The Estate Planner

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Should your life insurance be in an FLP?

Life insurance is one of the building blocks of a solid estate plan. It provides your family with liquidity to pay estate taxes and other expenses and, with proper planning, an additional source of tax-free wealth to supplement your estate.

The key to avoiding estate taxes on life insurance proceeds is to make sure you don't own the policy or possess any "incidents of ownership" in it, such as the right to change beneficiaries or borrow against its cash surrender value. One of the most common ways to accomplish this is to contribute funds to an irrevocable life insurance trust (ILIT) that purchases and holds the policy.

But the disadvantages of an ILIT are that you must give up control over the policy and have limited flexibility to modify it if your circumstances or the tax laws change. In a time of uncertainty about the future of gift and estate taxes, this can be problematic. One potential alternative that provides greater control and flexibility is a family limited partnership (FLP).

FLP basics

An FLP is a limited partnership that you form with your children or other family members. You contribute assets to the partnership — such as cash, real estate, marketable securities or a business — and either gift or sell limited partnership interests to your family.

The biggest benefit of having an FLP is that, by retaining a relatively small general partnership interest, you can remain in control over the assets while shifting a substantial amount of wealth to your family at a low tax cost. That's because the value of a limited partnership interest, which is relatively unmarketable and exercises little control over partnership affairs, can be discounted — sometimes deeply — for gift and estate tax purposes.

FLP must have a business purpose

To enjoy the benefits of a family limited partnership (FLP), you must ensure that the partnership has a legitimate business purpose apart from saving taxes and that you operate it as such. An FLP is unlikely to meet this standard if life insurance is its sole or primary asset.

Legitimate business purposes might include allowing you to transfer a business to your children without giving up management control, consolidating management of an investment portfolio, protecting family assets from creditors or managing fractional interests in real estate. A good rule of thumb is to make sure that life insurance policies represent less than 50% of the partnership's assets.

FLP pros and cons

As a vehicle for holding life insurance, an FLP has advantages and disadvantages. The main advantage is that, unlike an ILIT, the partners can modify the partnership agreement — to change the allocation of distributions, for example — or even terminate the partnership without causing the death benefits to be included in your estate.

Estate planning professionals generally believe that you can be a managing partner of an FLP that owns an insurance policy on your life without being deemed to have "incidents of ownership." But there's some uncertainty about how the IRS and the courts would rule on this issue. To be safe, include a provision in the partnership agreement that prohibits you from exercising any control over the policy.

An FLP also makes it easier to avoid gift taxes. ILITs generally can't own any assets other than the insurance policy, so premiums typically are funded with cash gifts within your annual gift tax exclusion (currently $12,000). And to qualify for the exclusion, you'll need to give the trust beneficiaries Crummey rights to withdraw the funds for a specified time period.

