

FOREIGN NATIONALS – INCOME TAX AVOIDANCE

There are many high net worth individuals considering permanent residence or temporary residence in the United States due to political and economic instability in their home countries. While many factors are involved in such a decision, many of them have children being educated in the U.S. and then remaining in the U.S.

The tests for U.S. residency for income tax and estate tax purposes differ from each other. For income tax purposes, the Green Card test is satisfied if the NRA secures permanent resident status during the tax year. A second test is the Substantial Presence test which is met if the NRA spends 183 days or more in the U.S. A weighted formula outlined in IRC Sec 7701(b)(1) measures the 183 standard over a several year time period. An NRA that is a U.S. resident is subject to taxation on worldwide income. An NRA's surviving spouse does not have the benefit of the marital deduction under IRC 2056A.

Investments in the U.S. give rise to effectively connected income (ECI) which results in a tax on gross sale proceeds and a substantial withholding tax requirement. The 1996 Act eliminated the grantor trust status of foreign trusts. The non-grantor status allowed for trust accumulation without trust taxation. However, ***income distributions to a U.S. beneficiary are treated as undistributed net income (UNI)*** and as such, are classified as accumulation distributions and taxed according to the throwback rules. Such distributions are income taxed on first earnings of trust income, and an interest penalty is assessed, ***the effect of which can result in an effective tax rate of 100%***.

The strategic planning by an NRA to benefit the U.S. beneficiaries is to employ the tax benefits of life insurance, which can avoid both the ECI and UNI adverse tax issues noted above.

Private Placement Life Insurance (“PPLI”) is an institutionally priced variable universal life insurance policy intended for accredited investors and qualified purchasers as defined under federal securities law. **The policy provides the ability to customize the policy's investment options with a range of asset classes from hedge funds to private equity and real estate.** The NRA can purchase the policy with an offshore life insurer. ***The carrier should be a carrier that has made an election under IRC Sec 953(d)*** to be treated as a U.S. taxpayer for corporate tax purposes. The significance of this election deals with the U.S. tax treatment of the offshore life insurer's separate account investments.

A PPLI Frozen Cash Value (“FCV”) policy is a specialty version of PPLI issued by offshore life insurers. The product is designed to fall under the U.S. tax law definition of life insurance, and avoid MEC status by application of 7702(g). FCV is primarily designed for large transactions where the amount of the funding in a traditional policy would result in a MEC policy.

The planning concept is straight-forward. The NRA sets up an offshore irrevocable trust prior to becoming a permanent resident (often referred to as the “Drop Off Trust”). While many foreign nationals find it difficult to obtain life insurance due to the medical and financial underwriting standards, we have found a proprietary PPLI design which can be issued and afford the tax benefits of the traditional PPLI or domestic life insurance policy.

The transfer to the trust in order to fund the PPLI contract is not subject to the U.S. gift tax and the investment income within the policy is not subject to U.S. or foreign taxation. The trustee may take policy loans or a partial surrender of the cash value ***to distribute to the trust's beneficiaries entirely tax-free.***