

**Steve Leimberg's Estate Planning Email Newsletter - Archive Message #915**

**Date:** 16-Jan-06

**From:** Steve Leimberg's Estate Planning Newsletter

**Subject:** [PLR 200601007 Investor Control Rules Deliberately Violated in Variable Annuity Plan to Avoid U.S. Taxation](#)

**Robert D. Colvin**, a partner in the firm of **Baker & McKenzie LLP** in Houston, Texas, advises high net worth international private clients on international business, tax, asset protection, estate planning and wealth accumulation strategies through foreign and domestic trusts, life insurance products, private companies, partnership entities, and other creative planning vehicles.

Bob fills LISI members in on the latest concept in annuities and taxation.

The IRS recently released two private letter rulings better defining application of the "investor control" principle to investments within variable annuity and variable life insurance contracts. This principle determines whether the assets within a variable contract are treated as owned by the carrier (which is a basic prerequisite to qualify for the usual federal income tax advantages) or, alternatively, are treated as owned by the contract purchaser under a constructive receipt type of attribution (in which case the standard tax benefits are typically lost).

PLR 200601006 primarily confirms many of the operating principles that practitioners in this area have come to accept, so we will simply leave that for your own perusal.

However, PLR 200601007 represents the first ruling in which a U.S. carrier has structured an annuity contract based on an intentional "violation" of the investor control rules as a means to avoid U.S. tax.

## **EXECUTIVE SUMMARY:**

PLR 200601007 holds that the assets supporting a group variable annuity contract issued by the foreign branch of a U.S. carrier to a foreign Pension Plan are considered to be owned by the foreign contract owner and not the insurance company. This treatment (1) avoids the 30% withholding tax that would typically apply on annuity payments to foreign contract holders, and (2) permits the annuity separate account to hold foreign investment funds without incurring a U.S. tax or interest charge under the PFIC rules.

## FACTS:

The foreign branch of a U.S. carrier proposes to sell group variable annuity contracts to a foreign Pension Plan established by a foreign employer.

Employees of the foreign employer will contribute to the Pension Plan and direct that the funds be invested in one or more of the investment options available under the group annuity contracts as selected by the contributing employee.

The investment options under the group annuity contracts include the equivalent of sub-accounts or sub-divisions of a separate account used in connection with U.S. variable contracts.

Each investment option invests in one or more of three different types of assets:

- (1) units of foreign investment funds similar to U.S. "private placement" investment funds;
- (2) units of foreign investment funds that are essentially the same as U.S. mutual funds; and
- (3) shares of stock of the foreign employer that established the Pension Plan.

None of these investment options constitute "insurance dedicated funds" ("IDF's") in that they are all available for purchase directly by the public without purchasing a variable contract.

[Note: IDF characterization is typically important because a contract owner is permitted to openly direct the carrier to invest the contract's separate account into an IDF without violating "investor control" principles. In contrast, contract owners are not permitted under these principles to instruct the carrier to invest in publicly available funds.]

Although for a fee an employee can elect at retirement to have his/her account applied to provide an immediate annuity, it is expected this option will rarely, if ever, be elected by any employee.

In a very unusual twist, the facts of the ruling expressly state that the group annuity contracts do NOT:

1. comply with the Section 72(s) minimum payout provisions (which is a mandatory requirement to be characterized as an "annuity" for U.S.

- tax purposes),
2. qualify as "variable contracts",
  3. meet the requirements of "pension plan contracts", or
  4. comply with Code Section 817(h) diversification requirements.

In effect, it is quite clear this product was designed to intentionally avoid characterization as a variable annuity contract for U.S. tax purposes, which at first appears to be a very strange position for a U.S. carrier.

## **COMMENT:**

### **A VERY DIFFERENT OBJECTIVE**

Typically, a U.S. carrier takes great pains to insure that its products qualify for the favorable tax benefits afforded annuities and variable life policy contracts. In particular, U.S. oriented products are structured and managed with a particular sensitivity to avoiding prohibited "investor control" that would cause the contract owner, rather than the carrier, to be considered the owner of the underlying separate account investments.

However, this ruling shows that foreign investors may have a very different perspective on things. In products designed for foreign markets, the primary U.S. tax objective may simply be to avoid the U.S. tax system.

### **U.S. WITHHOLDING TAX CONCERNS**

The trade or business of a foreign branch is generally treated as the activity of its U.S. "parent" entity for U.S. tax purposes. [Rev. Rul. 2004-75](#) and [Rev. Rul. 2004-97](#) held that payments under contracts issued to non-U.S. persons by the foreign branch of a U.S. insurance company are subject to the 30% U.S. withholding tax under Section 1441 (unless exempted by treaty).

Characterization of the PLR 200601007 contracts as "annuities" for U.S. tax purposes would have made payments under those contracts subject to this U.S. withholding tax and, therefore, unattractive to the foreign Pension Plan investors (unless located in certain treaty jurisdictions). However, if the contract does not constitute an "annuity" then this withholding tax could possibly be avoided.

