



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 device favored by senior family members because they recognize the importance of reducing 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 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 a partner's 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 with legal and other advisors 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, 1996-1 C.B. 616 the IRS announced that it will not issue advanced rulings on the status of partnerships where the sole assets are insurance on the lives of the partners. Nor will it rule 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

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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 determination letters will not be issued” until the Service resolves the issue through the publication of a revenue ruling, procedure etc.

Despite its no ruling position the Service issued a favorable ruling on the transfer-for-value issue in a number of recent Private Letter Rulings (PLR). 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 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 than 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 its 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 issues arise. Chief among these – precluding the insured partner from ever possessing incidents of ownership such that would cause the policy proceeds to be included in his/her estate under IRC § 2042(2).

Attribution to a partner of the incidents of ownership of a policy owned by the partnership. First it should be noted that there are no regulations dealing with incidents of ownership held by an insured/partner through a partnership as there are for controlling shareholders. Furthermore, the Service has not been consistent in its analysis of the issue – switching between the entity and aggregate theories of partnership law.

In *Estate of Knipp v. Commissioner* the Tax Court held that where the insured is a partner, and the partnership is both policyowner and beneficiary, the insurance proceeds should not be includable in the insured’s estate under the entity theory of partnership law.¹ The Tax Court held that the partnership, as an entity, held all incidents of ownership and there was no attribution to the insured/50% partner. In addition, the Tax Court noted that in this situation since the insured’s gross estate would reflect a share of the proceeds proportionate to his/her partnership interest the attribution of incidents of ownership would subject the proceeds to a second level of taxation; resulting in unwarranted double taxation.

¹ Estate of Knipp v. Commissioner, 25 T.C. 153 (1955).

Likewise in *Watson v. Commissioner* the Tax Court held that an insured-partner would not be considered as possessing the requisite incident of ownership merely by virtue of his control as a 50% partner even where the policy proceeds are paid directly to the surviving partner.²

In both these rulings the Tax Court examined the partnership as an entity. In this theory partners have no rights in the policy other than those following from their respective partnership interests. Under the entity theory, a partnership's incidents of ownership are analogous to the controlling shareholder issues in the corporate context.

In the corporate context, regulations provide that a corporation's ownership incidents are attributed to a shareholder only where a shareholder has more than 50% voting power and where the proceeds are payable other than to the corporation. If this logic applies in the partnership context an insured who is a limited partner, or general partner owning 50% or less, should have no portion of insurance included in his/her estate irrespective of the beneficiary.

However, in Revenue Ruling 83-147, 1983-2 C.B. 158. the Service considered a situation involving a policy on a one-third partner owned by a partnership but payable to a third party. The Service, applying the aggregate theory of partnership law, held that the insured partner had incidents of ownership in the policy.

Under the aggregate theory if the insured is a partner, any incident of ownership held by

the partnership is attributed to the partners. 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 proceeds 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. limited partner interest), and irrespective of the policy beneficiary.

Although this ruling seems in direct contradiction to the *Knipp* case the Service reaffirmed its results, but *only because the partnership in Knipp 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. However, the Service noted an insured partner would possess incidents of ownership in a life insurance policy where the proceeds are payable other than to or for the benefit of the partnership.

This point is reiterated in the Service's most recent private letter rulings where it has applied the aggregate theory of partnership law, but has not included the proceeds in the estate of the insured/partner where the

² *Watson v. Commissioner*, 36 T.C. Memo 1084 (1977).

proceeds were paid to the partnership.³ In all these rulings the insurance represented less than 50% of the partnership assets and the partnership agreement prohibited an insured partner from exercising any rights in a policy on his/her life. As a result of the most recent rulings commentators 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 unacceptable. 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 many 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.

³ PLRs 9725007, 200017051 and 200111038. See also PLRs 9623024, 9843024,

	ILIT	FLP
Flexibility	Difficult to amend or revoke – may require judicial intervention.	FLP agreement can be amended or 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.
3-Year Rule / The Transfer for Value Rule	<p>The 3-year inclusion rule applies to transfers of existing insurance policies gifted to a trust.</p> <p>The 3-year rule can be avoided where a policy is sold for full consideration; however, the transfer-for-value rule may apply.</p> <p>It may be possible to avoid tax under the transfer-for-value rule where the transfer is to the grantor/insured’s ILIT (such that the insured is considered the owner of the entire trust); however, the Service will not issue advance rulings on the issue.</p>	<p>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.</p> <p>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.</p>
Control	Full death benefit inclusion under IRC § 2042 (incidents of ownership) if the insured is trustee with control over the policy.	<p>Where insurance proceeds are payable to the partnership, in theory, the insured can be a managing partner without causing estate inclusion under IRC § 2042.</p> <p>The safer course would be to include provisions in the partnership agreement preventing the insured from exercising any power over the policy.</p>
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

ILIT

FLP

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 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 "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.
