



Limited Liability Companies, Life Insurance and Business Succession Development Planning

By: Randall H. Borkus, Esq.



Business owners like things straightforward and as their advisors we need to keep it that way for them. Transitioning ownership of a business to the next generation can be pretty complex stuff for many business owners so we really need alternatives to offer our business clients. Jack Welch (GE) once said “*Don’t make the process harder than it is.*”

Buy-Sell Planning Basics

The vast majority of buy-sell planning is constructed using a traditional buy-sell agreement and is generally funded by life insurance. This is by far the most popular planning tool for business succession upon the death of an owner or partner. What is important about traditional buy-sell planning is that business owners can agree to a predetermined disposition of each owner’s business interest upon her or his death or other event.

The two primary buy-sell planning scenarios generally involve an agreement between the business owners where: 1) the other owners agree to buy a deceased owner’s share upon death (referred to as a “cross-purchase agreement”), or 2) the business will buy back the deceased owner’s share upon death (referred to as a “redemption agreement”). The death of a business owner generally creates the need for liquidity to fund these obligations under the buy-sell agreement, so in most all cases life insurance on the business owners is the favorite liquidity mechanism.

Limitations of the Traditional Buy-Sell Planning Options

There can be significant limitations that prevent many businesses from implementing solid buy-sell planning.

Here are a few of the limitations:

1. Under a cross-purchase buy-sell agreement, the number of policies required to carry out the plan is expensive and can become difficult to manage when

you have many owners because each owner must own a policy on the life of the other owners. For example, a business with four owners needs (12) twelve policies.

2. The cash value (and death benefit) of the life insurance policies can be subject to creditor claims of the individual business owners under a cross-purchase agreement or the business under a redemption agreement.
3. Unintended and undesired income tax consequences can be triggered when remaining policies are transferred between owners following a death of an owner or upon entry of a new partner.
4. It can be difficult to structure the planning to avoid unwanted income tax consequences which result under the “Transfer-For-Value (TFV) rules in IRC §101.
5. The financial burden of paying the premiums may be allocated disproportionately where some owners are much older than others.
6. The success of a buy-sell plan depends upon everyone pulling their weight. The integrity of a plan can be compromised if an individual owner fails to make premium payments or refuses to use the death benefits pursuant to the buy-sell agreement. The control of winding up the buy-sell transaction can become a crap shoot.

An Alternative Structure: Use an LLC

One of our favorite buy-sell planning techniques is an insurance limited liability company (ILLC). This is a separate business entity used to own buy-sell insurance to provide liquidity when it comes time to purchase a deceased owner’s business interest. Under this technique, the business owners can still execute a “cross-purchase” agreement coupled with an ILLC to purchase and own a life insurance policy on the life of each owner.

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Using an ILLC to purchase, own and administer the insurance policies can combine both “redemption” and “cross-purchase” agreement benefits. Moreover, the ILLC eliminates many of the disadvantages of both while lessening the administrative burden and adding flexibility:

1. *Avoids Purchasing Several Policies:* In a typically cross-purchase agreement each business owner owns a life policy on each other business owner. But when using an ILLC to own the insurance the ILLC owns one policy on each life. In our earlier example, a business with four owners needs (4) four policies.
2. *Protection from Creditors:* Where the policies are owned by the business owners individually, the policies may be subject to a creditor’s claim depending on state law. If the policy is owned by the business, the policy may be subject to the business creditor’s claims. But when using an ILLC to own the buy-sell insurance, the policies are protected from the reach of a creditor’s claim against the business or the individual business owners when structured appropriately. (We use Wyoming Close Limited Liability Companies for much of our planning.)
3. *Transferability:* It is much easier for new owners to join the ILLC and participate in the existing insurance framework, while also allowing current owners to exit the ILLC prior to death without triggering undesired income tax consequences. At the death of an owner, a death benefit payment to the ILLC is used to buy the deceased owner’s business interest which eliminates any ongoing obligations to the deceased owner’s estate.
4. *The Transfer-For-Value Rule Exception:* By default if an LLC has two or more members it will be taxed as a partnership (unless the partners elect otherwise) so the TFV issues appear to be moot. In PLR 9625013, the Service held that when LLC members are classified as partners they are qualified for the transfers “to the partner” exception in IRC §101(a)(2). The partner exception to the TFV rule should mean that existing insurance could be freely transferred to the ILLC and new owners of the business are easily admitted as members to the ILLC. (Before implementing, read Rev. Rul. 2012-13 and note the Service’s no-rule position as to whether certain transfers of life insurance policies to unincorporated organizations will be exempt under the TFV rules).
5. *Economic Ease:* The use of an ILLC allows for flexibility in structuring how the premium costs for insurance policies are shared between the owners regardless of a particular owner’s age. The business can pay the premiums by making equal distributions to the members who then fund to the ILLC (or distributions may be made directly to the ILLC) to satisfy the total premium obligations. Alternatively, the ILLC can be funded with income producing assets contributed by each owner to create the cash flow to make premium payments.
6. *Ease of Administration:* The use of an ILLC provides a centralized management vehicle to purchase and service the policies which lessens the burden on the individual owners. This ensures proceeds are distributed as intended upon the death of an owner and lowers the risk of failure of a given buy-sell transaction.

Keeping things simple for business owners is the key. *Leonardo da Vinci* exclaimed “Simplicity is the ultimate sophistication.” The use of an ILLC to own life insurance policies limits the complexity of owning numerous policies, provides ease of administration, transferability, and economics while creating solid asset protection in a tax friendly structure that positions business owners for a smoother transition upon the death of owner or partner.

About the Author:

Randall is the senior manager of Wealth Preservation Concepts, LLC, a national business planning, strategic succession design and implementation oversight firm. Randall is also the founder of the Oak Brook Illinois law firm Borkuslaw, Ltd.

He in the business of counseling ultra-high net worth individuals, business owners and entrepreneurs as well as their advisors in asset protection, business succession, philanthropic and wealth transfer planning arenas. Such individuals include closely-held business owners, venture capitalists, investors, lawyers, doctors and former professional athletes. Randall has collaborated with professionals across the country on hundreds of cases involving ultra-high net worth clients. Randall also mentors and teaches attorneys, WealthCounsel members, financial advisors and CPAs devoted to asset protection, business succession, philanthropic and wealth transfer planning.