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THE COUNSELOR

The newsletter of the ISBA's Section on Business Advice & Financial Planning

Retirement plans, insurance and taxes

Publisher's note: In response to "The 70-80 percent tax trap: How to help clients avoid the double taxation of money in their qualified plan or IRA," which appeared in the last issue of The Counselor, a reader noted that the IRS has since issued guidance to shut down what it considers "abusive transactions" involving specially designed life insurance policies in retirement plans (so-called "section 412(i) plans").

The following excerpt is from an IRS press release dated February 13, 2004. Obviously, practitioners who are considering the "section 412(i) plan" option should read the release and related documents.

Today, the Treasury Department and the Internal Revenue Service issued guid-

ance to shut down abusive transactions involving specially designed life insurance policies in retirement plans, section "412(i) plans." The guidance designates certain arrangements as "listed transactions" for tax-shelter reporting purposes.

A "section 412(i) plan" is a tax-qualified retirement plan that is funded entirely by a life insurance contract or an annuity. The employer claims tax deductions for contributions that are used by the plan to pay premiums on an insurance contract covering an employee. The plan may hold the contract until the employee dies, or it may distribute or sell the contract to the employee at a specific point, such as when the employee retires.

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"The guidance targets specific abuses occurring with section 412(i) plans," stated Assistant Secretary for Tax Policy Pam Olson. "There are many legitimate section 412(i) plans, but some push the envelope, claiming tax results for employees and employers that do not reflect the underlying economics of the arrangements. ..."

For the full text of the release and links to Revenue Rulings 2004-20 and 2004-21, Revenue Procedure 2004-16, and related proposed regulations, visit the IRS Web site at <<http://www.irs.gov/newsroom/article/0,,id=120409,00.html>>

Advantageous uses of LLCs

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Introduction

Illinois Limited Liability Companies ("LLC") are governed by the Illinois Liability Company Act, 805 ILCS 180/1-1("LLCA").

An LLC is a separate legal entity and requires certain procedural steps be followed. First, the LLC organizer(s) must file articles of organization (the LLC counterpart to a corporation's Articles

of Incorporation) with the appropriate state agency (generally, the Secretary of State) and must include all the information required including the name and address of the principal place of business of the LLC; its period of duration; the business purpose (ordinarily, language to the effect of for the transaction of any or all lawful business for which limited liability companies may be organized under the Limited Liability Company Act); the registered agent's name, the registered agent's address; the name(s) and address(es) of the initial LLC's manager(s) or members; and a statement indicating that the LLC is managed by managers; the names and addresses of each organizer; and any other provision the members/managers elect to include.

Name selection is important as the name must be approved by the Secretary of State (the purpose of this approval is to prohibit the use of the same or similar names by two different business entities). An LLC must contain either the words "Limited Liability Company" or the abbreviations "L.L.C." or "LLC" after its name to indicate that it is an LLC. The use of the following words or abbreviations are prohibited: "Corporation," "Corp.," "Incorporated," "Inc.," "Ltd.," "Co.," "Limited Partnership," or "L.P."

An operating agreement detailing the rights and duties of all of the members is then drafted. Language is also included governing business succession and ownership interest transfer restrictions. Even though more expensive to

IN THIS ISSUE

- Retirement plans, insurance and taxes 1
- Advantageous uses of LLCs 1

create than a corporation, the costs associated with forming an LLC are relatively minimal in relationship to the asset protection features inherent in a properly drafted operating agreement in addition to statutory protection.

LLC basic advantages

Because of their flexibility and relative simplicity, the LLC is well suited for both start-up businesses and more mature businesses. LLCs have several advantages:

- LLCs provide greater management flexibility than corporations. For instance, corporations are required to have a formal structure with directors and corporate officers. LLCs are simply run by the members or managers.¹
- LLCs provide greater flexibility with regard to income distribution than do corporations. When corporations pay dividends, those profits must be distributed evenly on a dollar per share basis. LLCs may distribute income as desired.
- If a small business is interested in "pass-through" taxation, then LLCs have an advantage over S Corporations with regard to ownership flexibility. All shareholders of S Corporations must be citizens or permanent residents of the United States and there may be no more than 75 shareholders in total. LLCs do not have these restrictions, again allowing greater operating flexibility.
- Caveat: LLC distributions, unless structured properly pursuant to its operating agreement are generally subject to self-employment tax, whereas, dividends paid by S Corporations are not.

Use of a single-member LLC

A single-member LLC provides considerable flexibility for its owner. Individuals forming a new business may choose to forego the liability of operating the business as a sole proprietorship, or the forming a corporation to own the business, by creating a single-member LLC which would own and operate the business and assets. The single-member LLC provides advantages over partnerships with a single equity source because a single-member LLC eliminates the need to have two or more owners and this may result in fewer costs by avoiding the need for creation of more than one

legal entity to act as "partners." Additionally, single-member LLCs may be used to own multiple divisions of a business or multiple real properties.

A disadvantage of a single member LLC when owned by an individual or an otherwise disregarded entity for income tax purposes is the requirement of filing 1040 Schedule C. Unfortunately, Schedule C taxpayers have a higher audit incidence than non-Schedule C taxpayers.²

To hold real estate

Owning, developing and operating commercial real estate may be a liability-prone business. The owners of real estate can limit their liability with an LLC. However, LLC owners may not be fully exculpated from real estate liabilities using an LLC, because lenders often may require LLC members to personally guarantee loans.

LLCs may own, operate, and lease as a landlord, real estate. 805 ILCS 180/1-30(3) and (4). The LLC is not required to disclose its member's identity unless they are also the LLC organizers or managers. 805 ILCS 180/5-5(a)(4), (5) and (7).

Investors in real estate joint ventures may seek to obtain limited liability by becoming a limited partner. However, limited partners risk losing their protection against liability if they participate in control and management of a limited partnership. See 805 ILCS 210/303. Alternatively, an LLC will give the same investor the benefit of limited liability and the ability to manage the business. For example, a firm owning several real estate projects may form an LLC to own each project separate and apart from ownership of the other projects.³ This structure may have the effect of isolating liabilities to a given project or property.

LLCs also may be used in connection with like-kind exchanges intended to qualify under Code I.R.C. §1031. The general rule requires that the party who transferred the exchange property must receive replacement property received in an exchange. This requirement may create issues in that the transferor of the exchange property may wish to insulate itself from personal liabilities in connection with the exchange property, perhaps because of the different nature of the replacement property or because for historical reasons the exchange property had been vested in the transferee rather than in a single-purpose limited

liability entity such as a corporation, limited partnership, or LLC.

an LLC will be disregarded as a separate entity for income tax purposes, and the replacement property may be received by an LLC whose single member is the transferor of the exchange property, thereby permitting both completion of a like-kind exchange under Code I.R.C. § 1031 and limited liability for the transferor as a member in the LLC that receives the replacement property. Additionally, under very limited circumstances, the IRS has permitted the use of a two-member LLC to be treated as a disregarded entity and thereby complete an exchange when the second member does not have an interest in profits or losses of the LLC but instead has been inserted into the LLC's organizational structure for control purposes. See, e.g., PLR 199911033.

To hold tangible personal property or intangible assets

Where a corporation has many businesses and one of its businesses is a high-risk business, the corporation's shareholders could establish an LLC to carry on the high-risk business that would otherwise have been carried on by the corporation. The corporation leases the use of its fixed assets and licenses its intangibles to the LLC at fair market value rentals and payment of license fees. In addition to the LLC receiving the rentals and license fees, the corporation could use existing contracts, inventory and outstanding accounts receivable to capitalize the LLC. The LLC thereafter generates all future income of the high-risk business that would have otherwise gone to the corporation. This structure may isolate corporate assets from potential LLC future creditors.

- Caveat: Be sure to have counsel review fraudulent conveyance and fraudulent transfer statutes prior to any such transfer.

The LLC as a valuation "freeze" entity

Estate planners have developed devices over the years to freeze the value of certain assets such as interests in a closely-held business in the hands of the entrepreneur and to transfer the appreciation of those assets to others, usually the next generation, i.e., the owner's children. The goal is to freeze the assets value for estate tax purposes and yet pass on those assets to the next

generation at a reduced gift or estate tax cost. A common approach with a closely held business was to recapitalize the business to issue voting preferred stock to the older generation, parents, and issue non-voting common stock to the younger generation, children. The older generation would retain control, while the younger generation would receive all future appreciation on such stock. Congress attacked this type of planning by adopting a rule that not only prohibited such plans but was over broad in its application and applied to many other transactions that were not solely structured for estate tax purposes. See IRC § 2701. The Revenue Reconciliation Act of 1990, Chapter 14, IRC §2701 et seq. modified the application of this restriction on restructuring.

Section 2701 generally provides that transfers between certain family members will be ignored if the transferor retains an interest in the asset transferred. Thus, the preferred stock interest in a traditional estate freeze would be treated as a retained interest and would be valued at zero. The common stock interest would be valued at full fair market value or in accordance with the special valuation rules under Chapter 14. A gift tax would be due on the corporation's full value. The result is that the cost of such a transaction becomes prohibitive.

An LLC structure can be used in coordination with leasing agreements to essentially circumvent this restrictive section and to freeze an estate's value... The gift of appreciating assets to younger family members produces a freeze with the income shifting opportunities creating an effective utilization of the donated assets. However, compliance with the safe harbor provisions of IRC § 2701 must be observed. These provisions provide that:

- (1) the lease payments must be for full and adequate consideration;
- (2) a good faith effort is made to determine the fair market value of rental property under the lease; and
- (3) the terms of the lease reflect the value as determined. Treas. Reg. §25.2701-3(c)(ii).

The family LLC as an estate planning vehicle

LLCs have not yet been the subject of voluminous IRS or court rulings relative to estate planning. The IRS, however, has indicated that gifts of a limited partnership interest qualifies gifts of a

limited partnership interest qualify for the annual gift tax exclusion as a gift of a present interest.⁴ As an LLC when formed is taxed as a partnership, there is no authority that a contrary position would be taken with regard to an LLC. Further, most LLC statutes are derived in great part from limited partnership statute. For example, the concept of restricting creditor attachment to a charging order is generally utilizing language from the Uniform Limited Partnership Act as adopted on a state wide statewide basis. Therefore, taxpayers may consider using LLCs to increase the amount of property transferred via the annual gift exclusions and lifetime transfer exemptions. This is due to the ability to obtain discounts on the value of property contained within an LLC or a family limited partnership, FLP.

