

FRENCH LIFE INSURANCE “101” – FOR U.S. PERSONS, RUN AWAY

Authors

Sophie Borenstein
Neha Rastogi
Stanley C. Ruchelman

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Sophie Borenstein is a partner of attorneys Klein Wenner, based in Paris, where she heads the firm’s tax department. She regularly advises clients on French and international tax matters, with a focus on wealth and tax management.

INTRODUCTION

An individual takes out life insurance in order to provide for his heirs and to obtain peace of mind. Tax treatment for the individual during life and the heirs is straightforward when everyone resides in one country. But when a life insurance policy is written in France and the insured or the heirs are U.S. citizens or residents, what the policy holder, his estate, or the beneficiaries may encounter is anything but peace of mind. To their chagrin, each may find that he or she is in the crosshairs of contrary laws in two countries resulting in sub-optimal tax results. This article discusses the French and U.S. tax rules applicable to a French life insurance policy.

FRENCH LIFE INSURANCE POLICIES

A French life insurance policy is a contract under which the insurer receives payment of one or more premiums and undertakes the obligation to pay a capital sum or an annuity to a specified person at a specified date in the event of the death of the insured. The policy accumulates investment income, and the value grows tax-free.

Different Types of French Life Insurance Policies

The policy holder has choices between a single-support policy that is denominated in euros or a multi-support policy.

Single-support euro contracts offer policy holders the opportunity to invest their savings in a general or segregated asset commonly known as a “euro fund.” The asset is managed by the insurance company and backed by a capital guarantee. The capital is protected from day-to-day no stock market fluctuations. Each year, the interest generated in the euro fund is distributed by the insurer to the policy holders. Corporate bonds represent more than 80% of the investments held by euro funds. In return for the security provided by these investments, returns are limited.

Multi-support contracts are not based on the euro, but on one or more units of account, the value of which may rise or fall. These contracts are known as “variable capital” contracts. Their value varies according to changes in the value of the units of account, themselves reflecting fluctuations in the benchmark stock or real estate markets. The insurer guarantees the number of units of account, but not their value during the term of the contract. The policy holder bears the investment risk.

Purpose of French Life Insurance Policies

Life insurance can be used for alternative purposes.

- It can be used for savings purposes to supplement retirement income. The policy holder saves the income generated under the policy while working

and makes partial withdrawals from the policy to supplement income during retirement. It can also be used as precautionary savings vehicle that can be mobilized in the short term in case of need.

- It can be used to manage capital over the long term in a tax-privileged environment in order to supplement income through regular withdrawals or a life annuity.
- It can be used to pass on assets to surviving relatives in order protect loved ones in the event of death: It can provide appropriate solutions for preparing one's estate.

In France, the rules of civil inheritance law applies to the distribution of a decedent's assets. Forced heirship rules mandate that a certain portion of the estate – the “*réserve héréditaire*” – cannot be disposed during lifetime or at death to persons other than descendants, and under certain conditions, to a surviving spouse. But life-insurance policies are not covered by that rule. Policy holders can designate beneficiaries under certain conditions and limits, thereby bypassing French forced heirship laws.

DESIGNATION OF PARTICIPANTS

A life insurance contract brings together an insurer, a policy holder, an insured who usually is the policy holder and the beneficiaries.

The Policy Holder

The policy holder is often referred to as the “stipulator,” the “contracting party,” or the “subscriber.” The policy holder is the person who signs the insurance policy and undertakes to pay the premiums stipulated in the insurance contract. He or she also has the exclusive right to designate the beneficiary.

The premium is calculated by the insurer, considering the insured's age, the duration and characteristics of the policy taken out, and its own administrative costs. Premium payment terms are purely contractual. The policy holder may be offered the choice of paying

- a single premium, payable at once when the policy is taken out;
- programmed premiums, paid regularly over the life of the contract; or
- premiums paid in instalments at the policy holder's discretion.

The latter is the most common option chosen at the present time.

When spouses are married under the French matrimonial regime of community of property (“*communauté de biens*”), a difficulty may be encountered regarding the power to dispose of joint funds by designating a beneficiary other than the surviving spouse. In comparison, the difficulty disappears if the premiums are paid from the policy holder's separate funds. An individual is free to dispose of separate funds to take out the life insurance policy. However, the subscriber must make a declaration of reinvestment if he wishes the life insurance policy itself to retain the status of separate property.

Payment of premiums is optional, even if scheduled. The issuer of the policy has no means of compelling the policy holder to make payment.¹ In the event of non-payment of premiums, the insurer has several options:

- It may cancel the contract if the surrender value is insufficient.
- It may advance the policy holder the unpaid premium or fraction thereof, up to the surrender value the surrender value.
- It may reduce the contract if the surrender value is less than half the monthly minimum wage.²

The designation of the beneficiary belongs to the subscriber. It is a personal right, attached to the policy holder's status. In the event of the death of the policy holder before designation of the beneficiary, the solution depends on whether or not the policy holder is also the insured.

