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Estate of Morrissette v. Commissioner, 146 T.C. No. 11 (April 13, 2016)

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First Court Case Addressing Intergenerational Split Dollar Life Insurance, Partial Summary Judgment Holding That Economic Benefit Regime Applied

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Synopsis

The Tax Court, in a “regular” opinion of the full court, approved an intergenerational split dollar life insurance arrangement in which Mrs. Morrissette (actually her revocable trust) paid large lump sum premiums ($29.9 million) for Dynasty Trusts to purchase universal life insurance policies on the lives of her three children. Under the split dollar agreement, as each of the children died, the revocable trust was entitled to receive the aggregate premiums paid (without added interest) on the policies on that child’s life (or the cash surrender value of such policies, if greater [but the cash values may be lower than the aggregate premiums paid, because the cost of insurance and other costs of maintaining the policies in force would be charged against the policies each year]). Following Mrs. Morrissette’s death, her estate included her reimbursement rights under the split dollar arrangements in her estate, at a value of about $7.5 million (compared to the $29.9 million lump sum premiums she had paid), in light of the fact that her revocable trust would not receive the payments for many years in the future (as her children died-- actuarially expected to be about 15 years later). The IRS maintained that the full $29.9 million premium advance should be treated as a gift.

The split dollar regulations provide that split dollar arrangements can be taxed under either a loan regime (detailed in Treas. Reg. §1.7872-15) or economic benefit regime. The parties had not structured the arrangement as a loan (with a note bearing interest); that approach would not have resulted in as large of a discount in valuing the receivable at the parent’s death because the loan would have been entitled to interest during the delay before the repayment was made at the children’s subsequent deaths. Instead, the parties had relied on the economic benefit regime applying. Under that system, the parent is treated as making a gift each year of the current value of the life insurance coverage in that year (either from the carrier’s actual rates or Table 2001), less the amount of any premiums paid by the trust-owner of the policy in that year. The court rejected the IRS's position that the economic benefit regime did not apply; the IRS position was based on an argument that the structure failed to satisfy the technical requirements in the regulations for the economic benefit regime to apply.

The court granted partial summary judgment, holding that the technical requirements in the regulations for applying the economic benefit regime were satisfied. The court’s analysis waded through the hyper-technical details of the split dollar regulations. The loan regime generally applies if the donee is the owner of the policy (assuming the parties properly treat the transaction as a loan), or otherwise “general tax principles” apply. However, the donor will be the deemed owner of the policy (in which event the economic benefit regime applies, Treas. Reg. §1.61-22(d)(1)) if the only economic benefit provided to the donee is current life insurance protection. Reg. §1.61-22(c)(1)(ii)(A)(2). The central issue under the court’s analysis is its conclusion that the Dynasty Trusts had no current access to the cash values of the policies and received no additional economic benefit other than current life insurance protection. *Estate of Morrissette v. Commissioner,* 146 T.C. No. 11 (April 13, 2016) (opinion by Judge Goeke).

The court did not address the valuation issue; it will be addressed following this partial summary judgment decision.

This is the first court case addressing intergenerational split dollar insurance arrangements; it is a taxpayer victory in recognizing that the economic benefit regime applies to this intergenerational split dollar agreement. Larry Brody (St. Louis, Missouri) says he is aware of” at least a half dozen of these inter-generational arrangements where the IRS argued that because a single premium was paid up front," the loan regime applied. McManus, *IRS*

Stretched Too Far in Split-Insurance Estate Planning Case, BNA DAILY TAX REPORT (April 14, 2016). Many questions remain regarding the tax treatment of intergenerational split dollar insurance; it is not widely used (just by some very wealthy families), and the IRS may continue to address other ways to fight the overall result of a transfer with a huge discount (the IRS's brief characterized the plan as an effort to "minimize the taxable estate"). Nevertheless, this initial decision is a significant development regarding intergenerational split dollar agreements.

Basic Facts

1. **Issues Regarding Closely-Held Business**. Mr. Morrissette formed a moving company that grew into a large conglomerate, Interstate Van Lines, which eventually was owned by Interstate Group Holdings, Inc. (IGH). The stock was owned by various family members including Mrs. Morrissette's revocable trust, trusts created under Mr. Morrissette's revocable trust following his death, and three sons (as well as others). Mr. Morrissette managed the company to place his three sons in competition with other, which resulted in "deep-seated antipathies among them. They had differing goals for the company and do not get along with each other." In order to prevent two brothers from ganging up on the third brother, the corporate documents adopted a "fourth brother" provision requiring that if two sons disagreed with the third son regarding a decision, an independent trustee of trusts that owned shares would review the decision, with the expectation that the trustee would side with the minority sibling unless the position of the majority siblings was compelling. Mrs. Morrissette (apparently while she was still competent) was concerned that the "fourth brother" provision may cause deadlock detrimental to the company, and was concerned with the sons' disagreements regarding their goals for the company. In light of this background, Mrs. Morrissette (through her conservator and agents) created Dynasty Trusts for the three sons (and presumably transferred stock to those trusts), and entered into a Shareholders Agreement regarding the shares. [Observation: These business succession planning aspects of the factual background are included to point out that this overall arrangement had business purposes beyond just reducing the value of Mrs. Morrissette's estate.]

2. **September 2006 Transactions; Dynasty Trusts and Shareholders Agreement**. All of the following happened in September 2006, when Mrs. Morrissette was age 93.

   - The three sons became the successor trustees of Mrs. Morrissette's revocable trust.

   - An employee of the company served as conservator for Mrs. Morrissette from August-October, 2006.

   - Mrs. Morrissette (presumably through the conservatorship) created Dynasty Trusts for each of the three sons, and apparently conveyed company stock to those trusts.

