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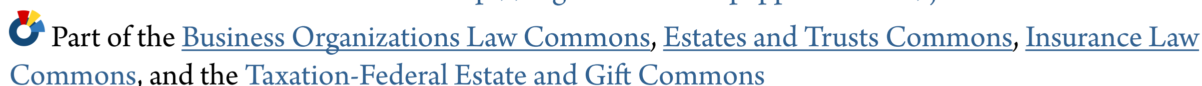
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THE FAMILY LLC: A NEW APPROACH TO INSURING DYNASTIC WEALTH

EVAN MICHAEL PURCELL[1]

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[1] George Mason University School of Law, JD Candidate. This Article is dedicated to my family, and especially my amazing wife Sarah, for their unwavering support and encouragement.

I. INTRODUCTION

The use of life insurance in estate planning continues to be a common and ever-evolving practice. New products created by the insurance industry, specifically whole life and universal life policies that blur the line between insurance coverage and capital investment, attempt to maximize the tax-free benefit of the policy holder.[2] Due to the special tax treatment of life insurance policies and their payouts, the irrevocable life insurance trust (ILIT) has become a valuable and commonly used tool amongst estate planning attorneys.[3] However, there is a disadvantage to the traditional ILIT: it is not flexible.[4]

Enter the limited liability company (LLC); with its unique ability to serve as a passive holding company, limit liability and exposure to risk, and divide shares of difficult-to-value assets between members, this pass-through entity has vast potential in the realm of estate planning due to its flexibility.[5] This Article will explore the benefits and possible pitfalls of designating an LLC, composed of family members, that purchases and holds life insurance policies on its members, for the purposes of long-term estate planning.

The goals of the experiment are threefold: first, to lower the barrier to entry so middle class families can take advantage of this favorable tax treatment; second, to allow wealth to be transferred through subsequent generations with the least tax liability; and third, to ensure wealth placed into such a vehicle is flexible enough to be both self-sustaining and adaptable to potential future tax reforms. This Article begins with an overview of the tax background of life insurance products and LLCs, then illustrates a basic hypothesis by example, examining the potential tax advantages and disadvantages, as well as the flexibility and dynastic potential of an LLC used to purchase and own life insurance of its members.[6] It concludes with an important and ever-present caveat: that, as always, hypothetical results are not guarantees, and this thesis is not universally applicable to every situation. For the sake of efficiency, this Article will focus only on taxation at the federal level and will not discuss taxation by other jurisdictions at the state or local

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[2] Rex P. Cornelison, III, *Federal Income Taxation of Life Insurance Products after the Tax Reform Act of 1984*, 1 GA. ST. U. L. REV. 237, 238 (1984–85).

[3] Adam L. Abrahams, *Irrevocable Life Insurance Trusts: An Effective Estate Tax Reduction Technique*, PRAC. TAX LAW. 35, 36 (2013).

[4] Gary A. Zwick, *Building Flexibility into the Irrevocable Life Insurance Trust*, 24 J. TAX'N INV. 211, 211 (2007).

[5] David T. Lewis & Christopher J.C. Jones, *Limited Liability Companies as Trust Substitutes Part 2*, 18 PROB. & PROP. 52, 52 (2004).

[6] *See infra* Diagram B.

level, which may vary. The current favorable tax treatment of life insurance death benefits and policy-secured cash flow loans, combined with the flexibility of LLC governance, is a powerful tool in the hands of the taxpayer, given proper planning.

This combination of a family LLC and whole life insurance planning is a do-it-yourself perpetual dynasty and business investment vehicle with significantly lower start-up costs that allows middle class families to build and distribute wealth. This Article introduces the taxpayer to the basic background principles needed to understand the inner workings of the investment, then provides a guide to drafting considerations for the family's attorney, and concludes with a general plan to maintain business legitimacy and take advantage of tax-favored status, while retaining the flexibility essential to combating the unexpected. Part II addresses the historically favored tax treatment of life insurance products, as well as relatively recent restrictive reforms.[7] Part III addresses the background foundation of the LLC entity and surveys its skeletal structure.[8] Part IV introduces a practical example of how to create an LLC that will serve the unique purpose of estate planning.[9] Part V demonstrates the way in which the LLC interacts with specific types of assets throughout its use.[10] Finally, Part VI discusses the transfer of LLC assets from one generation to the next, both during the lifetime and after the death of the founding members.[11] Through this proposal, significant tax and legal benefits will be utilized to stabilize and maintain the family assets.

II. THE RISE OF THE IRREVOCABLE LIFE INSURANCE TRUST

A. The History of Life Insurance

To understand why and how life insurance policies are taxed under the Internal Revenue Code, a brief history of the evolution of the modern life insurance policy is warranted. Life insurance originated in the mid-fifteenth century Mediterranean merchant economy and was used to insure against the deaths of sailors.[12] Almost immediately, insurance policies were used by borrowers for credit; borrowers would insure their own lives and name their

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[7] *See infra* Part II and accompanying notes 12–60.

[8] *See infra* Part III and accompanying notes 61–82.

[9] *See infra* Part IV and accompanying notes 83–108.

[10] *See infra* Part V and accompanying notes 109–128.

[11] *See infra* Part VI and accompanying notes 129–153.

[12] Susan Lorde Martin, *Betting on the Lives of Strangers: Life Settlements, STOLI, and Securitization*, 13 U. PA. J. BUS. L. 173, 175 (2010).

lender as beneficiary.[13] The concept was brought to England in the sixteenth century by Italian merchants.[14] Until an Act of Parliament in 1774, which introduced an "insurable interest" requirement, it was a popular pastime to "wager" on the lives of prominent public figures by purchasing life insurance policies on them.[15]

Life insurance in the United States began with religious groups seeking to provide for the wives and families of ministers, a stark contrast to the gamesmanship of its English counterpart.[16] The nineteenth century marked a shift from term policies to whole life policies, which would insure an individual for his or her entire life, rather than a term of years.[17] The other development of the nineteenth century came in the form of tontine-policies, which would pay dividends from lapsed policies of deceased group members to the surviving members.[18] Public criticism led to the prohibition of such policies in the early twentieth century.[19] Throughout the twentieth century, insurance companies began to experiment with life insurance policies by combining them with investment and savings accounts.[20] It is through this variation that the modern whole life policies came into being.

B. Types of Modern Life Insurance Products

Life insurance policies are grouped into one of two categories: term life, which provides only death benefit coverage for a term of years, and whole life, which typically provides death benefit coverage for the insured's entire life (hence the name) and includes a cash value account.[21] This Article focuses exclusively on whole life policies due to their investment potential. While whole life policies may vary by provider, a brief overview of the essential principles is necessary.

