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TOPIC: Tax Court Rules Intergenerational Split-Dollar Arrangement is Covered by Split-Dollar Regulations Section 1.61-22

CITES: *Estate of Clara M. Morrissette et al v. Commissioner*, 146 T.C. 11 (April 13, 2016); Treasury Regulations Section 1.61-22.

SUMMARY: Three dynasty trusts were established on behalf of the decedent, one for each of her sons. In 2006, six non-equity economic benefit so-called intergenerational split-dollar arrangements were created between Clara Morrissette's revocable trust and each of the dynasty trusts. Her revocable trust advanced a total of $29.9 million as one-time single premiums to the dynasty trusts to enable them to purchase insurance on the lives of each of her three sons.

Clara died in 2009 with the arrangements still in place.

The estate valued the amounts receivable by the revocable trusts from the dynasty trusts at $7.497 million. The IRS argued the arrangement was a gift at inception for the full $29.9 million dollar amount of the advances. That determination resulted in a gift tax deficiency of $13.8 million and a penalty of $2.7 million. The estate disputed the deficiency by filing a petition in Tax Court.

The estate filed a partial summary judgment motion with the Tax Court confirming that the arrangements were in fact economic benefit split-dollar arrangements under Treasury Regulations Section 1.61-22, and the court entered a summary judgment in favor of the estate.

RELEVANCE: While intergenerational split-dollar is a very advanced technique used by sophisticated practitioners for their clients, this is the first decision rendered in a number of cases pending in the Tax Court that deals directly with these arrangements.

The IRS has been arguing for most of a decade that single premium split-dollar arrangements could not use the economic benefit regime of the Regulations, but instead had to use the loan regime, because they provided "other benefits," or alternatively that the single premium payments "prepaid" all future economic benefits provided under the arrangement, or that since future premiums had been prepaid, the arrangements were, in effect, reverse split-dollar arrangements, and under Notice 2002-59, term costs could not be used to measure the benefit to the donee trust.

If the loan regime applied, since no interest was provided, the arrangement was a gift term loan under the Regulations, with the discounted present value of all of the imputed interest treated as a gift in the first year of the arrangement; if the single premium prepaid future economic benefits, they were all gifts in the first year of the arrangement.

This is a helpful decision for intergenerational split-dollar arrangements and the fact that it was a full Tax Court decision rather than merely a Memo decision gives it precedential value.

The opinion also is an interesting walk through the weeds of the split-dollar regulations in a way that can make them more understandable to anyone who is interested.

Editors' Comment: It is important to note that the key issue in this case – the gift tax valuation issue - has yet to be decided: **Howard Zaritsky**, in **Leimberg Information Services, Inc.** (LISI) Estate Planning Newsletter # 2408, stated:

It is understood from reliable sources that the receivables in Estate of Morrissette were valued by increasing the cash surrender value by the rate of growth projected by the insurers, reducing this figure by the ongoing tax liabilities, and then discounting it to reflect the delay that will be likely before the amount is paid. The Morrissette estate valued the receivable at approximately $7.5 million. The premiums paid a few years earlier were nearly $30 million. This, alone, removes $22.5 million from Mrs. Morrissette's gross estate.

The correct valuation of the receivables still must be decided in Estate of Morrissette, and until it is, practitioners cannot be certain about the full value of intergenerational discounted private split-dollar arrangements. If the court rejects these discounts entirely and holds that the estate's right to recover the premiums it has paid is equal to the amount it has paid, then this technique will still remain an effective way to pay substantial premiums without large gift tax liabilities. If, however, the court agrees to a significant discount, as seems appropriate, this technique may become a major means of transferring significant amounts of family wealth at greatly reduced tax costs.

Lee Slavutin of **Stern Slavutin** suggests that the drafting lawyer should provide in the split dollar agreement and collateral assignment that:

1. The purpose of the split dollar agreement: to fund a permanent life insurance policy for ………(in Morrissette it was a buy sell).

2. A preliminary recital that the agreement is intended to qualify as an economic benefit arrangement under Reg 1.61-22 and that the ONLY benefit intended to be provided to the "donee" trust is current life insurance protection.

3. Do NOT give the donee trust the right to borrow against the cash value.

4. Provide, at termination of the arrangement or death, that the donor gets the GREATER of cash value (without regard to surrender charges) or premiums paid.

5. The donor is REQUIRED to pay all premiums and the donee has no obligation to pay premiums. (If premiums are determined to have been "pre-paid" there will be no additional benefit to the donee trust.)

6. Do not include the disposition of the receivable at death. (Otherwise, it may be construed as an additional benefit to the donee trust).

FACTS: Clara M. Morrissette (CMM) was a widow. Her husband started a moving company in 1943 that, with other companies that were incorporated or purchased, became the Interstate Group (IG). She had three sons, Arthur (A), Donald (D), and Kenneth (K). In 1994 CMM established a revocable trust (CMM Trust), with her as initial trustee. In 2006, when CMM was 93, the three brothers became co-trustees of the CMM Trust. On August 18, 2006 a court found CMM permanently incapacitated and appointed an unrelated employee of IG as conservator.

The conservator, on behalf of CMM, established three dynasty trusts, one for the benefit of each son respectively. On September 19, 2006 the CMM Trust was amended to permit the trustee to "(i) pay premiums on life insurance policies acquired to fund the buy-sell provisions of the … (Interstate Group's) business succession plan, and (ii) make loans, enter into split-dollar life insurance agreements or make other arrangements." Additionally, the CMM Trust Amendment authorized the trustee to transfer each of the split-dollar receivables when repaid back to each dynasty trust owning the receivable or directly to each son. As noted, thereafter, the decedent's revocable trust and each dynasty trust entered into single premium, non-equity collateral assignment arrangements with each dynasty trust.