   - The revocable trust was amended to permit the trust to pay premiums on life insurance policies under a split dollar arrangement to fund a business succession plan. In addition, the amendment permitted the revocable trust to transfer each receivable from the Dynasty Trusts under the split dollar arrangement back to the Dynasty Trust owing the receivable or directly back to each son.

   - The Dynasty Trusts, the sons, and various other family shareholders entered into a Shareholders Agreement placing various restrictions on the shares, imposing transfer restrictions, and implementing a cross purchase agreement under which the shares owned by or for a deceased son would be purchased by Dynasty Trusts for the surviving brothers.

3. **October 2006 Transactions; Purchase of Life Insurance on Sons' Lives Under Split Dollar Arrangement**. In October 2006, each son's Dynasty Trust purchased life insurance on the other sons' lives to fund the buy-sell provisions in the Shareholders Agreement. Mrs. Morrissette's revocable trust advanced $29.9 million to the three Dynasty Trusts, which they used to pay lump-sum premiums on the policies to purchase of the life insurance policies under a "non-equity economic benefit regime split dollar" arrangement. The lump sum premiums were large enough to maintain the policies for the insureds' respective life expectancies (about 15 years). The following applied under the split dollar agreement.

   - When the insured died under each of the policies, the revocable trust had the right to receive the greater of (1) the aggregate premiums advanced, or (2) the cash surrender value of the policies. The revocable trust would not be reimbursed any of the premiums advanced for a particular policy until the insured for that policy dies. The Dynasty Trust that owned a policy would receive the balance of the death benefit payable under the policy (which would be available to fund the purchase the deceased son's shares as required in the Shareholders Agreement).
   - If the split dollar arrangement terminates during the life of a son, the revocable trust would get repaid and the Dynasty Trust owning the policy would receive nothing from the policy.
   - No one had the right to borrow against the policies.
   - The Dynasty Trusts collaterally assigned the policies to the revocable trust to secure the repayment of amounts due to the revocable trust under the split dollar agreement.
   - The split dollar agreement expressly stated the parties' intent that the arrangement be taxed under the economic benefit regime as described in the split dollar regulations and that the only economic benefit to the Dynasty Trusts regarding the life insurance policies was the current life insurance protection.

4. **Gift Tax Reporting in 2006-2009**. In 2006-2009, Mrs. Morrissette reported gifts each year to the Dynasty Trust consistent with the economic benefit regime of the split dollar regulations. She reported as a gift each year the cost of the current life insurance protection as determined using Table 2001 (less the premium paid by each Dynasty Trust during that year [apparently, the Dynasty Trusts paid some premiums in addition to the large single premium paid at the outset]).

5. **Estate Tax Reporting**. Mrs. Morrissette died September 25, 2009. Her estate tax return reported the receivables from the Dynasty Trusts as having a value of $7.479 million (based on an appraisal of the receivables).

6. **Notices of Deficiency**. The IRS treated all of the $29. 9 million transferred to the Dynasty Trusts as gifts, and assessed a Notice of Deficiency for substantial additional gift tax and penalties. In addition, the IRS issued a Notice of Deficiency for additional estate tax, increasing the value of the receivables from $7.479 million to almost $32.061 million. It characterized the split dollar arrangements as loans under the loan regime of the regulations (but it did not calculate the value of the loans).

7. **Court Documents**. Steve Gorin (St. Louis, Missouri) has assembled many of the court documents (including the parties' briefs, the gift and estate tax notices of deficiency, and the split dollar agreement) that have been filed with the Tax Court in *Morrissette*. They can be accessed at the following link: **http://tcinstitute.com/rv/ff0027b41763b2585644fea38b4d98e739cece38**.

Issues, Holding, and Basic Significance

The only issue addressed in this partial summary judgment decision is whether the arrangement should be taxed under the economic benefit regime or the loan regime of the split dollar regulations. This decision does not address the valuation of the receivables at the time of the decedent's death.

The Tax Court (in a regular decision of the court) held that the arrangement was governed by the split dollar final regulations and that the economic benefit regime applied to the arrangement.

This holding is very significant. Taxing "intergenerational split dollar insurance" under the economic benefit regime is helpful to support placing a substantial discount on the value of the receivable at the date of the death of the senior family member holding the receivable (or at the date of a gift or other transfer of the receivable by the senior family member) based on the fact that the repayment would not be made for what could be decades (at the death of the younger insured family member). If the loan regime applied, the loan would be valued under the assumption that interest would be paid on the loan, rather than just paying the aggregate premiums made (or the cash surrender value if greater). Alternatively, if the economic benefit regime did not apply and if the loan regime also did not apply because the parties did not properly treat the advance as a loan, the entire advance may have been treated as a gift under general tax principles. (Whether the loan regime treatment could apply is problematic under the Morrissette facts. The Morrissette split dollar agreement stated in two different places that the intent was that the arrangement be treated as an economic benefit transaction for federal tax purposes, but the Agreement also stated that if for any reason the Agreement was deemed to be a promissory note, the Dynasty Trust as maker promised to pay an amount equal to the total premiums paid by the donor together with an annual rate of interest "that reflects the prevailing market interest rate for both income tax and gift tax valuation purposes, as determined by a qualified independent appraiser.")

