Forbidden Knowledge

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Amazing Annuities: Offshore Annuities Can Protect Your Wealth, Defer Taxes and Help Diversify Your Portfolio Internationally

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Introduction

Through a properly set up offshore variable annuity, you can achieve many benefits that simply aren't available through any other investment: asset protection, privacy, top management, investment and currency diversification, and deferral of all tax on income or gain until you begin receiving payments from the annuity. In this special report, you'll learn all about this potentially lucrative and powerful offshore investment.

For your convenience, we have included contact information for several offshore insurance brokers in this report. To the best of our knowledge, these companies offer annuities which meet U.S. regulatory requirements and qualify for tax deferral. But U.S. tax laws are in a constant state of change. Through The Sovereign Society, we will aim to advise you of any changes that affect offshore annuity policies. But we recommend that before you invest in an offshore annuity, you obtain a written opinion from a U.S. tax lawyer or accountant stating that the annuity you chose is designed to qualify as a variable annuity under U.S. law.

This report is organized in two sections. In the first section, we'll introduce annuities, and describe features of them that are common to both domestic and offshore products. In the second section, we'll describe the unique benefits of offshore annuities.

SECTION 1: AN INTRODUCTION TO ANNUITIES

What is an Annuity?

The term "annuity" is often misunderstood because it is used in so many different ways.

Basically, an annuity is a series of payments over a period of time. *Webster's New World Dictionary* defines it as "An investment, yielding fixed payments." In a broader context, payments on a mortgage, an automobile or any other long-term loan are also annuities. Social security benefits are another type of annuity as are benefits from an employer pension plan.

Each annuity contract involves at least three parties:

- The **policy owner** who pays for the annuity.
- The **income beneficiary**, also known as the **annuitant**, who is usually the contract holder and who receives the benefits.
- The **insurance company**.
- If a contract provides for some payments after the death of the income beneficiary, then there may also be a death benefit beneficiary such as a spouse or child.

While the term "annuity" encompasses many types of income arrangements, most often, it's used to describe an arrangement where an insurance company agrees to make a series of payments to someone for the rest of their life in exchange for a single, fixed premium. For example, you give an insurance company US$100,000 at age 65. In turn, they agree to pay you an income of US$800 per month for the rest of your life. When you die, the payments stop. That's a typical **life income annuity**.

However, most annuities are purchased with a series of periodic payments until the buyer is ready to retire. Thus, if you are 50 years old and make monthly payments of US$330 a month for 15 years, the same insurance company might be willing to give you a lifetime income of US$800 a month when you retire at age 65.

If you compute the total amount of the payments of US$330 a month for 180 months, the sum is only US$59,400—a lot less than US$100,000. The US$40,600 difference represents the amount the insurance company can earn on the deposits that are accumulating during the 15-year accumulation period. At age 65, the insurance company should have US$100,000 with which to pay for your US$800 per month retirement annuity.

A major advantage of an annuity savings plan as described here is that none of the income earned by the savings is subject to tax until it's distributed as a retirement benefit.

Immediate and Deferred Annuities

When you give an insurance company a sum of money and they begin to give you payments for the rest of your life or for some agreed term of years, it is known as an **immediate annuity**. The benefits begin immediately—or most often within one year.

A **deferred annuity** is one where the payments to you are deferred for a set number of years or until a prescribed age, such as age 65. It doesn't matter if the premiums paid to the insurance company are made all at once, as a **single premium**, or in a series of premium payments. The "deferred" term refers to when the insurance company begins to make payments to you.

A deferred annuity is designed to provide long-term, tax-deferred savings. You do not receive a tax deduction on the money you invest in a deferred annuity. However, assuming that the annuity complies with U.S. tax laws, you pay no taxes on the build-up in value within the annuity until you begin making withdrawals. Unlike IRAs and most other types of retirement plans, there are no annual contribution limits or income

limits. A deferred annuity may be a good option to consider if you have reached the annual contribution limits to your IRA or pension plan and wish to increase your tax-deferred savings.

On the other hand, once you do begin taking payments from an annuity, the income you receive beyond your original contribution will be taxed at regular income tax rates, not the lower 15% rate that applies (until 2008 unless extended by Congress) to capital gains and most dividends. If the bulk of your investments consist of investments held to generate capital gains and dividends, you need to carefully consider the tax implications before you invest in an annuity. We'll discuss this topic in greater detail later in this report.

Fixed Return and Variable Return Annuities

A fixed return annuity (or fixed annuity) is one where the insurance company guarantees to make payments of a fixed amount for an agreed upon term of years or for the lifetime of the person—or **persons—**named as income beneficiaries.

Yes, that's right. If your spouse, partner or other loved one needs income from your annuity, you have the option of guaranteeing lifetime income for both you and that other person. Payments will be made to you and the other person for as long as one of you is alive. However, payments you receive with a lifetime income for two persons will be less than the single life option. To alleviate this problem, you may elect to have payments reduced after one of you dies. This choice results in higher payments while both of you are living. All payments cease after the death of the last survivor.

