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Using Life Insurance and Annuities in U.S. Tax Planning for Foreign Clients

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A Note on Terminology: This article focuses on “foreign clients,” i.e., non-U.S. citizen (hereinafter “non-citizen”) clients who are nonresidents for both U.S. federal income tax (hereinafter “U.S. income tax”) and U.S. federal transfer tax (hereinafter “U.S. transfer tax”) purposes. A non-citizen who is classified as a resident for U.S. income tax purposes is referred to herein as a “resident alien” (“RA”), a non-citizen who is classified as a nonresident

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for U.S. income tax purposes is referred to herein as a “nonresident alien” (“NRA”), a non-citizen who is classified as a resident for U.S. transfer tax purposes (where the determination of residency is based on domicile) is referred to herein as a “resident non-citizen” (“RNC”), and a non-citizen who is classified as a nonresident for U.S. transfer tax purposes is referred to herein as a “nonresident non-citizen” (“NRNC”).

INTRODUCTION: AN ELEGANT SOLUTION TO DIFFICULT PROBLEMS

U.S. tax planning for foreign clients involves complex issues and even more complicated rules. Advanced planning can, however, provide significant opportunities for clients to minimize or avoid costly tax consequences. The issues faced by these clients include high tax liabilities associated with potential accumulation distributions from undistributed net income earned in foreign trusts and taxation of an NRA’s U.S.-source income and an NRNC’s U.S.-situated assets.

As discussed in this article, investing a foreign client’s funds in a life insurance or an annuity policy can provide an elegant solution to many of these issues and numerous additional benefits. Life insurance and, to a lesser extent, annuities have long been favored under the U.S. Internal Revenue Code. Further, life insurance and annuities can be used as: (1) estate planning tools to mitigate estate tax liability

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and facilitate the orderly disposition of assets at death; (2) asset security vehicles, offering both financial privacy and protection from future creditors; and (3) mechanisms to augment the philanthropic goals of charity-minded clients. In some cases, life insurance and annuities can also reduce or defer clients' income tax liabilities through tax-free growth inside properly structured policies and via the avoidance of taxes and penalties associated with certain distributions from foreign non-grantor trusts. Finally, investing in life insurance or an annuity contract can also ease clients' income tax compliance burdens.

This article addresses the ways in which life insurance and annuities can be employed to maximize the benefits of these powerful planning tools, focusing on ways to minimize or avoid U.S. income and transfer taxes for foreign clients. We will examine the fundamentals of life insurance and annuities including the various types of life insurance available in the marketplace and basic structuring issues relating to annuities. We will discuss the U.S. tax rules that must be satisfied for a contract to qualify as life insurance or an annuity and, in some cases, a variable contract. We will analyze the U.S. income tax treatment and estate tax treatment of life insurance and annuities. Finally, we will discuss applications of life insurance and annuity planning to several key international estate planning topics, including the use of foreign trusts, pre-immigration planning, and the benefits of annuities for temporary U.S. residents.

STRUCTURING LIFE INSURANCE AND ANNUITIES

Types of Life Insurance

The primary types of life insurance in which a client may choose to invest are term life, whole life, variable life, universal life, variable universal life, and private placement variable universal life insurance. The practitioner should carefully consider the risks and benefits of each type of insurance as applied to the specific needs of the client before pursuing coverage under any of these various types of policies.¹

Term Insurance

As the name implies, term life contracts insure an individual for a predetermined specified term of years, provided the scheduled premium is paid timely, and the insurance expires at the end of the term. No death benefit is paid if the insured does not die during the specified term.

Whole Life Insurance

Whole life insurance insures an individual for his or her entire lifetime. The most common type of

whole life insurance is ordinary level-premium insurance, which has three components: (1) level periodic premiums payable for life; (2) a level death benefit; and (3) a schedule of cash surrender values that increase year by year, potentially positively impacted based on the insurance policy dividends paid by the insurance company within the policy.

Thus, the key differences between term insurance and whole life insurance are the continuing nature of the whole life insurance for the entirety of the insured's life and the steadily increasing cash surrender benefit available with whole life insurance.

Variable Life Insurance ("VL")

Variable life insurance is quite similar to whole life insurance but with additional flexibility for the policy owner, who may invest policy cash values in underlying investment selections (similar to mutual funds). Also, VL policies differ from whole life policies in several additional important ways: the VL contract is held in a segregated account that is separate from the insurance company's general account, and not subject to the claims of the general creditors of the insurance company (the "general account" is nomenclature used to describe the collective group of assets — typically fixed-income-type securities — held by an insurance company to satisfy its policyholder cash value liabilities); investment risk associated with the VL policy is borne by the policy owner, rather than the insurance carrier; and the VL death benefit is variable, rather than fixed.

Universal Life Insurance ("UL")

Universal life insurance policies are significantly different from term, whole, and variable life insurance policies. With UL contracts, the policy owner has significantly more flexibility and control over the structuring of the policy, including — within limits — the ability to alter the premium payment schedule, change the policy death benefit, and choose between various death benefit planning options. Also, during the life of the policy, policy cash values directly reflect interest crediting rates established by the carrier based on performance of the underlying assets in the general account. Because UL policies typically amortize the costs of commissions and underwriting (rather than front-end loading the charges, as would be the case with a typical whole life policy), UL policies tend to be more efficient than whole life contracts, and policy cash values generally grow more quickly.

Variable Universal Life Insurance ("VUL")

A hybrid of sorts, a retail (non-private-placement) variable universal life insurance policy combines features of both VL and UL insurance contracts. These policies not only allow flexibility with respect to the timing and amount of premium payments, death benefit options and levels, and withdrawals from the policy, but also allow the policy owner to allocate cash value amounts across a wide range of mutual-fund-like investment options. As with UL policies, many of the commission charges and underwriting charges are amortized over the life of the contract. As

¹ For an excellent, comprehensive review of the types of life insurance currently available in the marketplace, see Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis with Forms* (2d ed. 2004) (hereinafter "Zaritsky").

a VUL policy is a registered security, a prospectus is required to be provided to the prospective purchasers.² Furthermore, most UL and VUL contracts have meaningful surrender charges. Surrender charges are charges that are assessed against the cash value of a policy in the event of a surrender within a stated period of years (typically declining over the first 10–20 years of a policy). As many of the costs are amortized over the expected life of the policy, the surrender charge serves as a mechanism to reimburse the insurance company for the unamortized costs in the event of a surrender of the policy for a reason other than death of the insured.

Private Placement Variable Universal Life Insurance (“PPLI”)

Private placement life insurance policies are generally structured as VUL contracts offered as “private placements” in the high-net-worth marketplace. These policies are generally much less expensive than their retail equivalents (thus allowing for better accretion on premium contributions) and provide access to sophisticated investment funds (such as alternative investment classes including hedge funds, fund of funds, real estate, options, etc.). PPLI is much less expensive than its retail equivalents for several reasons, the primary reason being agent compensation. Agent compensation for retail policies can be as high as 120% of the first-year premium. Agent compensation for PPLI policies tends to be expressed as a percentage of cash value typically ranging from 0.20% to 0.50% with minimum front-end premium-based compensation. To qualify as a PPLI purchaser, prospective policy owners who are U.S. persons must meet the criteria for “accredited investors” (“AIs”) and “qualified purchasers” (“QPs”) under Securities and Exchange Commission (SEC) rules.³ Non-U.S. persons, while not required to satisfy the accredited in-

² These policies are registered under the Securities Act of 1933, as amended; segregated accounts are typically registered under the Investment Company Act of 1940, as amended.

