Ten Estate Planning Advantages of Limited Liability Companies

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In the eight years since the Service blessed the Wyoming limited liability company (LLC) statute, there has been an explosion of interest in LLCs, which are now available in 48 states and the District of Columbia (with Hawaii and Vermont the lone holdouts). See Bruce P. Ely, "The LLC Scoreboard," *Tax Notes*, Dec. 25, 1995, p. 1661. Although much has been written of the uses of LLCs in tax and business planning, comparatively little commentary has focused on the role of LLCs in estate planning. The LLC treatises generally devote little attention to estate planning articles that discuss the advantages of LLCs compared to S corporations, limited partnerships, and trusts. (A listing of these treatises and articles appears at the end of this article.) After a brief introduction, this article discusses 10 estate planning advantages of LLCs compared to other forms of organization.

Introduction

Estate planners have long sought to adapt the advantages of limited liability, passthrough tax treatment, and flexibility to a variety of estate planning situations. Unfortunately, neither the S corporation nor the limited partnership has proven to be an ideal vehicle in many situations. Jerry A. Kasner has discussed in these pages the new kid on the block — the LLC. See "LLC as Family Business Entities — Not There Yet, but Getting Closet," *Tax Notes*, June 5, 1995, p. 1357; "Is the Limited Liability Company a Viable Estate Planning Tool for Family Businesses?" *Tax Notes*, Apr. 11, 1994, p. 216. I want to present here an overview of 10 estate planning advantages of LLCs compared to S corporations, limited partnerships, and trusts.

Ten Estate Planning Advantages

1. Participation in Management. One of the principal disadvantages of using limited partnerships to operate the family business is the requirement of a general partner with exposure of at least some of its assets to creditors of the partnership. Various strategies exist to minimize this risk exposure, but there is the additional danger that parents and children who participate in the control of the business will be subjected to personal liability despite their limited partner status. See RULPA section 303(a); see also RULPA section 303(b) (list of activities that do not constitute participation in control of business of limited partner). Although limited partner status thus does not shield parents and children who participate in management from personal liability, their limited partner status may subject them to the passive loss rules. Section 469 (h)(2) states that a limited partner's interest is treated as a passive interest, except as provided in regulations. The regulations contain an exception under which a limited partner's interest is treated as active rather than passive upon satisfaction of any one of three of the seven tests for material participation in Treas. reg. section 1.469-5T(a) (participation in the business for more than 500 hours in the current year; material participation in 5 of the prior 10 years; or if the business is a personal service business, material participation in the prior three years. "Treas. reg. section 1.469-5T(e)(2)). The LLC is preferable to the limited partnership on each of these fronts.

First, no member of an LLC is liable to creditors of the LLC. Second members of an LLC can participate in the management of the family business in most cases without potential exposure to personal liability. As a result, parents can gradually give responsibility in the family business to their children, while retaining control. Moreover, imbuing all members of the LLC with management responsibility may be desirable in order to establish that the LLC lacks the corporate characteristic of centralized management. (Jerry Kasner has noted that every public and private LLC ruling has based partnership tax status on the LLC lacking the corporate characteristics of continuity of life and free transferability of interests, but other LLCs also lack centralized management when all of their members participate in management.) However, all of the LLC's income may be taxable to the parents under the family partnership rules of section 704(e) unless the children have the right to liquidate or sell their LLC interest without financial detriment under Treas. reg. section 1.7094-l(e)(2)(ii)(b). Of course, this may be desirable from an estate planning viewpoint if the parents and children are in the same marginal tax bracket because the tax payments will reduce the parents' estates while permitting the tax-free growth of their children's interest in the LLC. Third, the use of an LLC rather than a limited partnership may permit the members to avoid the statutory presumption of passive status and may allow them to prove their active status under any of the seven regulatory tests for material participation (including the four tests unavailable to limited partners: the member's participation constitutes substantially all of the participation in the business; the members participates 100 hours and no one participates more; the business is a significant participation activity, and the member's aggregate participation in all significant participation activities exceeds 100 hours; or the member participates in the business on a regular, continuous, and substantial basis under all the facts and circumstances).

