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Because you asked

Insurance LLCs

Buy-sell planning generally falls under two main types: cross-purchase or entity redemption. Under a cross-purchase arrangement, existing owners agree among themselves to purchase each other's business interests after a specified triggering event, such as death or disability. Alternatively, under an entity redemption arrangement, the business itself will agree to purchase an owner's interest under the same sort of circumstances, in an agreement between the business and each owner. Oftentimes a hybrid variation of cross-purchase and entity redemption is desired, especially when life insurance will be used as the primary funding source for the purchase obligations. This piece will explore one such variation, the Insurance LLC, and how this unique arrangement can help address a myriad of planning needs.

INSURANCE PRODUCTS	
MAY LOSE VALUE	NOT A DEPOSIT
NOT BANK GUARANTEED	NOT FDIC INSURED
NOT INSURED BY ANY GOVERNMENT AGENCY	

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1. What is an Insurance LLC?

An Insurance LLC is a limited liability company (LLC) created to own and manage one or more life insurance policies to help meet the obligations under a buy-sell agreement. The Insurance LLC is a new business entity formed under local law, separate and apart from the business or businesses that are subject to the primary buy-sell obligations.

The Insurance LLC is created by the owners of the business when the buy-sell agreement is executed or shortly thereafter. Typically, the membership interests of the Insurance LLC will mirror the ownership interests of the primary business. While not a requirement, the LLC will often be managed by a third-party manager — i.e., not the owners subject to the buy-sell agreement — to avoid potential incidents of ownership in the life insurance policies purchased by the LLC. See [question 10](#) for more about incidents of ownership.

The Insurance LLC is created under local law and will elect to be taxed as a partnership for federal income tax purposes.

2. How is an Insurance LLC used for buy-sell planning?

The owners of the business subject to the buy-sell agreement are also the members of the Insurance LLC. Under the buy-sell agreement, each owner agrees to buy each other owner's interest in the primary business under certain specified circumstances and each owner likewise agrees to sell their interest (i.e., a cross-purchase arrangement). A less common variation is that the Insurance LLC will be a party to the buy-sell agreement with each owner of the primary business and will itself buy the shares from the estate and distribute shares out to the surviving members. These circumstances will typically include the death or disability of an owner, but may also include other circumstances (e.g., a pre-emptive purchase if an owner attempts to sell to an unauthorized outsider).

To help provide liquidity for its members' obligations under the buy-sell agreement, the Insurance LLC will purchase life insurance on the life of each owner/LLC member in an amount sufficient to purchase each insured's interest in the business under the buy-sell agreement and also the insured's interest in the Insurance LLC. The Insurance LLC will distribute death benefit to surviving members to fund the purchase by those members of a decedent's interest. After the purchase and sale of the business interest under the buy-sell agreement and of the interest in the Insurance LLC, the selling owner ceases to be a member of the Insurance LLC by its terms.

Example

A, B, and C are equal co-owners of Company, currently valued at \$4.5 million. To facilitate the succession of Company, the owners enter into a buy-sell agreement and simultaneously create LLC together with X, an independent third-party who will be responsible for managing LLC. A, B, and C contribute property to LLC and will own virtually all interests in it. LLC will purchase one life insurance policy on each of A, B, and C with a face amount of \$2 million. The owners determined that this amount would be enough for the foreseeable future to liquidate an owner's share of Company as well as each owner's interest in LLC, upon a triggering event (e.g., death or disability) under their buy-sell agreement.

