Thomas Swenson 303-440-7800 tswenson@swenlaw.com www.swenlaw.com

Irrevocable Life Insurance Dynasty Trust -- Basics

Summary: An irrevocable life insurance trust (ILIT) comprises two main parts: (1) an irrevocable asset protection trust; and (2) a life insurance policy owned by the trust. Fixed index universal life insurance (FIUL) can provide good investment returns while reducing market risk. Variable life insurance offers the potential of higher market returns, but with the risk of market downturns. At the trustee's discretion, the trust may access policy cash value by withdrawals and tax-free loans during the life of the insured. The trust settler (grantor) may also be a beneficiary. Upon death of the insured, life insurance proceeds are paid into the ILIT free of income and estate taxes. Private placement life insurance (PPLI) in an ILIT can serve as a "wrapper" around a variable investment portfolio that grows free of income and capital gains taxes. Foreign PPLI is generally more flexible and less expensive than domestic PPLI.

For US persons, an irrevocable life insurance trust (ILIT) is arguably the most efficient structure for integrating tax-free investment growth, wealth transfer and asset protection. An ILIT comprises two main parts: (1) an irrevocable trust; and (2) a life insurance policy owned by the trust. An international (or offshore) ILIT is a trust governed by the law of a foreign jurisdiction that owns foreign-based life insurance. An offshore ILIT generally provides better asset protection than a domestic ILIT. Regarding US tax laws, a properly designed international ILIT is treated virtually the same as a domestic ILIT.

An ILIT becomes a dynasty trust (or GST trust) when the trust's settlor (or grantor, the person who establishes and funds the trust) applies his lifetime exemption for the generation skipping transfer tax (GSTT) to trust contributions. Once a dynasty trust is properly funded by applying the settlor's lifetime exemptions for gift, estate and GST taxes, all distributions to beneficiaries will be free of gift and estate taxes for the duration of the trust, even perpetually. The individual unified gift and estate tax exemption and the GSTT exemption are both \$11+ million (\$22+ million for a married couple) starting 2018, which are the highest amounts in decades.

Under the US tax code, no income or capital gains taxes are due on life insurance investment growth, and no income tax is due when policy proceeds are paid to an insurance beneficiary upon death of the insured. When a dynasty trust purchases and owns the life insurance policy and is named as the insurance beneficiary, no estate tax or generation skipping transfer taxes are due. In other words, assets can grow and be enjoyed by trust beneficiaries completely tax-free, perpetually. Depending on how a trust is designed, a portion of trust assets can be invested in a new life insurance policy each generation to continue the cycle.

Private placement life insurance (PPLI) is privately negotiated between an insurance carrier and the insurance purchaser (e.g., a dynasty ILIT). Private placement life insurance is a type of variable universal life insurance. The policy funds are invested in a separately managed account, separate from the general funds of the insurance company, and may include stocks, hedge funds, and other high-growth and/or tax-inefficient investment vehicles. Offshore (foreign) private placement life insurance has several advantages over domestic life insurance. There are fewer restrictions on policy investments, while US state regulations restrict a domestic policy's investments. The minimum premium commitment of foreign policies may be as low as US$1 million, whereas domestic carriers typically demand a minimum commitment of $5 million to $20 million. Also, offshore carriers often allow policy investments to be managed by an independent investment advisor suggested by the policy owner. In-kind premium payments (e.g., stock shares) may be allowed, whereas domestic policies require cash. Finally, offshore policy costs are lower than domestic costs. An election under IRC § 953(d) by a foreign insurance carrier avoids imposition of US withholding tax on insurance policy income and gains.

Whether domestic or offshore, PPLI must satisfy the definition of life insurance according to IRC § 7702 to qualify for the tax benefits. Also, key investment control (IRC § 817(g)) and diversification (IRC § 851(b)) rules must be observed. When policy premiums are paid in over four or five years as provided in IRC § 7702A(b), the policy is a non-MEC policy from which tax-free policy loans can be made. If policy loans are not important during the term of the policy, then a single up-front premium payment into a MEC policy is preferable because of tax-free compounding.

An offshore ILIT provides strong protection of trust assets against creditors of both settlor and beneficiaries. Courts in the US have no jurisdiction outside of the US, and enforcement of US court judgments against offshore trust assets is virtually impossible. Although all offshore jurisdictions have laws against fraudulent transfers, they are more limited than in the United States. In any case, an offshore ILIT is necessary to purchase offshore life insurance because foreign life insurance companies are not allowed to market and sell policies directly to US residents. An international trust, however, is a non-resident and is eligible to purchase life insurance from an offshore insurance carrier.

