A Unique Planning Opportunity For Business Owners:

Combining Split-Dollar Life Insurance And The Family Limited Partnership

by

Myron Kove and James M. Kosakow

On Sunday, December 22, 1996, the New York Times ran a page one article entitled "For Wealthy Americans, Death is More Certain Than Taxes." The article continues for two full pages reporting on a variety of techniques used by estate planners to reduce substantially and in some instances eliminate the catastrophic consequences of the federal estate and gift tax regime.

The Times article only briefly and superficially discusses the subject of family limited partnerships and does not even mention split-dollar planning. This article explores the use of split-dollar plans and family limited partnerships as part of an effective estate plan to preserve family wealth, especially the family business, from the ravages of federal estate and gift taxes. A split-dollar arrangement is an excellent device for funding the purchase of life insurance. A family limited partnership is an excellent vehicle to achieve significant gift and estate tax savings. Combining the two presents unique planning opportunities.

Part I
SPLIT-DOLLAR PLANNING

A split-dollar life insurance arrangement is an excellent device for using corporate funds to purchase life insurance for business owners and executives, and their spouses, at minimal cost to the owner or executive. If properly structured, as discussed below, such arrangements also have beneficial retirement, gift and estate tax consequences.

Traditional Split-Dollar Plan

Split-dollar arrangements are used to fund the purchase of cash value life insurance for business owners and executives. Generally, under a typical split-dollar arrangement the employer advances the premium for cash value life insurance on the executive's life. In the traditional split-dollar arrangement, known as the "endorsement method," the employer owns the life insurance policy.

By use of an endorsement (hence the name) to the policy, the employee has the right to designate the beneficiary. The beneficiary may not be changed without the executive's consent. At death (or on the surrender of the policy during lifetime), the employer recovers the greater of the premiums advanced or the cash value of the policy. The balance of the death benefit goes to the beneficiary. With traditional split-dollar planning the insured executive is primarily interested in the death benefit since he or she has no interest in the cash value.

Equity Split-Dollar

With an equity type split-dollar plan, the cash value in excess of the premiums advanced by the employer belongs to the executive (or third party owner). The policy is usually owned by the executive with a "collateral assignment" (hence the name) to the employer to secure the advances.

At death, the employer recovers its advances, and the balance of the death benefit goes to the beneficiary named in the policy. In the event the policy is surrendered prior to death. the employer is repaid its advances and the balance of the cash surrender value, if any, is paid to the owner of the policy, either the insured executive or a third party.

Equity split-dollar is the preferred type of planning since the executive owns the cash value buildup in excess of the premium advances. As discussed below, the excess cash value may be used for retirement planning.

Tax Consequences of Split-Dollar Funding to Employee

The employee is taxed only on that portion of the premium representing the cost of one-year term insurance (the economic benefit to the employee). This is calculated under an Internal Revenue Service table known as the IRS "PS-58 rates." Alternatively, if lower, the executive may use the insurance company's annual term rate. Generally, the insurance company's rates are lower. The effect is that the executive can obtain a substantially greater amount of cash value life insurance at a low income tax cost.

Advantages of "PS-58 Offset Plans"

A "PS-58 Offset Plan" is a variation of a split-dollar plan which avoids any tax to the executive. With this type

of plan, the employer advances 100 percent of the cost of the insurance. The employee reimburses the company to the extent of the economic benefit conferred on the employee (the PS-58 cost). Since the employee is entitled to deduct his or her premium contributions from the amount that is taxable, the result is that no income tax is due.

Second-To-Die Life Insurance and Split-Dollar Plans

A split-dollar arrangement is not limited to employees but may also cover spouses. For example, the executive and his or her spouse may be covered under a survivorship or second-to-die (SLI) insurance policy. The purpose of the SLI is to provide a fund to pay the settlement costs (estate taxes and administration expenses) at the time of the second death. No death benefit is paid on the first death. but only on the second death when the funds are needed to pay the settlement costs.