In a whole life policy, whenever the policy owner pays the insurance company a premium, the company takes a percentage of that premium and

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[13] *Id.*
[14] *Id.* at 176.
[15] *Id.*
[16] *Id.* at 181.
[17] *Id.*
[18] *Id.* at 182.
[19] *Id.*
[20] *Id.*
[21] Andrew D. Pike, *Reflections on the Meaning of Life: An Analysis of Section 7702 and the Taxation of Cash Value Life Insurance*, 43 TAX L. REV. 491, 498–99 (1988).

invests it.[22] The gains on the investment are held within the policy in the form of a cash value account.[23] As the policy owner continues to make premium payments over the years, interest on the cash value compounds and wealth is built up in the cash value account.[24] The amount in the cash value account is also known as the "surrender value" of the policy, because it is the amount that would be paid out to the policyholder if he were to cancel, or surrender, the policy entirely.[25]

Most insurers will guarantee either a minimum amount of interest or a "no-loss," meaning that as long as the company is solvent, the cash value will never decrease.[26] To the extent the cash value exceeds the premium payment due, the policy owner can either withdraw the cash as income or take out a loan.[27] The loan is issued by the insurance company, rather than coming out of the cash value account, so that interest continues to compound on the cash value.[28] If the policy owner does not pay back the loan before he dies, as long as the policy remains in force, the outstanding balance is taken from the death benefit before it is paid to the beneficiaries.[29] Excessive loans or failure to pay premiums may cause the policy to lapse, in which case the policy owner will no longer be entitled to the death benefit.[30] The policyholder is also able to "overfund" the policy by paying more than is required to sustain coverage, up to a statutorily defined amount. By overfunding the policy, the owner is essentially using the cash value account as a personal savings account. The amount overfunded will gain interest along with the portion of the premiums invested. Not only is that money able to fund premium payments later in the life of the policy, it is also used as collateral for "tax-free" policy loans.

Importantly, because overfunded dollars are deposited directly into the cash value account, they are afforded the same guarantee against loss. Given compound interest, even modest overfunding can result in dramatic increases in value over the life of the policy. These general principles hold true across

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[22] *Id.*

[23] *Id.*

[24] *Id.* at 500.

[25] I.R.C. § 7702(f)(2)(B) (2012).

[26] *Understanding Fixed Index Universal Life Insurance,* ALLIANZ LIFE INS. CO. 1, 4 (2015), https://www2.allianzlife.com/IIG/Content/Documents/Forms_And_Marketing_Materials/PFM/Marketing_and_Sales_Materials/M-3959.pdf [hereinafter ALLIANZ]. The policyholder always runs the risk the insurance company will be unable to pay out, but, if such a situation were to occur, it is likely the entire industry would be bailed out by the federal government. *Id.*

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.*

the spectrum of whole life products.

Typically products vary based on how and when premiums are paid and how investments in the cash value account are administered. "Traditional whole life" policies are based on a set annual premium to be paid every year until the policy-owner dies.[31] The cash value component of these policies is used to offset the higher cost of obtaining insurance as the insured grows older.[32] Annual premiums will generally be higher than the premiums on a similar term life policy; however, in later years of the policy, the whole life premiums will be lower than a similar term policy.[33] "Limited pay whole life" essentially works the same as traditional whole life, but premiums are only paid for a limited number of years—for example, a twenty year period.[34] In such a policy, the insurance company bears the risk, as it is counting on the future value of the premiums paid during the pay period to cover the cost of insurance throughout the rest of the insured's life. "Universal life" allows for variable premium payments, based on market interest rates, with the option to either maintain a level death benefit or a level net amount at risk.[35] In "variable life" policies, the premium payment amount does not change, but the death benefit varies based on the performance of the cash value account, invested in the market.[36] Finally, "variable universal life" combines aspects of universal and variable life policies; the policyholder is able to vary both the amount of the annual premium payments and the death benefit at his or her discretion.[37] It is for this reason that our model LLC will utilize variable universal life, to maintain maximum flexibility with regard to expenses associated with holding the policies.

C. Tax Treatment of Life Insurance

The Tax Reform Act of 1984 and subsequent statutes govern modern life insurance taxation at the federal level.[38] The impetus of the reform was to restrict the tax favored status of life insurance products by defining "life insurance," continuing to give "pure" life insurance beneficial tax status, and

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[31] WOLCOTT B. DUNHAM, JR., NEW APPLEMAN NEW YORK INSURANCE LAW, § 9.02 (Matthew Bender ed., 2nd ed. 2013).

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] Cornelison, *supra* note 2, at 237.

restricting favorable tax status for products that are merely investments masquerading as insurance.[39] Under the tax code, buildup of wealth in a cash value life insurance policy is tax-deferred,[40] and the payout of death benefits is not taxed as income.[41] Another advantage is the policyholder's ability to take out a nonrecourse loan on the cash buildup within the policy, using the death benefit payout in the amount of the loan as collateral.[42] However, a direct withdrawal of cash value qualifies as income and would be taxed because it is not paid out as a result of the death of the insured.[43]

To take advantage of the codified tax benefits, any product used must meet one of two tests.[44] Essentially, these tests ensure the cash buildup in the savings portion of the product does not exceed the amount of coverage able to be purchased in a single premium policy.[45] The purpose was to put a stop to single premium purchases that were purely for investment in a "tax shelter."[46] However, the reforms did leave the door cracked for modest tax-free increases in cash value over the lifetime of a policy and retention of the income tax-free payout of death benefits.[47]

The first test, the "cash value accumulation test," is satisfied as long as the surrender value of the policy does not exceed the cost of purchasing the same amount of benefits with a single premium.[48] For example, suppose an individual purchases a whole life policy with a death benefit of $1 million for a premium amount of $10,000 per year for thirty years. The total that will be paid will be $300,000 over the course of thirty years, so, at the time of the purchase, the single premium price for that same policy would be equal to the present value of $300,000. If we assume the present value of $300,000 to be $150,000, the amount of money in the cash value account, or "surrender value," of the policy cannot exceed that amount.[49] Surrender value is equal to the cash value that builds up in the policy. Therefore, if a taxpayer were to purchase such a policy for a single-payment of $160,001—$10,000 for the first year's premium and $150,001 in cash value—the policy would be treated as an

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[39] *Id.* at 250.
[40] 26 U.S.C. § 101 (2012).
[41] *Id.*
[42] *See* ALLIANZ, *supra* note 26.
[43] 26 U.S.C. § 101 (2012).
[44] Cornelison, *supra* note 2, at 250; *see also* 26 U.S.C. § 7702 (2012).
[45] Cornelison, *supra* note 2, at 251.
[46] *Id.* at 247–48.
[47] *Id.* at 250.
[48] *Id.* at 251.
[49] *See infra* Diagram A.

investment, and any gains on the cash value would be taxed yearly, rather than deferred.

The second test, which is similar in nature, is a "guideline premium requirement with a cash value corridor."[50] To satisfy this requirement, the policy must have a certain net amount at risk throughout the life of the policy. Basically, this means the amount paid into the policy each year cannot exceed a certain amount.

Both of these tests ensure single premium policies and front-loaded policies will be treated as investments, rather than life insurance.[51] It is only by remaining within these prescribed guidelines that the Internal Revenue Service (IRS) allows an individual to reap the tax-favored investment benefits of a life insurance policy. When a policyholder wishes to "overfund" his policy, he must be certain to remain within the cash value corridor. Importantly, this corridor is in effect throughout the life of the policy, which allows a taxpayer to carry over any unused potential overfunding to the following year.

To illustrate with the previous example, the taxpayer, after paying $10,000 for the first year's premium, could "invest" more money in the policy up to $5,000—present value ($150,000), divided by thirty years—to stay within the cash value corridor.[52] Suppose the taxpayer decided to forgo any additional investment in year one; after paying $10,000 for the second year's premium, he could "overfund" the policy up to $10,000.[53] The $5,000 the taxpayer elected not to invest carries over to the next year, and the taxpayer can invest more money while remaining within the cash value corridor. While obviously the taxpayer will want to take advantage of the timing benefits—an extra year of capital gain—by overfunding the policy to the maximum extent allowed each year, this carryover will be essential to funding the second generation in our LLC structure.

Thus, when properly utilized within the parameters of the tax code, the IRS still allows a build-up and transfer of wealth that is tax free.

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[50] Cornelison, *supra* note 2, at 251.

