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FAMILY LIMITED PARTNERSHIPS – PART III

In Parts I and II, we discussed what family limited partnerships are, who should consider them as planning tools, their advantages as well as disadvantages, and the basic tax implications.

In Part III, we will continue our series on FLPs with selected questions and answers pertaining to life insurance – and conclude with my "FLP Success" and "Valuation Quality-Control" checklists based on the lessons of recent cases and rulings.

LIFE INSURANCE PLANNING

In addition to the advantages of an FLP as a wealth management/transfer tool, there are other benefits in the area of life insurance planning afforded owners of FLPs that are not available to their counterparts in corporations. If structured properly, FLPs can provide flexibility and planning opportunities to their owners for both personal and business life insurance needs.

For instance, FLPs have the same business insurance needs as other types of entities: for key owner indemnification purposes, funding for entity purchase arrangements, etc. Likewise, partners to a cross purchase buy-sell will generally use life insurance proceeds to meet their obligations under the agreement. Because of the flow-through system of taxation and their "safe harbor" status under the transfer for value rule, FLPs and partners can simplify the ownership and transfers of policies without adverse tax consequences.

Q1. Why is a family limited partnership a potential alterative for an irrevocable trust with respect to life insurance used for estate planning purposes?

In many circumstances partnerships have an advantage over trusts in the ownership of life insurance. The major reasons are: control, flexibility, and tax considerations.

Control and Flexibility: By definition, irrevocable life insurance trusts are irrevocable. This implies loss of control. Although in some cases it may be possible to amend an irrevocable trust, such a change generally requires expensive and time-consuming judicial intervention. Likewise, the insured can name himself trustee of an irrevocable life insurance trust, but only at the risk of estate tax inclusion of the proceeds; thus endangering the single most important goal of most such trusts.

A partnership, on the other hand, is a creature of contract and applicable state law, and is governed by more favorable federal income tax law than those for most trusts. Should the parties to the partnership agreement (contract) want to change it, it can readily be changed, amended, or terminated if all or a requisite percentage of partners agree. So if the client (insured) becomes estranged from a child (partner) the partnership, through the dissolution process, could distribute cash to some partners (e.g. the estranged child) and assets in kind, such as the life insurance or a business interest held by the partnership, to other partners (e.g. the "good" children).

Alternatively, the client as managing partner could have the partnership sell the policy for its then value to a new partnership with only the "good" children as partners (or even to himself or herself). Neither possibility is likely with a trustee that is a bank or other independent professional fiduciary.

If the FLP owns life insurance on the client (general partner), only a portion of the proceeds would be includible in his or her gross estate – even though he or she has the power to terminate the partnership or force its liquidation. For instance, if a client is a general partner with one percent interest, nothing should be included in his or her estate beyond that percentage of value. So if the partnership purchases, pays for, and is the beneficiary of a $1,000,000 policy on a client's life, the entire proceeds at his/her death will be income-tax free to the FLP and will not be includable in his/her estate. Instead, the one percent FLP interest will be included in his or her gross estate and the value of his/her interest will be increased by 1% of $1,000,000 ($10,000) as well. Each of the surviving partners can also receive a distribution of his/her/its share of the proceeds income-tax free.

Avoidance of Crummey Hassle: Most irrevocable life insurance trusts depend on "Crummey" withdrawal powers to open the window wide and long enough to qualify contributions to trusts as present interest gifts for the annual exclusions available to the donors. In large premium situations or where the donors do not have or want many actual Crummey beneficiaries, premium payments can rapidly deplete or even exhaust the available gift tax exclusions and exemptions.

On the other hand, if life insurance is owned by an FLP, merely by making a contribution of capital to the firm in return for additional partnership interests (typically in the form of "units" which then could be gifted outright to family members), the client could indirectly provide the cash to pay premiums on partnership-owned life insurance. The transfer of cash to the partnership, per se, would not be a gift since he/she would be receiving partnership units equal in value to the cash contributed. Then the client's subsequent outright gifts of the partnership interests to the children would qualify for the annual exclusion. Alternatively, the client could give cash to the children and they, in turn, could contribute that cash to the partnership in return for increased interests in the FLP.

Note that the current gift tax annual exclusion is $11,000 per donee (or $22,000 for a split-gift). Assuming reasonable valuation discounts are allowed, the client can take advantage of the discounted value and "leverage" his/her annual exclusion – by making gifts of FLP units rather than cash.

Income produced by partnership property will be allocated among the partners and taxed at their individual rates. Income earned and held within a trust will be taxed at the trust's extremely high rates.

