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Estate of Morrissette and Intergenerational Split Dollar

On May 13, 2021, the Tax Court issued its final decision in *Estate of Morrissette,* a multi-issue case pertaining to the use of intergenerational split dollar ("IGSD") arrangements. In two distinct and significant opinions released in 2016 and 2021, the court analyzed:

(i) the validity of the IGSD arrangement under the economic benefit regime and related gift tax implications;

(ii) the inclusion of policy proceeds in the gross estate of the decedent under Code Sections 2036 and 2038;

(iii) the inclusion of policy cash surrender values in the gross estate of the decedent notwithstanding the restrictions placed on the decedent's access to the same in the IGSD; and

(iv) the determination of fair market value of the decedent's repayment rights under the IGSD arrangement under Code Section 2703 special valuation rules.

The Tax Court ultimately upheld the estate's argument that the IGSD arrangement should be governed by the split dollar economic benefit regime, the taxable gifts to the Dynasty Trusts were equal to the benefit of current life insurance protection, only the repayment right was includible in the decedent's estate and not the policy cash surrender values, and the repayments rights satisfied the terms of the Section 2703(b) exception. However, the Court disagreed with the valuation discount utilized to calculate the value of the repayment right under the IGSD arrangement. As a result of the revised discount the Court deemed appropriate, it determined that a 40% underpayment penalty applied for a gross valuation misstatement under Code Section 6662(h).

Background

Interstate Group Holdings, Inc. (the "Business") was a group of family businesses owned partially by Clara Morrissette's revocable trust (the "CM Trust"), her three sons, Buddy, Don, and Ken, other trusts, and family members. Over time, animosity developed between the sons, who each had differing goals with respect to management of the Business.

With this in mind, in September 2006 Clara, through her conservator, created a business succession plan by funding Dynasty Trusts for each of her three sons with shares in the Business and entering into a shareholder's agreement regarding the Business shares. The CM Trust was also amended to appoint Clara's three sons as successor trustees, to permit the trust to pay premiums on life insurance policies under an IGSD arrangement to fund the business succession plan, and to enable the CM Trust to transfer its split dollar repayment rights back to each Dynasty Trust owing the repayment.

In October 2007, each Dynasty Trust purchased life insurance policies on the other sons' lives, with an aggregate death benefit of $58 million, to fund the buy-sell provisions under the shareholders agreement. The CM Trust advanced approximately $30 million to the Dynasty Trusts to pay premiums on the policies under an IGSD arrangement, which provided that, upon the death of each insured, the CM Trust was owed a repayment amount equal to (i) the greater of the aggregate premiums advanced or (ii) the cash surrender value of the policy. The Dynasty Trust owning the policy would receive the balance of the policy death benefit to allow the purchase of the insured's shares in the Business. The split dollar agreement also expressly stated that it could not be unilaterally terminated and it was to be treated as an economic benefit transaction, but if it was deemed a promissory note, then the Dynasty Trusts would repay the advanced premiums with interest.

Between 2006 and 2009, Clara reported gifts to the Dynasty Trusts consistent with the requirements under the economic benefit split dollar regulations. By the time of Clara's death, the cash surrender value of the policies exceeded $32 million. Following Clara's death in September 2009, her estate reported the split dollar repayment rights includible in Clara's estate were valued at approximately $7.5 million. Immediately after her death, the CM Trust transferred the repayment rights to the Dynasty Trusts immediately, effectively terminating the IGSD arrangement.

The IRS re-characterized the split dollar arrangement under the loan regime, treated the full advance of approximately $30 million of the total premiums (and not just the economic benefit received by the Dynasty Trust), as each premium was pad as a gift, and also increased the value of the repayment rights to equal the cash surrender value of the policies of $32 million.

Partial Summary Judgment - Economic Benefit or Loan Regime?

In the 2016 opinion, *Estate of Morrissette v. Comm'r*, 146 T.C. 171 (2016), the Tax Court considered the appropriate split dollar treatment of the IGSD arrangement and concluded that it should be taxed under the economic benefit regime rather than the loan regime. Since (i) the CM Trust owned the split dollar repayment rights, (ii) Clara could amend the CM Trust at any time, (iii) the 2006 trust amendments were not part of the split dollar agreements, and (iv) the split dollar agreements did not require that that repayment rights be distributed from the CM Trust to the Dynasty Trusts; the court held the Dynasty Trusts had no access to the cash value of the policies.

Furthermore, the court also dismissed the IRS's argument that the $30 million in advances constituted a benefit of prepaid premiums (in addition to the economic benefit). The IRS had made this argument because under the Regulations when the advancing party provides benefits in addition to the economic benefit it provided, then the transaction is reclassified as a loan. If the court had held that the prepaid premiums were a benefit, the IRS' argument would have been successful.

Upon the rejection of this argument by the court, the transaction is classified as an economic benefit transaction and not a loan transaction under the Regulations and as a result, the taxable gifts that were made by Clara when the premiums were paid, are limited to the annual economic benefit provided to the Dynasty Trusts.

Final Decision – Estate Tax Inclusion and Valuation

Five years later, the Tax Court released its decision in *Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60, addressing the remaining issues of what exactly should be included in Clara's estate, and how the includible amount should be valued.

In a new set of arguments, the IRS argued for inclusion of the full $30 million in premium advances in Clara's estate or, alternatively, the $32 million in cash surrender value due to the CM Trust's : (i) retained possession, enjoyment, or right to income from the advances to the Dynasty Trusts under Section 2036(a)(1), (ii) retained power to designate the beneficial enjoyment of advanced amounts under Section 2036(a)(2), or (iii) retained power to alter the advances under Section 2038(a).

