PRE-IMMIGRATION PLANNING: DROP-OFF TRUSTS + PRIVATE PLACEMENT LIFE INSURANCE – IF THE TOOLS FIT, USE THEM

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INTRODUCTION

Given the worldwide reach of U.S. taxation, wealthy individuals who are contemplating a move to the U.S. will often seek advice on the construction of a pre-immigration plan that can minimize their tax exposure once in the U.S. Creating such a plan is no simple undertaking. It requires in-depth knowledge of myriad special rules and their exceptions. Care must be taken to ensure that the plan is compliant – not only with U.S. law but also with the laws of the home jurisdiction from which the individuals are planning to emigrate and, sometimes, other jurisdictions where assets are held. And, ultimately, the complexity and costs of pre-immigration planning often prevent individuals from achieving full implementation.

In this article, the use of the "drop-off" trust – a common planning tool that is often used in the pre-immigration planning context to reduce estate tax – is reviewed. When combined with private placement life insurance, the benefits may be substantially augmented. The results can be quite attractive.

PRE-IMMIGRATION PLANNING

Prior to immigrating to the U.S., nonresident aliens ("N.R.A.'s") are subject to U.S. income tax only on income sourced in the U.S. and to U.S. transfer taxes (*e.g.*, taxes on gifts, bequests, and generation-skipping transfers) on transfers of U.S.-situs real property and tangible property. Once an N.R.A. immigrates to the U.S., however, worldwide income is subject to U.S. income tax and worldwide assets are subject to U.S. transfer taxes once domicile in the U.S. is established.

Domicile results from a stronger connection to the U.S. than mere income tax residence. It requires both physical presence in the U.S. and no intent to leave at a later time.

Additionally, once an N.R.A. becomes a U.S. domiciliary, transfers of substantial assets outside the U.S. that could have been accomplished all at once before the establishment of domicile in the U.S. may require years to complete, because of strict limits on annual and lifetime gifts. Hence, it is generally best for wealthy individuals and families who intend to immigrate to the U.S. to implement tax plans *before* they immigrate, when they can still make unlimited transfers of property that does not have its situs within the U.S. without incurring U.S. taxes and without substantial delays.

One primary goal of pre-immigration planning is to minimize post-immigration exposure to U.S. transfer taxes by removing non-U.S.-situs property from the N.R.A.'s taxable estate before the N.R.A. establishes U.S. domicile. This goal is often

[1] Bernstein does not provide tax, legal, or accounting advice. In considering this article, a reader should discuss his or her individual circumstances with tax, legal, or accounting professionals before making decisions.

accomplished by having the N.R.A. create a properly structured irrevocable offshore trust that the N.R.A. funds with foreign property before immigration. This type of trust is sometimes referred to as a drop-off trust.

Drop-off trusts require certain precautions to ensure that they successfully protect the assets from U.S. transfer taxes after the N.R.A. immigrates to the U.S. Appropriate precautions include the following:

- Drop-off trusts should not be funded with all the grantor's assets to avoid an inference that the N.R.A. grantor expected to have access to such funds after moving to the U.S. Doing so could cause the assets to be included in the grantor's U.S. estate.
- No subsequent additions should be made to drop-off trusts to avoid tainting the otherwise exempt trusts.
- Distributions to trust grantors should be kept to a minimum or avoided altogether. If multiple distributions are made to the grantor or if such distributions follow a pattern, the grantor could be considered to retain an interest in the trust. This would cause the entire trust corpus to be included in the grantor's U.S. estate when the grantor dies, if the death occurs while the individual is domiciled in the U.S.

Thus, ascertaining the amount to be transferred to a drop-off trust is an important undertaking. If funded with too little, an opportunity to protect assets from U.S. transfer taxes is wasted. On the other hand, if funded with too much, the grantor may be left with insufficient funds to support an accustomed lifestyle in the absence of trust distributions, which jeopardize the benefits of the structure.

This is further complicated by the fact that, while a properly-structured foreign drop-off trust can be effective in protecting assets from U.S. transfer taxes, most do not shield the asset income from being subject to U.S. income tax once the grantor immigrates to the U.S. This is due to special rules applicable to foreign drop-off trusts that (i) have U.S. beneficiaries and (ii) are established within five years of the N.R.A.'s immigration to the U.S. Such trusts are known as grantor trusts, and all trust income is taxable to the grantor beginning as of the grantor's residency starting date.