Where policy size is significant and the problems of an irrevocable life insurance trust are considerable, planners must help clients weigh both the advantages and disadvantages of the FLP (and LLC) as vehicles for transferring wealth and leveraging those advantages with life insurance.

Q2. How can FLPs facilitate premium payments for life insurance?

There are many ways. Let me count them:

- Assuming insurable interest, an FLP may be the buyer, owner, premium payor, and beneficiary of a life insurance policy on the owner of an estate – and/or the owner's spouse. As discussed above, only a portion of the proceeds would be includible in the gross estate of the insured.

- Alternatively, a partner may use his or her partnership income to pay premiums and maintain his/her own life insurance program. In the case of a limited partner whose FLP units were gifts from the client (e.g., a parent or grandparent), the premium dollars are tantamount to "indirect" cash gifts – without the attendant annual gifting issues.

- FLP interests could be gifted to an irrevocable life insurance trust – even a dynasty trust. The interests would provide income to the trust (a limited partner), which in turn could be used to pay premiums on trust-owned insurance on the life of the grantor. In other words, the cashflow from the FLP will provide its limited partner, the trust, with cash each year to pay all or almost all of the life insurance premiums.

  Of course, the gift of the FLP interests would be a taxable gift. But this one-time (and probably discountable) gift simplifies the client's funding of premiums (and eliminates "Crummey Power" letters) by providing a source of non-gift income for the trust to pay future premiums.

  Assuming the trust is structured as a grantor trust since it owns insurance on the life of the grantor (and/or the grantor's spouse) and can or does use its income to pay life insurance premiums (without the consent of an adverse party), the grantor and not the trust will be responsible to report income and pay taxes – at the grantor's bracket. Eventhough the grantor pays income taxes that would otherwise be payable by the trust, his or her payments should not be considered additional taxable gifts.

- In view of the fact that the final split-dollar regulations were completely silent with respect to arrangements between partnerships and partners, and "private/family" split-dollars are more cumbersome to maintain under the new rules, many clients may have to use other funding mechanisms to "finance" their life insurance purchases. If it is economically feasible and it makes business sense, a client may consider forming an FLP to hold, for example, his or her business interest(s). The income from the FLP can be a viable alternate source of premium dollars to maintain much needed life insurance by the partners.

Q3. How can an FLP facilitate transfers of existing life insurance policies?

First, one of the most important safe harbors to the transfer for value rule is a sale or transfer to a partnership in which the insured is a partner, or to a partner of the insured. This makes it possible for an FLP (if it has sufficient cash flow) to buy an existing policy on the client's life from the policy-owner, whether it is the client, his/her spouse, or child(ren), or an ILIT, or even a third-party business associate – without violating the transfer for value rule. So, even if the policy has been purchased by the partnership for its full fair market value (which is a transfer for valuable consideration), the proceeds will still be income-tax free.

In addition, if the transfer is a bona fide sale, it will not be subject to the “transfer within 3 years of death” rule under Section 2035(a) – even if the client had been the policy-owner (or had an “incident of ownership”). This is because Section 2035(a) applies only to gratuitous transfers (e.g., gifts or transfers for less than full and adequate consideration). Section 2035(d) contains the exception to the three-year rule and exempts inclusion for estate tax purposes – if the transfer is a sale “for full and adequate consideration in money or money's worth.”

Note, however, that this technique will not work if the partnership is not a bona fide partnership under state law, or if it is not considered a separate operating entity under federal law (i.e. it is a sham). Nor will a sale of policy for less than full and adequate consideration qualify for the exception under Section 2035(d).

Q4. Does the “transfers within three years of death” rule of Section 2035 apply to transfers of life insurance to partnerships?

If an existing life insurance policy on the life of a partner is purchased by an FLP, it should not be subject to Section 2035(a) which applies only to gratuitous transfers (see discussion above). So, if the FLP pays the fair market value for the policy, the three-year rule should not be applicable. Neither should there be a problem with a new policy purchased by the partnership – even if it is within three years of the insured partner's death since he never held a personal incident of ownership in it.

Most authorities agree that where the partnership is both owner and beneficiary, there will be no “attribution” of ownership (constructive ownership) that would make even a general or controlling partner the beneficial owner of the insurance. Instead, a portion of the proceeds (generally equal to his/her proportionate share of FLP interest) will be includible in the insured partner's gross estate.

Q5. What is the effect of premium payment for partnership-owned life insurance?

First, neither the partnership nor its partners may take a deduction for the payment of premiums.

