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The No-Tax Dynasty Trust*

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[Published in Trusts & Estates (Primedia, March 2006)]

Virtually all of us in the estate planning community regularly use life insurance trusts and dynasty trusts to achieve huge estate tax savings. And these savings can be compounded for future generations if the trust accumulates some of its income. Unfortunately, the “problem” with these trusts has been two-fold. First, in order to get large amounts into the trust to give the trust fund a jump-start, we would often be faced either with potential gift taxes or with some complicated premium-financing arrangement. Second, we were (and are) always confronted with the federal income taxes due on the trust income, and the greater the trust corpus, (typically) the greater the income. Wouldn't it be great if there was a way to accumulate huge amounts of income with no income tax, and then to distribute that accumulated income tax-free to the trust beneficiaries? There is a way.

My idea utilizes what I call a domestic dynasty insurance trust and, because trusts and estates practitioners relish a good acronym, let's refer to my invention as the D-DIT.

* I express my gratitude to the generous and knowledgeable assistance of John Nelson Ferrara, CLU, and Kenneth Stanger, CLU, both of Boston, with the arcane and barely penetrable insurance concepts relating to this article.

Here is how it would work:

Abe and his wife, Mary Todd, have children and grandchildren. They also have a respectable estate they accumulated the old-fashioned way—honestly—and they would like to arrange it so that the estate grows in the future and provides handsomely for their descendants. In fact, Abe, who was a slave to his job, was heard to say, “I don’t want them to have to chop wood for a living.” Accordingly, they consulted their lawyer, Danny Webster, and he recommended that Abe and Mary Todd establish the Lincoln Memorial Trust, an irrevocable discretionary trust for the benefit of their lineal descendants. The trust would be established in a jurisdiction that does not limit its duration, and it was agreed that the trust would terminate on the expiration of 250 years or the United States achieving a balanced budget, whichever occurs first.¹

The trust would be funded either at once or over a period of time with an amount equal to Abe and Mary Todd’s combined gift tax exemption (\$2 million), and a portion of their generation-skipping transfer tax exemption would be allocated to the gifts.² The contributed funds then would be used to purchase a second-to-die life insurance policy on Abe and Mary Todd’s lives.³ At their respective ages of 64 and 62, the trustee of the trust could purchase a permanent policy with a death benefit of about \$11 million. On the death of the survivor of Abe and Mary Todd, the trustee will receive the death proceeds. The terms of the trust then would direct the trustee to use \$9 million of these funds to purchase one or more variable universal life policies⁴ on the life or lives of one or more of the trust beneficiaries selected by the trustee.⁵ The balance of \$2 million would be available to invest and provide funds for distribution at the discretion of the trustee. It is essential that the additional policies are not treated as modified endowment contracts, because a primary purpose of the plan is to have free access to the cash value build-up in the policies.⁶ Accordingly, the \$9 million of premiums would be paid in over seven years. These policies would be owned by and payable to the trustee.⁷

In a typical non-ILIT trust, it would be unusual for a trustee to place such a large portion of its funds in life insurance policies, as life insurance policies are not the typical prudent investment; hence there is a need for specific language in the trust directing and exculpating the trustee with

respect to this investment. It also should be noted, however, that such an instruction does not necessarily relieve the trustee from its duty of diversification and prudent investment. Nevertheless, I believe such investment responsibilities still may be accomplished through the use of variable universal life (VUL) policies.⁸

In addition to the exculpatory language and instructions in the trust regarding the life insurance policies, the trustee of the D-DIT would be given a non-binding, disclosable letter of wishes⁹ from the settlor instructing it to maintain these policies with a view towards using the tax-deferred cash value build-up in the policies to fund future specific bequests as provided under the terms of the trust. Such a letter would help address concerns that beneficiaries might have about the use of the funds and advise them of the settlor's purpose. Remember that a substantial amount of available funds were left in the trust on the receipt of the insurance proceeds on the initial survivorship policy on the lives of Abe and Mary Todd.

Assuming an investment in the new policies of \$9 million over a period of seven years and a modest compound annual growth of 6 percent on the cash value (after policy expenses), in 25 years the policies would have a cash value of over \$32 million¹⁰. At or around this point, several different scenarios could take place:

- The trust could provide for a distribution to one or more beneficiaries of a lump sum of money or a percentage of the cash value of the policies; or
- The trustee could be instructed to access a percentage of the cash value to make other trust investments such as real estate; or
- There could be a combination of both distributions and trust investments.

In any case, the funds would be borrowed from the policies on a tax-free basis.¹¹ Note that if the trustee used the borrowed funds to purchase income-producing real estate, it would enjoy its full depreciable basis, even though it acquired the property with tax-free funds.

Of course, if the return on the investments inside the policy was greater, the cash value result and funds available for tax free investment or distribution would be that much greater. But what if

the investments did poorly? Would that undermine the plan? Not really. If the selected investments did poorly inside the contract it is highly likely that the trustee's investments outside the contract would have done about the same, as there normally should be little difference in the investment approach. And let's not forget that the investment return and cash withdrawals from the policy are tax-favored, so that even if inside and outside the returns were about the same, the policy investments would produce a more favorable result.

