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CLOSELY HELD LIFE INSURANCE COMPANIES (CHLICS)

THE HOLY GRAIL OF LEGAL INCOME TAX AVOIDANCE, ESTATE PLANNING,[1] ASSET PROTECTION,[2] AND FOREIGN AND DOMESTIC INVESTMENT PLANNING FOR VERY HIGH NET-WORTH INDIVIDUALS

BY W. RYAN FOWLER

"You know, gentlemen, that I do not owe any personal income tax. But nevertheless, I send a small check, now and then, to the Internal Revenue Service out of the kindness of my heart." -- David Rockefeller.

DISCLAIMER: This article illustrates how a Very High Net-Worth (VHNW) individual may, partially or completely, legally avoid the requirement to pay income taxes. However, the information contained herein is for information purposes only and is not legal or tax advice. The information herein is general in nature and thus may or may not be appropriate for an individual's particular circumstances. Do not take any action based on the contents of this article without first seeking qualified legal and tax counsel.

EXECUTIVE SUMMARY

At its core, the Closely Held Life Insurance Company (CHLIC – pronounced chee-lick) concept is simple: life insurance is an income tax-free investment vehicle, but insurance companies sap your policy's growth with heavy maintenance fees and sales commissions. Forming a CHLIC means you form your own insurance company to write yourself and others' life insurance policies that may then be used as tax-free investment vehicles that are far more flexible than Roth IRAs or other tax-free accounts. Because you own your CHLIC, you can structure the policy to best suit your specific needs, which allows you to use your policy to invest in a very broad range of investments while realizing gains 100% tax-free. Furthermore, policy growth is not hampered by a 3rd party siphoning off profits. Instead, sales commissions are eliminated, account maintenance fees are drastically reduced, and you may recapture any profits that flow to your CHLIC. Finally, CHLICs themselves enjoy substantial tax benefits, since existing tax law

[1] When combined with a Synthetic Roth IRA (SynRoth) structure. The author discusses the SynRoth Appendix A of this article.
[2] Ibid.

exempts up to 60% of a CHLIC's annual net income from income taxes.[3] Within certain limitations, CHLICs may also convert profits to cash reserves, which are tax deductible.

Forming a life insurance company is not new – such has been done for hundreds of years. What is innovative about the CHLIC structure is how a relatively small life insurance company may be used by its owners for investment planning, income tax elimination, and estate planning. CHLICs leverage the most favorable foreign laws, domestic laws, and advanced, little-known strategies such as Private Placement Life Insurance (PPLI) for an individual's or group's maximum benefit.

In a nutshell, forming a CHLIC allows one to invest in a wide spectrum of investments, including real estate, hedge funds, mutual funds, and derivatives, while legally avoiding all or almost all the state and federal income tax liability normally associated with such investments. CHLICs may also be used as a powerful estate planning and gift and estate tax-free wealth transfer tool.

LIFE INSURANCE AS AN INCOME TAX- FREE INVESTMENT WRAPPER

It is common knowledge that the proceeds from life insurance are income tax free. You don't even need to report life insurance proceeds on your income tax return, since it is legally excluded from gross income.[4] Furthermore, one can purchase certain non-term, non-Mutual Endowment Contract (MEC) life insurance policies that build cash value over time; one may then borrow from the cash value of these policies tax-free. One may also purchase a Variable Universal Life (VUL) policy and invest the policy's cash value in mutual funds or other similar investments. The policy's cash value will then grow tax-free in accordance with the investment portfolio's performance.

There are relatively few investment vehicles that legally allow tax-free or tax-deferred growth. 401(k)s, IRAs, defined benefit plans, other ERISA-qualified pensions,[5] and annuities allow for tax-deferred growth and oftentimes (depending on the vehicle used) may be funded with pre-tax dollars i.e. dollars that are not taxed when initially earned. However, most of these retirement vehicles may not be accessed without incurring significant penalties until at least age 59 & ½, and when those funds are accessed one must pay taxes on principal and gains.

There are also a few tax-advantaged investment vehicles that may be funded with after-tax dollars. Profits from such plans are thereafter tax free, even when later withdrawn by the account holder. These investments include Roth IRAs, Roth 401(k)s, municipal bonds, and, of course, life insurance. Because taxes are paid on a smaller amount before growth rather than a larger amount when the funds are taken out many years later, the overall taxes paid are much lower.

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[3] IRC §806(a).
[4] IRC §72(e)(5).
[5] These are pensions and retirement plans governed by the Employee Retirement Income Security Act (ERISA); see U.S.C. Title 29, chapter 18. 401(k), Keogh, 403(b), and defined benefit plans are examples of plans governed by ERISA.

With the exception of non-term life insurance, the main problem with most tax-free investment vehicles involves the limited amounts that may be invested. Roth IRA annual contributions, for example, are capped at $5,000 annually for tax year 2009 ($6,000 if you're 50 or older) and if your income exceeds $120,000 annually ($176,000 if married filing jointly) then you are ineligible to use Roth IRAs. Roth 401(k)s fare only slightly better. They are available regardless of one's annual income, yet annual contributions are capped at $16,500 annually or $22,000 annually if you are 50 or older. Another significant drawback for Roth IRA and Roth 401(k)s is that funds may not generally be accessed before age 59 & ½ without paying a 10% early withdrawal penalty. In contrast, municipal bonds offer tax-free growth, may be accessed at any time without penalty, and may be bought in large amounts, but they offer puny returns – usually in the range of 2.5-6% annually.

Cash value life insurance may thus be a superior alternative to the foregoing. The amount of life insurance that may be purchased depends on one's age, health, and net worth. A high net-worth (HNW) or very high net-worth (VHNW) individual may thus purchase a multi-million dollar policy and, if such is a VUL policy, invest the policy's cash value and realize returns based on the investment account's performance. In a healthy market it is not uncommon for these returns to reach 10% annually, and one may access such growth by borrowing from the policy tax-free. If the loan is never repaid, no problem: failure to repay just means a reduction in the death benefit's payout amount. Nonetheless, VUL policies have significant downsides that make other, more advanced options much more attractive.