[51] *Id.*

[52] Just as before, if the taxpayer had added $5,001 to the policy in year one, he would exceed the allowable cash value corridor, and his policy would be treated as an investment.

[53] This is a rough estimation, the actual amount will be influenced by any gains accrued in the first year and actual present value determinations. Fortunately, many companies calculate these amounts as a service to their customers, which simplifies these transactions in practice.

D. The Irrevocable Life Insurance Trust

When held by an individual, death benefits payable under a cash value life insurance policy are included in that person's estate.[54] The theory is, because the individual has access to the built-up cash value in the policy, he or she has "incidents of ownership."[55] The effect on estate taxes is potentially devastating; for example, a person with a million dollar death benefit will use up nearly a fifth of his or her federal estate tax exemption.[56] A common technique for removing assets from a client's estate is placing it in trust for the benefit of his or her heirs.

The ILIT is a type of trust designed specifically to hold life insurance policies.[57] Ownership of the policy is transferred to a trustee, and the ILIT is designated as beneficiary of the policy.[58] Importantly, the insured cannot be named trustee, but an LLC, partnership, or corporation can be.[59] Once the insured dies, the death benefit is held by the trust for the benefit of the designated beneficiaries and is not included in the decedent's estate or any of the beneficiaries' estates.[60] In this way, the death benefit proceeds avoid both income and estate taxation.

III. THE LLC IN ESTATE PLANNING

A. The History of the LLC

The LLC is a non-corporate entity that is held and controlled by a manager or members.[61] "In simplest terms, the LLC is a business form which has the pass-through tax advantages of a partnership[] and the limited liability protection of a corporation."[62] The LLC is a pass-through tax entity, which means the entity itself is not taxed, but the profits and losses of the LLC pass through to its members.[63] Additionally, LLCs may simply decide to be taxed

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[54] Zwick, *supra* note 4, at 211.

[55] *Id.*

[56] 26 U.S.C. § 2010 (2012); *see also infra* Part V.D.

[57] *See generally* Bradley E.S. Fogel, *Life Insurance and Life Insurance Trusts: Basics and Beyond*, 16 PROB. & PROP. 8 (2002).

[58] Zwick, *supra* note 4, at 211.

[59] Lewis & Jones, *supra* note 5, at 52.

[60] Zwick, *supra* note 4, at 211.

[61] BLACK'S LAW DICTIONARY (9th ed. 2009).

[62] Joseph A. Rodriguez, *Wyoming Limited Liability Companies: Limited Liability and Taxation Concerns in Other Jurisdictions*, 27 LAND & WATER L. REV. 539, 539 (1992).

[63] Stuart Levine, *Limited Liability Companies, Limited Liability Partnerships, Limited Liability*

in this manner as a partnership.[64]

Essentially, an LLC consists of two contracts: the articles of designation and an operating agreement. Articles of designation are generally filed with the state of entity designation and provide contact information on the LLC's registered agent.[65] One of the advantages of the LLC is this default level of privacy in the public records. The operating agreement is basically a contract that governs all of the activities of the LLC.[66] Because of the contractual nature of the operating agreement, LLCs are more precisely able to create rules with regard to assets and to adapt to new situations. A contract can be amended with consent of all of the parties, while an irrevocable life insurance trust is just that: irrevocable.

The LLC originated in the late nineteenth century, when several states began to create partnership associations with limited liability.[67] The impetus of these associations was not taxation, as no federal income tax existed at the time, but rather flexibility; members of the general public had difficulty conforming with the strict, rigid, and formal requirements of incorporation.[68] When the federal income tax was instituted in 1913, some entities were classified as partnerships and others as corporations.[69]

Although the concept was not novel, it was not until the 1970s that states began passing legislation to create LLCs.[70] At that time, rigid requirements from the IRS made LLC recognition impossible unless the taxpayer could prove that two of the four traditional characteristics of corporations were lacking: "continuity of life, centralization of management, limited liability for corporate debts, and free transferability of interests."[71] It is interesting to note our hypothetical LLC will have all four of these characteristics, which illustrates the extent to which the requirements of LLCs have been liberalized. This liberalization culminated in the "check-the-box" regulations,[72] which automatically tax LLCs as partnerships unless they elect to have corporate tax

Limited Partnerships, and Other Novel Entities, CA86 ALI-ABA 501 (1996).

[64] I.R.S. Form 8832.

[65] Levine, *supra* note 63.

[66] Lewis & Jones, *supra* note 5, at 52.

[67] Rodriguez, *supra* note 62, at 539.

[68] *Id.*

[69] *Id.* at 541.

[70] *Id.* at 544.

[71] Sandra K. Miller, *A New Direction for LLC Research in a Contractarian Legal Environment*, 76 S. CAL. L. REV. 351, 359 (2003).

[72] I.R.C. § 7701 (1996).

treatment.[73] Thus, the modern LLC truly does have the best of both worlds: the limited liability of a corporation with the tax treatment of a partnership.

B. Estate Planning Considerations

The LLC is relatively new and controversial in the realm of estate planning; it has not existed as long as other more traditional trusts, thus there is less case law on the subject, and the IRS may reevaluate its treatment of the LLC entity. However, the LLC has been used in estate planning primarily for high net worth clients with large and valuable assets.[74] These LLCs are utilized in conjunction with trusts and diversifying assets, often in complex estate planning.[75] The main goal of such planning is to devalue assets by placing them within an LLC. For the purposes of this Article, asset devaluation is only part, albeit an important part, of the strategy. Thus far, the LLC seems to be withstanding scrutiny by the IRS.[76] For example, the IRS has explicitly recognized the legitimacy of asset devaluation within an LLC and will not attack LLCs if there is a non-tax purpose for their formation.[77]

Asset devaluation occurs because the fair market value of the percentage of LLC shares is not equal to that percentage of the fair market value of the LLC. Fair market value is defined as "the price that a willing buyer would pay a willing seller in the relevant marketplace with neither being under a compulsion to enter into the sale."[78] For example, if an individual owns a 10% share in an LLC worth $100,000, the fair market value of that 10% share is actually less than $10,000. This is due to the discounts of minority and marketability. The minority discount deals with control or, more specifically, the lack thereof. A minority shareholder lacks the control over business decisions in a way that a majority shareholder does not, because there is additional value intrinsic in decision-making authority.[79] The actual amount of the discount will vary, but studies show it can, on average, be as much as

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[73] Miller, *supra* note 71, at 359.

[74] John A. Miller & Jeffrey A. Maine, *The Fundamentals of Wealth Transfer Tax Planning: 2011 and Beyond,* 47 IDAHO L. REV. 385, 435 (2011).

[75] S. Stacy Eastland, *Some of the Best Estate Plan Ideas We See Out There (That Also Have the Merit of Playing Havoc with Certain "Conventional Wisdom")*, SS0044 ALI-ABA Course of Study Materials (2010).

[76] *Id.*

[77] *Id.*

[78] Sandra K. Miller, *Discounts and Buyouts in Minority Investor LLC Valuation Disputes Involving Oppression or Divorce*, 13 U. PA. J. BUS. L. 607, 611 (2011).

[79] *Id.* at 613.

36%.[80] The marketability discount is based on the difficulty associated with finding a buyer for a privately held, as opposed to a publicly traded, company.[81] Essentially the discount is due to the inability to readily liquidate these types of assets. Although the majority of courts now reject both types of discounts, some jurisdictions, such as New York and Florida, continue to allow this type of devaluation.[82] The flexibility and devaluation aspects make the LLC a useful tool in estate planning.