- If the policy holder is also the insured, the option to designate a beneficiary terminates. The contract is unwound, and its acquired value becomes part of the estate of the policy holder, with all related tax consequences. The policy holder's successors cannot act on his behalf retroactively.
- If the policy holder is not the insured, the contract is not terminated by death. The policy holder's heirs become joint policy holders of the life insurance unless one of the heirs is awarded the policy following a division of the estate. The new policy holders have the option of designating the beneficiary.

The Insured

The insured is the person whose death triggers the payout of the amount of the insurance contract. The policy holder and the insured are often the same person, but it is also possible to take out a policy on the life of another person. For example, a grandparent wishing to insure an annuity for grandchildren in the event of the death of their father will indicate the latter as the insured. In this case, the insured is the father and he must consent in writing to the capital or annuity initially guaranteed under the contract. Without that consent, the contract is null and void.³

The policy holder is not entirely free to choose the insured. The insured can only be a natural person. Moreover, the insured may not be a minor under the age of 12, an adult under guardianship, or a person placed in a psychiatric hospital.⁴ Failure to comply with the limitations on the insured person renders the contract null and void. Moreover, the insurer and the policy holder are also liable to a fine of €4,500.

The Beneficiary

At the death of the insured person, the amount provided for in the contract is paid to the designated class of beneficiaries. The beneficiary can be either a natural person such as a descendent or a legal person such as an association, a foundation or an endowment fund. Only two rules limit the freedom to choose the beneficiary of a life insurance contract.

¹ Article L132-20, al. 1 of the French Insurance Code.

² Article R132-2 of the French Insurance Code.

³ Article L 132-2 of the French Insurance Code.

⁴ Article L 132-3 of the French Insurance Code.

“In the event that the beneficiary clause is deemed null and void, the contract is deemed to have been drawn up without a named beneficiary.”

- The beneficiary may not be a member of a class prevented from being beneficiaries of the decedent, such as a physician who treated the insured individual during the final illness.
- The beneficiary must not have an immoral or illicit purpose.

In the event that the beneficiary clause is deemed null and void, the contract is deemed to have been drawn up without a named beneficiary. In that case, the beneficiary is the person or persons who are in a class that has been sufficiently defined in the stipulation to be identified when the guaranteed capital or annuity becomes payable.

For example, the following meets the condition of designated beneficiary:

- The designation relates to the born or unborn children of the contracting party, the insured, or any other designated person.
- The designation relates to the surviving spouse.
- The designation relates to the “heirs of the insured or of a predeceased beneficiary.”⁵

A beneficiary clause that is imprecise or ambiguous as to the identity of the beneficiary can place the insurer in a delicate situation. If the insurer wrongfully refuses to pay the designated beneficiary, the insurer may be liable to pay penalties of up to three times the legal interest rate.⁶ Moreover, if the insurer pays the funds to the wrong beneficiary, the insurer is not released from its obligation toward the actual beneficiary.

It is not mandatory to include a beneficiary clause in a policy. Nonetheless, it is almost always included. In the absence of a specific or determinable beneficiary, the amount to be paid out goes to the policy holder’s estate and is subject to inheritance tax. In comparison, a life insurance payout receives favorable tax treatment when it is linked to a specified beneficiary.⁷ Once a beneficiary is designated, the capital or annuity does not form part of the insured’s estate.⁸

While the absence of a beneficiary designation is most often involuntary and results from an oversight or a combination of unfavorable circumstances, it can sometimes be voluntary. For example, a choice may be made in favor of a transfer subject to inheritance tax, rather than life insurance, when the latter is lower than the 20% or 31.25% levy, or when the beneficiaries are resident in France and the insured policy holder has moved to a foreign country where the value of the life insurance policy is subject to inheritance tax.

The beneficiary’s acceptance is not required for the contract to be valid. Nor is it necessary for the beneficiary to be informed of the existence of the contract drawn up for his or her benefit. But the beneficiary’s acceptance has important consequences, since the policy holder cannot change the identity of the accepted beneficiary without the latter’s agreement and no withdrawal or advance can be made without the agreement of the accepting beneficiary.

⁵ Article L 132-8 of the French Insurance Code.

⁶ Article L 132-23-1 of the French Insurance Code: see no. 28427.

⁷ Article L 132-11 of the French Insurance Code.

⁸ Article L 132-12 of the French Insurance Code.