Implicit in any fixed annuity is an assumed rate of interest that the insurance company will pay based on the deposits made by the policy owner. In order to profit from such an arrangement, the company offers to pay a rate of interest that is less than it expects to earn by investing the funds it receives for the contract.

A fixed annuity will earn a guaranteed rate of interest for a specific time period, such as one year or five years. Once this period has elapsed, the insurance company sets a new guaranteed interest rate for the next period. While this arrangement is in some ways similar to a certificate of deposit (CD) purchased from a bank, unlike a typical CD, the value of an annuity is **not** guaranteed by a government agency, such as the Federal Deposit Insurance Corporation (FDIC). The guarantee is only as good as the financial health of the company that sells the annuity. Always check the financial status of the company from which you are purchasing an annuity.

Many investors are shocked at the relatively low rate of interest that an insurance company is willing to guarantee for an annuity. Rates of 4% to 6% are the most common, although it's possible to find companies that offer higher rates.

Many people like the tax deferral benefit of the annuity contract but they don't like the low fixed return offered by insurance companies. Over time, and in response to consumer demand, various companies developed "variable" return annuity contracts where some or all of the funds on deposit are invested in stocks or other securities. With this arrangement, the investment income earned by the insurance company will vary depending on the performance of the underlying investments during the years the contract is in force. Of course, the payments you eventually receive with this type of contract will also vary with the performance of the investments.

Some variable annuities offer an option that guarantees both principal and interest, much like a fixed annuity. That's accomplished by placing some of your money in a lower risk fixed income annuity and the remaining funds in higher risk investments such as stocks. Obviously, the greater the proportion of your investment you designate to high-risk investments, the less the amount of principal and interest the insurance company will guarantee.

You can also opt for a variable annuity with a **death benefit**. If you die, a person you select as a benefi-

ciary (such as your spouse or child) will receive the greater of: (i) all the money in your account, or (ii) some guaranteed minimum (such as all purchase payments minus prior withdrawals). Choosing this option can have unpleasant tax implications, however, which we'll discuss later in this section.

Tax Advantages of Annuities

Tax-Free Switching of Investment Funds

Most companies that offer variable annuities provide a range of investment choices during the time before you begin receiving income from the annuity. Typically, these investments are mutual funds that target specific markets or specific performance characteristics (e.g., growth, growth and income, or income). Mutual funds designed for growth provide the highest potential gains, but also come with the highest risks. Income funds are safer, but won't provide as much potential for high returns.

The larger insurance companies with large numbers of annuity policies are able to offer a wide assortment of different kinds of stock funds, such as emerging markets, high tech, mid-cap, and so on. An increasing number of companies offer stock or bond index funds that match the performance of selected market indices.

For example, you could designate 30% of your purchase payments to a bond fund, 30% to a U.S. stock fund, 20% to an international stock fund, and 20% to a fixed account paying a guaranteed amount of interest (e.g., 5% annually).

As in any family of mutual funds, you can generally switch your investment from one fund to another. However, unlike other types of non-tax-sheltered investments, with the variable annuity, there is no tax on any gain as a result of selling one fund and buying another.

In recent years, some insurance companies have developed annuity contracts with some highly innovative features. One popular option is to permit the annuity owner to request a specific investment manager to manage part or all of the assets in the portfolio (although to comply with IRS regulations, this request must be non-binding). Another option permits the contract holder to request the insurance company to purchase specific investments, including closely held stock in private companies. These contracts are called "wrap-around-annuities" because the annuity contract is wrapped around the investments selected by the contract owner.

However, the IRS became disturbed by the popularity of these arrangements and released regulations that outlined investment and diversification guidelines for variable annuities. Failure to meet these guidelines means that the contract is not an annuity contract for tax purposes. Therefore, if you opt for an annuity contract with any such innovative features, you should be certain that it is fully compliant with current U.S. tax rules. In addition, if you opt for an investment manager to manage the assets in the annuity, that manager must be educated on the issue and carefully monitored to assure compliance with the rules.

Two Periods of Tax Deferral for Contract Owners

The income or gain earned within an annuity contract is tax-deferred until the annuity payments begin. If the insurance company makes a lump sum payment of the accumulated amount, that will be the end of the tax deferral. You will have to pay income tax on the total received minus the total payments made to the insurance company.

However, there is an additional tax deferral benefit during the payout period when the payments are made over your lifetime or a substantial term of years. In some cases, the income earned during the payout period can exceed the income earned during the accumulation period of an annuity.

For example, if you invest US$12,000 a year for 20 years in an annuity and earn an average of 8% per

year on your savings (tax-deferred), you would accumulate a fund of about US$593,000. The tax-deferred earnings in this example amount to US$353,000. If you then elect to have the insurance company distribute these funds to you over a period of 20 years, and if the undistributed funds continue to earn 8% (tax-deferred), the fund would accumulate an additional US$615,000 of tax-deferred earnings. The earnings on the funds held during the payout period would be almost 75% more than the amount earned during the accumulation period.