The premiums for SLI are significantly less than if each spouse purchased individual single life policies. As with the typical split-dollar arrangement, the premiums are advanced by the employer. The tax consequences are the same except that with SLI. a different IRS table is used known as Table 38. This table covers joint lives. The cost to the employee is less under Table 38 than under PS 58 which is used for a single life.

Planning Idea With a Survivor ship Rider

Using split-dollar means that the couple is in a position to increase the value of their estates substantially at a relatively low cost. Further, if the policies contain a survivorship option, then on the first death, the survivor can increase the amount of insurance.

Generally, a "survivorship" rider gives the survivor the guaranteed right to purchase more insurance (usually up to four times as much) when the first spouse dies without submitting new proof of insurability.

Further Benefits Using Irrevocable Life Insurance Trusts

The couple can achieve beneficial estate planning results when split-dollar life insurance is owned by an irrevocable life insurance trust. In a typical structure. the employee creates an irrevocable life insurance trust (ILIT) which owns an SLI policy on the lives of the employee and his or her spouse.

The ILIT and the employer enter into a split-dollar agreement under which the employer advances the premiums for the insurance and takes back a collateral assignment of the policy to secure its advances. Each year, the employee contributes to the ILIT the amount of the economic benefit (the Table 38 costs) and the trust reimburses the employer for this amount. Except for the reimbursement, the benefit would otherwise be taxable to the employee.

Incidents of Ownership in Life Insurance

If neither spouse owns any incidents of ownership (such as the right to surrender the policy or change the beneficiary, among others) with respect to the policies, then the death proceeds will not be included in the estate of either of the insured spouses. Neither the employee nor the spouse should be trustees. The beneficiaries are the couple's children and their descendants. During their lifetimes, the economic benefit to the employee is a gift to the trust in the same amount. Gift tax may be avoided by giving children and/or grandchildren so-called "Crummey" withdrawal rights so that the gifts qualify for the annual $10,000 gift tax exclusion per donee.

Observations

If the policies are transferred to the ILIT by the insurers, then the proceeds will be included in the estate of the second-to-die insured if he or she dies within three years after the transfer. The policies should be procured by the ILIT to avoid application of the three-year rule.

With respect to a single life policy owned by an ILIT, the trust should provide that if the insured dies within three years of the transfer, then the surviving spouse should receive an interest in the proceeds that qualifies for the marital deduction. The death proceeds will then be protected from estate tax in the insured's estate under the umbrella of the marital deduction.

Retirement Planning and Equity Split-Dollar

The equity split-dollar arrangement is an excellent device for retirement planning. With a traditional split-dollar plan, although the executive designates the beneficiary, the employer is entitled to the greater of the premiums advanced or the cash value of the policy at the time of termination of employment or death.

With the equity plan, any cash value in excess of the premiums advanced by the employer is for the benefit of the executive. This means that at retirement, the executive may use the excess cash value for retirement planning. With the traditional split-dollar, the executive is looking solely to the death benefit.

Because of the retirement feature, equity split-dollar is very popular. The equity plan means that executives and business owners are able to take more money out of their companies at, until the recent TAM, a modest income and gift tax cost.

Gift Tax Consequences of Split-Dollar Plans

If the insurance policy is owned by a third party, such as an ILIT, the amount subject to income tax is also treated as a deemed gift to the third party. The amount of this gift is usually qualified for the annual $10,000 gift tax exclusion through the use of Crummey withdrawal powers in favor of descendants of the executive.

Treatment by the Employer

Generally, the equity split-dollar arrangement has a neutral tax impact on the employer. The premium advances represent assets on the books and records of the employer. The advances are secured by the collateral assignment of the insurance policy to the employer. To the extent the cash value equals or exceeds the advances, then the employer is fully secure. The repayment of the advances at the time of termination, retirement or death is not taxable to the employer.