An example of an estate planning technique may consist of gifts of ownership interests in an LLC to family members or to a trust for the family member's benefit. Since the LLC interest is being transferred, rather than a direct ownership in the underlying assets, discounts for lack of marketability, lack of control and minority interest discounts are generally available. As long as the donor does not retain impermissible control over the gift, any appreciation, as well as the gifted asset will generally not be included within the transferor's estate.

Any type of trust can be a member of an LLC, as opposed to ownership restrictions placed upon shareholders within S corporations. Additionally, valuation discounts for lack of marketability and control can reduce the potential gift tax on business interests gifted to family members. In the FLP scenario, which should be equally applicable to LLCs, combined discounts of 35 percent have been allowed, based upon recent court rulings.⁵

LLCs formed between family members for estate planning or income shifting strategies can be utilized to provide special classes of ownership such as preferred and subordinated interests in capital, profit and cash flow. For example, using multi-classes of ownership creates a method in which cash flows can go to a donor during their lifetime while providing substantial asset growth for the donees benefit. However, assuming that I.R.C. §2701 is applicable to an LLC in the same manner and method as to a partnership, IRC § 2701 must be understood.

In essence, the partnership rules

hold that I.R.C. §2701 applies to an LLC if an individual transfers an interest in the LLC to or for the benefit of a family member, while retaining a liquidation, put, call, conversion, or distribution right and the interest transferred is not of the same class or proportionally the same as the retained interest. Thus, to avoid triggering the application of I.R.C. §2701, care must be exercised when contemplating creating different classes of interests. Conversely, if different classes of interests are created, they should be limited to differences in the right to vote or manage the LLC as they should not cause §2701 to apply.

Not all is lost. It is still possible to use an LLC to transfer some value without creating differing classes of distribution rights and liquidation preferences that I.R.C. §2701 was designed to prohibit. For example, a family can create a member-managed LLC, where a senior member can receive compensation for managing the LLC. This appears to be one method of acceptable income shifting for LLCs and partnerships that may not trigger I.R.C. §2701.

Still another wealth shifting method is to receive lease payments from an LLC. Leasing has been a traditional income shifting technique used as an income tax planning device. A leasing agreement works as an estate freezing techniques also.

Additionally, though the annual gift exclusion likely applies to LLCs, these transfers must be analyzed in the context of estate tax law and retained interests. Specifically, IRC § 2036 transfers with retained life estates and IRC § 2038 revocable transfers that may include gifts made prior to death in a transferor's estate, applicable to LLC transfers. Particularly § 2036 appears to be the new tool of the IRS to attack transfers with retained interest.

Retained interests is an issue specifically raised in a family-held LLC, where an older member is also a designated manager. The general rule is that management powers retained by a general partner are subject to strict fiduciary duties imposed by state law. As a direct result of those fiduciary duties, such as the duty of loyalty and care, the prevailing view is that this authority is not treated as a retained interest includable in the taxable estate. Two letter rulings have held that the power that a general partner retains with respect to the partnership

interests he transfers to junior family members should not cause those transferred interests to be subject to estate tax inclusions within either I.R.C. §2036 or I.R.C. §2038.⁶ These rulings relied on the rationale of *U.S. v. Byrum*, 408 U.S. 125 (1972), which held that the stock transferred by a controlling shareholder to an irrevocable trust was not includable in his estate because the decedent had a fiduciary duty to the corporation and to the minority shareholders as a controlling shareholder and member of the board of directors.

Arguably, in an LLC, member-managers may also have a strict state law fiduciary duties to other members. Therefore, an LLC interest transferred to other family members should not be subject to either I.R.C. §2036 or I.R.C. §2038 by reason of the control rights. However, the landscape has drastically changed with the holding in *Estate of Strangi v. CIR*, 115 T.C. 478, (2000), aff'd in part and remanded in part, 293 F. 3d 279, (5th Cir. 2002), on remand, T.C. Memo. 2003-145, 2003.

In *Strangi*, the Tax Court eliminated all estate tax discounts for a family limited partnership that was created and the assets transferred within three years of the decedent's death. The Court held, as it had in prior cases, that § 2036(a)(1) required this result. However, the Court then went on to reach the alternative holding that § 2036(a)(2) also precluded the estate from claiming a discount. However, the alternative holding in *Strangi* appears to be based on a misreading of the Supreme Court's *Byrum* decision and is inconsistent with the Service's own published guidance.^{vi[6]}

§ 2036(a)(1) applies where the decedent has retained either:

- (i) the possession or enjoyment of the transferred property; or
- (ii) the right to the income from the transferred property.

Given the statute's disjunctive structure, the courts (although the Supreme Court has not yet spoken to the question) have understandably made clear that the retained ability to enjoy or possess property need not be legally enforceable.⁷ Thus, if the possession or enjoyment of transferred property is retained under an implied understanding or agreement that a decedent would not have been able to enforce under state law, inclusion is nevertheless required.

In contrast, section 2036(a)(2) applies only where a decedent has retained the right⁹ to control the beneficial enjoyment of transferred property. An important question arising under this provision is whether the decedent's retained practical control is sufficient to trigger estate inclusion where state law imposes certain constraints that narrow the scope of the decedent's power. It was precisely this question that the Supreme Court addressed in *Byrum*. The Service itself has read *Byrum* as establishing the proposition that the provision is applicable only where the decedent retained a legally enforceable right.¹⁰

Under this reading, if the decedent's ability to control is circumscribed by a fiduciary duty owed to an unrelated or related minority interest, the decedent cannot be viewed as having retained a legally enforceable right.¹¹ *Byrum* can also be read as strongly implying that the retained ability to cause the liquidation of an entity is too speculative to serve as a predicate for estate tax inclusion. Nevertheless, in *Strangi*, the Tax Court concluded, as part of its alternative holding, that the fiduciary duty that the decedent had owed to family members should be disregarded and that his ability to cause liquidation was sufficient to trigger § 2036(a)(2). The *Strangi* reading of § 2036(a)(2) flies in the face of the IRS' previous reading of *Byrum*.

In TAM 9131006, the Service concluded that § 2036(a)(2) did not apply to a family limited partnership even though the decedent, as general partner, had the ability to control partnership distributions to limited partner, donees, and all partners were related to the decedent. It predicated its conclusion on the decedent's fiduciary duty. In doing so, the court cited *Estate of Gilman v. CIR*, 65 T.C. 296 (1976) and *Byrum*, and made no reference to the fact that the decedent's fiduciary duty was owed exclusively to family members.

Additionally, the Service appears to have endorsed *Byrum* in a published ruling as well. In Rev. Rul. 81-15, 1981-1 C.B. 457, the Service invoked the *Byrum* fiduciary-duty analysis and concluded that § 2036(a)(2) did not apply in the case of corporate stock where a decedent had retained voting rights even though the only shareholders were the decedent and a family trust created by the decedent. Mysteriously, the *Strangi* court made reference to the

TAM, dismissing it on the grounds that it held no weight as a precedent, but it then failed to mention the revenue ruling, despite the mandate that the Service is obligated to respect its published rulings in Tax Court litigation.¹²

In *Strangi*, the court concluded that the decedent's ability to vote with others to cause a liquidation constituted sufficient control to invoke § 2036(a)(2). The court further held that the fiduciary duty the decedent had owed to his family members did not adequately constrain his retained right to vote on liquidation or distributions¹³ and therefore, should be disregarded.¹⁴ Granted, it is comprehensible that the Court wished to establish a set of laws that will end abusive family partnerships, yet neither *Strangi* conclusion follows given *Byrum*, Rev. Rul. 73-143, Rev. Rul. 81-15 and Congress's ratification of *Byrum*'s perceived understanding.¹⁵

Planning Around *Strangi*:

- a. Given *Strangi*'s § 2036(a)(2) holding, existing partnerships and LLCs should seriously consider restructuring their agreements relative to any retained interests.
- b. As for structuring new partnerships and LLCs, *Strangi* itself suggests a straightforward method for avoiding its § 2036(a)(2) holding. If other family members also contribute assets to the LLC at its formation in exchange for LLC interests and each receives an LLC interest equal in value to their contribution, *Strangi* suggests the potential to treat the transaction as a "pooling." If it qualifies, § 2036's bona fide sale exception would preclude § 2036(a)(2) from applying at the death of any contributing member. In structuring an LLC to qualify as a pooling, care must be taken in drafting the operating agreement.¹⁶

IRC §2702 issues

Consideration should be given to placing an LLC interest in a grantor retained annuity trust (GRAT) or a grantor retained unitrust (GRUT).

Grantor Retained Annuity Trusts (GRATs)

Under a Grantor Retained Annuity Trust ("GRAT"), a grantor transfers assets into an irrevocable trust while retaining a current income interest from the trust for a specified period of time.¹⁷ Concurrently, the grantor must

transfer a remainder interest in the trust property to the individuals to whom he intends to pass the assets upon his death.¹⁸ Normally, such a transfer would subject the transaction to substantial federal gift taxes. However, by structuring the current income interest as a fixed payment annuity, § 702 ("Special Valuation Rules in Case of Transfers of Interests in Trusts") permits the transfer to occur at least partially tax-free.¹⁹ Because the payments, if properly planned, will expire prior to the grantor's death, the remainder interest vests with the trust's beneficiaries prior to the grantor's death and the assets have effectively been removed from the estate. Moreover, any appreciation in value of the assets after the date of transfer to the trust is entirely removed from the estate.²⁰ Any return on the assets in excess of the annuity payments inures to the remainder interest free of any gift taxes. However, that as a grantor trust, the full value of the trust's income remains taxable to the grantor until the expiration of the annuity period.