Thus, the grantor must have the financial wherewithal to not only irrevocably part with the property in the trust but also to pay income tax on that property on an ongoing basis. Of course, it stands to reason that if a grantor could somehow not be liable for the payment of income taxes (Federal, as well as state and local) on income generated within a foreign drop-off trust, more assets can be transferred to the trust without causing economic discomfort for the grantor. This is where private placement life insurance can come into play.

PRIVATE PLACEMENT LIFE INSURANCE

Private placement life insurance ("P.P.L.I.") can offer a unique pre-immigration planning solution and relieve drop-off trust grantors of the burden of paying trust income tax after the grantors move to the U.S.

From an income tax perspective, the owners of life insurance policies do not realize taxable income from the policy's underlying investment accounts. Thus, investing a drop-off trust's assets in life insurance can reduce some, or all, of the trust's taxable income because income earned inside the policy is not taxed currently to the policy owner. Moreover, death benefits paid out of the policy to the drop-off trust are not subject to U.S. income tax and effectively enjoy a stepped-up basis, despite not being included in the grantor's estate.

However, a traditional life insurance policy ordinarily comes at a relatively high cost, comprised of commissions and fees, and offers somewhat limited investment options. Both factors often outweigh the tax benefits of the policy, and funds locked up in a traditional life insurance policy may not be readily accessible.

"A P.P.L.I. policy within a drop-off trust . . . could enable the dropped-off assets to grow income tax free, receive a stepped-up basis upon the death of the insured, and avoid U.S. estate tax."

P.P.L.I. policies are potentially a better alternative to traditional life insurance policies, for several reasons:

- **P.P.L.I. policies are generally less costly**, primarily due to much lower or entirely nonexistent agent/broker compensation.
- **P.P.L.I. policies typically provide access to more investment options**, which can generate higher income and growth that may justify incurring the cost of a P.P.L.I. policy.
- **The insured can withdraw from the policy funds up to the policy's basis** without incurring tax, if the P.P.L.I. policy is not considered a modified endowment contract ("non-M.E.C.").
- **The insured can borrow funds from the policy in excess of the policy's basis** on favorable terms, if the P.P.L.I. policy is considered a non-M.E.C.
- **P.P.L.I. policies can be custom tailored to a client's needs.**

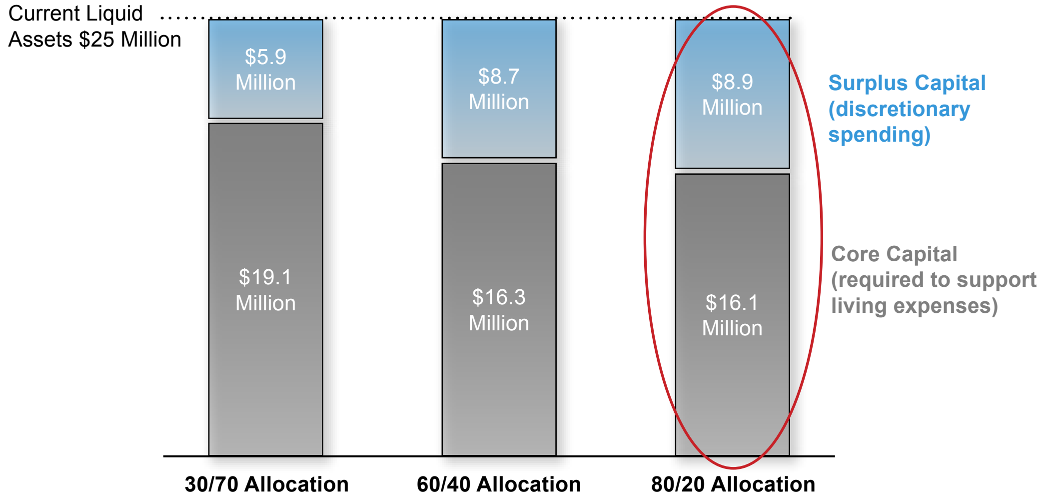
Mr. X, a 50-year-old executive, is preparing to relocate to the U.S. next year, along with his wife, of the same age, and their two teenage daughters. They intend to move to New York City to establish the presence of Mr. X's company there. The family's total liquid net worth is $25 million, held primarily in Mr. X's name. The couple expects to spend approximately $500,000 annually after their move. Mr. X's after-tax compensation should be sufficient to cover these expenses. Assuming that Mr. X will continue to work for 10 years, Mr. & Mrs. X will begin to draw from savings to support their spending needs in 2027.

