

# U.S. Tax Planning For Passive Investments

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## Gary S. Wolfe and David E. Richardson

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**Yes, there is a way to hold portfolio investments (especially hedge funds), while at the same time having a minimal reporting burden associated with it, as well as providing significant asset protection.**

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**IN HER** October 18, 2006 Wall St. Journal article, *Insuring Against Hedge-Fund Taxes*, Rachel Emma Silverman stated:

“A small but growing number of wealthy investors have discovered a legal way to invest in hedge funds without paying income taxes on the gains. It’s called ‘private placement’ life insurance. These special insurance contracts allow policyholders to invest in a wide range of products, including hedge funds. The main attraction: Because the investments are held within an insurance wrapper, gains inside the policy are shielded from income taxes - as is the payout upon death. What’s more, policyholders may be able to access their money during their lifetimes by withdrawing or borrowing funds, tax-free, from the policy....”

“Private-placement insurance policies are essentially variable insurance policies, which allow policyholders to invest a portion of their premiums in separate investment accounts...”

“The strategy’s chief advantage is the tax benefits that all life-insurance policies offer: Assets inside a life insurance policy can grow tax-free, and the death benefit can also be paid out free of income tax...”

### **Tax Planning Strategy For Passive (Portfolio) Investments**

U.S. taxpayers can achieve greater net-after tax returns and superior asset protection for their domestic or international investment portfolios by using a tax planning strategy utilizing private placement life insurance. The benefit is perhaps greatest when combined with investments like hedge funds that are taxed at ordinary income rates and also where unrealized income tax and taxable gains are flowed out annually to fund shareholders.

A summary of the benefits are as follows:

- Taxable ordinary income and short-term capital gains (taxed at 35% federal tax rate) now wholly tax exempted;
- For Foreign Trusts, investment portfolio income now compounds tax-free annually with no accumulation tax;
- Pre-empts IRS tax audits on investment portfolio income since there is neither any income tax nor any reporting due on the investment portfolio income;
- Absent a fraudulent conveyance, investment portfolio assets are immediately exempt from creditor seizure once held by the policy;
- U.S. tax compliance is minimized for filings: that is, no TDF 90-22.1 (“FBAR” filing), or IRS Form 8938 (Statement of Specified Foreign Financial Assets).

For U.S. taxpayers, the strategy requires that the investments are owned and held by a Puerto Rico issued Life Insurance policy- Puerto Rico is a US Commonwealth Territory and considered “U.S.” for many practical purposes, but with design and investment flexibility typically found “offshore.” In

turn, the policy could be owned by a U.S. Grantor Trust, domiciled say, in the Bahamas. The Bahamas is particularly well suited in that under local law, insurance is expressly exempt from the claims of creditors, provided that premium(s) used to fund the policy are not subject to any prior claim at the time of transfer.

The tax planning strategy is particularly appropriate to international investors (who are treated as U.S. resident taxpayers) who invest in U.S. hedge funds, but also a very wide variety of portfolio investments.

### **Reporting Benefits**

U.S. Taxable Residents with offshore structures ordinarily must file the following annual U.S. tax compliance:

- Annual Form 1040: report worldwide income (including hedge fund income);
- Foreign Financial accounts over \$10,000 file form TDF 90-22.1, Report of Foreign Bank and Financial Accounts, “FBAR Filing,” due June 30th following tax year (separate tax filing);
- Foreign Financial Assets valued in excess of \$50,000 file form 8938, “Specified Foreign Financial Assets” attached to form 1040 (Foreign Account Tax Compliance Act: “FACTA Filing.”)

Note that Filing form 8938 (with form 1040) does not relieve U.S. taxable residents of the requirement to file “FBAR,” Form TDF 90-22.1 if FBAR filing is otherwise due.

In contrast to these reporting obligations, the aforementioned strategy is not only compliantly tax exempted, but also relieves the taxpayer of all the reporting obligations listed above and thus diminishing the likelihood of IRS audit.