Grantor Retained UniTrusts (GRUTs)

The GRUT differs from the GRAT only in that the annual annuity payment is calculated as a percentage of the annual value of the trust, rather than as a fixed amount.²¹

A GRAT is optimal when it produces the income necessary to fund the annuity payments without any diminution in amount. An LLC taxed as a partnership is quite the opposite. This should usually be a good asset to fund a GRAT. Note that a partnership, and by extension an LLC taxed as a partnership, can receive basis adjustments under I.R.C. § 743 and I.R.C. § 754. Those adjustments are only available if the asset is purchased or upon death via a step up in basis under I.R.C. § 1014. This might make the gifting of an LLC interest to a GRAT or GRUT less desirable if the asset has a low basis.

IRC § 2703 issues

LLCs are subject to the same requirements with regards to rights and restrictions that other entities are for purposes of valuation. I.R.C. § 2703(a) provides that the value of any property shall be determined without regard to any restriction on the right to sell or use such property. The right or restriction

shall be disregarded for valuation purposes unless it can be shown that the right or restriction has a bona fide business arrangement, that it is not a device to transfer property to the decedent's family for less than full and adequate consideration, and that its terms are comparable to similar arm's length transactions. See I.R.C. § 2703(a), (b). Thus, I.R.C. § 2703 does provide a safe harbor in the context of a family entity. However, the Service has continually argued that the transfer of assets to the entity is in and of itself a device to transfer property for less than full value.²² There is another exception to the application of I.R.C. § 2703 and that is if non-family members own more than 50 percent of the entity's value. Treas. Reg. § 25.2703-1(b)(3). Furthermore, any right or restriction that is a modification to the agreement will be treated as a matter subjecting the entity to I.R.C. § 2703 unless it is a de minimis modification.

It does seem clear that the language of I.R.C. § 2703 applies to the property subject to the right or restriction and not the right or restriction itself. The basic fallacy here is in defining the "property" that is subject to the restrictions. In the typical family entity, the senior family member transfers assets to the entity in exchange for general and limited interests. The senior family member then transfers limited partnership or LLC interests to family members. The property being transferred is the partnership or LLC interests and not the underlying partnership assets. The possible application of I.R.C. § 2703 will depend on restrictions placed on the rights of donees in the partnership or LLC interests. The donees themselves never own the partnership assets, merely an interest in the entity itself. A contrary assumption, such as the one taken by the Service, would require the existence of the entity to be ignored so ignored so that a transfer is always of an undivided interest in the underlying assets. For a court to sustain the interpretation described above, it is generally agreed that one of two arguments must prevail:

- (1) the partnership is a sham and as such must be disregarded for transfer tax purposes; or
- (2) under the step transaction doctrine, contribution of property to the entity coupled with the subsequent transfer of an interest is actually one transaction, that of a transfer of an undivided interest in the underlying entity's assets.²³

IRC § 2704(a) issues

I.R.C. § 2704(a) (which pertains to lapsing rights) is also an issue that may arise in the context of a family-held LLC. I.R.C. § 2704(a) was designed to overturn the Tax Court decision in *Estate of Harrison v. Commissioner*, T.C. Memo 1987-8. In *Harrison*, the family partnership agreement provided that only the general partner during life had the power to dissolve the partnership. The right to liquidate the partnership terminated at the general partner's death. The senior family member was the general partner. The Tax Court decision was deemed too favorable to the taxpayer, such that Congress intervened, to overturn the ruling. The ruling held that the value of the general partner's partnership interest was greatly reduced since his liquidation rights lapsed at his death. Because the liquidation rights lapsed at death, the partnership interest's value for estate tax purposes was measured at death, without including considering the liquidation rights. This measurement significantly reduced the value of Mr. Harrison's estate and the resulting estate tax thereon.

The I.R.C. § 2704(a) anti-*Harrison* provision, provides that a lapse of voting or liquidation rights in an entity is treated as a transfer and the transferred interest is valued without regard to the right, if the family controls the entity both before and after the transfer. I.R.C. § 2704(a)(1). The lapse of a right occurs when the right is reduced or ceases to exist. Treas. Reg. § 25.2704-1(c)(2)(i). The lapse of a right that was previously valued under I.R.C. § 2701(a) in the hands of the holder is not subject to I.R.C. § 2704(a). Treas. Reg. § 25.2704-1(c)(2)(ii). The Service's intention is to prevent a double taxation issue from arising.

The sole designated purpose of I.R.C. § 2704(a) is to prevent an artificial diminution in value for transfer tax purposes. Consistent with this objective is the exception that establishes the rule that if the family is unable to liquidate after the lapse, any interest that could have been liquidated prior to the lapse there is not an I.R.C. § 2704(a) issue. Treas. Reg. § 25.2704-1(c)(2)(i)(A). Furthermore, a transfer of an interest that results in the termination of a liquidation right with respect to an interest other than the transferred interest is a lapse of the liquidation right only where the transferred interest is senior to the interest to which the liquidation right terminates. Treas.

Reg. § 25.2704-1(c)(1).

With respect to an LLC, an operating agreement which provides certain members with unilateral rights to liquidate triggers I.R.C. § 2704(a). However, further analysis is needed to determine whether I.R.C. § 2704(a) is truly applicable. If the transferor and his family control the entity, such a lapse is treated under the special valuation rules. If, however, other members of the LLC who are family cannot immediately liquidate the transferor's interest, there is no transfer for purposes of I.R.C. § 2704(a). This ability to liquidate is determined with reference to state law, as, as modified by the operating agreement.

- Caveat: The Service takes the position that if there is a transfer of an interest to an assignee and if the assignee of an interest cannot vote on liquidation, it is a lapse subject to I.R.C. § 2704(a). FSA 200049003. Furthermore, if the restriction on liquidation was to be disregarded under I.R.C. § 2704(b), which provides for applicable restrictions to be disregarded when they effectively limit the ability of the partnership to liquidate in a more restrictive fashion than state law, then an interest which is disregarded for purposes of I.R.C. § 2704(b) should also be disregarded for purposes of I.R.C. § 2704(a). See FSA 200049003.

IRC §2704(b) issues

Due to the fact that an LLC may restrict the continuity of life of the entity through the use of a liquidation provision, potential issues arise under Chapter 14, I.R.C. § 2704(b) of the special valuation rules. These rules provide that an "applicable restriction" on the right of a transferor to liquidate his or her interest is disregarded for purposes of valuation if there has been a transfer to or for the benefit of the transferor's family and the transferor's family controls the entity.²⁴ An applicable restriction is defined as a restriction which limits the ability of the entity to liquidate, and which lapses after the transfer, or the transferor or any member of the family, acting alone or collectively, has the power to remove the restriction.²⁵

Accordingly, if there is such a restriction and I.R.C. § 2704(b) causes it to be disregarded, the value for estate and gift tax purposes of the transferred interest is the full fair market value of the underlying asset with no discount for the restriction. Note, however, that the regulations to I.R.C. § 2704(b) provide that the Code's definition of an

applicable restriction will not be more restrictive than that of applicable state law. See Treas. Reg. § 25.2704-2(b). In other words, if the LLC operating agreement can be drafted so that any restriction on the right to liquidate is no more restrictive than state law, I.R.C. § 2704(b) can be avoided and its value for tax purposes is the value of future cash distributions (subject, of course, to the discount created by the time value of money). Conversely, if the restriction is more restrictive than state law, the restriction in the LLC's operating agreement is disregarded. See FSA 200049003. An example will prove helpful: An LLC has the requirement that liquidation of the entity is prohibited for 10 years, and that after 10 years it can be liquidated with 50 percent of the vote. State law provides that a liquidation can occur with approval of 40 percent of the voting interests without regard to any time restrictions. The applicable restriction is disregarded for purposes of I.R.C. § 2704(b).

In two cases, the Service has challenged and lost the argument that the "applicable restrictions" should be ignored for purposes of determining gift tax values in cases where the restrictions were no more restrictive than state law.²⁶

In the event that a certain percentage of an interest is required to compel liquidation, the Service continues to take the position that if the applicable restriction is disregarded in favor of state law, then the interest holders could band together in an effort to liquidate the entity. See FSA 200049003. This would have a greater utility in the estate tax arena than in the gift tax arena, but the precise valuation of such interests taking into effect IRC § 2704 is a factual-based issue subject to valuation principles, as determined by a valuation expert.²⁷

The rule regarding restrictions on liquidations does not apply in the case of commercially reasonable restrictions that arise as a result of financing with an unrelated party. See I.R.C. § 2704(b)(3). Nor does it include any restriction imposed by state or federal law. See I.R.C. § 2704(b)(3)(B).

Using an LLC to hold life insurance policies

Using LLCs in lieu of an irrevocable insurance trust adds flexibility for controlling and holding policy proceeds versus the constraints generally contained within an irrevocable insurance trust. However, when an LLC

invests in life insurance policies, important beneficiary and transfer for value concerns must be understood.

Beneficiary concerns. The issues explored in relation to corporate-owned insurance must also be addressed in the context of partnership or LLC-owned life insurance. The IRS' position on partnership-owned life insurance is set forth in Rev. Rul. 83-47, 1983-2 C.B. 158. Rev. Rul. 83-47 analyzes two situations regarding partnership-owned life insurance:

- (i) insurance on a partner's life is payable to the partnership, and
- (ii) where the insurance is payable to a third party for a non-partnership purpose.

In PLR 200017051, the IRS ruled that the general partners of a family limited partnership that owns policies insuring their separate and joint lives do not have incidents of ownership with respect to the partnership-held policies by reason of their general partnership interests. As the partnership agreement prohibited general and limited partners from participating in the exercise of any incident of ownership with respect to any policy insuring his or her life, no incidents of ownership were present. Note that proper drafting of the partnership agreement was crucial.

Similarly, in PLR 200111038, the IRS ruled that an insured couple did not possess § 2042(2) incidents of ownership in three survivorship policies on their lives that a trust they created planned to transfer to a limited partnership. The trust, which benefited one spouse's parents and the spouses' children, was to receive limited partnership interests in exchange for the policies. The couple also planned to contribute cash to the partnership in exchange for limited partnership interests. Additionally, another trust created by the couple planned to contribute cash in exchange for general partnership interests.