DOWNSIDES OF CONVENTIONAL VUL POLICIES

Despite the fact that VUL policies allow for tax-free growth, there are several reasons they are not for everyone. First, a VUL salesman's commissions are very substantial. This means a large chunk of your money is going in the salesman's pocket. For policies funded with periodic premium payments, 70% or more of your first year's premiums oftentimes go towards sales commissions. Sometimes a policy's cash value will be zero or nearly zero for the first few years as premium payments go in the pockets of the sales representative as well as the insurance company.

A policy paid for at its inception with a single large premium payment is also impaired by heavy sales commissions. Even though these commissions are usually in the lower 4-9% range, if a VHNW individual purchases a policy with a $10 million premium payment and the commission is 5%, the salesman just made $500,000 in a single transaction. A very lucky salesman indeed! This doesn't even include the profits made by the insurance company. Think of how long it may have taken you to acquire such an amount of money, and how quickly it would instantly disappear upon purchasing a single premium VUL.

Another drawback of VULs is the maintenance fees they are subject to. Account management fees, a.k.a. expenses and loading fees, are applied against the entire account's value and are substantially higher than similar trading accounts not contained in an insurance policy. These fees compound over time to significantly reduce a portfolio's final value upon the death of the insured person. For example, an additional management fee of 2% of an account's value, subtracted annually, may result in the account's value being only *half* of what it could have been 36 years later; an additional fee of 3% annually over 48 years may reduce the policy's cash value to as little as *one quarter* of what it could have otherwise been.

A final drawback for VULs is that the investments a VUL may choose are usually limited to mutual funds and similar investments. The PPLI, which we next discuss, is a much more flexible investment tool that overcomes some, but not all, of a VUL's shortcomings. For the greatest benefit, a VHNW individual would do well to form a CHLIC, which we examine later in this article.

PRIVATE PLACEMENT LIFE INSURANCE (PPLI): A GREAT PLANNING TOOL, BUT WE CAN DO EVEN BETTER

Private placement life insurance (PPLI) is essentially a custom-tailored policy sold at very low volume and tailored towards HNW individuals. This low volume makes the policy exempt from securities filings, which in turn means the policy is less restricted by regulations when compared to a VUL or other conventional insurance products. The article "Insuring Against Hedge-Fund Taxes" from the 10/18/2006 edition of the Wall Street Journal says the following concerning PPLI:

> "It's called "private placement" life insurance. These special insurance contracts allow policyholders to invest in a wide range of products, including hedge funds. The main attraction: because the investments are held within an insurance wrapper, gains inside the policy are shielded from income taxes — as is the payout upon death. What's more, policyholders may be able to access their money during their lifetimes by withdrawing or borrowing funds, tax-free, from the policy, depending on how it's set up…
>
> Private-placement policies are typically restricted to individuals paying at least $1 million in total premiums. They are offered by both domestic and offshore insurers, including American International Group Inc., Phoenix Cos.'s AGL Life Assurance Co., Sun Life Financial Inc., Massachusetts Mutual Life Insurance Co. and New York Life Insurance Co., among others. A private placement insurance policy is variable in nature, which allows the insurance company to invest the majority of the premium(s) in a legally separate, segregated account to be managed by either an investment manager of the client's choosing or the insurance company itself. There are no guarantees when it comes to the investment performance (as it varies, so does the death benefit but with a fixed minimum)."

As far as what the PPLI may invest in, the answer is almost anything. This is especially true in the case of offshore (foreign) PPLI policies, which can typically invest in any publicly available investment worldwide. PPLI may invest in real estate, derivatives, and hedge funds in addition to more traditional investments.

Another major advantage of PPLI is the fact that insurance agent commissions may be reduced to almost nothing. This money instead goes to the cash value of the policy itself – in your pocket instead of the insurance agent's. For this reason, insurance agents rarely tell their clients about PPLI, since doing so would cost them hundreds of thousands of dollars in commissions if a client chose PPLI over a VUL policy. Consequently, it is estimated that only about 100 PPLI policies are issued nationwide each year.

Notwithstanding the benefits of PPLI, it still has some of the drawbacks of standard insurance. PPLI remains subject to higher than normal maintenance fees, and when you borrow from your policy (in order to access the PPLI's investment gains) you are subject to interest rates in the neighborhood of 2-5%. Although at least initially this is less than the 15% federal long-term capital gains tax rate, state capital gains tax, and state and federal income or short-term capital gains taxes, the 2% interest on your loan compounds each year unless and until the loan is repaid. As we discussed earlier, 2% annual fees (or in this case interest) compounded over 36 years could ultimately cut your portfolio's value in half. Furthermore, even if the policy's cash value is never borrowed, we must remember that insurance companies exist to make profits. Therefore, a PPLI policy will be structured to take at least some money out of your pocket and place it into the pocket of the insurer. Oftentimes these drawbacks are significantly outweighed by the tax savings realized through utilizing the PPLI as an investment vehicle, but the drawbacks remain nonetheless.

THE ULTIMATE SOLUTION: CREATE YOUR OWN CLOSELY HELD LIFE INSURANCE COMPANY (CHLIC)

Forming your own fully-licensed life insurance company usually takes 3 to 6 months to do, and it isn't cheap. There are numerous regulatory and tax requirements a legitimate insurance company must comply with before it can be licensed to sell insurance. Creating a basic, properly licensed insurance company typically costs $100,000 or so. A complex structure could cost as much as $150,000, and a very complex structure could cost even more. Fortunately, however, it is generally not more expensive to form a foreign CHLIC instead of a domestic one.

Setup normally consists of a feasibility study to determine the specific pros, cons, and dynamics of forming an insurance company relative to a client's particular situation (typically this costs $10,000 or more), followed by actuarial underwriting for the company (typically this costs $25,000 or more), followed by company formation and licensing (typically this costs $65,000 or more). Furthermore, you can expect to pay at least $40,000 annually to maintain your company. Spending less money means cutting corners and therefore possibly running afoul of a state or foreign country's licensing agency as well as possibly the IRS. The risk of incurring fines and penalties by cutting corners is not worth it!

Despite CHLIC setup and operational costs, for Very High Net-Worth (VHNW) individuals, CHLIC expenses are far less than the cost of commissions or maintenance fees associated with conventional insurance (remember the $500,000 sales commission we mentioned earlier!), or even a PPLI policy. Furthermore, owning a CHLIC avails one of very substantial benefits that would otherwise never be realized.