IV. BUILDING THE CASTLE

A. Creating the LLC

Meet the Blackacre family. This typical family of four—Mr. and Mrs. Blackacre and their two children, Jack and Jill—earns $100,000 per year in income ($10,000 per year for long-term savings), owns $200,000 of equity in their principal residence, and owns a $150,000 rental property. This family will serve to illustrate the various points that will be made throughout the analysis. By organizing their assets into LLC form with the help of their attorney, the Blackacres will demonstrate the basic approach to the family LLC. After retaining an attorney to draft the LLC documentation, the Blackacres should be able to manage the LLC without further assistance from counsel, which will save them money, as opposed to designating the attorney as trustee of their assets, in which case the attorney will be entitled to reasonable compensation for the management of the trust.[83]

The Blackacre LLC is created by filing articles of designation and paying a small filing fee, typically about $100.[84] The articles of designation may indicate Mr. Blackacre, Mrs. Blackacre, or the drafting attorney as registered agent for the Blackacre LLC. Again, unless the additional layer of privacy in the public records is desired, a family member, rather than counsel, should be the registered agent to save on legal fees.

B. Operating Agreement

The operating agreement of an LLC is treated as a contract that governs

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[80] *Id.*

[81] *Id.* at 614.

[82] *Id.* at 614–15.

[83] U.T.C. § 708 (2010).

[84] *Virginia Limited Liability Companies*, COMMONWEALTH VA. ST. CORP. COMM'N, https://www.scc.virginia.gov/clk/dom_llc.aspx (last visited Apr. 20, 2015).

all of the activities performed by the LLC.[85] For our specific estate planning purposes, the Blackacres' operating agreement will need to include provisions for designating shares, business succession planning, arbitration, and gifting.

Designating who will own shares of the Blackacre LLC is crucial to the operating agreement. First, shares should be designated into two groups: voting and non-voting. Non-voting shares can be given to the son and daughter, while Mr. and Mrs. Blackacre can retain and split between them the voting shares. This arrangement is advantageous because it places control over business decisions in the hands of Mr. and Mrs. Blackacre, while allowing the children to maintain a lesser form of ownership.

The operating agreement should also designate that non-voting shares may only be liquidated by majority vote. This will devalue the children's shares and protect them from creditors, because creditors are unlikely to attempt to seize assets that cannot easily be liquidated. Creditors will be discouraged from going after non-voting shares because, even once they possess the shares, they do not have any say in when or how much will be paid out as a dividend; the transaction costs inherent in seeking attachment of the shares will outweigh the benefit to the creditor. The fact that non-voting shares are devalued will also come into play when assets begin to transfer to the next generation.

The free alienation of LLC shares can be restricted so only blood relatives of Mr. and Mrs. Blackacre may be gifted or sold shares. Such a provision ensures the assets held within the LLC are used and enjoyed only by the Blackacres. In the absence of this qualification, a disgruntled family member might attempt to sell or give away his shares to a non-relative.

A provision should designate arbitration as the sole means of settling disputes pertaining to legal rights. This will both reduce the frequency of lawsuits and make resolving disputes less costly. Because operating agreements are considered contractual in nature, an arbitration clause will be binding upon parties, unlike with an ILIT.[86] For example, the trustee may disagree with the beneficiary about how to invest the assets within the trust; a beneficiary could only stop the trustee by bringing suit for breach of fiduciary duty. Courts will generally protect a trustee acting in good faith, even if those actions are contrary to the recommendations of a beneficiary.[87]

Perhaps most critical to the day-to-day operations of the LLC is how business decisions are to be made and how the operating agreement is to be

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[85] *See* Levine, *supra* note 63.

[86] Lewis & Jones, *supra* note 5, at 53.

[87] U.T.C. § 105(b)(2) (2010).

amended. The United States Constitution provides a ready guide to craft a decision-making protocol. For the most important decisions, such as the transfer of voting shares, amendment of the operating agreement, or termination of the LLC, a vote of three-fourths shall be required.[88] For other decisions, such as purchasing new assets or deciding the face amounts of life insurance policies, a simple majority vote shall be required.[89]

An important consideration for the Blackacres will be how to pass down control of the LLC to the next generation. Alienability of voting shares requires careful drafting, because the holders of voting shares are actually making business decisions. A simple way to pass down these voting shares is by once again allowing voting shares to only be given or sold to blood relatives and also requiring a three-fourths vote to make any such transfer. This will ensure that in later generations the voting interests will only be passed on when the vast majority of shareholders controlling the business agree.

The Blackacres must also plan for the unfortunate event of a sudden or unexpected death of a voting member. They can structure the operating agreement to give the LLC the right to immediately buy back outstanding voting shares upon the death of a voting member. The money used to purchase back such shares will be included in the estate of the deceased, but any potential creditors will only be able to attach the proceeds, not the shares themselves. These shares can then either be distributed automatically between the other voting members, or, in the absence of other voting members—if both Mr. and Mrs. Blackacre die simultaneously—be distributed to their attorney to hold in trust until either one of the children come of age. This type of disaster planning will only be truly necessary during the first couple iterations of passing down the LLC. As the family grows naturally in size, the odds of every voting member dying simultaneously become ever slimmer.

Finally, a vote of three-fourths shall also be required before amending the operating agreement.[90] This will ensure that only when the agreement needs to adapt will it do so. For other more routine business decisions, such as acquiring property, a simple majority vote will suffice. It would likely be unwise to unduly restrict every decision that needs to be made regarding the Blackacre LLC.

The basic provisions outlined above form the framework within which the Blackacres can begin to work. Their decisions will likely be driven by two key goals, which will recur throughout operation of the LLC: maintaining a

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[88] *See* U.S. CONST. art. V.

[89] *See* U.S. CONST. art. I, § 7.

[90] *See* U.S. CONST. art. V.

legitimate business purpose and the ability to pay premiums on whole life policies.

There are other considerations, as well. Assets from family members should be pooled in the LLC, and each member should receive a pro rata share of any dividends. This strategy not only protects the assets from creditors[91] but also bolsters an argument against a sham transaction accusation, because shareholders in most businesses are entitled to pro rata dividends.[92] If a court were to find the LLC to lack economic substance, it may invalidate the LLC. Furthermore, whenever dividends are issued, they should be issued to each and every member according to their share, so it does not appear that a few members retain total control over the LLC.[93] Holding official meetings and maintaining proper minutes will both bolster the aforementioned claim and provide an outlet for the younger family members to understand and contribute to the Blackacre LLC.[94] Expressly creating a fiduciary duty in managing members to all other shareholders and making sure each shareholder holds more than a *de minimis* interest in the LLC is also essential.[95]

Through the aforementioned strategies, the Blackacre LLC will provide a strong foundation for the family's future. Once the company is up and running, the Blackacres can begin to manage their assets through the company, rather than as individual property. In practice, little will change, so Mr. and Mrs. Blackacre can both continue to work to provide income for themselves and for investment in their business. Over time, the assets within the LLC should grow sufficiently to allow for additional capital investment and the important step of diversification, discussed below.

C. "Tax Shelters" Distinguished and Passive Versus Active Participation

At this point, it is important to distinguish this type of family LLC from a typical "tax shelter." Tax shelters seek to reduce taxable income through creating artificial losses that can be offset against other investment or salary income. Shelters usually involve an aggressive interpretation of the tax code and engender transactions that are only entered into for the ultimate tax purpose. For example, the real estate tax shelters of the 1980s were created by inflating the value of property using nonrecourse loans to take massive

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[91] *See supra* Part IV.B.