Income Tax on Partial Distributions

When you begin to receive annuity payments, the normal method of computing the income tax on the accumulated earnings is to estimate the total payments that will be received and to then compute the ratio of the amount paid to the total expected payments.***IN GENERAL, THE RETURN OF YOUR ORIGINAL CAPITAL CONTRIBUTION IS TAX-FREE; THE INCOME THAT CAPITAL GENERATED WHILE INSIDE THE ANNUITY IS TAXABLE***

For example, if you made payments of US$80,000 over a period of years for an annuity that is expected to pay you US$1,000 a month for 20 years, your total payments are expected to be US$240,000. Of this US$240,000, US$160,000 represents untaxed income [in the contract]. You would compute the ratio of the US$80,000 to the US$240,000—which is one-third, or 33%. That represents a return of your investment, which is tax-free. The balance of each payment (2/3 or 66.7%) is taxable.

With a life income annuity, the calculation is based on your life expectancy. The IRS provides a method of estimating your life expectancy using five-year age ranges and a formula that is spelled out in your tax return instructions each year. It accomplishes the same general result as the example given above. Using this IRS formula, you may end up with more excluded payments than the total of what you paid for the annuity. When you have recovered all of your contributions tax-free, all future annuity benefits are fully taxable.

On partial distributions or withdrawals, the entire amount is treated as ordinary income to the extent of the untaxed earnings in the annuity contract. For example, if you invested US$50,000 in an annuity and left it to accumulate income for a few years, it might have a value of US$60,000. If you then take out a loan of US$15,000, US$10,000 will be taxable income and the other US$5,000 will be a return of your investment.

Tax Disadvantages of Annuities

Due to aggressive marketing of annuities by U.S. insurance and brokerage companies, there have been abuses in marketing deferred annuities or variable annuities to people who really can't benefit from this kind of investment.

Annuities aren't for everyone. Variable annuities are suitable for even fewer people. And offshore annuities, which we'll describe in the next section, are not for the novice investor or anyone who isn't able to assume and accept some risk.

Ordinary Income Instead of Capital Gain

One of the major disadvantages of an annuity contract is that income from an annuity is taxed as ordinary income, not as a long-term capital gain or qualified dividend.

In 2004, Congress lowered the tax rate for long-term capital gains and qualified dividends to 15% (for very low income taxpayers, to 5%). However, these rates do not apply to variable annuities. To complicate matters further, the 15% tax rate is set to expire in 2008, unless Congress extends it.

From a tax perspective, as things stand now, variable annuities make the most sense to hold income-producing assets or short-term gains from mutual funds that are actively traded. These investments are not eligible for the special 15% tax rate. There are at least two variables that may affect this calculation:

- For long holding periods (generally 20 years or more), the advantage of tax-free compounding year-after-year may outweigh the disadvantage of eventually paying tax at regular income tax rates (up to 35% for 2005 federal tax purposes, plus whatever state tax, if any, applies where you live) on capital gains or dividends generated inside an annuity.
- If your income will be relatively low at the time you begin receiving annuity payments, the disadvantage of paying income tax on these payments will not be as large as if your income is relatively high.
- If there are important non-tax reasons to purchase an annuity—asset protection in particular—this tax disadvantage may not be a significant factor in your planning.

Consequently, a tax-deferred annuity is most beneficial for the portion of a portfolio that generates interest income or short-term gains but not for the portion that generates dividends or long-term gains. Some annuity programs have fixed income portfolios to address this.

Deferred Income Tax and Estate Tax at Death

Under U.S. tax law, certain kinds of assets escape income tax at the death of the taxpayer. Generally, these assets are the same as the ones that qualify for long-term capital gain treatment. Other assets, such as annuities and pension plans, include untaxed ordinary income and that income is subject to income tax at the death of the owner.

For example, John Jones owns US$100,000 of stock in XYZ.com and Sam Smith owns an annuity worth US$100,000 at the time of their deaths. In both cases, the assets have a tax cost (basis) of US$20,000 and an untaxed gain of US$80,000. The Jones children will inherit US$100,000 of stock with a new tax cost that is "stepped up" to the market value of US$100,000 at the time of Jones' death. If they sell the stock for US$100,000, there is no gain and hence no tax. In contrast, the Smith children will have to pay income taxes on US$80,000 of what is called "income in respect of a decedent" or IRD.

In both cases, the US$100,000 of stock or the US$100,000 worth of annuity proceeds is included in the taxpayer's estate for estate tax purposes. The federal estate tax can consume as much as 47%, in 2005, (decreasing to 45% in 2009) of the value of an estate after taking off certain exemptions and deductions.

Estate tax planning is particularly problematic because Congress, once again, has enacted laws that are certain to be tinkered with in the future. In particular, as matters now stand, the estate tax is actually repealed for one year—2010—and then reinstituted in 2011 with the same US$1 million exclusion that applied in 2003 [see table below].

Prudent planning dictates that if your total estate, valued at its "highest and best use," including real estate and the value of all securities, along with any annuities that might be inherited by your heirs, exceeds US$1 million, you need to give careful consideration to the estate tax implications of purchasing an annuity contract that could potentially be inherited by your heirs.