CHLICs offer the following unique benefits:

- A CHLIC may issue PPLI or other policies to its owners or other individuals. Because you own the CHLIC, you will be able to draft the policy specifically to meet your needs. You will also be able to, within reason and certain regulatory limits, set premium rates so as to either maximize the cash value of a policy or shift more profits to the CHLIC.

- An offshore CHLIC may elect to be taxed as a domestic U.S. corporation,[6] meaning it avoids the complex rules and pitfalls inherent in international taxation, as well as the excise taxes that normally must be paid when a U.S. person purchase a foreign insurance policy.

- When you borrow from the cash value of your policy, you can choose to set the interest rate at a minimal acceptable level, such as 2%. This allows for maximum growth of your policy's cash value. Furthermore, the interest that accrues on the loan goes to your insurance company instead of to a 3rd party insurer.

- **The policy you or others purchase from your CHLIC <u>grows 100% income tax-free, and you may access that growth tax-free at any time</u> for retirement or any other need. Generally you avoid all state and federal income and capital gains taxes by investing inside a PPLI policy issued by your CHLIC. These taxes, which you legally avoid, typically range from 15% to over 40% depending on the state you live in and the type of investing you do.**

- **All CHLIC profits are your profits. No more losing money to sales agent commissions, 3rd party insurance company profits, or expensive annual account maintenance and management fees.**

- Under the Internal Revenue Code (IRC), **life insurance companies with less than $500 million in total assets <u>do not pay income taxes on 60% of their first $3 million</u> in annual insurance-related or investment-related profits.[7] That means if a CHLIC's annual profit is $3 million, it only pays taxes (taxed as a C corporation) on $1.2 million**

[6] See IRC §953(d). Electing a foreign insurance company with U.S. owners to be taxed as a domestic company is called a "953(d) election."
[7] IRC §806(a).

in profits. The remainder is tax free! Note, however, that this exemption is phased out gradually until there is no exemption once a CHLIC's net income reaches $15 million annually. You could, however, form multiple companies so that each company brings in no more than $3 million in profits annually, thus maximizing the 60% net profit tax exemption allowed by law for small life insurance companies. One should also not equate premium payments with profits. For example, in some instances it may be possible to bring in $20 million or more in annual premium payments while keeping CHLIC profits at or below $3 million.

- CHLICs in many instances may convert profits towards cash reserves set aside to pay future insurance claims. Conversion of profits to reserves is a tax deduction for the insurance company.[8]

- Domestic CHLICs can invest in hedge funds, derivatives, real estate, mutual funds, precious metals, or any other investment generally available to a U.S. person. A PPLI policy issued by a CHLIC likewise has a similarly wide range of investment options unavailable to conventional VUL policies. Foreign CHLICs are further enhanced in that, if structured properly, they may also easily access domestic or foreign markets almost anywhere in the world.

- CHLICs may access the reinsurance market. Reinsurance is insurance only available to other insurance companies. Because reinsurance is only lightly regulated and bought in large amounts, it is available for much, much less than consumer-end insurance (think of it as "wholesale" insurance pricing as opposed to end-user pricing). Purchasing reinsurance enables an otherwise undercapitalized CHLIC to pay a policy's death benefit if a policy holder dies prematurely. Note that many individuals form captive or closely held insurance companies solely for the ability to access the lower "wholesale price" reinsurance.

- A properly structured CHLIC facilitates the transfer of wealth to heirs free of gift and estate taxes. If the CHLIC is owned by one's children, or by a trust of which the children are beneficiaries, then all CHLIC profits will not be included in the parents' taxable estate when they die. Furthermore, a life insurance policy held in an Irrevocable Life Insurance Trust (ILIT) or Synthetic Roth IRA (SynRoth) passes to heirs free of gift and estate taxes. We examine SynRoths in Appendix A and ILITs in Appendix C of this document.

- Significant estate planning benefits are realized when a CHLIC is owned by a dynasty trust. Dynasty trusts are not subject to the rule against

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[8] IRC §§805(a)(2), 807(b).

perpetuities, meaning they can last a very long time, perhaps even indefinitely. **By using a dynasty trust to own a CHLIC, you ensure the CHLIC will not be included in a person's taxable estate. Therefore, the CHLIC will remain available to future generations, which means you could significantly reduce or perhaps even eliminate the income tax burden not only for you, but for your posterity as well.** We examine dynasty trusts in Appendix B of this document.

- In many states life insurance is partially or fully protected from the claims of creditors. In other states there is no statutory protection. An offshore CHLIC and the policies it issues, when combined with a dynasty trust and either a SynRoth or ILIT, is protected against creditor claims regardless of which state you live in.

In summary, the CHLIC is an ideal tax elimination tool for the VHNW individual or a group of HNW individuals. It allows for 100% tax-free investment growth within the policy, the ability to borrow from the policy regardless of age, recapturing of profits that would otherwise flow to a 3rd party insurer, elimination of losses due to sales commissions, maximum control of policy terms, the ability to invest in real estate and other investments not available to traditional life insurance policies, heavily tax-advantaged wealth accumulation within the CHLIC, and unique estate planning opportunities.

Finally, a CHLIC is 100% Internal Revenue Code (IRC) compliant and will pass the "smell test" of any competent tax attorney. In fact, **we strongly recommend you have your attorney or other income tax counsel review this article** or any proposal the author may draft, so s/he may fully understand the ramifications of forming a CHLIC and advise you accordingly.

WHY DON'T OTHER PLANNERS FORM CHLICS FOR THEIR CLIENTS?

The short answer is CHLICs are an evolution of other types of insurance companies that are themselves fairly new, that CHLICs are only appropriate for individuals or groups with an aggregate net worth of at least $10 million, and that properly forming a CHLIC requires expertise across a diverse range of disciplines. In other words, there are almost no experts nationwide that possess the knowledge, skill, professional connections, and client base that allow them to implement this recently developed, cutting-edge planning strategy.