When the policy is terminated, the capital sum or annuity is paid to the beneficiary, provided the latter accepts the benefit of the policy. A beneficiary has three months to accept the benefit of the policy once formal notice has been given.⁹ Beneficiaries have ten years to claim any sums due to them, from the date on which they became aware of the death.

FRENCH TAXATION AT VARIOUS POINTS

In terms of French life insurance taxation, three situations can be distinguished: (i) withdrawals (ii), the death of the policy holder, and (iii) and the conversion of the capital into a life annuity.

French Taxation Upon Withdrawal

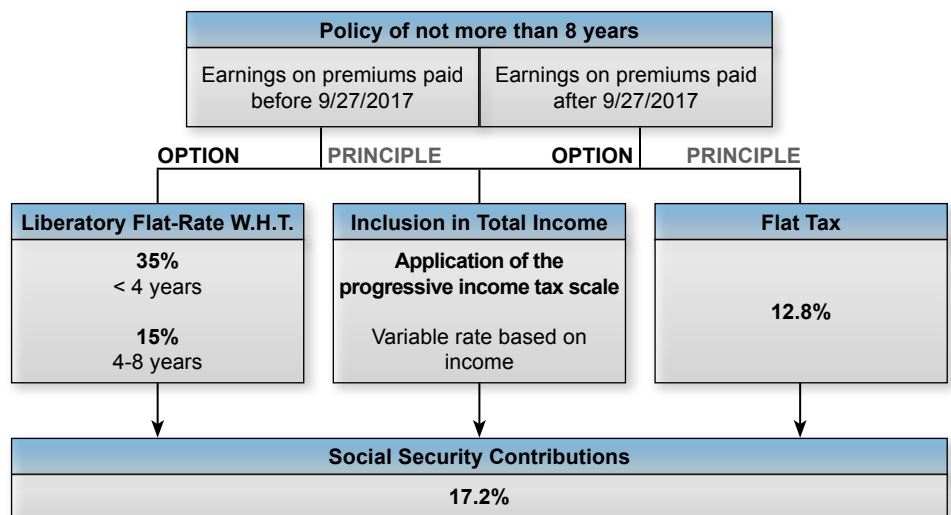
Policy Outstanding Not More Than Eight Years

The tax treatment arising from a withdrawal depends on the date of payment of the premiums and the date of the withdrawal.

- For premiums paid up to September 26, 2017, a choice must be made between a flat withholding tax and the tax bracket of the individual. The flat rate of withholding tax is 35% if the withdrawal takes place in the first four years of the policy. If the withdrawal is made in years five through eight, the flat rate of withholding tax is 15%. If the flat rate of withholding tax is chosen, no further tax is due.
- For premiums paid beginning on or after September 27, 2017, a choice must be made between a single flat-rate withholding tax of 12.8% and the tax bracket of the individual.

In all circumstances, social charges of 17.2% must be paid.

The following diagram illustrates the tax that may be due for withdrawals of premiums held for not more than eight years and made before September 27, 2017, and for comparable withdrawals made on or after that date.



⁹ Article L 132-9, I-al. 2, of the French Insurance Code.

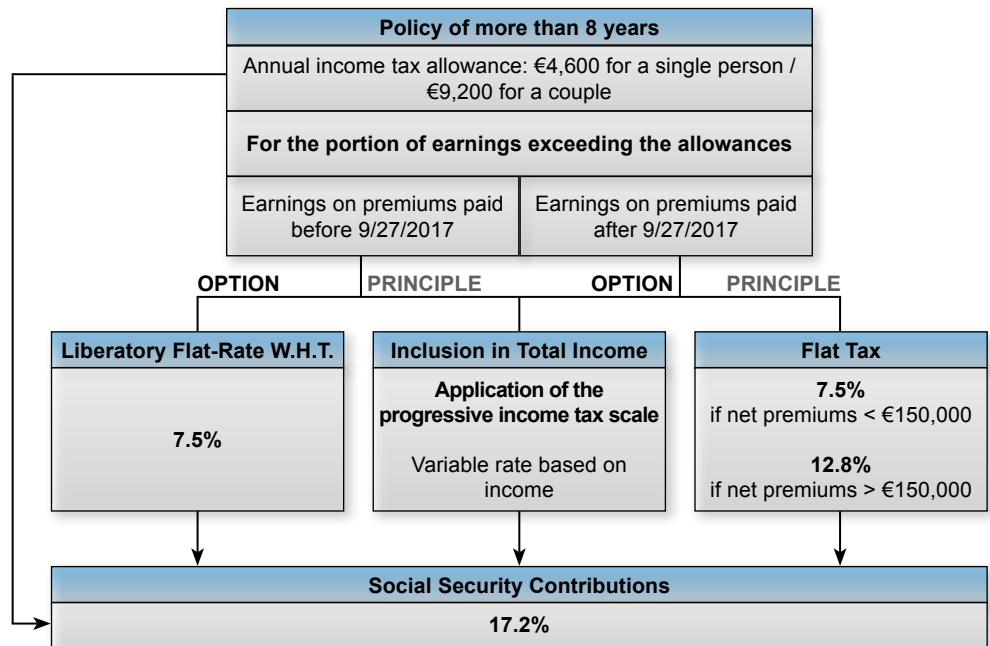
Policy Outstanding More Than Eight Years

The tax treatment arising from a withdrawal depends on the date of payment of the premiums and the date on which premiums are paid.