2. Eligible Owners and Ownership Interests. One of the constraining aspects in operating family businesses through S corporations is the inflexible rules governing eligible shareholders. An S corporation can have no more than 35 shareholders (section 1361(b)(1)(A)(1), with a husband and wife treated as a single shareholder for this purpose (section 1361(c)(1)). Many multigeneration estate plans bump up against this limitation. Only individuals who are citizens or resident aliens, estates, and certain qualified trusts are eligible S corporation shareholders (section 1361(b)(1)(B), (C)). A corporation is not an eligible shareholder, and an S corporation cannot hold 80 percent or more of the stock of another corporation (section 1361(b)(2)(A)). This rule prevents the operation of multiple family businesses under parent and subsidiary S corporations.

Qualified trusts include qualified subchapter S trusts (section 1361(d)) and grantor trusts (section 1361(c)(2)(A)(I)), each of which presents difficulties for ownership of the family business. For example, the QSST rules requiring annual distributions of income to a single beneficiary may be inimical to a parent's desire to give trustees discretion to

accumulate income and to make distributions among her children. Moreover, the use of multiple QSST trusts for each of the children increases administrative costs. In addition, the grantor trust route has the undesirable consequences of taxing the grantor on all trust income and treating the trust as an eligible shareholder for only 60 days or two years after the parent's death (section 1361(c)(2)(A)(ii)). Finally, the one-class-of-stock rule (section 1361(b)(1)(D)) limits the ability to vest parents and their children with different ownership interests and to provide for special allocations of income and loss. See also Treas. reg. section 1.1361-1(l).

The Revenue Reconciliation Bill of 1995, as recently reported by the House and Senate conferees but vetoed by the president, would have ameliorated some, but not all, of these estate planning concerns. For example, the bill would have increased the number of eligible shareholders to 75 (bill section 11501); added a new type of trust — "electing small business trusts" — as an eligible shareholder (bill section 11502); treated a grantor trust as an eligible shareholder for two years after the parent's death (bill section 11503); and permitted S corporations to own 80 percent or more of the stock of a C corporation and to own "qualified sub-chapter S subsidiaries" (bill section 11508). It is likely that these reforms will eventually be enacted, either as part of a budget compromise or as a separate tax bill later this year.

In any event, LLCs address the estate planning concerns raised by the S corporation rules. Because there are no restrictions on the number of types of LLC owners, parents can use a single master trust that imbues trustees with discretion to accumulate or distribute income or principal among their children and grandchildren as conditions warrant. An LLC also affords the opportunity to give different ownership interests to parents and children and to provide for special allocations of income and loss.

3. Section 2036(b) and Retained Voting Control. I previously have written in these pages of how a parent's desire to transfer the economic benefit of S corporation stock to her children while retaining voting control can result in the inclusion of the value of the stock in the parent's estate under section 2036(b). See "Section 2036 Ruling May Force Bengals Out of Cincinnati," *Tax Notes*, June 12, 1995, p. 1504. Section 1036(b)'s embrace of the section 318 constructive ownership rules makes it a perilous journey for a parent to reshuffle ownership of an S corporation within her family while retaining voting control. Although some commentators advocate a prior recapitalization of the S corporation into voting and nonvoting shares so the parent will not "retain" the right to vote in the transfer within the meaning of section 2036(b), such a transaction may be vulnerable to recharacterization by the Service under the step transaction doctrine. An easier way to accomplish the parent's goals is through the use of an LLC. The parent can transfer interests in an LLC while retaining voting control because section 2036(b) applies only to retained rights to vote stock of a controlled corporation.

4. Contribution of Appreciated Assets. Another way to reshuffle control of a family business is through the contribution of appreciated assets in exchange for an interest in the business. When the family business is conducted as an S corporation, the children would recognize gain on the contribution of appreciated property to the corporation in exchange for stock unless they satisfy the 80 percent voting control requirement of section 351(a). This may be inconsistent with the parent's desire to retain control of the family business while permitting the children to gradually increase their stake in the business. This desire can be met with an LLC because section 721 will shelter the children's contribution of appreciated assets to an LLC without reference to any control requirement.

5. Distribution of Appreciated Assets. It is not uncommon for family businesses to be divided among the children following the death of a parent. An LLC provides a corollary advantage over an S corporation in this situation through the treatment of distributions of appreciated property. Distributions of appreciated property generally trigger gain to an S corporation under sections 311(b) and 336(a), but not to an LLC under sections 731(b) and 736(b).