The term "Closely Held Life Insurance Company" (CHLIC) is a spin-off of the Closely Held Insurance Company, or CHIC. CHICs in turn evolved from Captive Insurance Companies (CICs), a very advanced planning tool utilized by most Fortune 500 companies. Although available in select foreign jurisdictions, CICs were not available in the U.S. until 1981 when Vermont passed the nation's first Captive Insurance Law.[9] Even

[9] Vermont Stat. title 8, ch. 141.

then, CICs were formed by insurance specialists unfamiliar with advanced estate planning and tax strategies. Likewise, advanced tax specialists were not in the insurance business and therefore were not aware as to how creating an insurance company could provide income tax and estate planning benefits. In 1998, the CHIC concept was created and CICs were used for the first time for estate planning.[10] However, there existed several ambiguities regarding tax treatment of CICs and CHICs that were not clarified by the IRS until they issued a series of Notices and Revenue Rulings between 2001 and 2005.[11] Finally, there are a few obstacles that have slowed the development of the CHLIC as a spin-off of the relatively new CHIC. Namely, unlike CHICs and CICs, CHLICs are not formed under captive insurance statutes; such statutes generally do not allow for the formation of life insurance companies. CHLICs must therefore be formed under "standard" insurance law, which, at least in the U.S., is somewhat more cumbersome from a regulatory standpoint. For example, for various reasons beyond the scope of this article, in most states the minimum capitalization would need to be several million dollars just to form the CHLIC; this does not include additional funding via premium payments. In contrast, a small CIC or CHIC could possibly be formed with as little as $100,000 in initial capital.

Note that although the minimum statutory capitalization requirements for a CHLIC are less than $1 million in many states,[12] a higher de facto minimum capitalization is usually required by a state's Insurance Commissioner in order to ensure that the insurance company will be able to pay any policy claims that arise. The best way to mitigate this high capitalization requirement is for the CHLIC to be formed in a favorable foreign jurisdiction and then buy reinsurance to cover potential claims, which is substantially less expensive than consumer-end insurance. However, it is difficult to find a reinsurance carrier willing to accept anything less than $500,000 in total premium payments. Thus, forming a CHLIC requires significantly more capital than a normal CHIC or CIC. It is therefore usually not cost effective for, for example, a $4 million net worth client who could nonetheless benefit from a more conventional CHIC that issued policies other than life insurance. For VHNW individuals, however, CHLICs are a very attractive planning tool.

The substantial hurdles of high capitalization and regulatory compliance requirements for U.S.-based CHLICs are lowered significantly by going offshore. Certain foreign jurisdictions allow the formation of a CHLIC with an initial capitalization as low as $50,000 – much lower than the multi-million dollar capitalization requirements of domestic CHLICs.[13] Minimal reinsurance premium payment requirements usually remain

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[10] Jay Adkisson, *Adkisson's Captive Insurance Companies*, p.13. iUniverse, Inc., Lincoln, NE 2006.
[11] See IRS Rev. Ruls. 2001-31, 2002-89, 2002-90, 2002-91, 2005-40, and Notice 2003-34.
[12] Utah's statutory minimum capitalization requirement for a non-assessable mutual life insurance company, for example, is only $400,000. See Utah Code §31-A-5-211(2)(a). Note that the Insurance Commissioner can and will, however, require a much higher capitalization amount, often to the tune of several million dollars, in order to ensure the insurance company will be able to pay claims as necessary.
[13] $50,000 *is* a minimum capitalization amount. A CHLIC that issues several million dollars worth of policies *will* have a higher minimum capitalization requirement, if only to allow for purchase of reinsurance to cover death benefit claims.

in the $500,000 range, but this is not the drawback some might consider it to be. We examine reinsurance in more detail in the next section.

When setting up a foreign CHLIC, The trick is to have the contacts in the right jurisdiction to properly set up the entity, and then to know how to structure the entity so it is taxed as a domestic company in full compliance with U.S. tax law.[14] In order to accomplish this, a planner or planning team must know:

- the insurance laws and regulations governing creation and operation of an insurance company;
- which foreign jurisdiction(s) are best suited for CHLIC creation and operation;
- which reinsurance companies will best meet a particular need;
- the insurance laws in the U.S., so that the foreign insurance company will not run afoul of such laws when U.S. persons purchase insurance policies from the foreign CHLIC (alternatively, the CHLIC must be able to legally avoid being subject to such laws);
- U.S. income and estate tax law;
- foreign tax law to the extent it applies to the foreign insurance company; and
- how to ensure the IRS will treat the foreign CHLIC as a bona fide life insurance company.

As the author of a leading book on Captive Insurance Companies stated:

> "The problem is that there are very, very few planners who are familiar with these [combined insurance, income, and estate tax planning] techniques and how to implement them – **probably less than half a dozen planners nationwide**. Again, most captives are formed by insurance managers, property-casualty brokers, and risk managers who simply have no understanding of these techniques. While these [captive insurance companies] may be effective from a pure underwriting standpoint, without knowledgeable planning they will miss some of the outstanding wealth planning advantages available to the owner."[15] [Emphasis is mine.]

When you add to the foregoing the idiosyncrasies forming a CHLIC presents over and above that of CICs and the relatively new CHIC, there are likely only a very few or

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[14] Electing a foreign insurance company to be taxed as a domestic company is commonly referred to as a *section 953(d) election*, due to the IRC section which allows for such.

[15] Jay Adkisson, *Adkisson's Captive Insurance Companies*, p.18. iUniverse, Inc., Lincoln, NE 2006.

perhaps even only one planning team (yours truly!) that is currently able to properly form a foreign or domestic CHLIC.

ENSURING YOUR CHLIC IS COMPLIANT WITH TAX AND OTHER LAW

The basis upon which the IRS determines whether a company is a legitimate insurance company or not is found in a single sentence of a 1941 U.S. Supreme Court case, which states:

> "Historically and commonly insurance involves risk-shifting and risk-distributing."[16]

Risk-shifting involves the shifting of risk from the insured person to the insurance company. This means there must be an actual possibility of loss and that the insurance company must be able to adequately compensate the insured person or other beneficiary when the loss occurs. So long as the insurance company is able to pay the claim, issuing a life insurance policy automatically qualifies as risk-shifting because everyone dies and thus the possibility of loss is not only possible, it is inevitable.

