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LIFE INSURANCE CONSIDERATIONS FOR FOREIGN NATIONALS

In a highly global economy, many wealthy citizens of other countries are purchasing property in the U.S., expanding their businesses to the U.S., or moving assets into U.S. financial services organizations for investment purposes. These situations have created the need for life insurance sales in the U.S., and many carriers have created programs to cater to these individuals.

This document defines the parameters of these programs, identifies benefits of foreign nationals purchasing U.S. life insurance and offers key tips and pitfalls in writing this type of business.

BENEFITS OF PURCHASING U.S. LIFE INSURANCE

Foreign national clients typically prefer life insurance policies written by U.S. carriers for several reasons:

1. Local companies in their home country may not offer life insurance as we know it in the U.S.; they may offer critical illness coverage, or they may have exceptionally low, maximum face amount limitations.
2. They may prefer U.S. dollar-denominated coverage to minimize exchange rate or inflation risk with their home currency. Local laws may prohibit their domestic carriers from writing dollar-denominated coverage.
3. There may be financial strength concerns with their local companies.

WHO IS A "FOREIGN NATIONAL"?

For non-U.S. citizens, it is important to understand the nature of their relationship to the United States and what that means for their residency status. Residency is critical, as it will determine the tax regime that is applied to the foreign national. We can divide non-U.S. citizens into two categories: resident aliens, and nonresident aliens (hereafter referred to as "foreign nationals").

Interestingly, the IRS defines residency for income tax purposes differently than it does for transfer tax (i.e., gift, estate, and generation-skipping) purposes. In this article, we define residency for transfer tax purposes only, with a focus on its effect on foreign nationals.

The residency test for transfer tax purposes is subjective in nature. An individual is classified as a resident alien if that person is domiciled in the U.S. at the time of transfer (by gift or death).[1]

As defined by the Treasury regulation, domicile in the U.S. is acquired by:

". . . living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal."

[1] Treas. Reg. Secs. 20-1(b) and 25.2501-1(b).

In short, U.S. domicile (and resident alien status) is established when he or she is present in the U.S. and has the intention of remaining here permanently. While this analysis is subjective, some factors that may be considered include:

- Length of time spent in the U.S. versus abroad
- Size, cost, and nature of residence(s) in the U.S. (owned or rented)
- Location of cherished personal possessions
- Location of family and friends
- Location of business interests
- Location of church and social club memberships
- Voting records
- Declaration of residency in one's legal documents (wills, trusts, etc.)
- U.S. visa status

ESTATE AND GIFT TAXATION OF FOREIGN NATIONALS

It is important to have a broad understanding of the transfer tax regime and its potential application to a foreign national's worldwide assets. Specifically, foreign nationals may own a variety of assets in the U.S. These commonly include real estate, business interest, brokerage, and investment accounts, as well as life insurance policies.

GIFT TAX

Foreign nationals will be subject to U.S. gift taxes on transfers of tangible property/assets located in the U.S. The question of whether an asset gifted by a foreign national is subject to U.S. gift tax jurisdiction is sometimes a difficult one. U.S. real estate is both tangible and located in the U.S. Cash from a U.S. banking institution has generally also been viewed as tangible property located in the U.S. and subject to U.S. gift tax.[2] However, if the foreign national makes a gift of cash drawn from a foreign bank account, it is not subject to U.S. gift tax.[3] Stock issued by a domestic corporation is considered property within the U.S. while stock issued by a foreign corporation is not.[4] However, stock and debt obligations are generally seen to be intangible, regardless of situs, and are therefore not subject to U.S. gift tax on their transfer by a foreign national.[5]

While the foreign national taxpayer does not have a lifetime gift tax exemption, they may exclude the following items from U.S. gift taxation:

1. Gifts that are not more than the annual exclusion for the calendar year; $16,000 for 2022
2. Tuition or medical expenses paid on behalf of a third party
3. Gifts to a spouse who is a U.S. citizen (i.e., the unlimited marital deduction). If the spouse is not a U.S. citizen, the marital deduction for gifts is limited to an annual exclusion of $164,000 for 2022.[6]
4. Gifts to a political organization for its use

