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The dynasty life insurance trust: Never use a regular ILIT again

STEVEN J. OSHINS, ESQ.

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Because a life insurance death benefit is subject to estate taxes at the death of the insured, it is common for the insured to set up an irrevocable life insurance trust (ILIT) for the benefit of the intended beneficiaries as a means of avoiding estate tax at the death of the insured. The ILIT is generally the initial owner and beneficiary of the insurance policy except in circumstances in which an already existing policy is transferred to an ILIT.

Just like any type of trust, some ILITs are better drafted than others. In fact, most ILITs suffer from exactly the same error in philosophy that is found in other types of trusts — having mandatory staggered distributions. Staggered distribution trusts should almost never be used. A staggered distribution trust is a trust which makes mandatory distributions to the beneficiaries at staggered ages. For example, the trust may distribute one-third of the trust assets to the beneficiary upon reaching age 25, one-half of the balance upon reaching age 30, and the balance upon reaching age 35.

This distribution philosophy does not consider that many of our clients' beneficiaries will have taxable estates and many, if not most, will either be sued or go through at least one divorce. Forcing the assets out of the ILIT because of

a deficient trust-drafting philosophy exposes the assets to estate taxes, creditors and divorcing spouses that could have easily been avoided.

Dynasty ILITs

An irrevocable trust set up by someone other than one of the beneficiaries provides the ultimate in creditor protection. With a divorce rate of over 50%, as well as an increasing number of lawsuits, creditor protection is often the most important objective of our clients.

The creator of a trust can dictate who may receive the beneficial enjoyment of the property and the extent and circumstances under which this enjoyment may be obtained. As a result, unless trust property is distributed outright to a beneficiary, it will generally be protected from the beneficiary's creditors.

For mature, competent family members who would receive the property outright were it not for the benefits that can be derived through the receipt of property in a trust, the trust should be designed to give the beneficiary of a trust the functional equivalent of outright ownership, including undisturbed control over the property. Many candidates for this type of planning would be unwilling to create such a structure unless the trust benefits are coupled with the ability of the beneficiary to obtain control over the trust property that is virtually tantamount to outright ownership.

In order to achieve the maximum transfer tax savings, the ILIT should be wholly exempt from the generation-skipping transfer tax. This will avoid the imposition of transfer taxes for successive generations. The ILIT should be drafted as a dynasty trust which is an irrevocable trust that is protected from estate taxes for as long as applicable state law allows. With proper drafting, a dynasty ILIT (DILIT) can also be designed to protect the trust assets from the creditors and divorcing spouses of the trust beneficiaries.

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The DILIT concept is that if it makes sense to protect the trust assets from creditors and estate taxes at the first generational level, then the identical concept should apply at the next generational level and each generational level after that until state law requires the DILIT to terminate and distribute all of its assets to the beneficiaries. Since the primary beneficiary at each generational

level can be given control over the trust if desired, there should be no reason to ever draft an ILIT without making it a DILIT.

Support trusts vs. discretionary trusts

A DILIT can be drafted as either a "support trust" or a "discretionary trust" for creditor protection purposes. The discretionary DILIT is slightly more complex, but much more protective than a support DILIT.

A support trust is created by the settlor to support one or more beneficiaries. A support trust directs the trustee to apply the trust's income and/or principal as is necessary for the support of a beneficiary. The beneficiary of a support trust can compel the trustee to make a distribution of trust income or principal merely by demonstrating that the money is necessary for the beneficiary's support, maintenance, education or welfare, or whatever other standard is contained in the trust. The standard for distributions often contains words such as "health, education, maintenance and support" since that language keeps the trust assets outside of the trustee/beneficiary's estate even though that person is both a beneficiary and is the sole trustee.

A discretionary trust allows the trustee complete and uncontrolled discretion to make allocations of income or principal if and when the trustee deems appropriate. Because the trustee is given such broad powers, the beneficiary can only compel the trustee to distribute funds if it can be shown that the trustee is abusing its discretion by failing to act, acting dishonestly, or acting with an improper purpose in regard to the motive in denying the beneficiary the funds sought.

A discretionary trust generally uses permissive language such as the word "may" instead of the word "shall." The permissive word "may" is still generally further qualified by granting the trustee unfettered discretion using words such as "sole and absolute discretion," "absolute and uncontrolled discretion," or "unfettered discretion."

Spendthrift provisions

A spendthrift provision is a provision in a trust agreement that states that the beneficiary cannot sell, pledge or encumber his beneficial interest, and that a creditor cannot attach a beneficiary's interest. At common law, the purpose of a spendthrift trust was to protect a beneficiary from his own spending habits. The idea was to provide for someone who could not provide for himself, and to keep such beneficiary from becoming dependent on public assistance. Therefore, if a spendthrift clause was added to a trust, the common law developed a legal principle that a creditor could not recover from the beneficiary's interest.

A beneficiary of discretionary DILITs does not need to rely on a spendthrift provision because neither the current distribution interest nor any subsequent interest is a property interest under state law. Therefore, neither the beneficiary nor the creditors of the beneficiary have any right to force a distribution from the DILIT. However, as a matter of course, trust scriveners should nearly always include spendthrift provisions even when using a discretionary DILIT.

The rule is different for support DILITs. The Restatement Second of the Book of Trusts, Section 157, carves out four key exceptions to spendthrift protection, where a creditor may attach the assets of a support trust. Those exception creditors are: (1) alimony or child support; (2) creditors for necessary services or supplies rendered to the beneficiary such as medical services; (3) services rendered and materials furnished that preserve or benefit the beneficial interest in the trust; and (4) a claim by the U.S. or a state to satisfy a claim against a beneficiary, such as a tax lien.

Applicable state law will often determine which exceptions, if any, apply. However, even if state law does not carve out an exception for a certain class of creditor, a judge may still determine that public policy should protect that class, so state law may not necessarily be determinative.

Beneficiary controlled discretionary DILITs

Since the terms of a discretionary trust exceed the ascertainable standard permitted by Section 2041 of the Internal Revenue Code, a beneficiary cannot serve as distribution trustee without causing the DILIT's assets to be included in that beneficiary's estate for estate tax purposes. Therefore, in order to draft the trust as a Beneficiary Controlled Discretionary DILIT, the trusteeship should be bifurcated into two separate roles. Upon reaching a selected age, the beneficiary becomes the investment trustee and has the power to fire and hire trustees. The other trustee, often the beneficiary's closest friend, acts as the distribution trustee since the beneficiary cannot have that power. Either the settler or the primary beneficiary or any other person can have the power to fire and replace any trustee.

Conclusion

It is generally insufficient to draft an ILIT or any other trust with mandatory staggered distributions for the beneficiaries upon reaching certain ages. Rather, the trust should be drafted to continue in trust for the beneficiary. For those beneficiaries who are financially astute, the trust should be drafted to give the beneficiary control as trustee. For maximum creditor and divorce protection, the trust should be designed as a discretionary trust rather than a support trust.

Steven J. Oshins is an attorney at the Law Offices of Oshins & Associates, LLC in Las Vegas. His practice is focused on estate planning and asset protection for high-net-worth individuals. Mr. Oshins is the author of Nevada's 365-year dynasty trust law. He can be reached at (702)341-6000, ext. 2 or at soshins@oshins.com.

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