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TOPIC: Generational Split Dollar (GSD): Where Are We Now?

MARKET TREND: With its recent success in disputing the valuation of the reimbursement rights in economic benefit GSDs, the IRS is doubling down on its challenges to these arrangements.

SYNOPSIS: Economic benefit ("EB") GSDs involve a split-dollar arrangement between a parent and his life insurance trust to fund the trust's purchase of life insurance on the parent's child. For wealth transfer planning purposes, EB GSDs assume that the present value of the repayment owed to the parent for premium payments is subject to a significant discount upon transfer due to the extended repayment period (i.e., the insured child's life). As discussed in WRMarketplace No. 18-18, recent summary judgment opinions of the Tax Court, including in the Est. of Cahill, rejected the applicability of a discount as a matter of law, but not as a final decision on the merits. Subsequently, the Cahill case settled, with the estate conceding that the full value of the GSD reimbursement was taxable in the parent's estate. Now, the IRS has gone on the offensive by filing its own summary judgment motion in the Est. of Morrissette, requesting that the Tax Court rule that no discount applies to the repayment right under an EB GSD, as a matter of law. These developments raise the question of whether EB GSDs have any future for planning purposes and whether loan regime GSDs are a viable alternative.

TAKE AWAYS: Clients with existing EB GSDs should meet with their advisors now to review their options, putting together an action plan that can be implemented promptly, as needed, if and when there is a final decision on EB GSD valuation. Clients considering new EB GSDs should contemplate the purpose of the arrangement and understand that no valuation discount may apply upon transfer of the GSD reimbursement. EB GSDs, however, may still offer the estate and life insurance planning benefits associated with traditional split-dollar planning, independent of any valuation discount, particularly if the insured child can't afford life insurance. Loan-regime GSDs may be another option, when clients have a legitimate non-tax purpose for the arrangement. However, loan-based GSDs could still fall under scrutiny as the IRS begins to enlarge its review of these arrangements. As decisions in the EB GSD cases could have broader implications for split-dollar and life insurance planning, AALU will continue to analyze these issues and monitor legal developments to provide additional updates to the industry, as well as take appropriate action when necessary.

WHAT IS GSD? A BRIEF REFRESHER

Overview. GSD[1] is a non-equity split dollar arrangement between a parent and the parent's irrevocable life insurance trust ("**ILIT**"), which funds the ILIT's purchase of a life insurance policy, typically insuring a child. The ILIT is the sole policy owner and beneficiary, and it usually benefits the child and/or his or her descendants.**[2]** GSDs can be created as EB GSDs or loan arrangements ("**Loan GSDs**") and will be taxed accordingly under the EB or loan regime of the final split-dollar Treasury Regulations.**[3]**

EB GSDs. Recent Tax Court cases involving EB GSDs have typically included similar features:

- Parent has the sole obligation to pay all policy premiums.
- The only benefit received by the ILIT under the GSD is the cost of current life insurance protection on the insured child (i.e., the term premium).
- The GSD terminates at the earlier of parent's death or **mutual agreement** of ILIT and parent (**parent cannot unilaterally terminate** the GSD or access policy cash value).
- Upon termination, parent is entitled to reimbursement equal to the **greater of** the total premiums paid or the policy's cash value at termination ("**GSD Reimbursement**").

Key Transfer Tax Assumptions. EB GSDs have relied on **two key transfer tax assumptions**:

- ***Application of EB Regime***. Assuming taxation under the EB regime, **parent's gift to the ILIT is limited to the annual gift of the term premium**, less any ILIT contributions. While the ILIT must eventually repay the GSD Reimbursement, it is not due for many years (i.e., upon the insured child's death), during which time any policy cash value continues to grow.
- ***Discount for SDA Reimbursement.*** The present fair market value of the GSD Reimbursement is subject to a substantial discount because: (1) the anticipated life expectancy of the insured child delays repayment, and (2) parent cannot unilaterally terminate the GSD to accelerate the repayment. Accordingly, minimal value is subject to gift or estate tax upon parent's lifetime or testamentary disposition of the GSD Reimbursement.

Example: In *Estate of Cahill*, the parent's estate valued its GSD Reimbursement at $183,700, a 98% discount from the policies' total cash surrender value of $9,611,624, resulting in a transfer of $9,427,924 without gift or estate tax.

WHAT'S HAPPENED?

