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DC Estate Planning Council Meeting

Life Insurance and the International Client: A Quagmire Requiring Targeted Solutions

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OVERVIEW

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The Opportunity

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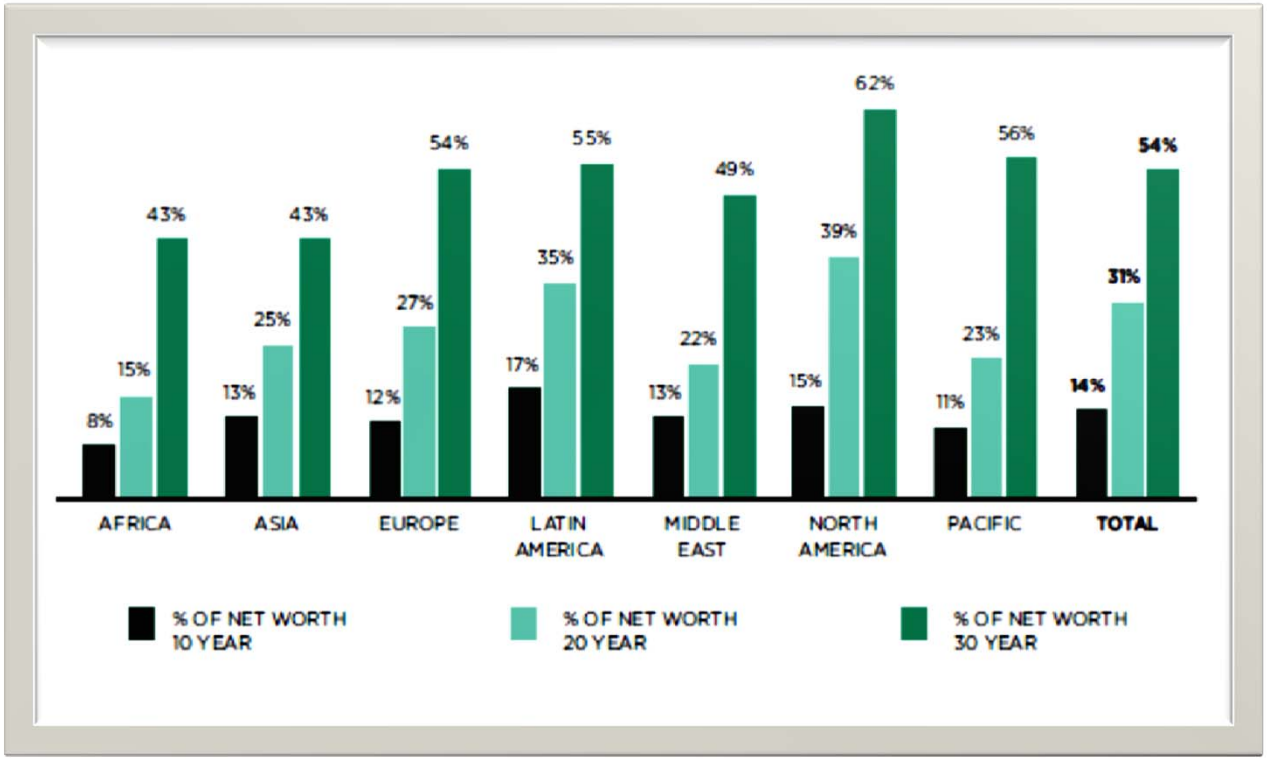
Proportion of UHNW Wealth to Pass to Next Generation



Wealth-X Family Wealth Transfer Report, 2015.

The Opportunity

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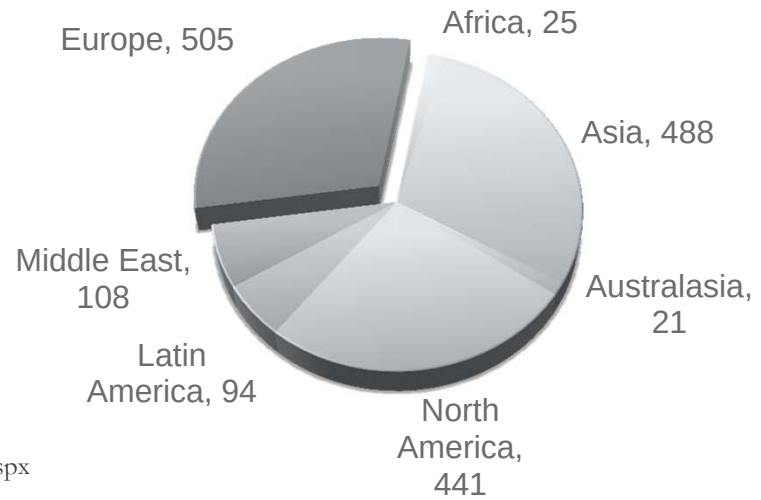
10 Year Growth of UHNWI's