However, if the investments inside the policy fall low enough, the policy may not be maintainable without payment of additional premiums and may have to be liquidated if additional funds are unavailable. This result would undermine the plan to make large tax-free distributions of accumulated cash value, but the results would be far from disastrous, as the likelihood is that there would be some cash left in the policy (but not enough to carry it) to return to the trust.

And what would happen if, after the loan was taken and the funds distributed tax free to the beneficiaries, the remaining investments in the policy took a serious downturn and the cash value eventually dissipated to the point at which it could not carry the loan and the policy, causing the policy to lapse? The first impression is that this would be a disaster. But, in fact, it produces quite an unusual and unexpected result—one certainly not contemplated by the IRS.

Let's take a look at a possible scenario:

The trustee in our hypothetical invests the \$9 million in a VUL (for this illustration let's assume there is just one policy) and administers the trust over the succeeding 25 years, during which he also manages to distribute most of the other \$2 million that was not placed in the policy. Say that in year 25 he has about \$300,000 left, plus the policy with a \$32 million cash value. He borrows \$22 million and, according to the terms of the trust, distributes that amount tax-free to the beneficiaries. Several years later, the market takes a deadly downturn and the insurance company notifies the trustee that unless a payment of several million is made to the contract (policy), it will lapse. Because the trustee does not have such funds, he is forced to allow the policy to lapse.¹² On a lapse, the insurer will issue a 1099 to the owner (here, the trustee), reflecting all

distributions made from the policy, in this case including the \$22 million loan, which is now effectively forgiven. Because the trustee already has received the \$22 million in cash, the lapse of the policy results in an income tax liability to the trust to the extent the cash received exceeds the \$9 million basis, or \$13 million in taxable income (for a tax at present rates of about \$4.5 million). The problem is that the trustee does not have the funds to pay the tax.

The trustee would not be personally liable for the tax out of his own funds, because there is no wrongdoing on his part. The cash left in the policy after the loan should have been adequate to carry it, and the market downturn was not something in the trustee's control. There is no transferee liability on the part of the beneficiaries, as there was no tax brought about by the distribution to them. There is no fraudulent transfer by the trustee as the "debt" (the tax) was neither in existence nor predictable at the time of the transfer. Thus, assuming the lapse was neither orchestrated nor reasonably foreseeable, it appears that the IRS is simply out of luck.

The lapse issue aside, I am not unmindful of the fact that when a loan is taken on the cash value of a policy, the insurer imposes an interest charge on the loan balance. At the same time, however, dividends would continue to be generated by the remaining cash value. In this regard, the VUL policy would produce a more favorable result than a whole life policy, because of the different treatment of the two types of policies by insurers when a loan is taken out. In the VUL illustrations I've considered, assuming the \$9 million premium payments and a \$32 million cash value build up as illustrated, after a loan of \$22 million, the policy would continue to support itself with no further premium payments, assuming the (6%) stated rate of return continued.

Because the policies are not modified endowment contracts, receipt of the borrowed funds by the trustee would not be taxable.¹³ For the same reason, distribution of those funds out to the beneficiaries would be tax-free.¹⁴ (Of course, the trusts' distributable net income would be taxable,¹⁵ but this would be negligible in comparison to the contemplated distribution of the cash withdrawn from the policy.) Thus, in our hypothetical, the trustee could be instructed to make a distribution of, say, \$22 million to selected beneficiaries 25 years after the death of the settlor and his spouse, free of any tax, and free of any danger that the IRS would confiscate the entire distribution through taxes and interest.

An important issue to be considered here is the amount of death benefit to be purchased on the insured beneficiaries. The beneficiaries would likely be the children and grandchildren of the settlor. If we are talking about an initial cash premium outlay of \$9 million (over a seven year period), this would purchase a considerable amount of life insurance regardless of the ages of the insureds. Furthermore, insurance companies generally will not provide an unlimited amount of life insurance just because someone will pay the premium. Thus, it may be easier, and practically necessary, for the trustee to insure as many beneficiaries as possible, but even with this approach, the amount of the death benefit would be considerable.¹⁶ What's more, the multiple policy approach would be more desirable, because it would offer additional planning opportunities in the future with respect to possible distribution of the policies themselves.

It's important that the D-DIT is settled in (or moved to) a jurisdiction that allowed perpetual or very long term trusts. This would be relatively easy to accomplish since so many states have adopted laws allowing perpetual or very long-term trusts.¹⁷

Unless a policy is distributed by the trustee to the insured beneficiary, it is assumed that the trustee would hold any policies required for the D-DIT plan until the death of the respective insured beneficiary. Otherwise, gain may be recognized, for example, on a policy surrender.¹⁸ On the other hand, receipt of the policy's face value on the death of the insured, less outstanding loans, will be completely tax-free to the trust (and to the beneficiaries, to the extent distributed).¹⁹ With this scheme there is also the potential planning benefit of being able to distribute a policy to a new dynasty trust for the benefit of the family of the insured beneficiary (sort of a sub-ILIT). Normally such a distribution also would not be taxable, thereby perpetuating the no-tax concept of the idea.

