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Asset Protection and Tax-Free Investments for the Moderately Wealthy

Summary: An irrevocable life insurance trust (ILIT) is a 100% tax-efficient tax shelter useful not only for the wealthy. In full compliance with U.S. tax laws, an individual or a couple having a net worth of $1 million or greater can fund an irrevocable life-insurance dynasty trust that provides a life insurance benefit, asset protection, tax-free growth of fixed or variable life insurance, tax-free policy loans during the life of the insured, tax-free payment of policy proceeds to the trust upon death of the insured and tax-free distributions to beneficiaries.

Life insurance is an underutilized, but potentially versatile and highly efficient investment vehicle. It is useful not only for wealthy families. An individual or family having a net worth of only $1 million is financially able to fund an irrevocable life insurance trust (ILIT).

It is well known that whole life insurance provides tax-deferred growth of the policy's cash or investment value. The growth rate of cash value within the policy is generally relatively low, usually a few percent annually. Index life insurance (IUL) policies may provide greater flexibility and growth because the annual interest credited to the policy account is tied to one or more market indices. Risk is controlled by a "floor" (e.g., a 0% or 1% floor), which means that a negative index return is never credited against the policy account. IUL is more complicated and offers fewer guarantees than whole life, but both types of policies can provide good death benefits and access to cash value during the life of the insured.

Private placement life insurance (PPLI) is a privately negotiated life insurance contract between insurance carrier and policy owner. PPLI is a variable insurance product, meaning the policy is exposed to the risk of negative market returns. Nevertheless, PPLI offers several advantages compared to fixed policies. Policy funds are held in segregated accounts that protect the funds against the carrier's creditors. PPLI enables a wider range of investment opportunities managed by a professional investment adviser selected by the policy owner. Finally, policy costs are transparent, negotiable and typically lower than off-the-shelf insurance products. A problem with domestic insurance companies offering PPLI in the U.S., however, is that they typically require a minimum insurance premium commitment of $10 million to $50 million.

Offshore PPLI policies are more favorable than domestic PPLI based in United States. Offshore insurance companies are not subject to strict SEC and state insurance regulations in the U.S., which limit the types of investments available to domestic insurance policies. Further, offshore PPLI policies are not subject to the state premium taxes charged by the various states. Although a policy issued by a foreign insurance carrier is subject to a 1% U.S. excise tax, this is balanced by not being subject to the federal deferred acquisition cost (DAC)

tax. One of the major benefits of offshore PPLI is that it is offshore, meaning that the offshore life insurance carrier can be selected so that it is not subject to the jurisdiction of U.S. courts. Offshore PPLI typically has a minimum premium commitment of $1 million or more, paid over five to seven years, and initial "loading" fees of offshore PPLI are typically about 1.5% to 2% of a premium.

An international (offshore) irrevocable life insurance trust (ILIT) optimizes tax free wealth building and the financial security of PPLI, as well as providing protection of policy assets and other trust property against the claims of beneficiaries' creditors. A well-planned offshore trust avoids the jurisdiction of U.S. courts and other U.S. government agencies in critical times. A number of offshore countries have adopted legislation specially designed to protect trusts registered in their jurisdictions against attack by outside courts and governments. An offshore trust jurisdiction typically requires that a trust pay an annual government registration fee and use the services of a local trustee. Since trust business is an important revenue source and contributes to the local economy, offshore jurisdictions are motivated to protect the integrity of locally registered asset-protection trusts against outside creditors of trust beneficiaries.

In a hypothetical example, a U.S. taxpayer establishes an irrevocable offshore asset protection trust in Switzerland under the favorable laws of the Cook Islands (South Pacific) or Nevis (Caribbean). Initially or over the next five to seven years, the individual irrevocably contributes to the trust assets having a value not exceeding the current lifetime exemptions for estate tax and generation skipping transfer tax (GSTT), for example, $2 million. The U.S. taxpayer allocates at least a portion of his lifetime exemptions to the trust contributions, thereby creating a dynasty trust that will be free of U.S. estate and GST tax perpetually. If the trust assets are not invested in life insurance, then U.S. income tax and capital gains tax are paid on investment growth in the trust. On the other hand, when trust assets are invested in a life insurance policy, investment growth is not taxed.

