

This report reviews the advantages and disadvantages of having a trust or a partnership own an ILIT. It also considers the effects of estate tax, gift tax, generation-skipping transfer tax and other planning on insurance proceeds.

Which Should Hold Your Life Insurance — A Trust or a Partnership?

The goal of life insurance planning is to ensure that policy proceeds will not be included in your or your spouse's taxable estate. To achieve this goal, neither you nor your spouse can be the owner of a policy on your life. Instead, we commonly recommend making an irrevocable life insurance trust (ILIT) the owner. A limited partnership, however, may be a better owner in certain situations. Because each has advantages and disadvantages, you need to consider both ownership options.

How the Two Compare

The ILIT ensures 100% exclusion of the insurance proceeds from both your and your spouse's estate as long as:

1. You don't die within three years of transferring the policy into the trust. If you do, the policy proceeds will be brought back into your estate. To reduce the harmful effects of such a scenario, an ILIT should provide for a contingent marital trust so that at least

the tax on the proceeds will be deferred until the death of your spouse.

2. You don't act as trustee or retain powers in trust administration.

A partnership can provide a similar estate tax result. How? You form a family limited partnership (FLP) and retain a 1% general partnership interest. Your family members hold 99% limited partnership interests. The FLP purchases a policy on your life and is the beneficiary of the proceeds. Under a strict reading of the Internal Revenue Code, the only portion of the partnership that should be included in your estate is a 1% interest.

As a general partner, you shouldn't be deemed to hold incidents of ownership in the life insurance policy because you are bound by fiduciary obligations. But the law in this area is not clear, so careful planning is necessary. It might be better if you aren't general partner or are instead co-general partner. In addition, if the IRS doesn't recognize the FLP as a valid partnership, you likely will be

deemed to have incidents of ownership in the policy, and the policy will be included in your estate.

Gift Tax Considerations

With an ILIT, you can make a cash gift to the trust, and the trust will in turn pay the insurance premium. Crummey rights of withdrawal held by the beneficiaries allow the transfers to qualify as present interest gifts, which are eligible for the annual gift-tax exclusion.

You may be able to obtain present interest gift treatment for transfers into an FLP. For general partnerships, if the partners have the right to withdraw from the partnership, gifts of the premium clearly qualify for annual exclusion. For limited partnerships, however, qualifying can be more difficult. The limited partners need to have the right to withdraw certain amounts from the partnership for the gifts to qualify for the annual exclusion. Or, you as general partner can hold limited partnership interests. You can then make gifts of limited partnership interests to the other limited partners. In all cases, carefully design the partnership agreement to ensure qualification for the annual exclusion.

GST Tax Considerations

An ILIT is a superior vehicle for generation-skipping transfer (GST) tax planning for life insurance proceeds. In general, you can allocate exemptions to an ILIT based on premiums paid or ILIT value at the time of allocation. This will ensure that 100% of the proceeds, when paid, will be exempt from GST tax, providing great leverage for the exemption. Ensuring that the trust qualifies as GST tax exempt, however, requires careful planning.

Other Planning Considerations

Because FLPs can be amended, they usually offer greater flexibility than ILITs. As general partner, you may be able to exert certain controls over the partnership assets, allowing you to retain some control over the insurance policy.

Although an ILIT is irrevocable, the trust agreement can include broad discretionary powers that, in the hands of a carefully chosen trustee, offer substantial indirect control. An ILIT can even allow the life insurance policy to be distributed or sold to a new trust or entity that better meets your needs.

Of course, the transaction must be designed to avoid a transfer-for-value problem, which can occur when a life insurance policy is sold. Unless the sale is to a specific type of buyer (such as the insured or a partnership in which the insured is a partner), the proceeds will be subject to income tax.

Finally, an ILIT can contain specific spend-thrift provisions that offer beneficiaries protection from creditors — though the FLP provides creditor protection as well.

ILIT or FLP?

There is no one right answer. Recently, the IRS has been scrutinizing both arrangements more closely. Please call us to review your situation. We'd be pleased to help you select the best alternative for your needs.