³ Private placement products offered by U.S. carriers to U.S. persons are subject to SEC regulations. Each purchaser generally must be a “qualified purchaser” under §2(a)(51) of the Investment Company Act of 1940, 15 USC §80a-2(a)(51), and an “accredited investor” under §501(a) of Regulation D of the 1933 Act, 17 CFR §230.501(a). The definition of an “Accredited Investor” includes, among other investors:

- (i) any organization described in §501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;
- (ii) any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000;
- (iii) any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

vestor and qualified purchaser rules for U.S. securities law purposes, will also be required by most insurance carriers to qualify as AIs and QPs. The primary purpose for this requirement is ease of administration for the carriers and funds who will not want to distinguish between fund investors but rather, want to ensure AI and QP status for all investors in the fund.

Annuity Basics

As with life insurance, there are various types of annuities. However, at their essence, annuities are either immediate or deferred and either fixed or variable.

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- (iv) any trust, with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in §230.506(b)(2)(ii); and
 - (v) any entity in which all of the equity owners are accredited investors.

17 CFR §230.501(a).

A “Qualified Purchaser” is defined as:

- (i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under §80a-3(c)(7) of this title with that person’s qualified purchaser spouse) who owns not less than \$5,000,000 in investments, as defined by the Commission;
- (ii) any company that owns not less than \$5,000,000 in investments and that is owned directly or indirectly by or for two or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons;
- (iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or
- (iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than \$25,000,000 in investments.

15 USC §80a-2(a)(51)(A).

Offering memoranda for PPLI policies offered by non-U.S. carriers typically reference “qualified purchaser” or “accredited investor” standards, as used in U.S. securities law, to describe suitable investors. In the offshore context, this should be considered merely a guideline and not a strict requirement because offshore policies are not actually subject to SEC regulations. However, if the premiums of an offshore PPLI policy are to be invested in funds that do require investors to be “qualified purchasers,” then it can be argued that the policy owner must be a “qualified purchaser” for that purpose.

Immediate Fixed Annuity

The annuity owner pays a lump sum to the insurance company. The insurance company invests the annuity proceeds in the insurer's general account assets and the insurer periodically (monthly, quarterly, or annually) pays a fixed amount to the annuitant. It is important to note that the amount paid to the annuitant is fixed regardless of investment market conditions. The insurance carrier assumes the investment risk and invests the annuity proceeds in a manner that will most likely yield a higher return than the fixed return paid to the annuitant.

Deferred Fixed Annuity

With a deferred fixed annuity, the annuity owner pays either a lump sum or, more commonly, periodic payments to the insurance company over a stated period of time. The contract assets (i.e., cumulative payments and accreted investment return) grow on a tax-deferred basis until the contract is annuitized and payments to the annuitant begin. Again, the investment risk is borne by the insurance carrier. As such, it is possible to receive cumulative periodic distributions that exceed the accreted value of the annuity assets.

Immediate and Deferred Variable Annuities

Both immediate and deferred variable annuities work like their fixed counterparts with one significant exception. With variable annuities, the periodic payment fluctuates with the underlying investment return. The annuity owner chooses how the annuity assets are invested, selecting from a variety of mutual funds (or alternative investments, for unregistered private placement annuities).

Annuitization

With all annuities, the payout period is determined once the annuitization occurs (i.e., payout begins). Typically, the payout option is either life certain, where the payments are guaranteed for as long as the annuitant is living, or period certain, where the payout is guaranteed for a certain period of time (e.g., 10 years, 20 years, etc.), provided the annuitant is living. With a period certain annuity, it is possible that the annuitant could die during the payout period. Some annuities provide that under such a scenario, the undistributed accumulated amount reverts to the insurance company, instead of being paid to a designated beneficiary.

U.S.-Issued Versus Offshore-Issued Products

From a purely U.S. perspective, the global life insurance and annuities market could be divided into products that are U.S. tax-compliant and those that are not U.S. tax-compliant. By "compliant," we are referring to life insurance policies that meet the definition of a "life insurance contract" under §7702⁴ or annuity contracts that meet the requirements of §72. U.S.-

compliant life insurance and annuity contracts are generally issued by U.S. companies, by offshore companies that have elected under §953(d) to be treated and taxed under Subchapter L as a domestic insurer (a "§953(d) election"), or by offshore companies that have not made such an election.⁵

Focus on Investment in U.S.-Compliant Products

In order to realize the generous tax benefits afforded to life insurance and annuity contracts under U.S. income tax laws, U.S. taxpayers must own U.S.-compliant contracts. The same holds true for non-U.S. persons with potential or future ties to the United States. Thus, it is important for NRA/NRNCs who are planning for temporary residency or preparing to immigrate to the United States and for foreign trusts with U.S. beneficiaries to acquire U.S.-compliant products in order to achieve their tax goals. For this reason, unless specified to the contrary, this article addresses the use of U.S.-compliant products only.

Domestic Versus Offshore Life Insurance Companies

As stated above, U.S.-compliant products are issued by domestic and offshore insurance companies; the offshore companies include those that have made a §953(d) election (typically, offshore subsidiaries of large U.S. insurers) ("§953(d) companies") and those that have not made that election ("non-§953(d) companies"). Generally speaking, the U.S.-compliant products issued by all three types of companies are very similar in design, pricing, and investment options, though (as discussed later in this article) certain applications will suggest whether or not to use a domestic or offshore insurer.

Typically, offshore companies are located in jurisdictions with fewer regulatory restrictions than those imposed on domestic carriers. One product of less restrictive regulation is that offshore carriers tend to have greater flexibility in timing the payout of a life insurance policy's death benefit, allowing the carrier to offer certain investment options not available on domestic insurance platforms — for example, hedge funds with restricted liquidity. One of the primary reasons, however, for acquiring insurance (particularly PPLI) from an offshore carrier is the reduced acquisition cost. Contracts issued and procured offshore do not incur U.S. state premium taxes, which can range from 2%-3% of the premiums paid. For a large PPLI policy, these savings can cover many of the transaction costs associated with the policy's acquisition and foreign ownership structure.⁶ Also, compared to their domestic counterparts, §953(d) companies tend to

"§" references are to the Internal Revenue Code of 1986, as amended ("the Code") and all "Regs. §" references are to the Treasury Regulations issued under the Code (and set forth in 26 CFR).

⁵ It is also possible for a foreign company to operate directly in the United States, in which case its U.S. operations would be subject to tax under Subchapter L of the Code.

⁶ Offshore insurance companies tend to require that the policy-

⁴ Unless the context clearly indicates otherwise, all section or

charge lower deferred acquisition cost expenses (commonly referred to as “DAC taxes”), usually resulting in savings of 0.30% or more of premiums paid — savings that can be material in the scope of large premiums for a PPLI policy. While non-§953(d) companies do not charge DAC tax expenses at all, premiums paid by a U.S. person to a non-§953(d) company are subject to a U.S. federal excise tax of 1.0%,⁷ which might suggest that NRA clients acquire a policy from a non-§953(d) company prior to residing in the United States. Of course, when acquiring an insurance or annuity contract from an offshore company, the client should ensure that the policy is acquired from a reputable carrier and is actually U.S.-compliant. Fewer regulatory restrictions in offshore jurisdictions may also result in limitations on enforcing a claim against an offshore insurer. Moreover, the policy owner should consider the possibility that its investment may be adversely affected by political changes in the offshore jurisdiction. Finally, acquiring a policy offshore may be more cumbersome than investing in a domestic policy, because the insured will be required to travel to the offshore jurisdiction in order to undergo medical underwriting.

QUALIFYING AS LIFE INSURANCE OR AN ANNUITY

To qualify as life insurance for tax purposes, and enjoy the tax benefits associated with life insurance, a life insurance policy must satisfy the requirements of §7702. To qualify as an annuity, the annuity contract must satisfy the requirements of §72. Further, all variable contracts, whether life insurance or annuities, must comply with the diversification requirements of §817(h) and with the investor control doctrine.