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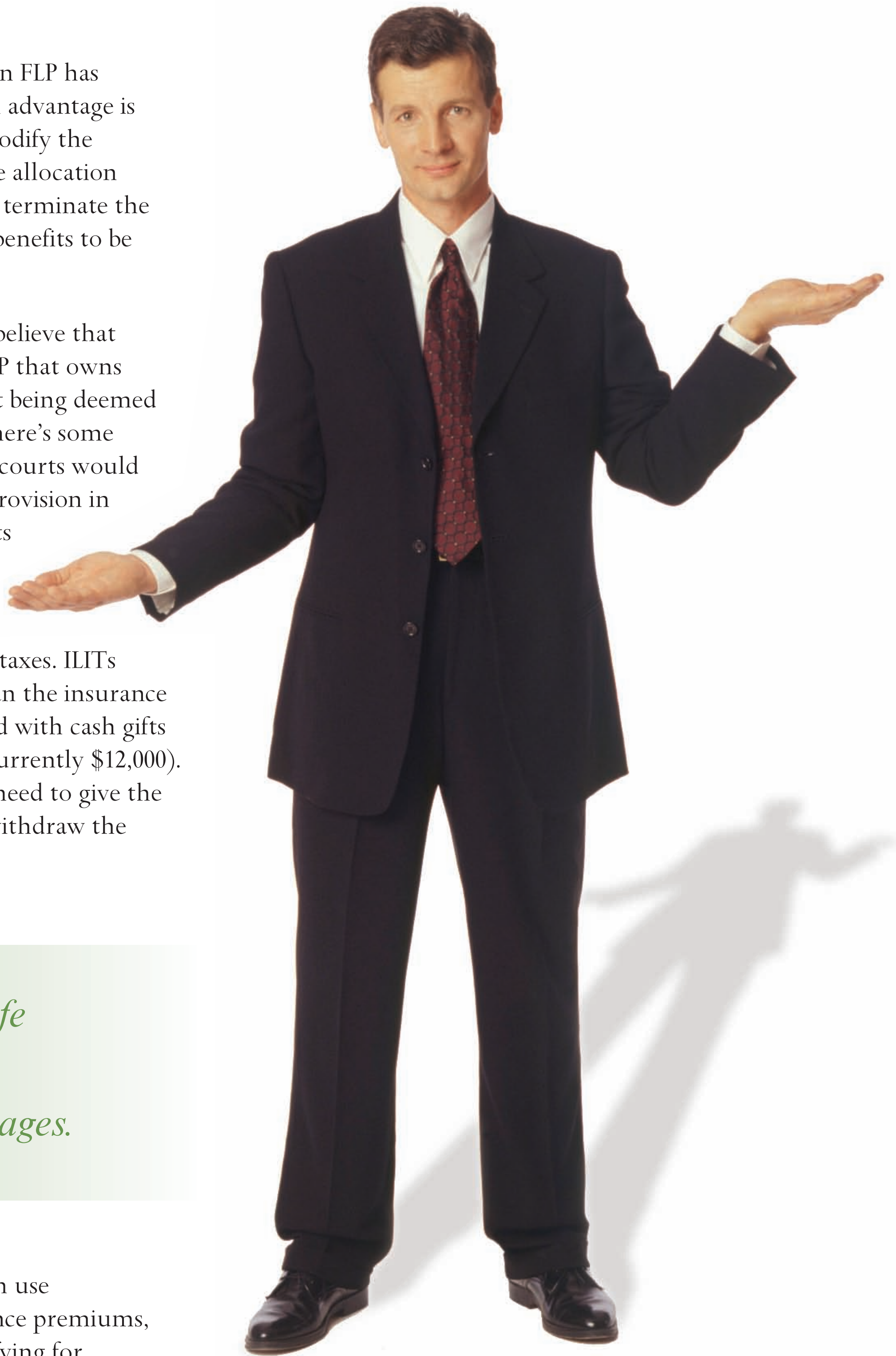
With an FLP, on the other hand, you can use partnership funds to pay the life insurance premiums, so there's no need to worry about qualifying for the annual exclusion.

One advantage of an ILIT is that, provided it's structured properly, all of the life insurance proceeds are removed from your taxable estate. With an FLP — even though there are no regulations on this subject — it's generally believed that, if the partnership is the beneficiary of the policy, the portion of the insurance proceeds included in your estate is limited to your proportionate interest in the partnership.



Weigh the alternatives

An ILIT offers the advantage of a well-established estate planning technique with predictable results, but its lack of flexibility makes it somewhat risky. An FLP, on the other hand, combines estate planning benefits with added control and flexibility, but its tax treatment is less certain. Which technique is right for you depends on your particular circumstances and an evaluation of the relative risks and potential benefits of each vehicle. ✤

Special needs require a special needs trust

No one likes to think about his or her own mortality, so it's no surprise that few people put estate planning at the top of their to-do lists. But to ensure that your wishes are carried out, you need to have an estate plan. And if your child, spouse or another family member is disabled, an estate plan featuring a special needs trust (also known as a supplemental needs trust) may be even more critical.

Avoid planning by default

Everyone has an estate plan, whether they know it or not. If you haven't developed your own, the government has one for you: In the absence of a will or living trust, state law determines how your wealth will be distributed when you die. For a typical family, that isn't necessarily a bad thing because in most states your assets are divided equally among your children or between your spouse and your children.

