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An Alternative to an ILIT – Life Insurance in a Partnership

Question: I have read a lot about using the Family limited partnership (FLP) to own a policy on the estate owner and his/her spouse for estate liquidity needs. Can you comment on the merits of this approach?

Answer: The FLP is a planning device favored by senior family members because they recognize the importance of estate planning to reduce estate and gift taxes, yet they fear that achieving maximum savings usually translates into giving up control. The FLP permits parents to retain control while at the same time transferring assets to the younger generations for the purpose of reducing estate taxes. In addition to the wealth transfer and income shifting benefits, the FLP may be a more flexible alternative to the ILIT.

Here is how it works: A typical wealth transfer FLP with the parents as general partners and the children as limited partners is established. The FLP is funded with sufficient assets to permit it to purchase and pay the annual insurance premiums on one or both of the parents' lives. The FLP is the owner and the beneficiary of the policies. Upon the death of the senior family member(s), the insurance proceeds are available to help pay taxes and expenses through loans to the estate; the purchase of assets from the estate; and distributions to partners/family members.

Placing insurance on the life of a senior member in a FLP serves several purposes. First, properly structured, estate inclusion of the proceeds can be limited to the proportional interest in the partnership. Second, there is no need to qualify for gift tax annual exclusion where the FLP earnings are the source of the premiums. Finally, the partnership entity allows the policy to be transferred to other family members who are partners without violating the transfer-for-value rule.

Sounds great, doesn't it? However, it takes careful planning and an understanding of the "ambiguities" of the tax law in dealing with FLPs to achieve the desired goal – a semblance of control for the insured without estate tax inclusion of the policy proceeds.

The danger of insurance as the only FLP assets. First, be aware that the IRS frowns on FLP partnerships when the partnership's only assets are the insurance policies.

In Rev. Proc. 96-12, the IRS announced that it will not issue advanced rulings on the status of partnerships where the sole assets consist of insurance on the lives of the partners; or on whether the transfer of life insurance policies to such partnerships will be exempt from the transfer-for-value rules.

Again in Rev. Proc. 98-3, the IRS stated that the exemption from the transfer-for-value rule for transfers to a partnership or similar entity "when substantially all of the organization's assets consist or will consist" of life insurance policies on the lives of the members is an area "under extensive study in which rulings or determinations letters will not be issued" until the Services resolves the issue through the publication of a revenue ruling, procedure etc.

Despite its no ruling position the Service has ruled favorably on the transfer-for-value issue in a number of recent private letter rulings. For example, in PLR 9843024, the Service ruled favorably on the transfer-for-value issue, but set forth a series of caveats indicating that it might

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attempt to construe the transfer-for-value exception based upon a transfer to a partnership as inapplicable when the partnership's only assets are the insurance policies transferred and/or when the insured's percentage interest in the partnership is de minimus.

Furthermore, in PLR 200111038, where life insurance was moved from an ILIT to an FLP the carefully drafted provisions that passed IRS scrutiny made it clear that at all times the aggregate net surrender value of the policies held by the limited partnership would represent less that 50% of its assets.

Thus, it is very important where life insurance will be placed in an FLP to design and document that the FLP has some type of activity – it is doing something other than holding passive assets such as life insurance i.e. it has a business purpose. That it's major purpose is not just to hold life insurance.

While the transfer-for-value issues can be circumvented by having the FLP purchase the policy as the initial owner and beneficiary – other planning issues arise. Chief among these – precluding the insured partner from ever possessing incidents of ownership such that all the policy proceeds would be included in his/her estate under IRC § 2042(2).

Attribution to a partner the incidents of ownership of a policy owned by the partnership. The IRS has long held the position that when a life insurance policy is owned by a partnership, each of the partners is considered to hold incidents of ownership in the policy. This is based on the position that a partner is an agent of a partnership and the acts of a partner bind the partnership. The logical extension of this position would be that if the insured is a partner in a partnership which owns a life insurance policy on his/her life, he/she could exercise an incident of ownership causing the entire death benefit proceed to be includable in his/her gross estate, regardless of the percentage interest in the partnership, regardless of whether or not he/she could exercise any authority over the policy in his/her capacity as partner (i.e. LP interest), and irrespective of the policy beneficiary.

However, in a leading case on this issue, *Estate of Knipp v. Commissioner,* 25 T.C. 153 (1955), the Tax Court held that a 50% general partner *did not hold* incidents of ownership in a policy owned by the partnership. This Tax Court holding seems in direct contradiction to the IRS position described above. The IRS has acquiesced in the *Knipp* case (1959-1 C.B. 4), but *only because the* ***partnership was the beneficiary of the policy and to include the proceeds of the policy in the insured/partner's estate would have resulted in unfair double taxation of a significant portion of the policy****.* That is, the gross estate of the insured would include not only the entire death benefit but also the value of the decedent's partnership interest that would reflect his/her proportionate share of the death benefit payable to the partnership.