3. What advantages does the Insurance LLC offer?

In many important ways, the Insurance LLC combines the best features of traditional cross-purchase buy-sell arrangements with the best of entity redemption arrangements, all in a flexible package that can evolve with the business that it serves. Some of the benefits from this type of arrangement include:

- Surviving business owners receive a step-up in tax basis in the shares/interests acquired in the primary business, as is common with traditional cross-purchase arrangements;
- Only one policy per business owner is required, like traditional entity redemption arrangements;
- When an owner retires or leaves the business, the parties to the arrangement don't need to unwind the policies, as is common with a traditional cross-purchase arrangement; instead, the policy on the departing owner's life can be distributed to them from the Insurance LLC;
- Policies and buy-sell obligations can be coordinated and managed by a single, trusted manager, avoiding the risk of relying on each of the business owners to be fully prepared and shielding the arrangement from the creditors of the individual owners and the separate business;
- The Insurance LLC can easily be amended as needed to reflect changes in the ownership of the business;
- A properly drafted and administered Insurance LLC creates a partnership relationship among the owners of the business, which can be helpful if transfer-for-value issues arise. See [question 6](#).



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4. How are premiums paid for by the Insurance LLC?

The most common funding method requires the LLC members to contribute cash or property to the LLC to cover the insurance premiums. The amount that each partner contributes is generally in proportion to their interests in the LLC or based on their interests in policies not insuring their own life. Such contributions, if done properly, will be treated as income tax-free contributions to the capital account of the contributing member. The manager will then use some or all of such contributions to pay premiums on the life insurance policies as they come due. The Insurance LLC agreement will typically contain a provision that allows the manager to call for additional contributions from the members if necessary. The Insurance LLC also can access excess property and cash that it owns, if any, including cash accumulation in the life insurance policies via withdrawals or loans if necessary. An alternative funding arrangement considers having the primary business fund the premiums via a split-dollar loan agreement. Of course, the Insurance LLC has available to it the full range of funding techniques that we see employed with other business-owned life insurance and irrevocable life insurance trusts such as premium financing and private financing.

5. Does the Insurance LLC need to get notice and consent under IRC §101(j)?

This is not clearcut, but likely a good idea. According to IRC §101(j), “employer-owned life insurance” applies to life insurance owned by an employer that insures the life of an employee; the definition of employee includes an officer or director of the employer. A member of the Insurance LLC may likely be considered an officer or director of the Insurance LLC, and therefore an employee for purposes of §101(j). If the life insurance falls within the definition of employer-owned life insurance, then the death benefit is income taxable to the

employer unless an exception applies and the notice and consent requirements of IRC §101(j)(4) are satisfied before the policy is issued. Exceptions to the taxability rule fall under the headings of either (a) the “status” of the insured or (b) the “use” to which the death benefit is put.

The definitions and rules under IRC §101(j) should be carefully examined before a life insurance policy is purchased by the Insurance LLC and, if found applicable, the notice and consent requirements must be met before a policy is issued. These requirements are rather straightforward and should be easy to satisfy with close attention.

For more information on §101(j) and employer-owned insurance, [click here](#).

6. Is a transfer of an existing life insurance policy to or from an Insurance LLC a “transfer for value” or a “reportable policy sale?”

A transfer of an existing life insurance policy to or from an Insurance LLC under almost all circumstances will constitute a “transfer for value,” but an exception to the rule may apply, keeping the death benefit income tax-free. As background, IRC § 101(a) provides that death benefit from a life insurance policy is typically received income tax-free, unless such policy has been transferred for valuable consideration and none of the outlined exceptions apply. In the case of a transfer of an existing life insurance policy to an Insurance LLC (taxed as a partnership), the transfer would likely meet the transfer-for-value exception applicable to transfers to a partnership in which the insured is a partner, thus preserving the income tax-free benefits of the policy.¹ Likewise, a transfer of a life insurance policy from the Insurance LLC to a member would also be a transfer for value, but would likely qualify under a different exception, most commonly (a) a transfer to the insured or (b) a transfer to a partner of the insured.²

As a reminder, however, the exceptions to the transfer-for-value rules will not apply if the transfer in question constitutes a “reportable policy sale” as defined by IRC §101(a)(3). That being said, in most cases the members of the Insurance LLC and the Insurance LLC will likely qualify as having a “substantial family, business, or financial relationship with the insured” and, therefore, a transfer of the policy between the members and the Insurance LLC would not qualify as a reportable policy sale.³

As with IRC §101(j) above, the provisions and regulations governing a reportable policy sale should be carefully examined by legal counsel to ensure that transfers to and from the Insurance LLC do not qualify as a reportable policy sale. For more information about these rules, [click here](#).



