

M INTELLIGENCE

INBOUND US TAX PLANNING WITH LIFE INSURANCE

Non-U.S. clients considering immigrating to the United States, leaving wealth to beneficiaries in the United States, or investing in the United States face a host of complex tax issues. Properly integrating life insurance into their U.S. tax planning often provides a simple and efficient solution.

PRE-IMMIGRATION PLANNING

THE ISSUE: U.S. WORLDWIDE INCOME AND TRANSFER TAXATION

The primary issue faced by wealthy non-U.S. residents immigrating to the U.S. is that the U.S. taxes its residents on their worldwide income and estates. For such clients, the prospect of paying U.S. taxes on family wealth earned entirely outside the U.S. prior to immigration is a tough pill to swallow.

Generally, these individuals have two options for shielding non-U.S. wealth from U.S. taxation: avoiding U.S. residency or relinquishing enough control of their wealth (usually via a pre-immigration trust, discussed further below) to avoid deemed ownership of the contributed assets under U.S. tax rules.

U.S. income tax residency is triggered if an individual meets the substantial presence test or the permanent residence test. An individual will meet the substantial presence test if they spend 31 days in the U.S. during the current year and if the sum of all U.S. days in the current year, one-third of all U.S. days in first preceding year, and one-sixth of all U.S. days in the second preceding calendar year equals at least 183 days.

An individual will meet the permanent residence test if they become a lawful permanent resident of the U.S. (i.e., obtain a green card). Residency for U.S. wealth transfer tax purposes is based on U.S. domicile, which

is acquired by living in the U.S., even for a brief period of time, with no definite present intention of leaving.

THE SOLUTION: PRE-IMMIGRATION TRUSTS WITH LIFE INSURANCE

Classic planning for non-U.S. residents expecting to become U.S. residents generally involves significant gifts to a pre-immigration trust for the benefit of the donor's spouse and descendants. Assets transferred by a non-U.S. resident into a properly structured trust can remain in trust indefinitely without imposition of U.S. wealth transfer taxes, even while the beneficiaries act as their own trustees, control all investment decisions, and make distributions for their own health, education, maintenance, and support.

Although this provides a tried and true technique for U.S. wealth transfer tax purposes, dealing with the income tax issues can be far more challenging. The challenge arises from the so-called five-year rule. The five-year rule can cause a non-U.S. resident who becomes a U.S. income tax resident within five years of funding a trust to be treated as the owner of the trust for U.S. income tax purposes under the U.S. grantor trust rules.

Accordingly, there is no U.S. tax deferral or avoidance for the use of a foreign pre-immigration trust, as the non-U.S. resident who creates the trust will be individually liable for the income taxes on such trust's income.

If, instead, the trust invests in a life insurance product, the inside will accrue free of U.S. income taxes.

Additionally, because the non-U.S. resident who creates the trust will not be an owner of the life insurance policy, the death benefit ultimately payable following the non-U.S. resident's immigration will not be subject to U.S. wealth transfer taxes. This means the death benefit can pass in trust to successive generations without incurring any U.S. wealth transfer taxes.

U.S. BENEFICIARIES OF FOREIGN TRUSTS

THE ISSUE: IMPOSITION OF THE "THROWBACK TAX"

Many multinational families face uncertainty about long-term citizenship and residency options, and the children or grandchildren may live in different jurisdictions, carrying multiple passports. When a client's potential heirs face these circumstances, selecting the proper structure from a U.S. tax perspective is challenging.

U.S. income tax efficiency often can be achieved by structuring a trust as a grantor trust. While the client remains a non-U.S. resident, non-U.S. income earned by a foreign grantor trust is attributed to them, and the client is afforded certain U.S. income tax preferences in making inbound U.S. investments. However, when a client's circumstances do not permit the use of a foreign grantor trust, or upon the client's death (and therefore termination of grantor trust status), use of a foreign non-grantor trust is often a viable, albeit more complicated, alternative.

A foreign non-grantor trust must be administered carefully to avoid making "accumulation distributions" to a U.S. person. For an accumulation distribution to occur, the foreign non-grantor trust must fail to distribute to trust beneficiaries all its distributable net income (DNI) in a given taxable year, thereby allowing DNI to accumulate inside the trust and be classified as undistributed net income (UNI).

If, in a subsequent year, the trust distributes trust income to a U.S. beneficiary that exceeds current year DNI, the excess generally is attributed to UNI, treated as an accumulation distribution, and taxed as if distributed to the beneficiary in the year(s) such income was earned. These throwback taxes are subject to a punitive interest charge.