Second, when partnership funds are used for premium payment, it is as if a distribution in that amount has been received by the partners. Consequently, the partners must personally pay tax on their respective shares of the premium, as well as reduce their basis accordingly. In other words, premiums paid by the partnership are made with the partners' "after-tax dollars" in proportion to their interests (unless the partnership agreement provides otherwise).

What happens if the policy develops cash value? The increase in cash value is a non-event for income tax purposes. No basis adjustment is necessary because the internal build-up of cash values is tax-deferred. Nor does the internal build-up necessitate any balance sheet change.

Q6. What are the income tax consequences with respect to partnership-owned life insurance when the insured partner dies, or if the policy is surrendered?

At the death of an insured partner, the proceeds will be received income-tax free by the partnership. Each partner's basis is increased dollar-for-dollar by his/her/its distributive share of the amount of proceeds (unless the partnership agreement provides otherwise). For example, if a client had a 4 percent general partnership interest and a 6 percent limited partnership interest, and a $1,000,000 policy became payable on the death of an insured partner, the client's basis would be increased by $100,000, or 10 percent (4% plus 6%) of $1,000,000. The proceeds, when received by the surviving partner(s), would be income-tax free.

If a policy is surrendered by the partnership, gain (the amount received from the insurer in excess of the partnership's net premium payments) is reportable by each partner in proportion to his/her/its interest in the partnership (unless the partnership agreement provides otherwise).

Note that the gain will be taxable as ordinary income rather than capital gain. Once the gain is reportable, each partner's basis in the partnership is increased by that amount (as if he/she/it had contributed it to the entity).

Q7. What are the federal estate tax implications of partnership-owned life insurance?

As noted above, the death benefit payable to the partnership itself should not be includable separately as insurance in the deceased insured partner's estate. However, the proceeds will be taken into account when determining the value of that partner's interest (unless the partnership agreement provides otherwise). For instance, in the case of a $1,000,000 policy on a one-percent general partner, $10,000 (at the most) would be includible in his or her gross estate.

The rationale for this result is based on regulations dealing with corporate-owned life insurance where proceeds would be includible in the deceased shareholder's gross estate – only to the extent they are not payable to, or for the benefit of, the corporation. Instead, the proceeds will be taken into consideration (along with other non-operating assets) in determining the value of the decedent's business interest for estate tax purposes. By analogy, the same result should apply to life insurance owned by the partnership on its partners.

To the extent insurance proceeds are payable directly to the partnership, or to a third party for a valid business purpose, the proceeds should not be separately includable in the insured's gross estate – even if he or she were the general partner.

If proceeds are paid to some party other than the partnership or its creditors, the IRS will claim, to that extent, the proceeds should be included separately as insurance in the deceased partner's gross estate. Generally, proceeds payable to the insured's estate or personal representative will be includible. However, it appears that if the proceeds (subject to a binding obligation) are to be applied to the purchase of the decedent's partnership interest, then the proceeds – to the extent they do not exceed the purchase price – should not be includible.

Of course, any incidents of ownership the insured can exercise in an individual capacity over partnership-owned insurance will also cause the proceeds to be includible for estate tax purposes. For example, when proceeds are payable to the insured partner's personal beneficiary, the insured is deemed to have an incident of ownership in his/her capacity as partner, regardless of his/her percentage of partnership interest; as a result, the entire proceeds of the partnership-owned policy will be includible in his or her gross estate.

Caution: In my opinion, a partnership will not be recognized as a valid entity if its only purpose is to purchase and/or hold life insurance policies. Unless the entity serves some type of business or profit purpose, it is highly likely that the partnership will be scrutinized. The IRS will attempt to characterize the entity as a revocable trust (making the insured general partner the trustee of a trust holding life insurance on his or her life) and thereby giving the insured incidents of ownership over the policy (or policies). If the IRS prevails and disregards the partnership's existence, or re-characterizes it as a trust, the entire proceeds would be includible in the insured's estate.

Q8. Can a partnership purchase life insurance on a partner and use the policy as a financing vehicle to provide nonqualified deferred compensation for the insured's benefit?

Because of the "pass-through" system of taxation, partnership payment of premiums is, in reality, made with its partners' after-tax dollars. So with respect to insurance purchased on the lives of partners, there is no deferral of the tax on profits diverted to premium payments. Therefore, nonqualified deferral compensation plans are not suitable for partners (in fact, there would be "double" taxation: tax on the premium payments, as well as the benefits when they are received); however, such plans may (and should) be considered to reward and retain key employees of partnerships.

Partners may find it preferable to have the business make cash distributions to them and personally use their after-tax income to pay for life insurance on their lives. They could make gifts of the after-tax cash to an irrevocable life insurance trust and/or adult children to purchase insurance on the donor's life; thus keep 100 percent of the proceeds out of the insured's gross estate.