ESTATE TAX

While U.S. citizens and resident aliens are subject to U.S. estate tax on their worldwide assets, foreign nationals are subject to estate tax only on those assets that are deemed to be U.S. situs property. U.S. situs property includes, but is not limited to, the following assets:[7]

- U.S. real property
- Tangible personal property in the U.S.
- Stock of domestic corporations
- Debt obligations of a U.S. person/entity or the U.S. itself (including political subdivisions)
- Annuities issued by entities domiciled in the U.S.
- The cash surrender value of a life insurance policy issued by a U.S. life insurer that insures the life of a third party (i.e., a foreign national owns the policy but is not the insured)

Assets owned by the foreign national that are *excluded* from U.S. estate tax jurisdiction include:[8]

- Personal bank deposits not connected with a U.S. trade or business
- Bank deposits with a U.S. branch of a foreign bank (if not connected with a U.S. trade or business)
- Currency located outside of the U.S.[9]

[2] GCM 36860 (Sept. 24, 1976); PLR 7737063

[3] PLR 8138103, 200340015

[4] Treas. Reg. 25.2511-3(b)(3)

[5] PLR 8210055; PLR 200340015

[6] IRC § 2523(i)

[7] IRC Secs 2103-2105; Treas. Reg. 20.2104-1(a)

[8] IRC Sec. 2105; Treas. Reg. 20.2105-1

[9] Treas. Reg. 20.2104-1

- Stock in companies incorporated outside the U.S.
- Life insurance proceeds from a deceased foreign national's policy

Unlike U.S. citizens and resident aliens, life insurance policies owned by foreign nationals that insure their own lives are deemed to be intangible assets and not subject to U.S. estate taxation. While this may appear to obviate the need for an irrevocable life insurance trust to remove the policy proceeds from a foreign national's estate, it may still be prudent to utilize a trust for reasons discussed below.

GENERATION-SKIPPING TRANSFER TAXES

Foreign nationals may be subject to Generation-Skipping Transfer (GST) taxes if the transfer is to a "skip person" and otherwise subject to gift or estate tax. Foreign nationals have the full GST exemption permitted to citizens, currently at $12.06mm for 2022.

BENEFITS OF AN IRREVOCABLE LIFE INSURANCE TRUST

Wealthy U.S. citizens who wish to have the proceeds of their life insurance excluded from their estate will often utilize an irrevocable life insurance trust (ILIT). However, when foreign nationals own life insurance policies insuring their own lives, the proceeds are excluded from U.S. estate tax jurisdiction. With that in mind, why might foreign nationals wish to consider U.S.-domiciled ILITs to hold their policies?

CONVENIENCE

Since foreign nationals do not reside in the U.S. (and may not have plans to do so in the future), an ILIT can provide them with the benefit of a domestic trustee. A domestic trustee can ensure that the premiums are paid on time, correspond with the life insurance carrier on their behalf while they are outside of the country, and provide for recordkeeping and administration of the policy. Should the insured pass unexpectedly, the trustee can assist in the timely filing of the death claim.

ADMINISTRATION AND PROTECTION

While the insured may be a foreign national, their children may elect to be U.S. citizens. An ILIT will provide a convenient onshore account that can be managed for their benefit in an efficient manner. The trust document can provide for additional controls over when distributions are made and for what purpose. The trust may also provide for added protection from the creditors of the insured's children, including former spouses.

TAXATION

Drafted appropriately, assets in the ILIT will remain outside of the estate of the trust beneficiaries. Assuming those beneficiaries are U.S. citizens or elect to be U.S. citizens, trust assets should be excluded from their estates. Furthermore, it may be possible to shield trust assets from additional taxation for transfers to subsequent generations of U.S. citizens through the allocation of GST tax exemption, where applicable.

HOW A FOREIGN NATIONAL CAN FUND AN ILIT

If foreign nationals are making gifts of tangible assets to their trusts located in the U.S., they will have to be mindful of avoiding gift tax liability. The grantor may elect to fund the trust with annual exclusion gifts. The amount that the grantor(s) can gift on an annual basis is equal to the number of donors multiplied by the number of trust beneficiaries (donees).[10] For example, if the trust has seven trust beneficiaries and the annual exclusion limit is $16,000 per beneficiary, a single grantor may gift $112,000 to the trust annually without becoming subject to U.S. income tax.