[92] Steve R. Akers, *Update of Planning Issues for Family Limited Partnerships*, SK093 ALI-ABA Course of Study Materials (2005).

[93] *Id.*

[94] *Id.*

[95] *Id.*

depreciation deductions that could offset ordinary income.[96] Eventually, the deductions would have to be accounted for upon sale of the property, but the taxpayer received a substantial timing benefit, by deferring gains and accelerating losses.

Congress reacted to these shelters by creating passive activity loss rules.[97] Essentially, these regulations "basketized" losses from passive activities, allowing them only to offset corresponding gains from passive activities. For example, if the taxpayer has a job that pays $50,000 in income for the year and a passive real estate investment, such as a share in a rental property that loses $5,000 for the year, that $5,000 may not be used to reduce the taxpayer's taxable income to $45,000 for the year. However, if the taxpayer owned other passive investments, such as long-term stocks that gained $10,000 for the year, then the $5,000 loss from the other passive investment may be used to offset the gain from the stock. Unless the taxpayer materially participates in the enterprise, it will be considered a passive investment. Other types of shelters involve arbitrage—taking advantage of the differences in interest rates between tax-free municipal bonds and ordinary bonds.[98]

Several key factors distinguish Blackacre LLC from a "tax shelter." First, Blackacre LLC, unlike tax shelters, does not interpret the statutes regarding life insurance aggressively, but rather expressly acknowledges the intent of the legislature in allowing tax-favored treatment for life insurance products that do not cross the line from insurance to investment. Second, the Blackacre LLC is not designed to intentionally incur losses. The Blackacres hope the value of their assets appreciates over time and new income-producing assets are accumulated by the LLC.

However, in the case of a bad year in which the Blackacre LLC shows a loss, the Blackacres will have to decide in advance if they should materially participate in the business so any such losses could be used to reduce the taxable income from their salaries. If the IRS contests the Blackacres' participation, there may be costly penalties or litigation; therefore, this Author recommends passive activity designation. Net operating loss provisions in the Internal Revenue Code still allow any losses that are incurred to be carried back two years, and forward twenty.[99] Therefore, given the Blackacre's expectation of profit, the cost of materially participating likely does not

[96] *See generally* Theodore S. Sims, *Debt, Accelerated Depreciation, and the Tale of a Teakettle: Tax Shelter Abuse Reconsidered*, 42 UCLA L. Rev. 263 (1994).

[97] 26 U.S.C. § 469 (2004).

[98] *See, e.g.*, Knetsch v. United States, 364 U.S. 361 (1960).

[99] 26 U.S.C. § 172 (2009).

outweigh the benefits. Should the Blackacres wish to materially participate in the business, however, they will have to satisfy one of the following requirements: working more than five hundred hours per year, being the sole person working on the business, or working more than one hundred hours per year with no other employee working more hours than the taxpayer.[100]

Unlike an ILIT, if an LLC were created for the sole purpose of holding life insurance policies as investments, the IRS would strike it down as a sham.[101] Although this may sound ominous, as long as the Blackacre LLC satisfies the economic substance doctrine, also known as the business purpose or sham transaction doctrine, as laid out in *Gregory v. Helvering*,[102] it should not be in danger of adverse classification. Additionally, recent trends in LLC laws show less of a focus on business purpose, which may lessen the Blackacres' risk if they designate in a state that allows LLCs for any purpose.[103]

In *Helvering*, the taxpayer created a new organization, transferred stock assets into it, then dissolved the corporation, distributed the assets to herself, and claimed no gain for the distribution.[104] The transaction was based on an aggressive interpretation of section 112(g) of the Revenue Act of 1928, which allows for the nonrecognition of gain if stock is distributed to a shareholder pursuant to a reorganization.[105] The taxpayer effectively orchestrated the reorganization for the sole purpose of obtaining nonrecognition for her assets. The Court sided with the IRS and imposed tax liability, stating:

> The legal right of a taxpayer to decrease the amount of what otherwise would be his [or her] taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.[106]

The court in *Horn v. Commissioner*[107] succinctly described the sham transaction doctrine as "simply an aid to identifying tax-motivated transactions that Congress did not intend to include within the scope of a . . . benefit-

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[100] 26 U.S.C. § 469(h) (2004).

[101] 26 U.S.C. § 7701(o) (2010).

[102] 293 U.S. 465 (1935).

[103] J. William Callison, *Nine Bean-Rows LLC: Using the Limited Liability Company to Hold Vacation Homes and Other Personal-Use Property*, 38 WM. MITCHELL L. REV. 592, 592 (2012).

[104] *Helvering*, 293 U.S. at 467.

[105] *Id.*

[106] Id. at 469 (citation omitted).

[107] 968 F.2d 1229, 1238 (D.C. Cir. 1992).

granting statute."[108] The Blackacre LLC is not designed to circumvent the Internal Revenue Code, but rather to adhere strictly to its limits and intent.

The Blackacre LLC will maintain economic substance by both working within the statutes that allow tax-favored treatment of life insurance policies and by centrally managing other capital assets within the LLC. As long as the policies purchased satisfy the statutory requirements of life insurance policies and demonstrate a legitimate insurable interest, it cannot be said the Blackacres are taking advantage of a benefit Congress did not intend or one that is outside of the scope of the Internal Revenue Code. Furthermore, as the Blackacre LLC begins to manage more assets, its members will gradually become more important to the business. Life insurance policies purchased on key members of a business are a legitimate transaction, in addition to the family context.

V. DIGGING THE MOAT

A. Income-Producing Assets

Once the Blackacre LLC is in place, it is time to get to work transferring assets into it. The first thing the Blackacres will need to do is to transfer their $150,000 rental property into the LLC. This transfer is both symbolic and practical, as it demonstrates business purpose and makes managing the property more centralized. Because the LLC is a pass-through entity for tax purposes, Mr. and Mrs. Blackacre will be taxed no differently on the income from renting the property than if they had kept the assets in their own name. However, their other personal assets, such as their home and income, are now protected from liability arising from disputes with tenants.[109] If the life insurance holdings begin to substantially outweigh the rest of the assets under management, the managing members may simply diversify by purchasing other assets or by paying out dividends to shareholders.

B. Life Insurance Product Purchase

For our purposes, the Blackacre LLC will purchase variable universal life policies for Mr. and Mrs. Blackacre with a death benefit of $500,000 each and a guarantee that cash value will accumulate at a minimum of 4% annually. Policy premiums cost $5,000 per year for each policy. To fund the policies'

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[108] Id.; see generally Kevin M. Keyes & Russell S. Light, Developments in the Economic Substance Doctrine, 20 J. TAX'N INVESTMENTS 284 (2003).

[109] It is important to note the Blackacres could still be held liable for negligence or other intentional torts. While the LLC does limit liability, it does not limit all types of liability.

premiums, the LLC sells shares to Mr. and Mrs. Blackacre for capital. The Blackacres chose variable universal life, a type of whole life policy that allows variations, rather than a fixed rate of premium payments, because this is a new enterprise, and the Blackacres will want to have the option to reduce or increase their premium payments at any time.[110] Furthermore, variable universal life policies allow a statutorily defined amount of "overfunding," in which after-tax dollars are placed directly into the policies' cash value.[111] Universal policies also tend to have lower transaction costs because there is no need to use an agent as an intermediary to alter the policy.[112]

Based on data measured by an actual whole life policy's performance, after ten years the LLC will have paid $50,000 for each policy and have a total cash value of $65,000 in each policy.[113] After twenty years, it will have paid $100,000 for each policy and have a total cash value of $180,000 in each policy.[114] After thirty years, it will have paid $150,000 for each policy and have a total cash value of $360,000 in each policy.[115]

Although this may seem a hefty price tag for an investment as opposed to a simple mutual fund, in the dynastic, multigenerational context, the safeguards put in place by the existence of a death benefit and the long-term tax-deferred growth potential justify the high initial cost. The Blackacres must not forget they are putting in place a self-sustaining model, which requires a lot of momentum at the outset. While the Blackacre LLC initially purchases policies only on Mr. and Mrs. Blackacre, it will eventually go on to purchase policies on their son and daughter, their grandchildren, and so on. As wealth builds up in the LLC, policies can be purchased on new members at a young age, which gives the cash value within the policy more time to compound.