Brief Background About Split Dollar Life Insurance and Discount Intergenerational Split Dollar Life Insurance

Split dollar life insurance has been used historically as a way that employers (or senior family members) could help pay for premiums on life insurance to benefit employees (or junior family members). In 1964, the IRS began taxing the death benefit portion of the policy as an economic benefit under Revenue Ruling 64-328. Split dollar arrangements have traditionally be structured as either endorsement arrangements (in which the employer or senior family member owns the policy and endorses some of the death benefits to employees or junior family members) or collateral assignment arrangements (in which the employee or junior family member owns the policy and assigns an interest back to the employer or senior family member to secure the right to be repaid the premium advances). The endorsement or collateral assignment arrangements could be structured as either equity or non-equity arrangements. (In equity arrangements, the employee or junior family member might share in some portion of the cash value of the policy.) Under the traditional treatment of split dollar policies, changing the structure of the party that owned the policy (i.e., endorsement or collateral assignment) did not fundamentally change the tax treatment of the arrangement. (This would change in 2003 under split dollar regulations, which provide that the tax treatment of the arrangement depends largely on who is the owner of the policy.)

Notice 2002-8 provided transitional rules for the treatment of split dollar arrangements entered into before September 18, 2003. The Notice (1) addressed valuation issues, allowing alternate rates to be used to value the current value of life insurance coverage (i.e., either Table 2001 rates [using a Table included in the Notice] or the insurer's one-year term rates in certain circumstances), and (2) provided certain safe harbors for avoiding tax on the transfer of the equity element of split dollar policies (either (i) treating the premium advances as a loan arrangement or (ii) continuing to apply the economic benefit approach of treating the current value of life insurance coverage as a transfer each year and not imposing additional taxes as long as the cash value was not accessed).

The split dollar regulations, applicable to split dollar arrangements entered into or modified after September 1, 2003, establish two alternative regimes for taxing split-dollar life insurance arrangements, depending on who owns the policy. Previously, the key factor impacting the tax treatment was whether the arrangement was an equity or non-equity structure. Under the regulations, the key is who owns [or is deemed to own] the policy. If the employer (or senior family member) owns the policy, as in a typical endorsement arrangement, the economic benefit regime applies, taxing the employee (or treating as a gift to the junior family member) on all economic benefits provided through the arrangement. If the employee (or junior family member or trust for a junior family member) owns the policy, as in a typical collateral assignment arrangement, the loan regime will apply under the §7872 rules for below-market loans and the OID rules in §§1271-1275, if the obligation is most appropriately treated as a loan under federal income tax principles (for example, using a note that is intended to be repaid unconditionally). A special ownership rule applies to non-equity arrangements; if the employee or donee is the owner of the policy but has no current access to the cash values of the policies and receives no additional economic benefit other than current life insurance protection, formal ownership designations will not control but the employer or donor will be treated as the owner of the contract, so that the arrangement can be taxed under the economic benefit regime rather than the loan regime. (Life insurance on a donor's life may be held in an irrevocable life insurance trust (ILIT) to avoid estate inclusion of the insurance proceeds under §2042. In effect [and oversimplified], this special exception provides that life insurance that is held in an ILIT can be taxed under the economic benefit approach that has historically been used for the tax treatment of split dollar insurance as long as the structure is a "non-equity" arrangement.)

Under traditional split dollar arrangements, a donor funds premiums on a policy on the *donor's* life, and the premium advances are repaid at the donor's death from the policy death proceeds. In contrast, under intergenerational split dollar arrangements, a parent pays premiums on a policy insuring a *child* (or *grandchild's* life), and the premium advances are not repaid until the insured's death, which could be decades in the future. If the reimbursement right is transferred by the parent (by gift or sale or as an asset of the donor's estate at her death), a substantial discount may apply in determining the *present* value of the reimbursement right. (The *present value* of the right to a set dollar amount, to be paid decades in the future, would obviously be much smaller than the aggregate payment that would be made many years in the future.) Taxing intergenerational split dollar insurance under the economic benefit regime is helpful in supporting a substantial discount on the value of the receivable; under the economic benefit regime the parent just receives the aggregate premiums paid (or cash surrender value if greater), but under the loan regime the reimbursement right would be for the premiums paid *plus interest* that would accrue over the many years before the repayment is made. (If the advance is a loan but the note does not provide for interest at the AFR, the IRS may argue that under the §7872 regulations, the person advancing the premiums makes a current gift of the present value all of the foregone interest for the life of the loan. *See* Alan Jensen & R. Brent Berselli, *Estate of Morrissette: Unfinished Business,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2418 (May 23, 2016) (hereinafter "Jensen & Berselli, *Unfinished Business*") (citing Treas. Reg. §1.7872-15(e)(5)(iv)(D).)

Alternatively, if neither the economic benefit regime nor loan regime applies (see the discussion below of the requirements to treat the arrangement as a loan), general tax principles apply to the arrangement. In that event, the donor is treated as making a gift of the full amount paid as premiums less the economic benefit that the donor received (and Treas. Reg. §1.61-22(d)(2)(ii) looks to whether the donor has current access to the cash value), and if, as would be typical, the donor does not have current access to the cash value, the donor's economic benefit is zero and the full amount of premiums paid is a gift. Treas. Reg. §1.7872-15(a)(2) has three requirements for the arrangement to be treated as a loan: (1) payment is made by the non-owner to the owner (including a payment directly to an insurance company with respect to a policy held by the owner); (2) the payment is a loan under general tax principles, or if it is not (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) repayment of the advance is to be made from or is secured by the policy's death benefit, the policy's cash surrender value, or both. Furthermore, Treas. Reg. §1.7872-15(d) provides that a nonrecourse payment under a split-dollar loan [and the repayment right is typically nonrecourse under split-dollar agreements] is a "contingent payment," which causes further significant complications under Treas. Reg. §1.7872-15(j), unless the parties represent in writing (by the time for filing the federal income tax return for the borrower or lender for the taxable year in which the lender makes the split dollar loan) that a reasonable person would expect that all payments under the loan will be made (and that representation must be attached to the income tax returns for all parties [which is frequently overlooked]). Thus, in the typical split dollar arrangement, if the economic benefit regime does not apply, the loan regime will apply if the parties have treated the advance as a loan, if there is a reasonable expectation that the premium advance will be repaid, and if the required written representations have been timely made and filed.