6. The Outside Basis Advantage: Debt. A major disadvantage of S corporations is the inability of shareholders outside the Eleventh Circuit (*Selfe v. United States*, 778 F.2d 769, 85 TNT 154-75 (11th Cir. 1985)) to increase the basis in their stock by their share of liabilities incurred by the corporation. See *Uri v. Commissioner*, 949 F.2d 371, 91 TNT 239-19 (10th Cir. 1991); *Harris v. Commissioner*, 902 F.2d 479, 90 TNT 136-21 (5th Cir. 1990); *Estate of Leavitt v. Commissioner*, 90 T.C. 206 88 TNT 32-8 (1988); *aff'd* 875 F.2d 420 (4th Cir.), *cert. denied* 493 U.S. 958 (1989); *Reser v. Commissioner*, T.C. Memo. 1995-572, 95 TNT 233-6; *Shaver v. Commissioner*, T.C. Memo. 1993-619, 93 TNT 261-22; *Ley v. Commissioner*, T.C. Memo. 1993-306, 93 TNT 148-14; see also Richard L. Winston, "Tax Treatment of Shareholder Guarantees of S Corporation Debt," *Tax Notes*, Nov. 20, 1995, p. 1027. Limited partners of a limited partnership typically suffer a similar outside basis disadvantage because general partners benefit disproportionately from basis increases arising from partnership liabilities as compared to limited partners. This results from the rules in the section 752 regulations for allocating partnership liabilities (and hence increases in outside basis) among the partners: recourse liabilities are allocated to the general partners who bear the associated economic risk of loss, while nonrecourse liabilities are allocated among the partners in accordance with their respective interests in the partnership.

These rules, of course, impair the ability of S corporation shareholders and limited partners to deduct losses and shelter distributions, and this basis impairment carries over to a donee who receives a gift of the S corporation stock or the limited partnership interest. In contrast, because all members of an LLC have limited liability, they will be able to increase their outside basis by their share of the LLC's liabilities, and this augmented basis will carry over to a donee who receives a gift of an interest in an LLC.

7. The Inside Basis Advantage: Section 754 Elections. Although S corporation stock received as a bequest enjoys a step-up in basis under section 1014, there is no corresponding adjustment to the corporation's inside basis of its assets, thus creating an outside basis/inside basis disparity. As a result the new shareholder must report gain on a later sale of assets by the corporation and must await the liquidation of the corporation or the sale of her stock before receiving the offsetting deduction to eliminate the outside basis/inside basis disparity. In addition to the cost of deferral, the new shareholder also will suffer the adverse consequences of treating the deduction as a capital loss if she has no offsetting capital gains at that later time.

In contrast, a step-up in inside basis is abailable for an LLC's assets through a section 754 election which would trigger a section 743 basis adjustment upon a bequest of shares. In this situation, the new member would receive both a step-up in the outside basis of her interest in the LLC as well as a step-up in her share of the LLC's inside basis in its assets. There is thus no outside basis/inside basis disparity, and the new member will be able to offset this increased inside basis against her share of the proceeds from a future sale of the LLC's assets. For a detailed discussion of these issues, see Danny P. Hollingsworth, "The Optional Basis Adjustment Provides Another Tax Planning Advantage for LLCs," 2 *J. Ltd. Liab. Cos* 114 (1995).

8. Valuation Discounts and Freezes. Perhaps no area currently is being mined with more tenacity by estate planners than the use of lack of marketability and minority discounts in structuring the ownership of family assets. Indeed, Jeffrey Pennell calls the use of such discounts "the tax shelters of the 1990s." "The Future of Family Limited Partnership Discounts, " *Tr. & Est*., Jan. 1996, p. 36. See also H. Bryan Ives III, "Valuation Discounts for Partnership and LLC Member Interests," 1 *J. Ltd. Liab. Cos*. 110 (1994). Although S corporations and limited partnerships provide similar discount opportunities, an LLC is particularly attractive because it need not be organized for profit. As a result, discounts are available for vacation homes and other similar assets owned by an LLC. (Of course, the role of business purpose is unsettled with the withdrawal of examples 5 and 6 of the anti-abuse regulations (Announcement 96-8, 1995-7 J.R.B. 56, 95 TNT 18-23; T.D. 8588, 95 TNT 255-1). For further discussion see William F. Nelson, "The Limits of Literalism: The Effect of Substance Over Form, Clear Reflection, and Business Purposes Considerations on the Proper Interpretation of Subchapter K" 73 Taxes 641 (1995); Samuel C. Thomas, "Ex-Government Officials Challenge Partnership Anti-Abuse Reg: An Analysis," *Tax Notes*, Dec. 11, 1995, p. 1395.)

