Unit-Linked

Dedicated life insurance solutions based on investment funds

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Unit-Linked
An Overview

In some specific situations that we will discuss in this dossier, one should consider the creation of a dedicated fund, widely known as unit-linked or, under a technical approach, a life insurance based investment product. In some jurisdictions, these life insurance solutions are also known as fonds dédies or life bonds. Whatever the nomenclature, they all represent the same concept. This concept, as well as its legal framework, are described in the following article of this dossier.

Flexible, able to attract sophisticated private customers and address particular needs, these solutions can be tailored to the specific needs of policyholders, insureds or beneficiaries, both in terms of the contract itself and the underlying financial assets. It is, furthermore, a product that can comprise domestic or multijurisdictional approaches. It is ideal for solutions aiming for wealth planning and long-term savings in a suitable and regulated manner, compliant under the applicable legal frameworks and regulations.

Hence, duly adapted to the specific customer needs and supported by professional legal and tax advice, the exact solution to be achieved, in each specific case, can and shall represent trust and peace of mind, features of any proper long-term financial commitment.

The term dedicated fund is, therefore, quite accurate in the sense that the word 'dedicated' sets the pace for further customization and orientation to the customer needs. Our approach on the subject and our concept of the product is not of an 'off-the-shelf' retail investment product but, in fact, of a custom-made solution that fits the specific needs of an individual person or his or her family.

We address the topic of meeting customer needs in two different articles: the topic of the Portuguese legal framework non-habitual residency regime is discussed in the article by Espanha e Associados, whilst the benefits and solutions for high net worth individuals relocating from Brazil to Portugal are the focus of the article by Taiza Ferreira.

Finally, Inge De Wolf addresses the relative stability (now with strengthened professional and information requirements under the, recently implemented, insurance distribution directive) of the applicable legal and regulatory framework.

Everything is in place for this market to become increasingly popular to meet the needs of a specific and small – yet significant – set of investors.

Notwithstanding, this type of insurance can effectively tackle more than just the needs of high net worth individuals. It may and shall also be used as a critical instrument to improve the relationship between companies and human capital.

“Flexible, able to attract sophisticated private customers and address particular needs, these solutions can be tailored to the specific needs of policyholders, insureds or beneficiaries, both in terms of the contract itself and the underlying financial assets.”

Nuno Leitão

Is senior advisor at MDS, working with individual and corporate customers, structuring bespoke unit-linked life insurance solutions.
Before joining MDS, Nuno held the position of sales and distribution manager in asset management companies, thus being a well-rounded professional in devising solutions aimed at high net worth individuals.
Nuno has a background in communication and holds a specialist course in tax law (Portuguese Catholic University, Lisbon).

When an employee negotiates a position, whether domestic or abroad, commonly the employee will take into consideration the full package of the company's compensation and benefits plan. Access to death and disability, as well as health insurance, pension funds and other incentives may favour one offer over another upon selecting a new challenge. Employees value both access to such benefits, as well as the fact that its continuation should prevail, even if they embrace a new challenge later on. In such situations, regardless of the tax regime, portability of vested rights comes into play, that is how and where do you transfer the vested rights.

In multi-jurisdictional life insurance solutions, portability is the feature that allows one to 'carry over' a given benefit from one country to another. Specialist advice should be sought after to determine the actual tax and legal regime in the destination country, so that no personal, professional or family detail is overlooked. For example, one of the main concerns for life insurance policy holders is the beneficiary clause. Such clause, if defined properly, allows pay-outs to the designated beneficiaries, regardless of the fact that several jurisdictions are to be considered.

Some occupations are not in the scope of the Portuguese legal framework non--habitual residency regime, as mentioned in the second article, but these type of insurance solutions are superlative due to the portability feature. Professional football players with international careers, to whom multi-jurisdictional solutions are fit for purpose, are living proof of the concept.

In Europe, two countries rank higher in the specialization and development of this insurance subsector. Luxembourg and Ireland have developed multi--jurisdictional solutions that fit most legal and regulatory frameworks.

Seven insurance carriers operating under the EU Freedom of Services in Portugal are to be considered, some of which include European solutions in their portfolios. We refer concisely to such solutions in this brief but shall revert to the subject in the near future, given their potential to centralise and reduce administrative costs. •

> "This type of insurance can also be used as a critical instrument to improve the relationship between companies and human capital."

Unit-Linked

A flexible and transparent solution

In simple terms, a unit-linked is a life insurance contract that is linked to one or more investment funds (not technically, but in the sense of an autonomous group of assets). Unlike a conventional pure risk insurance policy, it may provide investors with both insurance and investment under a single integrated contract. As a life insurance contract, it covers the risk of death or survival of a given insured person; as a contract that is linked to an investment fund, it offers the advantages of an investment vehicle.

