The Washington Report

Wealth Transfer Edition

The Washington Report is prepared exclusively for Finseca Influencer members by Jonathan M. Forster (Partner) and Douglas E. Murphy (Associate) at BakerHostetler.

The Family LLC: An ILIT Alternative

MARKET TREND: With perceived threats to grantor trusts and increasing desire for flexibility, some practitioners gravitated to the "Family LLC" as an alternative to the conventional irrevocable life insurance trust ("ILIT").

SYNOPSIS: The limited liability company ("LLC") has long-since been used as a wealth transfer device in legacy planning. Threats to the tax treatment of grantor trusts (including ILITs) led practitioners to view the Family LLC as a potential alternative vehicle to hold life insurance. The ownership of life insurance in a Family LLC structure can add estate tax inclusion risk and compromise the flexibility provided by the LLC structure.

TAKE AWAYS: The Family LLC provides a flexible vehicle for legacy planning that is here to stay. When life insurance is owned by a Family LLC, there is a tradeoff between the flexibility afforded by the Family LLC and the risk of estate tax inclusion to the parent/insured. And given the upcoming Corporate Transparency Act, the Family LLC may also have more complexity than previously thought.

MAJOR REFERENCES: Internal Revenue Code §§ 2036 and 2042.

THE TRIED AND TRUE . . . ILIT

The ILIT has been around for decades and, with proper setup and administration, is a proven approach to removing the face amount from the insured's taxable estate.
There are several benefits to the ILIT:

- Removes the face amount of a life insurance policy from the decedent's gross estate, which can result in Federal estate tax savings of 40% (or more if in a state with an estate tax);
- If generation-skipping transfer tax ("**GST**") exemption is allocated to the ILIT, the face amount escapes the transfer tax system for multiple generations;
- Uses the face amount to provide instant, tax-free liquidity by lending cash to, or purchasing assets from, the estate to pay estate taxes;

- Provides an efficient and leveraged way to utilize the annual gift tax exclusion or exemption by using those gifts to pay the premiums on the life insurance owned by the trust;

- Offers asset protection from creditors;

- The ILIT is not a "reporting company" for purposes of the Corporate Transparency Act; and

- Because an ILIT is a grantor trust it lends itself to all manner of transactions offering flexibility – split dollar, income tax-free transactions between the settlor and the trust, etc.

  There are also a few disadvantages to the ILIT:
- While the ILIT is irrevocable, the situs and even terms can still be changed via a decanting;

- Requires on-going administration, including the maintenance of Crummey Notices; and

- Somewhat complicates the ownership of a policy by requiring the imposition of a third-party trustee.

THE "NEW" ENTITY ON THE BLOCK – THE LIMITED LIABILITY COMPANY

The LLC is a flexible entity that combines the limited liability of a corporation with the pass-through taxation of a partnership. For these reasons, the LLC has become a popular entity for business, and increasingly for legacy planning purposes (the so called "**Family LLC**").

ATTACK ON THE GRANTOR TRUST – THE CATALYST

Recent legislative proposals, specifically the failed Build Back Better Act of 2021, sought to change the treatment of grantor trusts by including the trust assets in the taxable estate of the grantor and treating transactions between the trust and grantor as recognition events for income tax purposes. While the Build Back Better Act did not pass, the Biden administration has kept these proposed changes to the grantor trust rules in the 2023 Greenbook.[1]

Given this threat to grantor ILITs for life insurance planning, some practitioners view the Family LLC as a possible alternative.

THE FAMILY LLC

The Family LLC, like all LLCs, should have a non-tax reason for its formation or else the IRS may disregard the LLC as a sham. Potential non-tax reasons for forming a Family LLC include: diversification of assets; pooling of assets to enhance potential growth; centralized management of assets; asset protection; and succession planning. To achieve these non-tax goals, the Family LLC should own assets in addition to life insurance.

The Structure

The Family LLC is governed by an operating agreement, which can be used to restrict the ability to transfer membership interests (i.e., to keep ownership within the family), and to break out the ownership by class, such as voting and nonvoting. The operating agreement, unlike the ILIT, may be amended by the members of the Family LLC adding to its flexibility.

[1] General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals.

Family LLCs are created by the transfer of assets from one or more individuals to an LLC for the benefit of family members. In a common scenario, senior family members (parents) transfer assets to a Family LLC in exchange for membership interests that have certain rights like management control. The parents subsequently gift or sell interests in the Family LLC to their children or irrevocable trusts established for the benefit of their children. The parents may retain managerial control or may only retain economic interests in the Family LLC based on the circumstances (discussed in more detail in the "The Risks" section below). Ultimately, the parents will end up with a very small ownership percentage of the Family LLC with the children having almost the entirety of the interest (i.e., 1% and 99%).

Once formed, life insurance can be purchased by the Family LLC on the life of the parent(s). If planned successfully, only the portion of the face amount attributable to the parent's ownership percentage will be includible in their taxable gross estate. This result of shifting the face amount out of the insured's estate is similar to the ILIT. This planning requires the parent/insured to give up all incidents of ownership (a tax code term of art) in the life insurance policy, which generally requires the parent/insured to give up all voting and managerial rights in the Family LLC.