The first step in this strategy was to avoid "annuity" characterization, which was accomplished by explicitly "violating" the requirements of Section 72(s) that the contract provide for a minimum payout upon the death of the contract

owner.

Voila!! The "annuity" cloak disappears and if it's not an "annuity" then it can't be a "variable contract" either so the diversification rules don't apply!!

It looks like this thing is heading in the right direction. However, if the separate account assets are still considered owned by the U.S. carrier then there remains a risk that payments from the U.S. carrier to the foreign Pension Plan could be subject to this withholding tax under alternative theories.

The solution, therefore, was to completely remove the U.S. carrier from the chain of ownership for U.S. tax purposes. This is where the wheels start to turn a little faster....

### **WHY NOT USE THE INVESTOR CONTROL RULE TO OUR ADVANTAGE?**

In order to accomplish this goal the U.S. carrier needed some way for the U.S. to consider the foreign Pension Plan as the owner of the assets, while at the same time making sure the foreign jurisdiction respected the annuity.

As noted above, a "breach" of the investor control rules generally causes the contract owner, rather than the carrier, to be treated as the owner of the annuity's underlying separate account portfolio assets.

If the Pension Plan is considered the owner of the underlying portfolio investments for U.S. tax purposes then subsequent payments from those assets to the Pension Plan should not be considered an "annuity" distribution from the U.S. carrier. Therefore, the 30% withholding tax should not apply to such payments.

### **PFIC's A PROBLEM FOR THE CARRIER?**

Most likely the Pension Plan, at least initially, had a non-tax reason for preferring the foreign investment funds. However, a particularly troubling issue arises for U.S. based carriers investing in foreign investment funds under the passive foreign investment company ("PFIC") rules.

A PFIC is essentially a foreign company in which 75% or more of its income is from passive sources or 50% or more of its assets produce passive income or are non-income producing. Therefore, most foreign investment funds are characterized as PFIC's for U.S. tax purposes.

Without going through all the details of PFIC taxation, the basic problem is that a U.S. taxpayer generally incurs a very substantial interest charge penalty on distributions from a PFIC. More importantly, the prevailing view is the

special exemption that typically permits a U.S. insurance company to avoid tax on its investment income most likely does not avoid the PFIC tax or interest charge unless the PFIC makes a special "Qualified Electing Fund" election, which most foreign funds are not willing to do.

In effect, PFIC income is usually taxable to a U.S. carrier even if earned within the separate account of a qualifying variable annuity contract.

### **INVESTOR CONTROL CAN BE YOUR FRIEND**

So how does the U.S. carrier avoid the PFIC tax while still offering a benefit to the foreign Pension Plan? By turning the tables on the investor control rules and intentionally causing the Pension Plan to be treated as the owner of the underlying PFIC investments!!

From a U.S. tax perspective the foreign Pension Plan (and not the U.S. carrier) will own the foreign PFIC investments. No U.S. taxpayer. No U.S. source income - so no U.S. withholding. Therefore, no U.S. tax!!

### **PRETTY NIFTY PLAN**

So the bottom line is that by affirmatively asserting the investor control rules the U.S. carrier was able to design a unique product that successfully avoids U.S. tax (both withholding tax and PFIC charges) while maintaining the integrity of the annuity contract for foreign law purposes.

### **SO WHY DID A FOREIGN PENSION PLAN THAT WAS NOT OTHERWISE SUBJECT TO U.S. TAX WANT TO BUY A U.S. ISSUED GROUP VARIABLE ANNUITY?**

Well, you will have to ask them about that but we can reasonably assume that under the local laws where the Pension Plan is located there must be some tax, reporting, investment restriction, or other reason that justifies this exercise.

Some things will just have to remain a mystery!!

### ***EDITOR'S COMMENT:***

*Even if you never engage in a transaction like this - and I'm sure most of us will not - you have to admire the fine mind that crafted it.*

***HOPE THIS HELPS YOU HELP OTHERS!!!***

***Bob Colvin***

Edited by Steve Leimberg

## **CITE AS:**

Steve Leimberg's Estate Planning Newsletter # 915. Copyright 2006 Leimberg Information Services, Inc.(LISI) Reproduction in Any Form or Forwarding to Any Person Prohibited - Without Express Permission. For a free look or To Access LISI Archives or Join LISI: <http://www.leimbergservices.com>

## **CITES:**

PLR 200601006 (January 6, 2006); PLR 200601007 (January 6, 2006); PLR 200420017 (February 2, 2004); Rev. Rul. 2004-97, 2004-39 IRB 516; Rev. Rul. 2004-75, 2004-31 IRB 109; Rev. Rul. 2005-7, 2005-6 IRB 464; Rev. Rul. 2003-91, 2003-2 CB 347; Rev. Rul. 2003-92, 2003-2 CB 350; IRC Sections 72(s), 817(d), 817(h), 1441, and 1291-1298. **Tax Planning With Life Insurance** (800 950 1216).

HELP US HELP OTHERS! TELL A FRIEND ABOUT OUR NEWSLETTERS. JUST [CLICK HERE](#).