Insurance: The solutions sector

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My last article for *Offshore Investment* Magazine, "Diversity in the battle against adversity: cross-selling techniques using insurance"[1], highlighted the need for the various sectors of the offshore financial services industry to work more closely together, emphasising the importance of cross-selling products in an increasingly challenging environment.

Since that time, there has been a plethora of additional issues to address, ranging from a heightened level of anti-offshore political rhetoric, to documents leaked to a new breed of journalist - who seem determined to portray low-tax jurisdictions and related service providers in as much of an unfavourable light as possible.

As a result, never before has there been a time when the offshore industry in general needs to reaffirm its importance to the global economic system and demonstrate its ability to provide transparent and ethical solutions to onshore problems.

When it comes to creating solutions, the insurance industry remains one the offshore world's most innovative and entrepreneurial sectors. Perhaps somewhat under-utilised in the past, insurance structures and products are now being increasingly used for a variance of reasons, as solutions for both corporate and individual planning needs.

The primary intent of this article is to give some insight into how insurance products are used to address problems, both long-standing and new, facing international investors and high-net-worth (HNW) individuals.

New problems - old solutions

Certain aspects of the insurance sector, such as the captive insurance industry, continue to expand and evolve, both geographically and in terms of sophistication. However, it is often the use of the most basic and established products that can offer the most effective solutions to new problems.

A good example of this is reflected in the changes in UK tax law relating to the residential property market. The recent implementation of these sweeping changes has created widespread concern, especially amongst overseas based investors.

The UK real estate market remains one of the world's most attractive investment destinations, predominantly for non-resident high-net-worth and ultra high-net-worth (UHNW) investors. It continues to be seen as a safe, stable and secure asset hold, particularly when compared to the fluctuating property markets in mainland Europe and the US. Amazingly, only 19% of London properties sold for GBP10 million or more in 2012 were purchased by UK nationals.

Traditionally, a HNW or UHNW investor seeking to purchase UK property would do so through corporate ownership rather than direct ownership. This would simply involve the formation of an offshore or overseas company to hold the property asset, with the key benefits associated with doing so being the legal avoidance of inheritance tax (IHT) and the applicable Stamp Duty Land Tax (SDLT) when selling the property at a future date.

Secondary reasons for corporate ownership would include anonymity, asset protection, asset transfer and estate planning. However, as a result of

the UK Budget in March 2012, the taxation environment in this area changed dramatically.

Firstly, the Chancellor introduced a new 15% SDLT rate on UK residential properties purchased by "non-natural persons" and valued at over GBP2 million. In addition, the standard SDLT rate on such properties owned by individuals was increased to 7%. Therefore, the immediate cost differentiation between the two tax rates on a GBP2 million property would be GBP160,000.

Furthermore, a new "Annual Tax on Enveloped Dwellings" (ATED) was introduced from 13 April 2013, which only applies to properties valued at GBP 2 million and above and owned by "non-natural persons". These charges are highly punitive and were introduced as a measure to encourage direct property ownership. Amounts payable range from GBP15,000 per annum to as much GBP140,000 per annum for higher end properties.

As a result of the above changes, it is envisaged by most law firms and tax advisors that the vast majority of foreign investors in UK residential property will transfer any such assets held corporately to direct ownership. In fact, prior to the changes in tax law described herein, 32% of luxury homes worth over GBP10 million were purchased through offshore companies. After the implementation of the new rules, this fell to 3.8%.

Sadly though, the transfer to direct ownership creates yet another, bigger problem: an exposure to inheritance tax that can be as much as 40% of the property value.

Despite the attempts of many tax accountants and law firms to provide innovative solutions to negate IHT in this scenario, the resolve of the UK's tax authority (HMRC) continues to stand firm. Debt related strategies and ownership through alternative structures designed to test the interpretation of "non-natural persons" have been openly dismissed by HMRC.

As a result, the consistent advice being provided by law firms, tax and financial advisors around the globe is that the purchase of life insurance to offset expected future IHT liabilities of the related estate remains the only practical solution at present. To put this in perspective, in the overwhelming majority of cases, the annual cost of life insurance (for a policy equivalent to 40% of the property value) would be significantly lower than the applicable ATED.

In fact, so compelling is the argument that life insurance is the only viable solution to this problem, the associated demand has meant that our firm has taken the pioneering move to provide much needed additional capacity and create a dedicated insurance facility to serve this purpose. One of our primary intentions is to offer jumbo life policies in GBP and therefore assist our clients in avoiding unnecessary currency arbitrage issues in the future (given that most of the world's jumbo life insurance providers only offer USD policies).

Old problems, innovative solutions

In addition to standard term life and permanent life cover, such as universal life, there are many other hybrid products available that can offer all-encompassing solutions to a whole range of estate planning, tax optimisation, wealth management and even pre-immigration needs.

Private Placement Life Insurance (PPLI) is a prime example of an insurance product that can often provide wider planning attributes. Under the right circumstances, PPLI compounds the benefits of affordable life insurance with tax efficient investment returns.

In short, a suitable policyholder (who would need to pass medical underwriting and meet "accredited investor" and ""qualified purchaser" requirements) would make a premium investment, which would be held in a segregated account with a chosen specialist insurer. A proportion of this premium is used to fund term-life insurance, often referred to as the "cost of insurance" (COI), and the balance is invested.

Tax treatment and applicable laws relating to PPLI policies vary by country. For example, in the US, the IRS applies a number of tests and requirements relating to the relationship between the cash value and the death benefit. However, if these are suitably satisfied, the eligible tax benefits include the following:

- tax deferred investment accumulation;
- no income tax on death benefit (if held until death);
- transfer tax reduction (as part of estate planning).

In addition to the tax advantages, it's also important to remember that, particularly from a US standpoint, the use of PPLI can provide much sought after access to investment asset classes, such as hedge funds.

Asset protection is another associated benefit. This is obviously dependent on the laws applicable to the insurer, with offshore based insurers generally offering the most protection. The key points to note in this regard are that, firstly, the policyholder is protected from creditors as the policy assets are legally owned by the insurance company. Secondly, the policyholder is protected from creditors of the insurance company due to the nature of the segregated account treatment.

Continuing with the US theme, US pre-immigration planning is now a widely recognised necessity for foreign nationals moving "stateside", either on a temporary or permanent basis. Once deemed as a being domiciled in the US, immigrants are fully exposed to all local income and transfer taxes. However, with the right planning instruments and the use of US compliant life and annuity policies, much of this exposure can be avoided.

Global solutions

From a more global perspective, there are similar offshore insurance products available for residents and citizens of other countries. There are many factors to consider from a feasibility perspective.

The starting point is ascertaining if any restrictions are in force that could preclude the purchase of life insurance products from overseas or "unlicensed" insurers. Most countries do not impose such restrictions, as long as solicitation and execution do not take place in a prospective policyholders' home domicile. However, it's worth noting that there are many grey areas in this regard.

Thereafter, local taxation and proper planning advice should be sought to clearly ascertain the potential benefits and ensure that the policy ownership structure incorporates any other necessary instruments, such as trusts and corporate entities.

In conclusion, the world is changing at a rapid pace. The significant shift in the balance of international power will affect the offshore world in two ways. The level of taxation scrutiny in shrinking economies will increase, as will the anti-offshore sentiment. In growing economies, taxation legislation will become more sophisticated, as will enforcement.

Both cases clearly highlight a growing need for innovative products and structures. That, coupled with continued inter-sector collaboration, will be vitally important to the offshore financial services industry's success in the coming years.

END NOTES:

1. October 2012, Issue 230