Federal Estate Tax Applicable Credit Amount

Year	Exclusion Amount
2005	US$1,500,000
2006, 2007 and 2008	US$2,000,000
2009	US$3,500,000
2010	not applicable
2011	US$1,000,000

When you combine the income tax on the IRD of an annuity with the estate tax, the effects can be crippling. The top federal income tax rate is 35% (in 2005) and the top estate rate is 45%, so it might seem that

your heirs would only get about 20% of your annuity. Actually, it's not quite that bad because the estate tax can be taken as a deduction before computing the income tax. The US$100,000 annuity could generate an estate tax of up to US$45,000. That would be deducted from the US$80,000 untaxed gain, resulting in taxable income of US$35,000 for the heirs. At a 35% income tax rate, the income tax could then be as much as US$12,000 or 12% of the total value of the annuity. The heirs will get US$43,000 after paying the US$45,000 estate tax and the US$12,000 income tax. Thus, the combined income and estate tax of an annuity could be as high as 57% (in 2005) but it won't be 80%.

Some annuity sales people don't know about these tax issues. Others gloss over them. Some exaggerate the problem with outdated tax rates. However, when other factors are considered, such as the asset protection that annuities can offer, you may decide that the annuity is a better choice than other forms of asset protection.

On the other hand, some tax professionals believe that high income and/or high net worth persons should never buy an annuity. Instead, they urge high net worth clients to consider variable life insurance contracts combined with an irrevocable living trust for the benefit of the client's heirs. If you do not have children or feel you have adequately provided for your children, a charitable remainder trust may be a more attractive alternative than an annuity if you are in a high income and/or estate tax bracket.

Obviously, if Congress fails to renew the lower tax rates for qualified capital gains and dividends, or elects to make the one-year suspension of the estate tax in 2010 permanent, these tax disadvantages won't be as important. But you need to know about them, and consider them in your planning.

Extra Tax on Distributions Before Age 59-1/2

The tax deferral provided for investors in annuity contracts is politically justified on the grounds that it permits people to save for retirement with a minimum tax burden and therefore takes financial pressure off Social Security and other government entitlements for senior citizens. There is therefore a penalty tax of 10% in addition to the income tax on any withdrawals from an annuity contract before you reach age 59-1/2. There are a number of exceptions to this penalty, which we won't discuss here because the government keeps changing the rules. If you need to take early distributions from a tax-deferred annuity, contact someone who can help you interpret the current rules for Section 72(t) of the U.S. Tax Code.

Asset Protection

In the U.S., the various states protect certain assets from the claims of creditors, but the rules vary greatly from state to state. Twenty-three states provide some protection for annuity contracts. It appears that only nine states offer any substantial exemption protection for annuity contracts, and most of those require that the proceeds be payable to someone other than the contract owner. As indicated in the second section of this report, offshore annuity contracts in certain countries can offer much greater protection from the claims of creditors.

While it's important to protect the cash values of an annuity contract from future judgment creditors, it's also important to be sure the funds left with an insurance company aren't subject to the general creditors and other policyholders of an insolvent insurance company. In that regard, variable annuities offer more protection than fixed annuities.

The assets underlying a fixed return annuity contract are subject to the claims of all other policyholders and creditors of the insurance company. However variable annuity contracts are segregated from the general funds of an insurance company. They are therefore protected from the claims of other policyholders and from the claims of any other creditors. To be sure that a specific annuity contract is protected this way, you need to ask if it's held in a "separate account" or "segregated account." In some offshore policies, this is referred to as a "protected cell."

SECTION 2: THE BENEFITS OF OFFSHORE VARIABLE ANNUITIES

A U.S. (domestic) variable annuity offers income tax deferral, substantial investment discretion by the contract owner and it may also provide asset protection in certain states. There are privacy advantages as well: because the annuity is simply a contract between an individual and an insurance company, it's not recorded in any public database, such as the register of deeds or the records of corporations. No reports are filed with the IRS until the contract owner requests a distribution.

Why then would any U.S. investor prefer an annuity issued by an offshore company over one issued by a U.S. insurer? This section offers some of the reasons why an offshore annuity may have more appeal to some investors than a domestic annuity.

Enhanced Asset Protection

A variable annuity contract issued in the United States is segregated from the other assets of the insurance company and is not subject to the claims of the creditors of the insurance company or to the claims of other policyholders. Thus, there is substantial protection to the policy owner from mismanagement by the insurance company or economic hazards of the insurance business. A few foreign jurisdictions have similar arrangements with respect to variable contracts such as Switzerland, Liechtenstein, the Cayman Islands, Bermuda, and the Isle of Man. Some of the strongest protection in this regard is available in Liechtenstein.

Outside the United States, variable annuity policies may include provisions similar to the spendthrift provision in a trust, which prohibits the beneficiary from assigning his or her future benefit to a creditor or making an assignment in exchange for some immediate benefit.

