

U.S. TAX COMPLIANT INTERNATIONAL DEFERRED ANNUITIES AN OVERVIEW

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U.S. tax compliant deferred annuities sold by international life insurance companies are a simple and cost effective way to:

Enjoy the wealth accumulation benefits of income tax deferral;

Enjoy the flexibility of investment choices that are available in an international environment; and

Protect wealthy individuals' assets from the claims of creditors in those states such as Florida where annuities are exempt from creditors' claims.

The purpose of the following is to explain:

The nature of international deferred annuities;

The advantages of annuity ownership;

The U.S. income tax consequences of annuities;

The U.S. income tax requirements that must be satisfied in order for an insurance policy to be respected as an annuity for U.S. income tax purposes;

The benefits of an international annuity vs. a U.S. domestic annuity;

The relative security of an investment in an international insurance company; and

The unique ways annuities may be put to work to solve the problems of particular U.S. tax payers.

What are Annuities

An annuity is a contract between an insurance company and an individual that becomes a legal envelope into which the annuity owner will deposit cash or investment assets. It may be helpful to think of it as being analogous to a

corporate charter – another type of legal envelop people use to hold their assets. Just as different legal and tax consequences result from putting assets into a corporation, so also there are different legal and tax consequences which result from contributing assets to an annuity.

The insurance company will have legal title to the assets held for the account of the annuity, but frequently those assets are held in the U.S. Only title to those assets needs to be removed to an international financial center. Deferred annuities accumulate the income and reinvest it during the deferral period.

Advantages of Annuity Ownership

Two principal advantages to the ownership of annuities, whether intentional or domestic, is a deferral of income earned on the principal within the annuity contract, and, in some states, asset protection. In those states, assuming the transaction in which the annuity is purchased is not entered into for the purpose of defrauding creditors, the assets of the annuity are put beyond the reach of the creditors of the individual that owns the annuity.

U.S. Income Tax Consequences of Annuities

So long as the annuity satisfies the requirements of the U.S. tax code, the owner will not be taxed on the investment income inside the annuity during the deferral period. After the deferral period, annuity payments will be treated as having an income increment and an increment that represents the return of capital. The income increment will be determined at the time of the commencement of regular annuity payments and will be based upon the expected return of the contract over the life of the annuitant (or the life of the contract) and is determined from actuarially based tables published from time to time by the IRS.

Annuity payments are those regular and periodic payments that are calculated to systematically liquidate the principal and the income earned on that principal over a designated period of time that is either longer than one year or over the life of an individual. All other payments (non-annuity payments) are not treated as annuity payments and are subject to the “income first” rule”. Non-annuity payments are treated as consisting entirely of income up to the entire amount of income that has been earned inside the annuity between the initial issue date and the date of a given distribution. Once all of the income has been taxed, the remainder will be treated as a tax free return of invested capital. Loans are taxed as non-annuity payments. The entire amount of any non-

annuity payments made prior to age 59½, including policy loans, will also be subject to a penalty of 10% of the amount distributed.

With few exceptions, international deferred annuities are taxed identically to U.S. domestic annuities. One difference is the imposition by the United States of a one time 1% U.S. federal excise tax on the amount of premium paid.

The second difference is that certain investments inside the annuity will be subject to tax. A 30% withholding tax will be imposed on dividends paid with respect to stocks held for the benefit of the annuity. Secondly, capital gains from the sale of U.S. real property interests (as defined by Internal Revenue Code §897) will be subject to tax as if the foreign insurance company were an ordinary domestic corporation against which 10% of the proceeds of sale will be withheld. For this reason, U.S. real property interests should never be part of the investment portfolio of an international annuity.

It is also worth pointing out that ownership of an international insurance policy does not give rise to an IRS reporting requirement. There is no box to be checked on the 1040 asking about ownership of such a policy.

Funding An Annuity - Tax Consequences

The purchaser of an annuity will realize gain on the transaction if appreciated property is used to pay the premium. For example, a person considering purchasing an annuity might have an account with a stockbroker. He may want the securities within the account to become securities within an annuity. He would do this by establishing an annuity with an insurance company. The insurance company would establish an account with the stock broker, and the assets of the individual's account would be transferred to the insurance company's account. This will constitute the sale or exchange of all of the securities in the individual account in return for the annuity, and is a taxable event. The purchaser of the annuity will recognize the gains and losses in his account at the time of the conversion. Therefore, the purchaser may want to plan the timing of taking gains and losses and roll into the annuity gradually over time rather than simply converting the portfolio in a single transaction.