C. Insurance Policy Loans as Additional Investment Capital

Once cash value begins to build up in the policy, the LLC can use them for cash flow. The LLC will take out loans on the policy. Because a loan comes with a corresponding commitment to pay back the loan, loan proceeds

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[110] Cornelison, *supra* note 2, at 246–47.

[111] 26 U.S.C. § 7002 (1988).

[112] Cornelison, *supra* note 2, at 246–47.

[113] *Unlocking the Value of Whole Life*, MASSMUTUAL FIN. GROUP (2011), http://www.massmutual.com/mmfg/pdf/UnlockingValueWholeLife.pdf [hereinafter MASSMUTUAL FIN. GROUP].

[114] *Id.*

[115] *Id.*

are not recognizable as income by the LLC.[116] Additionally, loans are only backed by the cash value of the policies, not withdrawn from them. The insurance company cuts the LLC a check and uses the cash value and death benefit as collateral. If the loan is not paid back, the outstanding balance is deducted from the final death benefit payout.

There are two important implications arising from this special treatment of policy loans. First, cash value continues to compound while the LLC retains liquidity of assets. Second, as long as the premiums continue to be paid and the policy does not lapse, there is no set time frame in which the loans have to be paid back. Over time, insurance policy loans can be used to create cash flow for asset diversification, while continuing to compound interest within the policy. If the interest compounded exceeds the loan's interest rate—usually around 5%[117]—it is theoretically possible to increase wealth even while withdrawing liquid assets. For example, say the cash value account of Mr. Blackacre's policy totals $25,000, and he takes out a policy loan for $5,000. The $20,000 in the cash value account continues to compound, while the $5,000 loan has a fixed rate of 5%. If, after the first year of the loan, the cash value account earned 10%, the difference in interest rates—$2,000 - $250 = $1,750—works to Mr. Blackacre's favor. If a policyholder should pass away while loans are outstanding, the loan is simply paid from the death benefit proceeds, with the remainder going to the beneficiary—Blackacre LLC. In effect, this allows the LLC to leverage its eventual death benefit payout to secure immediate liquid cash at a rate of 5%. Because neither the loan nor the eventual payout is taxed, tax liability is taken out of the picture. Finally, because the insurance company does not withdraw the loan amount directly from the cash value account, gains continue to accrue while the loan is outstanding and may even exceed the interest rate in a good market year.

D. Estate Assets

To pass the assets in the Blackacre LLC on to the next generation, it is important to recognize what will happen when a voting member passes away. To that end, a brief overview of the probate process is useful. When an individual dies, everything he owns at the time of death is referred to as his "estate." The estate must be probated—the process of distributing the property of the deceased.[118] The process will depend in large part on whether the decedent has left a will—died testate—or not—died intestate. Either the will

[116] 26 U.S.C. § 61 (1984).
[117] *See* ALLIANZ, *supra* note 26.
[118] UNIF. PROBATE CODE § 3-101 (2014).

or the court will designate a personal representative to administer the estate.[119]

Administration includes notice to the public and potential creditors, who proceed to collect on any outstanding debts the decedent may have had.[120] Afterward, the residuary of property is distributed as described by will or to the decedent's heirs. The personal representative of the estate will receive from the estate a reasonable compensation for his or her work in administering the estate, which ultimately comes out of the inheritance of the heirs.[121] For this reason, most estate planning techniques revolve around removing assets from the estate before the individual passes away, thus shrinking the pool of assets, which can be diminished by creditor claims and administrative fees before being passed down to the heirs. Often, this result is achieved by placing assets into trust.

While there are many types of trusts, irrevocable trusts alienate the individual's control or ownership of assets prior to his or her death and place them into the hands of a trustee. The trustee is contractually bound by the trust agreement to invest and distribute the assets of the trust accordingly. Assets placed into such a trust avoid the probate process entirely. However, trustees, like personal representatives, are entitled to a reasonable compensation for the services they perform.[122]

There is evidence that retaining a voting interest in an LLC that owns life insurance on the individual does make a pro rata share of the payout a part of the estate.[123] This is because the decedent has a property interest in the Blackacre LLC, which is technically a distinct entity. Because the LLC is the beneficiary of the proceeds, a share of those proceeds benefit the shareholder, whether the LLC elects to issue a dividend or not. In cases of sudden or unexpected death, there may not be a way to avoid a portion of the proceeds being taxed as the decedent's estate. However, as long as the individual sells or gives away his shares of the Blackacre LLC before death, he will cease to have any "incidents of ownership" over the policy, and the proceeds will thus be effectively removed from his estate.[124]

Alternatively, an operating agreement provision that allows the buyback of outstanding shares at the moment of death also serves to remove the shares from the decedent's estate, but the value paid for the shares would be

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[119] *Id.* § 3-414.
[120] *Id.* § 1-401.
[121] *Id.* § 3-719.
[122] UNIF. TRUST CODE § 708 (2000).
[123] Miller & Maine, *supra* note 74, at 406.
[124] 26 CFR § 20.2042-1(c)(6) (2014).

included.[125] For example, suppose Mrs. Blackacre passes away at the age of ninety-five, while she owned a one-eighth voting share in Blackacre LLC. That share is part of her estate and will be sold to satisfy her debts or pass to her heirs. However, with the buyback provision in the operating agreement, the Blackacre LLC could buy back Mrs. Blackacre's shares using some of the proceeds from the death benefit. In this way, the cash would go into her estate, but the voting shares would remain with the company. So, if Blackacre LLC buys back the shares for $50,000, then that money would be a part of Mrs. Blackacre's estate. This would leave $950,000 in tax-free income to the rest of the family, assuming there were no outstanding policy loans at the time of death.

Say Blackacre LLC had taken out a loan of $100,000 five years earlier to invest in another rental property and had not made any payments on it by the time of Mrs. Blackacre's death. The result would be the same, but the $950,000 of tax-free income would be reduced by the balance of the loan—about $125,000—so the Blackacre LLC would only receive $825,000. The importance of this illustration is to show the Blackacres have essentially borrowed from their own future income to fund investments in the present. The important thing is the funds are safely tied up in the LLC, where they will not be liable for estate taxes.