There are some countries in which annuity or insurance contracts are additionally protected from creditor claims if the policy has an irrevocable beneficiary other than the policy owner. The strongest asset protection is available for policies issued in ***Switzerland*** and ***Liechtenstein***. If a Swiss annuity contract includes a prescribed minimum amount of life insurance (1% of the total premium or the option to annuitize), it is treated as a life insurance contract under Swiss law. That means that creditors can't get an attachment of the contract. If the beneficiary designation is irrevocable, the beneficiaries become the policy owners if there is a claim against the initial policy owner. The beneficiary designation may be revocable if the beneficiary is the spouse or a descendent (child, grandchild, etc.) of the policy owner without endangering this asset protected status. In ***Liechtenstein***, the unmarried partner of a policy owner may be a revocable beneficiary.

In contrast, in many U.S. states, a policy owner can be required by court order to liquidate the annuity policy and secure the cash value that is available for benefit of judgment creditors. Even in states where there are restrictions on creditors' rights to an annuity contract, creditors can simply wait until the policy matures and then demand the receipt of the annuity payments. Thus, a foreign annuity contract can be selected to provide the maximum amount of asset protection without having to worry about the uncertainty of any protection provided under state law.

Lower Cost than Offshore Trusts

The most common arrangement for U.S. persons to achieve maximum asset protection is a foreign trust. However, the cost of establishing and maintaining a foreign trust is substantially more than the cost of investing in a foreign annuity contract. And, the foreign trust does not offer tax deferral for a U.S. investor unless the trust invests its assets in an annuity contract that meets the IRS requirements for a tax-deferred annuity. In addition, there are substantial compliance costs for a foreign trust that don't apply to an annuity contract.

It's not uncommon for a foreign trust to cost from US$10,000 to US$30,000 (or more) to establish and from US$2,000 to US$5,000 a year to maintain. However, the fees are not a percentage of the amount of assets in the trust. Thus, the proportional cost for a trust with US$100,000 of assets is far greater than for a trust with US$10 million of assets. Most offshore trust advisors will suggest that it's difficult to justify the cost of a foreign trust with less than US$500,000 of assets in the trust.

By contrast, a foreign annuity can be obtained for as little as USUS$50,000 and the ongoing expenses can be less than 1.5% of the assets in the contract. There may also be a front-end load as high as 6%. However, this load, if charged, is generally payable over an extended period (typically, five years, or 1.2% per year). The initial expenses are those incurred to travel to a foreign country to actually purchase the contract (many foreign insurance companies require the insured to sign the documents and to make the premium payments outside the United States) and the cost of the "due diligence" or the comparison of alternative policies, companies and jurisdictions. One of the goals of this report is to make it easier for investors to identify foreign companies that will issue policies that meet the technical requirements for a U.S. variable annuity contract.

Greater Privacy

Although domestic annuity contracts are not recorded or registered in any government database that is open to the public, the policyholder and beneficiary information is included in the database of the insurance company. There are few restrictions on how the insurance company may use that information.

For instance, they can compile a list of annuity contract owners and/or beneficiaries and rent this information to another company. If a policy owner is required to disclose the existence of the annuity contract and the name of the insurance company, a plaintiff (or judgment creditor) can secure complete details about the policy from the U.S. insurance company.

In contrast, even if the existence of an offshore annuity contract is disclosed during a deposition or by court order, most offshore insurance companies will not disclose any details about the policy to any U.S. creditor or in response to any order by any U.S. court. An exception may apply if the applicable country has a treaty (such as a Mutual Legal Assistance Treaty) with the United States to permit an exchange of information, but this exception will not apply with respect to civil litigation or non-government creditors. Foreign insurance companies do not engage in the widespread U.S. business practice of renting the customers' names and addresses (with extensive demographic information) to anyone. Indeed, this practice is prohibited by law in jurisdictions such as Switzerland, where the same secrecy laws that apply to banks also apply to insurance companies.

Most U.S. tax advisors feel that a foreign variable annuity contract is a "financial account" that must be disclosed on Form 1040, Schedule B, Part III and on Treasury Department Form TD F 90-22.1. While this may be a problem for those who seek secrecy, it should not be a problem for those whose main concern is for financial privacy. Tax return information is not easily available to prospective plaintiffs or lawyers who are trying to decide whether to take a case on a contingent fee basis. (However, it can be demanded in a deposition or in the event of bankruptcy.)

Tax-Deferred Access to Offshore Securities Markets

U.S. tax laws and regulations issued and enforced by the Securities and Exchange Commission (SEC) make it extremely difficult for a U.S. investor to participate in foreign (non-U.S.) securities markets without suffering adverse tax consequences or substantially higher costs.

The offshore annuity is one of the few ways that U.S. investors can participate in foreign equity markets

without current taxation or substantial added costs. And it is one of the only ways to invest in foreign mutual funds without adverse tax results.

