

International Planning - Questions and Answers

Legal Compliance

Question: I have heard a lot about “offshore” schemes and scams where the client winds up in prison; are the international structures we are discussing legal?

Answer: Yes. Most individuals and corporations run afoul of the law when they fail to file required forms, try to hide their assets from the IRS, try to disguise the nature of the transaction, personally use property that they legally may not, and evade paying taxes.

The structures described in the accompanying Q&A documents use the existing laws to the client’s advantage and are completely transparent.

Residents of the United States are responsible for paying tax on worldwide income. Trying to “hide” income and assets is illegal.

It is extremely important to comply with the filing requirements associated with legitimate foreign transactions. Failure to file required returns may subject the taxpayer to substantial civil and criminal penalties. Also, failure to file these returns may extend the statute of limitations for assessment and collection of the related taxes (IRC 6501(c)(8)).

- Form 3520 - Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts - (IRC §§6039F and 6048 - effective for returns due after August 20, 1996)

There are several situations in which a Form 3520 (or statement with similar information) is required to be filed. The most common circumstances are where a U.S. person:

1. Creates or transfers money or property to a foreign trust (IRC 6048(a)).
 2. Receives (directly or indirectly) any distributions from a foreign trust (IRC 6048(c)).
 3. Receives certain gifts or bequests from foreign entities (IRC 6039F).
- Form 3520-A - Annual Information Return of Foreign Trust with a U.S. Owner - (IRC § 6048(b))

Any U.S. person who is considered to be the "U.S. owner" of a foreign trust must ensure that the trust files Form 3520-A. The determination of what constitutes a "U.S. owner" is made pursuant to IRC §§671 through 679.

- Form 5471 - Information Return of U.S. Persons With Respect to Certain Foreign Corporations - (IRC §6038)

Form 5471 is required of a U.S. shareholder who acquires, disposes of, or owns certain proportions of the stock of a foreign corporation, or who controls or serves as an officer or director of a "controlled foreign corporation" (IRC §§6038 or 6046). A controlled foreign corporation (CFC) is a foreign corporation, the stock of which is more than 50 percent owned (by vote, or value, at any time during the year) by "U.S. Shareholders". The determination of what constitutes a "controlled foreign corporation" is made pursuant to IRC § 951.

- Form 5472 - Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business - (IRC §§6038A and 6038C)

Form 5472 is required to be filed by a "reporting corporation" that has "reportable transactions" with foreign or domestic related parties. A "reporting corporation" is one that is either a 25% foreign-owned corporation or a foreign corporation engaged in a trade or business within the United States. A corporation is 25% foreign-owned if it has at least one direct or indirect 25% foreign shareholder at any time during the tax year.

- Form 926 - Return by a U.S. Transferor of Property to a Foreign Corporation - (IRC §6038B)

Form 926 is required to be filed by each U.S. person who transfers property to a foreign corporation in an exchange described in IRC §§332, 351, 354, 355, 356, or 361. The form is also required if the U.S. person makes a distribution described in §336 to a non-U.S. person. For special rules regarding the filing of Form 926, refer to the instructions on the form.

- Form 8865 - Return of U.S. Persons With Respect to Certain Foreign Partnerships - (IRC §§6038, 6038B, and 6046A)

Form 8865 is used to report the information required under §6038 (with respect to controlled foreign partnerships), §6038B (transfers to foreign partnerships), or §6046A (acquisitions, dispositions, and changes in foreign partnership interests). For more information about the requirements to file, refer to the Form 8865 Instructions. Within the instructions, there are four categories of filers. If a U.S. person falls into one of the four categories, that person must file Form 8865.

- Form TD-F-90-22-1 - Treasury Department Report of Foreign Bank and Financial Accounts.

You may find additional information about compliance and may report illegal schemes on the IRS website located at www.irs.gov.

Prepared By Michael B. Mangini, J.D.
35 Court Street, Freehold, NJ 07728
(732) 409-3209
michael@njapts.net

www.njapts.net

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International Planning - Questions and Answers

Do Foreign Asset Protection Trusts Work?