The phrase in the previous sentence "so long as the insurance company is able to pay the claim" must be emphasized and further examined. For example, if an insurance company issues a $5 million policy, and it only receives $1 million in premium payments that is added to its $50,000 in startup capital, then it will be unable to pay the claim if the insured person dies before the CHLIC can turn the $1.05 million into $5 million through investing or by bringing in additional premiums. Therefore this company may be challenged as not being a bona fide insurance company by the IRS. There are however two solutions to this problem:

- Sufficiently increase capital reserves, so there will be a sufficient amount to pay the claim if the insured person died prematurely, or

- Buy reinsurance sufficient to cover the claim.

Of the foregoing, the more likely solution would be to purchase reinsurance, which we will discuss shortly.

Risk-distributing means the risk assumed by the insurance company is shared among other policy holders. In other words, if an insurance company has only one policy holder, it is not a true insurance company and will not be treated as such for tax purposes. Neither is an insurance company treated as such by the IRS if it issues one large policy and a 2nd small policy. According to IRS Revenue Rulings, to ensure a company is considered an insurance company for tax purposes, more than 50% of the policy holders should be a taxpayer other than the CHLICs owner(s) (and no single policy should be tied to more than 50% of all premium payments made to the company), except there is no necessity for 3rd party policy holders if there are policies issued to 11 or more separate

[16] *Helvering v. Le Gierse,* 312 U.S. 531, 61 S. Ct. 646 (1941).

taxpayers.[17] This is not as hard to do as one might think. For example, if a CHLIC were owned by a parent, one or more children, or an irrevocable non-grantor trust, each parent could be insured with a $1 million policy, and a child could be insured with a small $50,000 policy, and then the "safe harbor" rules would be met to ensure the company would be treated as an insurance company. Alternatively, 11 policies of any amount could be issued on the lives of separate individuals (even if all policy holders were also owners of the CHLIC) to ensure the safe harbor rules are met.

Finally, an insurance company must be licensed as such in every jurisdiction it transacts business in, and it must be run as a bona fide insurance company. It should keep adequate books and records, have capital reserves and/or reinsurance sufficient to pay policy claims, have sufficient surplus capital as required by law, keep separate books and records for each of its affiliates or subsidiaries (if any), and its assets and operations should be separate from the assets and operations of its owners. In other words, everything must be done properly and without cutting corners.

USING CHLICS TO ACCESS THE REINSURANCE MARKET

Reinsurance is essentially insurance only available to other insurance companies. Because it is not available to the end-consumer and is bought in bulk (a typical minimum purchase is $500,000 in total premiums), reinsurance is much less regulated and provides much more value for each premium dollar spent. Reinsurance is significantly less expensive than consumer-end insurance (think of it as "wholesale" priced insurance), and you aren't throwing your money away when you purchase reinsurance, due to the fact that there will be a large payout from the reinsurer when an insured person dies. The reinsurance company will likely of course invest its premiums to ensure it turns a profit, but the profit going out of your pocket and into the 3rd party insurer is far, far less than if one would have bought a VUL policy at the consumer level. You will almost certainly realize a death benefit payout that is much larger than your corresponding reinsurance premium payment.

The attractiveness of reinsurance is emphasized when we consider the fact that many captive insurance companies (CICs) are formed primarily to have access to the reinsurance market. Forming a CIC allows the CIC owner or parent company to insure itself in a much more cost effective manner than is otherwise possible. In a CHLIC context, we can think of purchasing reinsurance as buying life insurance at a level of cost effectiveness we could not otherwise realize, and then the premium payments are essentially going into an insurance wrapper and invested so that all gains are easily accessible and 100% income and capital gains tax-free. If you therefore look at CHLICs and reinsurance from a combined investment and estate planning context, the CHLIC's true power becomes more apparent.

Of course not all CHLICs need reinsurance. CHLICs that have issued many policies or CHLICs that have sufficient reserves to pay death benefit claims do not need reinsurance. Nonetheless, such CHLICs will still often purchase reinsurance as a cost-

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[17] See Rev. Rul. 2002-89, Rev. Rul. 2002-52, I.R.B. 984 (12/30/2002), Rev. Rul. 2005-40.

effective way to provide for a large death benefit payout. After all, when an insured person dies, the only way to pay a large death benefit without significantly reducing the CHLIC's reserve capital is to buy reinsurance. Buying reinsurance can therefore be thought of as a means of hedging CHLIC funds against the risk of an insured person's earlier-than-expected death.

CAN I FORM A CHLIC IF MY NET WORTH IS LESS THAN $10 MILLION?

Even if your net worth is less than $10 million, it's still possible to benefit from a CHLIC. A group of individuals whose collective net worth is $10 million or more can pool their resources together to form a CHLIC and then reap the fruits of CHLIC ownership. For example, let's say 15 doctors form a CHLIC. Each doctor would only have to pay about $7,000 to form the CHLIC, contribute perhaps $40,000 to capitalize the CHLIC and purchase reinsurance, and they could each then purchase a PPLI policy. Maintenance costs for each doctor would be in the neighborhood of a very affordable $4,000-7,000 per year.[18] If each doctor were to thereafter continue paying premiums to build up their 'nest egg', then a CHLIC becomes a very powerful tool for even the garden variety millionaire. When combined with a dynasty trust (which we discuss later in Appendix B), you can even ensure CHLIC ownership remains closely held by future generations (as beneficiaries of the trust), thus providing a tax-free investment and wealth transfer vehicle for posterity.

HOW CAN I MAKE SURE MY MONEY IS SAFE WITH A FOREIGN CHLIC?