For instance, investments in offshore mutual funds are subject to the draconian Passive Foreign Investment Company (PFIC) tax rules that not only convert capital gains into ordinary income, but which can also impose punitive taxes on distributions from accumulated earnings in a foreign mutual fund or the disposition of fund shares. The simple solution (for tax purposes) is to make direct investments in the stocks of foreign companies instead of investing through a fund. However, the SEC makes that difficult without setting up a foreign trust or foreign corporation to be the holder of record. Both of those options have unpleasant tax and financial consequences that are beyond the scope of this report.

The SEC doesn't merely make it difficult for U.S. persons to purchase foreign securities. The agency also makes it difficult for foreign issuers of securities to do business directly with U.S. persons. The cost of compliance with SEC regulations is so high that many issuers of foreign securities only offer them to foreign (non-U.S.) buyers. They thereby escape the costs of complying with the requirements of the SEC, not to mention an additional 50 state securities departments and insurance departments.

These investments are therefore not easily accessible to U.S. persons. To buy them, a U.S. person must generally make the purchase outside the United States. However, many foreign banks and other financial institutions won't even sell foreign securities or funds to a U.S. person, even if the sales request comes from outside the United States. Thus, the U.S. buyer often has to form a foreign trust or a foreign corporation and must use an agent of the corporation or a foreign trustee to purchase any foreign securities that are not registered in the United States.

An alternative to the cost of a foreign trust or corporation is a foreign annuity contract, if the insurance company is willing to make the sale based on the exemption provided by SEC Regulation S. The foreign insurance company has access to a worldwide market of securities—including non-U.S. securities. Further, the foreign insurance company also has access to the best money managers in the world, many of which are not otherwise accessible to U.S. persons.

One note of caution: the IRS has issued regulations stipulating that an offshore annuity cannot invest mutual funds that are available to the general public and maintain its tax-deferred status. Instead, the mutual funds purchased through the annuity contract must be owned by the insurance company or by a group of insurance companies.

Access to the World's Best Performing Currencies

All U.S. annuity policies that the authors have surveyed are denominated in the U.S. dollar, without exception. In contrast, foreign insurance companies frequently permit premium payments, withdrawals, borrowings, and death benefits in different currencies.

Long-term, currencies such as the Swiss franc and the Japanese yen have more than tripled in value against the U.S. dollar in the past three decades. An annuity bought in 1971 and denominated in one of these currencies would be worth at least three times more than one denominated in U.S. dollars.

If the U.S. dollar continues to resume its long-term decline—as many analysts and currency specialists expect—then shrewd currency management could boost your annuity returns significantly over the long run.

Indeed, within a variable annuity, it is possible to actually switch the currencies targeted by the policy. (This is easiest and most practical with a portfolio of bonds.) For instance, you inform the insurance carrier or broker you wish to target Swiss franc-denominated investments instead of U.S. dollar-denominated investments.

Avoidance of Foreign Exchange Controls

The ability to select the underlying currency of a foreign insurance policy is a valuable option for another reason. Historically, many countries—including Great Britain and France in the 1970s—have instituted foreign exchange controls prohibiting their nationals from exporting their national currencies. This policy persists in certain Latin American countries, where governments periodically revalue the national currency, prohibit its export or force persons holding foreign currencies to exchange for virtually worthless domestic currency.

One solution that has proven effective for dealing with this threat is an insurance policy denominated in a foreign currency. Insurance policies have almost always been exempted from foreign exchange controls, regardless of the currency in which they are denominated, because they are classified as retirement or pension accounts, rather than investments. While this advantage is, at the moment, more relevant to non-U.S. investors living in countries with unstable currencies, how do you think the U.S. government would react if after some future catastrophe the U.S. dollar lost a substantial portion of its value in relation to other currencies, virtually overnight? Or, if consumer prices began rising 20% or more annually? In similar scenarios, foreign exchange controls have been adopted in dozens of countries.

Avoidance of U.S. Withholding Taxes

Foreign investors hold trillions of dollars of U.S. investments. Many of these investments are made through foreign banks.

Prior to 2001, U.S. banks and brokerage firms were not required to withhold U.S. taxes on certain kinds of interest or capital gains paid to foreign investors. However, the IRS became convinced that many U.S. persons invest in U.S. securities through foreign banks fail to pay taxes on their income or gains. Rather than target these tax dodgers directly, the IRS instead introduced "Qualified Intermediary" regulations. These rules require foreign banks that invest in U.S. securities markets on behalf of their customers to obtain a W-9 statement for their U.S. customers or to guarantee that certain payments are for the accounts of foreign persons.

Form W-9 uniquely identifies the U.S. investor by name and social security number and must be made available to the IRS if the U.S. investor purchases U.S. securities through the foreign bank. Any U.S. account holder of the foreign bank who refuses to complete Form W-9 is subject to backup withholding at the rate of 31% on both income and ***principal***. If a foreign bank does not agree to cooperate with the IRS, the U.S. payer of the income must withhold taxes from the payment to the foreign bank.

These rules do not apply to investors in annuity contracts either in the United States or offshore. However, information returns to the IRS by U.S. insurance companies are required when the companies make distributions to the beneficiary or owner of the annuity contract.