- For premiums paid up to September 26, 2017, an annual tax-free allowance of €4,600 is allowed for single individuals. The tax-free annual allowance is €9,200 for married couples or couples that register a civil union. Gains in excess of the annual allowance are subject to a flat rate of withholding tax of 7.5%.
- For premiums paid on or after September 27, 2017, an annual tax-free allowance of €4,600 is allowed for single individuals. The tax-free annual allowance is €9,200 for married couples or couples that register a civil union. Gains in excess of the annual allowance are subject to a flat rate of withholding tax of 7.5% withholding tax for the portion of the gains related to net premiums paid of not more than €150,000. The rate increases to 12.8% withholding tax for the portion of the gains related to net premiums paid in excess of €150,000.

In all circumstances, social charges of 17.2% must be paid.

The following diagram illustrates the tax that may be due for withdrawals of premiums held for more than eight years and made before September 27, 2017, and for comparable withdrawals made on or after that date.



In the U.S.-France tax context, the treaty provisions relating to interest income apply for life insurance income. Article 11 generally provides that interest income is taxable only in the state of residence of the recipient. Article 11 applies to income from the withdrawal of premiums under a life insurance policy. If the recipient of the income resides in the U.S., French tax will not be imposed.

Taxation upon Death of the Insured

The date and age of the insured at the time the premiums are paid will determine whether the capital can be transferred to beneficiaries at the date of death of the insured individual with or without inheritance tax.

- For premiums paid before the age of 70 years old, inheritance tax of 20% is due, capped at €700,000, then 31.25%, after an allowance of €152,500 per beneficiary.¹⁰
- For premiums paid after the age of 70 years old, inheritance tax is due for all such premiums that are in excess of an overall allowance of €30,500.¹¹

Interest and capital gains on life insurance policies are exempt from inheritance tax at the policy holder's death.

The France-U.S. Estate, Inheritance, and Gift Tax Treaty does not apply to this specific taxation. The levy is not owed when, on the date of death, the policy holder was not a resident of France for inheritance tax purposes unless the beneficiary is a resident of France on the date of death and was a resident of France for at least six of the ten years preceding the death.

French Taxation at the Conversion to a Life Annuity

Life insurance allows the conversion of the capital into a life annuity: the insurer guarantees to pay the policy holder an annuity until death. Payments may be made on a monthly, quarterly, or half-yearly basis. The conversion to a life annuity is irreversible. The policy holder permanently loses control of the capital accumulated in the life insurance policy and the life insurance policy cannot be transferred to beneficiaries at death of the insured.

The amount of the annuity depends on the amount of capital in the contract and the age of the policy holder at the time of conversion. The annuity payments are subject to income tax and social contribution when and as made. The taxable portion of the annuity depends on the subscriber's age when the annuity is triggered, and is fixed for the balance of the annuitant's lifetime. The taxable portion of the annuity payment is fixed as follows:

- 70% if the conversion occurs under the age of 50 years
- 50% if the conversion occurs between the ages of 50 and 59 years
- 40% if the conversion occurs between the ages of 60 and 69 years
- 30% if the conversion occurs over the age of 69 years

USUFRUCT/BARE LEGAL TITLE ARRANGEMENT

Under French law, ownership of an asset may be divided into two portions. One is the ownership of the income from the property, known as a *usufruct* interest. The holder of the *usufruct* interest is often referred to as the "*usufructuary*." The other

¹⁰ Article 990 I of the French General Tax Code.

¹¹ Article 757 B of the French General Tax Code.

is the bare legal ownership of the asset itself. In very broad terms, the bare legal ownership can be analogized to a tree and the *usufruct* interest can be analogized to the fruit of the tree. Where property is owned pursuant to a *usufruct* arrangement, ownership is said to be “dismembered.” Typically, the split ownership is united at the death of the holder of the *usufruct* interest.

Ownership of a life insurance product can be dismembered. The *usufruct* interest can be created at the time of an asset’s acquisition. Similarly, it can be created during the course of ownership. Both are discussed below.