Question 1: I have heard and read about the failure of foreign asset protection trusts (FAPT) to protect assets. Why would I want to do this?

Answer: Foreign trusts are not for everyone and some unethical promoters have “oversold” their benefits. First, a foreign trust may not be appropriate for you; you should consult an *ethical* and *knowledgeable* professional before venturing offshore. Second, although a FAPT has never been pierced, some courts have ordered grantors to pay heavy fines and serve time in jail for contempt. Third, you should always look to domestic devices before choosing an offshore structure. Fourth, asset protection is more about preventing lawsuits than avoiding paying judgments. Fifth, if you have committed or intend to commit fraud, tax evasion or protection from existing creditors, only an unethical advisor will help you.

You may want to use a foreign trust to (1) supplement an existing protection plan, (2) protect assets to the highest degree possible, (3) incorporate a trust into a foreign structure that may offer *legal* tax benefits, and (4) enhance investment flexibility.

Question 2: On the other hand, I have heard that foreign asset protection trusts are 100% bulletproof. I am confused.

Answer: Nothing is 100%. This statement is true but somewhat misleading. It is true that an FAPT has never been pierced, but it is also true that some FAPT grantors/beneficiaries have been sanctioned for failure to repatriate assets.

Question 3: You say that asset protection is more about preventing lawsuits than avoiding paying judgments. What do you mean?

Answer: Let’s say that a potential plaintiff visits a lawyer and they are trying to decide if a lawsuit is worth the effort. The lawyer is paid on contingency; he gets a percentage of the recovery. The lawyer will try to find out what you own. If he can’t find assets that are available to satisfy a judgment, chances are the lawyer won’t even take the case. You have no obligation to disclose your assets until after the trial, let alone before the lawyer has filed the complaint. Assume that the lawyer does file the complaint. If you are insured and the lawyer can’t find attachable assets, the plaintiff will probably settle the case for a dollar amount within the policy limits. If you are not insured for the risk, the plaintiff may decide to settle for considerably less than what he could get just to avoid the hassle and cost of trying to get at the foreign assets. These same principles apply in cases

where the lawyer gets paid an hourly fee. The plaintiff will do an asset search in deciding whether the cost of litigation is worth the effort.

Question 4: How does a person find my assets?

Answer: There are certain databases available to find assets, but there must be some official record of the asset. If there is no official record, the prospective plaintiff must ask you about an asset, and you have no obligation to answer until after the plaintiff wins a judgment against you. After the plaintiff has won the case, he may ask, and you are legally required to answer, questions about your assets. NJ Court Rule 4:10-2(a),(b); R. 4:51-9(e); R. 6:7-2.

Question 5: What about tax records?

Answer: The IRS maintains strict confidentiality policy (IRC 6103). Release of taxpayer information is closely guarded. A lawyer cannot get copies of your returns without your consent. After judgment a judge may order you to consent under limited circumstances. The same is true of New Jersey tax information. N.J.S. 54:5-8, et seq.

Question 6: I understand that, but what happens if the plaintiff goes to trial and wins?

Answer: After winning the case, the plaintiff gets a judgment against you. The judgment is a legally enforceable paper that states the amount that you must pay the plaintiff. The plaintiff is now ask about your assets, and you must answer truthfully. The plaintiff may still decide to settle for an amount less than the judgment or the plaintiff may decide to go after the foreign asset. This may require another trial and additional delay and legal fees. If the plaintiff decides to go through with the post-judgment trial and wins, the judge may order you to repatriate the foreign asset. If you refuse, the judge may impose sanctions for contempt, but there is no case where a judge as been able to pierce the trust. In most cases the grantor/defendants have cooperated to avoid sanctions for contempt.

Question 7: How can a judge in the United States force me to repatriate the foreign assets if I have done nothing wrong?

Answer: The judge has jurisdiction over you not over the foreign asset. In the cases that judges have ordered defendants to repatriate assets, the defendants have retained virtually unfettered control over the assets in the trust or have retained the right to appoint a U.S. trustee. The judge may find that you have the authority to repatriate the assets. If you have such authority, the judge may order you to exercise it. On the other hand, there are cases where the terms of the trust prohibit distributions to the grantor for a period of years. Under these terms, the judge probably cannot order repatriation, because you have no authority to compel distributions.