The limited partnership, as policy owner, planned to name itself as beneficiary. The partnership would own other assets in excess of the policies' face amount and would continue the historic trust investment activities, including activities including contributing the policies. The IRS noted that the limited partners could not exercise control over the partnership's business, management, or investment decisions, could not vote on or take part in the partnership's

management and operations, could not participate in the partnership's day-to-day affairs, and could not sign for or bind the partnership.

Insurance payable to or for the Partnership benefit. In *Knipp Est. v. Commissioner*,²⁸ a partnership-owned insurance policies on the life of a deceased partner, which were payable to the partnership. The court held that the partnership, not the decedent, possessed the policies incidents of ownership. Therefore, the insurance proceeds were not includable in a deceased partner's gross estate. The IRS acquiesced in *Knipp* since *Knipp* since inclusion of the policy's face value in the decedent's gross estate "would have resulted in unwarranted double taxation of a substantial portion of the proceeds. This was due to inclusion of the decedent's proportionate share of the partnership interest, which was increased by the receipt of the policy proceeds. This, however, still resulted in reduced estate taxation, due to valuation discounts present in the LLC or limited partnership structure.

The partnership, as an entity, possessed the policy's incidents of ownership. That view is contrary to the aggregate theory of a partnership endorsed by Rev. Rul. 83-147, that a partnership is merely a collection of individuals. Regardless of the IRS' rationale, the result of acquiescence of acquiescence in *Knipp* is recognition that insurance payable to a partnership should properly be taken into account for federal estate tax purposes only to the extent it affects the valuation of the decedent's partnership interest.

Insurance payable to a third party. In Rev. Rul. 83-147, the decedent owned a one-third interest in a partnership which owned an insurance policy on the decedent's life, payable to his child. Had a corporation, rather than a partnership, been involved, the corporation's incidents of policy ownership would not have been attributed to the decedent, since such attribution occurs only when an insured decedent owns more than 50 percent of the voting stock of the corporation.²⁹

The IRS took a different view in the partnership context. Viewing the partnership as an aggregate of individuals rather than a separate entity, the IRS found that the partners as individuals held the ownership rights in a partnership-owned policy. Thus, the IRS ruled that the decedent, in conjunction with

the other partners, possessed incidents of ownership in the policy.

Under Rev. Rul. 83-147 reasoning, the size of the decedent's proportionate partnership interest is irrelevant; inclusion in the gross estate results in every case where partnership-owned insurance on the life of a partner is payable to a third party.³⁰

Transfer for value rule. Under the general rule, the proceeds of a life insurance policy received by a beneficiary are excluded from his gross income. IRC § 101(a). An exception to this general rule is when there is a "transfer for a valuable consideration." IRC § 101(a)(2). This rule is known as the "transfer for value" rule. Where there has been a transfer for a valuable consideration, the amount excluded from gross income will be limited to the amount of the consideration paid plus the premiums subsequently paid by the transferee.³¹

While the transfer of a life insurance policy for estate planning purposes is ordinarily intended as a gift,³² in a business purpose context, the transfer of a life insurance policy is generally not intended as a gift. In business, there will generally be a "transfer for a valuable consideration." If the §101(a) exclusion from gross income for the proceeds of a life insurance policy is to be preserved, the transfer must fall within one of the two exceptions to the "transfer for value" rule.

The first exception is where the transferee's basis is determined by reference to the transferor's basis. The second exception provides that a "transfer for value" will not destroy the §101(a) exclusion "if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer."³³

The transfer of a life insurance policy in the business context frequently involves a policy which is intended to fund the buyout of an insured's interest in the business entity. In this context, it is well established that a "cross-purchase agreement" can easily be converted into an "entity purchase or a redemption agreement," but that the reverse may be difficult to accomplish. Several private letter rulings have approved a technique which may permit a conversion from an "entity purchase" to a "cross-purchase." PLR 9012063 and 9239033.

The IRS has also approved the transfer of a life insurance policy to an irrevocable trust, where the trust and the insured were partners in a long-stand-

ing partnership. See PLR 9235029.

Query: whether the transfer for value rule will be avoided if insurance policies are transferred to a partnership created for that express purpose?

In PLR 9309021, a corporation was the owner of insurance policies on the lives of its two shareholders. The shareholders planned to form a partnership, the only purpose of which appears to have been to "engage in the purchase and acquisition of life insurance policies on the lives of its partners." The IRS ruled favorably on the following rulings requested by the taxpayer:

1. The partnership will qualify as a "partnership" for federal income tax purposes.
2. The transfers of the life insurance policies from the corporation to the partnership qualify under the exception to the transfer for value rule under §101(a)(2)(B).
3. Proceeds of the policies distributed to one of the partners under an insurance contract on the life of the other partner would not be included in the gross income of the recipient partner.

The only issue seriously dealt with in PLR 9309021 was the qualification of the new entity as a "partnership" for federal income tax purposes. This issue involved an analysis of the four characteristics ordinarily found in a corporation. After finding that the entity did, in fact, qualify as a "partnership" for federal income tax purposes, the IRS ruled favorably on the other two ruling requests with little discussion. PLR 9309021 provides a blueprint for the conversion of a corporate redemption arrangement to a cross-purchase agreement; care must be given to the transaction.³⁴

- NOTE: Good drafting from a tax lawyer can save the day!

Rev. Proc. 98-3, causes a concern as it added to the no-rule area to indicate that, in certain situations where a life insurance policy is transferred to an unincorporated organization, the IRS will not rule on: (1) whether the organization will be treated as a partnership under §§761 and 7701; or (2) whether the transfer will be exempt from the transfer for value rules of §101 if substantially all of the organization's assets consist, or will consist, of life insurance policies on the lives of the members. This no-rule policy was retained in Rev. Proc. 2000-3, and Rev. Proc. 99-3, which super-

seded Rev. Proc. 98-3.³⁵

In Rev. Proc. 2003-3, the IRS continued its absolute no-rulings policy on this issue. This no-ruling policy indicates that the IRS will no longer follow the result in PLR 9309021. Thus additional caution in structuring partnerships for the sole purpose of transferring life insurance policies is advisable.

In PLR 200017051, a husband and wife established not only a partnership but also a limited liability company. Husband had established two life insurance trusts, one in 1984 that held only a policy on his life and one in 1988 that held two second-to-die policies on the joint lives of the husband and wife. Husband also had established a third trust (Trust 3), which over the years made unsecured loans to the insurance trusts for premium payments, evidenced by interest-bearing demand promissory notes.

Husband made similar loans to the trusts. Husband, wife, and Trust 3 later formed an LLC, with the trust contributing cash, securities, and real estate in exchange for membership units with limited participation rights. Husband and wife contributed cash in exchange for all the membership units with the authority to control the company. On the same day, husband and wife, as general partners, and Trust 3, as a limited partner, formed a family limited partnership ("FLP"). Wife contributed cash, husband contributed cash and the insurance trusts' promissory notes, and Trust 3 contributed cash, marketable securities, its interest in LLC, and the trusts' promissory notes. The stated purposes of both LLC and FLP include managing and controlling the family's assets and restricting the rights of non-family members from acquiring an interest in the assets.

FLP plans to demand payment on the promissory notes, which the insurance trusts will satisfy by transferring the insurance policies to FLP. If a policy's value, determined under Treas. Reg. § 25.2512-6, is greater than the balance due under the notes, then the trusts will withdraw cash value from the policy in sufficient amount to make the interpolated terminal reserve value (plus the proportionate premium amount extending beyond the proposed date of transfer) of the policies equal to the balance due. As the new owner of the transferred policies, FLP will designate itself as the beneficiary of the policies and will pay all of the policy premiums.

The IRS concluded that the transfers of the policies by the insurance trusts to FLP will be a transfer for valuable consideration because the transfers are for an amount equal to the value of each trust's interest in the policies and will discharge debt obligations that are enforceable under state law and are valid debt obligations for federal income tax purposes. The IRS then ruled that the transfer will satisfy the requirements of §101(a)(2)(B) and the amounts that FLP will receive under these contracts upon the deaths of husband and wife will be excluded from gross income because the transferee will be FLP, which is a partnership for federal tax purposes, and all of the insureds under the policies to be transferred will be partners of FLP at the time the policies are transferred.³⁶

A complex solution to a complex issue!

Using an LLC for venture capital projects and corporate joint ventures

Corporate Joint Venture:

Generally, a corporate subsidiary is the traditional business entity for a joint venture project. Two unrelated corporations join together to form a third corporation to conduct the joint venture business. This also involves appointing a third board of directors and subjects the two corporate owners to potential liability from the subsidiary. An LLC offers a structure that avoids both the need for a third board of directors and provides liability protection to the two corporate owners.

Capital Venture Projects: The LLC structure offers venture capitalists the ability to allocate profit and loss to provide different classes of ownership without compromising tax benefits or limiting liability protection for investors. Moreover, venture capitalists can use an operating agreement to provide explicitly under what circumstances changes in control can be exercised while minimizing the duties and obligations that a board of directors would have under corporate law if a corporate structure were implemented.

A venture capital LLC can also be used to facilitate a public offering. The LLC can transfer its assets into a newly created corporation and shares are then sold in a public offering. This is a complex transaction that requires the guidance of security law experts as well as tax experts to avoid taxation upon the transfer and to comply with

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security regulations.

Using an LLC in lieu of corporate subsidiaries

Minimizing environmental liability. Another use of the LLC to own real estate is to limit risk exposure of potential environmental liability. In a case where a parent corporation has a subsidiary that has environmental risk concerns, it must consider terminating its ownership of the subsidiary. However, the parent corporation could form an LLC and the subsidiary corporation would merge into the LLC directly. This would provide a shield against liability for the parent.

An S Corporation can use an LLC as the functional equivalent of a corporate subsidiary. This structure permits the S corporation to separate its assets from the LLC's business risk. Moreover, the desire to limit liability should constitute a valid business purpose and the S election should not be jeopardized by this strategy.

Note that S Corporations have successfully been merged into LLCs without creating a taxable transaction. See PLRivate letter ruling 130243-01.

The LLC as a private equity investment entity

Individuals wishing to pool their resources may form an LLC for use as a private equity investment vehicle. Yet individuals should be aware of the potential pitfalls prior to forming and utilizing an LLC as such. This analysis requires we assume that the LLC is taxed as a partnership for federal tax purposes.