Section 7702: Life Insurance Contract Defined

To qualify for the advantages afforded life insurance under the Code, a policy must satisfy the definition of life insurance under §7702. Under this section, a “life insurance contract” must: (1) be treated as a life insurance contract under applicable state or foreign law; and (2) meet one of two alternative tests: (a) the cash value accumulation test (“CVAT”); or (b) a two-part test consisting of the guideline premium test (“GPT”) and the cash value corridor test (“CVCT”).⁸ The purpose of these tests is to ensure that the goal of acquiring the contract is to secure life insurance by disqualifying policies created for their investment component without regard to the actual relationship between the cash value and the contractual death benefit.

CVAT

Section 7702(b) establishes the CVAT. A contract satisfies this test if, by the contract’s terms, the cash

owning entity be offshore as well, in order to minimize the policy’s nexus to the United States.

⁷ §4371.

⁸ §7702(a).

surrender value of the contract may not at any time exceed the net single premium that a policyholder would have to pay at such time to fund future benefits under the contract (effectively, a certain relationship must exist between the cash value and the death benefit at any point in time). The CVAT assumes a maturity no earlier than the insured’s reaching age 95 and no later than the insured’s reaching age 100, and is generally applied to test whole life contracts.

GPT and CVCT

Section 7702(c) and (d) set forth the GPT and the CVCT, respectively. A policy satisfies the GPT if the sum of the premiums paid under the contract does not at any time exceed the “guideline premium limitation” at that time.⁹ The CVCT is satisfied if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value.¹⁰ At age 40, the applicable percentage is 250%; it decreases in increments to 100% at age 95.¹¹

Section 72: Amounts Received as an Annuity

An annuity is a contract, generally issued by an insurance company, providing for regular payments to an annuitant and, potentially, to a beneficiary following the annuitant’s death. The Treasury Regulations state that to be considered “amounts received as an annuity,” such amounts should be:

- received on or after the annuity starting date;
- payable at regular intervals; and
- payable over a period of at least one year from the annuity starting date.¹²

Further, the total of the amounts payable must be determinable as of the annuity starting date.¹³

Payments may also be considered amounts received as an annuity if they are paid under a variable annuity contract, despite the fact that the total of the amounts payable under the variable contract may not be determinable as of the annuity starting date, if the amounts are to be paid for a definite or determinable time.¹⁴ If, because of positive investment experience in the variable annuity contract or other factors, the payment with respect to the annuity exceeds the investment in the contract (adjusted for any refund feature) divided by the number of anticipated periodic payments, then only part of the payment will be con-

⁹ §7702(c)(1).

¹⁰ §7702(d)(1).

¹¹ §7702(d)(2).

¹² Regs. §1.72-2(b)(2).

¹³ *Id.*

¹⁴ Regs. §1.72-2(b)(3).

sidered an amount received as an annuity.¹⁵ The excess is an “amount not received as an annuity.”

There is an important exception that applies to annuities issued by certain foreign insurers. In 2002, the IRS issued final regulations under §1275 clarifying that annuities issued by a foreign insurer that is not, or does not elect to be, subject to tax under Subchapter L of the Code on income earned on the annuity contract will not be taxed as annuities under §72. Instead, they will be treated as “debt instruments” subject to current taxation under the “original issue discount” provisions of the Code.¹⁶

A “debt instrument” is broadly defined to mean a bond, debenture, note or certificate, or other evidence of indebtedness.¹⁷ While the very nature of a variable annuity seems to preclude treatment of the insurer’s obligations as some form of indebtedness, a fixed annuity contract does constitute evidence of an indebtedness owed by the insurance carrier to the annuitant. As such, any accreted value of a fixed (whether immediate or deferred) annuity issued by a foreign insurer not subject to tax under Subchapter L of the Code on income earned on the annuity contract will be currently taxable to the annuity’s owner for U.S. tax purposes.¹⁸

Section 817: Treatment of Variable Contracts

If the client desires to invest in a variable contract (whether a life insurance variable contract or a variable annuity), then additional requirements must be satisfied under §817 to ensure preferential treatment under the tax code. Under this section, the investments made by a segregated asset account on which a variable contract is based must be “adequately diversified.”¹⁹ Further, the policy owner cannot engage in conduct deemed to be “investor control.”²⁰ If the account is not adequately diversified or if the contract owner violates the investor control doctrine, the contract owner will be deemed to directly own all of the policy’s assets, thereby causing the separate account’s income to be taxable to him or her.

Diversification

To be adequately diversified, the assets of the segregated asset account (the “account”) must be in-

vested in the securities of at least five different issuers, and:

- no more than 55% of the value of the total assets of the account may be represented by any one investment;
- no more than 70% of the value of the total assets of the account may be represented by any two investments;
- no more than 80% of the value of the total assets of the account may be represented by any three investments; and
- no more than 90% of the value of the total assets of the account may be represented by any four investments.²¹

For these purposes, all securities of the same issuer, all interests in the same real property project, and all interests in the same commodity are treated as a single investment.²² Further, each U.S. government agency or instrumentality is treated as a separate issuer.²³

In some cases, a life insurance policy’s segregated asset account may “look through” an investment partnership (such as a hedge fund or fund of funds) to its underlying investments to determine whether or not it meets the diversification rules outlined above. In other words, investment in the partnership is not treated as a single investment; rather, it is treated as an investment in the various funds in which the partnership itself is invested, thereby making it easier for the policy’s separate account to satisfy the diversification requirements of §817(h).

Certain investment companies, partnerships, and trusts may qualify for such “look-through” treatment under Regs. §1.817-5(f) if: (1) all the beneficial interests in the investment company, partnership, or trust are held by insurance company segregated asset accounts; and (2) public access to the investment company, partnership, or trust is available exclusively through the purchase of a variable contract.²⁴ If the account qualifies for such treatment, then beneficial interests in investment companies, partnerships, and trusts held by the account will not be treated as single investments of the account; rather, a pro rata portion

¹⁵ *Id.*

¹⁶ §§163(e) and 1275(a)(1)(B), and Regs. §1.1275-1(k).

¹⁷ §1275(a)(1)(A).

¹⁸ While this rule typically applies only to fixed annuities and not to variable annuities, caution should be exercised with all foreign annuities, as it may be possible that different types of annuitization provisions in *variable* annuity contracts could trigger the application of §1275.

¹⁹ §817(h).

²⁰ See Rev. Rul. 2007-7, 2007-7 I.R.B. 468; Rev. Rul. 2003-92, 2003-33 I.R.B. 350; Rev. Rul. 2003-91, 2003-33 I.R.B. 347; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12, *modified by* Rev. Proc. 99-44, 1999-48 I.R.B. 598; PLR 200601007; PLR 200601006; PLR 200244001.

²¹ Regs. §1.817-5(b)(1)(i).

²² Regs. §1.817-5(b)(1)(ii).

²³ §817(h)(6).