Lower Regulatory Expenses

Foreign insurance companies are not subject to the costly regulatory system to which U.S. insurance companies are subjected—particularly with regard to variable annuities, which are regulated not only by the insurance departments and securities departments of the 50 states but also by the SEC. All of these agencies require extensive disclosure of information about the product and the company. However, nearly all of them require different information or want the information presented in a different way. The rules and regulations in each agency are different and sometimes conflict with each other.

U.S. insurance companies are required to employ very expensive lawyers and auditors who specialize in

dealing with these agencies. The cost of these legal services is included in the commissions and fees you pay when you purchase a domestic variable annuity. In contrast, most foreign insurance companies are subject to regulation by only one agency so long as their products are purchased within their jurisdiction.

Thus, merely by taking an overseas trip, you can purchase an annuity from a company in a jurisdiction such as Bermuda or the Isle of Man, and that company is not required to bear the cost of complying with the regulators in every other country, let alone in each of the 50 U.S. states. This is a major factor in the lower administrative cost of policies issued in foreign jurisdictions versus those issued in the United States.

No State Premium Taxes

Most U.S. states impose a tax on the gross premiums received by U.S. insurance companies for policies sold to residents of each state. Each company that is licensed to issue policies in any state must collect this premium tax. It's essentially a sales tax and the cost is simply added to the fees paid by the customer. While this tax varies from state to state, it's generally 2% to 3% of the gross premiums paid for the policy. This puts U.S. insurance companies at a significant cost disadvantage compared to the sale of other kinds of investment products and to annuity products offered by offshore companies.

While there is no state premium tax imposed on annuities issued by offshore companies, there may be a 1% federal excise tax due, unless there is a Double Taxation Treaty between the United States and the foreign government to reduce or to waive the tax. For instance, there is a treaty between the United States and Switzerland to waive this tax.

No Federal Income Taxes on Foreign Insurer

U.S. insurance companies are subject to corporate income taxes, as are other U.S. businesses, but the method of computing the tax is dramatically different for an insurance company. In addition to the corporate income tax imposed on U.S. insurers, life insurance companies are subject to a curious tax called a "deferred acquisition cost" tax.

As with all the other taxes and fees required by state governments, this tax is borne by the purchaser. Other things being equal, companies that do not pay taxes can afford to offer a higher return to investors or lenders or they can offer their products at a lower price, thereby getting and keeping more customers.

Offshore insurance companies located in countries that do not impose a corporate income tax, such as the Isle of Man or Liechtenstein, or a low corporate income tax, such as Switzerland, therefore have a substantial competitive advantage over companies in the United States.

Lower Marketing/Distribution Costs

Most U.S. insurance companies have a multi-level commission marketing system that substantially adds to the cost of coverage or reduces the benefits available to the contract owner.

Typically, an agent receives a commission of 5% to 10% of the premiums paid for an annuity policy, whether the premiums are paid all at once or over time. In addition, there is frequently a supervising agent (sometimes called a district agent) who receives from 20% to 50% of the commission paid to the agent. The supervising agent often reports to a general agent who gets another 15% to 25% of the amount paid to the agent. In total, these agents may get commissions of from 6% to almost 15% of the premium. There are also extensive administrative costs for offices, training and recruiting of the agency force that must be paid from the premiums.

An offshore company rarely uses this kind of multi-layered commission system and some offshore compa-

nies basically have no formal marketing system like those in the United States. While commissions often exist offshore, they are generally lower and thus, there are substantially less expenses to be absorbed by the premiums collected.

Private Placement Policies

Large U.S. insurance companies tend to operate on the assembly line theory of production. They design a product that will have some appeal to the broadest possible market and expend huge amounts of money to advertise the same product to millions of prospects.

Foreign companies tend to be like the custom tailor or the private banker—particularly for the policy owner who can invest US$2 million or more in a single policy. The prospective policy owner can shop for a company that will design the policy to his specific needs so long as the design meets the tax law requirements for an annuity contract in his home country.

While the most innovative offshore products tend to be life insurance contracts, not annuity contracts, it's also possible to custom tailor a large annuity contract with innovative features such as in-kind premium payments (i.e., payment with non-cash assets), enhanced asset protection (e.g., anti-duress clauses), etc. Just ask. (However, the tax benefits of an annuity contract can be lost with in-kind payments.)

Expatriation Tax Planning

The United States is the only country that imposes significant income and estate taxes on the worldwide income and assets of every citizen, even those living outside its territorial boundaries. Giving up U.S. citizenship is the only way to potentially eliminate this liability.

Thousands of wealthy Americans have become citizens of other countries and subsequently given up U.S. residence and citizenship. In making such an "expatriation," they have substantially reduced (and with proper planning, eliminated) their liability to U.S. taxes. Such "tax exiles" include Michael Dingman, chairman of Abex and a Ford Motor Co. director; Campbell Soup heir John Dorrance III; former Star-Kist Foods Chairman Joseph Bogdanovich; and Kenneth Dart, an heir to Dart Container and the US$1 billion family fortune.

