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Estate of Cahill v. Commissioner, T.C. Memo. 2018-84 (June 18, 2018)

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Extension of *Estate of Powell*'s "In Conjunction With" Analysis for §§ 2036(a)(2) and 2038, and Broad Application of § 2703(a) to Contractual Rights; Tax Court Denial of Taxpayer's Motions for Summary Judgment in Intergenerational Split Dollar Case

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Table of Contents

Synopsis 1
Basic Facts 2
Analysis 3
Observations 7

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Synopsis

The decedent's revocable trust had advanced $10 million to an irrevocable trust under a split dollar agreement for the trust to purchase life insurance policies on the lives of the decedent's son and his wife. The estate valued the estate's right eventually to be reimbursed for its advances at only $183,700, because of the long period of time before the policies would mature at the insureds' deaths. The IRS argued, among other things, that the reimbursement right should have a value equal to the full cash surrender value of the policies (about $9.6 million) in part because of §§ 2036, 2038, and 2703, and the notice of deficiency asserted penalties for negligence, and either gross or substantial valuation misstatements, with the asserted penalties exceeding $2.2 million. The court rejected the estate's motion for a partial summary that §§ 2036(a)(2), 2038(a)(1), and 2703(a) do not apply and that Reg. §1.61-22 applied in valuing the decedent's reimbursement rights.

The court reasoned that §§ 2036(a)(2) and 2038(a)(1) could apply because the decedent, in conjunction with the irrevocable trust, could agree to terminate the split dollar plan and the decedent would have been entitled to the cash surrender value of the policies (without waiting until the insureds' deaths), and because the advance of the premiums in this situation was not a bona fide sale for full and adequate consideration. (The court cited its recent decision in *Powell v. Commissioner*, 148 T.C. No. 18, which applied § 2036(a)(2) to a decedent's contribution to a partnership in return for a limited partnership interest because all of the partners could agree to terminate the partnership.)

The § 2703(a) issue is whether restrictions on repayment rights under the split dollar agreement are 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. The taxpayer's counter argument is that the right to the receivable under the terms of the split dollar contract is the very property that is transferred (whether during life or at the owner's death), and the terms of the contract are not merely a restriction on the property transferred.

The court in *Cahill* concludes that § 2703(a) applies, to disregard the irrevocable trust's ability to prevent an early termination of the agreement in valuing the reimbursement right, because the provision preventing the decedent from immediately withdrawing his advance was an agreement allowing the third party to acquire or use property at a price less than fair market value (§ 2703(a)(1)), and because the agreement significantly restricted the decedent's right to use his "termination rights" under the agreement (§ 2703(a)(2)).

Reg. § 1.61-22 generally treats the amount transferred each year under a split dollar plan governed by the economic benefit regime as the cost of current life insurance protection in that year. However, that regulation applies for income and gift tax purposes, not for estate tax purposes. Therefore, the regulation does not apply directly in valuing the transfer at the decedent's death benefit rights for estate tax purposes, and is not inconsistent with the application of §§ 2036, 2038, and 2703.

The denial of the estate's motion for partial summary judgment means that the case will proceed to trial. Ultimately, the case will be appealable to the Ninth Circuit Court of Appeals (assuming the case is not eventually settled).

Planners have been concerned that the Tax Court's reasoning in *Estate of Powell*, applying § 2036(a)(2) because the partners could unanimously agree to terminate the partnership, may be extended to other situations involving multi-party transactions in which the parties could agree to "undo" the deal. Indeed, just a little over a year later, *Cahill* has indeed applied that same reasoning in the context of a different transaction other than one involving limited partnership interests. The court also applies the general rule of § 2703(a) broadly, leaving to a subsequent trial the issue of whether one of the exceptions in § 2703(b) might apply. *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018) (Judge Thornton).

