

## Understanding Cross Purchase Arrangements Using an ILLC in the Post-*Connelly* World

A business cross-purchase buy-sell arrangement using a special-purpose life insurance limited liability company (ILLC) may be a strategic alternative both to the individual ownership model of cross purchase planning and to an entity purchase arrangement. Using it, shareholders in a business can agree to buy a deceased shareholder's interest via a separate, special-purpose entity acting as agent on behalf of the shareholders. This arrangement is useful with more than two shareholders, and may mitigate certain estate valuation issues in the wake of the 2024 U.S. Supreme Court decision *Connelly v. U.S.* (For purposes of this article, the terms "shareholder" and "member" are used to distinguish the owners of the principal business from the owners of the ILLC, though they are the same parties.)

Using an ILLC instead of a traditional cross-purchase is not without additional risk. There are the legal and administrative costs of setting up and maintaining the ILLC, including ongoing management fees and annual tax reporting. The ILLC structure can also complicate decision-making and control, as it introduces an additional layer of management and governance. The ILLC must comply with laws governing its operations, which can be complex and vary by state. The ILLC structure may be less flexible than a traditional cross-purchase agreement in adapting to changes in business ownership or financial circumstances as individual shareholders and members join and leave the business, as well as upon its final dissolution. Lastly, as an insurance-owning business entity, the ILLC has not been subjected to judicial scrutiny under the new *Connelly* precedent. Even using some of the safeguards described in this article, and depending on individual facts and circumstances, ILLC buy-sell arrangements may still fall short of the goal of excluding life insurance proceeds from a shareholder's estate. As such, we recommend consulting your own tax or legal advisor before entering into such arrangement.

### How it works

The special-purpose life insurance LLC is not a new strategy. The arrangement is for closely held businesses with multiple shareholders who want to prevent the basis step-up issues inherent to an entity purchase buy-sell arrangement, and wish to use a cross-purchase arrangement instead. But consider Corporation XYZ with five shareholders, all of whom agree to buy the shares of any who die before the others in a cross-purchase agreement, and to finance the purchases using life insurance. Rather than requiring each shareholder to own four policies on the lives of the others the ILLC acts as a dedicated financial vehicle to hold one life insurance policy on the life of each shareholder, easing administration of the cross-purchase agreement. If a shareholder passes away, the ILLC receives the death benefit from the life insurance policy, and the money is then used by the ILLC to purchase the deceased owner's share of the business from their estate and redistribute it to the survivors.

### The post-*Connelly* LLC

Post-*Connelly*, if a business directly receives a death benefit on a shareholder's life, a portion of it will be likely included in the deceased owner's estate, potentially increasing that person's estate tax burden. But now, in the post-*Connelly* context, when a one life/one policy approach is what the business owners want, the ILLC provides a critical alternative to business ownership of the insurance because, as owner and beneficiary of the policies, it keeps the death benefit separate from the business's assets. And to avoid application of *Connelly* to the ILLC itself, the ILLC operating agreement may provide that a deceased member is deemed to withdraw immediately upon death with all membership rights in the membership interest terminated, as well as the ILLC's tax year with respect to the deceased member's interest.<sup>1</sup> Further, the operating agreement can specify that the value of a deceased member's interest in the ILLC is exclusive of the life insurance death benefit, reducing the value instead to the member's ILLC capital account balance, which may only consist of the decedent's interest in the remaining in-force life insurance policies owned by the ILLC.<sup>2</sup>

To further ensure that the life insurance proceeds are not included in the deceased shareholder's estate via Internal Revenue Code Section 2042, the ILLC members should not have the authority to make decisions regarding the insurance policies on their own lives.<sup>3</sup> For example, the ILLC can be managed by a third-party appointee or a rotating committee of members that excludes an insured. The members should understand these issues and their responsibilities and rights and conduct themselves accordingly to avoid any constructive incidents of ownership that could cause estate inclusion of the death proceeds for a decedent under Section 2042, a separate potential trap from the *Connelly* burden.

### **Transfer for Value Issues**

Assuming the ILLC is taxed as a partnership, any deemed shift in beneficial ownership in the policies to the survivors arising at the death of a member may qualify for the IRC S. 101(a)(2)(B) "partner of the insured" exception to the general transfer for value rule of S. 101.<sup>4</sup> This attribute may also be useful if the business structure changes over time, such as when new owners join the business, existing owners leave, or an existing buy-sell arrangement is restructured to use an ILLC and individually-owned or entity-owned life insurance policies are transferred to the ILLC.<sup>4</sup> For example, if a new owner joins the business and is required to "buy in" to the ILLC, the pro rata transfer of the life insurance policies to the new owner may avoid application of S. 101 transfer for value.

### **Other Advantages**

The arrangement is also flexible enough to take advantage not only of the tax-free nature of life insurance death benefits, but also, when permanent life insurance is used, the tax-advantaged nature of policy cash values. If policy performance is such that loans or partial surrenders from the policies do not jeopardize its death benefit, the money can be distributed to the ILLC members and returned to the business via capital contributions by the shareholders. The availability of cash value is also key when the agreement contains disability provisions requiring non-disabled shareholders to purchase the shares of a disabled shareholder by providing the cash to do this.

If a member fails to pay their share of the life insurance premiums, the business can step in and pay the premiums on their behalf. However, this amount must be treated as a loan or a reduction in the owner's capital account. This is important because it ensures that the premiums are not treated as additional compensation to the owner, which could result in additional tax liability, or, in the case of an S corporation, avoiding a disproportionate shareholder distribution that could put the corporation's Chapter S election at risk. For instance, if the business pays the premiums, it should be documented as a loan to the

owner, which the owner must repay, or which can be deducted from their capital account.

## Conclusion

A special-purpose ILLC can be a powerful tool for managing the transfer of business ownership in the event of an owner's death. By holding life insurance policies in a separate ILLC, the business can ensure that the remaining owners have the funds to purchase the deceased owner's share, while possibly minimizing potential tax and legal issues. The formation and operation of the ILLC require careful planning and adherence to legal and tax regulations, but the benefits of this arrangement can make it a valuable strategy for closely held businesses.

If you have a business planning opportunity, Prudential's Individual Life Advanced Planning team wants to help. We look forward to being of assistance, and can be reached at 800-800-2738, Option 4.

<sup>1</sup>IRC § 706(c)(2)(A) states that upon a partner's disposition of his or her entire partnership interest "The taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates (whether by reason of death, liquidation, or otherwise)."

<sup>2</sup>May be subject to how premium payments are allocated among the members, i.e. whether a decedent may be deemed to have paid premium on the policy insuring their own life.

<sup>3</sup>PLR 200747002 held that the transfer of existing cross-owned life insurance policies to an insurance LLC would not cause incidents of ownership in the insured LLC members if the LLC operating agreement was modified to limited the members' ability to make decisions regarding the policies. PLRs may only be relied upon as precedent by the taxpayer to whom the ruling is issued.

<sup>4</sup>Revenue Procedure 2025-3 states that the IRS will not rule on "Whether, in connection with the transfer of a life insurance policy to an unincorporated organization, (i) the organization will be treated as a partnership under §§ 761 and 7701, or (ii) the transfer of the life insurance policy to the organization will be exempt from the transfer for value rules of § 101, when substantially all of the organization's assets consist or will consist of life insurance policies on the lives of the members."

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