Recognition of gain on transfers of property to the LLC: Under I.R.C. § 721(a), an LLC member will not recognize gain or loss upon the contribution of property to an LLC. However, under I.R.C. § 721(b), an exception to this nonrecognition rule applies where such contribution is deemed to be a transfer of property to an investment company. The § 721(b) exception causes a contributing member to recognize built-in gain inherent in property contributed at the time of such contribution.

A transfer of property will generally be considered to be a transfer to an investment company when:

- (1) more than 80 percent of the value of the LLC's assets immediately after such transfer consists of stock

- or securities held for investment;³⁷ and
- (2) such transfer results in diversification of the transferor member's interest.³⁸

Under § 1.351-1(c) (5), diversification occurs when two or more members transfer nonidentical assets to the LLC. To the extent nonidentical assets are transferred that constitute an insignificant portion of the total value of assets transferred, such insignificant portion will be disregarded for the purpose of determining whether diversification has occurred.³⁹ Moreover, transferring a diversified portfolio by each LLC member will not be treated as giving rise to diversification.⁴⁰

Members of private equity investment LLCs are more likely to face this potential gain recognition issue given the asset makeup. To avoid potential gain recognition, the members should ensure that all capital contributions are in the form of cash or take the form of diversified portfolios.

Investment company classification under the Investment Company Act of 1940: Another potential pitfall for private equity investment LLCs is the classification as investment companies under the Investment Company Act of 1940. The Investment Company Act of 1940 is both a disclosure and a regulatory statute governing the operations of entities that fall within its definition.⁴¹ Compliance with the rules and regulations contained in the Investment Company Act of 1940 generally make the operation of private equity investment LLC unfeasible. Thus, investors are well advised to ensure that their private equity investment LLC fits within one of the exceptions to the definition of an investment company.

The two most likely exceptions are found in Sections 3(c) (1) and 3(c) (7) of the Investment Company Act of 1940.

Under Section 3(c) (1), an LLC used as a private equity investment vehicle will fall outside the definition of an investment company if it (i) is not making, and does not presently intend to make, a public offering of its equity interests and (ii) does not have more than 100 beneficial owners.⁴² A member of such an LLC who is a natural person will count as one beneficial owner. A member who is something other than a natural person (i.e., a corporation, partnership, LLC, etc.) will also count as only one beneficial owner provided, however, that if such

member (a) owns 10 percent or more of the LLC's outstanding voting securities and (b) is itself an investment company under the Investment Company Act of 1940 or would be an investment company were it not for the exceptions provided under Sections 3(c)(1) and 3(c)(7), then a special look-through rule applies whereby each equity owner of such member will be counted as a beneficial owner for purposes of Section 3(c)(1).⁴³

The look-through rule will also apply in the event it is determined that such a member was formed for the specific purpose of making an investment in the LLC.⁴⁴ Such a determination is generally based on all surrounding facts and circumstances, although an investment of more than 40 percent of such member's committed capital in the LLC is typically a strong indicator that such member was formed for the specific purpose of making an investment in the LLC.⁴⁵ Investors who are forming an LLC to invest in either a traditional venture capital fund or a fund-of-funds should pay special attention to this specific-purpose issue because such issue could create problems under the Investment Company Act of 1940 for the underlying investment that the LLC wishes to invest its funds.

Under Section 3(c) (7), an LLC used as a private equity investment vehicle will fall outside of the definition of an investment company if all of its members are qualified purchasers. Among other things, a qualified purchaser⁴⁶ is defined as:

- (a) any natural person who owns not less than \$ 5 million in investments;
- (b) any company that is owned by two or more natural persons who are related as siblings, spouses or direct lineal descendants and that owns not less than \$ 5 million in investments; or
- (c) any company that owns not less than \$ 25 million in investments.

Similar to Section 3(c) (1), a special look-through rule will likely apply in the case of a member that was formed for the specific purpose of making an investment in the LLC.⁴⁷ If the look-through rule applies, then each equity owner of the member must be a qualified purchaser for the LLC to fall within the 3(c) (7) exception.⁴⁸

In the event an LLC used as a private equity investment vehicle would have at least one member who would not be

a qualified purchaser and such an LLC would have more than 100 beneficial owners, then the organizers of such an LLC would be well advised to form two side-by-side LLCs, one of which would consist of solely qualified purchasers and the other of which would consist of 100 or less nonqualified purchasers. Under this side-by-side structure, one of the LLCs would fall under the Section 3(c) (7) exception while the other LLC would fall under the Section 3(c) (1) exception. Such side-by-side LLCs would make investments on the same terms and at the same time, with such investments being split between the two LLCs in proportion to their respective available capital.

The LLC as an asset protection tool

An LLC is extremely advantageous in that it provides both tax flexibility as well as significant asset protection. Owner(s) of a corporation, as is commonly known, are referred to as shareholder(s). Owner(s) of LLC interests, on the other hand, are referred to as member(s). The asset protection feature for LLCs works in two regards... One regard is inside out protection, which provides the same protection as does a regular corporation in terms of preventing a creditor, inside the entity, from pursuing an owner's personal assets to pay off business debt. The other protection is outside in protection, which prohibits any one individual owner's personal creditors, outside the LLC, from seizing company assets inside the company, or becoming owner-members of the LLC itself (against the will of the existing owner-members). This protection is derived from and is in accord with the protection afforded limited partners in a limited partnership.

Unlike a corporation, where a judgment creditor can seize a shareholder's stock interest and take control of the entity, most LLC state statutes limit judgment creditors to the remedy of a "charging order".

A charging order is essentially a lien upon a debtor's interest held by a judgment creditor and is the only statutory remedy available to a creditor seeking to enforce a judgment against an LLC member.

Specifically, a charging order entitles a creditor to attach a member's "economic interest" and receive income actually distributed to a member. A

creditor, however, does not assume any of the rights and responsibilities of a member. Furthermore, since a creditor attaches an income interest, whether income is distributed or not, the creditor may be taxed on income that has not been received. This is the same law that applies to other members of an income interest in other pass-through entities (partnerships and S-Corporations) for income tax purposes.

A creditor armed with a charging order against a debtor's membership interest has the same rights as an assignee of the interest: the right to attach a member's economic benefits. Profits and distributions by the company are examples of economic benefits. It does not, however, include the right to attach the company's underlying assets. It also does not include the ability to force a sale of the member's interest or even to vote for such action at the company level. This differs from the same situation involving a corporation, where a creditor may seize the debtor's shares of stock and if his ownership level is sufficient, actually end up owning the corporation.

There are other drawbacks for a creditor that seizes a member's interest. For example, the company may have a provision in its operating agreement that prohibits someone from becoming a member unless there is unanimous consent from the other members. Absent such an affirmative vote by the other members (which for obvious reasons is highly unlikely) the creditor may never become an LLC member and hence won't ever be able to have any control over or real influence in the company.

A provision also may be present in the articles of organization that requires the remaining members to purchase the interest of a charged member at a predetermined price. The price could be a fair market value price or at a price less than fair market value (if this lesser value approximates the value of the pro rata share of the company's asset value in the event of liquidation). Hence, through careful preliminary drafting, it is possible for LLC members to prohibit third parties (especially judgment creditors) from becoming, or even from wanting to become, members. Rather, the creditor may wish to settle with the debtor for a smaller sum of money than is owed. Therefore, we recommend inserting language to this effect into an LLC Operating Agreement.

Moreover, creditors with no right to cash flows will likely not want to have an economic interest in the LLC. For example, even though a partnership had a provision prohibiting an assignee from becoming a substitute limited partner without the consent of the general partners (and the general partners did not in fact consent), an assignee was nevertheless treated as a limited partner for income tax purposes due to his dominion and control of the interest. This ultimately meant that the assignee reported a distributive share of any income, gain, loss, deduction, and credit available to that interest in the amounts applicable to that interest as if that person were an actual substitute limited partner. (Rev. Rul. 77-137, 1977-1 C.B. 178; see also *Evans v. Commissioner*, 54 T.C. 40 (1970) (*Tax Court held that the assignee of a partnership interest was taxable as a partner because he held a capital interest in the partnership as defined in Treas. Reg. § 1.704-1(e)(1)(v)*)).

This poses obvious problems for a creditor-taxpayer that must report and pay applicable taxes on a distributive share of income that was not actually distributed. This party could wait for years until his claim is satisfied if the company in question is not cooperative and unsympathetic to his situation. *Moreover, the threat or the imposition of adverse tax consequences is a strong negotiation factor relative to settling a personal debt.*

Another major problem for a creditor with a charging order is that the debtor, not the creditor, still retains any company managerial powers held prior to the charge. It is a possibility that in the operating agreement, or perhaps as part of the judgment between the debtor and the creditor, that the debtor may be required to exercise any remaining (nontransferable) interests and rights in the company to the benefit of the creditor and his newly acquired economic interest. Yet such a scenario is unlikely as it may be interpreted to expand the statutory judgment limitations. (Rev. Rul. 77-137).

The Illinois Limited Liability Company Act differentiates between membership interests and distributional interests. The term "distributional interest" means all of a member's interest in distributions by the LLC. 805 ILCS 180/1-5. "Membership interest" is defined as a member's rights in the LLC, including the member's right to receive distributions of the LLC's assets. A mem-

ber is neither an owner, co-owner nor holder of a transferable interest in LLC property. 805 ILCS 180/30-1(a). Conversely, a distributional interest in an LLC is personal property and it may be transferred in whole or in part. 805 ILCS 180/30-1(b). However, the transfer of a distributional interest does not entitle the transferee to become or exercise any of the rights of a member. The transferee would only be entitled to receive the distributions to which the transferor would have been entitled. 805 ILCS 180/30-5. *The transferee of a distributional interest is eligible to become a member if and to the extent that the transferor gives such right as authorized by the operating agreement or upon the consent of all other members.* 805 ILCS 180/30-10(a).

A non-member transferee is not entitled to participate in the management of the LLC's business, or gain access to information concerning the company's dealings, or inspect or copy any of the company's records. 805 ILCS 180/30-10(d). A non-member transferee is entitled to distributions to which the member transferor would be entitled and distributions upon dissolution and winding up of the LLC's business. 805 ILCS 180/30-10(3).