However, it may be possible to fund a U.S. ILIT with offshore funds and avoid U.S. gift taxation: The IRS has ruled that a draft on a foreign bank account owned by the foreign national, and payable to a U.S. banking institution, is not subject to U.S. gift tax jurisdiction as it is an asset outside of the U.S.[11] Similarly, as stock is considered to be intangible, it may be gifted to the trust without gift tax.

Another option for funding the purchase of life insurance in trust is commercial premium financing (CPF). CPF is a temporary way to pay insurance premiums. A credit-worthy party — in this case, the foreign national — applies for loans to pay the premiums on the trust-owned policy. These loans

[10] In order to qualify for the annual exclusion, gifts must be "of a present interest." To qualify as a present interest, the trustee must issue "Crummey letters" to each beneficiary, notifying them of their right of access to the gifted funds. The mechanics of Crummey letter compliance are outside the scope of this piece.

[11] Treas. Reg 26.2511-3

recourse in nature and are fully collateralized (i.e., recourse financing) by the policy cash surrender value, with any shortfall being made up with collateral provided by the trustee or grantor. These loans are generally "interest only" variable rate loans, where interest is paid or accrued annually. Some foreign nationals may be interested in CPF, as they can secure better lending rates in the U.S. than they can in their home country. However, CPF is not without its risks and can introduce additional volatility into the transaction. An in-depth survey into CPF, the risks, risks management, and best practices, is outside the scope of this piece, but M Financial has produced a white paper on the topic.[12]

NEEDS FOR COVERAGE

Foreign nationals have similar needs to U.S. citizens for life insurance coverage, such as estate tax coverage or income replacement, but the estate tax liability incurred in the U.S. may be due to moving assets to the U.S. for multiple reasons, including privacy, reduced political risk, and avoiding higher estate taxes in their home country. They may also want insurance from a U.S. carrier in U.S. dollars as a hedge against local currency devaluation. Business insurance needs of foreign clients may be like U.S. needs in certain circumstances. For example, the applicant may own a company and have multiple children, but only one of the children intends to stay active in the business. In this case, they can use life insurance to compensate or buy out the other children.

In addition to these familiar life insurance needs, some foreign cultures value legacy sales. Their local cultures may place a high value on helping future generations, and insurance is a way to use premiums to fund investments with higher returns. These investments may also act as greater inflation hedges than those found in their home country.

For foreign nationals, second-generation family members (i.e., children of wealthy parents), the primary needs are income replacement and college funding. These can be a challenge to place in U.S. foreign national programs because they typically do not have enough assets in the U.S. to justify the sale (see carrier requirements below).

CARRIERS' FOREIGN NATIONAL PROGRAMS

"Foreign nationals" in this context are defined as clients that are not U.S. citizens and have their primary residence outside of the United States. However, to qualify for carriers' foreign national programs, the following items are required:

- **U.S. Nexus:** The individual must have interests in the U.S. that are to be protected by life insurance. This includes ownership of real estate in the U.S. (such as a condominium, apartment, home, or property); business interests in the U.S.; immediate family members in the U.S.; or investment holdings in the U.S. Most carriers have a minimum threshold that they require in order to establish a nexus.
- **Physical Presence:** The person must demonstrate regular and recurring visits to the U.S. Carriers typically establish a minimum number of days and may inquire about the purpose of the visits to ensure they are in relation to the insurance need.
- **Financial Presence:** There is typically a minimum threshold on the assets required to be held in the U.S., and this financial presence will be used to justify the coverage. The carrier may require a relationship between assets in the U.S. and the amount of coverage they will approve (such as 4x the amount of assets). Some carriers have minimum net worth and income thresholds as well.
- **Source of Funds & Policy Ownership:** Premiums typically need to be paid from a U.S. financial services company. One reason for this is to ensure the anti-money laundering controls required in the U.S. financial services industry are enacted, as all banks must run these controls and ensure that the funds are not used in a money-laundering or terrorist-financing scheme. The ownership of the policy will need to be immediate family members or a trust established in the United States with a U.S. Tax ID, Social Security number, or W-8BEN.