Basic Facts

1. The transactions involving the funding of the split dollar agreement occurred in 2010, when the decedent was 90 years old and unable to manage his own affairs.
2. The decedent's son was the trustee of a revocable trust for the decedent and was the agent under a power of attorney for the decedent.
3. The son, acting under the power of attorney for the decedent, created an irrevocable trust on September 9, 2010 with the son's cousin and business partner as the trustee. The purpose of the irrevocable trust was to acquire large life policies on the lives of the son and his wife.
4. Later in 2010, the revocable trust borrowed $10 million, with the loan proceeds being paid directly to the life insurance companies for the purchase of the policies. (The loan had a five-year term with an interest rate based in part on the LIBOR rate, and the bank was not required to extend the loan at the end of the five-year term.)
5. The irrevocable trust was designated as the owner of the policies, and the irrevocable trust and revocable trust entered into a split dollar agreement, providing that the revocable trust would be reimbursed for the $10 million premium advance. The reimbursement would be made (i) at the termination of the agreement if the two trusts agreed to terminate the agreement early, or (ii) following the deaths of the insureds. The opinion refers to the decedent's reimbursement rights in these two events as the "termination rights" and the "death benefit rights." If the agreement was terminated early, the irrevocable trust could keep the policies and pay the decedent the greater of the premiums paid or the cash surrender values of the policies or could transfer the policies to the bank in full or partial satisfaction of the decedent's obligation to the bank and the decedent would receive any excess of the cash surrender value over the loan balance. Otherwise, at the insureds' respective deaths, the decedent would receive the greater of the loan balance, premiums paid, or cash surrender value.
6. In 2010, the decedent reported total gifts to the irrevocable trust of $7,578, as determined under the economic benefit regime rules of Reg. § 1.61-22.
7. The decedent died about a year later on December 12, 2011. The decedent's executor is the son, who lives in Washington state (meaning that this case eventually will be appealable to the Ninth Circuit Court of Appeals).
8. The estate's reimbursement rights under the split dollar agreement, including its termination rights, were valued at only $183,700 on the estate tax return. (The estate maintains that the termination rights had no value on the date of death because allowing early termination of the split dollar funding arrangement would have made no economic

sense for the irrevocable trust, and the irrevocable trust would never have agreed to an early termination.) The IRS valued the reimbursement rights as equal to the cash surrender value of the policies on the date of death, or $9,611,624. The IRS presents alternative theories applying §§ 2036(a)(2), 2038(a)(1), and 2703(a)(1) and (a)(2). In addition, the IRS assessed over $2.2 million of penalties under the negligence penalty (§6662(a) and (b)(1)) and either the gross (§6662(h)) or substantial (§66662(b)(3)) valuation misstatements penalty.

9. The estate sought summary judgment that §§ 2036, 2038, and 2703 are inapplicable, looking to Reg. § 1.61-22 for support of its position.
10. Following trial and after a final judgment is rendered (assuming the case is not settled), the decision will be appealable to the Ninth Circuit Court of Appeals.

Analysis

1. **Economic Benefit Regime Applicable**. The court's analysis treats the funding agreement under the economic benefit regime described in the split dollar regulations. Regulation §1.61-22(b)(3)(i) generally treats a split dollar arrangement under the loan regime if a third party owns the policy, but applies the economic benefit regime if the only benefit provided to the donee is current life insurance protection (Reg. § 1.61-22(c)(1)(ii)). The Tax Court approved this treatment in *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016). Under the economic benefit regime, the amount treated as being transferred by the party advancing the premium payments is, for each year the arrangement remains in place, the cost of current life insurance protection in that year.
2. **Section 2036(a)(2) and Section 2038(a)(1) Applies**. Section 2036(a)(2) provides that if the decedent has made a transfer of property (other than a bona fide sale for adequate and full consideration), the property is included in the decedent's gross estate if the decedent retained "the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the property or the income therefrom." Section 2038(a)(1) applies to a transfer of property (other than a bona fide sale for adequate and full consideration) if the decedent had at the date of death the ability in conjunction with any other person to alter, amend, revoke, or terminate the transferee's enjoyment of the transferred property.

   The court reasoned that the decedent (actually the revocable trust, but the decedent and revocable trust will be treated interchangeably in this summary) had the power at any time to terminate the split dollar agreement "in conjunction with" the irrevocable trust, because the agreement provided that it could be terminated at any time by written agreement between the revocable trust and the irrevocable trust. The *Cahill* opinion cited the Tax Court's opinion from about a year earlier in *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (2017). The opinion's citation of *Powell* included a parenthetical with this quotation from *Powell*: "[D]ecedent's ability to dissolve … [her limited partnership] with the cooperation of her sons constituted a 'right … in conjunction with … [others], to designate the persons who shall possess or enjoy the property [she transferred to the partnership] or the income therefrom', within the meaning of section 2036(a)(2)." The court also cited *Estate of Strangi v. Commissioner,* T.C. Memo. 2003-145, *aff'd*, 417 F.3d 468 (5th Cir. 2005).

The taxpayer argued that the decedent held no such right because the right to terminate was held only in conjunction with the irrevocable trust, and as the recipient of the benefit of the arrangement, it could prevent the decedent from terminating the agreement. The court responded that the statute refers to "in conjunction with *any* person" in § 2036(a)(2) and "in conjunction with *any other* person" in § 2038(a)(1). The estate apparently acknowledged that the "in conjunction with" provision could apply if the decedent had been in complete control of the other party who had to agree with the termination, but the court answered that the statute by its terms does not require unilateral control.

The bona fide sale for full and adequate consideration did not apply to the split dollar arrangement. It was not a "bona fide sale" because the son "stood on both sides of the transaction," and the arrangement was not an arm's length transaction. Unresolved factual questions exist as to whether the stated non-tax reason of smoothing the transfer of a business owned by the son to his children at his death was a legitimate business purpose. (The court was skeptical, suggesting that perhaps the purpose was merely to eliminate the cash surrender value from the decedent's estate rather than to provide liquidity decades in the future, observing that the guaranteed return on the investment in the policies appears to be lower than the interest rate on the loan used to finance the purchase of the policies, and that the loan required a balloon payment of the entire principal amount in only five years.)

