# WRMarketplace

An AALU Washington Report

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## TOPIC: A First: Magic 8 Ball Says - Outlook Not So Good: Tax Court Speaks to Possible Estate Tax Treatment of Generational Split Dollar (GSD).

**MARKET TREND**: Despite positive opinions on GSD gift taxation, the Tax Court's analysis of the potential estate taxation of economic benefit GSDs will require a long, hard look at these arrangements and their continued viability.

**SYNOPSIS**: For the first time, two very recent Tax Court opinions (Est. of Cahill v. Commissioner and Est. of Morrissette v. Commissioner) have discussed the court's view of the estate taxation of economic benefit GSDs. These arrangements generally involve a parent who enters into a private split-dollar agreement with a life insurance trust agreeing to pay the premiums for the trust's purchase of life insurance on the parent's child. The transaction assumes that: (1) the gift taxation of the parent's premium payments is governed solely by the split-dollar Treasury Regulations (specifically, the economic benefit regime) and (2) the present value of the reimbursement due to the parent for the premium payments is subject to a significant adjustment, because it likely will not be repaid until the death of the insured child many years later. Accordingly, minimal value would be subject to transfer tax if the parent disposed of the reimbursement right, either by gift or through his estate. While prior Tax Court cases have upheld the assumed gift tax treatment of the GSD premiums, Morrissette and Cahill are the first to address the transfer tax valuation of the parent's reimbursement

right. Both rulings, however, find that, as a matter of law, no discount may apply to the value of the parent's reimbursement right for estate tax purposes.

**TAKE AWAYS**: Neither Cahill nor Morrissette is a final decision on the merits. Yet the court's reasoning in Cahill strongly suggests that, at least in that case, the Tax Court may find that the parent's estate includes the full value of the reimbursement right under the economic benefit GSD. This finding would eliminate the possibility of a significant valuation adjustment for the reimbursement and undercut one rationale for using economic benefit GSDs in estate tax planning. The rulings also may embolden the IRS to target these arrangements while making the job of defending the transactions more difficult. Existing economic benefit GSDs, their underlying policies, and the proposed exit strategies should be evaluated, with the understanding that the formalities, non-tax components, economics, and optics of these transactions all will be closely scrutinized.

**MAJOR REFERENCES**: Est. of Cahill v. Commissioner (T.C. Memo. 2018-84); Est. of Morrissette v. Commissioner (U.S. Tax Court Docket No. 4415-14, Order dated June 21, 2018).

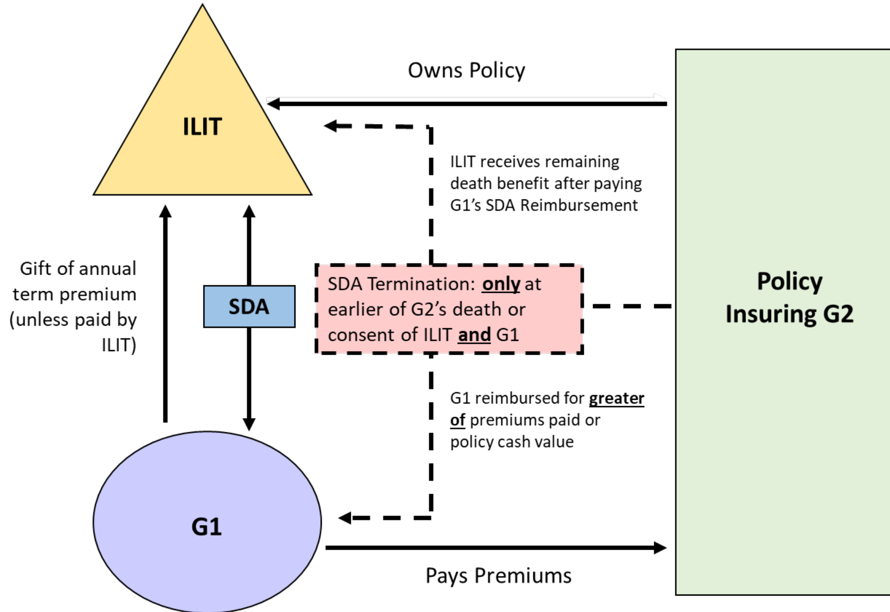
## *WHAT IS GSD?*

GSD[1] is a private, non-equity split dollar arrangement ("**SDA**") between a parent ("**G1**") and an irrevocable life insurance trust ("**ILIT**") created by G1, which funds the ILIT's purchase of a life insurance policy ("**Policy**") on G1's child or possibly a child's spouse or more remote descendants ("**G2**"). The ILIT is the sole Policy owner and beneficiary and typically benefits G2 and/or G2's descendants.[2]

GSD can be subject to gift tax under the economic benefit regime or the loan regime of the final split-dollar Treasury Regulations ("**SD Regs**").[3] Economic benefit GSDs, like the ones in *Cahill* and *Morrissette*, are intended to fall under the economic benefit regime and typically include the following features:

- G1 has the sole obligation to pay all Policy premiums (often, G1 pays a single premium payment or several initial large premiums to make the Policy self-sustaining).
- The ILIT only receives the economic benefit of the cost of current life insurance protection on G2 (i.e., the term premiums) and has no current or future access to the Policy's cash value.
- The SDA terminates at the earlier of G2's death or the ***mutual agreement*** of ILIT and G1.
- Upon termination, G1 is entitled to reimbursement equal to the ***greater of*** the total premiums paid or the Policy's cash value at SDA termination ("**SDA Reimbursement**").