Recent Tax Court Rulings. Three main cases have come before the U.S Tax Court dealing with the gift and estate taxation of EB GSDs: (1) *Est. of Cahill*, (2) *Est. of Morrissette*, and (3) *Est. of Levine*. These cases have generated the following rulings:

- ***Morrissette & Levine: EB Regime Applies.*** In dealing solely with the gift tax consequences of the premiums paid under EB GSDs, the Tax Court ruled that, **as a matter of law**, parent's gifts would be limited to the annual EB provided to the ILIT (the term premium).[4] These opinions confirmed the gift tax treatment of the premium payments, but did not resolve the significant question of how to value the GSD Reimbursement for gift or estate tax purposes.
- ***Cahill & Morrissette: Potentially No Discount for SDA Reimbursement.*** The Tax Court **refused to reject, as a matter of law, the IRS position that the full cash value of a policy under an EB GSD should be included in parent's estate**.**[5]** These opinions left open the possibility for gift or estate taxation of a lifetime or testamentary transfer at the full, undiscounted value of the GSD Reimbursement.

Current Case Status.

- ***Cahill***. Soon after these rulings, the *Cahill* case settled, with the estate fully **conceding the estate tax valuation** of the EB GSD, effectively agreeing to estate taxation on the undiscounted value of the underlying policy's cash value of $9,611,624 (i.e., the GSD Reimbursement).
- ***Morrissette.*** As discussed in a recent *WRNewswire*, following on its success in *Cahill*, the IRS has filed its own summary judgment motion in *Morrissette*, requesting that the Tax Court rule, as a matter of law, that the full cash surrender value of the policy underlying the EB GSD is includible in the parent's estate, in part because the build-up in the policy's cash surrender value is "income" in which the parent has retained a life interest after the transfer.**[6]** The taxpayer has been ordered to file a response to the IRS motion by January 15, 2019.
- ***Levine***. Levine has proceeded to a full trial, and a final opinion from the Tax Court on the valuation issue is pending, although the timing is uncertain.

WHERE DOES THIS LEAVE EB GSDs?

Given its actions in *Morrissette*, it appears the IRS believes that, after *Cahill*, the Tax Court could finally rule that the parent's estate includes the full value of the GSD Reimbursement, eliminating the possibility of significant valuation discounts for such reimbursements and the resulting benefits.

To be clear, the Tax Court has not yet issued a final decision, and, as discussed in *WRMarketplace No. 18-15*, *Cahill* included several facts that the court viewed negatively, notably: (1) the parent's son acted on the parent's behalf to create the ILIT and to negotiate the EB GSD between the parent and the ILIT, (2) there was a lack of a true non-tax purpose for the arrangement, and (3) a commercial loan was used to fund parent's obligations under the EB GSD, which charged interest at a rate higher than the guaranteed return on the policy's cash value and was repayable after only five years, well short of the GSD's expected termination. As *Morrissette* and *Levine* do not appear to have these same facts, the distinctions may result in a different Tax Court analysis.

However, until final resolution of the valuation question, the IRS's success in *Cahill* likely will bolster its scrutiny of EB GSDs and increase the chance of challenges. Accordingly, while waiting for a final Tax Court decision, clients with existing EB GSDs should consider the following:

- Promptly review the arrangement and potential options with advisors, including whether the structure can and should be unwound or whether it makes sense to leave the plan in place, even if a valuation adjustment for the GSD Reimbursement becomes unavailable.
- Consider the circumstances of the arrangement in light of the *Cahill* opinion and determine whether any changes are needed and/or can be made to further differentiate the arrangement from *Cahill* (e.g., repayment of any third-party premium financing loan, better substantiation of the non-tax purposes of the arrangement, etc.).
- Put together a plan of action based on the review that can be implemented promptly, if needed, after any final Tax Court decision.

Clients considering new EB GSDs should contemplate the purpose of the arrangement and understand the risk that a valuation discount may not apply upon transfer of the GSD Reimbursement. The client may wish to reconsider the EB GSD or review the potential advantages and issues associated with Loan GSDs (discussed below).

Note that EB GSDs can still offer the estate and life insurance planning benefits associated with traditional split-dollar planning, independent of any valuation discount for the GSD Reimbursement, particularly if the insured child cannot afford the life insurance. For example, assume the ILIT is structured as a GST-exempt dynasty trust. In paying the premiums on the policy insuring the child, the annual gift by the parent is limited to the EB cost (which may be fairly small depending on the insured child's age). Allocation of the parent's GST tax exemption to the ILIT would be correspondingly limited, and, if the ILIT can pay or reimburse the EB, no GST exemption allocation would be required. The death benefit received by the ILIT upon the child's death (in excess of any repayment obligation) would pass to the ILIT, fully-GST tax exempt and without income tax, potentially providing significant benefits to grandchildren. Of course, as with traditional split-dollar, an exit strategy should be considered at implementation of the GSD.