²⁴ Regs. §1.817-5(f)(2). Funds satisfying these two requirements are generally referred to as “insurance-dedicated funds” (“IDFs”). Notwithstanding the general rule that only insurance company segregated asset accounts may hold interests in the investment company, partnership, or trust, there are some exceptions that allow other investors to hold such interests. See Regs. §1.817-5(f)(3); see also Rev. Rul. 2007-7, 2007-7 I.R.B. 468 (addressing the exception of investors described in Regs. §1.817-5(f)(3) from inclusion as members of the “general public”).

of each asset of the investment company, partnership, or trust will be treated as an asset of the account.²⁵

The diversification rules must be satisfied on the last day of each quarter of a calendar year (i.e., March 31, June 30, September 30, and December 31) or within 30 days after the last day of the quarter to be considered adequately diversified for such quarter.²⁶

Investor Control

A variable contract may also lose its tax-preferred status if the contract owner engages in conduct deemed to be “investor control.” Investor control may occur when the contract owner determines investment strategy or makes investment decisions for the segregated asset account, including determining the specific allocation of the assets of the segregated asset account or requiring the manager of the account to acquire or dispose of any particular asset or to incur or pay any particular liability of the account.²⁷ Likewise, to avoid investor control, there cannot be any prearranged plan or agreement between the account manager and the policy owner to invest any amounts in any particular asset or subject to any particular arrangement.²⁸ With regard to management of any account assets, the account manager cannot consult with or rely upon the advice of any person that the account manager knows is a policy owner, beneficiary of a policy, a beneficial owner of any entity that is a policy owner, or fiduciary or beneficiary of a trust the trustee of which is a policy owner.²⁹

U.S. INCOME TAX TREATMENT OF LIFE INSURANCE AND ANNUITIES

U.S. Income Tax Treatment of NRAs and U.S. Citizens and RAs Generally

As a predicate for a discussion of the U.S. income tax treatment of life insurance and annuities and the planning that can be accomplished therewith, it is important to briefly address the general taxing framework applicable to nonresident aliens (NRAs), as compared with the tax rules applicable to U.S. citizens and resident aliens (RAs). U.S. citizens and RAs are taxed on their worldwide income, regardless of the source of that income and whether it is “con-

²⁵ Regs. §1.817-5(f)(1).

²⁶ Regs. §1.817-5(c)(1).

²⁷ See Rev. Rul. 2003-91, 2003-33 I.R.B. 347; PLR 200601006.

²⁸ Rev. Rul. 2003-91, 2003-33 I.R.B. 347; PLR 200601006; PLR 200420017.

²⁹ In CCA 200840043, which resulted from a withdrawn PLR, the Service opined that direct investment by the segregated asset account in assets that are available to the general public will result in a violation of the investor control doctrine; but most commentators have stated that the Service’s position was unsupported by existing law and represented a material departure from the Service’s previous statements on this doctrine.

nected” to any U.S. business.³⁰ This worldwide income is subject to the regular tax rates set forth under §1.

NRAs, on the other hand, are taxed only on taxable income “effectively connected” with the conduct of a U.S. trade or business and on certain U.S.-source gross income not connected with a U.S. trade or business.³¹ An NRA’s effectively connected taxable income is taxed at the regular tax rates applicable to U.S. citizens and RAs,³² and his or her non-effectively connected gross income is taxed at a rate of 30%, or a lower rate set by an income tax treaty.³³ It should be emphasized that this tax is applied only on amounts that otherwise constitute gross income under the Code.³⁴ Therefore, when planning for NRAs, the practitioner must first determine whether an amount would be includible in gross income under general tax principles. Then, the practitioner must consider whether the income is U.S.-source.

As with any planning involving the laws and rules of other jurisdictions, it is important to consider the potential impact of any income tax treaty between the United States and the other country. The United States is a party to more than 65 bilateral income tax treaties.

U.S. Income Tax Treatment of Life Insurance

Life insurance is a powerful planning tool due to its favorable treatment under the Code. While under §61(a)(10), gross income includes income from life insurance and endowment contracts, other Code sections — as discussed below — exclude substantial life insurance-related sums from the gross income of policyholders and beneficiaries alike.

Internal Build-Up

If a life insurance contract qualifies as life insurance under §7702, the accreted value on the investment in the contract, or basis, of that policy (i.e., inside build-up) is not taxed to the contract owner dur-

³⁰ §1; Regs. §1.1-1(b).

³¹ §§2(d), 871. U.S.-source gross income not effectively connected with a U.S. trade or business generally includes amounts received from sources within the United States as interest, dividends, annuities, and other fixed or determinable annual or periodical (“FDAP”) gains, profits, and income. §871(a). Importantly, such U.S.-source income also includes income from annuities and life insurance contracts issued by U.S. life insurance companies as well as foreign branches of U.S. life insurance companies. Rev. Rul. 2004-75, 2004-31 I.R.B. 109.

³² §871(b).

³³ §871(a); Regs. §1.871-12. This tax is generally imposed through withholding at the source. §1441.

³⁴ Regs. §1.871-7(a)(2). The regulations refer to the taxation of annuities as an example, stating that the amount of an annuity that is subject to tax under §871 is determined in accordance with §72. *Id.*

ing the policy's term.³⁵ This provides a particular benefit to investors seeking to invest tax-efficiently. Such investors can invest in assets that generate taxable returns through a variable life insurance policy and avoid the income tax ordinarily associated with such returns.³⁶

Distributions During Policy Term from a Policy Other Than a Modified Endowment Contract ("MEC")

If withdrawals are allowed under a policy contract, the policyholder taking a withdrawal will receive cash from the insurer in exchange for a partial surrender of the policyholder's rights under the policy.³⁷ If the policy is not a modified endowment contract (i.e., it is a "non-MEC") under §7702A, then the withdrawal can be effectuated tax-free up to the premium(s) previously paid with respect to the policy, subject to certain limitations (the "premium first" rule).³⁸ To the extent that the withdrawal exceeds the policyholder's basis in the contract, the withdrawal will be fully taxable to the extent of the accumulated income in the cash surrender value.³⁹ The investment in the contract as of any date is the "aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income" at the time such amount was received.⁴⁰

Policy loans and pledges or assignments of the policy are generally not treated as distributions and do not reduce the death benefit under the policy.⁴¹ To the extent, however, that a policy loan is not repaid prior to the death of the insured, the amount of such loan (and any accrued but unpaid interest associated therewith) will be deducted from the death benefit proceeds before payment to the beneficiaries.

Distributions During Policy Term from a MEC

The tax impact of the life insurance contract is different, however, if the policy is a MEC under §7702A. The key planning consideration in deciding whether to structure a policy as a MEC is whether: (1) the policy owner expects to require access to policy funds during the policy term; or (2) the purpose of the policy is to pass wealth from one generation to the next without requiring access to policy cash values. If

the policy owner does not plan or desire to withdraw money from the policy, then a MEC policy may be preferable due to the superior tax-free compounding effect achieved by a one-time, up-front premium payment and a smaller necessary relationship between the cash and death benefit, thus effectively reducing the insurance cost.

A policy will be considered a MEC under §7702A if it was entered into after June 21, 1988, and it fails to meet the "7-pay" test under §7702A(b).⁴² A contract fails to meet the 7-pay test if the accumulated amount the policy owner pays under the contract at any time during the first seven contract years exceeds the sum of the net level premiums that the policy owner would have paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums.⁴³ Generally speaking, non-MECs are characterized by a premium paid over several years (typically four to seven), or even for the duration of the policy, and MECs are characterized by a one-time, initial premium payment.

If the policy is structured as a MEC, an "income-first" rule will apply and a withdrawal from the policy will be fully taxable up to the amount of any gain in the policy assets before the withdrawal.⁴⁴ Furthermore, the withdrawal will be taxed at ordinary income tax rates, and it generally will be subject to a 10% penalty if the insured is under 59½ years of age.⁴⁵ To the extent that the withdrawal amount exceeds the policy's accumulated income, the remainder of the withdrawal will be tax-free as a withdrawal of the investment in the contract.⁴⁶

Surrender or Maturity of Policy Contract

When a life insurance policy is surrendered, or if a policy matures because the insured reaches the age to which that individual was insured,⁴⁷ the policyholder will have ordinary income to the extent that the amount received by the policyholder exceeds the policyholder's investment in the contract.⁴⁸

Policy Proceeds

Under §101(a)(1), life insurance proceeds are not included in the gross income of the insurance policy's beneficiary, absent the application of the "transfer for value" rules of §101(a)(2) or certain other exceptions noted in §101.