In Illinois, it is statutorily provided that an assignee of a partner's interest may seek dissolution by a court under specified circumstances, 805 ILCS 205/32(2), yet it has been held that such an assignee has no legal interest in the dissolution of a partnership.⁴⁹

Piercing the LLC veil

Piercing the LLC veil is an area of law that is best described as murky or undefined. Moreover, there is little, if any, guidance on point in Illinois. However, a review of Illinois case law suggests that LLC members should be held liable under the common law doctrine of piercing the corporate veil.

Many jurisdictions follow the "alter ego" test to determine whether to hold shareholders personally liable for the debts of the corporation.⁵⁰ The alter ego test emphasizes that piercing the corporate veil is appropriate where public policy interests are best served, such as protecting private rights, and where the corporation fails to remain a separate legal entity apart from its owners, the shareholders.⁵¹ In order to pierce the corporate veil in the Illinois courts, there must be:

(1) such unity of interest that the separate identity of the corporation on

one hand and the shareholder or officer on the other no longer exist; and

- (2) circumstances in which adherence to the fiction of a separate corporate existence would be fraudulent, unjust, or inequitable.⁵² In making this determination, courts consider the following variables:
- inadequate capitalization;
 - the failure to issue stock; and
 - to observe corporate formalities;
 - the non-payment of dividends;
 - the insolvency of the debtor corporation;
 - the non-functioning of other corporate officers or directors;
 - the absence of corporate records; and
 - the amount of control of the dominant stockholders.⁵³

The laws of other states have also been reviewed. Under New York law, *NetTech Solutions L.L.C. v. ZipPark.com* found that the facts alleged could justify a piercing of the LLC veil based upon the alter ego theory because:

- the defendant exercised complete control over the LLC;
- LLC had no employees;
- LLC was involved in no business other than that derived from the agreement with the plaintiff; and
- all of Plaintiff's dealings with the LLC were conducted through the sole LLC member and manager member, which were one and the same.⁵⁴

In *Hamilton v. AAI Ventures, L.L.C.*, the Louisiana court held that the alter ego theory could be applied to hold members of an LLC liable for company debt, just as the theory may be applied to hold shareholders of a corporation liable for corporate debt.⁵⁵ However, as stated earlier, the court proffered this proposition without giving any reasons or justifications for its determination, nor did it cite to any authority for the court's conclusion.⁵⁶ The court simply leaped from the fact that members of a Louisiana LLC will not be held liable for the debt of the LLC merely because of their status as members, to the fact that there are exceptions to the doctrine of limited corporate liability.⁵⁷

In Louisiana, the Fifth Circuit Court of Appeals in *Hollowell v. Orleans Reg' l' Regal Hosp. LLC* addressed the issue of whether the doctrine of piercing the corporate veil would apply to a Louisiana LLC.⁵⁸ The Fifth Circuit held that "Louisiana would treat the LLC in the same manner as a corporation" for alter ego purposes.⁵⁹

Under Illinois law 805 ILCS 180/10-10, liability of members and managers, "a member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager" unless the member consents in writing to be personally liable.

The United States Bankruptcy Court for the Northern District of Illinois held in *Securities Investor Protection Corporation v. R.D. Kushnir & Co.*, examining Section 10-10, stated "[i]t would seem from the foregoing that 'members' or 'managers' of an Illinois limited liability company cannot be held liable for the mere failure to observe corporate formalities or repayment, but nothing in the statute bars piercing of the 'corporate veil' for other grounds on which that may be done for ordinary corporations."⁶⁰

The Court in *Securities Investor Protection Corporation* explains that "[a]lthough generally true that corporations are distinct legal entities separate from their officers, shareholders, and directors, Illinois may allow the corporate veil to be pierced to avoid injustice. The corporate form may be disregarded when (1) there is such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist; and (2) the continued adherence to the fiction of a separate corporate existence would sanction a fraud or promote injustice."⁶¹

The limited case law from other in Illinois and other jurisdictions suggests the conclusion that the corporate piercing law shall be applied to Illinois LLCs. Therefore, Illinois courts will likely apply the typical "alter ego" analysis, minus the "lack of corporate formalities" factor which is statutorily provided for, in holding LLC members personally liable for the debts of the LLC.

The use of LLCs in international transactions⁶²

The development of LLCs in the United States introduces questions concerning the use of these entities in international business transactions. United States enterprises may consider using a U.S. LLC to conduct business in a foreign country (i.e., for outbound transactions). However, before doing so, a U.S. business must consider whether use of a corporation or a partnership for these same purposes is preferable. The choice of entity to conduct outbound transactions will have

significant U.S. tax ramifications at the organization, operation, and termination phases of the foreign operations.

Hybrid entities or U.S. transparent entities, such as a partnership, provide significant flexibility in structuring international transactions. Specifically, a hybrid entity provides the opportunity to use corporate status at the state law level to achieve certain foreign tax and business objectives such as limited liability, while using an entity taxed as a partnership to meet U.S. tax and business objectives.

The "check-the-box" regulations have created great flexibility in structuring the business form in which to carry out international transactions.⁶³ These regulations permit U.S. taxpayers to elect how certain U.S. organizations will be taxed for U.S. tax purposes, as well as how other important tax law provisions will apply. For example, U.S. businesses utilizing hybrid entities may elect out of subpart F and other foreign tax provisions.

Because foreign entities are generally not subject to U.S. taxation on their foreign earnings, transfers of property by U.S. persons to foreign entities present the opportunity to defer U.S. taxation on these earnings until they are repatriated back into the United States. These opportunities are greatest in foreign corporations, since its owners are not taxed currently on corporate earnings. Such opportunities are less significant with partnerships and disregarded entities because their earnings are taxed directly to owners whether or not distributed to owners. Consequently, anti-abuse rules are more significant with regard to transfers to foreign corporations.

Prior to August 1997, transfers of appreciated property by U.S. persons to a foreign partnership were subject to an excise tax if the regular income tax did not impose a tax on the transfer. On such transfers, § 1491 imposed a 35 percent excise tax on the amount calculated by the excess of fair market value of such transferred property over its adjusted basis.⁶⁴ Since it only applied to transfers not subject to the regular income tax, it only affected nonrecognition transfers such as tax-free contributions of property to partnerships. The Taxpayer Relief Act of 1997 repealed § 1491 and substituted § 721(c).⁶⁵ Since U.S. persons who are partners in foreign partnerships must include in their income their distributive share of the foreign partnership income or loss the

repeal is a welcome relief.

Unlike former § 1491, § 721(c) does not impose an excise tax. Under § 721(c), neither the partnership nor any of its partners recognize gain or loss from the contribution of appreciated property to the partnership.⁶⁶ Accordingly, this transfer is now treated the same as a transfer to a U.S. partnership since the partners will be taxed when the partnership realizes the gain. However, the Service reserves the right to alter the general nonrecognition rule as applied to non-U.S. persons. The Service has not yet issued regulations implementing guidelines on this important exception. Consequently, § 721(c) does not currently impose a tax on such transfers.

While § 1491 applied to transfers to foreign partnerships, and § 367 generally applies to transfers to foreign corporations,⁶⁷ neither section contemplates transfers to a disregarded entity. Like foreign partnerships, a U.S. person owning a single-member disregarded entity will be taxed currently on all foreign- and U.S.-source earnings of the entity as if it does not exist. Accordingly, as with foreign partnerships, there appears little current need for a special tax rule governing such transfers.

The Use of LLCs by the Professions⁶⁸

Because professionals typically have conducted business in unincorporated forms, they have faced unlimited liability for obligations arising from their professional practices. Those who have incorporated their practices may have encountered income tax problems (including double taxation of income when operating as a C corporation if one does not zero out their earnings and the lack of flexibility in ownership and operation as an S corporation) and non-tax problems (including administrative costs and the view that operation in incorporated form is either "unprofessional" or impractical). LLCs appear to avoid these problems.⁶⁹

As a result, LLC structures had become the focal point of professionals, including accountants and lawyers, seeking protection from unlimited liability while avoiding double taxation and the need to incorporate. A number of states have provisions specifically allowing professionals to practice as LLCs.⁷⁰

Nonetheless, there are important unresolved questions concerning multistate practice by professional LLCs, including the issue of cross-border

protection from liability and the difficulty for multistate firms to meet state regulatory or statutory restrictions.⁷¹ In order to be a member of a professional service LLC, the member typically must be authorized by law to provide the professional services for which the LLC was formed. Under the LLC statutes of some states, it is required that all members of a professional LLC be authorized to practice in the particular state in which the LLC is organized. Under other state legislation members need be only licensed in the state or states they actually practice.

LLC acts potentially impact the following professionals in particular:

- (1) accountants,
- (2) attorneys, and
- (3) other professionals practicing in Illinois merits consideration.

The American Institute of Certified Public Accountants ("AICPA") was among the first professional organizations to recognize the potential viability of the LLC as a practice vehicle on a profession-wide basis. Before 1992, the AICPA prohibited the practice of accountancy in any form other than as a proprietorship, a partnership, or a professional corporation whose characteristics corresponded to AICPA Code of Professional Conduct Rule 505. The rule was amended in January 1992 by an overall majority of members of the AICPA voting on the issue, and Rule 505, as revised, allows members to select any organizational form, including the LLC, to better serve accountants' needs in connection with limiting their exposure to liability and facilitating their ability to establish multistage practices in order to better serve clients who operate in more than one state.

Most of the LLC acts enacted to date have not explicitly authorized or approved of use of LLCs by accountants; however, as a statutory matter this does not appear to be necessary as long as they are not explicitly precluded from using LLCs. Indeed, the majority of LLC acts remain silent on this point. A Kansas Attorney General's opinion⁷² has authorized the use of LLCs by accountants, but other states have not explicitly issued rulings or attorneys general opinions regarding such usage.