Ab Initio Dismemberment

In an *ab initio dismemberment*, one of the subscribers to a life insurance policy subscribes to the *usufruct* interest and the other subscribes to the bare ownership interest. The funds that are used to subscribe generally come from the reinvestment of the sale proceeds received from the sale of another dismembered asset. As mentioned above, the *usufruct* is extinguished by the death of the *usufructuary*, and the joint bare-owner becomes the full owner of the policy.¹²

From a tax point of view, inheritance tax is not payable under article 1133 of the French General Tax Code, which states that the reunification of *usufruct* and bare ownership does not give rise to any tax when this reunification takes place at the end of the period initially set for the *usufruct* arrangement or at the death of the *usufructuary*.

Dismemberment of the Beneficiary Clause

On the other hand, the full owner of the life insurance policy may decide to divide the beneficiary clause between a bare owner and a *usufructuary*. In the most common case, where the policy is settled in cash rather than units of account, the dismemberment of the beneficiary clause gives the beneficiary a quasi-*usufruct* over the sums paid in.¹³ On the death of the insured, the insurer must pay the guaranteed capital sum to the *usufructuary*, who must then return an equivalent sum to the designated bare owner at the end of the *usufruct*.

The bare owner and the *usufructuary* are considered beneficiaries in proportion to their share of the sums paid out by the insurance company. This share is determined in accordance with the life *usufruct* scale set out in article 669 of the French General Tax Code. For premiums paid before the age of 70 years old, the €152,500 allowance is also distributed according to the scale set out in article 669 of the French General Tax Code.

However, where one of the beneficiaries is exempt from the levy, such as where the surviving spouse is designated as the *usufructuary* beneficiary, the tax authorities refuse to allow the exempt beneficiary’s share of the allowance to be used by the non-exempt beneficiaries.¹⁴

For premiums paid after the age of 70 years old, the deduction of €30,500 – which is shared when there are several beneficiaries – must be divided between the *usufructuary* and the bare owner according to the same scale that appears in article 669 of



¹² Article 617 of the French Civil Code.

¹³ Article 587 of the French Civil Code.

¹⁴ BOI-TCAS-AUT-60 no. 310.

the French General Tax Code. If one of the joint beneficiaries is exempt – again as is the case of a surviving spouse designated as the *usufructuary* – the bare owner can benefit from the full €30,500 allowance.¹⁵

Tax Treatment of the Restitution Claim

On the death of the *usufructuary*, the split-ownership of the beneficiary clause can result in the recognition of a liability that can be deducted under certain conditions from the estate when calculating inheritance tax. The amount of the liability corresponds to the amount due to the bare owners in respect of their restitution claim.

LIFE INSURANCE DEFINED FOR U.S. TAX PURPOSES

A life insurance contract for U.S. tax purposes is a contract that is a life insurance contract under the “applicable law,” provided one of the following two tests are met.¹⁶ The tests are the cash value accumulation test and the Guideline Premium Limitation / Cash Value Corridor Test.

Applicable Law

The phrase “applicable law” has not been defined in the Code, however, the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, JCS-41-84 (December 31, 1984), prepared by the Staff of 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.¹⁷

Therefore, a French life insurance policy is not disqualified *per se* from being a life insurance policy for U.S. tax purposes, however, it must meet at least one of the two tests mentioned above to qualify for beneficial U.S. tax treatment.

Cash Value Accumulation Test

This test is intended to allow traditional whole life policies, with cash values that accumulate based on reasonable interest rates, to continue to qualify as life insurance contracts.

The cash value accumulation test looks to the cash surrender value of the contract which is compared to the net single premium amount.¹⁸ The cash value accumulation test is met if the cash surrender value of the contract, by its terms, may not exceed the net single premium that would have to be paid at such time to fund the future benefits under the contract assuming that the contract mature no earlier

¹⁵ BOI-ENR-DMTG-10-10-20-20 n° 220.

¹⁶ Code §7702(a).

¹⁷ JCS-41-84 at page 646.

¹⁸ *Id.* at page 647.

“ . . . a French life insurance policy is not disqualified *per se* from being a life insurance policy for U.S. tax purposes, however, it must meet at least one of the two tests mentioned above to qualify for beneficial U.S. tax treatment.”

than age 95 for the insured.¹⁹ The test must be met at all times during the life of the insurance contract. The net single premium is a one-time payment that guarantees coverage for the policy holder without any additional expenses or fees.²⁰

The cash surrender value is computed without regard to any surrender charges, policy loans, or reasonable termination benefits.²¹

Whether a contract meets this test of a life insurance contract will be determined on the basis of the terms of the contract. In making the determination that a life insurance contract meets the cash value accumulation test, the net single premium for any time is computed using a rate of interest that is the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on the issuance of the contract. To be consistent with the definitional test reference to the cash surrender value, the “rate or rates guaranteed on the issuance of the contract” means the interest rate or rates reflected in the contract’s nonforfeiture values (*i.e.*, the cash surrender value), assuming the use of the method in the Standard Nonforfeiture Law.

