THE TAX ADVISER

A MAGAZINE OF
PLANNING, TRENDS & TECHNIQUES

REPRINTED FROM

MARCH 1996

Tax*Clinic*

Estates, Trusts & Gifts

Insurance in a Partnership? You Bet Your Life!

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PUBLISHED BY
THE AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS

Insurance in a Partnership? You Bet Your Life!

Irrevocable life insurance trusts (ILITs) have become so popular in recent years that estate planning professionals usually turn to these vehicles when faced with the challenge of trying to insulate life insurance proceeds from the insured's taxable estate. However, when examined closely, the ILIT may be a poor choice to accomplish the desired goal. ILITs have many disadvantages: they are inflexible, unable to provide the insured-grantor with control over the policy, expensive to administer, burdensome to manage if *Crummey* withdrawal powers are required and *irrevocable.*

Family limited partnerships (FLPs) have gained much attention of late for use in many general estate planning applications, but not as an alternative to the ILIT. The FLP, in most instances, is the estate planner's most effective tool for preventing estate taxation of policy proceeds. It can provide the insured-grantor with all of the benefits that are sacrificed when using ILITs: FLPs are able to provide the insured-grantor with greater control over the policy, are inexpensive to administer, are not complicated by *Crummey* withdrawal power requirements and are much more flexible than ILITs. An additional benefit exists in the grantor's ability to discount the value of transferred limited partnership interests. Finally, the whole array of problems that arise in managing Sec. 2514 issues caused by lapsing *Crummey* withdrawal powers is completely avoided.

However, before tax professionals begin advising clients to use FLPs instead of ILITs, they should be satisfied with the disposition of the issues that can be raised by the IRS.

☐ ***Will the FLP's general partner have incidents of ownership in a policy on his life that is owned by the FLP so that the entire proceeds are included in the estate?*** No. The Service has tried to impute incidents of ownership to a general partner in a similar case (*Est. of Knipp,* 25 TC 153 (1955)). A general partner cannot be imputed to have incidents of ownership over the policy because the partnership, not the partner, owns the policy. The general partner acts in a fiduciary capacity with respect to all other partners. The IRS finally agreed with this reasoning in Rev. Rul. 83-147. However, this result will occur only if the policy proceeds are payable for the partnership's benefit.

☐ ***How much of the proceeds will be included in the estate at death?*** The life insurance proceeds will be indirectly included in the estate only to the extent that such proceeds increase the value of the economic ownership of the partnership (Sec. 2033 and Regs. Sec. 20.2031-3).

☐ ***Can a life insurance contract be the only asset in an FLP?*** The Service has ruled that a partnership, owning only life insurance, is a valid partnership under Sec. 7701 (Letter Ruling 9309021). Both Sec. 7701 and subchapter K generally allow taxpayers to organize themselves as investment partnerships (see generally Secs. 721 and 731 and the regulations under Sec. 704). Life insurance may be considered an investment in forming a partnership.

Finally, if a client is still insurable and a new policy can be purchased at a reasonable cost relative to the existing premiums in the client's ILIT, consider terminating the ILIT (i.e., discontinue future premium payments) and purchasing new coverage within the client's existing FLP or within a newly created FLP.

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