WHAT ABOUT LOAN REGIME GSDs?

For valuation purposes, EB GSDs, rather than Loan GSDs, often were preferred because the undiscounted GSD Reimbursement was based on the greater of the total premiums paid by the parent (net of the annual EB) or the policy's cash value. With Loan GSDs, the full value of the loan repayment could be higher, as the loan amount typically equals the full value of the premiums paid with interest, which often is accrued for the entire duration of the loan (i.e., until the death of the insured child).

Given the valuation uncertainty regarding EB GSDs, however, the trend has been to look to Loan GSDs as an alternative, which can offer the following:[7]

- Compliance with the definitions of "split-dollar life insurance arrangement" and "split-dollar loan" under the split-dollar regulations can ensure the arrangement is treated both as a split-dollar loan and a loan for federal tax purposes.[8]
- Typically, there is no annual gift tax associated with the loan(s) used to pay the life insurance premiums (unless any loan interest is foregone).
- The split-dollar regulations specifically authorize split-dollar loans for the insured's life (an equivalent duration to an EB GSD).

- A lump-sum loan can lock in the interest rate (at currently low AFRs) for the entire loan term (i.e., the insured child's life expectancy).
- Interest can be accrued over the loan's duration (although the value of the repayment obligation will increase).
- The loan can be secured solely by the policy death benefits. Policy cash value is not required as collateral and is not a measure of the potential repayment due under the loan, potentially limiting the possible estate inclusion exposure (unlike in EB GSDs, where the SDA Reimbursement is tied to the greater of the total premiums paid or policy cash value).
- Restrictions inherent in the loan are required under the applicable Treasury Regulations, potentially limiting the risk that such restrictions would be disregarded for estate tax valuation.
- Discounts in valuing a promissory note/loan in a lender's estate have been allowed in the past.
- The IRS has not appeared to target Loan GSDs to the same extent as EB GSDs.

In addition, the *Cahill* court distinguished between the treatment of promissory notes and the treatment of a reimbursement right under an EB GSD. The Cahill court noted that, with a promissory note, the note term is a bargained-for part of the economic deal between the parties, with the debtor compensating for the term by paying interest to the lender. According to the *Cahill* opinion, nothing in the facts presented suggested that the ILIT ever paid anything to compensate parent for the indeterminate term of the GSD Reimbursement, making it entirely unlike bona fide notes. The possible implication is that an adverse Tax Court decision on the valuation of an EB GSD may not impact Loan GSDs.

Loan GSDs, however, have their own considerations:

- The IRS has placed the valuation of promissory notes for gift and estate tax purposes on its Priority Guidance Plan, which makes them a target for scrutiny.
- Even though Loan GSDs are governed by a different split-dollar tax regime for gift tax purposes, the valuation of the loan for estate tax purposes will still rely on generally applicable estate tax principles. Accordingly, the IRS may seek to challenge the valuation of Loans GSDs too, possibly using some of the same challenges as with EB GSDs.

- If the note under the Loan GSD is discounted for estate tax purposes, when it is finally repaid, the excess of the payments over the note's basis (i.e., the discounted estate tax value) will be ordinary income to the recipient (although this may occur years later).**[9]**
- Loan GSDs should still have a significant, non-tax planning purpose.

TAKE AWAYS

Clients with existing EB GSDs should meet with their advisors now to review their options, putting together an action plan that can be implemented promptly, as needed, if and when there is a final decision on EB GSD valuation. Clients considering new EB GSDs should contemplate the purpose of the arrangement and understand that no valuation discount may apply upon transfer of the GSD reimbursement. EB GSDs, however, may still offer the estate and life insurance planning benefits associated with traditional split-dollar planning, independent of any valuation discount, particularly if the insured child can't afford life insurance. Loan-regime GSDs may be another option, when clients have a legitimate non-tax purpose for the arrangement. However, loan-based GSDs could still fall under scrutiny as the IRS begins to enlarge its review of these arrangements. As decisions in the EB GSD cases could have broader implications for split-dollar and life insurance planning, AALU will continue to analyze these issues and monitor legal developments to provide additional updates to the industry, as well as take appropriate action when necessary.

