

# **THE LIFE INSURANCE LIMITED LIABILITY COMPANY™**

## **SMITH AND CONDENI LLP Attorneys at Law**

**600 E. Granger Rd.  
Second Floor  
Cleveland, Ohio 44131  
216.771.1760  
www.smith-condeni.com**

### **INTRODUCTION**

This article discusses the benefits, design and application of a specially designed Limited Liability Company to own life insurance that is primarily used to fund Buy Sell agreements between business owners. This is a planning technique developed by the attorneys at Smith and Condeni. We recognized that there are many benefits to separating life insurance ownership from clients' operating business. The Life Insurance Limited Liability Company (LILLC) is a separate entity that operates independently from the underlying business and is specifically designed to own insurance contracts on the lives of the business owners. The owners who are the parties to the Buy Sell agreement are also the Members of the LILLC. The following is a discussion of the major planning aspects of the LILLC.

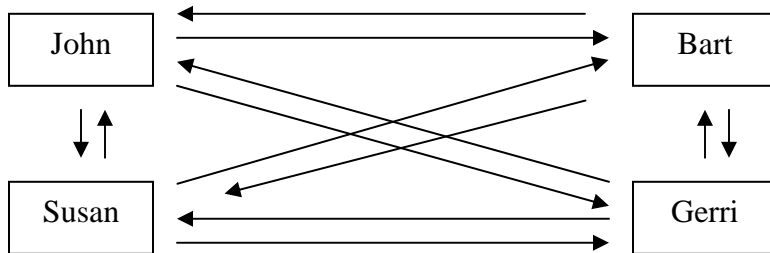
### **DISCUSSION OF BENEFITS OF LILLC**

- The use of an LILLC reduces the number of insurance contracts needed to fund Cross Purchase Buy Sell arrangements between business owners. Whereas four (4) owners will need twelve (12) policies under a traditional Cross

Purchase plan, the use of the LILLC requires only four (4) policies, as illustrated below:

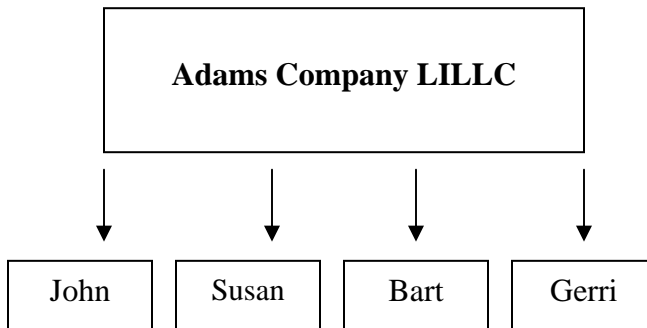
**Traditional Cross Purchase Buy Sell  
Funded with Life Insurance**

Each business owner owns (1) insurance policy on the life of each of the other business owners:



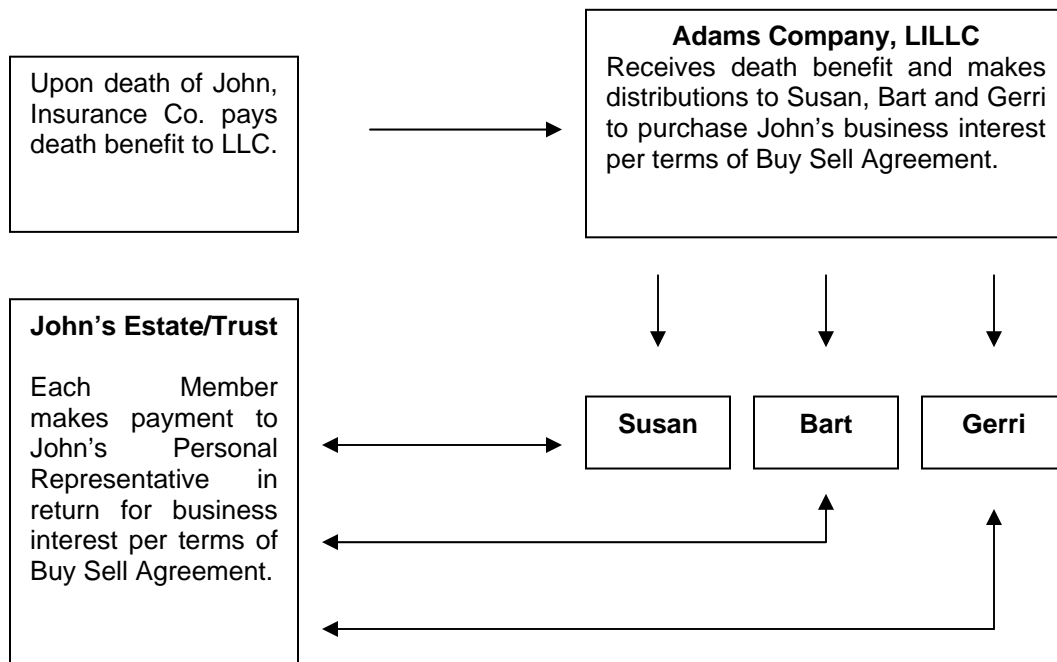
**LILLC Arrangement in Conjunction with  
Cross Purchase Buy Sell**

The LILLC owns one (1) insurance policy of the life of each business owner/Member:



- Common ownership of the policies makes premium payments simpler because fewer policies are required.