Guideline Premium Limitation / Cash Value Corridor Test

The second alternative test under which a contract may qualify as a life insurance contract has two requirements; the guideline premium limitation and the cash value corridor. The guideline premium portion of the test distinguishes between contracts under which the policyholder makes traditional levels of investment²² through premiums and those which involve greater investments by the policyholder. The cash value corridor disqualifies contracts which allow excessive amounts of cash value to build up (*i.e.*, premiums, plus income on which tax has been deferred) relative to the life insurance risk. In combination, these requirements are intended to limit the definition of life insurance to contracts which require only relatively modest investment and permit relatively modest investment returns.

The test is a two-part test that applies to both the premiums and the cash value.

The guideline premium requirement requires that the net premiums paid at any time cannot exceed the greater of (1) the single premium that would have been required upon issuance of the policy that is needed to fund the future benefits under the contract²³ or (2) the sum of the level annual premiums that would be required for that purpose over the life of an insured who lives until at least age 95.²⁴ A premium payment that causes the sum of the premiums paid to exceed the guideline premium limitation will not result in the contract failing the test if the premium payment is necessary to prevent termination of the contract on or before the end of the contract year, but only if the contract would terminate without cash value but for such payment.

¹⁹ Code §7702(b)(2). The future benefits to which this rule refers include death benefits, endowment benefits, and additional benefits for which the insured has paid.

²⁰ The net single premium is computed using the rate guaranteed in the contract that cannot fall below 4% and the mortality charges specified in the contract. If the contract is silent on the charges, the mortality charges used for computing statutory reserves are used to compute the premium amount.

²¹ Code §7701(f)(2).

²² JCS-41-84 at page 649.

²³ Code §§ 7702(a)(2)(B), 7702(c)(1), 7702(c)(2)(A), 7702(c)(3)(A).

²⁴ Code §§ 7702(a)(2)(A), 7702(c)(1), 7702(c)(2)(B), 7702(c)(4).

The cash value corridor test requires that the death benefits under the contract must always be more than an applicable percentage of the cash surrender value. The percentages appear in a statutory table that looks to the insured's age at the beginning of the contract year and provides a percentage that must be used, ranging 250% for individuals who are not over age 40 on the first day of the contract year to 100 to 105% for individuals who are between age 90 and age 95 on the first day of the contract year.²⁵ The legislative history illustrates the application of the cash value corridor as follows.

Applicable percentages are set forth in a statutory table. Under the table, an insured person, who is 55 years of age at the beginning of a contract year and has a life insurance contract with \$10,000 in cash surrender value, must have a death benefit at that time of at least \$15,000 (150 percent of \$10,000).²⁶

The two tests are extremely complicated and require actuarial estimations beyond the ability of most tax advisers. Thus, it is best to have the assistance of the insurance company's own actuaries.

If a life insurance policy meets at least one of the two tests, it is treated as a qualified policy subject to preferential tax treatment in the U.S. including the benefit of tax deferral. If a policy is an unqualified policy, the benefit of tax deferral is not available and the policy holder may be subject to immediate taxation.

U.S. TAXATION OF A QUALIFIED LIFE INSURANCE POLICY

A qualified life insurance policy is granted preferential tax treatment. The most substantive benefit is the nonrecognition of any annual appreciation in the surrender value and full exemption from tax on the proceeds on death to the extent they represent death benefits. A total list of benefits is as follows:

- **Annual Build Up:** The year-to-year increase in the cash value is not subject to income tax.
- **Death Benefit:** Proceeds attributable to the death benefit of the life insurance contract are not subject to income tax in the hands of the estate or heirs receiving the payment.²⁷
- **Dividends:** No U.S. tax is imposed if dividends are retained by the insurer as a premium. If not retained by the insurer, a distribution reduces the investment in the contract and is not taxed until the full investment is returned to the insured. At that point, the excess is fully taxed as ordinary income at rates of up to 37% under current law. The investment in the contract is the aggregate amount of premiums paid into the policy reduced by the aggregate amount received as distributions under the contract that were previously excluded from gross income (e.g., prior tax-free withdrawals).

²⁵ Code §7702(d).

²⁶ JCS-41-84 at pages 650-651.

²⁷ Code §101(a).



- **Withdrawal or Surrender:** Upon a payout before death, the amount in excess of the “*investment in the contract*” is subject to U.S. tax as ordinary income at the rate of up to 37%.
- **Sale of Policy:** Proceeds from the sale of a life insurance contract to a third party are taxed as follows. Amounts received are exempt from U.S. tax up to the investment in the contract. Any amount received above the investment in the contract (tax basis) up to the cash value is taxed as ordinary income. All remaining proceeds are taxed as capital gains.