Initially, however, it may be several years before the cash value equals premiums. So long as the premiums are more than the cash value, the employer is unsecured and the advances may not be recognized as an asset unless the executive agrees to repay the employer for any deficiency. The loss to the employer, if the advances are repaid in full, is only the time value of money. This is insignificant when compared to the benefits provided to owners and executives who benefit from this planning.

Although the arrangement is generally tax neutral to the employer, the payment of the life insurance premiums is not tax deductible. This means that the employer will be using after tax dollars to advance the premiums. For closely held regular C corporations, this may actually be an advantage since the income tax rates on the first $100,000 of C corporation taxable income is less than the owner's or executive's tax bracket.

The tax rate for regular C corporations is 15 percent on the first $50,000 of taxable income or a tax of $7,500; 25 percent on the next $25,000 or a tax of $6,250; the total tax is $13,750 on taxable income of $75,000. The total tax on the first $100,000 of taxable income is $22,250 or an effective rate of 22.25 percent. This may be one-half the marginal rate of income tax paid by the owners and executives who participate in split dollar plans.

Part II
PLANNING STRATEGIES IN RESPONSE TO IRS EQUITY SPLIT-DOLLAR RULING

IRS Technical Advice Memorandum (TAM) 9604001 holds that in an "equity" split-dollar life insurance arrangement, the employee is taxed on any cash value buildup in excess of the employer's premium payments. If the TAM becomes IRS policy, the effect would be to increase substantially the income tax to the employee. The following discusses a new planning technique designed to avoid this unfavorable ruling.

Tax Impact of TAM 9604001

TAM 9604001 changes the present tax scenario significantly. The TAM states that with respect to an equity spilt-dollar arrangement the buildup in the cash value of the insurance policy in excess of the premiums paid by the employer constitutes a taxable benefit to the executive. Even though the excess cash value is taxable to the executive, the employer does not receive any offsetting tax deduction since the payment of life insurance premiums is not deductible.

Since the purpose of an equity split-dollar plan is to create substantial cash values for owners and executives, if the TAM is eventually accepted by the IRS as tax policy, planners will have to create alternative planning designs.

Alternative Planning Suggestions - The Rollout

Planners will have to closely monitor existing and future equity split-dollar plans so as to avoid adverse tax consequences either by amending the agreement to adopt the "traditional" form (i.e., the employer owns the cash value) or adopting a strategy known as a "rollout."

A rollout means that the split-dollar arrangement is terminated and the policy is transferred to the executive at the time when the cash value buildup becomes taxable to the executive. An accurately designed policy illustration should approximate that period of time so that the parties can plan for the rollout.

Before TAM 9604001, the planned rollout contemplated the use of the "equity" format and the accumulation of unusually large policy cash values. Before the insureds reached their late seventies, the ILIT trustee would use a portion of the cash values to repay the entire premium advances. The remaining "equity" within the policy and future premiums would be sufficient to carry the policy well past the insureds' joint life expectancy. This significant

reliance on the "equity" format renders this form of planned rollout highly susceptible to damage by the TAM in question.

The Limited Partnership Strategy

The Limited Partnership is designed to solve the rollout problems created by the TAM. The strategy calls for the business owner to create a family limited partnership (FLP) funded with sufficient assets to permit it to pay the annual insurance premiums.

The FLP purchases a life insurance policy and enters into a traditional endorsement type split-dollar arrangement with an ILIT for the benefit of the owner's descendants. The ILIT is the beneficiary of the policy. The FLP owns the policy, but the death proceeds in excess of the greater of the cash value or the premiums advanced are paid to the ILIT. The advantage of using the FLP is that the owner has a vehicle for transferring wealth to his or her children and grandchildren through gifting limited partner interests to children and grandchildren.

At the first death, the split-dollar arrangement is terminated and the FLP owns the entire interest in the life insurance policy. Using this strategy there is no need for a rollout at the time of the first death. This not only solves all of the problems associated with a rollout, but it also eliminates taxation to the executive of any excess cash value since the executive does not have an equity interest in the policy. All the equity is owned by the FLP.

