Irrevocable Life Insurance Dynasty Trust -- Basics

Eliminate all taxes legally forever

Summary: An irrevocable life insurance trust (ILIT) comprises two main parts: (1) an irrevocable asset protection trust; and (2) a life insurance policy owned in trust. Indexed universal life insurance (IUL) 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, policy cash value can provide tax-free income to trust beneficiaries through tax-free loans. 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 (or declines) free of income and capital gains taxes, but subject to market risk. Foreign PPLI is generally more flexible and less expensive than domestic PPLI, but also more complicated.

For US persons, an irrevocable life insurance trust (ILIT) is arguably the most efficient structure for integrating tax-free investment growth, tax-free income, a death benefit, generational wealth transfer and asset protection. An ILIT comprises two main parts: (1) an irrevocable trust; and (2) a life insurance policy owned in the trust. An ILIT can make economic sense even for the moderately wealthy.

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 federal 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 exemptions 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, all or a portion of trust principal can be invested in a new life insurance policy each generation to continue the cycle.

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 $10,000 to $25,000. Annual costs for monitoring and maintaining an ILIT are several thousand dollars.

A foreign (or offshore) ILIT is a trust governed by the law of a foreign jurisdiction, and having a foreign-based trustee, 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. (In this paper, a "foreign" or "offshore" trust" is a trust outside the jurisdiction of US courts, even though it is subject to the US Internal Revenue Code (IRC) for tax purposes. An international trust is a trust designed for toggling between domestic and foreign status.)

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 international ILIT is necessary if offshore life insurance is to be purchased 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.

A "self-settled" ILIT is a trust in which the settlor has named himself as a discretionary beneficiary of the trust. If a "self-settled" ILIT is foreign, then 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 recent decades, however, the statutes of several US states have created so-called domestic asset protection trusts (DAPTs), which protect the assets of self-settled trusts against creditors of the settlor. The law regarding DAPTs is still somewhat uncertain, but a DAPT might be a less-expensive alternative to an international asset protection trust (IAPT). An international ILIT is a "hybrid" asset protection trust, which is administered as a domestic trust unless and until creditor risk arises, at which time trust administration is switched to a foreign trustee and the trust becomes a foreign trust.

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 estate-tax treatment upon his death. The new ruling gave 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 international 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 international ILIT is formally governed by the laws of a foreign jurisdiction and has at least one resident foreign trustee. 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 is shifted 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 provides the strongest protection of trust assets against unforeseen lawsuits, bankruptcy and divorce. The administrators of a foreign grantor trust, however, must remain aware of potential capital-gains recognition under IRC § 684. That is, if an international ILIT is in “foreign” status when the grantor dies, all gains of the ILIT will be subject to taxation. Therefore, the default status of an international ILIT should always be “domestic”, and after the grantor’s death, it should be administered exclusively as a domestic trust.

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 usually 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 PPLI. There are fewer restrictions on policy investments, while US state regulations restrict a domestic policy’s investments. The minimum premium commitment of foreign PPLI policies might be as low as US$1 million, whereas domestic carriers typically demand a minimum premium 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.

The objective of PPLI is to minimize life insurance costs and to maximize investment growth. The PPLI 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.

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 an international 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.

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 to maximize tax-free compounding.

An offshore "frozen cash value" policy is a variation of PPLI governed by IRC § 7702(g). The minimum premium commitment may be as low as $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 and court decisions have clarified the tax treatment of life insurance and irrevocable asset protection trusts. Strong, new asset protection legislation and reliable service providers in numerous domestic and foreign jurisdictions enable safe, efficient and flexible management of domestic and international trusts and insurance products.

A domestic or international ILIT can provide tax-free growth and tax-free income to trust beneficiaries in full compliance with US tax laws, for a set number of years or perpetually. Thus, a well-managed life insurance dynasty trust secures the financial well being of settlor, spouse, children and their descendants.

PPLI or IUL? Domestic or international ILIT? A high net-worth client (e.g., net worth of $10+ million) should consider and weigh the numerous factors discussed above. For a moderately wealthy client (e.g., net worth of $2-10 million), the author of this paper recommends as follows. A domestic asset protection trust can provide pretty good asset protection with less cost and complications than an international trust.

(If the settlor is not a beneficiary, then a domestic trust will provide completely adequate asset protection.) Domestic, “off-the-shelf” IUL provides good growth potential with virtually no downside market risk (in contrast to variable PPLI). Furthermore, premium-financed IUL can leverage investment dollars to the extent that cash-value growth in the insurance policy significantly outpaces any long-term market returns that could ever be reasonably expected in PPLI. Contact the Law Office for details.

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