The specific facts of the case regarding the desire to maintain the family business amidst the deteriorating relationship between Clara's sons led the Tax Court to disagree with the IRS based on the bona fide sale exception under Sections 2036 and 2038. The Tax Court explained that the regulations support a broad definition of "sale" and, accordingly, the two-pronged analysis of the bona fide sale exception was satisfied because the CM Trust and Clara received both financial and intangible benefits from the split dollar arrangement, including retained family ownership, succession of management and control of the Business, and financial security as a result of the buy-sell agreements. These facts evidenced the

presence of a legitimate non-tax purpose for the sale and adequate and full consideration in money or money's worth.

Switching gears to Section 2703, the IRS further argued that the repayment rights without discount was to be included in Clara's estate because the restrictions in the split dollar agreements, including the mutual termination provisions, should be ignored when valuing the amount includible in Clara's estate under Section 2703(a). Again, the Tax Court disagreed, stating that the Section 2703(b) exception (which permits such restrictions for valuation purposes) applied because

(i) there was a legitimate business purpose for the IGSD agreements (it was not just a testamentary device to bequeath property to family members),

(ii) the termination restrictions were comparable to provisions that would be found in other arms-length buy-sell agreements for similar family businesses, and

(iii) the transactions constituted bona fide sales.

The court agreed that the exception of Section 2703(b) did apply, and the valuation of such rights should include a discount considering such restrictions. However, when applying these discounts, the court held that the estate's discounts were too high.

The Service's failure on the Section 2036, 2038, and 2703 arguments did not mean that this case was a complete win for the estate. Instead, there were several facts that affected the Court's decision with respect to the final issue of valuation of the split dollar repayment rights that were includible in Clara's estate.

The estate claimed that the CM Trust's repayment rights under the IGSD arrangement were valued at only $7.5 million, based on the notion that repayment would not be made until the deaths of the insured, potentially decades later. While the Court agreed that the discounted cashflow valuation method was appropriate to determine the value of the split dollar repayment rights, it looked negatively upon the facts that

(i) the plan was marketed primarily as a means of reducing taxes;

(ii) (ii) the policies had high cash values compared to the death benefits, which would allow for recoupment of investment in the policies in the case of early termination;

(iii) (iii) the sons standing on both sides of the agreement, as trustees, had control over surrender of the policies and participated in email discussions regarding cancelling the policies after the statute of limitations on audit of the return had passed; and

(iv) (iv) the IGSD arrangement was in fact terminated shortly after Clara's death when the CM Trust transferred the repayment rights to the Dynasty Trusts that owned the insurance policies.

Accordingly, the Court determined that the estate's valuation of $7.5 million for the split dollar repayment rights was not a reasonable or a good faith estimate, and instead, valuation discounts of only 6.4% and 8.85% should have been used, applied based on values of the rights as of December 31, 2013, the date on which IGSD arrangement actually terminated. As a result, the value of the rights were considerable higher than reported and as a result, , the Court assessed a 40% gross valuation misstatement penalty under Section 6662(h) against the estate.

What We Now Know

Despite this case being an economic loss for Clara's estate, there are several important take-aways that may apply to future planning with IGSD arrangements, with the understanding that different facts in a case may lead to significantly different results:

- Premium advances paid pursuant to a split dollar agreement under the economic benefit regime are taxed based solely on the economic benefit and do not constitute a benefit of prepaid premiums that should be taxed under the loan regime, as the policy owner is not required to pay any portion of policy premiums.

- The bona fide sale exception under Sections 2036 and 2038 applies to split dollar arrangements to exclude the life insurance policy proceeds from the gross estate of the decedent. In *Morrissette*, the CM Trust voluntarily and in good faith transferred money to the Dynasty Trust in exchange for repayment rights and a succession plan, which constituted a bona fide sale, and Clara's desire to have a business and management succession plan constituted a legitimate and significant nontax purpose of the split dollar arrangement.

- Section 2703(a) special valuation rules do not apply if a legitimate business purpose is present, the restrictions in the arrangement are comparable to those in similar, arms-length arrangements, and the transaction constitutes a bona fide sale. Similarity in the comparison is key, but the parties in similar agreements must also be similar, – e.g., restrictions in public company arrangements are not necessarily comparable to those in family business arrangements.

- While discounted cash value methodology and conservative percentage discounts may be used in determining the fair market value of split dollar repayment rights, the appropriate size of the discount and maturity date for the determination of the value is fact specific.

Intergenerational Split Dollar Planning Can Still Work

While *Estate of Morrissette* may encourage practitioners to transition away from recommending economic benefit split dollar arrangements, it is important to consider the impact that certain bad facts specifically noted by the Court in this case had on the decision.

The results in this case may not significantly affect IGSD planning under the economic benefit regime, provided that the plan is established for the right non-tax reasons, the facts substantiate the treatment of the IGSD plan as a bona fide sale, and conservative discounts are taken when valuing repayment rights.

Fortunately, *Estate of Morrissette* is not likely to be the sole resource to support the appropriate valuation of repayment rights under similar IGSD plans, as *Estate of Levine v. Commissioner, case number 9345-15*, is a Tax Court case that is currently pending and expected to address the same matters. *Estate of Levine* does not have the same set of facts concerning the termination of the split dollar arrangement and plan to surrender the policies, but it also does not have as clear a business purpose as was present in *Morrissette*. Accordingly, this may lead the Court, when deciding *Levine*, in light of the recent *Morrissette* decision, to shed additional light on the factors that it considers when determining estate inclusion and valuation of the split dollar repayment rights under IGSD planning.