Mr. & Mrs. X wish to implement a pre-immigration estate plan to reduce their taxable estate. Their attorney advises Mr. X to create and fund a foreign drop-off trust for the benefit of his wife and daughters. Mr. & Mrs. X require assistance in determining how much they can afford to dedicate to funding the drop-off trust.

The analysis begins by quantifying Mr. and Mrs. X's core capital requirement (*i.e.*, the amount of liquid capital they need today to support their lifestyle for the rest of their lives). The calculation takes spending and life expectancies into account, along with projected investment returns and inflation. In order to determine core capital with a high degree of confidence, one should assume poor returns in the capital markets, higher-than-expected inflation, and the possibility that Mr. and Mrs. X could live to be very old.

Using our Wealth Forecasting System,[1] the amount of core capital required to sustain Mr. & Mrs. X's spending for the next 40 years was calculated as follows:

Core Capital Based on Asset Allocation*



* Core capital is calculated at a 90% level of confidence of maintaining spending over 40 years.

The right-hand bar shows that if Mr. & Mrs. X invest for growth, allocating 80% to equities and 20% to bonds, their core capital would be $16.1 million. That would leave nearly $9 million of surplus capital – property that they are unlikely to need to support their lifestyle. In comparison, the other bars indicate that their core capital contribution would be greater, and their surplus capital smaller, if they invested in a less stock-heavy portfolio. In any case, it should be noted that surplus capital not otherwise disposed of will be subject to U.S. estate tax upon their deaths.

One could argue that Mr. X should contribute all his surplus capital to the proposed drop-off trust before moving to the U.S. to shelter it from future U.S. transfer taxes. However, such a plan would be fatally flawed, because it fails to account for Mr. X's ongoing income tax liability with respect to the $9 million of surplus capital contributed to the drop-off trust.

In funding a foreign drop-off trust, the key question should not address simply the computation of the grantors' surplus capital. Rather, it should focus on the amount the grantors can afford to part with if they continue to pay tax on income generated by that capital for the rest of their lives. The correct amount depends on the specifics of each case, including the ages of the N.R.A.'s involved, their tax brackets, their locality, and how the funds are invested. An older N.R.A. who intends to live in Florida will have a different tax burden than a younger N.R.A. who intends to live in a high-tax jurisdiction like New York or Los Angeles. The younger individual will

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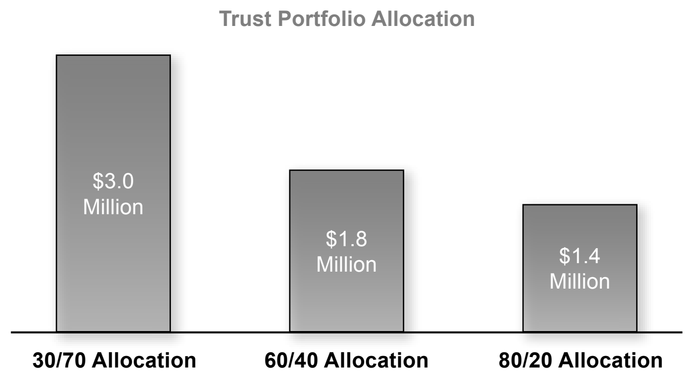
1 The Bernstein Wealth Forecasting SystemSM seeks to help investors make prudent decisions by estimating the long-term results of potential strategies. It uses the Bernstein Capital Markets Engine to simulate 10,000 plausible paths of return for various combinations of portfolios; and for taxable accounts, it takes the investor's tax rate into consideration. Data in this article do not represent past performance and are not a promise of actual results or a range of future results.

need to retain a greater portion of his or her capital to fund a higher tax liability for a longer period of time.

Given Mr. & Mrs. X's ages and their plan to move to New York City, the anticipated income tax liability was calculated on each $1 million of surplus capital invested for growth.

<u>Reserve Required to Pay Tax Liability*</u>



* Capital required to support payment of grantor trust taxes with 90% confidence over 40 years.