Question 8: In setting up an FAPT what are some of the things I should avoid?

Answer: First, do not expect to “hide” assets. This is illegal. Second, if you have already done something that is likely to lead to a lawsuit, make sure you leave enough money at hand to settle the case or make sure that there is a provision in the trust that permits the trustee to satisfy claims that have arisen prior to the funding of the trust. Third, don’t expect to commit fraud or tax evasion and hide behind the foreign trust. Most of the reported cases involve the federal government (with virtually unlimited resources) as the plaintiff. In U.S. v. Grant, (2005), the IRS was attempting to enforce a \$36 million tax lien against a trust over which the beneficiary had too much control. In U.S. v. Ameridebt, Inc. (2005), the FTC was enforcing a judgment against defendants who bilked customers out of millions and then funded foreign and domestic trusts, gave money to friends and relatives, and lived a lavish lifestyle. In FTC v. Affordable Media, LLC, (1999), the FTC was enforcing a judgment against defendants who bilked investors out of millions. In this case the defendants funded the trusts before the fraudulent conduct and spent six months in jail for contempt. Other cases come out of the bankruptcy courts and involve defendants who engaged in fraudulent conduct before or shortly after funding the trusts, e.g. Bank of America v. Weese, (2002); BankFirst v. LeGendre, (2002); In re Stephen J. Lawrence, (2002); In re Portnoy, (1996). There are several cases that involve husbands who attempted to shelter assets in contemplation of divorce. This never works.

Question 9: When considering an FAPT what should I do?

Answer: Consult an ethical professional who knows the risks and rewards of foreign structures as well as the techniques that are available domestically. Make sure that you have exhausted domestic structures before going foreign. Plan early. Have realistic expectations. Thoroughly consider your risks and your risk tolerance. Don’t focus just on asset protection; take advantage of the benefits available to the international investor. There are some prudent investments not available to United States residents. Combine the FAPT with a Variable Universal Life (VUL) Policy that adds another layer of protection as well as income-tax benefits. See the Q&A on international life insurance.

Question 10: How does a VUL Policy add another layer of protection?

Answer: There are a few ways. First, the value of a life insurance policy is protected from the claims of creditors under state law. N.J.S. 17B: 24-6(a). As long as you follow the IRS rules that qualify the VUL as an insurance policy, even if the plaintiff knows about the VUL that your FAPT owns, he cannot attach the assets in the VUL. Not even the judge can force you to repatriate the assets in your VUL. Second, the VUL is a recognized device to provide insurance coverage, retirement income, tax benefits, and investment flexibility. A judge is less likely to consider the transfer an attempt to defraud creditors, because there are legitimate reasons other than asset protection for the transfers into the FAPT that in turns purchases the VUL. One point to consider is that the foreign insurance company will not do business with a U.S. person; therefore the FAPT is

necessary to get the benefits of the VUL. Generally, I would suggest combining the FAPT with a VUL to get the greatest degree of protection.

Question 11: Where can I get more information?

Answer: The best place to look is on the IRS website (www.irs.gov), where you will find plenty of information about abusive schemes. The IRS also gives you the opportunity to report abusive schemes. Consult an advisor who is rated by the Asset Protection Society (www.assetprotectionsociety.org).

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International Planning - Questions and Answers

Foreign Asset Protection Trusts

Question 1: If I transfer property to a foreign trust, who is responsible for paying the tax on trust income?

Answer: You, as the U.S. person transferor, are responsible for the income tax. Under United States Internal Revenue Code sections 671 and 679, foreign trusts that have one or more U.S. beneficiaries are deemed “grantor trusts” for income tax purposes. This means that you are responsible for the income tax. Under Internal Revenue Regulation §301.7701-7, a trust that is not controlled by a U.S. entity and that is not subject to the jurisdiction of a United States court is a foreign trust. Although there are exceptions to this rule (Reg. 1.679-4), none of them applies to the typical foreign asset protection trust.