As noted, if a beneficiary/insured dies while the trustee owns the policy on his life, the proceeds will be paid to the trustee, less any outstanding loans, completely tax free. All or part of such proceeds then could be used to start still another round of tax-favored cash value build-up in new policies, ultimately providing more and greater tax-free distributions, assuming of course that the insurance lobby maintains its historic influence on Congress.

Conclusion

By thoughtfully parlaying the cash value build-up and proceeds of life insurance and its special tax benefits through one or more dynasty trusts and careful selection of the policies themselves, a settlor can easily generate tens of millions (or more) of completely tax-free funds for present as well as future generations.

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¹ As of this writing more than 20 states have either abolished the rule against perpetual trusts or substantially extended the rule. The trust could be established in any one of those states merely by appointing a trustee domiciled there and declaring that that state's law will apply. See Austin Wakeman Scott and William Franklin Fratcher, *The Law of Trusts*, section 571 (4th Ed. Little Brown and Co., 1988).

² IRC sections 2505 and 2631. The allocation of their GST tax exemption would give the trust a zero inclusion ratio. IRC section 2642. This would allow principal distributions to be made to future generations free of generation-skipping tax.

³ Whether the funds are applied at once to purchase a single premium policy or paid in installments over seven years to acquire a policy which is not a Modified Endowment Contract (IRC section 7702A) will depend on whether they wish to allow the trustee to access funds from the policy during their lives.

⁴ In my opinion, the VUL policies offer the best opportunity for long term growth of cash value, but a whole life policy from an issuer with a steady long-term return of 7 percent or more should still produce the desired result. I choose a VUL, because given the large up-front funding of the policy, I believe a VUL would offer the best chance of greater growth of the cash value over the extended term of the build-up, and furthermore, they are a better vehicle than a permanent policy when loans are to be taken out. This is because most of the large insurers reduce the dividends on a permanent policy when a loan is taken on it. It should also be noted, however, that a number of insurance companies have averaged a long term return of 7 percent on the cash value of their whole life policies, perhaps with less investment risk than a VUL.

⁵ The question arises here as to whether the trustee has an insurable interest in the lives of the beneficiaries of the trust. The answer may not be the same in all states. Some states, e.g., Washington, Connecticut, and Delaware provide by statute that the trustee does have an insurable interest in its beneficiaries. See Washington RWCA 48.14.030 (3)(c), Conn. Gen. Stat. Section 45a-235(2), and Del. Code Ann. Sect. 2704(5). Furthermore, there may be a presumption that if the insurance company issues the policy then the question is satisfied, but the law is unclear on the point. If the IRS successfully challenged the question (assuming it would have standing to challenge it), then the plan would be thwarted as the policy would be void.

⁶ I.R.C. § 7702A(a)(1). Withdrawals or distributions from modified endowment contracts are generally taxable as income to the extent there is any growth on the policy in excess of the owner's investment in the policy. I.R.C. § 72(e).

⁷ Actually, the premiums could be paid in over a period of less than seven years and still qualify as a non-MEC, so long as the requirements of IRC section 7702A(a)(1) are met. This would result in an even higher cash value in the illustration.

⁸ But see, for example, *Estate of Dumont*, New York Law Journal, July 13, 2004, Page 19 Col. 3, where a judge held a trustee liable under New York law for a loss purportedly resulting from a failure to diversify, even though the trust contained language specifically instructing the trustee not to sell the asset in question if such a sale was for purposes of diversification.

⁹ Alexander A. Bove, Jr., *Letters of Wishes, Trusts & Estates*, January 2006.

¹⁰ At a rate of 7 percent compounded annually, the result would be over \$40 million, and at 8 percent, nearly \$50 million. The concern is whether the death benefit of the policy could keep up with the huge cash value build-up to continue to comply with the cash value corridor test under IRC section 7702(d). Once the policies are issued, however, this should not be a problem because it is the responsibility of the issuing company to comply with the test.

¹¹ This assumes the policy is not treated as a modified endowment contract. *Supra* note 12. Note that if the trustee used the borrowed funds to purchase income-producing real estate, it would enjoy its full depreciable basis even though it acquired the property with tax-free funds.

¹² The trust expressly exculpates the trustee from liability in such a situation.

¹³ The trustee should be sure that the withdrawn funds are a loan and not a partial liquidation of the policy, thereby causing a reduction in the death benefit, as this could cause the withdrawal to be subject to tax under IRC section 72. See IRC section 7702(f)(7). Even if section 7702(f)(7) did not apply because of the 15 year rule, a distribution in excess of basis would still be subject to tax. IRC section 72(e).

¹⁴ IRC section 662(b).

¹⁵ IRC section 643.

¹⁶ For instance, an inquiry with one company, assuming \$9 million total premiums paid in over seven years and several insureds with a median age of 25, showed that that amount would purchase \$100 million in death benefits. In such an event, it is likely that there would be several insurers.

¹⁷ *Supra* note 7.

¹⁸ IRC section 72(e).

¹⁹ IRC sections 102 and 662(b).