U.S. Tax Requirements For Annuity Treatment

To be respected as an annuity for U.S. income tax purposes and have the benefit of the deferral of tax on the income inside the policy, the insurance contract must satisfy certain requirements:

First, it must meet the definition of an annuity. While the Internal Revenue Code doesn't provide a specific definition, there is judicial authority that would

require an annuity to be the sort of policy customarily regarded as an annuity in accordance with the trade practices of life insurance companies. With respect to a deferred annuity, after the period of deferral, the policy should provide for a series of payments over a period either longer than one year or for the life of one or more named individuals that will systematically liquidate the principal and earned income of the policy.

The investments made for the benefit of the annuity must satisfy the diversification requirements established by Treasury Regulations § 1.817-5. That is, as of the end of any calendar quarter, the assets of the annuity must be invested in at least five investments, and not more than 55% of the value of the assets within the annuity can be in one investment. Not more than 70% can be in two investments, not more than 80% can be in three investments, and not more than 90% can be in four investments. The portfolio will be considered adequately diversified if it is diversified as of the last day of the calendar quarter (or 30 days thereafter). According to IRS regulations, market fluctuations will not result in a violation of diversification requirements unless there has been an acquisition that is either wholly or partially responsible for the violation.

The annuity contract must have certain provisions for distribution on the occasion of the death of the annuitant. Specifically, if regular annuity payments were being made prior to the death of the annuitant, the post death payment must liquidate the remainder of the principal and income at least as rapidly as was the case with the payments prior to death. If the annuitant dies prior to the first annuity payment, then the policy must distribute the entire remainder of the principal and interest within five years of death.

The annuity must be owned by one or more individuals and not by a corporation or other entity. Ownership can be in a trust as long as the trust is holding title for the benefit of individuals.

International Annuities Vs. Domestic Annuities – Flexible and Cost Effective

With two important exceptions noted above, international annuities are taxed the same as domestic annuities. The reason to select an international annuity over a domestic policy is flexibility and price.

These contracts enjoy significant flexibility, because State insurance regulators do not regulate them.

Flexibility As To The Form Of Annuity Contract. The form is a matter of contract to be agreed upon between the insurance company and the purchaser of the annuity;

Flexibility As To The Kinds Of Assets That Can Be Held For The Benefit Of The Annuity. As assets can be distributed in kind (they need not be converted to cash prior to distribution) it is possible to invest in illiquid assets such as a minority interest in a closely held corporation; and

Flexibility As To The Investment Manager Hired To Direct The Investment Of The Capital Held For The Benefit Of The Annuity. While the owner of the annuity cannot direct the investment and reinvestment of the assets of the annuity, generally an international insurance company will appoint a money manager or stock broker acceptable to the purchaser to have discretion with respect to investments. Further, as the owner of the annuity is free to do an IRC §1035 tax free exchange of a given annuity for an annuity issued by another company, foreign or domestic, the issuing insurance company is likely to be cooperative in replacing fund managers from time to time as requested by the policy owner.

Cost Effective. International annuities generally are no load investment vehicles. They don't have a sales commission built in, and there is usually no penalty (other than an income tax penalty) for an early withdrawal or a 1035 exchange for another annuity. That is they are generally much more cost effective than their U.S. counterparts.

International Insurance Products – The Security of the Investment

Investors can take comfort in the security of the assets in their annuity for a number of reasons. First, Cayman Islands law provides, “No one other than the policyholder can make a claim against the segregated account cash value of the life insurance policy or annuity.” That is, if the insurance company were to become financially troubled, the other creditors of the insurance company, including the other policyholders, can not make a claim against the assets of a given annuity. Other foreign jurisdictions have similar provisions.

The investor may also take comfort in the fact that the assets are usually held in the U.S. by an investment advisor chosen by the owner of the annuity. They are not usually held by the management of the international insurance company.

Putting Annuities to Work

A variety of structures can be put together to take advantage of the characteristics of U.S. tax compliant deferred international annuities – a deferral on the imposition of U.S. income tax, asset protection and flexibility of investment.

Asset Rich Persons with High Liability Exposure. Certain people who have not only significant assets but significant exposure to liability from creditors claims – such as doctors, attorneys, contractors, nursing home and other elder care facility operators may wish to avail themselves of the asset protection qualities of annuity policies if they live in states where annuities are asset protected.

Temporary U.S. Residents. Persons who are not U.S. citizens but who are planning to live in the United States for a long enough period of time as to make them U.S. tax payers, can put their investment portfolio inside an annuity prior to entering the United States. While in the United States they are under no obligation to report the existence of the annuity, and their investment income is sheltered from current taxation. If, after they leave the United States and are no longer subject to the imposition of U.S. income tax, they can cash in their annuity. The result is the income earned inside the annuity during the period they were a U.S. resident will never be subject to U.S. tax.

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