The nature of the contract, however, is that of an insurance policy. Albeit linked to investment funds, the contract (insurance policy) is underwritten by an insurance company authorized for this type of product. The investor is the policyholder, who can either be the insured person himself/herself or appoint a different insured person whose life is covered by the policy. It is also the policyholder who appoints the beneficiaries of the insurance, whether in case of survival whether in case of death, depending on the policyholder's purposes.

In addition to the insurance company, this type of product typically involves several other parties subject to professional and compliance rules, like the asset manager, the custodian bank and the insurance intermediary – feature that provides confidence and legal certainty to the unit-linked policy vis-à-vis other investment products.

How does it work? Whilst part of the premium paid by the policyholder may be used to provide life insurance coverage, the whole or the remaining part is invested in one or several investment funds, at the policyholder's choice, taking into consideration his/her investment objectives, risk tolerance and investment horizon. Premium can be single, regular or flexible depending on the product in question.

The type of fund that is linked to the insurance policy will depend on the products offered by each insurance undertaking. Some specialized insurance companies offer tailor made products built according to the investor's needs.

It's up to the policyholder to choose the investment fund (or funds) linked to the insurance policy, based on his/her risk tolerance and preferences. The fund's portfolio may include different types of assets, such as shares, fixed-interest securities, money market instruments, property, derivative instruments, etc. The policyholder typically has a choice of funds having different characteristics to which premiums can be allocated. The information on the funds' portfolio and investment rules is mandatorily provided to the policyholder previously to the policy subscription.

The premium invested by the policyholder, after deducted any applicable fees or charges, is converted into a given number of fund units, each of which has a net asset value that is stated on a regular basis, depending on the chosen investment funds. In simple terms, the cash value of the policy corresponds, at each moment, to the total value of the investment fund times the proportion of the number of units held by the policyholder to the total number of units in the investment fund. This means that the value of a unit-linked policy directly depends on the value of the investment funds to which it is linked, which in turn depends on the value of the assets kept in the fund's portfolio.

The portfolio allocated to the investment fund underlying the unit-linked policy does not give the policyholder any right of ownership over the portfolio. The fund remains the sole property of the insurance company; nonetheless, the allocation grants to the policyholder a contractual claim against the insurance company in accordance with the provisions stipulated in the agreed insurance policy.

Policyholders are usually allowed to make changes or to switch funds throughout the duration of the unit-linked policy, which confers flexibility to the investment, depending on the policyholder's investment needs or objectives at each moment. Policyholders are also allowed to "transport" their policies to another EU member State when they change of address, which ensures maintenance of the investment notwithstanding any changes in the client's personal or professional life.

From a client perspective, unit-linked policies can be designed to do almost anything a conventional risk policy can, with the advantage that they can also offer more flexibility. The major disadvantage of conventional risk policies lies in the fact that the cash value of the policy at a particular time is not always clear to the client. The transparent nature of a unit-linked policy has a major appeal to policyholders who wish to monitor the progress of the value of their investment. Further advantage of unit-linked policies is that the policyholder has control over the degree of investment risk, by directing premiums to the investment funds most appropriate in relation to his/her risk tolerance.

Unit-linked products can be structured in many different ways and have a wide range of application, like family protection, inheritance or tax planning, saving for retirement, mortgage or loan repayment, employee pension, executive benefits, etc. In addition, these products typically benefit from a tax deferral regime, depending on the tax regime applicable in each country.

Insurance intermediaries have a key role in advising the client – among a range of products available at the market – on which unit-linked policy is more suitable to the client's objectives, as they have the ability (and responsibility) to explain the main features of the product, including commission terms and conditions, and to explain how the product meets the client's needs.

Under the recent EU Insurance Distribution Directive (IDD), insurance intermediaries became subject to reinforced obligations in terms of disclosure of information and professional requirements, which necessarily increased the level of client protection and ensured a higher quality of service to investors that search unit-linked policies, when in comparison with other types of products. •

João Espanha

With 30 years of career behind him – and appointed as Tax Specialist by the Portuguese Bar Association –, his work consists on providing legal and tax advice to individuals and businesses, with emphasis on tax advice on life insurance. João often represents clients in disputes with the tax authorities and in judicial proceedings and he is also a tax arbitrator at the CAAD, where he is frequently appointed by the taxpayer in large-scale complex disputes.
His large experience affords him an overall view of the problems, thus contributing to offering effective solutions to clients. João is founding Partner of Espanha e Associados Law Firm.