The chart shows that over 40 years, every $1 million of capital invested for growth will likely generate an income tax liability that requires a current reserve of $1.4 million to be included in core capital. As a result, Mr. X can afford to fund the drop-off trust with $3.7 million, as it would be necessary to keep $5.2 million of the nearly $9 million surplus capital in reserve to pay the trust's income tax liability.[2]

In practice, core capital (*i.e.*, money the investor will need) is often invested more conservatively than surplus capital (*i.e.*, money the investor doesn't need). If Mr. & Mrs. X invested their core capital more conservatively – with 30% allocated to stocks and 70% to bonds – they would require more than twice as much reserve capital: $3 million for each $1 million they put in the trust. This is because the trust's growth-oriented investments could outperform the core capital portfolio's more conservative investments.

In that case, the trust would generate a greater tax liability, which would be paid from the reserve. Mr. & Mrs. X's core capital requirement would also be higher if they adopted a more conservative allocation, as the previous chart showed, which would leave only $5.9 million in surplus capital. Subtracting the greater reserve from the reduced surplus capital would leave Mr. & Mrs. X with $1.5 million to fund the trust.

However, if Mr. & Mrs. X instead purchased a P.P.L.I. policy with the surplus capital, they wouldn't have to worry about paying income tax on the trust's income, allowing them to dedicate more of their surplus capital to the trust. They should, however, consider the costs incurred in issuing and maintaining the P.P.L.I. policy. Would the tax savings outweigh the costs of the P.P.L.I. policy? The charts below illustrate the answer.

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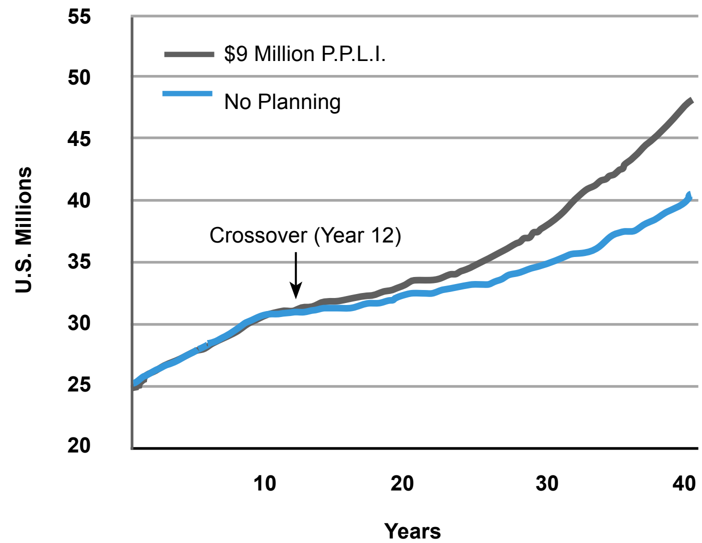
[2] The probability of sustaining spending and taxes for a $9 million grantor trust over 40 years is 41%.

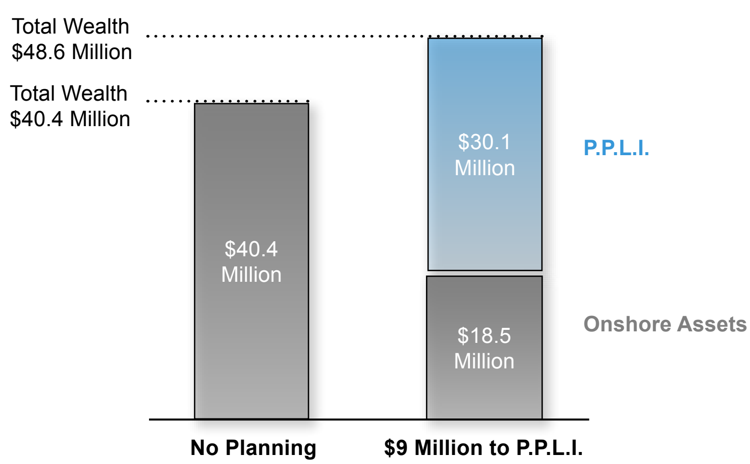
“The cumulative income-tax savings would begin to outweigh the costs of the P.P.L.I. policy after 12 years and, in 40 years, would result in an additional $8 million of wealth for the family.”

Potential Income-Tax Benefits of P.P.L.I.*

Lifetime Wealth of Mr. & Mrs. X



Accumulated Wealth of Mr. & Mrs. X After 40 Years



* Charts reflect median outcomes (adjusted for inflation) based on estimates of the range of returns for the applicable capital markets over the periods analyzed. Asset values represent the estimated market value; if the assets were liquidated, additional capital gains or losses would be realized that are not reflected here.