Some people are not comfortable with taking their money offshore. Although investing offshore is safe when one exercises reasonable caution, the solution for those who do not like going offshore is simple: keep CHLIC assets in the U.S. You see, even though a CHLIC is formed in a foreign jurisdiction, and may only sell insurance to non-U.S. persons (such as a Nevis, Panama, or other foreign LLC or trust; the insured individual may of course be a U.S. citizen), there is nothing that prevents it from holding money and investing in the U.S. This is especially easy to do once it elects to be taxed as a domestic corporation by filing an IRC section 953(d) election. The CHLIC may open a trading account, invest in real estate, or conduct any other domestic investment activity. It may also invest in foreign markets, but the choice to invest offshore rests solely with the CHLIC's owners. If the owners wish to keep cash and investments in the U.S., then that's not a problem. The account managers and company directors may also be U.S. residents. The only caveat is that, to avoid being subject to federal and state insurance laws and regulations, a policy must be purchased via an offshore entity with offshore funds. Furthermore, the CHLIC must never solicit business from a U.S. person. Telling someone you personally know about your CHLIC is not a problem – just don't solicit to strangers or someone you only played one round of golf with. This necessitates forming an

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[18] Forming an offshore CHLIC would necessitate the forming of one offshore LLC and bank account for every shareholder, which should cost less than $10,000 to set up with annual maintenance fees in the $1,500-3,000 range. If a group collectively purchased several offshore LLCs and bank accounts, individual costs could perhaps be as low as $5,000 per LLC and offshore bank account. None of this would be necessary if the CHLIC were domestic, however.

offshore entity and opening a foreign bank account, which should cost less than $10,000; costs may be even less if a group of owners order offshore LLCs and bank accounts en masse. A bank account may be set up in any reputable tax haven jurisdiction with a large and well established bank that may or may not have a U.S. presence as desired. Once the policy is purchased, funds may then return to the U.S. and be invested domestically. If an individual wishes to never have too much money offshore, he need only take relatively small amounts of money (say $10,000 or so) offshore at any given time in order to make as many premium payments as is necessary to adequately fund his policy.

WHERE DO I GO FROM HERE?

If you are interested in further exploring whether a CHLIC is right for you, we recommend you contact the author by calling 800-798-2008 or by visiting www.pfshield.com. The Privacy & Financial Shield LLC ("PF Shield") implements the CHLIC structure with the assistance of insurance experts and a U.S.-based attorney who has experience forming life insurance companies in a stable and favorable foreign jurisdiction in Central America. We also will utilize tax counsel and other advisors in our network to ensure your CHLIC is set up and operated in a safe and legally compliant manner. We are happy to work with your tax and/or legal advisor so that s/he understands the CHLIC concept and is confident that it is fully compliant with all applicable tax and insurance laws.

ABOUT THE AUTHOR

W. Ryan Fowler is the managing member and chief consultant of The Privacy & Financial Shield LLC. A graduate of Brigham Young University, he is the author or co-author of two books on asset protection and estate planning. He consults with attorneys and their clients nationwide on a wide range of domestic and offshore asset protection and estate planning strategies. Mr. Fowler is a pioneer in the use of many of the most advanced asset protection and estate planning strategies, which include the use of DEMMLLCs, DBETTs, obligation-based liens, CHLICs, UFTA §8(a) defense strategies, and other strategies known to only a few of the most elite planners in the nation. His latest book, *Asset Protection in Financially Unsafe Times* is co-authored with Dr. Arnold Goldstein, PhD, JD, LLM, MBA and is considered by many to have set the standard for domestic and offshore asset protection planning. He is currently writing his third book, *The Coming Supercrash: A Financial Survival Guide.* Mr. Fowler lives in Salt Lake City, Utah.

APPENDIX A

THE SYNTHETIC ROTH IRA (SYNROTH)

The Synthetic Roth IRA (SynRoth) is a very advanced structure utilizing the latest estate planning strategies, including the Defective Beneficiary Taxed Trust (DBETT, also sometimes referred to as a BETIR trust). Using a SynRoth is not necessary to realize the income tax and investment advantages inherent in CHLICs. However, if one wishes to reinforce their policy against creditor claims (which is especially important if the policy owner lives in a state that does not protect life insurance from creditors), or if one wishes their life insurance policy's death benefit to pass outside their taxable estate while still being able to access the policy's cash value during their lifetime, then a SynRoth is a valuable tool that complements the CHLIC very well.

The SynRoth is a planning tool that mimics the traditional Roth IRA, but lacks many of its restrictions and drawbacks. Like the traditional Roth, a SynRoth is funded with after-tax dollars, however distributions from the SynRoth are tax-free. The SynRoth is also more heavily asset protected, even in states that don't exempt Roth IRAs from creditors, does not have low annual contribution restrictions, and is not subject to estate taxes; neither is it subject to the income in respect of decedent (IRD) tax that a traditional non-Roth IRA would be subject to.

In essence, a SynRoth is a DBETT that purchases a life insurance policy with assets sold to it by its beneficiary. This policy will insure the beneficiary's life, and could be from a domestic insurer, or for greater potential growth, it may also be from a foreign insurer (we talk about foreign insurance in the next chapter.) A SynRoth acts somewhat like an ILIT (which we examine in Appendix C) inasmuch as the insurance proceeds are not included in the insured person's estate when he dies, however it also acts like a Roth IRA inasmuch as the insured person may receive retirement income by borrowing from the policy's cash value as the policy is invested and grows. By using the insurance policy as an "insurance wrapper" investment vehicle, the insured person may invest in domestic investments with a domestic policy, or global investments with a foreign policy. Furthermore, wealthy or even merely "well-to-do" individuals may purchase insurance in amounts that far exceed the annual $5,000/6,000 contribution limit[19] allowed a Roth IRA, insurance proceeds or amounts borrowed from the policy are income tax free, and unlike with a traditional Roth, there is no 10% tax penalty for withdrawing cash from the SynRoth before age 59 & ½. Furthermore, unlike with traditional IRAs there are no required distributions that must be made once the insured person attains the age of 70 & ½. Table A.1, below, compares the SynRoth to the traditional and traditional Roth IRA. In light of these benefits, anyone who wishes to annually invest $10,000 or more after-tax dollars in a tax-free retirement account should consider the SynRoth.

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[19] For 2008, the contribution limit is $5,000 for an individual age 49 or younger, and $6,000 for someone age 50 or older. This annual contribution limit may increase in subsequent years in increments of $500 in accordance with annual inflation rates.