But if a family member is disabled, failure to plan can have disastrous consequences. For one thing, an inheritance likely will disqualify that person from receiving government benefits that would otherwise help pay for his or her care.

Assist without jeopardizing eligibility

A special needs trust provides resources to ensure that a disabled family member receives the care he or she needs. It places responsibility for managing the assets with a qualified trustee, and it protects the assets from creditors and fraudsters. Perhaps most important, it allows you to assist a loved one without jeopardizing his or her eligibility for government benefits.

Federal assistance programs, such as Medicaid and Supplemental Security Income (SSI), pay for basic medical care, food, clothing and shelter. But those benefits are unavailable to a person with more than $2,000 in "countable resources." These include cash or other liquid assets, real estate, or any other property that's readily converted into cash. Certain assets don't count toward the $2,000 limit, including:

- A home (with some exceptions),
- One car (subject to value limits),
- A small amount of life insurance,
- Burial plots or prepaid burial contracts, and
- Personal effects and household items, such as furniture, appliances, clothing and jewelry.

Assets placed in a properly designed special needs trust don't belong to the beneficiary, so they won't disqualify him or her from Medicaid or SSI benefits. For this strategy to be effective, however, the trust must limit use of the assets to expenses the government programs don't pay for, such as noncovered medical expenses, insurance, education, transportation, recreation, entertainment and travel.

There are several ways to fund a special needs trust, including cash, stock, real estate or life insurance. Generally, it's advisable to make the trust irrevocable so the assets are removed from your estate and sheltered from estate taxes — though contributions may be subject to gift tax.

Word the trust carefully

A special needs trust requires precise language to ensure that it protects your beneficiary without interfering with

government assistance. For example, it should give the trustee sole discretion to make distributions and prohibit him or her from using the funds for support items covered by Medicaid or SSI. For added protection, the trust document should explicitly state your intention to use the assets for only nonsupport expenses.

Although not required, you may want to provide specific instructions about the types of expenses the trust should pay, such as educational costs or travel expenses for visiting family members.

Special care must also be taken in drafting Crummey withdrawal powers. To preserve the annual gift tax exclusion for contributions, most trusts give beneficiaries the right to withdraw funds contributed to the trust within 30 days (or some other time period) after they're contributed.

But with a special needs trust, Crummey powers likely would disqualify the beneficiary from government assistance. One possible solution to this problem is to name another family member as remainder beneficiary and give that person the right to withdraw contributions. Tread carefully, though, as this is a particularly unique area of estate tax law that has innumerable traps for the unwary.

Finally, be sure to discuss the special needs trust with your family and friends. They must know that, by providing financial assistance directly to your beneficiary, they might unintentionally disqualify him or her from receiving government benefits. Explain to them that the best way to help is to make gifts to the trust.

A special needs trust provides resources to ensure that a disabled family member receives the care he or she needs.

Provide a safety net

If a disabled family member will require a nursing home, assisted-living facility or other long-term care after you're gone, the cost can be enormous, so you'll need to tap every resource at your disposal. A special needs trust allows you to leave as much as you can for your loved one while making the most of government assistance. ✤

The inheritor's trust

An estate planning strategy for your heirs

You've created a sound estate plan that effectively limits estate tax liability at your death and clearly spells out how you want your assets to be distributed. But estate planning doesn't end with you. When your heirs receive their inheritance, it becomes part of their own taxable estates. To avoid this, an heir can, with your permission, create an inheritor's trust. This allows your loved one to receive the inheritance in trust, rather than as an outright gift or bequest, thus keeping the assets out of his or her own taxable estate.

Multiple benefits

Having assets pass directly to a trust benefiting an heir not only protects them from being included in the heir's taxable estate, but also shields them from other creditor

Trust setup requirements

To ensure full asset protection, your heir must set up an inheritor's trust before he or she receives the inheritance. The trust is drafted so that your heir is the investment trustee, giving him or her power over the trust's investments.