UNDERWRITING CONSTRAINTS

Carriers use reinsurance to assume risk above their retention levels. Existing reinsurance arrangements exclude foreign national business, so carriers have

[12] "Commercial Premium Finance" M Intelligence, August 2021. Speak with an M Financial representative for more information.

separate reinsurance limits for this business. In addition, carriers have reduced retention for this business and subsequently, their ability to automatically bind their reinsurance pools is limited. The available capacity for foreign national business is lower than capacity for domestic business.

Country of residence will also be a factor in underwriting. Insurers group countries by class (A, B, C, etc.) based on assumed mortality risk. This grouping will determine maximum capacity available, jumbo limit, and best rate class available. Some carriers will also only allow permanent products or term coverage in limited situations — such as business coverage — for foreign nationals.

SOLICITATION REQUIREMENTS

When applying for coverage for a foreign national, insurance law requires all solicitation to occur in the United States. That is defined as all documents signed in the U.S. (e.g., the application, exam, illustration, delivery requirements, etc.). Carriers do not have the ability to get around this, nor will signature at the U.S. embassy in their home country fulfill this requirement. However, some carriers do allow electronic delivery of their policies.

EXCLUSIONS FROM THESE PROGRAMS

The anti-money laundering rules established by the Office of Foreign Asset Control (OFAC) prohibit U.S. financial institutions from doing business with Politically Exposed Persons (PEPs). PEPs are people entrusted with prominent public functions by a foreign country. This includes — but is not limited to — heads of state, senior politicians, senior government officials, senior judiciary, senior military leaders, or senior executives of state-owned corporations. This designation also applies to members of that person's immediate family.

Pilots, journalists, military members, missionaries, police officers, sports figures, and other professions and avocations may be excluded from these programs as well, but not because they are considered Politically Exposed Persons. Instead, these occupations have higher mortality in certain countries.

Finally, internet searches have become commonplace during the underwriting process; expect the underwriter to perform a search on the applicant. It is considered a best practice to perform such a search before submitting the underwriting papers to avoid surprises.

PRODUCER CHALLENGES

Building the underwriting file is more difficult with these cases than with domestic cases. Carriers will inspect every document and have heightened controls and extra signoffs. They will also scrutinize the insurable interest and may tighten up some of their financial underwriting guidelines.

There are likely to be challenges obtaining medical records from the home country, and these will need to be translated before submitting to the carrier for review. The medical facilities in the home country may not have complete records. In some countries, the patient maintains the file but, if this does not occur, the records may not be available.

In addition, most of the clinics and hospitals do not have electronic records stored on a system, nor do they have medical records departments. An office clerk may have to pull and copy any records on file. Allow extra time; persistence is required and the applicant may need to be involved to obtain the records.

Suggestions to Speed Up Underwriting

1. **Include a cover letter explaining the following:**
    - **Introduce the applicant: Who are they and how did they acquire their wealth?**
    - **What is the purpose of the coverage? What are they trying to accomplish? Why are they choosing U.S. coverage?**
    - **Describe the U.S. nexus:**
        - **How often do they travel to the U.S.? How long do they stay?**
        - **What property do they own? Include the address(es) to enable a Google search.**
        - **What investments/assets are in the U.S.?**
        - **What bank do they use in the U.S. and how many assets do they have there (deposit and/or investment accounts, etc.)?**

- Where else do they travel and how often? How much time do they spend at each location?
- Where is their primary residence? What is the address to enable a Google search?

2. Begin gathering the medical records immediately, as this could take a while.
3. Do not push the face amount to or beyond the typical limits as it may cause concern by the underwriter. It is better to aim a bit low than to change an underwriter's mind if they have initial concerns with over-insurance.

FINANCIAL JUSTIFICATION

When submitting a case on a foreign national, assume the carriers will request copies of identification (passport, U.S. immigration card, driver's license, etc.). Also, financial need must be demonstrated and documented. As mentioned earlier, the face amount will be tied to (or not exceed) a multiple of the assets held in the U.S. Assume you will need to provide documentation of these assets (brokerage statements, addresses of all real property, a balance sheet, proof of income, etc.). If the carrier has minimum income and/or net worth requirements, they may require verification. This is sometimes challenging with assets overseas.

Don't forget to check the carrier's foreign national guidelines for more specifics, as each program is slightly different.

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