Life insurance experts Donald O. Jansen (Austin, Texas) and Charles L Ratner (Cleveland, Ohio) have summarized the application of these general rules regarding split dollar life insurance under the split dollar regulations to intergenerational split dollar insurance in the context of a grandparent funding the purchase of a life insurance policy on a grandchild's life to be owned by an irrevocable life insurance trust:

> Unless the insured is very elderly, the term premium under the economic benefit regime is almost always lower (sometimes significantly lower) than the applicable federal interest rate (AFR) used for a loan regime split-dollar arrangement. With regard to the split-dollar arrangement between the grandparent and the trustee, the economic benefit regime involves smaller payments/gifts than the loan regime. But, to avoid a current gift of cash value of the policy to the trust, the economic benefit regime split-dollar contract must give all of the cash value to the premium payer (the so-called "non-equity split-dollar.")
>
> The split-dollar economic benefit regime normally requires the premium payer (the grandparent in our example) to be the owner of the insurance policy with the pure insurance allocated to the insurance trust by an endorsement to the policy (the so-called "endorsement split-dollar.") Generally, if a person other than the premium payer (for example, the trust) owns the policy, the loan regime with its higher AFR would apply. But

> if the grandparent owned the policy and all of its cash value, the full cash value of the policy, without discount, would be in the grandparent's gross estate at death or would be the value of the sale or gift if the policy were later sold or given by the grandparent to the trust.
>
> Discount private split-dollar solves this problem by taking advantage of a special provision in the split-dollar regulations allowing non-equity private split-dollar collateral assignment arrangements. Under the regulations, even though the life insurance policy lists the trustee as the owner, it's the grandparent who's treated as the owner—so long as the only economic benefit that the arrangement ever provides the trust is life insurance protection.
>
> Thus, a split-dollar contract between the trust that owns the policy and a grandparent/collateral assignee qualifies as an economic benefit regime arrangement as long as the arrangement gives all of the cash value (a non-equity arrangement) to the grandparent. The favorable basic tax economics of the arrangement then can be strategically customized by (1) obligating the grandparent to pay at least a certain number of premiums, and (2) expressly forbidding the grandparent from unilaterally terminating the split-dollar contract or accessing the policy's cash value. The hope is that these restrictions will result in a steep discount to the value of the grandparent's interest when he dies, or gives or sells that interest to the trust (or to another party).

Donald O. Jansen & Charles L. Ratner, *Discount Private Split-Dollar Does It Work?*, TRUSTS & ESTATES 19, at 19-20 (May 2008) (hereinafter "Jansen & Ratner, *Discount Private Split-Dollar*").

Court Analysis

For excellent analyses of the court's decisions see Howard Zaritsky, *Morrissette v. Commissioner: Tax Court Holds That Economic Benefit Regime Applies to a Family Split-Dollar Life Insurance Arrangement Between Trusts,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2408 (April 19, 2016); Steve Gorin & Howard Zaritsky, *Tax Court Approves Some Key Issues with Intergenerational Split-Dollar Arrangements*, 28 PROBATE PRACTICE REPORTER 1 (June 2016).

1. **2003 Split Dollar Regulations Apply**. These split dollar arrangements are governed by the 2003 split dollar regulations because they were entered into after September 17, 2003.

2. **Tax Treatment Depends on Owner of Policy**. The 2003 split dollar regulations adopted a new approach of basing the tax treatment on who is the owner of the underlying life insurance policy.

   - **Economic Benefit Regime.** The economic benefit regime applies in a donor-donee context if "the donor is the owner of the life insurance contract (or is treated as the owner of the contract…" Treas. Reg. §1.61-22(b)(3)(ii)(B).

   - **Loan Regime**. If the conditions for applying the economic benefit regime do not apply (based on whether the donor is the owner or deemed owner of the policy), the loan regime may apply if the arrangement is treated as a loan under Treas. Reg. §1.7872-15(a)(2).

   [BACKGROUND COMMENTARY NOT IN COURT ANALYSIS: The loan regime does not apply automatically merely because the donor is not the owner or deemed owner of the policy. If neither the economic benefit regime nor loan regime applies, general tax principles apply to the arrangement and the full amount of the premium payment may be treated as a gift. (See the discussion in the Brief Background Regarding Split Dollar Life Insurance Section above.)]

3. **Owner of Policy**.

(a) **General Rule**. The person or entity named as the owner in the insurance contract is generally treated as the "owner," and any other person with a direct or indirect interest in the contract is the "non-owner." Treas. Reg. §1.61-22(c)(1)-(2). Under this general rule, the Dynasty Trusts would be considered the owners of the policies.

(b) **Exception—Donor as Deemed Owner**. A special rule applies if the split dollar arrangement involves the performance of services or "is entered into between a donor and donee" if the arrangement provides only death benefit protection (generally thought of as a non-equity arrangement). More specifically, in the donor-donee context:

> A donor is treated as the owner of a life insurance contract under a split-dollar insurance arrangement that is entered into between a donor and a donee (for example, a life insurance trust) if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section. Treas. Reg. §1.61-22(c)(1)(ii)(A)(2).

If the donee receives any additional economic benefit, other than current life insurance protection, the donee will be considered the owner and the loan regime will apply.

(c) **Key Question—Any Additional Economic Benefit**? Thus, the key question in the case is whether the lump-sum payment of premiums made on the policies generated any additional economic benefit other than current life insurance protection to the Dynasty Trusts.