Your heir then selects an unrelated person — someone whom he or she knows well and trusts — as the distribution trustee. The distribution trustee will have complete discretion over the distribution of principal and income, which ensures that the trust provides creditor protection.

Your loved one should design the trust with the flexibility to remove and change the distribution trustee at any time and make other modifications when necessary, such as when tax laws change. Bear in mind that the unfettered power to remove and replace trustees may jeopardize the creditor protection aspect of the trust and cause inclusion of the trust property in the heir's taxable estate, unless the replacement trustee cannot be related or subordinate to the heir.

claims, such as those arising from a lawsuit or a divorce. Because the trust, rather than your loved one, legally owns the inheritance, and because the trust isn't funded by the heir, the inheritance is protected.

For example, if your daughter is having marital problems and is concerned that her inheritance could one day become community property, establishing an inheritor's trust can provide asset protection. Why? Because everything you gift or bequeath to the trust (including growth and income from the trust) is owned by the trust, and therefore can't be treated as community property. An inheritor's trust can't replace a prenuptial or postnuptial agreement, but it can provide a significant level of asset protection in the event of divorce.

With an inheritor's trust, your heirs can also realize wealth building opportunities. If you fund an inheritor's trust before you die, your loved one can use a portion of the money to, for example, start a new business. A prefunded inheritor's trust can also own the general partnership interest in a limited partnership or the voting interest in a limited liability company (LLC) or corporation. If you decide to fund the trust now, your initial gift to the trust can be as little or as much as you like.

Because it's your heir, and not you, who sets up the trust, he or she will incur the bulk of the fees, which will vary depending on the trust. In addition, he or she may have to pay annual trustee fees. Your cost, however, should be minimal — only the legal fees to amend your will or living trust to redirect your bequest to the inheritor's trust.

To ensure full asset protection, your heir must set up an inheritor's trust before he or she receives the inheritance.

Your heir should consult an estate planning professional to draft the trust in accordance with federal and state law. This will help avoid potential IRS audits and court challenges — and maximize the asset protection benefits of the trust.

Educate your heirs

After a lifetime of building wealth, you're pleased with the thought of your loved ones being able to enjoy it after you're gone. To help them keep the assets out of their taxable estates — as well as enjoy protection from creditors and wealth building opportunities — educate your heirs about the benefits of creating an inheritor's trust. ✤

Estate Planning Red Flag

You haven't funded (or fully funded) your living trust

A revocable living trust is the centerpiece of many estate plans. It serves many purposes, including avoiding probate and managing your assets in the event you become incapacitated. A will alone does neither.

A living trust is fully effective only when it's fully funded. Having a trust that you neglect to fund is like buying a top-of-the-line safe but neglecting to lock your valuables inside.

What does it mean to "fund" a trust? You must transfer ownership of all or most of your assets to the trust or designate the trust as beneficiary of your IRAs, qualified retirement plans or insurance policies.

Assets you leave out of the trust may have to go through probate when you die, and they won't be subject to the trust's control if you're incapacitated. So, it's critical to take inventory of all of your assets, determine how each asset is owned, and talk with your estate planning advisor about whether and how each asset should be transferred to the trust.

Assets to address include real estate, bank accounts, certificates of deposit, IRAs, retirement plans, stocks and other investments, partnerships and other business interests, insurance policies and annuities, vehicles, and personal property (such as jewelry and collectibles).

The steps you need to take to transfer title depend on the type of property. Real estate, for example, is transferred by a deed recorded in the county where the property is located. Transferring a bank account may be as simple as executing a new signature card or presenting the bank with a letter of direction.

To avoid triggering current income taxes and penalties, you shouldn't transfer ownership of IRAs or retirement plans to your trust. Rather, name the trust as beneficiary. For insurance policies and annuities, you can transfer ownership or change the beneficiary designation; your advisor can help you decide which approach is appropriate.

Funding a living trust is an ongoing process. For each substantial asset you acquire, consult your advisor to determine whether it belongs in your trust.

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