U.S. TAXATION OF AN UNQUALIFIED INSURANCE POLICY

As discussed above, a French life insurance contract typically is not designed to provide a death benefit. Rather, it serves as an investment tool for the owner of the policy. Consequently, it likely will not meet either test relevant to determine whether a policy is a qualified policy for U.S. tax purposes.

In general, a contract that is a life insurance contract under applicable law that fails to meet the tests under Code §7702 continues to be a life insurance contract for all purposes of the Code except for the following two purposes:²⁸

Annual Build-Up in the Policy Value is Subject to U.S. Tax

The income on the contract for any taxable year of the policy holder is taxed as ordinary income by the policy holder during such year.²⁹

The income on the contract is the increase in the net surrender value of the contract during the taxable year as (i) increased by the cost of life insurance protection provided under the contract during the taxable year and (ii) reduced by the premiums paid under the contract during the taxable year.³⁰

No foreign tax credit is available in the U.S. since no French income tax is due on the annual buildup.

Taxation of Death Proceeds

A portion of the death benefit will be received free of income tax, and the balance will be taxed as ordinary income at rates of up to 37%.³¹ For this purpose, the death benefits are divided into two parts. The proceeds, to the extent of the net surrender value, are treated as amounts received under an annuity contract and are includible in the recipient’s gross income as ordinary income.³² The excess of the amount paid by the reason of the death of the insured over the net surrender value of the contract is received tax free under Code §101.

²⁸ Code §7702(g)(3).

²⁹ Code §7702(g)(1)(A).

³⁰ Code §7702(g)(1)(B).

³¹ Code §7702(g)(2).

³² Clarified by the French government [here](#).

Withdrawal or Surrender

Upon a payout before death, the amount in excess of the “investment in the contract” is subject to U.S. tax as ordinary income. The excess is also taxed in France if the policy holder is a French resident. The income is treated as interest income taxed as ordinary income.

As mentioned above on page 32, Article 11 (Interest) of the France-U.S. income tax treaty grants exclusive right to tax to the country of residence of the recipient. Thus, a U.S. citizen who resides in France will be subject to French tax under the treaty. He or she will also be subject to U.S. tax under the saving clause of the treaty.³³ The income will be foreign source for U.S. tax purposes since interest is sourced to the country of payor. Therefore, the policy holder will be entitled to claim a foreign tax credit for the French taxes paid on that income.

Sale of Policy

Proceeds from the sale of an unqualified life insurance contract to a third party are treated as follows:

- Amounts received are exempt from U.S. tax up to the investment in the contract.
- Any amount received above the tax basis up to the cash value is taxed as ordinary income.
- All remaining proceeds are taxed as capital gains.

Article 13(6) of the Treaty grants exclusive right to tax to the country of residence of the seller. Thus, a U.S. citizen who is a French tax resident will be subject to French income tax under the treaty but will also be subject to U.S. tax under the saving clause. The income will be foreign source for U.S. tax purposes if U.S. citizen has a tax home in France.³⁴ Therefore, the policy holder will be entitled to claim a foreign tax credit of the French taxes paid against his U.S. income tax liability.³⁵

However, French law allows only a partial withdrawal or a complete surrender of the policy. It does not allow for a sale of a policy.

Excise Tax on Foreign Life Insurance Premium

An excise tax of 1% is imposed on insurance premiums paid to a foreign life insurance company insuring U.S. risks.³⁶ At the same time, premiums subject to the excise tax are exempt from the 30% F.D.A.P. withholding tax.³⁷ The person making a premium payment files Form 720 (Quarterly Federal Excise Tax Return) and remits the excise tax to the I.R.S.

³³ Paragraph 2 of Article 29 (Miscellaneous Provisions).

³⁴ Code §865(a).

³⁵ Re-sourcing rules under the treaty must be examined if the policy holder has a tax home in the U.S.

³⁶ Code §4371.

³⁷ Treas. Reg. §1.1441-2(a)(7).

The excise tax does not apply in either of the following circumstances:

- The premiums generate effectively connected income for the foreign insurance company.
- The premiums are exempted from the excise tax under an applicable income tax treaty.

The France-U.S. Income Tax Treaty includes the excise tax as a covered tax.³⁸ Therefore, since the insurance premiums would be considered business profits in the hands of the insurance company, the excise tax exposure will not arise in the U.S. in the absence of a permanent establishment in the U.S.

To qualify for the exemption, the foreign life insurance company must meet three conditions:

- It must enter into a closing agreement with the I.R.S.
- It must be a resident of France.
- It must meet one of the tests under the Limitation on Benefits provision.