In addition, the transfer was not for "full and adequate consideration" because according to the way the estate valued the reimbursement right on the estate tax return, the value of what the decedent received "was not even close to the value of what decedent paid" (i.e., $183,700 vs. $10 million, or a discount of over 98%).

3. **Section 2703 Applicability**.

   a. **Overview**. Perhaps the most problematic part of the opinion to the intergenerational split dollar plan is its § 2703 analysis. The IRS prevailed in its position that the irrevocable trust's "ability to veto termination of the split dollar agreements should be disregarded under section 2703(a)(1) or (2) for purposes of valuing decedent's rights in the split dollar agreements." The court concluded that on the basis of the undisputed facts, "the requirements of section 2703(a)(1) and (2) are each met."

   b. **Statute**.

   SEC. 2703. CERTAIN RIGHTS AND RESTRICTIONS DISREGARDED.

   (a) GENERAL RULE.—For purposes of this subtitle, the value of any property shall be determined without regard to—

   (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

   (2) any restriction on the right to sell or use such property.

   (b) EXCEPTIONS.—Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

   (1) It is a bona fide business arrangement.

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

c. **"Property" Transferred for Purposes of § 2703**. The estate contended that the IRS was improperly treating the *policies* as the "property" that was transferred as if they were directly owned by the decedent, and that restrictions on being able to access the policy values should be ignored under § 2703. Instead, the estate argued that the bundle of rights under the split dollar agreement was the "property," and that any restrictions are merely inherent in that bundle of rights.

The IRS responded that it was "viewing the property interests owned by decedent in light of all relevant facts and circumstances, including the split dollar agreements," and that the "contractual rights to an amount at least equal to the cash surrender value … were held by decedent through the split dollar agreements … and more restricted because the agreement also allowed the [irrevocable trust] to prevent decedent's immediate access to that amount."

The court reasoned "that the parties agree that the relevant property interests for purposes of section 2703(a) are the rights held under the split dollar agreements," and that the "decedent did in fact own the termination rights," so the estate's position was ill founded. Therefore, the court proceeded with an analysis of whether § 2703(a) applied to those rights.

d. **Section 2703 Applicable**. The heading is somewhat of an overstatement. The court merely determined that on the agreed facts, the taxpayer's motion for summary judgment could not be granted. The court's analysis, however, suggests that the taxpayer will have a very difficult time establishing that § 2703 does not apply.

Section 2703(a)(1) applies because "the split dollar agreements, and specifically the provisions that prevent decedent from immediately withdrawing his investment, are agreements to acquire or use property at a price less than fair market value." Section 2703(a)(2), addressing any restriction on the right to sell or use property, also applies because "the split-dollar agreements, and specifically [the irrevocable trust's] ability to prevent termination, also significantly restrict decedent's right to use the termination rights. The split-dollar agreements, taken as a whole, clearly restrict decedent's right to terminate the agreement and withdraw his investment from these arrangements."

The estate contended that the split dollar agreements are like promissory notes and partnership interests, as to which § 2703(a) does not apply. The court disagreed. The split dollar agreements are not like notes because the irrevocable trust "did not bargain for the split dollar agreement (it provided nothing to fund these arrangements), nor did [the irrevocable trust] agree to repay with interest the money provided by decedent." The split dollar agreements "are therefore entirely unlike bona fide notes."

The court also disagreed with the analogy to partnership interests. The Tax Court in *Estate of Strangi v. Commissioner* held that a decedent's interest in a limited partnership should be valued by taking into consideration the limitations on a limited partner's rights to partnership assets under § 2703(a): "Congress did not intend, by the enactment of section 2703, to treat partnership assets as if they were assets of

the estate where the legal interest owned by the decedent at the time of death was a limited partnership or corporate interest." 115 T.C. 478, 488-489 (2000), *aff'd as to this issue, rev'd on another issue sub nom Gulig v. Commissioner*, 293 F.3d 279 (5th Cir. 2002). The court in *Cahill* concluded that analysis does not apply to the decedent's rights under the split dollar agreement because"[n]o state law entity is involved in this case," and because the IRS did not argue in *Strangi* that the "shareholder's agreement should be disregarded… under section 2703(a)."

The court also rejected the estate's arguments that § 2703 applies only to option or buy-sell agreements or to arrangements involving a restraint on alienation.

