An elegant solution

Leslie Giordani, Michael Ripp and Mari Reed discuss US planning opportunities for non-citizens and non-resident aliens using life insurance and annuities

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Planning for non-US citizen (non-citizen) or non-resident alien (NRA) clients involves complex issues and even more complicated rules. Advanced planning can provide significant opportunities for clients to minimise 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 non-grantor trusts, taxation of the worldwide income of US citizens and US residents and taxation of an NRA's US-source income and US-situated assets. Investing a noncitizen or NRA client's funds in a life insurance or an annuity policy can provide an elegant solution to many of these issues, and offer numerous additional benefits.

International estate planning applications

Foreign non-grantor trust planning

Life insurance can be an extremely useful planning tool for foreign persons who have created foreign (non-US) trusts with US 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.

What is a Foreign non-grantor trust?

In the simplest terms and as its name implies, a FNGT is a foreign trust that is not a grantor trust. Under Internal Revenue Code (IRC) section 7701(a) (31) (B), a foreign trust is any trust that is not a US person. A trust is a US person if it satisfies two requirements:

- a court within the United States is able to exercise primary supervision over the administration of the trust, and
- one or more United States persons have the authority to control all substantial decisions of the trust (IRC § 7701(a)(30)(E).

A 'grantor trust' is a trust that is treated, for US federal 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 IRC §§ 671-679.

Trusts with foreign owners offer unique tax benefits because they are not liable for US income taxes in many situations. With a foreign owner, the foreign grantor trust is treated for US income tax purposes as an NRA, and the foreign grantor is taxed only on the trust's US-source income. For this reason, foreign grantor trusts are not favoured under US tax policy, and the US Congress has taken steps to significantly restrict the opportunities for foreign persons to use these types of trusts.[1] Thus, unlike US domestic trusts, which are not difficult to qualify as a grantor trust (assuming proper structuring), a foreign trust will only be a grantor trust in very limited circumstances. Specifically, a foreign trust qualifies as a grantor trust if: the trust is revocable, or if distributions from the trust may be made only to the trust's grantor or the grantor's spouse, or if the trust is a compensatory trust.[2]

Instead, most foreign trusts are foreign non-grantor trusts with respect to which the foreign person who created the trust is not considered the owner of the trust's assets for US tax purposes. These FNGTs are subject to draconian tax rules intended to eliminate the ability to defer the payment of income tax by US beneficiaries of the trust. If a FNGT has one or more US beneficiary, 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, which 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.

Tax consequences of foreign non-grantor trust: 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 tax year to the trust beneficiaries, it is accumulated in the trust and becomes UNI, carried forward to the next tax year and beyond until it is finally distributed to the trust beneficiaries.[3]

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.'[4] This tax imposes an interest charge on the regular income taxes imposed on the US distributees. The goal of the throwback rules and the interest charge is to simulate, and charge the US 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 the interest charge is compounded over the period during which the trust has UNI, and to the extent that capital gains are accumulated and distributed as UNI, they are stripped of their favourable tax character.[5] Thus, the longer UNI remains in the trust, the bigger the problem. And, to the extent that the trust is continuing to earn income, the problem will grow even larger each year that distributions are not sufficient to carry out the entirety of the trust's DNI.

Private placement life insurance (PPLI) as a solution to the accumulation distribution problem

While life insurance will not eliminate UNI already existing in a FNGT, it can be an effective tool to cut off the accumulation of further taxable income inside the FNGT. Investment in a non-modified endowment contract (non-MEC) policy is particularly favourable because none of the following are treated as taxable income:

- the income and investment returns inside the policy
- withdrawals up to premium
- policy loans, and
- death benefit proceeds.

Therefore, these items are also not considered DNI and cannot add to the FNGT's UNI.[6] Furthermore, trust assets can be used to pay the life insurance premiums on the non-MEC policy, depleting the existing source of trust DNI.

Investment in a modified endowment contract (MEC) policy can also be a useful tool for a planner working with a 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 to the throwback tax. Withdrawals from the MEC policy will be considered as ordinary income (i.e. DNI) in the year of withdrawal (up to the amount of the difference between the cash value of the policy over the premiums paid into the policy) (IRC § 72(e)(10); § 72(e)(2)(B). Because distributions of DNI from a 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.' Despite the fact that the distributions from the MEC constitute ordinary income to the recipients, and a tax penalty of 10 per cent may be incurred with respect to distributions made prior to age 59 and six months, 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 of funding a FNGT with life insurance is even more successful when applied prospectively, prior to the accumulation of any UNI in the trust, for example before a NRA establishes US residency. By funding the FNGT with life insurance when the trust is first established, and using proper planning to ensure that the life insurance policy is considered a non-MEC, and funds are only withdrawn from the policy up to basis, if at all, the trust and its US beneficiaries can remove UNI complications altogether. Applying this strategy to the pre-immigration planning process makes a strong case for the use of life insurance. When taking this approach the practitioner should look to the law of the NRA's home jurisdiction prior to implementing the PPLI/foreign trust strategy, to avoid any associated tax liabilities in that jurisdiction.

Planning for temporary residents

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

Prior to relocating, the client should acquire an annuity contract from a foreign insurer.[7] By placing her non-US assets into the annuity for the term of US residency, the client can mitigate the tax on these worldwide assets, which would otherwise be incurred as a result of the loss of NRA status. Then, when the client leaves the US and resumes NRA status, she can cash out of the annuity and resume the pre-residency status quo.

Purchase from a non-US carrier is key to this temporary resident strategy, otherwise the contract will be a US-situated asset subject to both federal income tax and federal estate tax if the client were to die while resident in the US (Rev. Rul. 2004-75; IRC §§ 72, 2039) or if the client were to cash out of the annuity on return to the home country (under IRC § 871(a) (IRC § 871(a). A US-situated contract would also subject the client to mortality risk because the annuity contract would be included in the client's estate, should the client pass away while residing in the US (IRC § 2039). In addition the benefit of buying from a non-US carrier is lost if the client surrenders the annuity while still considered a US resident, as the client would be subject to all of the income tax from the surrender as part of the tax on worldwide assets.

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

1. The *Small Business Job Protection Act* of 1996 significantly restricted the tax advantages available to foreign individuals seeking to establish trusts with US beneficiaries.
2. IRC § 672(f). In some circumstances, a US beneficiary of a trust could be considered the owner of the trust, which is otherwise owned by a foreign person, if that US beneficiary transfers assets to the foreign person for less than full and adequate consideration. *Id.* Also, any foreign grantor trust that was in existence prior to 20 September 1995, is 'grandfathered' and will continue to be a grantor trust as to any property transferred to it prior to 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 19 September 1995, together with all income and gains thereof.
3. When a distribution is made from a 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.
4. This throwback tax was imposed by US lawmakers as a defence against the tax-deferral opportunities associated with the use of a FNGT.
5. For additional information regarding the throwback rules and the method of calculating the throwback tax, see Amy P. Jetel, 'When Foreign Trusts Are Non-Grantor', *Trusts & Estates*, April 2008.
6. 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.
7. By purchasing the annuity contract prior to moving to the US, the client can avoid a 1 per cent excise tax on the purchase. NRAs are exempt from this excise tax.