	2013	2023	% Growth
Africa	1,868	2,858	53%
Asia	41,114	58,588	43%
Australasia	3,828	4,526	18%
Europe	60,504	73,396	21%
Latin America	9,677	13,711	42%
Middle East	7,052	9,498	35%
North America	43,626	52,536	20%
WORLD	**167,669**	**215,113**	**28%**

Billionaires Worldwide - 2013



The Wealth Report 2014 – http://my.knightfrank.com/research-reports/thewealthreport.aspx

The Opportunity

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A Broad Spectrum of Global Clients

- U.S. Citizen/Resident with Assets Abroad or May Inherit
- U.S. Citizen/Resident with Non-U.S. Citizen Spouse
- U.S. Citizen/Resident who Lives Abroad
- Non-U.S. Resident with U.S. Citizen Spouse
- Non-U.S. Citizen who Lives in the U.S. Full or Part-time
- Non-U.S. Resident with Assets in the U.S.

The Problem

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	TOTAL UHNW WEALTH TO BE TRANSFERRED IN NEXT 30 YEARS	MAXIMUM INHERITANCE TAX RATE	APPLICABLE TO ASSETS
JAPAN	US$1,645 billion	50%	¥300,000,000 (US$2,900,000)
GERMANY	US$1,645 billion	50%	€6,000,000 (US$7,900,000)
UNITED STATES	US$6,040 billion	40% STATE TAXES VARY BETWEEN 0% & 16%	US$5.34 million
UNITED KINGDOM	US$830 billion	40%	£325,000 (US$540,000)

	TOTAL UHNW WEALTH TO BE TRANSFERRED IN NEXT 30 YEARS	MAXIMUM INHERITANCE TAX RATE	APPLICABLE TO ASSETS
ITALY	US$175 billion	4-8%	€0 - €1,500,000 (US$1,980,000)
BRAZIL	US$560 billion	8% VARIES BY STATE	R$20,000 - R$200,000 (US$90,000 - US$90,000
CHINA	US$425 billion	NONE	
RUSSIA	US$115 billion	NONE	

Wealth-X Family Wealth Transfer Report, 2015.

U.S. Tax Considerations for NRA's and NCNR's

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Tax and Residency Rules

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Income Tax

- Tax Rules for U.S. Citizens or Residents with Foreign Assets
  - U.S. Citizens or Residents are taxed on their worldwide income from whatever source derived
- U.S. Residency Rules
  - Green Card Status;
  - Substantial Presence; and
  - Election into Resident Status (if eligible)

Transfer Tax

- Tax Rules for U.S. Citizens or Residents with Foreign Assets
  - Subject to U.S. estate, gift, and generation-skipping transfer tax on worldwide assets
- U.S. Residency Rules
  - Domicile test
  - A person is "domiciled," and thus treated as a U.S. Resident for transfer tax purposes, if he/she is living in the U.S. with no intention of moving to another country

Transfer Tax Rules for a NCNR

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- Estate Tax
  - A NCNR is subject to the estate tax upon U.S. real property, interests in U.S. entities, or tangible personal property located in the U.S.
  - Exemption $60,000
- Non-U.S. Situs Assets include:
  - Foreign Real Estate
  - Foreign Corporate Shares
  - Bank Deposits
  - Tangible Personal Property
  - **Life insurance proceeds on the life of a non-U.S. person**