If Mr. X were to fund the drop-off trust with $9 million, and the trust, in turn, were to use that amount to purchase a P.P.L.I. policy,[3] the cumulative income-tax savings would begin to outweigh the costs of the P.P.L.I. policy after 12 years and, in 40 years, would result in an additional $8 million of wealth for the family.

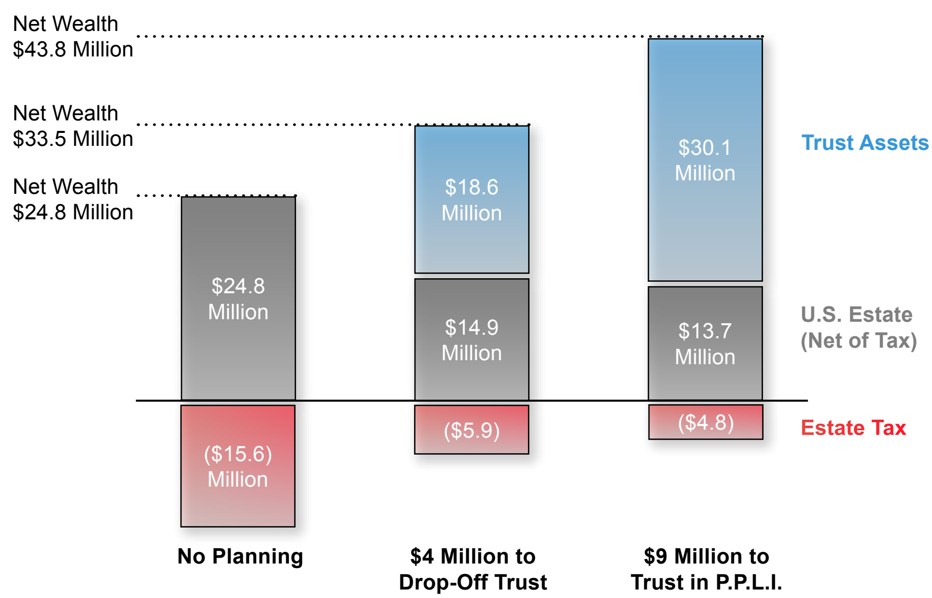
Using the P.P.L.I. policy for the trust investments would also give Mr. & Mrs. X greater flexibility to choose investments based on total-return potential. Their options could include tax-inefficient investments that are typically avoided for grantor trusts

3 Because it is the desire of Mr. & Mrs. X to maximize flexibility and keep access to the funds, the policy can be structured as a non-M.E.C.

– when the grantor is responsible for paying the tax. It would also significantly reduce the cost of compliance for Mr. & Mrs. X with respect to the drop-off trust.

The final chart highlights the incremental estate- and income-tax savings achieved by combining a drop-off trust with a P.P.L.I. policy.

Potential Tax Savings*



* Chart reflects median outcome of the range of returns for the applicable capital markets for the next 40 years with 80/20 asset allocation. Estate tax calculation assumes combined Federal exclusion of $10.98 million (adjusted for inflation), marginal Federal estate tax rate of 40% on assets in excess of the exclusion amount, and marginal state estate tax of 16% on all assets.

It is estimated that if Mr. & Mrs. X were to pass away in 40 years without immigration planning, their after-tax family legacy would be $24.8 million (adjusted for inflation). Creating a drop-off trust and funding it with $4 million before immigrating to the U.S. would add $8.7 million (also adjusted for inflation) to their after-tax legacy. By adding a P.P.L.I. policy to their plan, Mr. & Mrs. X can pass an additional $10.3 million to their daughters, more than doubling the tax savings benefit of the drop-off trust.

Additionally, since Mr. & Mrs. X's P.P.L.I. policy is structured as a non-M.E.C. policy, in the highly unlikely event that their core capital proves to be insufficient, in 15 years' time they should be able to withdraw the $9 million of premiums and borrow the excess at a very reasonable cost, free of income tax, as long as the loan meets certain requirements.

CAVEATS

Life insurance policies commonly marketed to Europeans may be viewed as investment accounts rather than life insurance under U.S. tax laws. As a result, income accumulating inside such a policy may be recognized currently, rather than deferred, and the death benefit may not be wholly exempt from U.S. income tax.