Question 2: What are the exceptions that would permit me not to pay the tax on income?

Answer: The regulations offer four exceptions: (1) Any transfer of property to a foreign trust by reason of your death; (2) Any transfer of property to a foreign trust described in sections 402(b) (employee’s trust), 404(a)(4) (stock bonus, pension or profit sharing trust organized outside the United States, or 404A (foreign deferred compensation plan; (3) Any transfer of property to a foreign tax-exempt trust described in section 501(c)(3) (without regard to the requirements of section 508(a)); and (4) Any transfer of property to a foreign trust to the extent the transfer is for fair market value. Reg. 1.679-4.

Question 3: If I transfer appreciated assets into my foreign asset protection trust, will have to pay capital gains when I make the transfer?

Answer: No. Generally, I.R.S. considers the transfer to a foreign trust a “sale” that triggers capital gains (Reg. 1.684-1), but the Code also provides an exception to the general rule for transfers to a grantor trust (Reg. 1-684-3). See question 1, above for the description of a grantor trust.

Question 4: If my foreign asset protection grantor trust sells appreciated property, will I be responsible for paying capital gains tax?

Answer: Yes. You are responsible for tax on all rents, royalties, dividends, interest, profits and gains from the sale of property in excess of your cost basis. IRC Sec. 61(a).

Question 5: If I suffer a loss within my foreign asset protection trust, may I claim a deduction?

Answer: You may deduct losses to the same extent that you could deduct them if the property were owned in your own name.

Question 6: In addition to asset protection, I want income tax benefits; may I reduce my income tax liability using an asset protection trust?

Answer: Yes. By combining a trust with a Variable Universal Life Insurance Policy you may enhance your asset protection and reduce your income tax liability. Please refer to the Q & A on International Variable Life Insurance. Remember that a FAPT is income-tax neutral; the trust alone does not offer income-tax reduction.

Question 7: I have a large estate and would like to legally reduce the tax that my estate will have to pay. May I accomplish this with a Foreign Asset Protection Trust?

Answer: Yes, but if your primary objective is to reduce estate taxes, an FAPT alone will not accomplish the objective any better than a domestic, irrevocable trust. On the other hand, if you combine the FAPT with a VUL and a business risk management component, you may realize substantial asset protection, estate and gift tax reduction and income tax benefits. Please refer to the Q & A on Business Risk Management using international structures.

Question 8: Will the value of the assets in my FAPT be included in my estate when I die?

Answer: It depends on how the trust is drafted. Most clients who establish FAPTs do so for the primary purpose of protecting assets from creditors and predators. The client wants the assets available if the client needs or wants them. The following are three common retained powers that would cause trust assets to be included in your estate,

(1) If you establish the trust and retain the right to the income, use and enjoyment for life, the value of the trust assets as of the date of your death will be included in your estate. IRC 2036

(2) If you transfer assets into your trust and provide that your beneficiary cannot possess or enjoy the property until your death and you have retained a reversionary interest valued in excess of five percent of the trust assets, the trust assets will be included in your estate. IRC 2037

(3) If you transfer assets into your trust and retain the right to alter, amend or revoke the trust or provisions of the trust or the right to control the timing and amounts of distributions, the value of assets will be included in your estate. IRC 2038

Question 9: Will I have to pay gift tax when I transfer assets into my FAPT?

Answer: It depends on how the trust is drafted. Ordinarily, you retain powers that make the gift incomplete and not subject to tax.

The gift tax applies to completed gifts. The gift is complete when you have so parted with dominion and control over the property or interest in property so as to leave you with no power to change its disposition whether for your own benefit or for the benefit of another. Reg. 25.2511-2(b).

A gift is incomplete if you reserve the power to regain the beneficial ownership. A gift is also incomplete if a reserved power gives you the power to name new beneficiaries or to change the interests of the beneficiaries. Reg. 25.211-2(c)

A gift is not incomplete merely because you reserve the power to change the manner or time of enjoyment. Reg. 25.211-2(d)

A grantor of a trust does not make a gift to trust beneficiaries by paying the income tax on trust income taxable to the grantor under the grantor trust rules. Rev. Rul. 2004-64.