The Marital Deduction & Generation Skipping Transfer Tax Rules for NCNRs

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- Marital Deduction
  - ***General Rule***:
    - Unlimited gift and estate tax marital deductions for the value of any interest in property passing to his or her U.S. citizen spouse regardless of status of donor
  - ***Special Rule for Gifts to non-Citizen Spouses*** (not unlimited):
    - Annual gift exclusion of $147,000 (2015) to resident alien or NRA spouse, and no "gift splitting" for NRA spouse
  - ***Special Rule for Estates Passing to non-Citizen Spouses*** (not unlimited):
    - Applicable exclusion amount at death is $60,000 (not indexed for inflation); Applicable exclusion amount for use at death from estate of U.S. citizen or resident is $5,430,000
- GST Tax Rules
  - Determination of NCNR status for GST tax purposes is the same as for gift and estate (domicile test)
  - Applies only to gifts and estates that are otherwise subject to U.S. gift and estate tax
    - GST tax only applies to an NCNR's U.S. situs assets
  - GST tax exemption is $5,430,000 (2015)

Basic U.S. Life Insurance And Planning

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Overview of Life Insurance Products for Tax Planning

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- Life insurance death benefit proceeds on the life of a NCNR are generally tax-free, and life insurance cash values may be accessed on an income tax-free basis

- Life insurance owned by the NCNR on the life of someone else is subject to U.S. Estate Tax

- If death benefit proceeds are paid to a U.S. Citizen/Resident, then those proceeds will then be includable in recipient's estate

Trusts and Life Insurance

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Trusts

- May be appropriate if the proceeds are passing to a U.S. person where it will then be includable in the U.S. person's estate
- Non tax reason for using an Irrevocable Life Insurance Trust ("ILIT") is for creditor protection
- A NCNR must be careful when funding an ILIT so as to avoid a U.S. taxable gift
- Known interests by US persons in a foreign trust are reportable on Form 8938 if the policy crosses the threshold

Life Insurance

- Can be used:
  - To pay U.S. or foreign estate/inheritance tax
  - To help manage undistributable net income ("UNI")
  - To help pay the "throwback tax" on trapped UNI in a Foreign Nongrantor Trust
  - For pre-immigration planning of NRA in the U.S. for a short duration to avoid U.S. income tax
  - To benefit from lower inheritance tax rates in some countries

Areas of Concern?

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- Clients should be careful if they hold life insurance in an ILIT in some countries (e.g., France and the U.K.)
- Clients should be careful of the reporting requirements on foreign life insurance for a U.S. person:
  - Cash value of foreign life insurance policies are reportable as an account on an FBAR Disclosure (FinCEN Form 114)
  - Foreign life insurance is a foreign asset to be reported on Form 8938 (Statement of Specified Foreign Financial Assets)
  - Certain foreign life insurance policies (i.e., foreign life insurance wrappers) are treated as “passive foreign investment companies” (PFICs) and thus trigger interest charges reportable in the U.S. (also need to file Form 8621)

What Questions Should I Ask?

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1) When preparing a life insurance trust, discuss with clients if it should be a a foreign trust or a U.S. trust (this limits trustee choices)
2) Where are the beneficiaries? Insurance trust beneficiaries matter, as their residency determines how much they are taxed on any distribution from the trust
3) Consider whether your client's estate is subject to forced heirship claims (i.e., in civil law jurisdictions, nationality or citizenship heirship rules) which could disrupt the intent of the trust and also consider the tax clause in the trust in these circumstances
4) Do any tax treaties apply? When advising clients with any foreign connection, check the provisions of any applicable tax treaties
5) Will any gifts be transferred in the U.S.? Gifts to the ILIT are considered sitused where they are made (i.e., from NCNR's bank account in the U.S.), thus you should structure NCNR's gifts outside the U.S. to avoid U.S. taxes and/or take advantage of applicable exclusions and avoid triggering gift tax

Planning for Foreign Persons Coming to the U.S.

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I'm Coming For You

Overview of Pre-Immigration Planning and Life Insurance

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- By shifting a significant portion of an NRA's assets into LIPs or annuities prior to establishing U.S. residency, the NRA can successfully avoid U.S. income taxes
- With timely and proper trust planning, the assets may also be shifted out of the NRA's estate for U.S. Estate Tax and GST purposes
- Private Placement Life Insurance Plans ("PPLI(s)") and Private Placement Deferred Annuities ("PPDA(s)") are good tools
  - PPLIs – Better for long term immigration to the U.S.
  - PPDAs – Better for short term immigration to the U.S.

