Flexibility In Times of Uncertainty: Family Limited Partnership As An Alternative To A Trust

It takes careful planning to make sure your heirs receive the wealth that you've accumulated over your lifetime. Unless you do some preventative planning, your estate tax liability could erode the value of the estate passing to your heirs.

One of the first techniques used for estate tax reduction and liquidity is the irrevocable life insurance trust, or ILIT. Properly structured the policy proceeds owned by an ILIT are received estate tax-free. The price of creation of this estate tax-free fund is loss of control and lack of flexibility – two objectives that you may be reluctant to go without in today's world of quasi-estate tax repeal.

In today's climate of estate tax uncertainty the family limited partnership, or FLP, presents itself as an alternative to the ILIT; providing greater amount of control and flexibility.

Which option is right for you? Each technique has its own unique risks and rewards that should be considered before implementation. The chart that follows summarizes some key considerations between using an ILIT or an FLP as the vehicle for owning your life insurance policy.

	ILIT	FLP
Flexibility	Once established an ILIT is difficult to amend or revoke – may require judicial intervention. Provisions can be included, at the time the trust is being established, which can provide some flexibility in trust distributions.	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 "Crummey 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.
Control	Full death benefit inclusion 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. 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.	No regulations deal with incident of ownership held by a partner through a partnership. 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).

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	ILIT	FLP
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 "Crummey" 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.

Clearly, the climate of uncertainty created by the recent estate tax legislation has made careful estate planning more important than ever. Far from eliminating estate planning the legislation has caused individuals to focus more attention on identifying strategies that preserve and enhance the assets while providing some degree of control and flexibility. The family limited partnership is one strategy that can confer a number of estate planning benefits.

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