Since the arrangement is a traditional endorsement type split-dollar plan, all of the cash value is preserved in the policy for the FLP. The ILIT has no equity interest in the SLI policy. Since the children should wind up owning most, if not all the FLP limited partner interests, the equity in the policy and the death proceeds will be owned by them and not the parents.

Simultaneous Death

If both parents die simultaneously before they have had an opportunity to transfer all of the limited FLP interests to the children, the death proceeds are collected by the FLP which reimburses itself for the greater of the premiums paid or the cash value and the balance of the proceeds are paid to the ILIT. The portion paid to the ILIT is not taxable in the estate of either parent.

If, for example, the death benefit is $1 million, the cash value is $50,000 and the premiums advanced at the time of the simultaneous deaths are $100,000, then $100,000 is retained by the FLP and the balance of $900,000 is paid to the ILIT.

Part III
GIFT AND ESTATE TAX BENEFITS OF THE FAMILY LIMITED PARTNERSHIP

For many senior family members, one of the most compelling reasons for using a FLP are its estate and gift tax savings. The FLP is well suited as a device to be used by senior family members to facilitate their estate planning so as to minimize gift and estate taxes.

Gifts of Limited Partner Interests

The gift and estate tax advantages are achieved through gifts of limited partnership interests made by the parents to children, grandchildren and/or trusts for their benefit. Even though the parents will maintain control of the FLP, either as the general partners or by control of the corporate general partner, the gifts will not be included in their estates for estate tax purposes under Code Sec. 2036 (transfer with a retained life estate) and Code Sec. 2038 (revocable transfers).

Retention of Management Powers Does Not Affect Gift

In IRS letter Ruling 9415007 it was held that the transferor's retained power as general partner of the FLP would not cause the transferred interests to be included in the transferor's estate. The ruling held that the management powers possessed by the transferor father, including control over distributions, must be exercised by him in a fiduciary capacity, and did not transform the gifts into future interests. Similarly, the right of first refusal granted to the other partners, in the event of a sale of an interest, does not affect the status of the gifts as gifts of present interests. (Accord, IRS Technical Advice Memorandum 9131006.)

Transferred Interests Not Included in Transferor's Estate

Relying on the U.S. Supreme Court decision in *Byrum, 408 US 125 (1972)*, Letter Ruling 9415007 also held that the transferor's retained power as general partner would not cause the transferred interests to be included in his estate under Code Sections 2036 (transfer with a retained life estate) and 2038 (revocable transfers).

Byrum held that a decedent who transferred stock in a closely-held corporation to an irrevocable trust, but retained the voting rights, had a fiduciary duty to promote the interests of the corporation and could not exercise his voting rights for personal gain at the expense of minority shareholders. Accordingly, the decedent's retained vot-

ing rights did not cause the transferred stock to be included in his estate.

Observation

After the decision in *Byrum*, Code Sec. 2036 was amended to provide that the retention of voting rights in a controlled corporation will cause the transferred stock to be included in the gross estate. The private ruling makes clear that the amendment does not apply to partnerships.

Annual Exclusion Gifts

Letter Ruling 9415007 also held that gifts of limited partnership interests qualify for the $10,000 annual exclusion. To qualify for the exclusion the gifts must be of a present interest. Under Reg. Sec. 25.2503-3(b), a present interest is an unrestricted right to the immediate use, possession, or enjoyment of the property. A future interest includes remainders, reversions, and other interests which are limited to commence in the future. Since the gifts of the limited partner interests were outright and not subject to any restrictions, they qualify for the annual exclusion.

Planning Strategy Using Trusts for Minors

In the ruling, gifts for minor children were to be made to Code Sec. 2503(c) trusts. That section provides that gifts for individuals under age of 21 qualify as present interest gifts (and therefore qualify for the annual exclusion) if (1) the property and income may only be used for the benefit of the donee prior to attaining the age of 21, and (2) to the extent not so used pass to the donee on attaining age 21, and in the event the donee dies before age 21, are payable to the donee's estate or as the donee may appoint under a general power of appointment.