The I.R.S. publishes a list of foreign life insurance companies that have entered into qualifying closing agreements.³⁹

U.S. Policy Holders / Form 8621 / P.F.I.C.'s Held by French Insurance Company

Premiums paid under a life insurance policy to a French insurance company are used by the company to make investments. If an investment takes the form of collective investment vehicles (among which are *Organisme de Placement Collectif en Valeurs Mobilières*, (O.P.C.V.M.'s)), the collective investment vehicle likely will be categorized as a Passive Foreign Investment Company ("P.F.I.C.").

However, a U.S. policy holder of a French life insurance policy will be required to report the P.F.I.C.s and include income therefrom only if he or she is treated as a direct or indirect shareholder in the P.F.I.C. The report is filed on Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.). In the circumstances, the question presented is whether the owner of the policy is considered to be an indirect shareholder of a P.F.I.C. in which the French insurance company holds shares. An indirect shareholder of a P.F.I.C. is determined based on certain attribution rules. Attribution of ownership of a P.F.I.C. from a foreign corporation to a shareholder is possible under two situations:

- The foreign corporation is itself a P.F.I.C.⁴⁰
- The foreign corporation is not a P.F.I.C. and the shareholder owns 50% or more in the value of the foreign corporation.

³⁸ Article 2 (Taxes Covered), Paragraph 1(a) (ii). Note, however, the treaty benefit is lost if, and to the extent, the risk is reinsured with a company based in a country that has not entered into an income tax treaty with the U.S. that provides comparable benefits regarding the excise tax in the U.S.

³⁹ See [here](#).

⁴⁰ In this case, the ownership percentage of a shareholder in the foreign corporation holding a P.F.I.C. is irrelevant.

In general, active foreign insurance companies are not considered to be P.F.I.C.'s under the active insurance exception to P.F.I.C. status.⁴¹ As a result, a French life insurance company should not be treated as a P.F.I.C. and attribution under the first attribution rule is inapplicable. Attribution is also unwarranted under the second attribution rule because a French life insurance company is not a P.F.I.C. When a foreign company is not a P.F.I.C., its investment in a lower-tier foreign company that is a P.F.I.C. may be attributed only to a U.S. person that is a 50% shareholder of the foreign corporation, which is outside the fact pattern presented.

In view of the above, a policy holder of a French life insurance policy should not be viewed to be an indirect owner of shares in a P.F.I.C. held by a French life insurance policy. The policy holder should have no P.F.I.C. exposure in the facts presented.

The conclusion is buttressed by Rev. Rul. 2003-91, which addresses whether, for U.S. income tax purposes, the holder of a variable life insurance contract would be considered to be the owner of the assets that fund the variable contract. In the ruling, the policy holder purchased a life insurance contract under which he specified the allocation of the premium among available subaccounts maintained by the insurance company. 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 the policy holder did not have any legal, equitable, direct, or indirect interest in any of the assets held in an investment account. Therefore, interest, dividends, and other income derived from the assets that fund the variable contract cannot be included in the holder's gross income when and as earned under the policy.

U.S. Reporting Obligation for the Foreign Life Insurance Policy

Every U.S. tax resident and every U.S. citizen must annually report all interests held in all foreign financial accounts if the aggregate value of all foreign accounts at any time exceed \$10,000. The report is made to the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Treasury Department. FinCEN Form 114 (Report of Foreign Bank and Financial Accounts (F.B.A.R.)) is the form used to make the report.

The definition of "foreign financial accounts" includes an account that is an insurance or annuity policy with a cash surrender value. A French life insurance policy constitutes a foreign financial account for F.B.A.R. purposes. Consequently, a U.S. person who holds a French life insurance policy must report the investment in the policy on an F.B.A.R. if the dollar threshold is met.

In addition for F.B.A.R. reporting to FinCEN, a U.S. taxpayer must report the investment on I.R.S. Form 8938 (Statement of Specified Foreign Financial Assets) provided that the life insurance policy is a cash value insurance policy having a positive value and the aggregate value of all foreign financial assets held by the U.S. taxpayer exceeds a specified threshold that varies based on the marital status of the individual and place of physical residence.

⁴¹ Code §1297(b)(2)(B).

CONCLUSION

As the world gets smaller and investment opportunities cross borders, it is easy to ignore the complexities of tax laws and commercial laws in other countries. As evidenced in this article, a safe investment in a life insurance contract issued under the laws of a foreign country brings with it a world of complexities that are easy to miss in the absence of competent cross border tax planning.

“ . . . a safe investment in a life insurance contract issued under the laws of a foreign country brings with it a world of complexities that are easy to miss in the absence of competent cross border tax planning.”