The typical valuation discount strategy is to wrap cash, stock, real estate, or a family business within an LLC, with current control vested in parents and appreciation opportunities given to the children. The goal is to maximize the lack of marketability and minority discounts, with many estate planners using 35 percent as a benchmark discount. For example, at the recent PLI Annual Estate Planning Institute, Richard B. Covey noted an upward trend in these discounts to the 40-50 percent range, with taxpayers in litigated cases claiming even higher discounts. "Trends in Valuation Discounts Addressed," 23 *Est. Plan*. 38 (1996). John A. Bogdanski recently embraced a lower target, observing that "judicial decisions have tended to hover around 35 percent." "Dissecting the Discount For Lack of Marketability," 23 *Est. Plan*. 91, 95 (1996). See, e.g., *Mandelbaum v. Comnissioner*, T.C. Memo. 1995-255, 95 TNT 114-15 (court cited 35 to 45 percent as "benchmark" discount, but applied a lower 30 percent discount to family S corporation stock given by three brothers to their children, rather than 70 to 75 percent discount claimed by brothers' expert at trial); Bernard J. Long Jr., "Tax Court Again Ignores Financial Reality," *Tax Notes*, July 3, 1995, p. 121 (criticizing ˆ*Mandelbaum* decision as "astonishing," "naïve," and "appalling"). In any event, the use of an LLC to leverage the valuation discounts raises a number of difficult issues concerning the interplay of partnership classification, estate freeze, and state LLC rules.

Because an LLC by definition enjoys limited liability, it will achieve partnership tax status only if it lacks two of the remaining three corporate characteristics; continuity of life, centralized management, and free transferability of interests. As noted earlier, Jerry Kasner has observed that every public and private LLC ruling blessing partnership status has been based on the LLC lacking continuity of life and free transferability of interests. (For a thoughtful discussion of the application of these classification standards to LLCs, see Karen C. Burke, "The Uncertain Future of Limited Liability Companies," 12 *Am. J. Tax Pol'y* 13,1 30-47 (1995). Of course, these standards would be irrelevant under the proposed check-the-box classification rules (Notice 95-14, 1995-14 I.R.B. 7,95 TNT 62-10). However, some commentators question whether the Treasury has the statutory authority to replace the classification regulations with the check- the-box system (see Martin McMahon Jr., "AALS Tax Section Looks at LLCs and Taxation of Business Enterprises," *Tax Notes*, Jan. 29, 1996, p. 511), and in any event it likely would be some time before conforming amendments were made to state LLC statutes. For further discussion of the proposed check-the-box approach, see Susan Pace Hammill, "A Case for Eliminating the Partnership Classification Regulations," *Tax Notes*, July 17, 1995, p. 335; Daniel Shefter, "Check the Box Partnership Classification: A Legitimate Exercise in Tax Simplification," *Tax Notes*, Apr. 10, 1995, p. 279. For favorable reports from tax sections of various bar associations, see 95 TNT 173-64 (New York State); 95 TNT 166-43 (New York City); 95 TNT 145-25 (ABA).)

LLCs generally lack continuity of life because they dissolve on the death, disability, or withdrawal of a member. In most states, an LLC can continue only with the unanimous consent of its members, which does not give the LLC the corporate characteristic of continuity of life. Treas. reg. section 301.7701-2(b)(1). Some states permit an LLC to continue with the approval of a majority of its members, and the Service has applied to LLCs the rule in the regulations permitting a majority of the remaining partners to continue a limited partnership following the withdrawal of a general partner. See Rev. Rul. 94-30, 1994-1 C.B. 316,

94 TNT 89-14. In any event, the unanimous or majority consent provision gives dissident family members the power to force a dissolution of the LLC. Valuation discounts on gifts of interests in such family LLCs thus would be in doubt in this situation because the Service could try to value the gifts on the basis of the value of the underlying assets rather than on the basis of the value of the LLC interests themselves. Many planners try to revive the discounts by inserting a clause in the LLC operating agreement to restrict a member's ability to withdraw from the LLC and receive a full net asset value for his interest. However, it is unclear whether such restrictions will be respected under the anti-freeze rules of section 2701(b).