Reg. Sec. 25.2503-4(b) permits the donee to extend the term of the trust at age 21. This possibility of extension may mean that Section 2503(c) trusts are more desirable than transfers under the Uniform Gifts to Minors Act or the Uniform Transfers to Minors Act. There is no such option under the Uniform Acts.

Valuation Discounts For Transfers of FLP Interests

A FLP provides greater valuation discounts than might otherwise be available if the asset which is the subject of the gift is transferred directly to the recipient. If, for example, the parents wanted to transfer $100,000 equally among their four children, the value of a gift of $100,000 is $100,000.

The Hypothetical Buyer Test

The valuation test "is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts." Reg. Sec. 25.2512-1. Value is determined at the time of the gift or at death (or the alternate valuation date) for date of death transfers.

Transfers to FLP Rather Than Children

Instead of transferring the cash to the children, the parents may form a FLP to which they transfer the $100,000 in exchange for 99 limited partnership interests (representing all the limited interests) and one general partnership interest. The partnership invests the $100,000 in real estate. Both the general and the limited partner interests have identical rights, other than that the general partner has exclusive management control and unlimited liability. The parents thereafter transfer their 99 limited partner interests equally among their four children. The issue that then arises is the value of the gifts for gift tax purposes. Is the value of each gift $24,750 or some lesser amount? If the value is some lesser amount what is the justification for the lower valuation?

The Fair Market Value of the Gifts

Under the hypothetical buyer test, the gifts have a real value that may be considerably less than each interest's pro-rata share of the partnership's assets represented by the 99 units transferred to the children. There are three primary reasons why a hypothetical buyer would be reluctant to purchase the interests based solely upon the value of the underlying assets.

First, as a limited partner the buyer has no control over the investment of partnership assets. Control is with the general partner. Second, there is no market for the limited partnership interests. If the buyer needs cash, he or she would probably not be able to sell the interest except at a substantial discount. Third, each interest represents only a minority interest in the partnership. It may be difficult to find a buyer interested in acquiring a minority interest in an enterprise. Because of these factors, the fair market value of each gift is considerably less than $24,750.

The Discount Factors

Although the underlying value of the 99 limited partner interests may be $99,000, the true value of the gift to each child is much less under the willing buyer/willing seller test. The discount factors used to value the gift are the following:

Lack of Management Participation

A limited partnership interest does not participate in the management of the FLP . Management is solely in the general partners. This lack of management participation translates into a lower value since, under the hypothetical buyer test, a willing buyer will pay less for a passive investment over which he or she has no control.

Minority Interest

Another factor that substantially limits value and enhances the discount is the minority interest discount. The willing buyer will want to pay less for an interest that does not possess any voting rights.

Marketability Discount

A discount will be allowed since there is no public market for the partnership interests. The absence of a public market means that the interest may be difficult to sell and should therefore be discounted. A willing buyer will pay less for an investment that is difficult to sell than for one for which there is a ready and open market.

The Fair Market Value of Limited Partner Interests

The net effect of these discount factors is that the transfer of a limited partnership interest may be valued at a fraction of the value of the underlying assets. The effect of the discounts may reduce the value of the gift anywhere from 30 percent to 60 percent or more. Therefore, instead of paying gift tax on 100 percent of the underlying value, the tax may only have to be paid on 70 percent or 40 percent of the underlying value.

The Authority for Discounts

The IRS has always recognized marketability discounts and in 1993 issued a landmark ruling giving recognition to minority discounts in family owned businesses. Rev. Rul. 93-12, 1993-1. CB 202; Rev. Rul. 59-60, 1959-1, CB 237; Rev. Rul. 83-20, 1983-2, CB 170; IRS Valuation Guide for Income, Estate and Gift Taxes, Lesson 8, pages 85-86; *Moore, TC Memo, 1991-546, Dec. 47,723(M).*

The Use of Experts to Appraise the Property

When attempting to establish value, the use of experts is important. The experts will not only appraise the asset, but they will also give an opinion as to the appropriate discount for each of the discount factors and the reasons for arriving at the value and the amount of the discounts. The use of experts assumes even greater importance as the business of the FLP changes, expands or grows.

