified endowment contracts are treated as distributions, and thus subject to these same rules.
- US Federal Excise tax of 1% is charged on premiums payable to non-US insurers, subject to applicable tax treaties.

3.3 Rules for Tax Qualification

Variable life policies must satisfy many of the same requirements as DVAs. For example, contract owners cannot “control” the underlying investments and those investments must satisfy certain asset diversification rules. In addition, there are US tax rules specific to variable life policies. For example, if favourable tax treatment is to apply, there can be no “transfer for value” of the policy under section 101(a)(2) of the US tax code, and the policy must satisfy the requirements of section 7702 of that code.

Section 7702 of the US tax code specifies that the policy must be defined as a life policy under the law of the jurisdiction in which the policy is issued. It must also pass the “Cash Value Accumulation Test” or the both the “Guideline Premium Test” and the “Cash Value Corridor Test”. In practice, offshore variable life policies are designed to meet the second of the two tests, as this minimises the required amount of life coverage and maximises the investment return. Details of these tests are given in the Appendix.

Under both the Cash Value Accumulation Test and the Guideline Premium/Cash Value Corridor Test, the death benefit must always be at least equal to a specified percentage of the cash value based on the policyholder’s age. Under both tests, this means that constant monitoring of the relationship between the cash value and the death benefit generally is required to avoid the policy losing its qualifying tax status. Such monitoring is particularly important in the context of life policies that allow for flexible premium payments. This work is normally either carried out by an actuary or, if the death benefit is reassured, by the reinsurer.

3.4 Transfers of Policies

Care should be taken if a policy is transferred to another insurer under Section 1035 of the IRS Code. If the charging structure is changed (normally to a more favourable one), the death benefit will change and a retrospective cost adjustment could trigger non-compliance with the IRS requirements for favourable tax treatment.

4. Regulatory Issues

The following regulatory issues either apply specifically to providers of variable annuity or variable life contracts or require special attention in the context of these policies:

4.1 Fit and Proper Tests

The directors, shareholders and officers of a provider of variable life and annuity products must show absolute evidence that they are fit and proper. Investigations should be made with respect to their honesty, integrity, competence, capability and financial soundness.

Variable annuities and life contracts are taken out by third parties and as such are exposed to fraud. It is therefore critical for a regulator to use careful judgement when approached by an applicant to form a company offering these products.

4.2 Are policies in compliance with US tax laws?

Confirmation of compliance with the US tax laws should be obtained before issuance of a variable life policy or annuity contract and continue after. An independent tax expert should provide an assessment of the product structure as part of the application. Regulators should consider requiring an applicant to obtain a written opinion, favourably addressing legal and actuarial aspects of the US tax law requirements applicable to the policy or contract, from an unrelated, reputable tax advisor.

4.3 Does the insurer monitor risks and limitations associated with the policy?

The company must monitor the risks associated with the policy being treated as a non-registered security under US securities laws. The risk is greater if the company is marketing directly to retail customers rather than to high net worth individuals through professional intermediaries. Regulators should consider requiring an applicant to obtain a written opinion from unrelated, reputable counsel that the issuance of the policy or contract does not cause any violation of US securities laws.

4.4 Are companies monitoring the limitations of not doing business in the US?

The company must ensure that it is not treated as effectively carrying out business in the US unless it is licensed to do business in the US and pays corporate income tax to the US. This means that care must be taken with the design and use of marketing material, the location of medicals and contract signature. The principals of the company must cover these points in a comprehensive marketing strategy that is part of the application, and if regulators have questions as to the adequacy of the approach being proposed, they should consider requiring the applicant to obtain favourable written confirmation from unrelated, reputable counsel.

It is important that no sales or solicitation activities take place in the USA. It is often beneficial for the policy to be taken out by an offshore trust to clearly establish that the policy was effected offshore.

4.5 Reinsurance Structure

Reinsurance is critical to the financial viability and solvency of life insurance companies and close attention should be paid to the proposed reinsurance structure. The reinsurer needs to have adequate financial strength as well as the ability if necessary to monitor the premiums(s) collected and the cash value on behalf of the ceding company and ensure that the applicable test under section 7702 of the US tax code is met.

A company will typically only retain a portion of the mortality risk with the balance being passed to the reinsurer. The reinsurance treaty needs to be flexible enough to cope with changes in death benefit that might be needed to continue to comply with the tests.

Treaties must be finalized and filed with the regulator before any policies are issued, particularly as the market for reinsurance of this type of business is limited.