Question 10: In the answer to question 1 you write “a trust that is not controlled by a U.S. entity and that is not subject to the jurisdiction of a United States court is a foreign trust.” Where should I set up my foreign asset protection trust and who controls it?

There are a number of jurisdictions available where you can establish your FAPT. I suggest the Caribbean Island nation of Nevis for the following reasons.

Nevis permits an individual to establish a self-settled, spendthrift trust. Nevis law prohibits attorney contingency fees and fee shifting. Nevis trusts are exempt from Nevis taxes and duties.

Nevis requires the creditor to prove “beyond a reasonable doubt” that the trust was established “with principal intent to defraud that creditor” and that the trust’s establishment or funding left “the settlor insolvent or without property by which that creditor’s claim (if successful) could have been satisfied.” The settlor’s sworn declaration of solvency at the time of settlement of the trust is prima facie evidence that the settlement and disposition of assets was not made with the requisite intent to defraud.

A creditor must bring an action to set aside a fraudulent transfer within two years after the cause of action accrued.

Nevis prohibits the Courts of Nevis to entertain any proceedings for or in relation to the enforcement or recognition of a judgment obtained in a jurisdiction other than St. Christopher and Nevis against an international trust; a settlor of an international trust; a trustee of an international trust; a protector of an international trust; a beneficiary of an

international trust; a person appointed or instructed in accordance with the express or implied provisions of an instrument or disposition to exercise a function or undertake any act, matter or thing in connection with an international trust; or property of either an international trust or of a trustee or a beneficiary thereof if that judgment is based upon the application of any law inconsistent with the provisions of Nevis law or that judgment

relates to a matter or particular aspect that is governed by the laws of St. Christopher and Nevis.

Nevis prohibits the application of non-Nevis law to void any trust or set aside any transfer into the trust or compel any distribution from a Nevis trust.

Nevis requires every creditor before bringing any action or proceeding against any trust property to first deposit with the Permanent Secretary in the Ministry of Finance a bond in the sum of \$25,000.00 from a financial institution in Nevis, for securing the payment of all costs as may become payable by the creditor in the event of his not succeeding in such action or proceeding against the trust property.

All judicial proceedings, other than criminal proceedings, relating to international trusts, are heard *in camera* and no person may publish any details of the proceedings without leave of the Court.

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International Planning - Questions and Answers

Income Tax Planning with International Life Insurance

Question 1: What is a Variable Universal Life Insurance Contract?

Answer: A Variable Life Insurance Contract is a contract (1) that provides for the allocation of all or part of the amounts received under the contract to an account which, according to applicable law or regulation, is segregated from the general asset accounts of the company and (2) the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and the market value of the segregated asset account. IRC 817(d).

Question 2: How does a VUL combined with a FAPT help me reduce income taxes?

Answer: Items of income, dividends, interest, rents, royalties and capital gains are not subject to income tax inside an insurance contract.

Question 3: Is the cash surrender value of VUL taxable income?

Answer: Cash values are not constructively received where they are not available without surrendering the policy. The necessity of surrendering the policy is a substantial "limitation or restriction" on their receipt. Cohen v. Commissioner, 39 TC 1055 (1963). The cash surrender values of paid-up additions are not constructively received by the policyholder. Nesbitt v. Commissioner, 43 TC 629 (1965). The same rule applies whether the policy is a single premium policy or a periodic premium policy.

Question 4: If the value of property held in my insurance policy increases in value or is sold for a profit, will I have to pay income tax?

Answer: If the contract is a life insurance contract, as defined by law, the tax on the increase in value is deferred. IRC Sec. 7702(g).

Question 5: How is "life insurance contract" defined?

Answer: The term "life insurance contract" means any contract which is a life insurance contract under the applicable law, but only if such contract (1) meets the cash value accumulation test of IRC 7702(b) or (2) meets the guideline premium requirements of IRC 7702 (c) and falls within the cash value corridor of IRC 7702 (d).

Question 6: In your answer to Question 4 you write that “the tax on the increase in value is deferred. Does this mean that I will have to pay income tax at some time in the future?”