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7. What happens if an owner of the business retires?

When an owner retires, they typically will have their interest in the Insurance LLC liquidated and will sell the interests in the primary business to the other owners as specified in the buy-sell agreement. As part of the liquidation from the Insurance LLC, the departing owner may receive a distribution of cash or property; in particular, the departing member may receive the policy insuring their life as part of this liquidation. If the policy insuring the departing owner's life is distributed to them, such distribution is typically not a taxable event, allowing the insured to take over the ownership of the policy for personal needs without the LLC or the insured having to recognize gain in the policy.⁴ When the distribution of the policy is in liquidation of the owner's interest in the Insurance LLC, the owner's basis in the distributed policy generally will be equal to the owner's outside basis in the LLC.⁵

Once the departing business owner is liquidated from the LLC, the remaining members can access cash value or other assets in the LLC toward the purchase of the departing owner's primary business interests. The remaining owners may consider using the assets or cash value in the LLC to pay the agreed-upon value to help with the purchase of the primary business interests; alternatively, they may use an installment note, as specified in their buy-sell agreement, to pay for the purchase over time.

Example

Continuing our example from [question 2](#), assume that B does not die, but C, who is now 67 years old, decides to retire from the business. Their buy-sell agreement allows A and B to purchase C's interest in the primary business before C can sell to anyone else. Their Insurance LLC agreement also allows C to leave the partnership and liquidate his interests upon his retirement. C's interest in the Insurance LLC is liquidated based on capital account value, which is based on C's contributions to the Insurance LLC and the approximate current value of the policy insuring C's life. C receives the policy income tax-free as part of the liquidation from the LLC and C's basis in the policy may be adjusted depending on C's "outside basis" in the partnership.

A and B also elect to purchase C's interests in the primary business per their buy-sell agreement. They decide to use some of the cash value of the policies owned in the LLC to provide a down payment on the purchase and provide an installment promissory note to C to pay off the remaining fair market value over 15 years at applicable interest rates.

8. What happens when a business owner dies?

When an owner dies, the Insurance LLC receives the death benefit from the policy on that owner's life, income tax-free. The Insurance LLC immediately makes a special allocation that credits the receipt of the death benefit only to the capital accounts of the surviving members, as directed by the operating agreement. Following receipt of the death benefit, the Insurance LLC will typically:

1. redeem the decedent's interest in the Insurance LLC from the decedent's estate using part of the death benefit proceeds; and
2. distribute the remainder to the surviving members of the Insurance LLC according to the terms of the operating agreement.

The death benefit provides the liquidity necessary for each member to satisfy their obligation to purchase the decedent's interest in the business at the price set by the buy-sell agreement.

The Insurance LLC then continues to maintain the remaining life insurance policies in case a purchase from another owner is triggered under the buy-sell agreement. If a new owner is admitted to the underlying business, that new owner would be required to also become a member of the Insurance LLC, which will then take out a life insurance policy on the new owner's life. The Insurance LLC can be amended to accommodate changes to the underlying buy-sell agreement, so it is as flexible as the owners may need it to be.



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Example

Continuing our example, assume that B dies. LLC applies for and receives the death benefit of \$2 million from its policy insuring B's life. LLC makes a special allocation of the death benefit only among the capital accounts of A and C. Even though the death benefit is received by LLC income tax-free, it nonetheless constitutes income to LLC that increases the basis of the members to whom it is allocated.

