

LIMITED LIABILITY COMPANIES IN UTAH

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Using the LLC to Hold Life Insurance Policies

Like a limited partnership, an LLC may be a viable alternative to an irrevocable life insurance trust in estate planning. The use of an LLC may provide a more flexible approach.

One possible strategy would involve the purchase of life insurance with cash provided by the insured to the LLC. The insured retains management control of the LLC through a 1% member-manager LLC interest. The balance of the LLC interests would be held by the insured's family. The operating agreement of the LLC would then include restrictions on distributions and transferability to protect the family similar to those normally included in an irrevocable insurance trust.

The insured's children or other family members could obtain their LLC interests through outright gifts. These gifts, if properly structured as gifts of present interests, could fall within the \$10,000 gift tax annual exclusion without the need for providing Crummey notices.

Unlike an irrevocable insurance trust, the LLC members can agree to amend the organizational document or terminate the LLC if a change in family circumstances occurs. Because distributions in-kind from partnerships are not taxable under I.R.C. Section 731(a), the managing member may, subject to the new limitations of Sections 704(c)(1)(B) and 737, be able to direct the insurance policy or policy proceeds to one family member and direct other LLC assets to other family members. Transfer of the policy to an LLC member escapes the transfer for value rule of I.R.C. Section 101(a) because the members are treated like partners of a partnership for income tax purposes.

The foregoing strategy allows a client to (1) maintain direct control of the policy while having only a nominal percentage included in his estate, (2) gain access to cash for investments (and control the investments), (3) change the terms of the organizational documents as appropriate, and (4) avoid the burdens and costs of Crummey notices. In addition, provided that the LLC owns the policy from the inception of the policy, no incidents of ownership in the policy should be attributable to the insured solely by virtue of his management of the LLC. Consequently, only the value of the insured's nominal interest in the LLC should be included in his estate. See Rev. Rul. 83-147, 1983-2 C.B. 158.

In addition, an LLC taxed as a partnership enjoys an advantage over irrevocable insurance trusts from an income tax standpoint. The highest marginal tax bracket of 39.6% applicable to the income of trusts is reached at an income level of only \$7500, thus giving trusts the dubious distinction of having the steepest marginal tax brackets of any available organizational entity. While that trust tax

bracket can be avoided through annually zeroing out the trust's income through distributions of the income to the trust's beneficiaries, it is not always advantageous to do so. Indeed, distributing out the income each year effectively precludes the trust from being an accumulation vehicle for beneficiaries. It should additionally be noted that insurance trusts are in most cases considered per se "grantor defective" such that any income taxability in the trust is allocated to the grantors.

In addition, in the event of a need to retain assets inside the trust to protect those assets from a beneficiary's creditors, the highest marginal tax bracket on the trust's income can quickly come into play. An LLC, in contrast, is a true pass through entity where, assuming that the LLC has been appropriately structured to avoid the anti-shifting provisions of I.R.C. Section 704(e), the LLC's income is taxed at the member's individual tax rates regardless of whether or not the LLC's income distributed to the members.

It is important to note that LLC's may also be effectively used in conjunction with split dollar arrangements or as the clearing house for an integrated business insurance plan.

Notwithstanding the foregoing, several issues must be considered before utilizing an LLC in lieu of an irrevocable insurance trust. First, the LLC may not qualify as a partnership for tax purposes and instead be taxed as a trust (subject to the steeper tax brackets and rules discussed above) if the partnership is engaged in no independent trade or business for profit and does nothing more than hold insurance policies. In addition to the steeper tax brackets, the donor/manager/member who is the insured under the policy would be the "trustee" of the recharacterized trust, and as such would possess, through his power to deal with the policy as trustee, incidents of ownership sufficient to cause the policy death proceeds to be included in the donor's gross estate under I.R.C. Section 2042.

Second, in order to qualify for the annual gift tax exclusion for cash contributions made by the donor to pay the policy premiums, care must be taken that the cash contributions are made to the other LLC members' capital accounts and that those other LLC members have the unlimited right to withdraw their capital accounts at any time. If access to capital accounts is restricted, then no annual exclusion gift protection may be available.

Third, in light of the need to provide unrestricted access to the amounts contributed to the other LLC members' capital accounts, one may question whether it would be wiser to use an irrevocable insurance trust with lapsing, Crummy withdrawal powers. Crummy withdrawal powers at least lapse after a limited period of time, thus providing some restriction on the ability of the junior family members to withdraw the amounts contributed down the road.

In light of the above, it should not be assumed that an LLC in all instances is preferable to irrevocable insurance trusts for holding insurance policies. The decision as to which entity is most appropriate will depend upon the facts and circumstances in each client's case.