Under section 2704(b), an "applicable restriction" that "effectively limits the ability of (a) corporation or partnership to liquidate" is disregarded for estate and gift tax valuation purposes if (I) the interest in the entity is transferred to or for the benefit of a member of the transferor's family; (ii) the transferor and her family members control the entity; and (iii) after the transaction, the restriction either lapses or can be removed by the transferor or her family members. Treas. reg. section 25.2704-2(a), (b). The statute and the regulations, however, contain arguably inconsistent rules on the effect of state law on the definition of applicable restrictions. Section 2704(b)(3)(B) requires that an "applicable" restriction be more restrictive than those "imposed, or required to be imposed, by any…State law." The regulations, in turn, require that an "applicable" restriction be "more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." Treas. reg. section 25.27042(b). The question thus is whether clauses inserted in LLC operating agreements in an attempt to preserve valuation discounts by restricting a member's ability to withdraw from the LLC and cash out her interest will be disregarded as "applicable" restrictions.

Under most state LLC statutes, the members are free to impose any liquidation restriction they want in the operating agreement; only if they fail to do so does the state default rule apply. If the language of section 2704(b)(3)(B) is followed strictly, any liquidation restriction agreed to by the members would be treated as an applicable restriction; because there are no restrictions "imposed" by state law, any restriction agreed to by the members would be more restrictive than the state law rule. The regulations, however, arguably would treat as an "applicable" restriction only those limitations that are more restrictive than the state default rule that would be applied in the absence of a provision in the operating agreement. For example, when the state default rule requires the unanimous consent of all members to continue the LLC following an event of dissolution, any provision inserted in the operating agreement to revive the valuation discounts by permitting less than unanimous consent to continue the LLC arguably would be more restrictive than state law because it would be more difficult for a dissident family member to force a liquidation. Jerry Kasner has suggested that the safest strategy for satisfying section 2704(b) is for states to amend their LLC statutes so that their default rules will mirror the requirements in Rev. Proc. 95-10, 1995-3 I.R.B. 1, 94 TNT 245-2. Under this approach, parents who transfer interests in the family LLC to their children would retain control and be designated as manager-members. Valuation discounts would be appropriate on the transfer because the LLC would not dissolve on the death, disability, or withdrawal of the children as non-manager-members.

9. The Trust Alternative. An LLC affords several advantages compared to a trust in implementing a parent's gift-giving program. For example, a *Crummey* trust has long been a preferred gift-giving vehicle because it avoids the unattractive features of the UTMA and section 2503(c) trust (mandatory termination at age 21) and the section 2503(b) trust (mandatory distribution of income) while still satisfying the present interest requirement of the annual exclusion through the beneficiary's right to demand that the parent's contribution to the trust instead be distributed to her. Despite the *Crummey* trust's popularity, planners have grappled with three nettlesome features.

First planners worry that the annual *Crummey* drill of requiring written notice of the beneficiaries' withdrawal rights may be inadvertently omitted by a busy trustee. In LTR 9532001, 95 TNT 158-11, the Service recently rejected an attempt to solve this problem by having the beneficiaries waive, in advance, their right to receive annual *Crummey* notices. Second although in most cases it is in the beneficiary's financial interest to waive her withdrawal rights (otherwise her parents are likely to retaliate by foregoing further contributions to the trust), planners worry about the wayward beneficiary actually exercising her *Crummey* power. Third the beneficiary's waiver of her withdrawal rights can create gift tax problems under the lapse rules of section 2514(e) absent some creative planning including the use of "hanging" powers. See Howard W. Harris & Steven W. Jacobson, "Maximizing The Effectiveness of the Annual Gift Exclusion," 70 Taxes 204(1992); Richard W. Harris, "Avoiding Taxable Lapse Treatment for Crummey Trust Transfers," Trep & Est., Apr. 1992, at 45.