The court viewed the estate's position as meaning that if § 2703(a) applies to the split dollar agreement, "it would also apply to all sorts of other options, agreements, rights, and restrictions" because "'almost every two-party agreement has a restriction that one party cannot just unilaterally terminate the agreement.'" The court gave no reasons why § 2703(a) would not apply to all two-party agreements that restrict a party from unilaterally terminating in the agreement, but responded that the issue would be whether one of the exceptions in § 2703(b) to the application of § 2703(a) would apply, and particularly whether the arrangement has "terms comparable to similar arrangements entered into by persons in an arms' length transaction."

The § 2703(b) issue about the applicability of exceptions was not before the court in this summary judgment proceeding, so the court did not "consider whether the exception applies in this case."

4. **No Double Counting**. The estate argued that applying §§ 2036, 2038, and 2703 would result in a double counting of gifts and amounts included in the estate, because the cost of current life insurance coverage will continue to be treated as gifts under the split dollar rules after the decedent's death. The court responded that the gifts of current life insurance protection to the irrevocable trust after the decedent's death "would not be a gift from decedent but rather from whoever happens to succeed to decedent's interests in the split-dollar agreements."

5. **Split Dollar Regulations Are Not Inconsistent With Applying §§ 2036, 2038, and 2703**. The estate argued that under Reg. § 1.61-22, the only transfer that occurs under the economic benefit regime of the split dollar regulations is the annual cost of insurance protection, and applying §§ 2036, 2038, and 2703 to include the cash surrender value of the underlying policies in the decedent's gross estate is inconsistent with the approach of the regulations.

   The court instead viewed the split dollar regulations as explaining the gift tax consequences of transfers from the decedent to the irrevocable trust under the split dollar arrangement, whereas the "estate tax, by contrast, taxes the transfer of the decedent's taxable estate to the decedent's heirs (rather than to a counterparty of the split-dollar arrangement) under a will or by operation of law (rather than under a split-dollar arrangement)."

   Indeed, the court turned the consistency argument against the estate. The split dollar regulations treat the donor/owner under an economic regime arrangement as the owner of the cash surrender value (citing Reg. §1.61-22(b)(3)(i), (ii)(B), (c)(1)(ii)(A)(2), (d)(2), (4)(ii)), and the benefit of current insurance protection as a gift from the decedent to the irrevocable trust under the regulations, so "[c]onsistency between the regulations and the estate tax

Code sections would therefore demand that the cash surrender value remaining as of decedent's date of death be valued as part of, or included in, decedent's gross estate." The court reasons in footnote 12 that the estate essentially seeks to treat the decedent as the owner of the policy for gift tax purposes but to treat the irrevocable trust as the owner of the policy for estate tax purposes.

Observations

1. **"Hogs Get Slaughtered**." The case exemplifies the "pigs get fat, hogs get slaughtered" mantra. The court's reaction to an attempt of an incompetent 90-year old's son to structure the transfer of $10 million to a trust and only make a transfer of less than $200,000 for gift or estate tax purposes is not surprising. Furthermore, the *Cahill* case does not present a sympathetic fact situation. The transaction was implemented by a decedent's son under a power of attorney. The transaction was implemented with an irrevocable trust created by the son under the power of attorney, having the son's cousin (and business partner) as trustee, apparently with no negotiation. The arrangement involved borrowing $10 million from a third-party lender under a 5-year note, without any assurances of the note being renewed, even though the split dollar arrangement ostensibly would be in place for decades.
2. **Key Issue—Value of Termination Rights**. The case analyzes the decedent's interest under the split dollar agreement as involving "termination rights" (in general, the right to receive the cash surrender value of the policy upon an early termination before the insureds' deaths) and "death benefit rights" following the insureds' deaths (which would likely be decades in the future). The key issue in valuing the decedent's reimbursement rights under the split dollar agreement is whether the termination rights have no value because the irrevocable trust would never have agreed to an early termination. The case concludes that the restriction on the decedent's ability to receive the cash surrender value at any time – the requirement of obtaining the irrevocable trust's consent to an early termination – should be ignored for estate tax valuation purposes under §§ 2036, 2038, and 2703.
3. **Important Extension of *Powell* Analysis**. Planners have been concerned that the reasoning of the *Powell* case (decided only about a year before the *Cahill* case) could be extended to almost any arrangement involving multiple parties. *Powell* applied § 2036(a)(2) to the decedent's limited partnership interest to include a pro rata value of the partnership assets in the decedent's estate (without any discount attributable to the limitations on the rights of limited partners under state law) because the decedent "in conjunction with" other partners could at any time vote to dissolve the partnership. A detailed discussion of the *Powell* case, together with an analysis of the prior partnership cases that have addressed § 2036(a)(2), is found **here** and available at **www.Bessemer.com/Advisor**. Under the *Powell* facts, the partnership agreement provided that the partners could unanimously vote to dissolve the partnership. Even absent that express provision, however, the partners (or the participants in any joint undertaking) could always unanimously agree to undo the partnership or other relationship.