This point is reiterated in Rev. Ruling 83-147 and in numerous private letter rulings, and is consistent with the regulations dealing with the incidents of ownership held by controlling shareholders.[1]

The difficulty in determining what is included in an insured/partner's estate stems from the lack of regulations dealing with the incidents of ownership held by a partner through a

[1] PLRs 9623024,9725007,9843024. See also PLRs 9843024, 200017051 and 200111038

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partnership. As a result planners question how compelling the logic in the *Knipp* case would be if the insured is a nominal controlling general partner or the insured possesses management powers similar to trustee powers.

Where insurance is placed on a partner a safer approach is to limit ownership rights to that of a limited partner. However, if a significant purpose of the partnership is to allow the insured to control assets this approach may be an unacceptable alternative. An alternative solution may be to have a provision in the partnership agreement prohibiting an insured/general partner from participating in any decisions involving a life insurance policy on such partner's life.

In Summary: The family limited partnership can provide may benefits to a client who wishes to use wealth transfer techniques to reduce transfer taxes. The value of the partnership interests can be discounted and future appreciation passed to heirs free of transfer tax, thus leveraging the value of each gift. The FLP provides a method for shifting income to lower tax bracket family members and serves as an asset protection device for the limited partners.

Finally the FLP can act as an alternative to an ILIT. The chart that follows compares and contrasts some of the major differences between insurance owned in an irrevocable life insurance trust and a policy owned and payable to a family limited partnership.

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	ILIT	FLP
Flexibility	Difficult to amend or revoke – may require judicial intervention.	FLP agreement can be amended / terminated by agreement of the partners. Allocation of distributions may be changed without court intervention.
Gifting Limitations	Premium limited to annual exclusion gift with valid "Crummy rights" and the limitations of the 5%/$5,000 lapse rule.	FLP earnings may provide the source of the premium payment, eliminating the need to qualify under the annual exclusion gift rules.
3-Year Rule / The Transfer for Value Rule	The 3-year inclusion rule applies to transfers of existing insurance policies **gifted** to a trust. The 3-year rule can be avoided where a policy is **sold** for full consideration; however, the transfer-for-value rule may apply. It may be possible to avoid tax under the transfer-for-value rule where the transfer is the grantor/ insurer's ILIT (such that the insured is considered the owner of the entire trust); however, the Service will not issue advanced rulings on the issue.	A policy can be **sold** for adequate and full consideration to a partnership and avoid both the 3-year estate inclusion rule and the tax under the transfer-for–value rule as long as the transfer is to a valid partnership (or partner) in which the insured is a partner. Where an FLP consists **solely** of life insurance the Service will not rule on the status of the partnership or on the transfer-for-value issue. However, the Service has ruled favorably on both these issues where the insurance held by the partnership represented less than 50% of the total value of the assets. The Service has indicated that the interest of the insured/partner must be **substantial and continuing** and the partnership must continue to include non-insurance assets.
Control	Full death benefit inclusion under IRC § 2042 (incidents of ownership) if the insured is trustee with control over the policy.	Where insurance proceeds are payable to the partnership, in theory, the insured can be a managing partner without causing estate inclusion under IRC § 2042. The safer course would be to include provisions in the partnership agreement preventing the insured from exercising any power over the policy.
Estate Inclusion	Properly structured, 100% of the insurance proceeds are removed from the insured's estate. The insured should not have an incident of ownership under IRC § 2042.	No regulations deal with incident of ownership held by a partner through a partnership as there is for a controlling shareholder. General belief is that where the partnership is both the owner and beneficiary of a policy on a partner's life, the partner's gross estate includes just his/her proportionate share of his FLP interest (the value which reflects a proportionate share of the death proceeds). This position is based on the logic that to include the death proceeds in addition to the FLP interest (the value which already reflects

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	ILIT	FLP
		the death proceeds) would result in double taxation of a substantial portion of the proceeds. Questions exist on whether this logic applies where the insured is a nominal controlling general partner.
Business Purpose	Not Applicable: the ILIT may hold just a policy	The FLP must have a business purpose. It is questionable whether there is a business purpose in a partnership where the sole or major asset is insurance.
Administrative Requirements	Annual "crummy" notices to the beneficiaries required for contributions to the trust to qualify for annual gift tax exclusion	The FLP must be run as a business with appropriate records, accounting entries and tax returns to be respected as an entity by the Service.
Creditor Protection	Transfers to the trust are protected from creditors – provided no intent to defraud. Spendthrift trust provisions protect trust assets from the claims of the beneficiaries' creditors.	Generally creditors may only receive a charging order - giving them the right to share in earnings. Under a charging order a creditor normally does not have the right to force liquidation of partnership assets or have the right to manage the partnership. Consequently, the charging order may give a creditor no value unless the FLP distributes income. In addition, a creditor with a charging order can wind up with a tax liability to the extent distributions are less than taxable income – as they are treated as a substituted partner for federal income tax purposes.
Insurable Interest	There must be an insurable interest in the life of the individual insured or it will be taxed as a wagering contract. Where insurance is purchased in a trust because of a family relationship it may not be necessary to have a pecuniary interest in the life insured (state law should be consulted).	In a business situation relationship alone will not normally support a finding of insurable interest. The basis of insurable interest in a business situation is the prospect of pecuniary loss upon the death of the insured.