Q9. What are the tax ramifications of an insurance-funded partnership entity buy-out arrangement?

A buy-sell arrangement is essential for partnerships and partners in terms of business succession and estate planning purposes. Under an entity arrangement, the partnership is the owner and beneficiary of life insurance on each of the partners, and is the purchaser of his or her interest at death, disability, retirement, or other triggering event(s).

Premiums:
Each premium paid by the partnership is treated as a distribution to the partners in proportion to their respective share of partnership interest; thus each premium paid by the firm reduces their basis accordingly (unless the partnership agreement provides otherwise).

Death Benefit:
The death benefit is income-tax free to the partnership (and its partners).

Basis:

Upon the insured partner's death, the proceeds are typically allocated among (or between) the partners according to their pro rata share of partnership interest. This gives the surviving partner(s) at least a partial increase in basis.

Since the estate already receives a step-up in basis at the partner's death, that part of the allocation to the insured's estate is "wasted." Therefore, it is often suggested that the partnership agreement provide for a "special allocation" of all of the proceeds to the basis of the surviving partner(s) and none to the deceased partner. This will give the surviving partner(s) an increased basis similar to what would have been received under a cross purchase arrangement.

Note that the special allocation by agreement must be justified as providing "substantial economic effect" to the partner(s). If the insured partner is not (and, technically, should not be) charged for any portion of the premium attributable to the policy on his/her life, it may help to justify the "economic substance" of the special allocation.

Policy(ies) on Surviving Partner(s):

The decedent's estate will include his/her proportionate share of the policy cash value(s) on the life (lives) of surviving partner(s) owned by the partnership.

Existing policy(ies) on the surviving partner(s) may continue to fund the arrangement. Transfers of policy ownership (or an interest in the policy) will be exempted from the transfer for value rule. (A "trust" may be used to facilitate the ownership of policies – especially if there are a large number of partners and their interests are unequal.)

Q10. What are the tax implications of an insurance-funded partnership cross purchase plan?

Under a cross purchase arrangement, each partner is obligated to purchase the interest of another partner upon a triggering event such as death, disability, or retirement. Policy (policies) on the selling partner(s) is (are) owned by, and payable to, the buying partner(s) – either individually or jointly. The tax implications are:

Premiums:

If the partnership pays the premiums on behalf of its partners, each premium payment is treated as if the entity had paid out cash in an amount equal to the premium payment to the partner(s)/policy-owner(s). Each partner will be responsible for his/her/its tax for the pro rata share of premium(s) on the policy(ies) insuring the selling partner(s); and their basis will also reflect the premium payment accordingly.

Alternatively, each partner may pay his/her/its share of the premium personally – either with after-tax income from the partnership or other sources.

Death Benefit:

The proceeds are income-tax free to the surviving partners.

Basis:

Each partner receives a dollar-for-dollar increase in basis in the amount paid for the interest of a deceased partner.

Policy(ies) on Surviving Partner(s):

The decedent's estate will include his/her proportionate share of the policy cash value(s) on the life (lives) of the surviving partner(s).

Existing policy(ies) on the surviving partner(s) may continue to fund the arrangement. Transfers of policy ownership (or an interest in the policy) will be exempted from the transfer for value rule. (A "trust" may be used to facilitate the ownership of policies – especially if there are a large number of partners and their interests are unequal.)

LEIMBERG'S 20-QUESTION FLP SUCCESS CHECKLIST

To ensure the success of an FLP, the planning process should begin as early as possible – while the client is still relatively young and healthy. As with any type of business entity, the formation of an FLP should be done carefully and consideration be given to its advantages and disadvantages. To the extent possible, the FLP should be structured to fit the client's particular circumstances, as well as meet the applicable state law requirements (for partnership) and comply with federal income tax law. The day of the "FLP-in-a-Box" (or for that matter, other tax-oriented or tax-savings schemes "de jour") has passed (if it ever was); and time for highly knowledgeable legal, accounting, and life insurance advice to create customized FLPs and monitor their operation is at hand.

To help clients, insurance professionals, and other advisors win the FLP battle, I have created the following 20-question checklist based on my analysis of the key FLP cases in the last five years.

1. Were the entity-forming documents required under applicable state law properly executed and filed in a timely manner?
2. Has the planning team carefully documented the significant non-tax benefits to the client to justify the creation and maintenance of the FLP? Are there demonstrable bona fide business/investment purposes in its formation and operation, and is there economic substance to the entity?