  Note: Practitioners need to consider local law to avoid any looming foreign tax traps

Examples

Private Placement Deferred Annuities ("PPDA")

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- Effective for Foreign Persons residing temporarily in the U.S. but not planning to permanently relocate to the U.S.
- Allows client to defer U.S. income tax liability during stay in the U.S., and allows for avoidance of both U.S. income and estate tax if properly implemented
- KEY: Client should *only* consider the use of Foreign Carriers for the Annuity in this situation, otherwise the contract is a U.S. situs asset…
  - Subject to U.S. income and estate tax if the holder dies in the U.S. while a resident or included in decedent's estate if he/she dies in the U.S.
  - Subject to 30% withholding (if no treaty) on the income when the client cashes out of the annuity when he/she returns to his/her home country

PPDAs – Step by Step Guide

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1. Before relocating, client should acquire the annuity contract from a foreign insurer
2. Client should channel his/her non-U.S. assets into the annuity for the term of his/her residency to avoid U.S. tax on these assets upon the loss of NRA status
3. When the client leaves the U.S. and resumes NRA status, the client should cash out of the annuity and resume pre-U.S. residency status-quo

- KEYS:
  - Client should not surrender the annuity while considered a U.S. resident
  - Most clients prefer annuities over using life insurance in this situation as the annuity purchase will generally be less expensive due to the absence of a death benefit element

Example - PPDAs

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- The client and his wife are UK Residents and Italian and French citizens respectively
- Their assets are held in a Channel Islands “Remittance Trust” (CIRT) domiciled in Guernsey
- Under UK law, the income of the trust is not taxable to them unless it is remitted to the UK
- The CIRT is an effective barrier to UK income taxation
- The client’s employer wants him to move to New York in 2014 for a temporary period of at most 5 years
- Under U.S. law, the client, as a Resident Alien, would be deemed to be the grantor of the CIRT and thus all of the CIRT’s income would be taxable to him regardless of whether or not he received it
- What is your advice to him?

Solution - PPDAs

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- The CIRT can purchase a PPDA paying the premium in kind with all the CIRT's assets before the client comes to the U.S.
- To mitigate the risk of a possible income tax if he were to die while resident in the U.S., he could use a joint and survivor annuity so that neither his nor her death would be a taxable event
- Time matters. To create a PPDA the client and advisor must (1) create a separate account to hold the assets, (2) get approval of the separate account custodian and manager, and (3) obtain opinions of counsel in four jurisdictions as to the
  - U.S. tax consequences and creditor protected status of the Bermuda separate account,
  - The validity of the Channel Islands trust and the trustee's authority to purchase the annuity, and
  - The absence of any U.K., Italian or French tax consequences

U.S. Persons as Beneficiaries of Foreign Trusts Problems and Solutions

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U.S. Trust Rules

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- Domestic Trust –
  - Any trust that (i) a court within the United States is able to exercise primary supervision over the administration of the trust, and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust
  - If these requirements are not satisfied, then the trust is a Foreign Trust
- Foreign Grantor Trust ("FGT") vs. Foreign Nongrantor Trust ("FNGT")
  - A Foreign Trust is a FGT (and thus an NRA under the U.S. tax code) if:
    - (1) The trust is revocable; OR
    - (2) Distributions from the trust may be made only to the trust's grantor or the grantor's spouse during the grantor's lifetime; OR
    - (3) The trust is a compensatory trust
  - Most foreign trusts are FNGTs, meaning the foreign person who created the trust is not considered the owner of the trust's assets for U.S. tax purposes
  - FNGT's are subject to draconian tax rules to prevent deferral of U.S. income tax

Taxation of FGTs

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- Income Taxed to Grantor
  - Income, deductions, and credits of the trust are taxed to the grantor, rather than at the trust level (also the items retain their character)
- General Classification Rule
  - A U.S. person who directly/indirectly transfers property to a foreign trust is treated as owner of the portion transferred if the trust has a U.S. beneficiary
- Exceptions to General Rule
  - (1) Testamentary Transfers and (2) Exchanges for FMV Consideration
- U.S. Beneficiary
  - A trust is treated as having a U.S. beneficiary unless (1) under the terms of the instrument, no part of the income may be paid or accumulated to or for the benefit of a U.S. person, and (2) if the trust terminated during the year, no part of the income or corpus could be paid to or for the benefit of a U.S. person.
  - Attribution rules apply
  - U.S. beneficiary status presumed