(d) **Example to Preamble to Regulations**. The preamble to the final regulations includes an example suggesting that a non-equity split dollar arrangement would satisfy the "no additional benefit" requirement so that the economic benefit regime would apply. (The example concludes: "Thus it follows, that where a donor is to receive the greater of the aggregate premiums paid or the CSV of the contract, the possibility of the donee receiving an additional economic benefit is foreclosed.") Preambles to regulations are afforded little weight, but they do reflect the IRS's interpretation of its own regulations. The court hinted that it would give greater weight to a statement in a Preamble that supports a taxpayer's position than a self-serving statement that supports the government's position that is not supported by the actual substantive terms of the regulation itself.

(e) **Current Access to Cash Values**. One way a policy could afford "additional economic benefits" is if the trust that owns the policy (but that is deemed to be the non-owner) has current access to any of the policy cash value. Treas. Reg. §1.61-22(d)(2)(ii). This could include having a current or a future right to some of the cash value, or if the cash value is "directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors." Treas. Reg. §1.61-22(d)(4)(ii). The IRS argued that the receivable would pass to the Dynasty Trust or to Mrs. Morrissette's sons under the terms of her revocable trust. The court concluded that that the Dynasty Trust had no legally enforceable right to the receivables, and that the revocable trust could be revised. Furthermore, the court reasoned that it would look only to what the split dollar documents provide and whether they *require* that some of the cash value will pass to the non-owner (citing Treas. Reg. §1.61-22(d)(1), which refers to "[t]he value of economic benefits provided to the non-owner for a taxable year *under the arrangement*").

(f) **Any Other Economic Benefit?**

(i) **Notice 2002-59**. The IRS argued that Notice 2002-59 prohibits the economic benefit regime from applying in some circumstances and that it evidences that that the pre-paid premium represents an "additional economic benefit." However, Notice 2002-59 deals with "reverse split dollar" arrangements, in which a trust owns the policy; the insured has the right to receive the policy's death benefit for a particular year, and the insured pays for that current coverage by paying "P.S. 58 rates" that were substantially greater than actual mortality charges incurred by the trust. The arrangement was typically terminated after several years (i.e., the insured stopped "renting" the current coverage), and the trust could pocket the excess cash value that built-up in the trust due to the excessively large premium payments. The court rejected that analogy to an arrangement in which the insured made large upfront premium payments, because this situation was the reverse in that the insured kept the sole access to the cash surrender value of the policies.

(ii) **Prepaid Premium as an Additional Economic Benefit**. The IRS argued that prepaid premiums "pay not only for current insurance protection, but also for future protection, which is a benefit other than current life insurance protection." The government's memorandum in support of its position in response to the motion for summary judgment maintains that "the prepayment of the policy provides funds for additional years of coverage, effectively, a permanent fund to pay the cost of insurance." It draws an analogy to a parent that "irrevocably funds an account to pay current and future property taxes on a child's house,' and observes in that situation "the gift is not a gift each year that the tax becomes due and payable, but rather a gift up front. As in this case, the prepayment is a benefit to the Dynasty Trusts distinct from current life insurance protection." The court rejected this argument, first observing that the government relied on Notice 2002-59 for its position that a premium prepayment confers policy benefits other than current life insurance protection (and the court previously disagreed that the rationale of Notice 2009-59 applied to this totally different situation), and also reasoning that the Dynasty Trusts were not otherwise required to pay the premiums but the revocable trust was obligated to pay all premiums; therefore, the premium prepayment "would not relieve the Dynasty Trusts of any obligation to pay premiums because the Dynasty Trusts were not required to pay any premiums."

OBSERVE: The argument that the payment of any premium in excess of current year cost of coverage would suggest that almost all split dollar arrangements would have to be treated as owned by the person with legal title (in which event the economic benefit regime would not apply if the donor does not own the policy) because split dollar arrangements almost always involve the advance of premium amounts greatly in excess of just the cost of current year coverage under the policy. Alan Jensen and Brent Berselli (both of Portland, Oregon) indicate they have had a somewhat similar intergenerational split dollar case in which the IRS also made this "prepaid premiums" argument:

> The IRS advanced this same "prepaid premiums" argument in our recent litigation, and this was a point that the Service's appellate conferee made repeatedly during settlement negotiations. Specifically, the IRS asserted: "The permanent setting aside of money in the life insurance policy to pay future life insurance costs is an economic benefit to the donee. The value of the economic benefit is to be determined but might approximate the value of the life insurance policy." *Morrissette* addressed this "prepaid premium" argument directly and issued the correct opinion that single premium policies do not provide an additional economic benefit. This is an accurate analysis, as in our case and in *Morrissette*, the only benefit provided to the donees was current life insurance protection. In each instance, the donees had no current or future access to cash value, and all cash value was pledged to the donor under the respective [split dollar agreements].
>
> …
>
> The fact that policies subject to [split dollar agreements] are structured as single premiums does not, and should not, change the result that the only benefit afforded to the donee in any given year is "current life insurance protection" as defined in Treas. Reg. § 1.61-22(d)(3).

Jensen & Berselli, *Unfinished Business*.

(iii) **Dividends**. Not mentioned in the opinion, presumably because the IRS did not raise the issue, is that §2.02 of the split dollar agreement used in the *Morrissette* situation allowed the trust to apply policy dividends as the trust deems appropriate. Even though §6.01 of the agreement said that it was to be interpreted such that the only economic benefit is the current life insurance protection, the trust's right to take dividends in cash would seem to be a right other than current insurance protection, which would preclude using the economic benefit regime in a situation like in *Morrissette.* In structuring an intergeneration split dollar arrangement using the economic benefit regime, the agreement should restrict the trust's use of policy dividends and require that dividends be used to provide paid-up additions.