Income Taxation of Life Insurance Applicable to NRAs

An NRA will be subject to tax on amounts received under a life insurance contract only to the extent that

³⁵ §7702(g). If the contract fails to qualify as life insurance under the provisions of §7702, then the income on the contract will be taxed to the contract owner annually. *Id.*

³⁶ Of the various types of life insurance discussed in this article, PPLI offers the most efficient investment opportunities due to its significantly reduced cost structure, as compared to registered or "retail" variable universal policies.

³⁷ Zaritsky ¶2.05[2].

³⁸ §72(e)(5). Withdrawals made within the first 15 years of the policy's life may be subject to so-called "recapture" tax. §7702(f)(7).

³⁹ §72(e)(5)(A).

⁴⁰ §72(e)(6).

⁴¹ §7702(f)(7); Zaritsky ¶2.05[2][b].

⁴² §7702A(a).

⁴³ §7702A(b).

⁴⁴ §72(e)(10)(A).

⁴⁵ §72(q).

⁴⁶ §72(e)(10)(A).

⁴⁷ Most carriers offer, either as part of the policy itself or as an endorsement to the policy, a maturity extension benefit allowing the policy to mature at the later of the stated maturity or the death of the insured, thus avoiding any adverse tax consequences of living past the stated maturity of the policy.

⁴⁸ §72(e)(5)(A), (E).

such amounts would be included in the gross income of a U.S. citizen or RA. Thus, the rules governing the taxation of life insurance discussed above generally apply equally to an NRA as to a U.S. citizen or RA. The primary difference between the taxation of NRAs and the taxation of U.S. citizens and RAs lies in the tax rates applied to each. To the extent that amounts received by an NRA under a life insurance contract are taxable, they will generally be subject to the 30% tax under §871 and withholding under §1441, rather than the ordinary income tax rates under §1.

U.S. Income Tax Treatment of Annuities

As with life insurance, annuities are tax-favored investments under the Code. Unlike life insurance, however, the primary income tax benefit of an annuity is derived from: (1) the ability to defer the payment of income tax on the annuity payments; and (2) the compounding effect of the tax deferral, rather than the avoidance of income tax, as with investment in a life insurance policy. Generally, under §72(a), gross income includes any amount received as an annuity under an annuity, endowment, or life insurance contract. The income tax effect of an annuity depends, however, on numerous factors, such as whether the tax is being applied to a distribution during the annuity's accumulation period or annuitization period, and whether the distribution occurs after the death of the holder of the annuity contract or after the death of the annuitant (assuming that the holder and the annuitant are different persons).

Tax During Accumulation Period

If the annuity contract holder is a natural person, income on the annuity contract will generally not be taxable during the accumulation period of a deferred annuity. If, however, the annuity holder opts to take a non-annuity distribution ("NAD," which may take the form of a withdrawal, loan, assignment, or pledge), then the distribution typically will be subject to tax as ordinary income to the extent of the income on the contract.⁴⁹ The distribution may also be subject to a 10% withdrawal penalty.⁵⁰ If a NAD exceeds the income on the contract, the excess distributed will not be subject to tax, but the distribution will reduce the owner's investment in the contract. If the holder takes a loan against the annuity contract, or assigns or pledges the contract, then the investment in the contract will be increased by the amount included in the holder's gross income as a result of that loan, assignment, or pledge.⁵¹

If a person other than a natural person is proposed as the annuity contract holder, additional care must be

⁴⁹ See §72(e)(2)(B), (4). With respect to the tax rate applied to NADs, U.S. citizens and RAs are subject to the standard rate structure for gross income. §§1, 72. NRAs, on the other hand, are generally subject to a flat 30% tax and withholding on the income derived from the NAD. §§871(a), 1441.

⁵⁰ §72(q).

⁵¹ §72(e)(4).

taken to ensure that the contract will still qualify as an annuity.⁵² Otherwise, the contract will not be treated as an annuity and income on the contract will be taxable to the holder as ordinary income during both the accumulation and annuitization periods.⁵³ A contract holder that is not a natural person will not be taxed on the contract income, however, if such person merely holds the annuity as an agent for a natural person.⁵⁴ Section 72(u)(3) sets forth additional exceptions to this requirement that the contract holder be a natural person, including exemptions for annuity contracts that are acquired by a decedent's estate, annuity contracts held under a §401(a) or §403(a) plan or under an IRA or §403(b) program, and immediate annuities.⁵⁵

Tax During Annuitization Period

During the annuitization period, each payment under an annuity has two components: (1) income on the annuitant's investment in the contract; and (2) principal.⁵⁶ Generally, a part of each annuity payment constitutes a return of the cost of the annuity and is excluded from income. The remainder of the payment is income to the annuitant. For U.S. citizens and RAs, the return on the annuity is taxed at ordinary income rates. NRAs are subject to a 30% tax and withholding under §§871 and 1441.

The taxable and nontaxable portions of the annuity are calculated using the "exclusion ratio." Application of the exclusion ratio limits gross income to "that part of any amount received as an annuity bearing the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date)."⁵⁷ The exclusion is, however, limited to the holder's unrecovered investment in the contract.⁵⁸ NADs paid during the annuitization period are generally included in gross income and taxed as ordinary income to the recipient.⁵⁹

⁵² See §72(u).

⁵³ §72(u)(1).

⁵⁴ *Id.*; see PLR 200626034 (example of how trust may qualify as agent for natural person).

⁵⁵ §72(u)(3).

⁵⁶ Regs. §1.72-1(c)(1).

⁵⁷ §72(b)(1). The investment in the contract is defined as the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludible from gross income under the Code. §72(c)(1). If the annuity is for life, the expected return is determined based on the life expectancy of the annuitant, in accordance with tables prescribed by the Treasury Secretary. §72(c)(3)(A). If the annuity is for a term certain, the expected return is the aggregate of the amounts receivable under the contract as an annuity. §72(c)(3)(B).

⁵⁸ §72(b)(2).

⁵⁹ §72(e)(2)(A); Regs. §1.72-1(d). Under §72(c)(2), special rules apply to contracts including a refund feature. Additional rules also apply to the taxation of distributions following the death of the contract owner and distributions following the death of the

Tax Following Annuitant's Death

Section 72(s)(1) requires that, in order for a contract to be treated as an annuity contract for U.S. income tax purposes, the contract must provide that:

(A) if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and

(B) if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.

In addition, §72(s)(2) provides that, to the extent that the remaining portion referred to in §72(s)(1)(A) is paid out to a designated beneficiary over the beneficiary's lifetime and the distributions begin within one year of the holder's death, then the remaining portion shall be treated as distributed in a lump sum on the date that the distributions begin.

While those provisions — which are subject to various exceptions for surviving spouses and for retirement-related annuities — direct the timing of the distributions and maximum duration of any deferral, it is §691 that confirms the tax character of the distributions and provides the distinguishing disadvantage of annuities versus life insurance. Whereas life insurance proceeds are excludible from the beneficiary's gross income, §691 identifies such distributions as income in respect of a decedent ("IRD"), having the same character in the hands of the beneficiary as it did in the hands of the decedent. The result is that any deferred gains not taxed before the holder's death will ultimately be taxed as ordinary income upon the beneficiary's receipt or deemed receipt, as the case may be. Moreover, because the annuity was likely included in the holder's gross estate for U.S. estate tax purposes, those deferred gains potentially are subject to successive taxes.⁶⁰ This taxation of the annuity assets following the annuitant's death is the primary reason why life insurance is generally superior to annuities as a tax planning tool.

Income Taxation of Annuities Applicable to NRAs

As with life insurance, an NRA will be subject to tax on amounts received under an annuity contract only to the extent that such amounts would be included in the gross income of a U.S. citizen or RA. Thus, the above-mentioned rules governing the taxation of annuities generally apply equally to an NRA. The primary difference between the taxation of NRAs

annuitant. These rules are beyond the scope of this article.