Leonor Futscher de Deus

Has worked at Espanha e Associados since 2005, providing ongoing assistance to national and foreign clients from insurance and banking sectors. She is very focused on practical solutions and has excellent understanding of client's needs. Her work involves providing legal advice on day-to-day activities (new products, commercial partnerships, drafting documentation related to products, etc.) and on more complex transactions, such as setting up foreign undertakings in Portugal (through branch offices or through freedom to provide services) or assisting on the internationalisation of Portuguese companies. She has a wide experience in what concerns life insurance, in particular unit-linked insurances. Leonor is Senior Associate of Espanha e Associados Law Firm.

Unit-Linked

A wealth structuring solution

Latin America's sleeping giant

When it comes to Latin America, Brazil is the giant of the region. Its prominence is the result of a combination of many factors including its size, diversified natural resources and a huge consumer market. In the 2000s, the economy profited from global growth and high demand for its commodities. In 2008, the global financial crisis put such prosperity under threat, although the country was able to partially contain its effects. Unfortunately, Brazil did not view its commodities boom as an opportunity to tackle important issues that have been challenging sustainable economic growth for decades. Instead, it kept the same mediocre policies. It did not push forward with the necessary fiscal and political reforms, nor did it make essential investments in infrastructure.

Furthermore, the country has been gripped since the beginning of 2015 by an endemic corruption scandal known as Operation Car Wash. It dominated international headlines and impacted on people at the highest levels of business and politics, including former presidents Lula and Dilma. This widespread corruption scandal has been testing Brazil's institutional and democratic limits. As a result, many have claimed the country suffered its worst recession. Despite hints of a recovery underway and a new president elected, the quality of life is still not improving for Brazilians. The jobless rate is high and violent crime is on the rise due to drug-related activities and widespread police corruption. Access to quality public services such as education and health care is still a huge challenge. Despite its potential and size, Brazil is a sleeping giant intoxicated by its socioeconomic challenges and corruption scandals.

Portugal's many advantages

Amidst the political and economic uncertainty, over the past few years a Brazilian diaspora has been spreading and one of the favorite destinations so far has been Portugal. Among its attractions are: a great quality of life, no language barrier, cultural proximity and a low cost of living. In addition, Portugal is very much 'in vogue' nowadays and even Madonna has been extolling the delights of living in the sunshine capital of Europe!

At the meeting point of three continents, the Iberian nation boasts an advantageous geographic location and excellent transport connections both to the rest of Europe and overseas destinations. Once the hub of a colonial empire, it offers touristic sites full of history and impressive architecture redolent of past imperial glory. Whether in the northern Douro Valley wine region or on the southern Algarve coast, the country offers an excellent affordable lifestyle and a very attractive fiscal regime with no wealth or inheritance taxes. Portugal also has an extensive double tax treaty network to mitigate the risk of double taxation of income earned in multiple countries. In addition, the government has stimulated inbound mobility by creating the Non-Habitual Resident regime (NHR) and the Golden Visa program.

An individual may qualify as a NHR by registering as a tax resident in Portugal, as long as they have not been tax-resident in any of the previous five years. Individuals meeting this condition may benefit from the special regime for a 10-year period, involving a special tax rate of 20% applicable to work-related income from high added-value activities as well as tax exemption for foreign-source income.

The Golden Visa programme offers a special residence card for foreigners meeting an investment criterion, including a minimum €1 million capital transfer or the purchase of real estate worth at least €500,000, allowing investors to live and work in Portugal. The residence permit also allows visa exemption for travel within the Schengen Area and the opportunity to apply for permanent residence or citizenship.

Once they decide to move to Portugal, Brazilian HNWI's[1] must meticulously assess the most efficient and compliant way to structure their wealth.

Benefits of a foreign unit-linked life insurance product

Unit-linked life insurance is a product fully recognised and compliant in Portugal. Since it entails a savings regime for individuals, it enjoys favorable tax treatment. By comparison with traditional fiduciary structures, it can be a more effective means of investing and transferring wealth in a flexible and tax-efficient way. Although many people in Portugal are not yet very familiar with this cover, demand has been increasing in recent years as the high net worth community and its advisors learn about the product and its benefits for wealth structuring and asset protection.

This enterprising product offers the unique security of a contract issued in Luxembourg, a leading investment jurisdiction that offers the protection of a rigorous regime popularly known as the Triangle of Security. In addition, Luxembourg offers tax neutrality since taxation is based on the policyholder's country of residence.