Suppose Mrs. Blackacre is getting on in years and wants to avoid having any of the LLC's assets in her estate. She can act both while living and through her will to further bolster the LLC. First, while living, she could simply sell or gift her shares until she has none left. In fact, Blackacre LLC could even use a policy loan to buy back Mrs. Blackacre's shares. The proceeds could then be placed in trust to avoid probate. Through her will, assuming she does not have any outstanding debts, she could gift assets titled in her name to the LLC. The LLC would then also receive the benefit of "stepped-up" tax basis, in which the LLC would receive basis equal to the fair market value of whatever property had been gifted.[126]

For example, suppose the family's principal residence is titled in her name, and Mr. Blackacre predeceased her. Presumably, during her ownership of the residence, it would have appreciated in value. Suppose she bought the house for $150,000, and it is now worth $250,000. Normally, if she were to sell the house, ignoring the principal residence exception,[127] she would have to recognize $100,000 of taxable gain. Similarly, if she gifted the house to her

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[125] 26 U.S.C. § 691(a)(2) (2004).
[126] 26 U.S.C. § 1014 (2010).
[127] *Id.* § 121.

daughter while living, her daughter would receive Mrs. Blackacre's substituted basis of $150,000 and would also have to recognize taxable gain upon sale. But, if Mrs. Blackacre gifted the property by will to the LLC, the LLC would have basis of $250,000, rather than $150,000, and could sell the house at that price without recognizing any taxable gain.[128] Importantly, this is a one-way street. The LLC cannot gift assets to individuals in this manner because, as a fictional entity, it cannot die. What this does allow is for the LLC to benefit from stepped-up basis in any property gifted to it by will. Combine these tax-free proceeds with the tax-free death benefit payout, and the Blackacre LLC would have substantial assets for use and investment by the later generations in a relatively short amount of time.

VI. PULLING UP THE DRAWBRIDGE

A. Gifting Shares of Devalued Assets

LLC shares can be gifted at a value discounted due to the lack of marketability. This discount serves to maximize the actual assets that can be gifted each year under the yearly exemption amount. For example, suppose Mr. and Mrs. Blackacre wanted to gift their son $50,000 over the course of five years without incurring gift taxes. Rather than simply giving cash each year at the annual exclusion amount, the Blackacre LLC can gift non-voting shares of the LLC to the son. The shares can pay out dividends, but the value of the shares is less than cash because they are subject to the lack of alienability clause in the operating agreement and do not convey any sort of control over the Blackacre LLC itself. This explains why we drafted our operating agreement in such a way that only non-voting shares are distributed to general members, while voting shares are more carefully protected.[129]

B. "Crummey" Gifting and Lifetime Exclusions

Mr. and Mrs. Blackacre intend to gradually give away all of their shares of the company to their children and grandchildren by the time they are eighty years old. However, they do not want to incur any gift tax liability for these transfers. For gifts to minors, the Blackacres can take advantage of "Crummey Trust" gifting.[130] The Blackacres can also apply their lifetime exclusion to

[128] Id. § 1014.

[129] See infra Part IV.B.

[130] Bradley E.S. Fogel, Back to the Future Interest: The Origin and Questionable Legal Basis of the Use of Crummey Withdrawal Powers to Obtain the Federal Gift Tax Annual Exclusion, 6

gifts in excess of the annual exclusion amount. If the estate of each Blackacre family member is reduced through gifting and trust allocation, the older Blackacres will incur no gift or estate taxes for the transfer of Blackacre LLC shares.

A gift to a minor is normally under the control of the parent until the minor comes of age. However, to allow the child to receive the full amount of the gift, while still getting gift tax exclusion treatment, gifts will be placed in a Crummey Trust. Essentially the minor will be given a time frame within which to take control of the gift. If the time lapses and the recipient has not taken control, the gift is placed in trust. The terms of this trust could allow for complete transfer upon the minor's eighteenth birthday. The key is both the annual gift tax exclusion and lifetime exclusions will apply to the gift because it is technically a current interest. If shares are placed into this type of trust for the minor, any dividends paid out by the LLC will be kept in trust until the minor comes of age.

We have already examined how to devalue the shares that will be gifted; now we will examine the balance between annual and lifetime gift tax exclusions and residuary estate exemptions. Currently, an individual can gift up to $14,000, and a married couple up to $28,000, worth of property per year without incurring gift tax liability.[131] In addition, although any amount above the annual exclusion gives rise to tax liability, the grantor is not out of pocket if he elects to use his lifetime exclusion amount.[132] Using the lifetime exclusion allows a taxpayer to avoid having to pay the gift tax in the year of the gift, but the amount that is taxed must be deducted from the taxpayer's estate tax exclusion amount.[133] For an individual, this amount is about $5 million and for a married couple about $10 million.[134]

For example, suppose Mr. Blackacre gifts his daughter shares of Blackacre LLC valued at $114,000. The first $14,000 will be applied to Mr. Blackacre's annual exclusion, assuming this is the only gift he gives this year. For the other $100,000, Mr. Blackacre can either elect to pay the gift tax that year or deduct the amount from his estate exemption. Afterwards, his estate would only be exempt from taxation to the extent of $4.9 million. The key to properly utilizing the lifetime exclusion is to carefully monitor the size of the

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Fla. Tax Rev. 187, 193 (2003) ("A Crummey power is a temporary power, which is generally given to the beneficiaries of the trust, to withdraw an aliquot portion of a gift made to the trust."); see Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

[131] 26 U.S.C. § 2503(b) (1998).

[132] 26 U.S.C. § 2505 (2010).

[133] *Id*.

[134] *Id.*

estate so the entire estate is not taxed, as well as using the remainder of the lifetime exclusion to avoid gift tax liability during the lifetime of the taxpayer.

C. Succession, Perpetuity, and Viability

Assuming stable market conditions, the Blackacre LLC should continue to grow. As the elder generation passes away, the coffers of the LLC become saturated with tax-free income. This influx of capital may in turn be used to diversify and invest in other business ventures. Perhaps most importantly, the death benefit can be used to fund future life insurance policies on the next generation. If the Blackacre family is fruitful and multiplies, the investments should grow nearly exponentially.[135]

Two case studies serve to illustrate the viability of this type of investment. Before the insurable interest requirement had become strictly enforced, these types of policies were heavily abused by large corporations.[136] These corporations would purchase and own single-premium whole life policies on any employee who walked in the door, without notifying the employee.[137] Whenever the employee happened to die, whether or not they still happened to be working for that corporation, the corporation would reap the death benefits, tax-free.[138] Additionally, the corporations would use the cash value built up in the policies as collateral for loans, even deducting the interest.[139]

These types of policies were more commonly known to the corporations as "dead peasant policies" or "janitor policies."[140] The more policies the corporation was able to purchase, the wealthier it became when the insureds passed away. Eventually, the abuse was curbed by the abolition of single-premium life insurance purchases and the mandatory insurable interest.[141]

Insurable interest means, to purchase and own life insurance on another person's life, the owner must have a valid interest in the insured's life.[142] Without a valid interest or advantage in the life of the insured, a named beneficiary would simply be purchasing a wager under which the purchaser

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[135] *See infra* Diagram B.

[136] Susan Lorde Martin, *Corporate-Owned Life Insurance: Another Financial Scheme That Takes Advantage of Employees and Shareholders*, 58 U. MIAMI L. REV. 653, 653 (2004).

[137] *Id.*

[138] *Id.*

[139] *Id.* at 670.

[140] *Id.* at 653.

[141] Martin, *supra* note 136, at 653.

[142] *Id.* at 655.

would "win" if the insured died.[143] Before the law of insurable interest, people used to do just that, purchasing life insurance policies on celebrities or complete strangers.[144] Clearly, it is bad public policy to allow a person to have an interest in the death of a stranger.[145] Today, "an insurable interest . . . must . . . reasonably justify a well-grounded expectation of advantage, dependent upon the life insured . . . ."[146]

For example, the National Broadcasting Company (NBC) would have an insurable interest in Jimmy Fallon's life, because his continued existence is substantially vital to its business. NBC could purchase what is called a "key employee" life insurance policy on Jimmy Fallon but could not purchase a similar policy on the life of the studio's janitor. Furthermore, consent of the insured has been more strictly required in a minority of jurisdictions.[147] The Blackacre LLC would not be disqualified under the tax reform rules because the insureds would not only be family members, upon whom other family members have an insurable interest in most jurisdictions,[148] but they would also likely qualify as key employees. Additionally, the Blackacre LLC is not purchasing single-premium policies, but rather building the cash value more reasonably and within the bounds allowable by statute.