Taxation of FNGTs

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- Distributable Net Income ("DNI")
  - Distributions of DNI are taxable to beneficiaries and trust receives a deduction from its taxable income to the extent of those distributions (character determined at trust level)
  - Capital gain income retains character only if distributed in the year earned by trust
- UNI
  - When a distribution is made from a FNGT the distribution is carried out (1) first from DNI, then, (2) from any UNI accumulated in the trust, then (3) from trust principal (which is not taxable)
- Accumulation Distributions
  - When UNI is distributed to the beneficiaries it is called an "Accumulation Distribution"
  - Subject to the "Throwback Tax"
  - Imposes an interest charge on regular income taxes imposed on the U.S. distributees

The UNI Problem – The "Throwback Tax"

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- Under the "Throwback Rules"
  - (1) The interest 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 character (treated as ordinary income upon UNI distribution)
- "Throwback Tax" rules tax accumulated distributions to the beneficiary as though the tax was paid in the year the trust earned that income
- The longer UNI is in the trust the bigger the problem
- Distributions classified as UNI are subject to an interest penalty
  - This interest penalty can cause an effective tax rate of 100% to apply after several years of accumulation in the trust

Strategies to Avoid the Throwback Tax

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- Qualifying as a grantor trust owned by NRA (FGT)
- Stripping distributions: distribute all UNI to NRA beneficiaries in one year and year later distribute DNI and principal to US beneficiary
- Isolating UNI in a separate trust
- In kind distributions
- Pecuniary amount rule in 663(a)(1)
- Limiting distributions to FAI ("bunching" followed by shifting to the default method
- Use the default method to squeeze some value out without TBR, depending on PY distribution amounts
- Migrating to U.S. to avoid 643 rules

Throwback Tax Strategies cont'd

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- Using the grantor as an intermediary: If Grantor is still living, distribute UNI to NRA grantor who then gifts to the US beneficiaries
- Resettlement by an NRA granto
- 645 elections
- Bunching by use of sales
- Zero coupon obligations
- Use of entities
- Using life insurance as accumulation vehicle

Variable Life Insurance as Solution to Accumulation Distribution Problem

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- Goal: to reclassify trust income as something that is exempt from income tax
- Variable life insurance policies achieve this because:
  - Income earned inside the policy is not taxed currently to the owner of the policy (Death Benefit is also income tax free)
  - The policy owner can access income distributed from the policy during life by making withdrawals from a non-MEC policy up to the basis amount, then switching to policy loans thereafter
- For existing FNGTs with UNI –
  - Can stop/slow accumulation of income in FNGT with a variable life insurance policy
  - If the policy is a MEC, then the use of trust assets to purchase the MEC LIP which generates DNI that is taxed in same year to the beneficiary as a withdrawal can defer liability for the throwback tax and penalty on the UNI built up in the trust

MEC's – Another Solution to UNI Problem

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- MEC LIPs facilitate distributions from FNGTs without subjecting beneficiaries of the FNGT to the throwback tax
- Withdrawals from the MEC LIP will be considered current income (i.e., DNI) in the year of the withdrawal (up to the amount of the difference between the cash value of the policy over the premiums paid into the policy)
  - Distribution to trust beneficiaries equal to the withdrawal is not an accumulation distribution and not subject to the throwback tax
- However, a tax penalty of 10% may be incurred if distributions made prior to age 59 ½ and the cost of these penalties may be less than the throwback tax
- ALSO: Can use a non-MEC LIP and only withdraw funds up to policy basis to avoid the UNI problem altogether

FNGT Could Buy Two LIPs

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- FNGT with UNI could purchase 2 LIPs
  - (1) MEC LIP – To create DNI and use UNI in the FNGT as leverage
  - (2) Non-MEC LIP – For discretionary distributions to trustee and then to U.S. beneficiaries for income-tax free access to funds

Examples

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Example 1 – Using 2 LIPs to Address the "UNI Problem"