LLC uses \$500,000 of the death benefit to liquidate B's LLC interest from B's estate (which represents B's one-third interest in LLC, not including the \$2 million death benefit allocated to A and C) and then distributes the remaining \$1.5 million death benefit equally to A and C. This distribution to A and C is received income tax-free because of the basis increase received from the special allocation previously mentioned. A and C then use the distribution to purchase the shares of Company from B's estate, as obligated under the buy-sell agreement. A and C each receive a step-up in basis on the purchased interest equal to the price paid.

9. Are death benefits received by the Insurance LLC taxable?

Generally, no. As owner of the life insurance policies, the Insurance LLC should receive the death benefit income tax-free under §101(a) of the Internal Revenue Code. The receipt of the death benefit will be allocated to the capital accounts of the surviving LLC members

according to the Insurance LLC agreement⁶ and will increase the tax basis of a member's interest in the Insurance LLC in an amount equal to the allocation.⁷ When the Insurance LLC distributes the death benefit to a surviving LLC member to fund the purchase obligation under the buy-sell agreement, that distribution, if characterized properly, should be treated as a distribution from the capital account of the recipient member and should therefore be received by the member income tax-free as well.

See [question 5](#) regarding important considerations about the potential application of IRC §101(j), which could impact the taxability of the death benefit.

10. Are death benefits includable in the insured's estate under IRC §2042?

With proper drafting and administration of the Insurance LLC, the risk of estate inclusion under IRC §2042 can be minimized. Under IRC §2042, a decedent's gross estate includes death benefit from life insurance insuring the decedent's life with respect to which the decedent possessed any "incidents of ownership" at the time of death. The Insurance LLC can be drafted such that management of the Insurance LLC, including all power to exercise incidents of ownership in the life insurance owned by the Insurance LLC, is reserved to an independent manager who is neither an owner of the primary business that is the subject of the buy-sell agreement nor a member of the Insurance LLC. The LLC members typically will have no power to take any action with respect to the life insurance policies.⁸

If the Insurance LLC gives a member the right to purchase the contract insuring the member's life under certain circumstances, that right can be triggered by events either beyond the member's control (e.g., disability) or acts of independent significance (e.g., leaving the business, retirement, etc.) thus minimizing incidents of ownership.

Example

Continuing our example, when A, B, and C entered into their buy-sell agreement and simultaneously created LLC, they included X as the manager of LLC. X is not an owner of Company and holds no membership interest in LLC. A, B, and C hold equal interest in 100% of LLC but have no power to take action with respect to the life insurance policies insuring their lives that are owned by LLC. All such authority is held by X, who is guided and bound by the provisions of the LLC founding documents.

11. Can death benefit be allocated to just the surviving owners of the Insurance LLC?

Yes. Section 704(a) of the Internal Revenue Code provides that a member's distributive share of income, gain, loss, deduction, or credit may be determined by the partnership agreement. An allocation that departs from the members' proportional ownership interest in the Insurance LLC should be respected so long as it has "substantial economic effect," meaning that the allocation in fact changes the members' individual shares of income or loss from the Insurance LLC as well as their tax consequences of the allocation.⁹

The Insurance LLC should be drafted by competent counsel familiar with partnership law and federal income taxation.



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1. §101(a)(2)(B). But see Rev. Proc. 2023-3, where the IRS has indicated that it will not rule on whether an insurance-only LLC will be treated as a partnership for tax purposes or whether the transfer of policies to the insurance-only LLC is exempt from the transfer-for-value rules under §101.

2. Ibid.

3. Treas. Reg. §1.101-1(d)(3) and (4)

4. IRC §731

5. §732

6. §703(b)

7. §705(a)(1)(A)

8. PLR 200747002

9. §704(b), and IRS Treas. Reg. S1.704-1(b)(2)

Loans and withdrawals will reduce the death benefit and the cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Withdrawals in excess of the cost basis (premiums paid) will be subject to tax and certain withdrawals within the first 15 years may be subject to recapture tax. Additionally, policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½.

Withdrawals are available after the first policy year.

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Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are few exceptions such as when a life insurance policy has been transferred for valuable consideration.

Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds. There can be costs associated with drafting a trust.

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