The use of an LLC rather than a trust obviates each of these concerns. Outright gifts of LLC interests qualify for the annual exclusion without any lapse problems, and the LLC's operating agreement could restrict the children's access to the LLC's assets. Of course, care should be taken to ensure that these restrictions are not so onerous so as to run afoul of the present interest requirement of the annual exclusion. See Jerry A. Kasner, "Gifts of Stock in a Corporation That Does Not Pay Dividends Qualify for the Annual Exclusion," *Tax Notes*, Mar. 21, 1994, p. 1576.

The LLC alternative also avoids the current planning pitfalls associated with *Crummey* trusts due to the more onerous trust income tax rates. With the top 39.6 percent rate applied to trust income in excess of $7,900 in 1996 (Rev. Proc. 95-53, 1995-52 I.R.B. 1, 95 TNT 243-7), there is a greater desire to make distributions to beneficiaries so the income is taxed at the lower individual tax rates (in contrast, the 39.6 percent rate is applied to income in excess of $263,750 for single and joint filers in 1996). Even when the beneficiary is a child under 14 years of age and thus subject to the kiddie tax of section 1(g), distributions from

the trust would result in income tax savings in many situations. Of course, it is often undesirable for nontax reasons to make such distributions to children. The LLC solves this conundrum because its income is taxed to the members regardless of whether it is distributed. In many cases, an LLC may choose to distribute only the amount of income necessary to satisfy the members tax obligations.

To be sure, an LLC may not in all cases be more desirable than a *Crummey* trust. For example, a *Crummey* trustee often has the ability to vary income and principal distributions among the beneficiaries to respond to future changes in their circumstances, while an LLC manager-member is much more constrained (e.g., the power to direct different assets to different members upon liquidation). In addition, *Crummey* trusts are able to leverage the annual exclusion through the use of contingent beneficiaries after *Estate of Cristofani v. Commissioner*, 97 T.C. 74, 91 TNT 159-11 (1991), but the use of an LLC requires that the interest be vested in the member upon receipt.

10. The Life Insurance Trust Alternative. An LLC also offers several advantages over a trust to maximize the tax advantages offered by life insurance policies. For example, one of the disadvantages of a life insurance trust is that the parent must relinquish all control over the policy to avoid the inclusion of the proceeds in her estate under section 2042(2). The right to change the beneficiaries of the policies, the right to obtain the cash surrender value of the policy, and the right to borrow against the policy are all treated as incidents of ownership in the policy that cannot be held by the parent at her death (or relinquished within three years of her death) without adverse estate tax consequences. Treas. reg. section 20.2042-1©(2). Of course, this disadvantage is somewhat mitigated by the Service's recent announcement in Rev. Rul. 95-58, 1995-36 I.R.B. 1, 95 TNT 153-15, that it would revoke Rev. Rul. 79-353, 1979-2 C.B. 32, and accept the result in *Estate of Wall v Commissioner*, 101 T.C. 21,, 93 TNT 210-7 (1993). Thus, a parent who retains the power to remove the trustee of a life insurance trust and appoint a successor unrelated trustee will not be treated as retaining the prohibited incidents of ownership held by the trustee.

In any event, when the life insurance policy is held by an LLC rather than by a trust, the parent can retain control over the policy through her manager-member interest in the LLC without running afoul of section 2042(2) if the proceeds are payable to the LLC upon the parent's death. In this situation, the incidents of ownership held by the LLC are not attributed to the parent under Treas. reg. section 20.2042-1(c)(6). Instead, only the parent's proportionate share of the proceeds attributable to her ownership interest in the LLC is included in her estate under section 2033. This results in minimal estate tax exposure when the parent has made a series of annual exclusion gifts of interests in the LLC, leaving her with only a 1 percent interest in the LLC. Indeed, a discount in the estate tax value of the parent's LLC interest may be appropriate if the parent were a key service provider to the LLC, thus reducing even further the 1 percent of the insurance proceeds includable in her estate.