NOTES

[1] The arrangement also may be referred to as "intergenerational split dollar" or "discount private split-dollar."

[2] The parent retains no interest in the ILIT as a trustee or beneficiary. The child is not a trustee of ILIT and holds no incidents of ownership in the policy for estate tax purposes.

[3] See Treas. Regs. §1.61-22 and §1.7872-15.

[4] *See Est. of Morrissette* (146 T.C. No. 11) and *Est. of Levine* (U.S. Tax Court Docket No. 009345-15, Order and Decision dated Jul. 13, 2016).

[5] *See Est. of Cahill*, TC Memo 2018-84 and *Est. of Morrissette,* U.S. Tax Court Docket No. 004415-14, Order and Decision dated June 29, 2018. Each estate requested that, as a matter of law, the policy's cash value was not subject to inclusion in the parent's estate under Internal Revenue Code ("**Code**") §2036 and §2038 (*Cahill*) and §2703 (*Cahill* and *Morrissette*). Note that, unlike the *Cahill* opinion, the Morrissette opinion did not provide a significant analysis of the issues, but simply followed the *Cahill* decision.

[6] The IRS motion also argues that estate inclusion should result at a matter of law because (1) the parent, in conjunction with another person (the ILIT) retained the right to designate person who would possess or enjoy the property because the parent could agree with the ILIT to terminate and recover at least the cash surrender value of the policy; (2) the parent, in conjunction with the ILIT, retained the right to terminate the EB GSD, which would immediately provide the parent with complete control over the cash surrender value of the policy upon exercise; and (3) the restrictions imposed by the EB GSD's on the parent's unilateral right to terminate the EB GSD and receive repayment (equal to the policy's full cash surrender value) should be disregarded, effectively treating the parent as owner of the underlying policy, not the repayment right. *See* Code §§2036(a), 2038, and 2703. The IRS also argues that the exception to §§2036 and 2038 for a bona fide sale for full and adequate consideration does not apply because the parent did not receive full and adequate consideration for the amounts advanced under the EB GSD, based on the discounted value of the repayment right.

[7] See e.g., Steve R. Akers, "*Estate of Cahill v. Commissioner, T.C. Memo. 2018-84 (June 18, 2018), Extension of Estate of Powell's "In Conjunction With" Analysis for §§ 2036(a)(2) and 2038, and Broad Application of § 2703(a) to Contractual Rights; Tax Court Denial of Taxpayer's Motions for Summary Judgment in Intergenerational Split Dollar Case*," Bessemer Trust Company, June 2018; Lee Slavutin, Richard Harris, & Martin Shenkman, "*Intergenerational Split Dollar, Recent Adverse Decisions in Morrissette and Cahill – Where Do We Go from Here,*" LISI Estate Planning Newsletter #2651 (July 17, 2018) at leimberg.com.

[8] Treas. Reg. § 1.61-22(b)(1) defines a "split-dollar life insurance arrangement" as any arrangement between an owner and a non-owner of a life insurance contract that meets the

following: (1) either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract, including payment by means of a loan to the other party that is secured by the life insurance contract; (2) at least one of the parties paying premiums is entitled to recover, conditionally or unconditionally, 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: (3) the arrangement is not part of a group-term life insurance plan under Internal Revenue Code §79 unless such plan provides permanent benefits to employees. Under Treas. Regs. §§ 1.7872-15(a)(2)(i) and (b)(1), a "split-dollar loan" meets all the following requirements: (1) the payment is made, directly or indirectly, by the non-owner to the owner (including a premium payment made by the non-owner directly or indirectly to the insurance company with respect to the policy held by the owner); (2) the payment is a loan under general principles of federal tax law or, if it is not a loan under general principles of federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest); and (3) the repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both. Treas. Reg. §1.7872-15(d)(2)(i) provides a safe harbor for satisfying the second requirement if both parties to the split-dollar loan represent, in a signed writing that contains the information and statements specified in Treas. Reg. §1.7872-15(d)(2)(i), that a reasonable person would expect that all payments under the loan will be made. Each party should attach a copy of the representation to its federal income tax return for each taxable year in which the lender makes a loan to which the representation applies (see Treas. Reg. §1.7872-15(d)(2)(ii)).

[9] For lifetime gifts of a note, however, Code §1015 provides for carry-over basis – i.e., the recipient's basis in the note would be the donor's basis for purposes of determining the amount of any gain. Therefore, a reduction in value of the note up to the time of the gift should not result in a reduced basis, at least for purposes of determining later gain.