An international ILIT may be self-settled, that is, the settlor of the trust may be a beneficiary without exposing trust assets to the settlor's creditors. In contrast, in the United States, the general rule is that self-settled trusts are not honored for asset protection purposes.

In Private Letter Ruling (PLR) 200944002, the IRS ruled that assets in a discretionary asset protection trust were not includable in the grantor's (settlor's) gross estate even though the grantor was a beneficiary of the trust. The trustee of a discretionary trust uses his discretion in making distributions to beneficiaries consistent with trust provisions. Previously, it was questionable whether a settlor could be beneficiary of an ILIT without jeopardizing favorable tax treatment upon his death. The new ruling gives some assurance to a US taxpayer who wants to be a beneficiary of a self-settled, irrevocable, discretionary asset-protection trust that is not subject to estate and GST tax. As a result, the trustee can (at the trustee's discretion) withdraw principal from the PPLI or take a tax-free loan from the policy's cash value and distribute it tax-free to the settlor, as well as to other beneficiaries. In other words, a settlor need not sacrifice all enjoyment of ILIT benefits in order to achieve asset protection and preferred tax treatment.

An offshore ILIT is typically designed to qualify under IRS rules as a domestic trust (for tax purposes) during normal times and as a foreign trust in case of domestic legal threats to its assets. The offshore ILIT is formally governed by the laws of a foreign jurisdiction and has at least one resident foreign trustee there. As a "domestic" trust under IRS rules, the trust also has a domestic trustee who controls the trust during normal times. If a domestic legal threat arises, control of the trust shifts to the foreign trustee, outside the jurisdiction of US courts, and the trust becomes a "foreign" trust for tax purposes. A domestic trust "protector" having negative (or veto) powers may be appointed to provide limited control over trustee decisions. An international ILIT protects trust assets against unforeseen lawsuits, bankruptcy and divorce.

The objective of PPLI is to minimize life insurance costs and to maximize investment growth. The life insurance policy acts as a "wrapper" around investments so that they qualify for favorable tax treatment. Nevertheless, PPLI still provides a valuable life insurance benefit in case of an unexpected early death of the insured. Premium "loading" charges are in a range of about 1% to 2% of premiums paid into offshore PPLI (compared to 2 -- 4% in domestic PPLI). Annually recurring charges depend on policy value and vary widely among PPLI carriers, so careful comparison shopping is advised. For example, annual asset charges should be in a range of about 40 to 150 basis points (0.4% to 1.5%) of the policy's cash value. The annual cost of insurance is not substantial and declines over time.

Initial costs of setting up an ILIT are high, but they are recouped after a few years of tax-free investment growth. Initial legal and accounting fees are typically in a range of $15,000 to $35,000. Annual costs for monitoring and maintaining an offshore trust are several thousand dollars.

Cash may be contributed to the ILIT, which then purchases life insurance (IUL or PPLI). If asset protection of vulnerable fixed assets in the US is a concern, then equity stripping can be used to generate cash, which is then contributed to the offshore ILIT. Of course, stocks and bonds and other assets may also be contributed to the ILIT and used for investing in PPLI. Various value-freezing and valuation discounting techniques can be used to leverage the GSTT exemption.

An offshore "frozen cash value" policy is a variation of PPLI governed by IRC § 7702(g). The minimum premium commitment is about $250,000. During the life of the insured, the cash surrender value is fixed at the sum of the premiums paid. Withdrawals up to the amount of the paid-in premiums are tax-free, but cash value in excess of the premium amounts is inaccessible until after death of the insured.

Another alternative investment for an ILIT is a deferred variable annuity (DVA). There is no cost of insurance, so investment growth is faster. Tax on appreciation is deferred, but DVA distributions are taxed as income.

Generally, for public policy reasons and because the insurance industry possesses strong political influence, life insurance has long enjoyed favorable tax treatment. Over the past two decades, numerous IRS rulings have clarified the tax treatment of PPLI and irrevocable discretionary trusts. At the same time, strong, new asset protection laws and reliable service providers in numerous foreign jurisdictions have enabled safe, efficient and flexible management of international trusts and insurance products. As a result, an international irrevocable, discretionary trust owning a life insurance policy can provide tax-free growth of a global, variable investment portfolio managed by a trusted financial adviser in full compliance with US tax laws. At the discretion of the trustee, trust assets (including tax-free insurance policy loans and withdrawals) are available to the settlor during his lifetime. Upon death of the insured, policy proceeds are paid tax-free to the trust. Thus, a well-managed life insurance dynasty trust perpetually secures the financial well being of settlor, spouse, children and their descendants.