Also, when policy proceeds are paid to the trust (as policy beneficiary) upon death of the insured, no income tax, no estate tax and no GST tax are payable. The overall result is that trust beneficiaries benefit from tax-free life-insurance investment growth and tax-free wealth transfer perpetually. The asset protection and tax advantages of an irrevocable life insurance trust (ILIT) are available using fixed, domestic insurance policies, not just through PPLI. An advantage of PPLI is greater investment flexibility, which allows greater investment growth potential. An additional advantage of a preferred structure including a self settled, irrevocable life insurance trust is that the settlor (the person establishing and funding the trust) may benefit from the trust during his lifetime through tax-free insurance-policy loans, at the discretion of the trustee. Initial professional fees (legal and accounting services) for setting up a preferred structure are typically in a range of about from $15K to $35K. Annual trust and trustee fees are generally about $5,000.

Full compliance with U.S. tax law is an important characteristic of a preferred structure that includes an offshore asset protection trust owning offshore PPLI. In fact, the preferred structure recommended here is tax neutral, that is, there are no tax advantages or disadvantages resulting from being offshore. Formation and administration of the offshore ILIT structure is slightly more complicated and expensive than a domestic trust. But, unless there are creditor problems, the trust is administered and treated as a U.S. trust for U.S. tax purposes. Although a few extra forms must be submitted to the IRS annually, the tax situation is the same whether onshore or offshore. The offshore advantages are secure asset protection, lower policy costs, greater investment flexibility and lower minimum premium commitments.

The greater investment flexibility of offshore PPLI, especially compared with conventional life insurance, allows investment of policy funds in high-growth assets, such as hedge funds or start-up companies. As a formality, policy assets are held in segregated accounts owned and managed by the insurance company. The insurance company may hire an asset manager acceptable to the policy owner, possibly the same manager who manages the settlor's other non-trust assets. Some of the same benefits of a preferred structure can be achieved using less preferred structures. For example, a fixed domestic life insurance policy owned in a domestic life insurance trust provides favorable tax treatment (i.e., no taxes on income, capital gains and estate), but policy assets would be held in the insurer's general fund, investment returns might be lower, and asset protection would be less strong. Fixed life insurance is less exposed to market risks, however.

An irrevocable life insurance trust (ILIT) and an offshore PPLI policy can be funded using various types of assets, basically anything to which a value can be attached: stocks, bonds, hedge funds, commodities, collectibles, real estate, business enterprises. Equity stripping of assets located in the United States through loans on real estate and business equipment can be used to generate cash for contribution to a domestic or offshore asset-protection life-insurance trust. Estate tax and GSTT exemptions can be leveraged by contributing assets to the life-insurance trust before high growth occurs. Promissory note sales and discounting of closely-held property can also be used to leverage estate tax and GSTT exemptions. A married couple can use both spouses' lifetime exemptions to fund the trust.

The long-term outlook for the US dollar and the U.S. economy is bad. The U.S. manufacturing base continues to move overseas. Even services such as software development, technical support, accounting and legal work are migrating from the U.S. to low-paying developing countries. The U.S. national debt of $22.3 trillion (May 2019) is barely surmountable, unless it is paid down through inflation.

Individual federal states and local jurisdictions are sinking under the weight of ill-conceived and irresponsible compensation and pension plans for civil servants, as well as federally-mandated social engineering and entitlement programs. Whether through anticipated increases of federal tax rates or by some other impetus, sooner or later, the U.S. Congress, states and local governments will drastically increase effective taxation of U.S. residents. The U.S. economy will probably not disintegrate overnight, although it almost did in September 2008. Nevertheless, as a practical matter, earning money and keeping it will become much harder in the coming years. Further, any person living in the U.S. can be sued by anyone for almost any reason, and the cost of defending a lawsuit can be as much or more than simply paying to make it go away. An individual or business owning significant assets located in the U.S., or an individual trying to earn a living or run a business, is hostage to these realities.

The antidote, or vaccine, against these threats to financial well being is a self-settled, asset-protection, irrevocable life insurance trust (also known as a dynasty trust or GST trust). The preferred structure provides several significant benefits to the settlor and other beneficiaries. It moves substantial assets offshore, where U.S. courts or other government agencies cannot levy them. It allows tax free growth of a global investment portfolio managed by a trusted financial adviser in full compliance with U.S. tax laws. At the discretion of the trustee, trust assets (including tax-free insurance policy loans) are available to the settlor during his lifetime. Upon death of the insured, policy proceeds are paid tax-free to the trust. The assets in a well-managed dynasty trust grow perpetually. Thus, the dynasty trust secures the financial well being of spouse, children and their descendants perpetually. These benefits are especially valuable in a world of punitive taxes, deteriorating employment opportunities, decreasing incomes, mismanaged economies, overpopulation, disintegrating societies, unnecessary wars and corrupted governments. Through creative legal and financial planning, the benefits of a private placement life insurance trust are now available to moderately wealthy individuals and families.

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