   Anecdotal reports are that IRS officials have been asserting a broad application of the *Powell* reasoning in estate tax audits, and *Cahill* is the first reported case applying the *Powell* reasoning, and it is extending the "in conjunction with" analysis to a contractual arrangement rather just applying the analysis to another partnership.

Planners have wondered whether cases that have limited a broad application of the "in conjunction with" phrase in § 2038 might yield a different result. *See e.g., Helvering v. Helmholz*, 296 U.S. 93 (1935), *aff'g* 75 F.2d 245 (D.C. Cir. 1934) (a power conferred by state law to revoke or terminate a trust with the consent of all beneficiaries is not taxable under the "in conjunction with" clause, reasoning that this power exists under state law in almost all situations, and to hold otherwise would cause all trusts to be taxable); *Tully Estate v. Commissioner*, 528 F.2d 1401 (Ct. Cl. 1976) (decedent was a 50% shareholder; corporation and decedent entered into a contract to pay a death benefit to the decedent's widow; even though the beneficiary designation was irrevocable, court rejected IRS argument that it could be amended for several reasons, including that the decedent and the other 50% shareholder could cause the corporation to agree with the decedent to change the beneficiary, because "Congress did not intend the 'in conjunction' language of section 2038(a)(1) to extend to the mere possibility of bilateral contract modification").

A possible distinction of applying the logic of these § 2038 cases to the "in conjunction with" language in § 2036(a)(2) is that the regulations under § 2038 specifically state that a settlor's ability to act in concert with all donees/beneficiaries is not a retained power under § 2038, but the analogous provisions in the regulations under § 2036 regulations do not include that same statement. *See* Reg. §§ 20.2038-1(a)(2) (§ 2038 does not apply "[i]f the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law"); 20.2036-1(b)(3). However, applying the "in conjunction with" clause in a different manner in those two situations does not seem supportable under any policy rationale.

The court may not view the *Helmholz* and *Tully* line of cases as being persuasive, however, in situations in which the decedent specifically structured the transaction with the restriction on the individual's ability to reach valuable assets, and particularly where the "other party" who must join is the very party the decedent intends to benefit. On the other hand, the party being benefitted would likely object to any attempt by the donor to decrease the value of that party's interest.

4. **Eliminating Necessity of Donor Consent to Early Termination**. What if the split dollar agreement had allowed the irrevocable trust to terminate the arrangement early unilaterally? Would that be enough to avoid the "in conjunction with" analysis because the decedent would have no ability to participate in the decision to obtain immediate access to a large value? Even without the explicit right, the donor could still join with the irrevocable trust to revise the arrangement because all of the parties to a contract could always revise or terminate that contract. Furthermore, on these facts, the lender of the $10 million might require that the borrower be able explicitly to initiate negotiations to terminate the arrangement if the lender became uncomfortable with its financial position and the ability to be repaid.

   What if the split dollar agreement were totally silent about what would happen if the irrevocable trust attempted to terminate its obligations under the agreement prior to the insureds' deaths? (A third-party lender would be very uncomfortable with that approach.)

   Even if those revisions in the typical split dollar arrangement were adopted, however, that still probably would not avoid the § 2703 analysis, because § 2703 does not depend on any "in conjunction with" language in the statute.

5. **Ramifications of the § 2703(a) Analysis**. Section 2703(a) describes the *general rule* that if any "property" is subject to an agreement or restriction allowing someone to acquire or use the property for less than fair market value or restrict the sale or use of the property, such agreement or restriction must be ignored in valuing the property. Section 2703(b) describes an *exception* to that general rule. The *Cahill* case just addresses the general rule, and appears to apply the general rule in a broad manner in which many if not most multi-party arrangements may be subject to the general rule of § 2703(a), and the determining issue will then be whether the exception applies.

   The § 2703(a) issue for split dollar arrangements generally is whether restrictions on repayment rights are 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.

   The key issue that arises in determining whether § 2703(a) applies to any particular "property" is whether the property being tested under § 2703(a) is an asset with inherent characteristics that impact its value or whether the property is an asset subject to some agreement or restriction that allows someone to acquire or use the asset at less than its fair market value or that restricts the right to use or sell the asset, which restriction must be ignored under § 2703(a) in valuing the "property."

   For example, is an automobile that has a governor limiting its maximum speed to 30 miles per hour valued as an under-30 MPH vehicle (with a minimal value), or is it valued as an automobile subject to a restriction on the right to its use because the governor restricts it from exceeding 30 MPH, which restriction must be ignored in valuing the automobile under § 2703(a)?

   The estate argued that the decedent transferred $10 million in return for a bundle of contractual rights and that any characteristics impacting the value of the bundle of contractual rights were just inherent in the nature of what was acquired. The estate argued that its rights under the split dollar agreements in their entirety was the "property" (rather than having any interest in the policies burdened by restrictions). The court acknowledged that the estate owned contractual rights, but viewed these rights as including a right to terminate the contract (and access the cash surrender value) but only with an agreement and restriction that impacts that value (i.e., the requirement of obtaining the irrevocable trust's consent), which restriction was subject to § 2703(a). Is that appropriate?