⁶⁰ Although §691(c) allows the beneficiary to deduct a proportionate share of the U.S. estate taxes attributable to the annuity's includible value, in most cases that deduction does not entirely eliminate double taxation of the deferred gains.

and that of U.S. citizens and RAs is the difference in tax rates applied to each. Amounts received by an NRA under an annuity contract generally will be subject to the 30% tax under §871 and withholding under §1441, rather than the ordinary income tax rates under §1.

U.S. ESTATE TAX TREATMENT OF LIFE INSURANCE AND ANNUITIES

U.S. Estate Tax Treatment of NRNCs and U.S. Citizens and RNCs Generally

For U.S. estate tax purposes, nonresident non-citizens (NRNCs) generally are taxed only on transfers of U.S.-situated assets.⁶¹ In contrast to the rules applicable to NRNCs, and like the U.S. income tax rules applicable to U.S. citizens and RAs, U.S. citizens and resident non-citizens (RNCs) are taxed on transfers of their worldwide assets.⁶²

As noted with respect to income tax planning, it is also important to consider the potential impact of a tax treaty between the United States and another country. The United States is, however, party to only 15 estate and/or gift tax treaties.⁶³ Therefore, the application of the estate and/or gift tax treaties will be much more limited than the application of the income tax treaties.

U.S. Estate Tax Treatment of Life Insurance

The death benefits payable at the death of a U.S. citizen or RNC are significantly different from those payable at the death of an NRNC.

U.S. Citizens and RNCs

As a general rule, life insurance proceeds are included in a decedent's gross estate and are subject to U.S. estate tax, regardless of the situs of the insurance, if:

- with respect to a policy insuring the life of the decedent, the proceeds are payable to the insured's executor;⁶⁴
- with respect to a policy insuring the life of the decedent, the insured possessed at his or her death incidents of ownership over the policy;⁶⁵

⁶¹ §§2101, 2103.

⁶² §§2001, 2031.

⁶³ The United States has estate and/or gift tax treaties with Australia, Austria, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Switzerland, and the United Kingdom. *See also* U.S.-Canada Income Tax Treaty, Arts. II 2(b)(iv), XXVI 3(g), XXIX B.

⁶⁴ §2042(1).

⁶⁵ §2042(1).

- the insured transferred incidents of ownership over the policy within three years of the insured's death;⁶⁶ or
- the insured transferred incidents of ownership in the policy, other than for full and adequate consideration, and retained a lifetime right to beneficial enjoyment, a reversionary interest, or a right to alter, amend, revoke or terminate the policy.⁶⁷

Further, the decedent's gross estate will also include the value of a life insurance policy on the life of someone other than the decedent if he or she owned the policy on the date of death.⁶⁸

NRNCs

Section 2105 specifically provides that "the amount receivable as insurance on the life of a non-resident not a citizen of the United States shall not be deemed property within the United States." Therefore, the death benefits payable with respect to the life of an NRNC decedent are not subject to U.S. estate tax, regardless of whether: (1) the decedent held incidents of ownership over the insurance policy; (2) the death benefits are payable to the NRNC's estate; or (3) the beneficiary is located inside or outside of the United States.

This rule is specific to insurance on the life of the NRNC, however. If the NRNC decedent owned insurance that is situated in the United States on the life of another individual, then the value of that policy will be includible in the NRNC's gross estate for U.S. estate tax purposes.⁶⁹ Insurance on the life of someone other than the decedent is situated in the United States if the insurer issuing the policy is a domestic (rather than a foreign) insurer.⁷⁰

U.S. Estate Tax Treatment of Annuities

U.S. Citizens and RNCs

Under §2039, with respect to U.S. citizens and RNCs, it is clear that the value of an annuity or other payment made under an annuity contract (the "annuity payment") is included in a decedent's gross estate if: (1) the annuity payment is receivable by the beneficiary because the beneficiary survived the dece-

dent; and (2) the annuity payment was payable to the decedent, or the decedent possessed the right to receive the annuity payment (alone or in conjunction with others) for life, for a period not ascertainable without reference to his or her death, or for a period that did not in fact end before his or her death.⁷¹ The amount includible in the gross estate is limited to a part of the annuity payment proportionate to the amount of the purchase price contributed by the decedent.⁷²

NRNCs

In contrast with life insurance, rights under an annuity contract issued by a U.S. domestic insurance company are generally considered U.S.-situated property includible in the gross estate of an NRNC.⁷³ Because no specific exclusion for annuity contracts exists like the exclusion for life insurance policies, most commentators believe that the rules applicable to U.S. citizens and RNCs under §2039 also apply to determine whether an annuity payment made pursuant to a U.S.-situated annuity contract is subject to tax in the NRNC's estate. Some commentators, however, argue that, because §2105(a) does not specifically use the term "life insurance contract," but instead refers to "the amount receivable as insurance on the life of a non-resident not a citizen of the United States," an annuity contract could satisfy §2105(a) and not be deemed property within the United States.⁷⁴ The key to this argument would be establishing that the annu-

⁷¹ §2039(a); Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions* ¶13.04[1].

⁷² §2039(b).

⁷³ Regs. §§20.2104-1(a)(4), 20.2105-1(e); Spielman, *U.S. International Estate Planning* ¶10.03[14][a][iv]; see also *Guaranty Trust Co. of N.Y. v. Comr.*, 16 B.T.A. 314 (1929) (distinguishing between insurance contracts and annuity contracts). Pursuant to the regulations related to §§2104 and 2105, annuities "issued by or enforceable against a resident of the United States or a domestic corporation" are considered to be situated in the United States. Regs. §§20.2104-1(a)(4), 20.2105-1(e). Under this rule, annuities issued by offshore insurance companies that have made a §953(d) election to be treated as a domestic corporation ("§953(d) carriers") should be considered situated in the United States and includible in the NRNC's gross estate for U.S. estate tax purposes. See Regs. §§20.2104-1(a)(4), 20.2105-1(e); §953(d). Annuities issued by offshore insurance companies that have not made a §953(d) election ("non-§953(d) carriers") will not be considered situated in the United States and are not includible in the NRNC's gross estate. Therefore, NRNCs who are not engaged in pre-immigration planning and do not intend temporary U.S. residence should carefully consider whether investment in a policy issued by a U.S. domestic carrier or §953(d) carrier is appropriate, given the particular circumstances at hand. While investment in a policy issued by a domestic carrier or a §953(d) carrier may be appropriate, it may also be the case that the costs of such investment outweigh the benefits to the potential policy owner.

⁷⁴ See, e.g., Heimos, 837 T.M., *Non-Citizens — Estate, Gift and Generation-Skipping Taxation*, IV, D, 4.

⁶⁶ §2035.

⁶⁷ §§2036–2038.

⁶⁸ §2033.

⁶⁹ §2033; see also Zeydel & Chung, "Estate Planning for Non-citizens and Nonresident Aliens: What Were Those Rules Again?" 106 *J. Tax'n* 20 (Jan. 2007).

⁷⁰ Regs. §§20.2104-1(a)(4), 20.2105-1(e); Michael A. Spielman, *U.S. International Estate Planning* ¶10.03[14][a][iii]. Offshore insurance companies that have filed an election under §953(d) to be treated as a domestic corporation should be considered "domestic insurers" for this purpose. See Regs. §§20.2104-1(a)(4), 20.2105-1(e); §953(d). Therefore, such insurance is situated in the United States and includible in the NRNC's gross estate for U.S. estate tax purposes.

ity contract involved an actual insurance risk at the time the transaction was executed.⁷⁵

A recent private letter ruling, PLR 200842013, not only highlights a very limited exception to this rule for NRNC clients, but also serves to demonstrate one of the many convoluted ways in which these rules sometimes apply. In this private letter ruling, annuity proceeds held by three life insurance carriers on behalf of an NRNC were not property situated within the United States under §2105(b)(1) and were, therefore, excluded from the NRNC's gross estate under §2103.⁷⁶ The decedent, an NRNC, was the beneficiary under an annuity owned by her brother, a U.S. citizen and resident of "State." Following her brother's death and before her own death, the decedent failed to submit a claim to the insurance companies that issued the annuity contracts. Therefore, the proceeds of the annuities were still being held by the insurers. Relying on §871(i), the Service held that, under these facts, the annuities were equivalent to deposits being held by the insurers and were excluded from the decedent's gross estate for estate tax purposes under §2103.