The appraisal should be prepared by a recognized expert in accordance with standard appraisal practices. The appraisal is crucial to an effective gift program because of the possibility of an IRS audit. The absence of an appraisal or an improper appraisal may mean that the IRS will take a more aggressive position that the value used by the transferor is too low. An appraisal prepared in accordance with regular appraisal practices by a qualified appraiser may temper the IRS position and make a reasonable settlement easier and less costly to achieve.

Observation

The appraisal should be updated on a regular basis, especially when there has been a significant change in the partnership business. If gifts are made annually, it may be necessary to have the appraisal updated. Planning gifts in December and January should mean that updates are needed only every other year, rather than annually.

Planning With the Annual Exclusion

The gift tax burden may be further reduced when planning annual gifts by taking advantage of the annual $10,000 gift tax exclusion. With split gifts by husband and wife, the exclusion is increased to $20,000 per year. If, for example, each limited partnership interest has an underlying asset value of $10,000, but the net effect of the discounts is to reduce that value to $5,000, each parent can transfer to each child every year (assuming no change in value) four limited partner interests.

If there are four children and the parents split their gifts, they may transfer a total of sixteen units with an underlying value of $160,000, but which have a gift tax value of only $80,000. All of the transfers come within the annual exclusion and the parents do not have to use any part of their respective unified credit. If there are a total of 100 limited partner units, the parents may, assuming there are no valuation increases, transfer all the limited interests having an underlying value of $1 million to the four children in less than seven years without paying any gift tax under the umbrella of the annual gift tax exclusion.

Annual Exclusion Gifts Avoid Generation-Skipping Transfer Taxes

If there are grandchildren and great grandchildren, the senior family members can transfer substantial amounts of wealth using the FLP and the annual gift tax exclusion. Gifts that qualify for the annual exclusion are also exempt from

the generation-skipping transfer tax (GSTT). Transfers in trust that qualify for the exclusion are also exempt from the GSTT if the interest of the beneficiary is vested. An individual's interest is vested if (1) no portion of the income or corpus may be distributed to anyone other than the beneficiary, and (2) the trust assets are included in the beneficiary's estate if the beneficiary dies before the trust is terminated. Code Sec. 2642(c).

Annual Exclusion Formula Gifts

The gift may be expressed in the form of a formula to avoid a gift larger than the annual exclusion amount. The gift would be a fractional interest in the FLP, of which $10,000 would be the numerator and the fair market value of the FLP would be the denominator. For example, if the value of the FLP is $500,000, an annual exclusion gift would result in a transfer to the donee of a two percent interest (10,000/500,000=0.02).

Lifetime Gifts as Against Death Transfers

A 1994 private ruling demonstrates that the difference in the manner in which assets are valued for gift and estate tax purposes may provide grantors with a substantial advantage with lifetime gifts as against death transfers. In IRS Technical Advice Memorandum 9449001, the donor owned 100 percent of his corporation which he proposed to transfer in equal shares to his 11 children. The issue was whether the value of the simultaneous gifts to two or more donees is determined in the same manner as a bequest of stock in a corporation to two or more legatees. Although the TAM involved corporate stock, the same principles should apply with respect to partnerships.

Estate Tax is Imposed on the Aggregate of Decedent's Assets

If a decedent dies owning a controlling block of stock which is divided under the will among several individuals, so that each legates has a minority interest, the block will nevertheless be valued in decedent's estate as a control block. The reason is that the estate tax is imposed on the privilege of transferring the taxable estate and not on the privilege of receiving property from the decedent. *Ahmanson Foundation, 674 F2d 761 (CA-9 1981)*. A different rule applies for lifetime gifts.