However, the U.S. Congress has enacted a series of "anti-expatriation" laws, the aim of which is to frustrate the ability of wealthy citizens to lower their tax liability by giving up U.S. residence and citizenship. Creative use of an offshore annuity is one strategy to legally avoid these provisions.

Currently, the U.S. Tax Code imposes income and estate taxes for 10 years after an individual gives up their U.S. citizenship. Also covered are permanent resident aliens ("green card" holders) or anyone else who has resided in the United States for any eight of the preceding 15 years. U.S. persons with a net worth exceeding US$2 million or paid more than US$620,000 in federal income taxes over the five years before expatriating are presumed to have left for tax reasons.

The rules apply only to the net combined amount of U.S. source income and income "effectively connected" with a U.S. trade or business. In addition, they apply to controlled foreign corporations owned by the taxpayer at the time of expatriating and certain kinds of property where the taxation was deferred by virtue of a non-taxable exchange transaction. However, as of this writing, the rules do NOT apply to investments in offshore annuities.

Therefore, an offshore annuity may offer a way for prospective U.S. expatriates to accumulate tax-deferred savings that will not be subject to future U.S. income taxes after expatriating.

Compliance with U.S. Tax Law

Because U.S. investors are subject to tax on their worldwide income, it's important that any offshore variable annuity you purchase be designed to qualify as a variable annuity under tax Sections 72 and 817 of the U.S. Tax Code.

Perhaps the most critical single issue involving an annuity issued by a foreign insurance company is whether it will be treated as an annuity by the IRS or as a debt instrument. If the IRS concludes that an annuity contract is a disguised debt obligation, then the income that accumulates each year will be subject to current tax by the policy owner.

Most experts seem to feel that a variable annuity is clearly not a debt instrument and is therefore safe from being taxed as interest on a debt obligation. Even so, the conservative course of action would be to have a U.S. tax professional who is familiar with these rules review the terms of the contract to ensure that it could not be construed as a disguised debt obligation.

With the proper structure by the insurance company, the contract can qualify as an annuity for U.S. tax purposes and the income earned on the cash value of the contract is deferred until distributed to the beneficiary of the contract.

Investments in non-compliant offshore annuity contracts will be taxed as if the annuity didn't exist. This is particularly onerous if your offshore annuity invests in offshore mutual funds classified as "Passive Foreign Investment Companies" under the U.S. Tax Code. In that event, you might not only be subject to back taxes, interest and penalties, but a separate interest charge imposed for the "privilege" of deferring tax for the time you owned the offshore mutual funds. In some cases, this interest charge not only eliminates any profits generated from the mutual fund investments, but additionally eats into your investment principal.

Another precaution you'll want to take is to insure that the annuity policy doesn't permit you to control the investments held within the policy. It's OK to request the insurance company to invest your funds aggressively, conservatively or in a balanced portfolio, but you are not permitted under IRS regulations to specify the exact investments the annuity should purchase. Similarly, while it's permissible to have an investment manager oversee the annuity portfolio, you may not assign the manager directly—the insurance company must do so.

To avoid a costly dispute with the IRS, seek a written opinion from a U.S. tax lawyer or tax accountant as to whether the variable annuity would qualify as such under U.S. tax law. Sometimes the insurance company or one of their agents will get a written opinion from a U.S. law firm or accounting firm. Other vendors prefer not to appear to be catering to the U.S. market and leave it to the investor to get an opinion from a U.S. tax professional. (However, be prepared for substantial fees for a written opinion. New rules imposed by the IRS on written opinions by tax professionals have the effect of causing the professional to do far more work than before. Hence, the cost is much higher than it used to be.)

The Best Jurisdictions for Offshore Annuities

The primary offshore jurisdictions for life insurance and annuity policies are (1) Switzerland; (2) Liechtenstein; (3) the Isle of Man; (4) the Cayman Islands; (5) The Bahamas; and (6) Bermuda.

Switzerland and ***Liechtenstein*** have an extensive regulatory system for insurance companies and appear to offer the best asset protection from the claims of creditors of the policy owner. The ***Cayman Islands*** have adopted a protected cell company law, so that policies issued there are basically the same as U.S. segregated account policies. ***The Bahamas*** has insurance companies with the ability to create custom tailored plans for high net worth investors. ***Bermuda*** is also a popular jurisdiction of offshore insurance policies.

Broker Recommendations

Note: Some offshore insurance companies are very sensitive about incurring the "wrath" of the U.S. Securities & Exchange Commission or getting into a dispute with U.S. state insurance departments. They prefer not to be named in any public information as a source of products that are designed to meet the tax requirements for U.S. investors. We therefore are not listing specific annuity products but rather the names of brokers who can provide introductions to offshore insurance companies.

Some of the annuities offered by these companies or brokers are designed to meet U.S. regulatory requirements and, in our opinion, should qualify for tax deferral. But, again, we recommend that you obtain a written opinion from a U.S. tax lawyer or accountant before you invest.

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