INTERNATIONAL ESTATE PLANNING APPLICATIONS

Foreign Non-Grantor Trust Planning

As explained below, life insurance can be an extremely useful planning tool for foreign persons who have created foreign trusts with U.S. beneficiaries. In many cases, these individuals may face a substantial undistributed net income ("UNI") problem in the foreign non-grantor trust ("FNGT"). While investing in a life insurance policy cannot eliminate the UNI already existing in the FNGT, putting the trust assets into a policy can cut off further accumulation of UNI and "stem the bleeding," so to speak. This section explains FNGTs generally, discusses the accumulation distribution problem, and then analyzes how this problem can be minimized using life insurance.

What Is FNGT?

In the simplest terms and as its name implies, an FNGT is a foreign trust that is not a grantor trust. Under §7701(a)(31)(B), a foreign trust is any trust that is not a U.S. person. A trust is a U.S. person if it satisfies two requirements:

1. A court within the United States is able to exercise primary supervision over the administration of the trust; and

⁷⁵ *Helvering v. Le Gierse*, 312 U.S. 531, 539–40 (1941) (highlighting risk-shifting and risk-distributing as essential elements of a life insurance contract).

⁷⁶ PLR 200842013.

2. One or more U.S. persons have the authority to control all substantial decisions of the trust.⁷⁷

A "grantor trust" is a trust that is treated, for U.S. income tax purposes, as having an owner — typically the trust's grantor (the person who transferred assets to the trust) — under the principles set forth in §§671–679 who is taxed currently on the trust income regardless of its distribution.

Trusts with foreign owners offer unique tax benefits because they can avoid U.S. income taxes in many situations. With a foreign owner, the foreign grantor trust is treated for U.S. income tax purposes as an NRA, and the foreign grantor is taxed only on the trust's U.S.-source income. For this reason, foreign grantor trusts are not favored under U.S. tax policy, and Congress has taken steps to significantly restrict the opportunities for foreign persons to use these types of trusts.⁷⁸ Thus, unlike a U.S. trust with a U.S. grantor, which is not difficult to qualify as a grantor trust (assuming proper structuring), a foreign trust will be a grantor trust only in very limited circumstances. Specifically, a foreign trust qualifies as a grantor trust if:

1. the trust is revocable;
2. distributions from the trust may be made only to the trust's grantor or the grantor's spouse; or
3. the trust is a compensatory trust.⁷⁹

Thus, most foreign trusts are FNGTs with respect to which the foreign person who created the trust is not considered the owner of the trust's assets for U.S. tax purposes. These FNGTs are subject to draconian tax rules intended to eliminate the ability to defer the payment of income tax by U.S. beneficiaries of the trust. If an FNGT has one or more U.S. beneficiaries, all of the worldwide distributable net income ("DNI") in the trust should be distributed to the beneficiary or beneficiaries each year. If all of the trust's DNI is not distributed, it is carried forward as UNI in the trust. UNI, when distributed, is subject to additional interest charges that have been compounded over the length of time the UNI exists in the trust, on top of the regular tax owed by the trust's beneficiaries, as well as potential penalties.

⁷⁷ §7701(a)(30)(E).

⁷⁸ The Small Business Job Protection Act of 1996 (P.L. 104-188) significantly restricted the tax advantages available to foreign individuals seeking to establish trusts with U.S. beneficiaries.

⁷⁹ §672(f). In some circumstances, a U.S. beneficiary of a trust could be considered the owner of the trust that is otherwise owned by a foreign person if that U.S. beneficiary transfers assets to the foreign person for less than full and adequate consideration. *Id.* Also, any foreign grantor trust that was in existence before Sept. 20, 1995, is "grandfathered" and will continue to be a grantor trust as to any property transferred to it before such date, provided that the trust continues to be a grantor trust under the normal grantor trust rules. Separate accounting is required for amounts transferred to the trust after Sept. 19, 1995, together with all income and gains thereof.

Tax Consequences of DNI, UNI, and Accumulation Distributions

When distributions of DNI are made from a FNGT, the beneficiaries of the trust are taxed on their share of the distributions, and the trust receives a deduction from its taxable income to the extent of those distributions. As discussed above, to the extent that DNI is not distributed in a taxable year to the trust beneficiaries, it is accumulated in the trust and becomes UNI, carried forward to the next taxable year and beyond until it is finally distributed to the trust beneficiaries.⁸⁰

The accumulation of UNI in the trust is problematic because when UNI is distributed to the beneficiaries, it is classified as an accumulation distribution, subject to the “throwback tax.”⁸¹ This tax imposes an interest charge on the regular income taxes imposed on the U.S. distributees. The goal of the throwback rules is to simulate, and charge the U.S. beneficiary at, the tax rate that would have been paid if the income had been distributed in the year that the trust originally earned such income and tax was paid at such time.

The problems associated with UNI are further exacerbated by the fact that under the throwback rules: (1) the interest charge is compounded over the period during which the trust has UNI; and (2) to the extent that capital gains are accumulated and distributed as UNI, they are stripped of their favorable tax character.⁸² Thus, the longer UNI remains in the trust, the bigger the problem. Moreover, to the extent that the trust is continuing to earn income, the problem grows larger each year that distributions are not sufficient to carry out the entirety of the trust’s DNI.

PPLI as a Solution to the Accumulation Distribution Problem

While life insurance will not eliminate UNI already existing in an FNGT, life insurance (particularly PPLI) can be an effective tool to cut off the accumulation of further taxable income inside the FNGT.⁸³ As discussed above, investment in a non-MEC is particularly favorable because of the non-taxable treat-

⁸⁰ When a distribution is made from an FNGT, the distribution is first considered a distribution of the trust’s DNI. If the distribution exceeds DNI, the excess is deemed to carry out any UNI that has accumulated in the trust. If the trust has no UNI, or if the distribution exceeds both the trust’s DNI and UNI, then the excess is considered a distribution of trust principal. These principal distributions are not taxable income to the beneficiary.

⁸¹ This throwback tax was imposed by U.S. lawmakers as a defense against the tax-deferral opportunities associated with the use of an FNGT.

⁸² For additional information regarding the throwback rules and the method of calculating the throwback tax, see Jetel, “When Foreign Trusts Are Non-Grantor,” 147 *Tr. & Est.* (Apr. 2008).

⁸³ Of the various types of life insurance, PPLI — particularly offshore PPLI — is the most effective solution to the accumulation distribution problem because of its reduced cost structure, enhanced investment platform (including alternative investments), favorable policy loan provisions, and certain negotiable contract terms.

ment given to: (1) the income and investment returns inside the policy, (2) the withdrawals up to the premium(s) previously paid, (3) the policy loans, and (4) the death benefit proceeds. Therefore, these items are also not considered DNI and cannot add to the FNGT’s UNI.⁸⁴ Further, trust assets can be used to pay the life insurance premiums on the non-MEC policy, depleting the existing source of trust DNI.