4.6 Financial Reporting

A typical balance sheet will show two offsetting entries in the assets and liabilities titled “segregated portfolio assets” or “unit linked assets”. Depending on the accounting standard adopted there may be no premium shown as flowing through the income statement. This should not in itself raise a concern to the regulator, as the benefit and burden of investment performance of the policy assets normally remains with the policyholder.

Additional information to the financial statements should be requested if necessary.

4.7 Are proper KYC rules being adopted?

Offshore life assurance is as vulnerable as the banking industry to money laundering. If not properly regulated, a violation could jeopardise the entire industry. Within the insurance system, money launderers may structure transactions, coerce employees to cooperate and not to file proper reports or establish apparently legitimate “front” insurance entities to launder money.

Money laundering will normally take place through early surrender of policies or through a fraudulent claim. Care must be taken if requests are made to pay monies to third parties.

The directors of a company offering variable life or annuity policies must have the proper controls in place to “know your customer”. If a trust is involved in the contract, the checks that the company carries out must also extend to the trustees, the settlor of the trust and, if appropriate, to the beneficiaries.

The IAIS has published a guidance paper “Anti-Money Laundering Guidance Notes for Insurance Supervisors and Insurance Entities”. The IAIS Core Principle 28 also concerns anti-money laundering and combating the financing of terrorism.

It is critical that both the identity of the prospective policyholder and the source of funds for the policy are identified. It is also critical that the Directors provide the regulator with a comprehensive plan that covers systems and controls for verifying the identity of policyholders, identifying the source of funds, identifying and reporting suspicious activities and maintaining proper books and records.

4.8 Premium Financing

Variable life and variable annuity products are often used in connection with a “premium financing” facility. The intermediary will arrange for a bank to lend funds against the security of the policy to gear the exposure to the particular asset class. A charge for security will be taken against the value of the policy and a fall in the value of the asset can lead to requests from the bank to partially repay the loan to reduce their exposure.

Although premium financing can in some circumstances meet a genuine need, for example if a policyholder wants to increase exposure to the asset class without liquidating other assets, it is essential that the intermediary fully explains the risks to the client and obtains their written confirmation that they fully understand the risks involved. Consideration should also be given to requiring the intermediary to disclose the level of commission being received to the client as premium financing can increase commission levels relative to the initial investment, hence giving rise to a risk of mis-selling.

Premium financing is not normally suitable to gear exposure to assets with a moderate expected return such as bonds as the interest on the loan can exceed the potential return on the underlying assets. On the other hand it can lead to excessive volatility if used in connection with investments which themselves are geared such as hedge funds.

5. Appendix

5.1 Seven-pay test

A policy will fail the seven-pay test and will therefore be classified as a modified endowment contract if the cumulative premiums paid at any time during the first seven years of the contract exceed the sum of the net level premiums that would have to been paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums. Such net level premiums are based on actuarial assumptions specified in section 7702A of the US tax code.

This means that no less than seven level annual premiums, or eighty-four level monthly premiums, need to be paid for a policy in order for it to pass the test, and often the funding allowed is even more restrictive. A policy with steadily increasing annual or monthly premiums will also pass. A single premium policy will however fail the test. Special rules apply if changes are made in policy benefits.

5.2 Guideline Premium Test

The Guideline Premium Test is met if the sum of the premiums paid is never greater than the “guideline premium limitation”. This is defined, as of any date, as the greater of the “guideline single premium” or the sum of the “guideline level premiums” paid to date on the policy.

The “guideline single premium” is in turn defined as the premium at issue needed to fund the future benefits under the contract. The “guideline level premium” is similarly defined as the level annual equivalent of the guideline single premium paid over a period not ending before the life assured reaches age 95. For all of the foregoing, mortality, interest rate, other charge assumptions, and certain other rules that must be followed, are set forth in section 7702 of the US tax code.

The purpose of this test is to ensure that the premium actually paid does not contain an excessive “investment” element relative to the amount of life cover.

5.3 Cash Value Corridor Test

A variable life policy meets this test if the death benefit at any time is at least as large as a specified percentage of the surrender value. The percentage is laid down in section 7702(d) of the US tax code, and ranges from 100% to 250%, depending upon the age of the insured.

The purpose of this test is to ensure that the surrender value does not contain an excessive “investment” element relative to the amount of life cover.

5.4 The Cash Value Accumulation Test

The Cash Value Accumulation Test is met if the cash surrender value of the life policy, according to its terms, may not at any time exceed the net single premium that would be necessary at such time to fund future benefits under the policy. The “net single premium” is determined by using certain mortality, interest rate, and other assumptions set forth in section 7702 of the US tax code.

The purpose of this test is to ensure that the surrender value is sufficiently low relative to the value of future death benefits