The Latest Speedbump – The Corporate Transparency Act

It is important to note that effective January 1, 2024 (or January 1, 2025 for existing entities), Family LLCs will be subject to the reporting requirements of the Corporate Transparency Act, a new piece of Federal legislation affecting many existing and newly formed business entities. Family LLCs will now be required to disclose information on each "beneficial owner" to the Financial Crimes Enforcement Network, including: (1) the individual's full legal name; (2) date of birth; (3) current residential or business street address; and (4) a unique identifying number from an acceptable identification document (i.e., passport); a somewhat staggering result, eliminating anonymity and likely increasing the cost of entity formation and maintenance.

Some Serious Tax Risks – Taking a Chance With The Internal Revenue Code

The ability to potentially shift the face amount of life insurance from the parent/insured's estate with the Family LLC has some risk, specifically from Internal Revenue Code ("**IRC**") Sections 2036 and 2042.

IRC Section 2042

IRC Section 2042 includes in the gross estate the value of life insurance to the extent the decedent possessed, at his death (or three years prior), any of the incidents of ownership in the policy, exercisable alone or in conjunction with any other person.[2] Basically, if a decedent retained any "incident of ownership" in a life insurance policy, even if the decedent was not entitled to receive the face value, the entire policy proceeds are included in their gross taxable estate.

Treas. Reg. § 20.2042-1(c)(2) provides that "the term 'incidents of ownership' is not limited in its meaning to ownership of the policy in the technical sense. Generally speaking, the term makes reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc."

[2] IRC § 2042 and IRC § 2035.

For instance, if the parent/insured is a manager or has voting control over the Family LLC which owns a policy on their life, it is likely that the parent would be deemed to have "incidents of ownership" under IRC Section 2042 sufficient to bring the value of the life insurance policy back within the parent's estate.

To minimize the IRC Section 2042 risk, it is advisable for the parent/insured to relinquish all voting right and managerial control. The Family LLC should be "manager-managed", and an independent manager should be named, likely not terribly appealing to most families who desire control.

IRC Section 2036

IRC Section 2036(a) attempts to prevent a taxpayer from giving assets away while still retaining the income from the gifted asset or the right to enjoy the assets in some manner. IRC Section 2036(a) provides that "[t]he value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death – (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either along or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

The more "strings" of ownership the transferor retains, such as the right to amend the operating agreement or dissolve the entity, the greater the risk of estate tax inclusion under Section 2036. The largest risk around Section 2036 when structuring the Family LLC is naming the transferring parent the manager, or having the parent retain voting control. To minimize this risk, the transferring parent should not be named manager, nor retain voting control. An important exception to Section 2036 exists for interests transferred by sale for adequate and full consideration, for example, if the transferor sold the interest to the next generation, there should not be IRC Section 2036 inclusion risk.

In fact, in Estate of Powell v. Commissioner,[3] an important Tax Court case addressing family limited partnerships (which is applicable to Family LLCs), the Tax Court extended the application of IRC § 2036(a)(2) to a decedent owning only limited partnership interests because the decedent retained the right, along with the other partners, to dissolve the partnership. Practitioners should consider limiting the transferor's ability to participate in the decision to dissolve the LLC in the operating agreement of the Family LLC and other similar "control" features.

Complexity

In addition to the tax risks, the Family LLC also requires significant bookkeeping to properly track basis, capital accounts, and triggers an annual tax return filing. The Family LLC's operating agreement will also establish certain formalities that must be followed to ensure the Family LLC is respected – such as holding an annual meeting.

THE BOTTOM LINE – THE FAMILY LLC, ILIT, AND THE FUTURE

When making the decision of how to structure the ownership of life insurance, consider the following:

- The Family LLC is a flexible vehicle which allows for the gradual succession of business interests within the family. The Family LLC has the ability to aggregate family assets with the flexibility to control management within the family.

[3] 148 T.C. No. 18 (May 18, 2017).

- When owning life insurance, the Family LLC may have to compromise some of its trademark flexibility to minimize the risk of estate tax inclusion under IRC §§ 2036 and 2042.
- If estate tax exclusion of a life insurance policy is a planning goal, the parent/insured should not retain voting control or serve as manager of the Family LLC and should not have the ability to independently dissolve the entity.
- The Family LLC will now be subject to the onerous reporting requirements of the Corporate Transparency Act, which eliminates anonymity and increases the cost of entity formation and maintenance.
- The ILIT remains the tried and true, conservative approach to owning life insurance outside of the taxable estate of the insured, and has a great degree of flexibility.
- A GST-exempt ILIT provides the ability to remove the proceeds of life insurance from the transfer tax system for generations.

The Family LLC is one possible alternative to the use of a grantor trust. Other alternatives that taxpayers will want to examine include the use of non-grantor ILITs, utilization of any remaining gift/estate tax exemption to front load the funding of an ILIT, and private split-dollar arrangements to pay premiums on ILIT owned life insurance policies.

TAKE AWAYS

The Family LLC provides a flexible vehicle for legacy planning that is here to stay. When life insurance is owned by a Family LLC, there is a tradeoff between the flexibility afforded by the Family LLC and the risk of estate tax inclusion to the parent/insured. And given the upcoming Corporate Transparency Act, the Family LLC may also have more complexity than previously thought.

Disclaimer: The information contained herein is provided solely for Finseca. The content herein is not intended nor written for, and cannot be used as, the basis of any legal or tax advice by anyone else or any other organization. Such taxpayers should consult with their own legal or tax advisors for specific legal or tax advice. Reference to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by the authors or Finseca. BakerHostetler does not provide investment or insurance related advice.