   The court viewed the estate as specifically arguing (by its reference to *Estate of Elkins v. Commissioner*) that § 2703(a)(2) applies only where the property interest "exists or is created separately from the restrictions." This goes to the basic notion that § 2703(a) applies only when some separate restriction impacts a "property" interest. This is similar to the argument that the taxpayer's bundle of rights under the split dollar agreement should be valued in light of its inherent characteristics that would not be subject to § 2703(a). The court disagreed, responding that "nothing in the statute" suggests that distinction.

One analogy suggested by the estate was to a transfer in return for notes. The court drew factual distinctions between a note and the rights under the split dollar agreement (with the note having bargained terms, interest, and required payments at definite times) and concluded that the split dollar arrangement was unlike bona fide notes. That analysis seems to apply a § 2703**(b)** analysis (i.e., whether the arrangement is a bona fide arrangement comparable to similar arm's length transactions) in determining whether the property is within the scope of § 2703**(a)**.

The estate's next analogy was to partnership interests, because the Tax Court had held in *Estate of Strangi* that a decedent's limited partnership interests were not subject to § 2703(a), differentiating a right to partnership assets vs. the right to a limited partnership or corporate interest. *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), *aff'd as to this issue sub nom Gulig v. Commissioner*, 293 F.3d 279 (5th Cir. 2002). *See also Church v. U.S.*, 85 AFTR 2d 2000-804 (W. D. Tex. 2000). The court distinguished the *Strangi* holding (and the limited partnership analogy) for two reasons–(i) the split dollar agreement did not involve a state law entity (without discussing why that distinction was relevant), and (ii) the IRS in *Strangi* had not argued that the shareholder's agreement should be disregarded.

As to that second reason, various cases have held that the any restrictions in partnership or LLC agreements are subject to § 2703(a), and many have held that the restrictions failed to meet the § 2703(b) exceptions and should be disregarded in valuing interests in the entity (but restrictions inherent under state law can still be taken into consideration). *E.g.*, *Holman v. Commissioner*, 601 F.3d 763 (8th Cir. 2010) *aff'g* 130 T.C. 170 (2008) (transfer restrictions in the partnership agreement should be disregarded under § 2703 in valuing limited partnership interests); *Fisher v. U.S.*, 106 AFTR 2d 2010-6144 (S.D. Indiana 2010) (right of first refusal allowing payment with long-term notes ignored under § 2703; bona fide business arrangement requirement in § 2703(b) was not satisfied); *Estate of Smith v. United States*, 94 AFTR 2d 5283 (2004), *rehearing on other issues*, 96 AFTR 6549 (W.D. Pa. 2005) (right of first refusal, which allowed payment with notes payable over up to fifteen years with interest equal to the long term AFR, ignored under § 2703).

Relatively few cases focus on the applicability of § 2703(a); most of the § 2703 cases focus on whether the § 2703(b) exception applies. *Cahill* does apply § 2703(a) in a setting other than an agreement or restriction regarding interests in an entity. A step removed from ignoring contractual restrictions in entity agreements, and perhaps a small step removed from the *Cahill* § 2703(a) analysis, is a notion that any restriction on a person's being able to acquire the maximum possible value under a contract would be viewed as a § 2703(a) restriction.

This analysis may result in a general treatment of any contractual limitation on achieving maximum value as a § 2703(a) agreement or restriction, with the key issue being whether the § 2703(b) exception requirements are satisfied. Intergenerational split dollar arrangements in the commercial setting (for example, to fund legitimate buy-sell arrangements for business owners) may be more likely to satisfy the exception under § 2703(b).

6. **Section 2703 Analysis Is Particularly Important for Intergenerational Split Dollar Purposes**. Individuals entering into intergenerational split dollar arrangements could avoid the §§ 2036 and 2038 reasoning by making a transfer at some point (at least three years before the individual's death) of his or her rights under the split dollar agreement. Sections

2036 and 2038 apply only for estate tax purposes, but § 2703 applies for estate *and gift* tax purposes. If § 2703 applies, it would apply for valuing the transfer of reimbursement rights for either estate or gift tax purposes, meaning that the individual would never be able to transfer his or her reimbursement rights at a de minimis value if the policy has a substantial cash surrender value.

An argument could be made that the § 2703(a) analysis would not apply if the split dollar plan were structured to give the irrevocable trust the unilateral ability to terminate the split dollar arrangement without the involvement of the donor and not to give the donor the explicit authority to terminate the agreement with the trust's consent (or if the agreement were structured so that no one had the ability to terminate the agreement before the insured's death).