(g) **Conclusion**. "Because the Dynasty Trusts receive no additional economic benefit beyond that of current life insurance protection, the [revocable trust] is the deemed owner of the life insurance by way of the special ownership rule under section 1.61-22, Income Tax Regs. Thus the economic benefit regime under section 1.61-22, Income Tax Regs., and not the loan regime of section 1.7872-15, Income Tax Regs., applies to the split-dollar insurance arrangements."

4. **Valuation Not Addressed**. The court specifically noted that it was not addressing the valuation of the receivable.

Planning Considerations

For an overview of planning issues regarding intergenerational split dollar life insurance, see Lee Slavutin, *A Post-Morrissette Roadmap for Drafting Intergenerational Split Dollar Agreements*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2414 (May 12, 2016); Jensen & Berselli, *Unfinished Business;* Lee Slavutin & Richard Harris, *Intergenerational Split Dollar Life Insurance; What Can We Learn from* Morrissette, Levine *and* Neff?, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2443 (August 9, 2016); Espen Robak, *Intergenerational Split Dollar Valuation Issues,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2444 (August 9, 2016).

1. **Only One Narrow Issue in *Morrissette***. *Morrissette* is important because it is the first court case addressing intergenerational split dollar insurance, and it is a taxpayer victory by the full Tax Court. But the court addresses only one narrow issue (on the taxpayer's motion for partial summary judgment as to that narrow issue), and the IRS is no doubt

advancing a variety of other issues in the case (in addition to the valuation issue). The Notice of Deficiency treated most of the approximately $30 million advance of premiums as a gift. That would not have been the case under either an economic benefit regime or loan regime treatment. Apparently, the IRS position is that almost all of the premium advance was a gift, because the Dynasty Trusts were the owners and Mrs. Morrissette's interest in the cash value was disregarded under Treas. Reg. § 1.61-22(d)(2)(ii).

2. **Other Potential IRS Attacks**. A variety of potential issues, other than whether the economic benefit regime applies, exist regarding intergenerational split dollar arrangements. Some of these other issues are as follows.

   a. **Treatment of Insurance Coverage Following Premium Payer's Death**. What is the tax treatment of the economic benefit regime arrangement after the client dies (who advanced the premium payments) but before the insured's death? Is the benefit of current life insurance coverage somehow treated as a future transfer each year by the estate or its successors in interest under the economic benefit regime? (The IRS noted this issue in its memorandum in response to the summary judgment motion: "One taxpayer has argued that a deceased parent continues to make gifts each year as the cost of insurance became due and payable, irrespective that the parent had died. The National Office has found no authority supporting the position that a deceased person can make gifts, 20 or 30 years after he or she is dead." Respondent's Memorandum of Points and Authorities in Opposition to Petitioner's Motion for Partial Summary Judgment, at 20 n.3 (filed Feb. 11, 2015).)

   b. **Section 2703**. Are restrictions on repayment rights under the split dollar agreement treated as restrictions on the right to sell or use property that must be ignored in determining the value of property that has been transferred? A counter argument is that the right to the receivable under the terms of the split dollar contract is the very property that is transferred and the terms of the contract are not merely a restriction on the property transferred. This is similar to the courts' analysis in rejecting the IRS's argument that §2703 applies to value the transfer of interests in a partnership. However, the split dollar situation may have more difficulty meeting the comparable arm's length test under the §2703(b) exception–would an individual enter into one of these split dollar arrangements "with you or me if we weren't relatives?" Jansen & Ratner, *Discount Private Split-Dollar*, at 23. The IRS made this §2703 argument in a relatively recent intergenerational split dollar cases handled by Alan Jensen and Brent Berselli:

   > The Service sought to value the [split dollar receivable] without considering any of these limitations, arguing that under IRC § 2703, G-1's restricted access to the life insurance policies and their cash surrender values are disregarded. The Service's IRC § 2703 analysis was incorrect. IRC § 2703 disregards certain rights and restrictions in valuing an asset, but it was inapplicable in our case. The assets to be valued in G-1's estate were the [split dollar] receivables, which contained no restrictions. G-1 could have freely sold or granted options with respect to those receivables. All of the restrictions were contained in the [split dollar agreement] itself and related to G-1's rights with respect to the policies. The [split dollar agreements] themselves were not valued on G-1's estate tax return, and IRC §2703 is not relevant to the valuation of the … receivables as G-1 had unfettered control of those assets.

   Jensen & Berselli, *Unfinished Business.*

   c. **Sham Transaction; Lack of Business Purpose**. Is the full amount of the premium payment a gift on the creation of the arrangement under the theory that the arrangement is a "sham" transaction that lacks a business or non-tax purposes (other than generating a valuation discount on the ultimate transfer of the receivable)? In *Morrissette*, the life insurance arrangement had a clear business purpose of funding a buy sell agreement. In other situations, the taxpayers may be able to point to the life insurance as a way to provide necessary liquidity at the death of the insured.

d. **Step Transaction**. If the client makes a gift or sale of the receivable under a planned arrangement, the IRS might argue that the client had intended all along to make a gift or sale of the receivable. The client-premium payer may be treated as gifting the premium payment or the life insurance policy directly to the donee. The step transaction argument may be weaker if the client holds the receivable until his or her death (perhaps unless the client is very elderly at the time of the advance under the split dollar arrangement). *See* Jansen & Ratner, *Discount Private Split-Dollar*, at 23. Even aside from a gift, sale or bequest of the receivable, the IRS may use a step transaction theory to argue that the entire amount of premiums advanced constitutes a gift. This is the position that it is taking in *Estate of Marion Levine v. Commissioner,* T.C. No. 9345-15 (petition filed April 8, 2015) ("transfer … constituted gifts … in a series of interrelated steps with a value equal to the cost of the … premiums paid"). The Tax Court entered summary judgment in favor of the taxpayer on July 13, 2016 in *Estate of Levine,* resulting in no gift tax deficiency or penalties, on the basis of the *Morrissette* opinion.