- LILLC ownership ensures all policies are kept in force and avoids the possibility of one business owner dropping coverage on another owner. There is more assured stability with regard to the funding of the Buy Sell arrangement where there is one owner (the LILLC) in charge of maintaining all of the policies.
- Control of the policies by the LILLC ensures administration of policies in an organized manner and facilitates use of death benefits by surviving business owners/Members for purchase of the decedent's interest in the underlying business pursuant to the terms of the Buy Sell agreement. The following flowchart shows how distributions are made upon the death of a business owner/Member:



- The LILLC also maintains control over the remaining policies when a business owner/Member dies. Under a traditional Cross Purchase plan, upon the death of an owner, the policies owned by them on the lives of the other owners frequently pass to the decedent's heirs as an asset of the estate. This deprives the surviving owners of the opportunity to control the policies insuring each of their own lives (which is often desired when an owner becomes otherwise

uninsurable). The use of the LILLC avoids this because the policies are controlled by the LILLC at all times, including upon the death of a business owner/Member. Because of this continuity of ownership, the remaining policies' death benefits are always available to the remaining business owners to continue the Buy Sell arrangement.

- A similar benefit is achieved if the death benefits are never needed to fund the Buy Sell agreement. For example, if the underlying business itself was sold, the LILLC arrangement would allow for the distribution of the policies to each insured business owner/Member for use in his/her own individual wealth management and estate plan. Without this unified ownership of the policies within an LILLC, the business owners will have no obligation to transfer the policies that they own to one another.

- The benefits of unified insurance ownership within the LILLC can also be seen if we consider the rise of the life settlement industry. Many individuals are selling life insurance policies for amounts far in excess of their traditional value (i.e., cash value or to be technical, the interpolated terminal reserve). Suppose in our example, that while the business was being sold to a third party, one of the business owners developed significant health problems. The policy insuring that owner's life may now have economic value far in excess of the cash value of that policy which in turn may make the owner of that policy reluctant to give up ownership.

- Moreover, even if the owners were amenable to an open exchange of the policies amongst themselves, such exchanges would constitute taxable events for income tax purposes, as they do not qualify for tax-free treatment as IRC 1035 exchanges. See Reg. 1.1035-1(c). Such non-excludable exchanges are taxable under IRC 1001 to the extent of any excess in the value of the contract being received over the adjusted basis of the contract being given (where the

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“value” equals replacement cost and “adjusted basis” equals premiums paid, less any dividends paid or credited). See Rev. Rul. 54-264. This excess amount is taxed as ordinary income, *not* capital gain.

- In a traditional Cross Purchase Buy Sell arrangement, the policies held by a deceased owner on the lives of the other business owners are included in the deceased owner's estate for estate tax purposes. This inclusion is avoided through use of the LILLC, as the LILLC itself owns all of the policies. A technical discussion on the value of a deceased owner's Membership interest in the LILLC (which is includible in the deceased owner's estate) is discussed later in this article.
- The transfer of policies from the business owners to the LILLC (in the event the policies are issued prior to creation of the LILLC) and the distribution of those policies to the insured business owners upon termination of the LILLC are permissible exceptions to the transfer for value rules set forth under Section 101 of the Internal Revenue Code.
- The LILLC may also be useful for other life insurance applications. For example, it can own key man insurance outside of the regular corporate structure providing more flexibility. For example, suppose the operating business is a C corporation and owns key man insurance on an employee who dies. Death benefit not used for replacing that person is trapped in the C corporation and cannot be distributed without causing income taxation to the distributees. Key man insurance owned by an LILLC does not have this impediment to deal with an unused death benefit can be distributed income tax free to the LILLC Members. The LILLC can lend cash needed for key man purposes to the operating business. Loan repayments are not taxable.

## **DISCUSSION OF ADMINISTRATIVE MATTERS**

- The LILLC is structured as a Manager Managed (as opposed to Member Managed) Limited Liability Company to ensure that the Members are not deemed to have any retained incidents of ownership in the policies, which would cause estate tax inclusion of death benefits upon a Member's death. The LILLC strictly prohibits the Members from serving as Managers and further disallows the exercise of any right or power by any of the Members with regard to insurance contracts insuring their lives.
- Each Member is required to make capital contributions so that the LILLC can make premium payments on the insurance contracts. Capital contributions made by a Member are credited to that Member's Capital Account.
- Capital contributions do not have to be equal between the Members. The contribution amount required from each Member may be determined by the amount of death benefit required by each Member to satisfy their purchase obligations under the Buy Sell agreement.
- The Members' underlying operating business can make these capital contributions payments directly to the LILLC and allocate the contributions to each business owner as income as the business owners themselves determine.
- The LILLC will not have any income tax liability if all contributions are used to make premium payments on the contracts because any income earned inside the contacts is non-taxable.
- The LILLC may own other assets. It is not restricted to ownership of just life insurance policies.