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- Peter is a divorced 65 year old citizen and resident of Sweden
- His children, also Swedish citizens, live and work in the United States and are U.S. Persons
- Peter wants to move to the U.S. and understands that in doing so he will expose his worldwide investment income to U.S. income tax
- Peter has a substantial amount of assets that he has put in a Irrevocable Foreign Trust for the benefit of his children and grandchildren
- For the past 10 years, that trust has not made full distributions of its DNI as his children and grandchildren have not required any discretionary distributions
- Peter understands that any income payable to his children in the future will also be subject to U.S. income tax and he realizes that any future distributions to them of UNI could be problematic due to the Throwback Tax Rules
- Peter asks you if there is any way to mitigate his trust's U.S. tax exposure?
- Or if there is a way to make the trust's assets income tax exempt?

Example 1 – Using 2 LIPs to Address the "UNI Problem"

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Solution

- The Irrevocable Foreign Trust, with 10 years of built up UNI, will be a FNGT for U.S. tax purposes and poses a UNI problem
- The trustee of the FNGT, should purchase two LIPs – One MEC LIP and one Non-MEC LIP
- The FNGT assumedly has built up a considerable amount of UNI over 10 years. The trustee should first purchase a MEC LIP with the trusts assets because (1) this will use assets that are generating UNI currently to pay for the policy and (2) because withdrawals from a MEC LIP will generate DNI (up to the amount of the difference between the cash value of the policy over the premiums paid into the policy) if distributed to the beneficiary in the same year as the withdrawal
- This strategy allows distributions of trust assets in excess of current year non-insurance income to be taxed as DNI and avoid the throwback tax and penalty associated with a distribution of UNI

Example 1 – Using 2 LIPs to Address the "UNI Problem"

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Solution

- The trustee of the FNGT can also make discretionary distributions from the Non-MEC LIP via policy withdrawals or loans
- These amounts are received by the trustee of the FNGT income-tax free, and thus they are generally nontaxable when distributed to the U.S. beneficiaries (here, Peter's children and grandchildren)
- In this way, Peter accomplishes his goal of addressing his UNI problem (with the MEC LIP and its generation of DNI via withdrawals from that policy) and reclassifying some of the trust income as something that is exempt from U.S. income tax (for the income generated in the Non-MEC LIP)
- As a reminder, withdrawals from a Non-MEC LIP up to the policy basis are nontaxable during the life of the insured
- Also, all death benefit amounts paid by the policy are not subject to U.S. income tax
- If the FNGT makes a distribution, even of life insurance proceeds, it will still carryout first DNI, then UNI, then principal

Example 2 – The Benefit Is In The Numbers

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- A South African grandfather established an offshore trust for the benefit of his heirs
- The grandfather died in 1991 at which time the trust became a FNGT
- The current beneficiary of the trust is his only granddaughter
- The granddaughter moved to the U.S. prior to 1991
- No distributions have ever been made to the granddaughter
- The granddaughter is now 50 years old and is reviewing her distribution options
- The trust balance in 1991 at the grandfather's death was $10,000,000
- Currently, the trust has a balance of $30,900,000
- Based on these figures the trust, currently, has $20,900,000 of UNI ($30.9M – 10M)

* Analysis in future slides is based on 4 assumptions: (1) the distribution is made when granddaughter is 85; (2) all the invested funds grow at a 5% annual rate; (3) the life insurance policy is placed on the granddaughter (the trust beneficiary); and (4) the life insurance is funded by after-tax cashflow.

Lee, G. (Speaker) (2015, March 12). Using Life Insurance to Solve the Undistributed Net Income (UNI) Quagmire. *11th Annual International Estate Planning Institute*. Lecture conducted from New York State Bar Association, New York, New York.