Gift Tax is Imposed on Each Gift

Unlike the estate tax, the gift tax is imposed on property passing from the donor to each donee. The fact that the gifts are simultaneous does not change this rule. Therefore, it is possible that the same property may have a different value when it is the subject of multiple gifts than its value if the property were included in the donor's estate. The private ruling held that the value of each gift is determined separately and not by aggregating all of the donor's holdings in the corporation prior to the gift.

This difference in valuation methodology was recognized in the landmark Rev. Rul. 93-12, 1993-1, CB 202, which held that when valuing gifts of shares in a closely held corporation, the factor of family control is not considered. In the ruling, the donor owned 100 percent of the outstanding shares of a corporation which the donor transferred in equal shares to his five children. The revenue ruling held that the shares of the family members would not be aggregated to determine whether the transferred shares should be valued as part of a controlling block. Thus, the donor was entitled to a minority discount as well as a marketability discount for each gift.

Planning Strategy

The difference in valuation methods should encourage more lifetime gifts, especially in those situations where the donor has a controlling interest. Other estate tax benefits from lifetime gifts include: avoiding estate tax on the increase in value on the transferred block; except for gift tax paid within three years of death [Code Sec. 2035(c)], any gift tax paid on the transfer is also excluded from the donor's estate.

Observation

Another big benefit of lifetime gifts over death transfers is that the gift tax is imposed on a tax exclusive basis. The estate tax, however, is tax inclusive; it is imposed on the entire value of the estate, including assets used to pay the tax. For example, a donor in the 50 percent transfer tax bracket, with $150,000 could gift $100,000 during lifetime and pay $50,000 in gift tax. From the same amount at death. the heirs will receive only $75,000 ($150,000 in the taxable estate less $75,000 in estate tax).

Funding the Unified Credit With Limited Partner Interests

Since limited partnership interests are subject to substantial discounts, they are suitable assets to be used to fund the credit shelter trust. A credit shelter trust is designed so that it is not included in the estate of the survivor if the surviving spouse is a beneficiary. The credit shelter trust is designed to pass to descendants a total of S1,200,000 estate tax free ($600,000 from each estate).

If neither spouse has used any part of his or her unified credit with lifetime gifts, and each owns limited partner interests at death as well as other property, their respective wills (or living trusts) may provide for funding the credit shelter trust with the limited partner interests.

Liquidation Value or Going Concern Value - Code Sec. 2704

Generally, the purpose of Code Section 2704 is to require that a family controlled partnership or corporation be valued, for gift and estate tax purposes, based on its liquidation value rather than as a going concern. Agreements typically restrict the ability of any partner or stockholder to liquidate the firm. Limited partners are usually prohibited from withdrawing from the FLP. Otherwise, under most state laws, a limited partner may withdraw from the firm on six months notice. Code Section 2704(b) provides that such a restriction is ignored. Therefore, the decedent's interest is valued based upon his or her withdrawal right rather than the going concern value.

Although Section 2704 will result in an increased value for the entity, the use of marketability and minority discounts is preserved. Both the Senate Report and the Conference Committee Report state that the adoption of Section 2704 does "not affect minority discounts or other discounts available under present law" (Revenue Reconciliation Act of 1990). Further, Section 2704 only applies to family controlled entities. It is therefore not unusual to find nonfamily members (such as charities and other "loved ones") owning a small (i.e., 1%) interest in the corporate general partner. If the agreement requires the consent of all the stockholders to liquidate the FLP, then the FLP is not family controlled. since the nonfamily member has the ability to veto any liquidation attempt.

Conclusion

Business owners have an excellent opportunity to significantly increase the value of their estates by acquiring life insurance funded under a split-dollar arrangement. This funding mechanism permits the use of corporate funds with minimal income tax consequences. The FLP strategy is designed to provide all the benefits usually associated with equity split-dollar while at the same time avoiding the need for a rollout and without the adverse income tax consequences created by the 1996 TAM. The FLP also presents an opportunity to reduce values significantly for gift and estate tax purposes.

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