## Economic Benefit GSD




***Crucial to the arrangement*, *G1 has no unilateral right*** to terminate the SDA or to access Policy cash value before termination.

### *WHY USE GSD*

**Deferred Gift Tax Cost of Premiums**. Assuming gift taxation under the economic benefit regime, ***G1's gift to the ILIT is limited to the annual gift of the term premium***, less any contribution from the ILIT. This tax treatment arguably allows the funding of significant life insurance premiums at a deferred gift tax cost, while removing a substantial portion of the premium's value from G1's estate, due to the conditions described below.

**Valuation Adjustment for SDA Reimbursement.** Another key assumption of GSDs is that the fair market value of G1's SDA Reimbursement (on a present value basis) is subject to a substantial valuation adjustment because: (1) the anticipated long life expectancy of the Policy's insured (G2) delays repayment of the SDA Reimbursement and (2) G1 cannot unilaterally terminate the SDA to accelerate that repayment. Accordingly, minimal value would be subject to tax upon G1's disposition of the SDA Reimbursement right, either by gift or at passing. The Reimbursement is essentially the equivalent of a long-term loan or other obligation owed to the decedent.

### *WHAT HAPPENED IN MORRISSETE & CAHILL: THE FACTS*

***Morrissette*.** The G1, Clara Morrissette, entered into SDAs (through her revocable trust) with three irrevocable trusts that she had established, one for each of her three sons. G1's revocable trust transferred approximately $30 million to the irrevocable trusts. Each trust used the contribution to pay premiums on two universal life insurance

policies, one on the life of each other son. The stated purpose of the SDAs was to finance a shareholder buy-out agreement in a family-owned group of companies in the event of the death of one of the sons.

Each SDA included features typical of economic benefit GSDs, including that (1) upon the insured's death or other termination of the SDA, G1's revocable trust was entitled to a SDA Reimbursement equal to the greater of (a) the applicable policy cash surrender value or (b) the total premiums paid by G1 for that policy, and (2) G1 could not unilaterally terminate the SDA. When G1 passed, her estate valued the total SDA Reimbursements at $7,479,000 (a 76%+ discount from the $32,060,070 total cash surrender value of the policies).

***Cahill***. The G1, Richard Cahill, was incapacitated at the time of the GSD transactions and represented by his attorney-in-fact, Patrick Cahill (his son). Patrick, as G1's agent and trustee of G1's revocable trust, had G1's revocable trust enter into three SDAs with an irrevocable trust G1 created (again through Patrick, as his agent) for the benefit of Patrick and his descendants. The SDAs funded the irrevocable trust's acquisition of three life insurance policies, two on Patrick's wife and one on Patrick and provided for the lump sum payment of $10 million in total premiums. The stated purpose was to ensure sufficient liquidity when the insureds (Patrick and his wife) died, so as to smooth the transfer of a business owned by Patrick to his children.

Unlike in *Morrissette*, G1's revocable trust paid the $10 million of premiums using a commercial bank loan, which had a 5-year term and bore annual interest at the greater of 1.5% or one-month LIBOR plus 1.14%. No principal payments were required during the loan term, and the bank was not required to refinance at the end of the term.

Similar to *Morrissette*, however, each SDA provided that (1) upon an insured's death or other termination of the SDA, G1's revocable trust was entitled to a SDA Reimbursement equal to the greater of (a) any remaining balance on the loan secured by the applicable policy, (b) the applicable policy's cash surrender value, or (c) the total premiums paid by G1 on that policy, and (2) G1 could not unilaterally terminate the SDA. When G1 passed a year later, his estate valued the total SDA Reimbursement at $183,700 (a 98% discount from the policies' total cash surrender value of $9,611,624).

## *WHY THESE OPINIONS MATTER*

**First Rulings on Valuation of SDA Reimbursement**. These recent opinions are the first to address the transfer tax valuation of the SDA Reimbursement. Prior Tax Court opinions in *Morrissette* and in *Est. of Levine v. Commissioner* had addressed only the gift tax consequences of the premium paid under economic benefit GSDs.[4] Both of the opinions effectively supported economic benefit GSDs by ruling that, as a matter of law, G1's gifts would be limited to the annual economic benefit provided to ILIT (*e.g.*, the term premium).

