Irrevocable Life Insurance Trusts Have Potential Tax and Estate Planning Benefits

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Irrevocable life insurance trusts ("ILITs") are one of the most commonly used estate and tax planning tools for both U.S. and foreign persons. ILITs offer the possibility of U.S. tax savings, avoidance of probate, and asset protection. In addition, certain types of policies (for example, universal life products) may provide investment flexibility. Depending upon various facts and circumstances, it may be preferable to establish an ILIT in one of three ways: (1) a “totally offshore” trust governed by foreign law (such as the Cayman Islands) with a foreign trustee; (2) a “hybrid” trust with both domestic and foreign legal characteristics and foreign and U.S. trustees; or (3) a “totally domestic” trust with the law of a U.S. state governing the trust and one or more U.S.-based trustees. Although most ILITs established are of the “totally domestic” variety, both U.S. and foreign persons have demonstrated an increased interest in the other two types of ILITs, each of which have their own unique characteristics.

From a wealth preservation standpoint, so long as the person establishing the trust gives up dominion and control over the trust and retains no benefits, an ILIT shelters the cash surrender value of the policy during such person’s lifetime. Upon his death, the policy proceeds may continue to be protected from the creditors of the settlor and the trust beneficiaries. For this reason, these trusts are often drafted to enable the trustee to retain the policy proceeds following the death of the insured, with distributions made thereafter only as needed or desirable under somewhat flexible standards.

Properly drafted and maintained ILITs can provide considerable U.S. income, gift and estate tax benefits. Because ILITs generally have little or no current income, with the internal growth build-up not generally being currently taxable, there are usually only insignificant U.S. income tax consequences during the insured’s lifetime. ILIT’s with foreign settlors can be designed to avoid taxation of any residual bank account interest or other income items that may be received tax-free by foreign individuals. Certain qualifying policies enable indirect access to their cash values through loans without the imposition of U.S. income tax. Life insurance proceeds generally may be received by the trust free of U.S. income tax. Depending upon the amount of the policy premiums, sufficient funds may often be contributed to the trust to in part pay such premiums without the imposition of U.S. gift tax. If the trustee of the trust initially acquires the policy in question, and the insured individual dies the day after the policy becomes effective or at any time thereafter, the policy proceeds are generally not then subject to U.S. estate tax. In contrast, if the creator of the trust transfers an existing policy on his or her life to an ILIT and then survives for three years thereafter, the policy proceeds similarly escape U.S. estate tax. In either circumstance, the settlor/insured cannot maintain any incidents of ownership over the policy. Although the estate of a non-U.S. resident/non-U.S. citizen is not subject to U.S. estate tax on the proceeds of a life insurance policy on his life, a foreign person may still wish to utilize an ILIT to own such a policy if he is not the insured, for enhanced asset protection beyond that otherwise granted by applicable law, or to have a more structured holding vehicle for the proceeds that may continue on after his death.

If an ILIT is established as either a “totally offshore” trust or a “hybrid” trust which at any time changes into a “totally offshore” trust, and either the settlor or any of the potential trust beneficiaries are or become U.S. citizens or residents, certain complex U.S. tax and compliance rules apply. These rules are described in our prior articles. As a bottom-line, most ILITs with U.S. settlors are designed to be “domestic trusts” for U.S. income tax purposes, with the trust possibly becoming “foreign” at some point only if mandated by asset protection considerations. In contrast, an ILIT initially established as a “foreign” trust often may be “domesticated” into the U.S. if it later becomes desirable from a U.S. tax standpoint or another reason. A prospective foreign settlor could establish an ILIT either as a “foreign” or “domestic” trust, depending upon the unique circumstances of each client and his family. For example, the asset protection laws of a particular offshore or domestic jurisdiction may dictate the choice of where to form the trust. In any event, particularly after the death of the ILIT’s settlor, if the trust was or then becomes a “foreign trust” for U.S. tax purposes with any potential U.S. beneficiaries, the trust must be carefully monitored to ensure that the trust and such beneficiaries are in full compliance with the foreign trust reporting and income tax rules.

This article only briefly outlines a number of the relevant considerations involved in forming an ILIT. Professional tax and estate planning advice should be consulted prior to the establishment of such a trust, as relatively minor differences in trust language, the choice of jurisdiction, and other seemingly insignificant variations may ultimately produce quite different results.