A MEC policy can be a useful tool as well for a planner working with an FNGT that has a UNI problem. Purchasing a life insurance policy that is structured as a MEC can provide a mechanism for facilitating distributions from the FNGT without subjecting the beneficiaries of the FNGT to the throwback tax. Withdrawals from the MEC policy will be considered ordinary income (i.e., DNI) in the year of withdrawal (up to the amount of the excess of the cash value of the policy over the premiums paid into the policy).⁸⁵ Because distributions of DNI from an FNGT are not subject to the throwback tax, the trustee of the FNGT may distribute a sum equal to the amount of the withdrawal to the trust beneficiaries without the distribution being considered an “accumulation distribution.” Although the distributions from the MEC constitute ordinary income to the recipients, and the recipients may incur a tax penalty of 10% with respect to distributions made before age 59½, the cost associated with these penalties may still be less than the throwback tax that would otherwise be incurred under the UNI rules.

Pre-Immigration Planning

The strategy (discussed earlier) of funding an FNGT with life insurance is even more successful when applied prospectively — before the accumulation of any UNI in the trust. By funding the FNGT with life insurance when the trust is first established and by using proper planning to ensure that the life insurance policy is not considered a MEC and that funds are withdrawn from the policy only up to basis (if at all), the trust and its U.S. beneficiaries can avoid UNI complications altogether.

By shifting a significant portion of an NRA/NRNC’s assets into one or more life insurance policies prior to its establishing U.S. residency (presumably in a manner consistent with its other estate planning needs and good financial planning principles), the NRA/NRNC-now-U.S.-resident can avoid much of the tax that would otherwise be imposed on these assets. When combined with timely and proper foreign trust planning, the assets might also be shifted out of the RNC’s estate for U.S. estate tax purposes and possibly even avoidance of U.S. generation-skipping transfer tax.⁸⁶ This makes life insurance a strong tool that should be considered during the pre-

⁸⁴ §643(a). Interest charges will continue to compound with respect to existing UNI in the trust, however, until that UNI is distributed to the trust’s beneficiaries.

⁸⁵ §72(e)(10), (2)(B).

⁸⁶ Note that the trust might be considered a grantor trust during

immigration planning process. However, the practitioner should also look to the law of the NRA/NRNC's home jurisdiction before implementing the PPLI/foreign trust strategy to avoid any local tax traps associated with acquiring the PPLI policies or transferring assets into the foreign trust.

Planning for Temporary Residents

Investment in a variable annuity can be a highly successful planning technique for clients who are contemplating a temporary move to the United States but not planning to permanently relocate. Not only can the client defer U.S. income tax on inside build-up in the annuity during his or her stay in the United States, but the client can also avoid both income tax and estate tax if the annuity purchase and surrender are properly planned and implemented.

Planning Strategy

Before relocating, the client should acquire an annuity contract from a foreign insurer.⁸⁷ By funneling his or her non-U.S. assets into the annuity for the term of the client's U.S. residency, the client can avoid the tax that these worldwide assets would otherwise incur as a result of the loss of NRA/NRNC status. Then, when the client leaves the United States and resumes NRNC status, the client can cash out of the annuity and resume the pre-residency status quo.

Purchase from a non-U.S. carrier is key to this temporary resident strategy. If the annuity contract is purchased from a U.S. insurer, or a foreign subsidiary of a U.S. insurer, then the contract will be a U.S.-situated asset subject to both income tax and estate tax (if the client dies while resident in the United States).⁸⁸ If the contract is U.S.-situated, then when the client cashes out of the annuity upon returning to his or her home country, the client will receive U.S.-source income subject to the 30% income tax imposed on income earned by NRAs under §871(a).⁸⁹ Further, a U.S.-situated contract will also subject the client to mortality risk because the annuity contract will be included in the client's estate should the client pass away while residing in the United States.⁹⁰

Also critical to the strategy is ensuring that the client does not surrender the annuity while still considered an RA. Otherwise, the client will lose the benefit of acquiring the contract from a foreign insurer as the client will be subject to all of the income from the surrender as part of the tax on the client's worldwide income.

While a similar strategy could be implemented using life insurance, most clients will likely want to pur-

sue the strategy using an annuity, because the annuity purchase generally will be less expensive. However, if the client desires to receive a death benefit component, a life insurance purchase should be considered.

As with any planning involving foreign clients, the practitioner should assess the tax impact to the client in the client's home jurisdiction before implementing this strategy. Specifically, the practitioner should consider whether the client's surrendering the annuity following a return to the home jurisdiction will result in negative tax consequences that would outweigh the benefit of pursuing the strategy under U.S. tax law.⁹¹

Potential FBAR Filing Requirement

Implementing this strategy will most likely require the client, upon obtaining U.S. residency, to file Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts, or "FBAR"). The FBAR is a U.S. Treasury Department form by which U.S. persons annually report their financial interests and signature or other authority over foreign accounts. The filing requirement will arise only if the contract is issued under the law of a foreign jurisdiction, rather than under the law of a U.S. state. (Recall that one key to the planning discussed above is that the contract is not a U.S.-situated asset.) In that context, a contract issued by a §953(d) carrier presents a problem in that the segregated asset account exists under the law of a non-U.S. jurisdiction, yet the carrier itself is treated as a domestic corporation (at least for tax purposes). Some might argue that the company's U.S. tax status bestows domestic character upon its segregated asset accounts, particularly in light of the company's withholding obligations. In that event, the §953(d) carrier's U.S. policy owners would not be required to report their policies on the FBAR.⁹² The conservative position, however, would be for the client to file the FBAR, reporting his or her financial interest in the segregated asset account to which the contract relates.

Moreover, the IRS is revisiting the FBAR filing requirements and trying to expand the scope of accounts subject to FBAR reporting, so practitioners should keep a close eye on further developments that could impact FBAR reporting arising from ownership of an offshore contract.

Finally, the client should also be aware that, upon becoming a U.S. resident, the client will be required to report not only any foreign insurance or annuity contract, but also any "financial interest in or signa-

⁹¹ The client's failure, while residing in the United States, to comply with the tax, regulatory, and legal requirements imposed by the client's home jurisdiction could subject the client to civil and even criminal penalties under U.S. law. *See, generally, Pasquantino v. U.S.*, 544 U.S. 349 (2005) (upholding wire fraud convictions of defendants in connection with scheme to evade Canadian liquor importation taxes).

⁹² Further complicating matters is the fact that the policy's segregated asset account might itself own a brokerage or custodial account at a foreign financial institution. Does the U.S. person's interest in that custodial account give rise to an FBAR filing requirement?

the U.S. residency period of the former NRA, which could be for the remainder of his or her lifetime.

⁸⁷ By purchasing the annuity contract before moving to the United States, the client can avoid a 1% excise tax on the purchase. NRAs are exempt from this excise tax.

⁸⁸ Rev. Rul. 2004-75, 2004-31 I.R.B. 109; §§72, 2039.

⁸⁹ §871(a).

⁹⁰ §2039.

ture or other authority over any [other] foreign financial accounts.”⁹³

CONCLUSION

Non-citizen clients who are considering residence in the United States or who are otherwise planning to

⁹³ See General Instructions, Form TD F 90-22.1 (Rev. 10-2008). It should be noted that, under recent changes to the FBAR filing requirements instituted by the IRS, an NRA/NRNC may also have an FBAR filing requirement before acquiring U.S. residency if the person is “in and doing business in the United States.” Because of complaints from taxpayers and practitioners regarding the breadth and ambiguity of that phrase, the IRS has postponed enforcement of this requirement temporarily, and further instructions on this issue are expected later this year.

transfer assets to U.S. citizens or residents face many complicated issues under the U.S. tax laws. Thus, the non-citizen client’s advisor must make sure to consider not only the law of the client’s home jurisdiction, but also the U.S. income and transfer tax laws potentially governing a proposed transaction with U.S. nexus. Fortunately for the advisor and the client, life insurance and annuities are favored investments under the U.S. tax regime and those of most foreign jurisdictions. For a relatively minimal cost, those contracts can be deployed to deftly avoid, or at least significantly mitigate, the impact of the U.S. tax issues facing the non-citizen client — all while realizing the traditional estate planning and asset protection benefits of life insurance and annuities.