TABLE A.1 Traditional Roth IRA and Traditional IRA vs. the SynRoth (Advantages are Underlined)

	Traditional IRA	Roth IRA	SynRoth
Funded with Before or After-Tax Dollars	<u>Before-tax dollars (tax deductible)</u>	After-tax dollars	After-tax dollars
Tax Free Distributions	No	<u>Yes</u>	<u>Yes</u>
Possible IRD Tax Liability	Yes	<u>No (IRD tax free!)</u>	<u>No (IRD tax free!)</u>
Included in Gross Estate (Higher Estate Taxes for Larger Estates)	Yes	Yes	<u>No (estate tax free!)</u>
Funded with Life Insurance	Prohibited	Prohibited	<u>Yes; may also be funded with other assets but these may not generate tax free growth. However, life insurance is normally used as an “insurance wrapper” to access other domestic or foreign investments</u>
Annual Contribution Limit (2008)	\$5,000, or \$6,000 if 50 or older	\$5,000, or \$6,000 if 50 or older	<u>Limit depends on the amount of life insurance one may purchase, which is determined by a person’s age and net worth. For a high-net worth individual, this amount will be much, much higher than the annual contribution limit for IRAs</u>
Protected from Creditors	Only if protected by state law (some states afford protection, some don’t.)	Only if protected by state law (some states afford protection, some don’t.)	<u>Yes, protected in all states</u>
Required Distributions	Required minimum distributions begin at age 70 & ½	<u>No</u>	<u>No</u>
Early Withdrawal Penalty	Penalty is 10% of any amount withdrawn before age 59 & ½	Penalty is 10% of any amount withdrawn before age 59 & ½	<u>No</u>

APPENDIX B

WHAT IS A DYNASTY TRUST AND HOW MIGHT IT ENHANCE MY CHLIC?

Most trusts, by law, cannot last forever because of the rule against perpetuities. The rule of perpetuities originates from English common law and prohibits a trust from existing longer than 21 years after the death of the last surviving beneficiary. However, some states and foreign countries have abolished this rule, and therefore trusts in those jurisdictions, at least in theory, may survive forever. Such trusts are called *dynasty trusts* and can be very powerful estate planning tools. Their chief benefit is that trust assets may remain forever exempt from gift, estate, and generation skipping taxes (GST).

The domestic jurisdictions best known for allowing dynasty trusts are Alaska and Delaware, although other dynasty trust states include Nevada, Oklahoma, Illinois, Rhode Island, and Utah.

When forming a dynasty trust, one must pay special attention to five major areas:

1) Ensuring the most ideal assets are transferred to the trust, and that these assets are exempt from GST by making a special election;

2) choosing which jurisdiction the trust will be established in;

3) knowing the rules for creating and maintaining a dynasty trust in that jurisdiction;

4) what type of dynasty trust should be used (a pot trust, generational subtrust, or a dynasty ILIT, which we'll discuss shortly); and

5) how might the trust be structured so as to allow for an "exit strategy" (trust termination) if necessary, as well as to allow sufficient flexibility to handle unforeseen challenges?

One of the most important considerations is to make sure all assets transferred to the trust have had a GST exclusion allocated to them. Failure to do this means at least some trust assets will be subject to transfer taxes for each successive generation of beneficiaries. Consequently, many dynasty trusts contain language specifically prohibiting a trustee from acquiring any property that has not had a 100% GST exclusion allocated to it. Furthermore, because each person only has a $2,000,000 lifetime GST exclusion to allocate they should only make allocations to "non-wasting" assets such as real estate, perpetual-duration company stock (a company that terminates in 30 years, for example, may not be an ideal contribution unless it owns assets of a permanent nature), collectibles, etc. as opposed to perishable or short-term duration items. Dynasty trusts are best used to hold "permanent" items that will exist for a long time and grow in value or continuously produce income. A great asset to fund a dynasty trust with is life insurance;

some dynasty trusts are even structured like ILITs to specifically hold life insurance as its primary asset. A $2 million premium payment made when the insured person is 50, for example, will have a death benefit of about $6.5 million. If the policy is purchased by or immediately transferred to the dynasty trust, then $6.5 million will effectively pass outside the grantor's estate free of GST. Premium payments may also be made over time so as to allow for $12,000 annual tax-free gifts or $24,000 annual split-gifts made by a husband and wife. Such gifts would require the dynasty trust to have Crummey provisions, which are possible albeit more complex to properly implement with a dynasty trust.

The next consideration is where the trust should be domiciled. This goes hand in hand with knowing the laws of that jurisdiction in relation to the trust's creation and administration. If the trust will be domestic, one must choose which state (of the ones that allow dynasty trusts) will be used as the trust's situs. Of the states with dynasty trust legislation, Alaska and more especially Delaware have the most favorable laws. Delaware's laws seem to be the most flexible of all the states and require the following for a dynasty trust to be valid:[20]

1) The trust must be irrevocable;

2) the trust must be a spendthrift trust;

3) the trust and its corpus must be subject to Delaware law (the trust document should state this); and

4) the trustee must be either a Delaware resident or a Delaware entity that is qualified to act as a trustee under Delaware law.

The larger question is not which state a trust should be formed in, but whether the trust should be domestic or offshore. Domestic dynasty trusts generally have the following advantages over foreign trusts:

1) They are easier and less expensive to create and maintain.

2) They enjoy simpler tax treatment.

3) Because trust assets and the trustee are within reach of U.S. courts, it's harder for a trustee to steal trust assets and abscond.

The offshore dynasty trust has its own unique benefits, which include the following:

1) If a trust is self-settled, an offshore trust will provide better asset protection than a domestic one while the grantor is alive.

[20] Title 12 Del. Cd. §3570(11).

2) An offshore trust may invest in attractive foreign investments that are unavailable to U.S.-situs trusts.

3) Perhaps best of all, after the grantor dies an offshore dynasty trust is taxed as a foreign non-grantor trust. This means that if the trust is created and administered correctly, trust assets will henceforth grow free of U.S. estate, gift, GST, *and income taxes* so long as the trust does not derive income from the U.S. A U.S. beneficiary will only pay income taxes when he receives a distribution of income from the trust. However, the authors caution that the correct implementation and administration of this type of trust is very complex[21] and should not be attempted without the assistance of qualified counsel. Furthermore, there are generally no income tax advantages exclusive to offshore trusts while the grantor is alive; income tax savings are generally only possible after the grantor's death. Note that domestic dynasty trusts cannot obtain this income tax benefit.

Typically there are two factors used to answer the offshore vs. domestic situs question. The first is whether the grantor is comfortable with going offshore, and the second is whether the grantor is willing to pay the higher setup and administrative costs of going offshore. If the grantor is comfortable with going offshore, and is willing to pay the higher costs, then the long-term tax asset protection and tax advantages of an offshore dynasty trust give it a clear advantage.