Moreover, contracts can be tailored to provide portability if individuals relocate between various jurisdictions during their lifetime. They also have access to a flexible and wide range of underlying assets, including external investment funds and internal collective funds, as well as dedicated funds that offer discretionary management according to the policyholder's personal objectives. Another interesting feature is that clients may withdraw a portion of their original investment if needed.

Regarding taxation, the attractive treatment of unit-linked life insurance in Portugal provides a broad scope for inheritance and tax planning. For death claims, life insurance benefits are tax-free, not being subject to either income tax or stamp duty. In the case of surrenders, only the portion exceeding the amount initially invested is subject to taxation. If at least 35% of the total premiums are paid in the first half of the policy lifetime, either one-fifth or three-fifths of the income may be excluded from taxation in cases where the surrender takes place after five or eight years respectively of the contractual period, which could result in an effective taxation rate as low as 11.2%.

All these factors mean that unit-linked life insurance may be the best option for Brazilian individuals resident in Portugal to hold financial assets that can produce income to be distributed throughout their lifetime. If properly structured, it can be the most efficient wealth management tool, since it offers great flexibility in terms of investment and a more attractive tax regime than other options.

In a changing world where transparency is 'de rigueur' and control is a priority for investors, unit-linked life insurance facilitates compliance with the evolving legal, regulatory and fiscal environment, at a time when certain traditional structures risk losing competitiveness and relevancy. •

1. High Net Worth Individuals

Taiza Ferreira

Is a qualified lawyer registered with the Brazilian and Portuguese Bar Associations. Taiza graduated from Law School at Pontifical Catholic University, Rio de Janeiro (Brazil) and has a master's degree in international and European business law from Université Jean Moulin Lyon III (France). Experienced in international tax advisory with a six-year 'Big Four' background in both LatAm and Europe, she has been working for the past years as a wealth structuring expert in the Luxembourg life assurance industry. Taiza is Senior Wealth Planner at OneLife.

Unit-Linked

The new distribution regime

IDD came into force on 1 October 2018. It introduces new rules enhancing client protection in the insurance industry, in parallel with similar rules recently adopted in other sectors of the financial industry. IDD is an European Directive and applies therefore to the interests of European resident clients.

In this article we focus on the distribution of insurance based investment products (IBIPs or unit-linked insurance contracts).

The creation of a level playing field

For the first time in insurance history, sales performed directly by insurance companies have been identified as distribution activity and require insurance companies to align with distribution obligations applicable to insurance intermediaries (tied or independent). Everyone involved in the 'intermediation' activity is now considered a 'distributor' and as such affected by the provisions.

The client at the heart of the product development process

Insurance companies as product manufacturers have to ensure that throughout the product development process the clients' interests are considered as a priority, adapting the product and distribution to the target market. This involves the need to describe the product's risks, to comply with prudential requirements, to respond to the general good provisions of the client's country of residence. Whilst insurers have already implemented most of this, the product development process has to be formalised with an embedded distribution strategy for each product including a regular review of the processes. Manufacturers and distributors will have to work together to ensure that the expertise and feedback from the distributor are reflected in an appropriate and suitable product offering.

Any distributor has to take a holistic view of the client's needs and personal situation. Moreover an independent intermediary is also to know the offering available in the market, to be able to compare it in the client's interest, and finally to identify together with him the offer that best suits his personal situation and requirements.

The key provisions and what it means for insurance professionals

The product development process needs to be laid down in a Product Oversight and Governance process (POG). All relevant POG information must be made available to each intermediary, depending on the products that he is authorised to distribute in the relevant markets.

IDD also imposes increased disclosure requirements. The distributor must be transparent about costs and charges and the intermediary has to disclose the cost for the distribution service and what the service is composed of.

Each distributor has to ensure a proper needs-analysis of the client. Where advice is provided by the distributor regarding an IBIP, the latter will have to complete an appropriateness and suitability check. This will be a kind of in-depth 'Know-Your-Customer' process, to obtain information on the knowledge, experience, financial situation and investment objectives of the client. Subsequently, the distributor must ensure that the contract sold corresponds to the client's needs and to the advice given to (and accepted by) him.

Insurance distributors shall act honestly, fairly and professionally and put procedures and controls in place to avoid causing any detriment to the clients and to be transparent about costs and services. •

Inge De Wolf

Joined Swiss Life Global Solutions as Legal Director in 2017. Inge looks back on more than 20 years experience in cross-border life insurance both as Legal & Tax Director and Head of Compliance, leading an international team of lawyers. She started her carrier in a small law firm before she integrated the insurance sector in Luxembourg. In 2000, she joins a leading international insurer where she heads the Legal Department for a number of years before being appointed Legal & Tax Director.
Inge has also founded consulting and brokerage structures in Luxembourg.
She is a Belgian lawyer with a degree in both Belgian and French law, a French master in Private and Banking law, and certification in investment products and international taxation. She is a London Business School graduate in Leadership & Management and a certified PNL Practitioner.
Inge is International Head of Legal Swiss Life Global Solutions.