The opinion might be construed to treat the requirement that the trust consent to the donor's termination of the split dollar agreement as a restriction on the donor's ability to reach the cash surrender value of the policies, perhaps suggesting that § 2703(a) would not have applied if the donor had no explicit authority under the arrangement to initiate discussions about terminating the arrangement. For example, one sentence of the § 2703(a)(2) analysis reasons that "the split-dollar agreements, and specifically [the irrevocable trust's] ability to prevent termination, also significantly restrict decedent's right to use the termination rights." This might suggest that the "property" as referenced in § 2703(a) is the ability to reach the cash surrender value by terminating the arrangement, and that the requirement of obtaining the trust's consent is a restriction on the right to sell or use that "property" at less than fair market value (§ 2703(a)(1)) or as a restriction on the right to sell or use such "property" (§ 2703(a)(2)).

On the other hand, the next sentence of the § 2703(a)(2) analysis refers somewhat more broadly to the arrangement in its entirety as restricting the donor from being able to "withdraw his investment from these arrangements." Furthermore, the court's analysis of § 2703(a)(1) refers to "provisions that prevent decedent from immediately withdrawing his investment" as being "agreements to acquire or use property at a price less than fair market value." Even if the decedent had not been able, under the express provisions of the agreement, to initiate a termination of the agreement, the court likely would have viewed the trust's ability to prevent the donor from reaching the cash surrender value as a § 2703(a) restriction.

7. **Similar Denial of Motion of Summary Judgment Regarding § 2703(a) in *Morrissette v. Commissioner*.** The initial case in *Morrissette v. Commissioner,* 146 T.C. No. 11 (2016) determined that the economic benefit regime applies to the split dollar arrangement in that case. The IRS made arguments under §§ 2036, 2038, and 2703, similar to its arguments in *Cahill*. The estate filed a motion for partial summary judgment that § 2703(a) is inapplicable (but, unlike in *Cahill*, the taxpayer did not request a summary judgment regarding §§ 2036 and 2038). Three days after the entry of the *Cahill* decision, the Tax Court entered an Order in *Morrissette* on June 21, 2018 denied the taxpayer's motion for summary judgment that § 2703(a) was inapplicable, concluding that "[t]he restriction on the decedent's termination rights is a restriction for purposes of section 2703(a)(2)." Order in Docket No. 4415-14 (June 21, 2018 (Judge Goeke).

8. **Interaction of §§ 2036, 2038, and 2703**. The *Cahill* court noted that the same result occurs in this case under any of §§ 2036, 2038, or 2703 (i.e., the cash surrender value would be included in the decedent's gross estate). The court observed in footnote 10 that it did not need to address the interaction of those sections as it would have if those sections had produced different results.

9. **Brief Background about Intergenerational Split Dollar Insurance**. 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, which might not be repaid for decades. (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 (and is treated as making a transfer each year of the current value of life insurance coverage), 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.

   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 NEWSLETTER #2414 (May 12, 2016); Alan Jensen & R. Brent Berselli, *Estate of Morrissette: Unfinished Business,* LEIMBERG ESTATE PLANNING NEWSLETTER #2418 (May 23, 2016) Lee Slavutin & Richard Harris, *Intergenerational Split Dollar Life Insurance; What Can We Learn from* Morrissette, Levine *and* Neff?, LEIMBERG ESTATE PLANNING NEWSLETTER #2443 (August 9, 2016); Espen Robak, *Intergenerational Split Dollar Valuation Issues,* LEIMBERG ESTATE PLANNING NEWSLETTER #2444 (August 9, 2016).

10. **Major Blow to Intergenerational Split Dollar Plans**. The *Cahill* decision is a major blow to the desired extremely advantageous tax treatment of intergenerational split dollar plans. Treating the person advancing huge premiums under an intergenerational split dollar plan as effectively having reimbursement rights equal to the cash surrender value of the policy would eliminate the possibility of transferring huge amounts to a trust to fund its purchase of life insurance without treating the transferor as ever having made a substantial transfer for gift or estate tax purposes. If the case is not eventually reversed on appeal (assuming it is ever appealed), it will present a major hurdle to the ability to transfer huge economic value under intergenerational split dollar arrangements (at least for economic benefit regime structures) without ever making a significant transfer for gift or estate tax purposes. Future cases will revolve around attempting to distinguish the reasoning of the *Cahill* decision (for example, pointing out distinctions from the *Cahill* reasoning by using loan regime arrangements and by eliminating the explicit ability of the donor/premium advancer to participate at all in the decision to terminate the agreement during the insured's life).

11. **Continuing Litigation about Intergenerational Split Dollar; Other Cases; Potential Attacks**. The denial of the taxpayer's motion for partial summary judgment in *Cahill* means that the case will proceed to trial (unless it is settled by the parties), and the case eventually will be appealable to the Ninth Circuit Court of Appeals after final judgment has been entered by the Tax Court.