In addition to jurisdictional issues, one must decide what type of dynasty trust they want. The two main types are pot trusts and generation subtrusts. Pot trusts are designed to allow multiple individuals and successive individuals to contribute to the "pot" a.k.a. the trust. The pot trust is a single trust and is easier to administer than the generational subtrust. The downside is that each beneficiary typically has an equal beneficial interest in the trust. Therefore, a distant cousin might someday have the same interest in the trust as a direct descendant of the trust's original grantor. This may discourage heirs from making additional contributions to the trust, since they may wish their lineal descendants to have a larger share of trust assets than more distant relatives.

The solution to pot trust shortcomings is to divide the dynasty trust into subtrusts each time the first member of a new generation is born or the last survivor of an old generation dies. Using subtrusts allows certain contributions to be dedicated to specific branches of future generations, which encourages successive generations to contribute to the trust. However, one may expect the number of subtrusts to grow over time, which will cumulatively add to the expense and hassle of administering this more complex arrangement.

[21] IRC §679 is the primary statute that determines whether an offshore dynasty trust becomes free of U.S. income taxes (so long as it derives no U.S.-source income) once the grantor dies. This statute normally causes one or more U.S. beneficiaries to be treated as the trust's owner for income tax purposes, meaning all worldwide trust income will be paid by the beneficiaries. However, with proper planning this provision may be legally sidestepped so that U.S. beneficiaries are not liable for taxes on trust income.

Finally, one must draft a dynasty trust so that it may effectively handle future unforeseen challenges. Careful drafting will add needed flexibility to such a trust, and we accordingly recommend dynasty trusts contain the following provisions:

- Since certain jurisdictions do not allow dynasty trusts to hold real property, the trust should only accept personal property. The workaround for real property is to first transfer it to an LLC or LP (if its state of domicile allows for perpetual duration), and then contribute the company to the trust.

- The trustee should have the right to change the situs of the trust to another jurisdiction in the event of political instability or adverse changes in the jurisdiction's laws.

- If a beneficiary is allowed to enjoy trust property (jewelry or artwork, for example), the trust should require that person to insure the property against, theft, loss, damage, or destruction.

- The trustee should be given broad investment powers, including the right to invest internationally.

- Consider naming two or three trustees instead of just one.

- It's often a good idea to appoint one or two trust protectors (who should never be a grantor or beneficiary) who may veto trustee actions or terminate and appoint new trustees and successor protectors.

- The grantor may wish to give the trustee the power to terminate the trust if his last lineal descendant dies while leaving no specified heirs (in such an event, the trustee may have discretion to give remaining assets to a certain charity or a type or class of charities), or if the administration of the trust becomes cost prohibitive in relation to the value of trust corpus. The trust may also allow for a quorum of beneficiaries to vote to terminate the trust at some future point. Allowing for an "exit strategy" is a good idea, since it's possible at some future time the trust will no longer be desirable.

APPENDIX C

THE IRREVOCABLE LIFE INSURANCE TRUST (ILIT)

The ILIT is a very popular estate planning tool, which also may provide excellent asset protection for life insurance policies purchased in a state that does not exempt such from creditor attachment.

Although life insurance proceeds are income tax free, they are *not* exempt from estate taxes. Thus, if insurance proceeds are payable to the insured person's estate or the estate's executor, the payout will be included in the decedent's gross estate. One way to sidestep this is to make the owner and beneficiary of the policy someone other than the person who is insured, and who will not be an executor over the insured person's estate upon his or her death. The insured person could then make gifts to the beneficiary to pay policy premiums. Such an arrangement will cause the policy proceeds to *not* be included in the insured person's estate when s/he dies.

While this arrangement works from a tax savings perspective, is simple to do, and does not require a trust, it has certain drawbacks:

- Life insurance proceeds are often used to pay estate taxes and other expenses when a person dies. However, if the beneficiary is someone other than the decedent's estate or executor, then that person has no obligations to the estate, and may keep the money for himself. Although an ILIT cannot directly pay estate taxes and other expenses without the insurance proceeds being included in the decedent's estate, the ILIT can pay for these expenses in one or more less direct ways, which may include purchasing assets of the estate or making cash loans to the estate.

- In addition to (indirectly) increasing an estate's liquidity, an ILIT can also allow the insured person to direct (through the trust document) how insurance proceeds will be used after he dies. Payouts made directly to an individual beneficiary will be spent or squandered by that individual however he sees fit.

- A beneficiary's creditors may, in some states, be able to attach insurance proceeds. An ILIT can be structured so as to prevent this.

- An ILIT will protect beneficiaries that are receiving aid from various government programs (Medicaid, etc.) so that they may continue to receive such aid.

- If an individual beneficiary dies, the insured person may not be able to control where the policy's beneficial ownership is transferred. An ILIT prevents this from happening.

In light of the foregoing, using an ILIT to keep life insurance proceeds outside one's taxable estate is often preferable to naming an actual person as the policy's owner and beneficiary. However, if the trust's grantor retains any "incidents of ownership" over the policy, the policy may still be included in the grantor's taxable estate.[22] Practically speaking, if a person retains any power to change a policy's beneficiaries or otherwise direct who the policy proceeds will go to, to use the policy as collateral for a loan, or to assign, revoke, cancel, or surrender the policy, or to direct the policy's nominal owner to do any of the foregoing, then such powers are an incident of ownership and the policy shall be included in that person's gross estate when he dies. Even if a person needs another's consent before doing any of the foregoing, if he has any of the aforementioned rights or powers the policy's proceeds will still be included in his estate.[23]

One must also be careful when transferring an existing life insurance policy into an ILIT. If a person dies within 3 years of transferring their policy, the policy will be included in their estate.[24] Finally, if one wishes to make up to $12,000 tax-free gifts each year to the ILIT, the ILIT must have a Crummey provision. And, like all Crummey trusts, one should consider reinforcing the trust against a beneficiary's creditors by placing the beneficial trust interest in a Disregarded Entity Multi-Member LLC (DEMMLLC.)

[22] Title 26 U.S.C. §2042(2).
[23] Activities that constitute incidents of ownership are set forth in Title 26 U.S.C. §2042(2), as well as other sections of Title 26 U.S.C., Subtitle B, Ch. 11, Subch. A, Part III.
[24] Title 26 U.S.C. §2035(a).