Answer: Not necessarily. Withdrawals and distributions from the cash value of the life insurance contract may be (1) return of premiums that are not taxed as income; (2) policy loans that are not taxed as income; (3) death benefits that are not taxed as income and (4) distributions upon surrender that are taxed to the extent the value of the distribution exceeds the value of premiums paid. If you have loans outstanding at the time of your death, the death benefit is reduced accordingly.

Question 7: Can I get the same income tax benefits by purchasing a VUL from a United States insurance company?

Answer: Yes. The international structure is developed and administered so that it complies with all tax laws of the United States. The structure uses the tax code in the same manner that a United States insurance company would. You, as a United States person, receive no tax benefit beyond the benefits you would be entitled to if you bought an insurance policy from a United States insurance company.

Question 8: Does an international insurance structure offer any asset protection beyond the protection that United States law offers the cash values and death proceeds of my life insurance policy?

Answer: Yes. First, there is no United States law that protects life insurance from creditors. Each state has its own law covering insurance cash values and death proceeds. Many states offer significant protection, but holding the policy inside your FAPT adds another layer of protection.

Question 9: What kind of property may I invest in my insurance policy?

Answer: Your segregated account may own almost any kind of property as long as the investments in the account are “adequately diversified.” Generally, the IRS considers the account “adequately diversified” if no more than 55 percent of the value of the total assets of the account is represented by any one investment, no more than 70 percent by any two investments, no more than 80 percent by any three investments, and no more than 90 percent by any four investments. If the investments in your segregated account are not adequately diversified, the income on the account will be taxed. IRC 817(h); Reg. 1.817-5(b)(1); Rev. Rul. 91-17.

Question 10: May I invest my primary residence or vacation home in my segregated account?

Answer: No. If you retain control over the assets you transferred to your segregated account, the IRS will disregard the transfer and hold you responsible for paying tax on the income. The mere fact that you have transferred legal title, and not beneficial ownership, to a tax-exempt or tax-deferred entity does not alone absolve you of your responsibility to pay tax on the income earned by the transferred property. Your control over the assets in the segregated account is restricted significantly.

To avoid running afoul of the control issues and to preserve the income-tax benefits of the VUL, you may not invest personal-use property in your segregated account.

A long standing doctrine of taxation provides that “taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid.” Corliss v. Bowers, 281 U.S. 376 (1930). The incidence of taxation attributable to ownership of property is not shifted if the transferor continues to retain significant control over the property transferred, Frank Lyon Company v. United States, 435 U.S. 561 (1978); Commissioner v. Sunnen, 333 U.S. 591 (1948); Helvering v. Clifford, 309 U.S. 331 (1940), without regard to whether such control is exercised through specific retention of legal title, the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency. Christoffersen v. U.S., 749 F.2d 513 (8 Cir.), rev'g 578 F. Supp. 398 (N.D. Iowa 1984). As a resident of the United States, you are taxed on all income from whatever source derived, including capital gains, interest and dividends (I.R.C. 61(a)).

Question 11: What kind of real property may I invest in my VUL segregated account?

Answer: The best kind is real property held and used solely for income and investment. To avoid taxation due to your control over the property, you should retain an independent company to manage, maintain and collect rents from the property. You may not use the property.

Question 12: How about other investments? How much control may I have?

Answer: You may not retain the right to direct the custodian of the segregated account to sell, purchase, and exchange securities or other assets held in the account. You may not exercise an owner’s right to vote account securities either through the custodian or individually. If you can select and control the investment assets in the segregated account, then the IRS treats you as the owner of those assets for federal income tax purposes. Thus, any interest, dividends, or other income derived from the investment assets is included in the purchaser’s gross income. Rev. Rul. 77-85.

You may not select and control the certificates of deposit in the segregated account. Rev. Rul. 80-274.

If your segregated account invests in mutual fund shares or partnership interests that are available for purchase by the general public, the IRS will consider you the owner. However, if the mutual fund shares are available only through the purchase of an insurance contract, then the sole function of the fund is to provide an investment vehicle that allows the issuing insurance company to meet its obligations under its contracts and the mutual fund shares are considered to be owned by the insurance company and not you. Rev. Rul. 2003-92 (partnership interests); Rev. Rul. 81-225 (mutual fund shares) .