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Unit-Linked

An efficient investment

Being very versatile for financial planning and an important wealth protection instrument, unit-linked insurance is also a very efficient investment vehicle for individuals, from a Portuguese tax perspective. In fact, under Portuguese Personal Income Tax (PIT) Code no tax is due upon the growth of the policy during its term, meaning that if no surrender occurs, no tax will be due on income or gains in the assets held within the policy (this being an important advantage when compared to direct investment). Also, in case of partial surrenders, the positive difference between the amounts paid and the income derived from the policy will only be subject to PIT if and from the moment the amounts withdrawn from the policy exceed the sum of the premiums paid.

In case of surrender, advance disposal or maturity of the policy, the positive balance between the amounts paid under the form of premiums or amounts invested by the beneficiary, and the amounts withdrawn shall be considered, for individual taxation purposes, as investment income (capital income). In order to encourage these savings instrument, the Portuguese legislator established a regime provided to which, where the sum of the premiums paid during the first half of the term of the policy amounts to, at least, 35% of the total premiums paid during the term of the policy, the taxable income will be reduced as follows: if the maturity occurs (i) between the 5th and the 8th year of the duration the policy, only 80% of the above difference will be subject to tax, (ii) on or after the 8th year of the duration of the policy, only 40% of the above difference will be subject to tax. In the remaining cases, the total amount of the income shall be subject to tax. The taxable income (i.e., 100%, 80% or 40% as applicable) shall be subject to 28% flat rate (resulting in effective tax rates of 28%, 22.4% and 11.20%, respectively). Alternatively – even though it is generally less favorable – the taxpayer has the option to include (aggregate) such income with other sorts of ordinary taxable income (e.g., business, employment, pensions). In that case the income will be subject to tax at progressive rates up to 48%, plus additional solidarity surtaxes.

Under the special Non-Habitual Residency (NHR) regime, taxable persons who meet the conditions to qualify as residents under Portuguese law and have not been tax residents in this territory in the five preceding years may benefit from the special scheme for a period of 10 years. The granting of NHR status allows taxpayers to obtain tax advantages in respect of the following income sources: (i) employment and self-employment income obtained in Portugal from high added value activities as listed in a ministerial order; (ii) employment income; self-employment income from high added value activities; passive income and pension income, whenever, in any of these cases, the income is earned abroad.

As far as passive income is concerned, it includes interest, dividends, other investment income, rental income and capital gains. This class of income will be exempt from Portuguese taxation as long as (i) It may be taxed in the source state in accordance with a double taxation agreement made between Portugal and that state, or in case no tax treaty exists, if: (a) this income may be taxed in the source state in accordance with the

OECD Model Tax Convention; (b) the same is not deemed earned in Portugal under the PIT Code; and (c) the country, territory or region that is the source of the income is not on the Portuguese list of tax havens.

Therefore, when derived from a Portuguese source, the income originating from unit-linked insurance will not benefit from NHR scheme but will be taxed in accordance with the advantageous regime described above. When the insurance company is not located in Portugal, the exemption of the income received under NHR status depends on whether the tax treaty entered into force with the source country refers to the definition of interest of each of the signatory countries and the income is qualified as such under such source country legislation. Hence, in most cases, although income will not be exempt under NHR and will be subject to PIT according to the general rules applicable to this instrument although we are aware that in certain jurisdictions and under certain circumstances this status quo may be about to change very soon. Finally, note that there is no inheritance tax in Portugal. Gifts and transfers upon death are subject to Stamp Tax (at a 10% rate), although gifts and transfers upon death between spouses and between parents and their children are exempt from Stamp Tax for both the donors and the recipients, regardless of their tax residency. Nonetheless, credits arising from life insurance policies, notably death benefits, are not subject to Stamp Tax regardless of who the beneficiaries are and what is their family relationship with the policyholder or the life assured.

Hence, even if NHR do not benefit from an exemption on income derived from unit-linked, this instrument allows for a very efficient tax planning, providing for policyholder to determine when (and if) liability to tax arises, benefitting from a tax saving (under circumstances described) and allowing no Stamp Tax to arise on payments to beneficiaries of insurance policy irrespectively of the degree of kinship with the policyholder. •

> “unit-linked insurance is also a very efficient investment vehicle for individuals, from a Portuguese tax perspective.”

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