Essentially, the strategy is to mimic the practices of corporate "janitor policies" but to do so in a way that does not aggressively interpret or abuse the Internal Revenue Code. Blackacre LLC cannot deduct interest on loans it takes on policies it owns and will have an undeniable insurable interest on each family member, along with that family member's consent. Furthermore, Blackacre LLC will never be a publicly traded company with outside stockholders, so there is no need to conceal life insurance activity to promote a "bottom line" or artificially increase the LLC's valuation.

The second case study is the Walton family, of Wal-Mart fame. The Walton family utilized a family LLC, not only to centralize and manage wealth but also to involve their entire family in business decisions.[149] In his book, Sam Walton talks about the non-economic value of the family LLC and how bringing the family together to make decisions regarding the business was an important exercise and teaching tool.[150]

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[143] *Id.*

[144] *Id.*

[145] *Id.* at 656.

[146] *Id.* at 655.

[147] *Id.* at 653.

[148] *Id.* at 656.

[149] *See generally* SAM WALTON: MADE IN AMERICA (1993).

[150] *Id.*

As the LLC grows in size and assets, disputes will inevitably arise. The best way to avoid these costly disagreements is to require a majority vote on all major business decisions within the operating agreement. Another useful provision is a vote to force a buyback of outstanding shares from a particular individual. Members of the LLC who are uncooperative, or wish to squander the assets, will thus be prevented from doing so. In this way, the self-interest of each member will be aligned in fueling the growth of the Blackacre LLC.

Another potential advantage of family owned and operated LLCs is business organization and corporate governance will become more familiar to more people. This knowledge is also readily applicable to many other businesses a family member might desire to start. Such knowledge may also be useful in creating a business plan and obtaining approval for capital loans, as experience in prior successful business ventures is an important leverage.

D. Cost-Effectiveness and Irrevocable Trusts Distinguished

Individuals can take advantage of many of the same estate tax benefits through the use of irrevocable trusts. When property is placed in trust, legal ownership is transferred to the trustee, removing the asset from the grantor's estate. While anyone can serve as a trustee, typically an attorney is retained to both draft the trust agreement and serve as trustee. The cost of drafting a trust and drafting an LLC operating agreement is likely to be about the same. However, after the operating agreement is finalized, the assets transferred to the LLC remain under control of the voting members, rather than a trustee. The key difference is a trustee is entitled to a reasonable fee for managing the assets in trust.[151] While a family member serving as trustee might waive such fees, an attorney is unlikely to do so. Therefore, having the family working together to manage the LLC will avoid these costs. While the difference may not seem significant, over the course of the LLC, which is indefinite, the savings will accrue.

The family will also have more interest in preserving and increasing its assets than a third party attorney. Although an attorney-trustee will have a fiduciary duty to use reasonable skill and care in administering a trust,[152] he or she will not be as directly interested in the increase and preservation of the family's assets as the family itself. The more direct interest, and savings on administration costs, give the family LLC a distinct advantage over a traditional irrevocable trust.

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[151] UNIF. TRUST CODE § 708 (2010).

[152] UNIF. TRUST CODE § 802 (2014).

An argument can also be made that the liberalization of trust decanting statutes and availability allows the irrevocable trust to be adapted. However, such adaptations must be either instituted or approved by the trustee. Furthermore, a decanting trust has limits, in that the original trust cannot be changed drastically, while the LLC may be completely dissolved or re-worked at any point in time.

E. Changes in the Law

As the tax reforms of the mid-1980s demonstrate, the government is capable of instituting broad policies to limit the effectiveness of life insurance as an investment. One might be wary of potential future amendments that limit the viability of this model. However, there are two important considerations that serve to limit the risk of tax reform. The first is, although not technically required to, the IRS will often grandfather in transactions that took place under older tax codes.[153] The second is an LLC, unlike an ILIT, is based on an amendable operating agreement. Were a devastating tax reform to come down the pike, the voting members of the Blackacre LLC will be able to respond by amending their business model.

Suppose, for example, the estate tax is repealed as it was in 2010, and this time the change is permanent. A taxpayer without debt who placed his or her assets in an irrevocable trust to avoid probate taxation will lose money in the form of fees for trust management. However, the Blackacre LLC could choose to terminate and distribute all of its assets to the family. The difference is, while both forms of investment had costs, the LLC can be undone, while an irrevocable trust cannot.

VII. CONCLUSION

The basic framework described in this Article is one that is accessible to the enterprising middle class family, who wish to set up a more hands-on approach to managing its assets than placing them in trust. The minimal fees for drafting the agreements and filing the LLC are far less than the ongoing legal costs associated with managing a trust. Benefits of the LLC structure are more than simply financial, as demonstrated by the Walton family and others, who use the family LLC as a teaching tool for managing assets for the next generation. Not only is asset management itself a useful skill in and of itself, but the general business organization and operative knowledge that comes with

[153] *See generally* J. E. Keefe, Jr., *Construction of "Grandfather Clause" of Statute or Ordinance Regulating or Licensing Business or Occupation*, 4 A.L.R.2d 667 (2009).

creating this structure is universally applicable in other business contexts. The contractual form and arbitration requirements further ensure familial disputes are either repressed, through majority voting, or handled as efficiently as possible without the hefty cost of litigation.

Most importantly, the modern whole life insurance products offer a unique way to amass and transfer wealth from one generation to the next without tax liability. The concept has been tested and proved on a larger scale by companies that utilized "janitor policies" to boost their profit margins. Through this system, a family of relatively modest means can manage its assets and estate with relative autonomy.

The castle metaphor was carefully chosen to evoke not just the protection and insulation of wealth but also to warn of the uncertainty of the future. The same evolutions that rendered the medieval castle obsolete may in turn destroy this one, no matter how carefully constructed. Siege, by which the inhabitants are gradually starved into surrender, may come in the form of restrictive tax reform. Although normally grandfather clauses may apply, there is never a guarantee. The cannonball, which shattered the mighty walls, may come in the form of as yet undreamt of global events and changing geopolitical landscapes. That being said, we have little choice but to utilize the best tools at our disposal today. By combining different techniques in new and unpredictable ways, we are able to preserve the wealth of our clients to themselves and their posterity to the absolute best of our knowledge and ability.

Diagram A:

Diagram B:

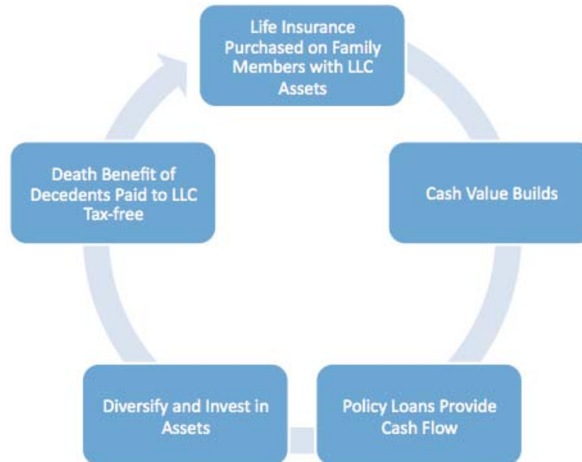

Diagram C: