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"Morrissette II" — the Tax Court drops another shoe: What we know (and what we don't) about inter-generational split dollar

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Estate Planning for high net worth clients can often involve many different concepts and tools used to transfer wealth, family property and business interests; all while mitigating erosion by tax liabilities and creditors. At the heart of the *Morrissette* cases is just such a concept known as "intergenerational split dollar." In April of 2016, the U.S. Tax Court, in the case of *Estate of Clara M. Morrissette et al.*, 146 TC 171 (04/13/2016), handed down the first official pronouncement considering the proper tax treatment of this particular type of split dollar arrangement. This opinion granted summary judgment as to some of the open issues regarding the validity of the concept itself but left a lot of questions unanswered. On May 13, 2021, the Tax Court issued a second opinion dealing with several of these open issues.

The *Morrissette* cases are very technical and rely heavily on a robust factual background, but as we will see by the Tax Court's decisions, the differences between intergenerational split-dollar and plain vanilla economic benefit split-dollar can make all the difference.

What is intergenerational split-dollar?

In its simplest form, intergenerational split dollar uses available funding by grandparents ("Gen 1") to pay for life insurance on one or more life of the next generation ("Gen 2") for the benefit of future generations ("Gen 3+"). In essence, it is nothing more than an economic benefit regime split dollar arrangement with the family serving as the bank, thereby funding premiums to the life insurance policy owner — typically an irrevocable life insurance trust ("ILIT").

In a traditional economic benefit split dollar arrangement the grantor creates an ILIT for the purpose of owning life insurance on the grantor's life for the benefit of the grantor's children and other descendants. The funding for the premiums on that life insurance policy is generally advanced to the ILIT by the grantor. In return, the grantor receives a collateral assignment on the policy entitling them to receive the greater of aggregate premiums advanced or cash surrender value at the time of termination.

Because this obligation must be repaid by the ILIT, the IRS views the gift to be the economic benefit of the policy, not the whole of the premiums advanced. Thereby, gift taxes can be minimized or eliminated. The arrangement will either terminate at the death of the grantor/insured or at some earlier targeted date. In short, the goal of this traditional split dollar arrangement usually seems clear: providing a death benefit for the grantor's children at a minimum of gift-tax cost.

By contrast, in an intergenerational split dollar arrangement, the lender is Gen 1, and the loan is to an ILIT for the benefit of Gen 3+. The ILIT owns life insurance insuring the life of Gen 2. Notably, one thing that is *not* different is that the repayment obligation is generally due upon the death of the insured(s), which is expected, in the usual course of life, to be after the death of the Gen 1 lender. As a split dollar arrangement, it does the same work. But how do the differences in these two approaches change how the arrangement must be treated for gift/estate tax purposes?

What the court has said.

In *Morrissette,* Gen 1 (Mom) created three ILITs for the benefit of Gen 2 (her three sons). She then entered into an economic benefit split dollar arrangement with the ILITs and transferred about $30M across those three ILITs to buy life insurance on the lives of her sons. The underlying purpose of the life insurance was to fund a buy/sell agreement between Mom and the ILITs, so that, upon the death of any of the sons, the surviving sons' ILITs could buy the decedent son's shares in the family business. Mom reported gifts to the trusts for tax years prior to her death using the economic benefit regime. When Mom died her estate claimed the value of the split dollar agreement as $7.48M, but the IRS disregarded the continuing split dollar agreement, treated the $30M transfer as a taxable gift to the ILITs, and filed a tax deficiency suit. In Morrissette I, the Tax Court disagreed and ruled against the IRS, saying instead that the arrangement was a valid economic benefit split dollar arrangement.

In the second *Morrissette* opinion, the Tax Court went a bit further. The IRS argued that the death benefit should be included in Mom's estate under either of two sections of the Internal Revenue Code, specifically §§2036 and 2038. IRC §2036 requires that a decedent's estate include any property transferred during life where the decedent retained the right to the income from property for the decedent's life. The IRS's argument was that because Mom was entitled to receive the greater of cash surrender value of the property or aggregate premiums paid, she and only she enjoyed the gain on the policy apart from death benefit. Likewise, IRC §2038 requires that a decedent's estate include any property that the decedent gave away during life if the transfer was revocable. The IRS contended that Mom's funding of the policy was a revocable transfer and therefore the full value of the policy death benefit was includible. The Tax Court disagreed on both arguments and said that because the split-dollar arrangement was made in a bona fide sale for full and adequate consideration, neither of these Code sections applied. On its face, a win for the taxpayers.

More importantly, the Tax Court favorably ruled that the value of Mom's rights under the split dollar agreement must be included in her estate, but allowed them to be valued using a "discounted cash-flow method of valuation" based on the underlying contract. The IRS had argued that the full $30M funded should be included as a contractual split dollar right. However, because those contractual rights were to receive a value far in the future, they were valued at less than the face value at the time of Mom's death. Again, viewed solely on those findings, this could be construed as a win for the taxpayers.

Nevertheless, because of specific provisions in the split dollar agreement, the Tax Court agreed with the IRS's argument that the agreement most likely would not be continued until that "far in the future date" but rather terminated in the near future, and set the value of the rights in Gen 1 Mom's estate at approximately $28M. Therefore, based solely on the language the rulings seem favorable to the taxpayers, but the IRS ultimately got almost all that it had been asking for.

What we still don’t know.

The rulings in *Morrissette*, as well as in other cases after the first *Morrissette* opinion in 2016, are heavily based on specific provisions in those particular split dollar agreements as well as the factual circumstances of the families, their businesses, and the relationships among them all. For future reference, we cannot be certain how the courts might rule in a different intergenerational split dollar case with even slightly different facts. How will other intergenerational split dollar cases turn out? We don’t know much more about that now than we did before *Morrissette*.

Conclusion

This latest *Morrissette* opinion represents a formal victory for the taxpayer on almost every point, but the IRS got almost everything it wanted. The Court found that the ~$30M of the funding for the trust-owned life insurance policies was a valid split-dollar arrangement and not a gift, that IRC §§2036, 2038, and 2703 did not cause inclusion of any of the funding or life insurance values in the estate of the decedent because of applicable *bona fide* “sale” exceptions under each section. The value of the split-dollar receivable in the estate of the Gen 1 Mom should be valued as the present value of a future interest. All good news for the taxpayers. However, the taxpayer estimated the value the interests in the decedent’s estate at ~$7M, but the court held that the value as closer to $27M (score one for the IRS). The Tax Court held that the 40% penalty under IRC §6662 was justified (score another one for the IRS). And most importantly, the Tax Court holdings in this opinion are so incredibly fact-specific that it provides an extremely narrow path for other taxpayers to follow in order to expect similar tax treatment in the future. At the end of the day, the *bona fide* exceptions depend on the split dollar arrangement having an independent non-tax justification and not being merely a device to transfer wealth to family members at a lower tax cost.

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