    Two other cases before the Tax Court also involve non-equity intergenerational split dollar economic benefit regime arrangements. *Estate of Morrissette,* Docket No. 4415-14, and *Estate of Levine v. Commissioner*, Docket No. 9345-15. All of these cases involve the determination of the value for estate tax purposes of the value of the decedent's reimbursement rights under intergenerational split dollar arrangements. The *Morrissette* and *Levine* cases have somewhat more sympathetic fact situations than in *Cahill*. For example, in *Morrissette*, the arrangement was used to assist in funding a buy-sell agreement for a closely held business interest at the deaths of the decedent's children, and *Morrissette* did not involve lending from a third party with the decedent owing interest to a third party lender, with interest accruing on the note, even though the decedent was merely entitled to reimbursement of the fixed amount of the advanced premiums (or the cash surrender value if greater) without interest.

    In *Morrissette*, the IRS is disputing not only the valuation of the reimbursement right, but also maintains that §§ 2036, 2038, and 2703 apply. Similar issues were raised by the IRS in *Levine.*

    Levine is set for trial in the Tax Court in October, 2018. *Levine* may thus be the first reported case deciding the estate tax treatment of intergenerational split dollar insurance in the donor's estate.

    The IRS may also be raising other equitable tax doctrine general issues, such as sham/step transaction/duty of consistency types of issues, in these types of cases. These cases can be contrasted from situation in which an investment or arrangement results in a "changed value" (for example, the interests owned by business owners are initially worth less than the cash amounts contributed by them to the entity), as compared to situations resulting in a "split value" (for example, a situation in which the parent's value goes down in value while the children's value increases by a similar amount). The intergenerational split dollar arrangement is a type of split value situation, in which the arrangement results in a substantial decrease in the parent's value and a somewhat offsetting increased value in the younger generation's interest. Courts will likely be less inclined to respect the latter "split value" types of situations to result in removing substantial value from the estate for estate tax purposes.

    A variety of potential issues exist regarding intergenerational split dollar arrangements, including:

    1. Treatment of insurance coverage following premium payer's death;
    2. Section 2703;
    3. Sham transaction; lack of business purpose.

4. Step transaction – this is one of the positions the IRS is taking in *Levine* ("transfer … constituted gifts … in a series of interrelated steps with a value equal to the cost of the … premiums paid"); the Tax Court entered partial summary judgment in favor of the taxpayer on July 13, 2016 in *Levine,* resulting in no gift tax deficiency or penalties, on the basis of the *Morrissette* opinion;
5. Modification under the split dollar regulations;
6. Sections 2036 and 2038; and
7. Duty of consistency.

For a discussion of the IRS attacks under each of these arguments, see Item 27.f.(2) of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

Intergenerational split dollar arrangements in the commercial setting (for example, to fund legitimate buy-sell arrangements for business owners) will be more likely to survive these attacks, and in particular the sham transaction/lack of business purpose argument and also the § 2703 attack because it will be more likely to satisfy the exception under § 2703(b).

12. **Loan Regime Intergenerational Split Dollar 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 NEWSLETTER #2443 (August 9, 2016) (loan treatment can be assured, loan can be for life of insured allowing lock in of low interest 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). The IRS so far generally has not been emphasizing audits of loan regime arrangements. 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.

For a discussion about the ability to discount notes having an interest rate below the commercial rate (even if it is at the AFR) because the IRS has never finalized regulations adopting the concepts of § 7520 for estate tax purposes, see Item 2.c.(2) of the Estate Planning Current Developments Summary (Nov. 2015) found **here** and available at **www.bessemer.com/advisor**. If the note is discounted for estate tax purposes, when the note is later paid (possibly decades later), the excess of the payments over the note's basis (i.e., the discounted estate tax value) will be ordinary income to the recipient, as discussed at Item 4.c.(3) of the Heckerling Musings 2016 and Current Developments (February 2016) found **here** and available at **www.bessemer.com/advisor**. But that potential income tax liability would be years (or decades) in the future.

If the loan regime arrangement could be combined with facts in which the donor does not participate in any way in a decision to terminate the split dollar arrangement, the taxpayer may be able to avoid some of the conclusions in *Cahill* regarding the application of §§ 2036, 2038, and 2703.

13. **Simple Loan Arrangements.** Some of the desired estate tax advantages of intergenerational split dollar arrangements could be achieved much more easily with simple relatively long-term loans to younger generation family members or trusts for their benefit (particularly grantor trusts to avoid recognition of interest payments). Cash loans clearly can use the AFR interest rate without gift consequences under § 7872. If the loans can be discounted at death for estate tax purposes (because no estate tax final regulations adopt the concepts of § 7872), some of the valuation arbitrage effects resulting in reduced estate tax values could be achieved without all the complexity of split dollar arrangements. The loans must still satisfy the requirements of being classified as "debt" rather than an "equity" interest, and very long-term notes are more at risk of being treated as equity interests. (See the discussion in Item 12 above regarding the estate and income tax effects of discounting notes.)