**Opens Door for Estate Taxation of Full Cash Value.** The *Cahill* opinion ***refused to reject, as a matter of law, the IRS position that full policy cash value should be included in G1's estate***, based on Internal Revenue Code ("Code") §§2036, 2038, and 2703*.* Although the opinion is addressing a procedural motion for summary judgment, it provides a fairly significant substantive analysis as to how the IRS arguments may apply, including that:

- G1's inability to unilaterally terminate the SDA did not eliminate his right or power, alone ***or in conjunction with any person*** (e.g. the trustee of the ILIT): (1) to designate, under Code §2036, the persons who shall possess or enjoy the policies' cash value (by seeking payment of the SDA Reimbursement) or (2) to alter, amend, revoke, or terminate, under Code §2038, the transferee's enjoyment of the policies cash value (by payment of the SDA Reimbursement), which powers could result in inclusion of the policies' full cash value in G1's estate.

- Since G1 transferred $10 million in premiums and received property worth 98% less in return (the discounted value of the SDA Reimbursement), G1 apparently did not receive adequate and full consideration for his transfer, and thus would not fall under the bona fide sale exception to either Code §§2036 or 2038.

- Code §2703, which operates to disregard certain restrictions on the right to acquire, sell, or use property for estate and gift tax purposes, should apply to disregard the restriction on G1's ability to terminate the SDA when valuing the SDA Reimbursement.

While also notable, the scope of the *Morrissette* opinion is much more limited, because: (1) the estate in that case only sought summary judgment with regard to Code §2703, and (2) the court simply follows the *Cahill* opinion with little analysis, providing that, as a matter of law, Code §2703 may apply to disregard the restriction on G1's ability to terminate the SDA when valuing the SDA Reimbursement.

***INITIAL INSIGHTS: DON'T HIT THE PANIC BUTTON….YET***

**Not a Final Disposition**. Both the *Morrissette* and *Cahill* opinions are decisions on summary judgment, and not final decisions on the estate tax treatment of economic benefit GSDs based on the facts and merits of the cases. In ruling on summary judgment, the standard of review requires the Tax Court to view all facts in a light most favorable to the IRS, not the taxpayer. If the cases continue forward, the next step would be for a full trial on the factual issues.

**But Less than Rosy Outlook**. While not a final decision, the analysis in the *Cahill* opinion strongly suggests that, at least in that case, the Tax Court will find that G1's estate includes the full amount of the policies' cash value. Such a ruling would eliminate the possibility of a significant valuation adjustment for SDA Reimbursements, undercutting one rationale for economic benefit GSDs and likely their use for estate tax

planning. Unlike the prior rulings on the gift taxation of economic benefit GSDs, the *Cahill* and *Morrissette* opinions may further embolden the IRS to target these arrangements, making the job of defending these transactions more difficult.

**"Bad" Facts Can Make "Bad" Law**. The *Cahill* opinion specifically identified some features of that transaction that it found less than desirable. For example:

- The court suggested that the fact that G1's son, Patrick, acted on behalf of G1 both in creating the irrevocable insurance trust and executing the SDA may evidence that the transaction was not negotiated at "arms-length."

- The court specifically questioned the features of the loan used to finance the *Cahill* premiums (a factor not present in *Morrissette*), including:

    - With the guaranteed return (3%) on the investment in the policies appearing lower than the loan's interest rate (one month LIBOR plus 1.14%), taking into account all economic facts, would the arrangement actually be capable of providing liquidity decades later, and at what cost, in present value terms?

    - Why was an arrangement intended to provide liquidity decades later funded with a loan that required a balloon principal payment after only five years (i.e., why would G1, as a prudent business person, fund a long-term obligation with a short-term loan)?

These questions show that the formalities, non-tax components, economics, and optics of a GSD transaction all matter.

## *TAKE AWAYS*

Neither *Morrissette* nor *Cahill* is a final decision on the merits. Yet the court's reasoning in *Cahill* strongly suggests that, at least in that case, that the Tax Court may find that the parent's estate includes the full value of the reimbursement right under the economic benefit GSD. This finding would eliminate the possibility of a significant valuation adjustment for the reimbursement and undercut one rationale for using economic benefit GSDs in estate tax planning. The rulings also may further embolden the IRS to target these arrangements while making the job of defending these transactions more difficult. Existing economic benefit GSDs, their underlying policies, and the proposed exit strategies should be evaluated, with the understanding that the formalities, non-tax components, economics, and optics of these transactions all will be closely scrutinized.

## NOTES

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[*] Admission to the District of Columbia Bar pending.

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

[2] G1 retains no interest in the ILIT as a trustee or beneficiary. G2 is not a trustee of ILIT and holds no incidents of ownership in the Policy for estate tax purposes.
[3] Treas. Reg. §1.61-22.
[4] *Est. of Morrissette v. Commissioner* (146 T.C. No. 11) and *Est. of Levine v. Commissioner* (U.S. Tax Court Docket No. 9345-15, Order and Decision dated Jul. 13, 2016).