An LLC also affords more flexibility than a life insurance trust to accommodate changes in the family's circumstances. Sections 2036 and 2038 require that the life insurance trust be irrevocable, with no power in the parent to alter, amend, revoke or terminate the trust. In contrast, the members of an LLC may be able to agree to amend the operating agreement in light of these changed circumstances without adverse estate tax cost to the parent. Moreover, an LLC also provides some flexibility for the parent even if a wayward child refuses to agree to changes in the operating agreement. For example, if a parent wishes to change the beneficiaries of the policy to exclude a child who has joined the Hell;s Angels (or the Young Republicans' Club) and is unwilling to consent to the change, the parent could form a second LLC with only the "good" children and then either transfer the policy from the first LLC to the second LLC for its fair market value or stop paying the premiums on the first policy and purchase a new policy through the second LLC.

Finally, ownership of a life insurance policy by an LLC also is desirable in certain planning situations in light of some specific life insurance and alternative minimum tax rules. Although section 101(a)(1) excludes from the income tax proceeds received under a life insurance policy paid by reason of the death of the insured, this rule does not apply to certain "transfers for value." Under section 101(a)(2), if a life insurance contract is transferred for a valuable consideration, the exclusion only extends to the amount of the consideration plus any future premiums paid by the transferee; the balance of the proceeds received upon the insured's death are thus taxable to the transferee. However, there is an exception in the transfer-for-value rules that protects transfers of the policy "to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer." Section 101(a)(2)(B). The exception was enacted to protect policies transferred for "legitimate business reasons rather than for speculation" (S. Rep. No. 1622, 83d Cong., 2d Sess. 14 (1954)) and is often utilized in the context of buy-sell agreements involving the parent's interest as a key person in the family business. Although the exception covers transfers among partners and from partnerships to partners (and thus presumably protects transfers among members of an LLC and from LLCs to members), the statute does not reach transfers among S corporation shareholders and from S corporations to shareholders. As a result, an LLC affords greater flexibility in transferring a life insurance policy without causing the proceeds to lose their tax-free character. For further discussion of these transfer-for-value rules, and the myriad planning situations in which the issue can arise, see Alan Kupferberg & Robert M. Wolf, "Transferring Life Insurance Policies to a New Partnership," 20 *Est. Plan.* 340 (1993); Sherwin P. Simmons, "IRS Rules Favorably on Partner Exception to Transfer-for-Value Rules," *Tax Notes*, Dec. 27, 1993, p. 1601)' Sherwin P. Simmons, "The Partnership Exception to the Transfer-for-Value Rule," *Tax Notes*, May 31, 1993, p. 1223; see also LTR 9511009, 95 TNT 54-51; LTR 9410039, 94 TNT 49-17; LTR 9347016, 93 TNT 242-15; LTR 9328020, 93 TNT 150-29; LTR 9328019k, 93 TNT 150-28; LTR 9328017, 93

TNT 150-27; LTR 9328010, 93 TNT 53-21; LTR 9309021, 93 TNT 53-21; LTR 9239033, 92 TNT 196-31; LTR 9235029, 92 TNT 179-38; LTR 9045004, 90 TNT 230-44; LTR 9042023, 90 TNT 215-49; LTR 9012063, 90 TNT 65-22; LTR 8951056, 89 TNT 259-36; LTR 8906034, 89 TNT 36-43. An additional benefit of holding life insurance in an LLC is the avoidance of alternative minimum tax liability that could result if an S corporation receives the life insurance proceeds. See Treas. reg. section 1.56(g)1(c)(5)(v) (excess of life insurance proceeds over basis treated as adjusted current earnings); see also Ronald W. Lyster, "Corporate Ownership of Life Insurance Must Be Reevaluated," 18 *Est. Plan.* 342 (1991).

Conclusion

Although this article has focused on the estate planning advantages of LLCs, I do not want to overestimate their importance. To be sure, there are real tax advantages of LLCs compared to S corporations. However, the relative advantages of LLCs over limited partnerships will not be decisive in most situations. Estate planners should proceed with caution because the decision to embrace the LLC requires buying into a series of business relationships that are by and large untested and often quite different from their RULPA counterparts. Thus, before jumping onto the LLC bandwagon, estate planners should carefully consider the business consequences of the LLC regime. In most cases, the business considerations will prove to be far more important than the tax considerations. Estate planners should be wary of letting the tax tail wag the nontax dog.

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