FAMILY PARTNERSHIPS -- AN ALTERNATIVE TO IRREVOCABLE INSURANCE TRUSTS

I. Disadvantages Of Irrevocable Insurance Trusts
  A. Amounts Available To Purchase Premiums Are Limited To $5,000 Per Donee Per Year
    1. Premiums are purchased from annual gifts made to the trust by the insured
    2. The insured will owe tax on the gifts into the trust unless the donees have the right to use or enjoy the gift at or near the time it is made (a "present interest")
    3. A present interest is created by a provision in the trust giving the donees the right to withdraw their share of the gift from the trust during at least a 15 day period ("Crummey withdrawal rights")
    4. Waiving the withdrawal constitutes a taxable gift by the donee unless the right to withdraw does not exceed the greater of $5,000 or five percent of the trust principal ("5 by 5 power")
  B. The Clients May Not Control The Trust
    1. The policy proceeds may be included in the clients' estates if they retain control over the trust
    2. Therefore, a spouse or a corporate fiduciary should be the trustee
  C. The Trust cannot Be Amended As Circumstances Change
  D. Hanging Powers Have Been Expressly Disapproved By The IRS
    1. hanging powers are provisions within the trust whereby the right to withdraw amounts of the annual gift exceeding the 5 by 5 power does not lapse but is instead suspended until the years when the annual gift does not exceed the 5 by 5 power
    2. in years when the amount of the annual gift does not exceed the 5 by 5 power, the trust provisions allow the donee to withdraw the amounts that were subject to the suspended withdrawal right, up to the greater of $5,000 or five percent of the trust principal
    3. if the donee dies before the amounts subject to the suspended withdrawal rights are exhausted, those amounts will be included in the donee's estate
  E. After The Insured's Death, The Trust May Incur Income Taxes At The Highest Rate
    1. The trust will incur income taxes if the trust does not annually distribute all of its income to the beneficiaries

            a. in 1994, trusts will be taxed at the 39.6% bracket on taxable income exceeding $7,500

II. Family Partnerships

   A. Basics of Partnerships

      1. general partnership

         a. all partners have the right to manage the partnership unless the partnership agreement designates one or more partner as the managing partner(s)
         b. the partnership liquidates upon the death of any partner unless otherwise provided by the partnership agreement

      2. limited partnership

         a. two classes of partners

            1. general partner -- manages and controls the operations of the partnership
            2. limited partner(s) -- passive ownership

         b. the death of a partner will not liquidate the partnership
         c. the general partner must be capitalized in an amount equal to 10 percent of the total partnership capitalization

      3. The partnerships agreement may give the managing or general partner discretion in making distributions to the partners similar to that which may be exercised by the trustee of a trust
      4. Distributions from partnerships to the partners are tax-free to the extent of their basis in the partnership; distributions exceeding basis are taxed in accordance with the character of the underlying transaction

III. Advantages Of Family Partnerships

   A. Amounts Available To Purchase Premiums May Exceed $5,000 Per Donee Per Year

      1. The clients contribute an amount to the partnership sufficient to purchase a paid-up policy
      2. If the clients cannot fully fund the partnership, they may make periodic contributions to the partnership
      3. In return for the clients' initial contribution, the clients receive interests in the partnership as general and perhaps as limited partners

         a. in their capacity as general partners, the clients would own as little as a one percent interest in the partnership
         b. in their capacity as limited partners, the clients would own as much as 98 percent of the partnership

4. The clients make gifts or loans to their heirs enabling each heir to purchase a one percent partnership interest
5. In the year of the contribution and in each succeeding year, the clients make gifts of part of their interests in the partnership to their heirs
   a. the gifts should quality for the annual exclusion
   b. in effect, interests in the policy proceeds greater than an amount proportionate to the $10,000 or $20,000 annual exclusion may be given annually because the value of the limited partnership interests that the clients give to their heirs may be discounted to reflect minority interests, lack of control, and lack of marketability
6. Upon the clients' death, the life insurance proceeds are distributed to the partners in accordance with the partnership agreement
   a. the agreement can defer distribution to particular partners and can distribute varying amounts amongst the partners
7. The gifted partnership interests should not constitute retained interests for purposes of the valuations rules under Section 2701

B. The Partnership Agreement Can Be Amended By A Vote Of the Partners
   1. a vote of all partners should be required to avoid inadvertent inclusion of the gifted partnership interests in the clients' estate

C. Use Of A Partnership Will Not Increase Income Taxes After The Clients' Death
   1. Partnerships pay no income tax -- all gains and losses flow through to the partners in accordance with the partnership agreement and are taxed to the partners at their respective marginal tax rates
   2. Partners are taxed on their distributive share whether or not they receive the distributions
      a. therefore, the partnership agreement should provide that the partnership will distribute at least an amount equal to the tax liability incurred by the partner by reason of the distributive share

IV. Possible Pitfalls And Disadvantages In Using Family Partnerships

A. Possible Limitations On Availability Of The Annual Exclusion
   1. may not be available if the IRS considers that the cash contribution(s) and the gift(s) of the limited partnership interests are not separate and independent acts

        a. therefore, the clients should not make contemporaneous contribution(s) and gifts
    2. may not be available unless the partnership agreement permits the partners to withdraw at any time and receive an amount equal to the liquidation value of their partnership interests
        a. during the clients' lifetime, the liquidation value would probably be the value of the withdrawing partner's interest in the policy's cash surrender value
        b. after the client's lifetime, the liquidation value would probably be the value of the withdrawing partner’s interest in the undistributed proceeds

B. The Value Of The Clients' Interests In The Partnership At Their Death Will Be Included In Their Estates
    1. The Value of the clients' interests may be minimized through the allocation provisions of the partnership agreement
    2. Through the marital deduction, tax may be deferred by leaving the interest to the surviving spouse

C. The Value Of The Other Partnership Interests May Be Included In The Clients' Estate If They Are Deemed To Retain The Power To Alter, Amend, Or Revoke The Partnership
    1. The power to make discretionary distributions to the limited partners constitutes a power to alter, amend, or revoke
    2. Discretionary distributions from the partnership to the clients' heirs can be accomplished by giving the partnership interests to one or more irrevocable trusts. Crummey notices should be sent by the trust to the beneficiaries

D. A Family Partnership Is More Costly To Organize And Maintain
    1. Partnership agreements are more complex to draft
    2. Partnership accounting is more complex than trust accounting

E. Family Partnerships Created To Hold Life Insurance Are Virtually Untested
    1. The IRS could argue that the family partnership has no business purpose and therefore, the incidents or ownership of the policy are attributed to the general or managing partner
    2. The IRS argument should not prevail if the insurance proceeds are payable to the partnership and not to the partners

3. The IRS argument should be even further weakened if the family partnership had entered into an agreement to purchase all or part of the stock or assets of the clients' business. This should establish the business purpose of providing liquidity to help the enterprise after the loss of a key principal

F. Trustees May Be Held To Greater Fiduciary Standards Than General Or Managing Partners

G. The Use Of Family Partnerships To Hold Life Insurance Involves Travelling Through Uncharted Waters. There Is Little Guidance In The Form Statutes, Regulations, IRS Rulings, Or Court Cases.