e. **Modification Under Split Dollar Regulations**. A gift or sale of the receivable might be treated as though the donor transferred the entire life insurance policy that had been deemed to be owned by the donor. The split dollar regulations provide that if the split dollar arrangement is modified and the donor is no longer the owner under the split dollar arrangement, the donor "is treated as having made a transfer of the entire life insurance contract to the [trust] as of the date of such modification." Treas. Reg. §1.61-22(c)(1)(ii)(B)(2); *see* Jansen & Ratner, *Discount Private Split-Dollar*, at 23-24.

f. **Section 2036 and 2038**. Is the transfer of the premium a transfer with a retained right of enjoyment or the retained right to control beneficial enjoyment? (The IRS is making that argument, as well as the §2703 argument, in *Cahill v. Commissioner*, discussed below.) In the case handled by Messrs. Jensen and Berselli, the "appellate conferee analogized the valuation of a [split dollar] receivable to that of a family limited partnership or limited liability company holding cash or marketable securities." Jensen & Berselli, *Unfinished Business.* The IRS's primary argument in the FLP/LLC cases has been under §§2036 and 2038. A sale of the receivable during the donor's life should avoid the §2036/2038 risk at the donor's death (assuming §2035 does not apply).

g. **Duty of Consistency.** The IRS may argue, under the "duty of consistency" analysis used in some cases, that the taxpayer owes a duty of consistency in valuing the receivable for gift and estate tax purposes. The IRS made this argument in the recently settled intergenerational split dollar insurance case that was handled by Messrs. Jensen and Berselli:

> The Service contends that, if the taxpayer, under the economic benefit regime, reports a relatively minor gift amount at the outset of the arrangement, then the remaining value of the premiums advanced, without discount, should be included in the decedent's gross estate.

> Whereas, the Service's consistency argument has the benefit of simplicity, it fails to account for the economics of the arrangement. In our litigation, we continually pressed the appellate conferee to tell us how the [split dollar agreements] failed to comply with the Regulations. Our appellate conferee dismissed these questions out of hand without authority. In our view, provided that we complied with the Regulations (which we did), the valuation standard should be that of a debt instrument with no fixed term, not subject to payment on demand, and with no annual principal or interest payments.

Jensen & Berselli, *Unfinished Business.*

3. ***Estate of Cahill v. Commissioner***. A new case that has been filed in the Tax Court is illustrative of additional issues that arise with intergenerational split dollar insurance. *Estate of Cahill v. Commissioner,* T.C. No. 10451-16 (petition filed May 3, 2016). Issues raised by the IRS in that case include:

    - Property paid to the trust (to pay premiums) is included in the decedent's gross estate under §2036(a)(1) and 2036(a)(2), and the transfer was not a bona fide sale for adequate and full consideration;
    - Certain provisions of the split-dollar agreement constitute a restriction on the right to use or sell the decedent's property, or an option, agreement, or other right to acquire or use decedent's property at a price less than fair market value under §2703;
    - Property paid to the trust is included in the gross estate under §2038;
    - Under §2043, the excess of the fair market value at the time of death of property otherwise included under §2038 or §2035 over the value of the consideration received by decedent was included in the gross estate;

4. **Valuation of Receivable**. The court in *Morrissette* made clear that it was not addressing the value of the receivable in the partial summary judgment decision; that will be addressed subsequently. However, at least one commentator predicts that "*Morrissette* will not proceed to a decision on the merits of the valuation of the [split dollar] receivable. There is simply too much at stake to be wrong–for the taxpayer and the IRS. We faced a similar dilemma and ultimately settled on a discount of 35% as opposed to our claimed 95%." Jensen & Berselli, *Unfinished Business.*

    In the case referenced by Jensen and Berselli, G-1 advanced premiums to life insurance trusts to purchase life insurance on the lives of G-1's children (G-2). The split dollar receivables were reported on the decedent's estate tax return on the basis of independent valuations of the split dollar receivable, which considered the decedent's restricted access to repayment as well as the actuarial life expectancy of each of the insureds. The receivables were reported with a 95% discount–and the parties settled at a 35% discount.

    In *Cahill,* the values reported on the estate tax reflected about a 98% discount compared to the value asserted by the IRS. An independent appraiser (WTAS, LLC, now Anderson Tax) valued the receivable using the discounted cash flow method using a discount rate of 15%.

    As mentioned in the in sub- paragraph 5 below, some planners have reported settlements with discounts of 65%-90% or more.

One appraiser examines empirical data from lottery prize transactions, private note transactions, structured settlement transactions, and life settlement transactions to determine an appropriate discount factor for valuing intergenerational split dollar loans. He observes that one company that manages a portfolio of 600 policies acquired in life settlement transactions reports discounts rates ranging from 15.0% percent to 24.5%, with a weighted average discount rate of 17%. Espen Robak, *Intergenerational Split Dollar Valuation Issues,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2444 (August 9, 2016).

5. **Loan Regime Arrangements**. Some intergenerational split dollar arrangements are structured using the loan regime with notes documenting the advances with an AFR interest rate. The discounts may not be as large as under the economic benefit regime, but planners suggest that significant advantages may still be available. (For example, significant discounts may still apply because the interest rate on the loan may be much lower than the discount rate that an appraiser will apply in valuing the note.) One planner reports settling an intergenerational split dollar loan under the loan regime with a 65% discount. Other planners acknowledge that discounts are lower under the loan regime approach, but only nominally so (about 90% discount under economic regime vs. about 80% discount under loan regime). The *Morrissette* holding will not be directly relevant to loan regime split dollar arrangements (because it addresses how the loan regime can be *avoided* if that is what the parties prefer in structuring the arrangement.