On September 21, 2006 the dynasty trusts and all of the trusts (including the CMM Trust and other unspecified trusts) entered into a shareholders' agreement that provided that on the death of any of the brothers, the surviving siblings or their dynasty trusts would purchase the IG stock of the decedent. Life insurance policies were purchased in each of the dynasty trusts on the lives of the brothers. Each trust would own policies on the other siblings (six policies total) so that A's trust would own policies on the lives of D & K, D's trust would own policies on the lives of A & K, and K's trust would own policies on the lives of A & D.

CMM Trust advanced approximately $9.97 million to each of the three dynasty trusts. Each of the trusts used the advances to pay lump sum premiums on each of the respective policies. From the language of the decision it appears that the policies were universal life policies under which the amount of the premium to be paid (if any was to be paid) could be determined by the owner.

The split-dollar arrangements stated that upon the death of the insured or the termination of the arrangement while the insured was alive, the CMM Trust would receive the greater of (a) the premiums advanced or (b) the cash surrender value.

Each arrangement had the following recital:

> WHEREAS, the parties intend the Agreement be taxed under the economic benefit regime of the Split-Dollar Final Regulations, and that the only economic benefit provided… is current life insurance protection.

The dynasty trusts executed collateral assignments to the CMM Trust as per the agreements. In each year from 2006 to 2009, gifts were reported using Table 2001 for the face amount of the policies less the greater of the premium advance or the cash surrender value.

The petitioners filed a motion for a partial summary judgment as to whether these were economic benefit split-dollar arrangements as described in Section 1.61-22. The IRS maintained that this was a matter of fact, not of law, and had claimed that a summary judgment was therefore not appropriate. In its discussion of the case, the Tax Court said the question was a legal issue and not an issue of fact. It decided the taxpayer's request for partial summary judgment was appropriate.

To support its contention that the premium advances were gifts, the IRS made four different arguments.

1. The arrangements didn't qualify under the split dollar economic benefit regime of Treasury Regulations Section 1.61-22.

2. The arrangements were loans covered under Treasury Regulations Section 1.7872-15.

3. The arrangements were reverse split-dollar arrangements as described in Notice 2002-59.

4. The payments were pre-paid premiums and not split-dollar advances.

This is the court's response to each argument:

1. The court paraphrased Regulations Section 1.61-22(b)(1) describing a split-dollar arrangement:

   > as an arrangement between an owner and a non-owner of a life insurance contract in which: (i) either party to the arrangement pays, directly or indirectly, all or a portion of the premiums on the life insurance contract; and (ii) the party paying for the premiums is entitled to recover all or any portion of those premiums, and such recovery is to be made from, or is secured by the proceeds of the life insurance contract.

   Because of the language of the regulations, in general the owner of the insurance contract will be deemed the owner of the policy. Under the regulations, the way the terms "owner" and "nonowner" are used, an arrangement using a collateral assignment in which the beneficiary of the policy is the owner would be a loan regime arrangement. An exception is made such that, even if a collateral assignment is used, if the parties to the arrangement consistently treat it as an economic benefit arrangement and the premium provider is entitled to the greater of premiums advanced or cash values (without regard to surrender charges) it will be treated as such [1.61-22(c)(ii)(A)(2)]. Finally if any other economic benefit is conferred *other* than the net death benefit, it will be treated as a loan under Regulations Section 1.7872-15.

   The court determined that, based on the language of the arrangement, the CMM Trust was entitled to recover the greater of the advance or the cash value and therefore no economic benefit (other than the value of the reported term life insurance coverage) was conferred on the dynasty trusts.

   Regarding the applicability of Section 1.61-22, the Service argued that under the amendment to the CMM Trust, the dynasty trusts or the sons would be the recipients of the receivables upon CMM's death. The court noted that the CMM Trust was a revocable trust and that CMM had the absolute right to change the trust during her lifetime. The decision said:

   > The 2006 Amendment to the CMM Trust is not part of the split-dollar life insurance arrangements between the CMM Trust and the Dynasty Trusts.

   It went on to say that, since the CMM Trust owned the receivables, it was appropriate that the Trust account for the disposition of the receivables. The split-dollar arrangements do not address the disposition of the receivables.

2. The court stated that if there were other economic benefits conferred, it would fall under Regulation Section 1.7872-15. The dynasty trusts had no current access to the cash values of their respective policies. Since there were no economic benefits conferred, the arrangements did not fall under the split-dollar loan regime.

3. The court did an analysis based on the Service's position that this was a reverse split-dollar arrangement under Notice 2002-59. The Service has taken the same position regarding other intergenerational split-dollar arrangements. The court found that the arrangement was not a reverse split-dollar arrangement as described in the Notice. It also said that the measure of the value of the economic benefit was determined under Table 2001 as stipulated in the Notice 2002-8, not Table PS 58 that had produced the benefits of reverse split-dollar.

4. Finally, since the arrangement was governed by the economic benefit regime of Regulations Section 1.61-22, this precluded considering the advances as pre-paid premiums.

Unless the IRS appeals this case, all that's left to deal with is the valuation of the receivables.

One interesting point made by the court in this case: "Mrs. Morrissette, who was 94 at the time she set into motion these arrangements, wanted the Interstate Group to remain in her family." This seems to be dicta as far as the decision goes, but something the court thought worth mentioning. How or if it influenced the court's decision is unclear.

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