You may choose among general investment strategies (for example, among stocks, bonds and money market instruments) at the time of the initial purchase or later. Rev. Rul. 82-54.

There must be no arrangement, plan, contract, or agreement between you and the issuing insurance company or between you and the independent investment advisor regarding the availability of a particular sub-account, the investment strategy of any sub-account, or the assets to be held by a particular sub-account. You may have the right to allocate premiums and transfer funds among the available sub-accounts, but all investment decisions concerning the sub-accounts are made by the issuing insurance company or the independent investment advisor in their sole and absolute discretion. You may have no legal, equitable, direct, or indirect interest in any of the assets held by a sub-account; you may have only a contractual claim against the issuing insurance company to collect cash in the form of death benefits or cash surrender values under the contract. Rev. Rul. 2003-91; PLR 200601006; PLR 200420017

Question 13: How does a non-U.S. insurance carrier comply with U.S. law for tax-free characterization?

An insurance company, for federal income tax purposes, is a company whose “primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.” The mere existence of the words “insurance company” in the taxpayer’s name, and the fact that state or foreign laws grant the corporation powers and regulate the corporation as an insurance company, will not determine the income tax treatment of that company.

A company is an “insurance company” only if it uses “its capital and efforts primarily in earning income from the issuance of contracts of insurance.” The IRS will determine whether an offshore corporation is an insurance company by looking at all of the relevant facts, including the size and activities of its staff, whether it engages in other trades or businesses, and its sources of income.

Question 14: If I invest in a segregated account that underlies my life insurance benefit, am I not just insuring myself? Where is the risk shifting and distribution?

Answer: On your death, the non-U.S. insurance company must pay to your named beneficiary a death benefit. The value of the death benefit equals the value of the segregated account plus a term insurance benefit. The non-U.S. carrier is contractually responsible for paying the full death benefit. The carrier enters into a reinsurance contract. The re-insurer reimburses the non-U.S. company for term insurance benefit. The IRS has noted that:

[r]isk shifting occurs if a person facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of the potential loss to the insurer. The effect of such a transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the “law of large numbers” to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. IRS Notice 2003-34.

Question 15: May I purchase the VUL directly from a non-U.S. insurance company?

Answer: No. A non-U.S. insurance company is not authorized to solicit in the United States, and it may not sell insurance products to U.S. persons. The non-U.S. company may sell to non-U.S. entities only, therefore your FAPT or other foreign entity must own the VUL.

Question 16: Must I pay any tax when my FAPT transfers assets to the segregated account?

Answer: Yes. Although the transfer from you to the FAPT is not a taxable event, the subsequent transfer from the FAPT to the segregated account is a “deemed sale” under general tax principles, i.e. you are receiving something for value in return for your appreciated property. You will be responsible for paying tax on the difference between your cost basis and the fair market value of the asset as of the date of transfer. IRC 367, 704, 721.

Question 17: So, the segregated account may own investment real property located anywhere in the world. My use and management of it is strictly limited. All rental income goes into the segregated account and is not taxable. When

the segregated account sells the real property, there is no taxable gain. How do I access the funds without paying income tax?

Answer: You may take a loan against the cash value. A loan taken from a life insurance policy that is not includable in income because it is not treated as a distribution. IRC Sec. 72(e)(5). If you surrender the policy or allow it to lapse before repaying the loan, the value of the outstanding loan is taxable to the extent the cash value exceeds the premiums paid. See Atwood v. Commissioner, TC Memo 1999-61. If you do not repay the loan before your death, the payment to your named beneficiary is reduced by the amount of the outstanding loan.

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The information contained in this communication is not legal advice and shall not be considered as such. It is for information purposes only. The use of foreign insurance contracts is case specific. Whether or not this technique is appropriate for any individual depends on a complete analysis of the individual's assets and liabilities and personal circumstances. Consult knowledgeable professionals before employing this technique.