   The IRS so far has not been auditing loan regime arrangements. A general trend is emerging among planners using intergenerational split dollar to prefer the loan arrangement for various reasons. *See* Lee Slavutin & Richard Harris, *Intergenerational Split Dollar: What Can We Learn from* Morrissette, Levine *and* Neff?, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2443 (August 9, 2016) (loan treatment can be assured, loan can be for life of insured allowing lock in of low interst rate, easier to understand, all variables locked in at outset, large history of loan receivables being valued at a discount, and no report of any intergenerational split dollar loan regime cases being audited). .

6. **Endorsement vs. Collateral Assignment Arrangement**. Under the classic endorsement split dollar arrangement in a family (donor-donee) context, the donor owns the policy, pays some or all of the premiums, and endorses to a donee the right to the death benefit to the extent that it exceeds the greater of the premiums paid by the donor or the cash surrender value of the policy. The endorsement approach is not typically used in a family context with a classic split dollar arrangement for a policy on the *donor's life* because the donor's rights as owner of the policy would constitute incidents of ownership under §2042 causing the insurance death proceeds to be in the donor's gross estate. Using a collateral assignment approach, with an irrevocable life insurance trust owning the policy and the donor merely having a "bare-bones" right to be reimbursed for the premium advances, avoids estate inclusion of the policy proceeds. (*See* Rev. Rul. 76-274.)

   Eliminating incidents of ownership in the donor is unnecessary when the donor is not the insured. Therefore, intergenerational split dollar arrangements could be structured as endorsement plans, with the donor owning the policy, and thereby avoid the issues raised in *Morrissette* (as to whether the donor is the deemed owner of the policy, because the donee has *no* benefits other than current life insurance protection, so that the economic benefit regime can apply) without risking estate inclusion of the policy death proceeds in the donor's estate.

The collateral assignment approach may result in greater discounts on the value of the receivable than with an endorsement approach under which the donor owns the policy. For example, the donor that owns the policy can control investments (which is very important for a variable life policy), and may have rights to borrow the cash value (with the caveat that the donor cannot borrow enough to endanger the policy). Those rights may blunt the "lock-in" aspect of the arrangement that supports very large discounts. Perhaps that is the reason that some planners continue to use the collateral assignment approach even though the endorsement approach is safer from a gift tax risk standpoint (although the gift tax risk has been greatly ameliorated by the *Morrissette* decision).

7. **Sale of Receivable**. A sale of the receivable during the donor's life may reduce the likelihood of the IRS raising other arguments summarized in Paragraph 2 above on an audit of the donor's estate tax return if the return merely includes cash or another note that makes no reference to a life insurance policy.

8. **Summary by Steve Leimberg.** The following excellent summary by Steve Leimberg summarizes current practices and suggests best practices from a planning standpoint.

> In my opinion the summary judgment granted the taxpayer in *Morrissette* was a relatively minor issue that the IRS had very little hope of winning. The pre-eminent issue concerns the appropriateness of the discount taken. That issue has yet to be decided, and my guess is that it's likely that issue isn't settled and we will see no formal opinion on the valuation issue. Having said that, my understanding is that the other [generational split dollar] cases I've been following have been settled on this issue (sometimes with pretty generous results). I've heard there are around 20 or so [generational split dollar] cases currently under audit, with several on the tax court docket. All of these cases currently under audit were apparently done using the economic benefit regime. (It does not appear the Service is challenging cases done under the loan regime.) … That makes the safer course of action use of the loan regime.
>
> Inter-generational split-dollar may be troublesome to some insurance carriers - mainly because of the persistency risk. As we've seen so many times in the past, insurance purchases that are not intended to meet a legitimate life insurance need of the younger generation, but rather, are designed to move money from the older generation to the younger generation with minimal transfer tax consequences generate problems. In too many instances, the funds are being paid into the policy as a single premium (even ignoring the fact that putting a collateral assignment on a MEC policy is a bad idea due to Code sections 72(e)(10) and 72(e)(4)). In addition, the policies were designed to have a high early cash surrender value, oftentimes utilizing riders to accomplish this. Once the split dollar receivable was transferred (either by gift or at death) and the discount taken, then the policies were generally immediately surrendered for their cash value by the younger generation. This surrender generally took place within 2-5 years. … The persistency risk is that a carrier's breakeven point may not be until year 8 or 9, and carriers are in business to make a profit, not merely to break even. So the [generational split dollar] arrangement described above would be bad business" for carriers, and clients and producers are profiting using a "sham transaction" to the detriment of life insurance carriers.
>
> Bottom Line:
>
> I believe there is still significant tax and legal risk involved in inter-generational split-dollar. I do not believe *Morrissette* changed that. I do feel that risk can be alleviated somewhat by using the loan regime, holding the receivable until the death of the second generation rather than gifting it, structuring the policy as a non-MEC, and ensuring that there is a legitimate need for the insurance.

Caution: Even those precautions may not be adequate in situations where the arrangement is entered into primarily as a means to transfer funds from one generation to the next with minimal transfer tax consequences and the intent is to surrender the policy after the transfer of the split dollar receivable. Such abusive uses of [generational split dollar] remain subject to IRS attack as a sham transaction. In addition, insurance carriers generally have no appetite for such bad persistency business and are increasing screening for such arrangements in an attempt to prevent the use of their products with them.

Comments by Steve Leimberg appearing in Jensen & Berselli, *Unfinished Business*.