In Illinois, the practice of public accounting is governed by statute.⁷³ A person, either individually or as a member of a partnership or an officer of a corporation, may be deemed to be in practice under the Illinois Public Accounting Act. 225 ILCS 450/8. The

practice of public accounting without licensure with the Illinois Department of Professional Regulation is a Class B misdemeanor. 225 ILCS 450/7, 450/28(a). The Illinois Public Accounting Act was amended by P.A. 88-36, effective January 1, 1994, to permit the practice of public accounting in limited liability company form. 25 ILCS 450/8. The LLC must make application to the Department of Professional Regulation for licensure and pay the requisite fee. 225 ILCS 450/13.

The Illinois Society of Certified Public Accountants previously sought to remove regulatory restrictions that might preclude accountants from utilizing an LLC. It is anticipated that in light of the amendments to the Illinois Public Accounting Act many accountants will perform services as an LLC, and it is unlikely that the Illinois Supreme Court will invalidate this form of organization or prevent limitation of accountants' liability. Although use of the LLC is unlikely to protect a member from personal liability for his or her own malpractice, there is a good likelihood that the LLC form will protect a member of an accounting firm from vicarious personal liability for malpractice committed by a co-owner unlike the case for lawyers, discussed below. Since accountants can utilize LLCs in Illinois, it is anticipated that most accounting firms will explore the structure, using a cost-benefit analysis in their deliberations. Accountants likely to give serious thought to practicing as an LLC are those engaged in practices prone to malpractice and/or bankruptcy (i.e., those who prepare certified audits for publicly traded companies, those who provide tax advice and/or tax return preparation, and those involved in audits of industries such as savings and loans and banks that have been relatively prone to potential professional liability litigation in the event of the bankruptcy or collapse of their audited clients).

The typical disadvantages of using LLCs also apply to professionals, including the filing fees and related costs of formation and operation, which are substantially higher than those of the general partnership form, the lack of law in interpreting many of the provisions that must be utilized in the firm's operating agreement, and the uncertain protection that LLCs provide with respect to shielding a member from practice liability (such as malpractice) that arises due to actions of other members or employees of the firm. In addition, there are certain tax

issues relating to operating as an LLC when one is in a professional practice, including a question of the ability to retain the cash method of accounting rather than being forced into the accrual method, with potentially disastrous tax consequences.

On the basis that every member actively practiced the profession and had voting rights on numerous matters affecting the firm's governance and operation, the IRS has indicated in two Private Letter Rulings a willingness to permit professional service LLCs to use the cash method of accounting. See PLRs. 9321047, and 9328005. It is by no means clear that medium- or large-sized firms will be willing to permit all their members to participate in firm management to the extent permitted in the aforementioned letter rulings. Therefore, professionals would be prudent to seek letter rulings for their own protection absent a Revenue ruling or regulation promulgated on point.⁷⁴

The so-called "Final 4" national accounting firms have chosen to operate as limited liability partnerships ("LLPs") rather than as LLCs. It is understood that this choice was based on numerous factors, including the inability of professionals to operate as LLCs in a few states, the relative ease of registering as an LLP and remaining uncertainties as to the deductibility under §736 of payments to redeem the interests of members of an accounting firm LLC. Accounting firms doing business in Illinois or adjoining states are free to practice in LLC or LLP form, and small- and medium-sized Illinois accounting firms use both types of formats.

Attorneys and Law Firms.⁷⁵ On April 1, 2003, the Illinois Supreme Court issued an amendment to Supreme Court Rule 721 and created Rule 722, authorizing limited liability legal practice.⁷⁶ The Rules were in response to a joint petition filed by the Chicago Bar Association and Illinois State Bar Association in March 2002 requesting that the Court amend the Rules to allow lawyers practicing in limited liability entities to be protected from unlimited vicarious liability under certain circumstances. The Rules took effect July 1, 2003. The Rules eliminate mandatory vicarious liability of law firm partners for malpractice committed by other firm lawyers not in their control. The centerpiece of the Rules is a quid pro quo permitting lawyers with an equity interest in professional corporations,

professional associations, limited liability companies, and registered limited liability partnerships to avoid vicarious liability as long as the firm maintains adequate insurance or other proof of financial responsibility.

A minimum level of insurance under the rules is \$100,000 per claim and \$250,000 annual aggregate, times the number of lawyers in the firm, and insurance need not exceed \$5 million per claim and \$10 million annual aggregate. As a result, the Rules improve clients' ability to recover for malpractice. While every other state allows limited liability practice in some form, only 11 require insurance as a condition of limited liability. Illinois is now one of 12 states which clearly express an interest in putting clients' interests first.

Additional provisions of the Rules protecting clients are that partners remain fully liable for their own malpractice and that of lawyers under their direct supervision and control; partners remain jointly and severally liable for amount of insurance deductible unless proof of financial responsibility is provided in the amount of the deductible, and law firm assets remain liable for malpractice committed by any firm lawyers.

Other Professionals.⁷⁷ There has been some interest in the use of LLCs by other professional groups, including doctors, architects, and engineers. Outside Illinois, various professional groups have responded in different ways to the use of LLCs for their practice groups. In some cases, the political policies relating to the profession itself, rather than specifically to the LLC form, will affect the ability of a particular service group to use LLCs.

In order to permit certain professionals to operate in LLC form, that particular state LLC Act has been amended to explicitly permit a few professionals to use the LLC format. However, the large majority of those professions and occupations that are regulated by the Illinois Department of Professional Regulation have not obtained amendments to the Illinois LLC Act.⁷⁸ Those professions that have benefited from amendments to the LLC Act and/or corresponding professional acts are the following: Architects, professional engineers, and structural engineers. Members of these professions can practice in LLC form in Illinois provided that two thirds of the members of the LLC are licensed in those respective professions. 225 ILCS 305/21.

Dentists: The Illinois Dental

Practice Act, 225 ILCS 25/44, was amended effective August 11, 1994, to authorize use of LLCs by dentists (P.A. 88-573), and the LLC Act (§1-25) was similarly amended to permit the practice of dentistry in the LLC form if all of the members and managers are licensed as dentists.

Physicians: The Illinois Medical Practice Act of 1987, 225 ILCS 60/22, was amended in 1995 to permit physicians in Illinois to practice in LLC form (P.A. 89-201), and the LLC Act (§§1-25 and 5-1) was similarly amended.

Professional land surveyors and land surveyors-in-training: These professionals may practice in LLC form if they possess a valid Illinois license to so practice. 225 ILCS 330/16.

Real estate brokers and real estate salespersons: These professionals can conduct their activities in LLC form provided that every managing member of the LLC holds a license as a real estate broker and no individual salesperson or group of salespersons controls more than 49 percent of the ownership in the LLC. 225 ILCS 455/3.

However, a cost-benefit analysis may cause many service providers to determine that operation in partnership or corporate form is preferable, particularly if the perceived magnitude and risk of personal liability are minor.

Limited liability partnerships (LLPs)

A registered limited liability partnership is a form of business entity established by statute in 1994 within the framework of the Uniform Partnership Act. The Uniform Partnership Act contains provisions under which an existing partnership may become a registered limited liability partnership. 805 ILCS 205/8.1 The Uniform Partnership Act applies to registered limited liability partnerships except where the particular statutes pertaining to those partnerships are inconsistent with the Act. 805 ILCS 205/6(2). The primary distinction of a registered limited liability partnership is the limitation of the joint and several liability of partners found in a general partnership under the Act. 805 ILCS 205/15.

It is this ability to limit liability for the malpractice and misdeeds of one's co-owners while retaining the simplicity of operation and favorable tax treatment of a partnership that makes the LLP attractive to many businesses. For professionals using a traditional partnership, the protection from malpractice liability provided by a LLP

greatly outweighs the expense of maintaining the registration.

1. § 805 ILCS 180/10-10. Liability of members and managers. . . . (c) The failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company.

2. See IRS audit statistics <<http://www.irs.gov/taxstats/index.html>>.

3. Delaware Series LLC.

4. PLR 9415007, 9131006, 8611004.

5. See, e.g., *Estate of Jones v. Commissioner*, 116 T.C. 121, 139, 2001 TNT 45-12 (2001) (40 percent combined discount); *Estate of Strangi v. Commissioner*, 115 T.C. 478, 491-93 (2000) (31 percent combined discount), aff'd in part and rev'd in part 293 F.3d 279, 2002 TNT 118-10 (5th Cir. 2002); *Estate of Dailey v. Commissioner*, T.C. Memo. 2001-263, 2001 TNT 193-8 (40 percent combined discount); *Estate of Weinberg v. Commissioner*, T.C. Memo. 2000-51, Doc 2000-4664 (31 original pages), 2000 TNT 32-10 (approximately 50 percent combined discount).

6. PLR 9332006, 9131006.

7. See supra note 2; see also LTR 9310039.

8. See, e.g., *McNichol's Estate v. CIR*, 265 F.2d 667 (3rd Cir. 1959); *Estate of Linderme v. Commissioner*, 52 T.C. 305 (1969).

9. Even where the decedent could exercise the right only in conjunction with a person having an adverse interest, the section nevertheless applies. See Treas. reg. section 20.2036-1(b)(3).

10. See, e.g., LTR 9415007; LTR 9310039; and TAM 9131006.

11. See id.

12. See *Rauenhorst v. CIR*, 119 T.C. 157, (2002) (holding the Service is bound by a taxpayer-friendly revenue ruling).

13. If the decedent had control regarding partnership distributions and if the partnership agreement had eliminated his fiduciary duty concerning distribution decisions, inclusion under section 2036(a)(2) would have been unquestionably appropriate as required under *Kimbell v. U.S.*, 244 F. Supp.2d 700, 705 (N.D. Tex. 2003) (holding that the ability to control distributions where the agreement negates a fiduciary duty triggers the section).

14. Note also the *Strangi* court also disregarded the fiduciary duty the decedent had owed to a charity that held a 1% limited partnership interest.

15. See, e.g., *U.S. v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 220 (2001) (indicating that long-standing Service interpretation unchanged over a substantial time is deemed ratified where Congress has reenacted the statute without altering the interpretation); see also Mitchell M. Gans, "Deference and the End of Tax Practice," 36 Real Prop. Prob. & Tr. J. 731, 764-75 (2002) (discussing the reenactment doctrine); William N. Eskridge Jr., "Interpreting

Legislative Inaction," 87 Mich. L. Rev. 67, 73 (1988) (discussing the cases that have found Congress implicitly approved of outstanding lower court decisions that were settled at the time of enactment).