### **In Greater Detail: U.S. Tax Compliance/ Tax And Asset Protection Benefits**

- Income Tax (Form 1040). Under Code section 72(e)(5), income from assets held under a qualifying life insurance policy (i.e. Puerto Rico Life Insurance policy), is not subject to income tax, nor is there tax reporting. Effectively, the investments otherwise taxable income and gains are not subject to U.S. income tax or tax reporting.
- Report of Foreign Bank and Financial Account (“FBAR”: TDF 90-22.1). The “FBAR filing” is a financial disclosure for U.S. taxpayer foreign financial accounts (i.e. a report of taxpayer’s foreign financial accounts if the account value is over \$10,000). As a U.S. territory, an account in Puerto Rico is not considered a foreign account so no “FBAR filing” is due for the Puerto Rico life insurance policy.
- Statement of Specified Foreign Financial Assets (IRS Form 8938). The Puerto Rico life insurance policy may be classified as a foreign financial asset (i.e. a foreign financial account maintained by a foreign financial institution), subject to reporting under IRS Form 8938. Since the U.S. taxpayer (Internal Revenue Code §679(a) (1) Foreign Grantor Trust (i.e. Bahamas Discretionary Trust) owns the policy, the U.S. taxpayer may file an abbreviated Form 8938 (only completing Parts I and IV) confirming that the specified foreign financial asset (i.e. Puerto Rico Life Insurance policy with more than \$50,000 cash value) was reported on the Foreign Grantor Trust (Nassau Trust) tax filings (Forms 3520, 3520-A).
- Policy lifetime withdrawals may be tax-free and not subject to tax reporting (as either a return of premium/basis or a loan). The Modified Endowment Contract (“MEC”) rules may or may not apply depending on policy design. IRS Private Letter Ruling 200244001 (May 2, 2002): IRS audit risks are minimized since assets held under a qualifying life insurance policy are neither subject to investor income tax, nor is there any required income tax reporting (under Code §72(e)(5)), reference: Rev. Rul. 81-225 (situation #5), Rev. Rul. 82-54, 1982-1 C.B.11.
- In addition to the substantive tax and reporting benefits, for audit purposes there would be no presumed IRS tax avoidance, due to the fact that life insurance has been granted an “angel exception” (i.e., is an IRS approved transaction) (IRS Revenue Procedures 2007-20, 2013-11, 2004-67, 2004-68).
- As a U.S. territory, Puerto Rico life insurance policies do not require filing of “FBAR” Form TDF 90-22.1 (Report of Foreign Bank and Financial Account). Since taxpayer’s foreign Grantor Trust (i.e. Nassau Trust) owns the Puerto Rico Life Insurance policy an abbreviated Form 8938 may be filed (only Parts I and IV).
- In contrast, foreign life insurance issued to U.S. persons is subject to “FBAR filings” annually (if valued at more than \$10,000) with the report filed directly with the IRS (Treasury Department), and disclosure as a specified foreign financial asset (over \$50,000) with the annual filing of Form 8938, a separate tax compliance form filed with annual income tax returns (Form 1040). Additional income tax benefits: (i) Assets inside a life insurance policy grow and compound income tax free; (ii) Death benefit paid income tax free. Code §101. Short-term capital gains exempt from income tax (41 percent Federal/California income tax, i.e. Federal 35 percent tax rate over \$379,150, California: 9.3 percent tax rate over \$48,029. Note that Proposition 30 has increased California’s tax rates. *See* [www.wtas.com/publications/newsletter/december-2012/keeping-up-with-californias-tax-changes](http://www.wtas.com/publications/newsletter/december-2012/keeping-up-with-californias-tax-changes)). Bond interest exempt from income tax (taxed at 41 percent ordinary income rates

Federal/California). Under Puerto Rico law, the cash value benefits of a life insurance policy are expressly exempt from seizure by creditors (absent fraudulent conveyance funding of the policy). Act No. 399 of Sept. 22, 2004, as amended by Act No. 98 of June 20, 2011. Under Act No. 98 (6/20/11), which amended Act no. 399 (9/22/04), the policy owner and policy beneficiary are statutorily protected from seizure.

In summary, a properly structured U.S. compliant private placement life insurance as issued by a duly licensed Puerto Rican carrier, and as owned by a Bahamian Foreign Grantor Trust is very legitimate and tax effective way to hold portfolio investments (especially hedge funds), while at the same time having a minimal reporting burden associated with it, as well as providing significant asset protection.