Advisers planning for impending establishment of U.S. tax residence should coordinate with tax counsel in the N.R.A.'s home country to ensure that establishing a P.P.L.I. policy and/or drop-off trust prior to a move to the U.S. does not give rise to unintended adverse tax and other consequences in the home jurisdiction of the N.R.A. Matters related to information reporting under the Common Reporting Standard must also be taken into account during the pre-immigration period.

"P.P.L.I. is a variable policy supported by segregated accounts and, therefore, must satisfy a diversification test on a quarterly basis."

Compliance requirements in the U.S. are substantial. In order for a P.P.L.I. policy to be considered an insurance policy for U.S. tax purposes, several tests must be met:

- The contract must qualify as a life insurance contract under the law of the state or foreign country where issued.
- The contract must meet either (i) the cash value accumulation test or (ii) the guideline premium/cash value corridor test,[4] as follows:
  - The cash value accumulation test is met if the cash surrender value of the insurance contract may not, at any time during the life of the policy, exceed the net single premium that would have to be paid at that time to fund future benefits under the contract. This test is designed to ensure that the value of the policy does not exceed an amount that is reasonably appropriate for the death benefit to be met, using sound actuarial assumptions.
  - The guideline premium requirement is satisfied if the sum of the premiums paid under the contract does not at any time exceed the guideline premium limitation at that time as provided by U.S. tax law. The cash value corridor is satisfied if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value determined under tables provided in the Internal Revenue Code. This test is intended to prevent a buildup of cash value beyond that required to fund the death benefit.
- P.P.L.I. is a variable policy supported by segregated accounts and, therefore, must satisfy a diversification test on a quarterly basis. Under the diversification test, the following requirements must be met each testing date:
  - There must be at least five different investments.
  - Not more than 55% of the value of the total assets of the account can be represented by any one investment.
  - Not more than 70% of the value of the total assets of the account can be represented by any two investments.
  - Not more than 80% of the value of the total assets of the account can be represented by any three investments.
  - Not more than 90% of the value of the total assets of the account can be represented by any four investments.

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[4] "Frozen cash value" policies arguably qualify for favorable U.S. income tax treatment, despite failure to comply with either the cash value accumulation test or guideline premium test. Investment in such a policy requires close consultation with competent tax and insurance advisers.

- Furthermore, the owner of a variable policy is restricted in his or her ability to control the investment choices under the policy.

Three final caveats should be considered in connection with this planning opportunity:

- First, for an individual to have tax-free access to the cash value of the P.P.L.I., it cannot be categorized for U.S. income tax purposes as a modified endowment contract, or M.E.C. An insurance policy is considered to be an M.E.C. where premiums are heavily front loaded. To avoid M.E.C. status, the total amount of premiums paid by the holder within the first seven years cannot exceed the amount required to have the policy be considered paid up within that time. If the P.P.L.I. is an M.E.C., gains are deemed distributed before capital and a 10% penalty is imposed on distributions prior to age 59½.
- Second, premium payments made to a foreign insurance company in connection with an insurance policy covering the life of a U.S. insured person are subject to a 1% excise tax. This excise tax may be eliminated under an applicable income tax treaty that covers the issuer of the policy and through certain elections under U.S. law by the insurance company.
- Finally, a P.P.L.I. is viewed to be a foreign financial account that must be reported to the I.R.S. Financial Crimes Enforcement Network. It is also a financial account under F.A.T.C.A. As a result, insurance companies located outside the U.S. must report information regarding U.S. policyholders and the policyholders must comply with reporting obligations with respect to Form 8938, *Statement of Specified Foreign Financial Assets*. Substantial penalties are imposed for noncompliance.

CONCLUSION

Pre-immigration drop-off trusts have long been used by practitioners as an effective technique to reduce estate tax. However, by combining the drop-off trust with a P.P.L.I. policy practitioners can turn the drop-off trust into a tool that reduces both estate and income taxes. Furthermore, the substantial income-tax savings should enable an N.R.A. to fund the drop-off trust with additional assets and ultimately achieve even greater U.S. estate-tax savings.

The ability to transfer assets freely out of one's estate without the use of exclusion amounts or the imposition of transfer taxes makes this combination particularly compelling in the pre-immigration planning context. However, planning that includes a P.P.L.I. policy should not be undertaken without input from a tax planner with experience.