When foreign non-grantor trusts are anticipated to make distributions to U.S. beneficiaries, the only way to

avoid throwback taxes is to ensure that all DNI is distributed to the beneficiaries in the year it is earned. Forcing income distributions to U.S. trust beneficiaries may be disadvantageous; for instance, large distributions may be difficult for a young beneficiary to manage responsibly. If the beneficiary is a U.S. person, it unnecessarily increases the beneficiary's taxable estate. Additionally, trust beneficiaries may not remain U.S. persons over their lifetimes, in which case it would be better to let trust income accumulate and be distributed after the beneficiary becomes a non-U.S. resident.

THE SOLUTION: USE LIFE INSURANCE TO AVOID UNI ACCUMULATION

Investment of foreign non-grantor trust principal in life insurance avoids the throwback tax regime, as the policy growth does not generate taxable income. Therefore, there is no DNI, and without DNI, there can be no accumulation of UNI leading to accumulation distributions and the imposition of the throwback tax. When the insured dies, trust beneficiaries' respective income tax residencies can be assessed, informing the decision of how to manage trust investments going forward, including possible domestication or redeployment into additional life insurance products.

INBOUND U.S. INVESTMENT

THE ISSUE: TAXATION OF U.S. SOURCE INCOME

Non-U.S. clients often seek to invest in the U.S. while remaining tax residents in their countries of origin. While these individuals are not subject to worldwide U.S. income and transfer taxation, their U.S. investments may nevertheless trigger U.S. income tax if they generate U.S. source income. U.S. tax law does, however, provide some generous exceptions for certain capital gains and U.S. source interest income.

U.S. source income that is fixed, determinable, annual, or periodic, which includes interest, dividends, rents, royalties, annuities, salaries, and wages, is subject to a 30% withholding tax at the source; the tax may be reduced by treaty, but deductions are disallowed. Income effectively connected with a U.S. trade or business, which includes income from the disposition of U.S. real property interests, is taxable at graduated rates and may be offset by deductions if the non-U.S. resident timely files a U.S. income tax return.

Sales of U.S. real property interests by non-U.S. residents require the buyer to withhold 15% of the gross sales proceeds (FIRPTA withholding). U.S. real property interests include any interest, other than solely as a creditor, in U.S. real property, certain personal property associated with the use of such property, and certain real estate holding companies. Not only does this produce a tax drag on the investment return, it also results in U.S. tax filings, which can be complex and disclose to the U.S. certain information, which many non-U.S. clients prefer to avoid.

PRODUCT AND OPERATIONAL ADVANTAGES

The U.S. industry's scale, duration, and competitive structure have resulted in a wide variety of price-efficient and effective product offerings for affluent individuals. As insurance products rely upon the pooling of risks, a more thorough understanding of risks leads to more transparent and competitive pricing. The thorough understanding of mortality rates in the U.S., along with improvements in mortality in recent decades, has led to lower mortality charges in U.S. life insurance products than in other international jurisdictions.

The competitive nature of the U.S. life insurance industry leads to an increased motivation for insurance carriers to pursue product innovation and bring competitive new offerings to the market. Many U.S. life insurance products offer sophisticated and innovative features that are not found in other markets.

The underwriting process, where risks are assessed and categorized by insurers, is well-defined, with

sophisticated knowledge and procedures, allowing U.S. life insurers the ability to efficiently and appropriately price risks. This leads to better product pricing for clients and better performance for in-force policies. In addition, U.S. life insurance companies are global leaders in implementing technology-based solutions that enhance the underwriting process.

The U.S. life insurance market offers purchasers and policyholders well-developed in-force policy service standards, claims payment processes, and dispute resolution options. Eligibility requirements for U.S. products vary across carriers, but often include a combination of financial and physical presence in the U.S.

CONCLUSION

The U.S. life insurance market offers a number of compelling purchasing motivators for non-resident individuals with multi-jurisdictional planning needs. As the laws surrounding multi-jurisdictional tax and legal planning structures are complex and case-specific, global investors should consult qualified advisors to determine the most advantageous planning structure for their unique situations.

About the Authors

Scott A. Bowman is a partner at McDermott Will & Emery LLP, and Michael Rosenblum is an associate with Snyder & Snyder, P.A. Their practices focus primarily on developing and implementing advanced estate planning techniques for high net worth individuals and their families, including the international aspects of estate planning, to minimize the exposure of multinational families to U.S. taxation. For additional information on the article or to discuss international opportunities, Scott may be contacted at 202.756.8065, and Michael may be contacted at 305.563.9436 or michael@snyderlawpa.com.

Carlson Hammond

CA (415) 256-8960 | HI (808) 532-2826 | carlsonhammond.net

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M Financial Group | 1125 NW Couch Street, Suite 900 | Portland, OR 97209 | 503.238.1813 | fax 503.238.1815 | mfin.com