Example 2 – The Benefit Is In The Numbers

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- Granddaughter's Options
  1. Do nothing and allow more UNI to accumulate on current earnings – "**Accumulate**"
  2. Distribute the UNI amount today and pay tax/interest (UNI Tax & Throwback Tax) on that amount (i.e., "decant" it) – "**Distribute**"
  3. Convert foreign trust to a U.S. domestic trust (i.e., "domesticate" it) – "**Freeze**"
     - Making the foreign trust a U.S. trust stops the UNI from accumulating, effectively, freezing and deferring the UNI and Throwback taxes
     - This allows the UNI amount to stay in the trust and aid in future gain; essentially, "use it knowing you're going to lose it"

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Example 2 – The Benefit Is In The Numbers

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- Options <u>Without</u> Insurance
  - Accumulate: over time the tax will grow until it completely swallows any distribution for prior years (157.5M – 157.5M); upon end, the granddaughter will be left with the current year's income plus the original capital
    - **RESULT**: $14,800,000
  - Distribute: granddaughter will experience a $12.6M tax/interest bill—allowing $8.7M + current income + capital amount to continue growing over next 35 years
    - **RESULT**: $33,200,000
  - Freeze: the entire amount stays intact allowing it all to accumulate over the next 35 years with a capped UNI tax/interest amount of $20.9M
    - **RESULT**: $45,800,000

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Example 2 – The Benefit Is In The Number

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Options <u>With</u> $30,900,000 of Life Insurance

- Accumulate
  - **RESULT:** $37,800,000
- Distribute
  - **RESULT:** $52,900,000
- Freeze
  - **RESULT:** $87,300,000

Options <u>With</u> $99,000,000 of Life Insurance

- Accumulate
  - **RESULT:** $88,400,000
- Distribute
  - **RESULT:** $84,500,000
- Freeze
  - **RESULT:** $126,100,000

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A Primer on Reporting Obligations

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Foreign Trust Related Filings

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- Settlor/Grantor
  - Form 3520 – Annual Report to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts
  - Form 709 – U.S. Gift (and GST) Tax Return
- Trustee(s)
  - Form 3520-A – Annual Information Return of Foreign Trust with a U.S. Owner
  - Foreign Grantor Trust Owner Statement
  - Foreign Grantor or Nongrantor Trust Beneficiary Statement
  - Appointment of U.S. Agent for tax Reporting Purposes
  - Form 1041 – U.S. Income Tax Return for Estates and Trusts
  - Form 1041NR – U.S. Non-Resident Alien Income Tax Return
- Beneficiaries
  - Form 3520 - Annual Report to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts
  - Form 4970 – Tax on Accumulation Distribution of Trusts

Filing Requirements for U.S. Owned Foreign Entities

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- Form 8832 – Entity Classification Election
- Form 8833- Treaty Based Return Position
- Form 8858 –Foreign Disregarded Entities
- Form 8865 – Ownership of Foreign Partnerships
- Form 1065 – U.S. Partnership Return of Income
- Form 8938 – Statement of Specified Foreign Financial Assets
  - The owner of an interest in a PPLI policy is required to file a Form 8938 annually
- Form 5471- Owner/Officer relationships with Foreign Corporations
- Form 5472- Foreign ownership of U.S. Corporation
- Form 8621- Passive Foreign Investment Companies
- Form 926- Transfers to Foreign Corporations

FBAR and FATCA

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- Foreign Bank Account Reporting - FBAR – The U.S. owner of an offshore PPLI policy (a "foreign financial account") is required to report the value to the IRS, even though no U.S. income tax is due, and is subject to penalties if such filing is not made
  - This includes PPLI's through both 953(d) and non-953(d) Offshore Insurers
  - Note: there are new filing rules for FBAR
- Foreign Account Tax Compliance Act - FATCA – Under FATCA, PPLI policies are foreign accounts that must be disclosed under FATCA by non-953(d) Offshore Insurance Companies.
  - However, if an offshore insurer elects to be taxed as a U.S. company under 953(d) then that offshore insurance company is *not* subject to FATCA. Thus, as an elective U.S. taxpayer, these non-U.S. insurance companies can avoid FATCA reporting requirements, achieve transparency, and avert withholding taxes.

Conclusion - There are Solutions to the Quagmire

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- International clients require innovative solutions to their often colorful and complex problems
- Jurisdictions are coming up with more ways to find assets (informational disclosure regimes) and tax individuals on their accounts regardless of the jurisdictions' those assets are in
- Thus, by utilizing life insurance as a tool in international client's' estate plans, these clients can facilitate their goals of preserving their estates and minimizing their overall income and estate tax burdens from a global perspective

Questions?

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