- Upon the death of a Member, the death benefit paid from the contract insuring that Member's life is allocated to the Capital Accounts of the surviving Members in the proportions necessary to allow each Member to fulfill his/her purchase obligation under the terms of the Buy Sell Agreement. The effect of this allocation is discussed more fully below.
- The LLLC provides asset protection planning benefits, as a creditor of one of the Members cannot get at the assets of the LLLC. Policies owned directly by the business owners on the lives of one another are probably not protected from creditors' claims. This means that creditors in a judicial proceeding can attach those policies. For example, in Ohio, life insurance policies are only exempt if the named beneficiary is a spouse, child or other dependant of the insured. See O.R.C. 3911.10. In a traditional Cross Purchase arrangement where the policy owner would be expected to name himself as beneficiary, the statutory protection discussed above would not be available.

#### **TECHNICAL DISCUSSION**

- Commentary on this topic often suggests that a valid business purpose is required to (i) create the LLC; and (ii) avoid estate tax inclusion of death benefit in a deceased owner's estate. Each of these contentions are addressed below.
- With regard to this first item, we note that the Ohio LLC Act does not require that an LLC have a business purpose in order to be valid. Rather, in the State of Ohio, an LLC can be formed for any lawful purpose. See O.R.C. 1705.02.
- On the issue of estate tax inclusion, it has been held that any right, power or privilege exercisable by a partnership, corporation or LLC is attributable to the controlling owners of the entity. Such rights, powers and privileges are deemed to be "incidents of ownership" for estate tax purposes, which can cause life insurance proceeds owned by an entity to nevertheless be included in a

deceased owner's taxable estate. See Rev. Rul. 83-147; IRC 2042(2); Reg. 20.2042.

- However, it has also been held with regard to business-owned insurance contracts that if the contracts are owned, and the death benefits paid, for a valid business purpose, then the business owners will not be deemed to have any incidents of ownership in their *individual* capacity and, therefore, the proceeds will not be included in their taxable estates. See Rev. Rul. 83-147; IRC 2042(2); *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955).
- As noted in the previous section, the LILLC is designed as a Manager Managed LLC that expressly prohibits the Members from exercising any incidents of ownership with regard to the insurance contracts of their own lives. Because of this intentional separation of ownership and management, the rights of the LILLC over the contracts will not be attributed to the Members.
- In addition, it has been held that a business owner's interest in an entity is precisely that: an interest in the entity itself, and *not* in the business's underlying assets. *Estate of Shapiro v. Commissioner*, 79 AFTR 2d 97-2152 (1997).
- Moreover, some commentators have indicated that the use of an LLC to manage and control life insurance contracts on the lives of its Members to facilitate a Buy Sell arrangement (even for a separate entity) is a valid business purpose in and of itself, which should satisfy the business purpose requirement to keep death benefits out of the Members' taxable estates. See "Life Insurance-Funded Buy-Sell Agreements for Pass-Through Entities," Alan J. Mittelman, Estate Planning Journal (WG&L), Vol. 34, No. 7, July 2007. The Operating Agreement for the LILLC states the distinct business purposes of this entity and is described as being part of the overall business ownership succession plan for the operating business.

- While it is considered “best practice” to have a non-insured person serve as Manager of the LILLC, in certain circumstances there may be no other option than to have an insured serve in a managerial capacity. In such rare instances, the Operating Agreement still provides safeguards to ensure that the insured Manager is prohibited from exercising any measure of control over the policy insuring his/her life that might trigger an estate tax inclusion issue by virtue of the incidents of ownership rule. In addition, such an arrangement should also be protected by virtue of the business purpose rules discussed above.
- Because the value of a Member’s Membership Interest in an LLC is determined with reference to the value of that Member’s Capital Account in relation to all other Capital Accounts of the LLC, the allocation of a death benefit to the Capital Accounts of the surviving Members acts to deflate the value of the deceased Member’s Membership Interest in the LILLC. This further ensures that death benefits are not included in the deceased Member’s taxable estate by virtue of their exclusion from the determination of the value of that Member’s Membership Interest.

## **CONCLUSION**

We believe the LILLC to be the ideal planning solution for business succession planning funded with life insurance. It provides reliability, efficiency, predictability and flexibility for changing circumstances all while maintaining the unique tax advantages that insurance products provide.

Please feel free to contact one of our Estate and Business Planning Attorneys with questions that you may have.

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