16. See *Estate of Thompson v. CIR*, T.C. Memo. 2002-246 (holding that no pooling had occurred because the children had not made a genuine contribution given that, under the partnership agreement, the economic benefits generated by the assets they had contributed would be allocated to them solely and not to the decedent).

17. See BNA Tax Management Portfolios: Estates, Gifts and Trusts, 800 TM VII Estate Planning (2003).

18. Id.

19. Id.

20. See HOWARD M. ZARITSKY, *Tax Planning For Family Wealth Transfers* (3d ed. 1997).

21. See HOWARD M. ZARITSKY, *Tax Planning For Family Wealth Transfers* (3d ed. 1997id).

22. *Church v. United States*, 2000-1 U.S.T.C. P 60,369 (W.D. Tex. 2000), *aff'd without published opinion*, 2001 U.S. App. LEXIS 17551 (5th Cir. 2001). See also FSA 200049003.

23. Several court opinions have addressed the use of family limited partnerships and family corporations. See, e.g., *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001); *Knight v. Commissioner*, 115 T.C. 506 (2000); *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000); *Shepherd v. Commissioner*, 115 T.C. 376 (2000), appeal ending, No. 01-12250-HH (11th Cir. 2001); *Kerr v. Commissioner*, 113 T.C. 449 (1999), appeal pending, No. 00-60903 (5th Cir. 2001); see also *Sather v. Commissioner*, 251 F.3d 1168 (8th Cir. 2001), *aff'g*, T.C. Memo. 1999-29.

24. See I.R.C. § 2704(b)(1), (2).

25. See I.R.C. § 2704(b)(2); Treas. Reg. § 25.2704-2(a), (c).

26. See *Kerr v. CIR*, 113 T.C. 449 (1999); *Estate of Harper v. CIR*, T.C. Memo. 2000-202, in which the court refused to reconsider its *Kerr* decision at the urging of the Service.

27. See *Kerr v. CIR*, 113 T.C. 449 (1999); *Estate of Harper v. CIR*, T.C. Memo. 2000-202; see also FSA 200049003

28. *Knipp Est. v. CIR*, 25 T.C. 153 (1955), *acq. in result*, 1959-1 C.B. 4, *aff'd on another issue*, 244 F.2d 436 (4th Cir. 1957), *cert. denied*, 355 U.S. 827 (1957) (The IRS acquiesced on the issue); see also PLR 200214028 (estate does not include proceeds of life insurance policies on decedent's life that were held and maintained by general partnership, in which decedent had a one-third interest, where proceeds were for benefit of partnership and facilitated partnership's obligation to purchase deceased partner's interest); PLR 9623024 (partner has no incidents of ownership in insurance policy on his life owned by partnership since partnership holds the policy for business purposes).

29. See Treas. Reg. 20.2042-1(c)(6).

30. See also Rev. Rul. 83-148, for the treatment of partnership group-term life

insurance.

31. *Id.*: A sale or assignment of a life insurance contract on the life of an insured who is terminally or chronically ill to a qualified viatical settlement provider would not be a transfer for value except in certain business situations, see §101(g), as added by the Health Insurance Portability and Accountability Act of 1996, P.L. 104-191, §331.

32. The clear implication of Rev. Rul. 69-187 is that as long as there is a gift element in the transaction, the § 101(a)(2)(A) exception to the transfer for value rule applies. But Rev. Rul. 69-187 does not discuss A's basis in the policy. Would the result be different if, at the time of the transfer, the amount of the indebtedness with respect to the policy exceeded A's basis? Treas. Regs. § 1.1015-4 sets forth the rule for determining basis in the hands of the transferee when the transfer is in part a sale and in part a gift:

(a) General rule. Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of —(1) Whichever of the following is the greater: (i) The amount paid by the transferee for the property, or (ii) The transferor's adjusted basis for the property at the time of the transfer, and (2) The amount of increase, if any, in basis authorized by § 1015(d) for gift tax paid; see also Treas. Reg. § 1.1015-5.

33. §101(a)(2)(B); see also PLRs 200111038 (no transfer for value results from transfer of survivorship policies on insured couple from trust they created to limited partnership of which they are limited partners); 9625013-019; and 9625022-023 (shareholders will not possess incidents of ownership in insurance policies on their lives funding a buy-sell agreement, as long as a shareholder may not make any decision with respect to a policy on his life).

34. See Kupferberg & Wolf, *Transferring Life Insurance Policies to a New Partnership*, 20 Est. Plan. 340 (Nov./Dec. 1993). Caution is advisable in this area.

35. Under the "check the box" regulations, a limited liability company can assume the characteristics of either a corporation or a partnership for federal tax purposes, depending upon the LLC's election. See Treas. Reg. §301.7701-3(a). So how the exceptions to the transfer for value rule apply in the case of a limited liability company is not always clear.

36. CAVEAT: The IRS missed a number of opportunities in its ruling, which bring into question the usefulness of this ruling as a model for other taxpayer transactions. The IRS accepted the classification of FLP as a partnership based on the representation that it will not elect to be treated as other than its default classification under Treas. Reg. §301.7701-3(c)(1), but, generally following the no-rule policy, specifically expressed no opinion on FLP's classification as a partnership if it disposes of its interest in LLC. The IRS also specifically expressed no opinion on the validity of the loans and promissory notes for federal tax purposes, the applicability of §§1271-1275 and 7872 to the purported

loans, and husband's treatment as the owner of Trust 3 under the grantor trust rules.

37. Treas. Reg. § 1.351-1(c)(1)(ii).

38. Treas. Reg. § 1.351-1(c)(1)(i).

39. E.g., see Treas. Reg. § 1.351-1(c)(7).

40. I.R.C. § 368(a)(2)(F)(ii) (A diversified portfolio is defined as any portfolio in which not more than 25 percent of the value of its total assets are invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total assets is invested in the stock and securities of 5 or fewer issuers).

41. 15 U.S.C. §§ 80a-3(a)(1)(A), (C), 80a-3(a)(2).

42. U.S.C. § 80a-3(c)(1).

43. U.S.C. § 80a-3(c)(1)(A).

44. 15 U.S.C. § 80a-47(a).

45. See Cornish & Carey Commercial, Inc., SEC No-Action Letter (June 21, 1996); Cornish & Carey Commercial, Inc., SEC No-Action Letter (Feb. 26, 1996).

46. 15 U.S.C. § 80a-2(a)(51)(A)(i)(ii)(iii).

47. 15 U.S.C. § 80a-47(a).

48. *Id.*

49. See *Meridian Homes Corp. v. Nicholas W. Prassas & Co.*, 683 F.2d 201, 34 FR Serv 2d 495, 73 ALR Fed 439 (CA7 Ill 1982).

50. *People v. V & M Industries, Inc.*, 700 N.E.2d 746, 750-51 (Ill. App. Ct. 1998).

51. *Id.*

52. *Id.* at 750.

53. *Id.* at 751.

54. *NetTech Solutions L.L.C. v. ZipPark.com*, 2001 U.S. Dist. LEXIS 14753.

55. *Hamilton v. AAI Ventures, L.L.C.*, 768 So.2d 298, 302 (La. Ct. App. 2000).

56. *Id.*

57. *Id.*

58. *Hollowell v. Orleans Reg'l Regal Hosp. LLC*, 217 F.3d 379, 385 (5th Cir. 2000).

59. *Id.* at 38 n.7. The court further notes "[c]ommentators also agree that for purposes of piercing the corporate veil, an LLC would be treated like a corporation." *Id.* (citing Susan Kalinka, *The Louisiana Limited Liability Company Law After "Check-the Box"*, 57 La. L. Rev. 715, 794 (1997); Eric Fox, *Piercing the Veil of Limited Liability Companies*, 62 Geo.

Wash. L. Rev. 1143, 1167-68 (1994)).

60. See *Sec. Investor Prot. Corp. v. R.D. Kushnir & Co.*, 274 B.R. 768, 775 2002.

61. *Id.* (citing *Van Dorn Co. v. Future Chemical and Oil Corp.*, 753 F.2d 565, 569-70 (7th Cir. 1985)).

62. Substantially from Carter G. Bishop and Daniel S. Kleinberger, *Limited Liability Companies – Tax and Business Law*, WARREN GORHAM & LAMONT 2001.

63. See Treas. Reg. §301.7701-3(a)

64. See repealed IRC § 1491.

65. The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 914-918 (the Act).

66. See IRC § 721(a).

67. See applicable transfers referenced in IRC § 367(a)(1).

68. Incorporated substantially from ILLCE on LLCs (2000).

69. See Sheldon I. Banoff, *From the Thoughtful Tax Advisor: Top Ten Reasons for Professionals to Consider Using LLCs*, 73 Taxes 515 (1995).

70. See Sheldon I. Banoff, *Alphabet Soup: A Navigator's Guide -What Business Form Is Best for Professionals?*, 4 A.B.A.BQs.L. Today, No.4, 10 (Mar.-Apr. 1995).

71. See Sheldon I. Banoff, *Setting Up a Multistate, Professional Practice as an LLC*, 2 J. Limited Liability Cos. 66 (Fall 1995).

72. See Op. Att'y Gen. (Kan.) 92-23 (Feb. 14, 1992).

73. See the Illinois Public Accounting Act, 225 ILCS 450/0.01, et seq.

74. See generally Sheldon I. Banoff, *New IRS Ruling Encourages Professionals To Form Limited Liability Companies*, 79 J. Tax'n 68 (1993); Sheldon I. Banoff, *New Ruling Adds Further Encouragement for Large Firms To Form LLCs*, 81 J. Tax'n 12 (1994).

75. Jennifer T. Nijman, *PRESIDENT'S PAGE: NEW LIMITED LIABILITY RULES GOOD FOR LAWYERS AND THEIR CLIENTS*, 17 CBA Record 12 2003.

76. A copy of the Rules can be found on the CBA Web site at <www.chicagobar.org>.

77. ILLCE.

78. Illinois Department of Professional Regulation, <<http://www.dpr.state.il.us/>>.

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