3. Have the client's assets been transferred to the FLP in a timely and business-like manner (before partnership units are gifted to family members)?
4. Was the client instructed to hold and keep out of the FLP personal assets that are not appropriate to a business or investment enterprise?
5. Was a full-time accredited, independent, and experienced (preferably court-tested) valuation professional used to appraise the property/assets transferred to the FLP? Was the appraisal based on the specific facts of the FLP, and were realistic and justifiable assumptions used in developing the valuation discounts? Did the valuation expert document each of the reasons for the types and amounts of discounts? (See the "Valuation Quality Control" checklist for more information.)
6. Has there, in fact, been a significant change in the administration and management or investment strategy of the assets – after they have been transferred to the FLP?
7. Do the transfers of assets really represent more than a mere change in title, and is not a recycling of value? What has been done to prove it? Do allocations of partnership income, gain, loss and deductions reflect the partners' respective ownership interests in the underlying partnership assets? Are special allocations justified?
8. Has the client avoided co-mingling of his/her and the FLP's funds? Are there separate bank accounts for the FLP and the client?
9. Did the client retain sufficient assets to maintain his/her standard of living without the need to rely on a disproportionate amount of income from the FLP? Or does the client have "first call" on FLP income for his or her support and maintenance, and other expenses as well? For example, does the FLP pay for the client's medical bills (or even income or estate taxes)?
10. Was the client informed that only business or investment assets should be placed into the FLP? Did the client contribute personal assets to the FLP – such as the family home and continue to live there? Was the client informed he/she had to either vacate the residence, or actually pay (not accrue) a fair market rent to the FLP? If so, has the client actually paid rent in a timely manner? Have the transactions been carefully and fully documented?
11. Did the FLP initially – and does it continue to – meet the appropriate state's definition of an FLP?
12. Are accurate records and books kept separately for the partnership as well as the partners? Are the client's subsequent contribution of assets to the FLP, and/or gifts of FLP units promptly documented and reflected in the capital accounts of the partners involved?
13. Are general partners really and actively involved in business? Are they reasonably compensated for services rendered to the FLPs?

14. Did the client retain excessive power – either as general partner or limited partner? For example, if the client is a limited partner (but retains a controlling interest) has he/she given up the right to replace or remove the general partner?
15. Did the client (and his/her spouse) give up the right (directly or indirectly) to unilaterally decide when, how much, and to whom distributions from an FLP would be made?
16. Does the FLP conduct formal meetings and observe generally accepted business practices and formalities?
17. Are there meaningful negotiations and bargaining between and among the partners?
18. Was the FLP created while the client was relatively young and healthy, and competent? Or was the entity formed when the client was extremely elderly, and/or in very poor health (or practically on his/her deathbed), or was legally incompetent? In that case, the FLP entity could be challenged and construed as a substitution for a will and/or a device for testamentary transfers of assets.
19. Have adult children contributed assets to the FLP? Do they actively represent their own interests – or are they completely subservient to their parents?
20. Is there a buy-sell arrangement? Is the agreement properly drafted by competent counsel and executed by the parties? Will the agreement "fix" the value for estate tax purposes? That is, does it meet the three-prong test for "family buy-sell agreements" under Section 2703? (For more information, see FLP Part II.)

LEIMBERG'S VALUATION QUALITY CONTROL CHECKLIST

1. An appropriately large number of guideline comparable companies should be used in the comparison. Two or three companies are probably not sufficient.
2. Are these comparable companies really comparable? Are they similar in fundamental ways? (Have the core fundamentals been stated in the valuation report?)
3. Identify the companies used in the comparisons.
4. The valuation report should document and justify why these companies are comparable. Is the line of business the same, or as similar as possible? Are the product mix and/or customer base the same or similar?
5. Provide cogent, realistic, defensible, and objective reasons to support the size of the valuation discount that has been taken.

6. Use independent, full-time professional appraiser(s). Make sure the appraiser(s) has (have) appropriate credentials, considerable experience with the type of property/entity being appraised.
7. Provide the appraiser(s) with full access to tax, legal, and financial documents, and to relevant information from key people of the business.
8. The planning team should consider and anticipate the abilities of the appraiser as an expert witness – in the event he or she should be required to testify in court.
9. Has each and every assumption and position been backed up and proven or justified in the written valuation report?
10. Does the written valuation report show why the numbers or assumptions are objective, and the results of careful analysis and not arbitrary?
11. Has the planning team considered or examined the arguments, assumptions, positions the IRS or a court would, and is likely to, make?
12. Check and recheck the math and the valuation date(s).