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Subject: Howard Zaritsky - Morrissette II Sets the Bar for Intergenerational Split-Dollar Life Insurance Arrangements

"The Tax Court in Estate of Morrissette v. Comm'r, T.C. Memo. 2021-60 (May 13, 2021) (Morrissette II) has provided more favorable answers to several of the estate tax questions surrounding intergenerational split-dollar life insurance agreements than had the prior cases. The court now held that: (a) the policy proceeds are not includible in the gross estate of the deceased grantor of the revocable trust under Sections 2036 or 2038, because they were made in a bona fide sale for adequate and full consideration; (b) the special valuation rules of Section 2703 do not require inclusion of the cash surrender value of the policies in the decedent's gross estate; (c) the fair market values of the decedent's split-dollar rights could be calculated using the discounted cash value methodology; and (d) a 40% gross valuation misstatement penalty under Section 6662(h) was appropriate."

Howard Zaritsky provides members with important and timely commentary on *Estate of Morrissette v. Commissioner,* T.C. Memo. 2021-60*.* Members who wish to learn more about this topic should consider watching these two powerful **LISI** Webinars:

- "**Morrissette: Isn't It Ironic?**" May 27th @ 1PM ET with **Brent Berselli**
- "**Morrissette – Tax Court Moves Split-Dollar Battle to Valuation**" June 4th @ 3PM ET, with **Bob Keebler**, **Martin Shenkman**, **Espen Robak**, **Lee Slavutin** & **Richard Harris**

Howard Zaritsky is a retired estate planning attorney He is the author or co-author of numerous articles and treatises, including: Tax Planning for Family Wealth Transfers During Life, Tax Planning for Family Wealth Transfers at Death, and – with Steve Leimberg - Tax Planning with Life Insurance (all published by Thomson-Reuters/WG&L). He is a Fellow of the American College of Trust and Estate Counsel and the American College of Tax Counsel, a member of the Virginia State Bar, and former Chair of the Virginia Bar Association Section on Wills, Trusts & Estates.

Here is his commentary:

EXECUTIVE SUMMARY:

The Tax Court in *Estate of Morrissette v. Comm'r*, T.C. Memo. 2021-60 (May 13, 2021) (*Morrissette II*) has provided more favorable answers to several of the estate tax questions surrounding intergenerational split-dollar life insurance agreements than had the prior cases. The court now held that: (a) the policy proceeds are not includible in the gross estate of the deceased grantor of the revocable trust under Sections 2036 or 2038, because they were made in a *bona fide* sale for adequate and full consideration; (b) the special valuation rules of Section 2703 do not require inclusion of the cash surrender value of the policies in the decedent's gross estate; (c) the fair market values of the decedent's split-dollar rights could be calculated using the discounted cash value methodology; and (d) a 40% gross valuation misstatement penalty under Section 6662(h) was appropriate.

FACTS:

AN INTRODUCTION TO INTERGENERATIONAL SPLIT-DOLLAR LIFE INSURANCE

A popular use of private split-dollar life insurance is the inter-generational split-dollar plan. Inter-generational split-dollar involves using the "economic benefit regime" with a collateral assignment non-equity split-dollar agreement, to avoid both gift and GST taxes. Under this arrangement, a senior-generation member (grandparent) pays part of the premiums on a single life or second-to-die policy insuring the life or lives of one or more middle-generation members (child, child and spouse, or children). The death benefits are payable to a trust for the benefit of lower-generation members (grandchildren and more remote descendants). The grandparent typically pays the portion of the premium equal to the value of the present insurance coverage, under Table 2002 (IRS Notice 2002-8), or the insurer's alternative term rate, if lower. The grandparent often also makes gifts to the trustee to enable the trustee to pay the balance of the premiums.

Proponents of this concept posit that the senior generation does not make taxable gifts by paying premiums; rather, the senior generation advances funds to the trustee, with a full right to recover the greater of the cash value or the total premiums paid from the policy death benefits. The senior generation's payments are usually designed to create a sufficient cash value in the policy during the first five years to enable the trustee to pay all future premiums from the annual exclusion gifts made to the trust.

BACKGROUND: THE EARLIER CASES – *MORRISSETTE I* AND *CAHILL*

The first reported case to address the utility and results of intergenerational split-dollar life insurance was *Estate of Morrissette v. Comm'r,* 146 T.C. 171 (2016) *(Morrissette I)*, which involved the estate of Clara M. Morrissette, who had established a revocable trust and contributed to it her shares in the family's corporation, Interstate Group Holdings, Inc. (IGH), which owned and operated Interstate Van Lines. Clara was the initial trustee, but her three sons were later added as co-trustees to assist her in managing her affairs after she reached an advanced age.

In 2006, the revocable trust was amended to permit the trustee to "(i) pay premiums on life insurance policies acquired to fund the buy-sell provisions of the * * * [Interstate Group's] business succession plan, and (ii) make loans, enter into split-dollar life insurance agreements or make other arrangements." The same amendment also authorized the trustee to transfer each receivable from the split-dollar life insurance agreement, when paid by one of the three dynasty trusts Clara had created for her sons, back to the irrevocable trust owing the receivable or directly back to each son.

A few days later, the revocable trust, the three dynasty trusts, Clara's brothers-in-law, and some other trusts entered into a buy-sell agreement, under which, on the death of any of the three sons, the remaining sons and their dynasty trusts would buy the deceased's IGH stock. To fund the buy-sell agreement, each of the dynasty trusts bought a universal life insurance policy on the life of each other son. The revocable trust entered split-dollar insurance agreements with three dynasty trusts.

The revocable trust contributed $29.9 million to the three dynasty trusts to enable them to buy universal life insurance policies on each of the sons. The revocable trust was entitled to receive a portion of the death benefit from each policy equal to the greater of the cash surrender value of the policy or the aggregate premium payments on that policy. Each dynasty trust would receive the balance of the death benefit under the policy it owns on the life of the deceased, which would be available to fund the purchase of the stock owned by or for the benefit of the deceased. The split-dollar agreements included a recital that the parties intended that the agreements be taxed under the economic benefit regime, rather than the loan regime, and that the only economic benefit provided to the dynasty trusts was current life insurance protection.

The dynasty trusts executed collateral assignments of the policies to the revocable trust to secure their obligations under the split-dollar agreements. None of the trusts had the right to borrow against a policy held under this agreement. Clara reported gifts to the trusts for the 2006–2009 tax years using the economic benefit regime.

After Clara's death, the IRS determined a gift tax deficiency and penalty against the estate, treating the entire $29.9 million as a gift in 2006. The estate challenged the deficiency in the Tax Court and sought partial summary judgment regarding whether the split-dollar agreements were governed by the economic benefit regime.

The Tax Court (Judge Goeke) granted the partial summary judgment, holding that (1) the agreements in this case were clearly split-dollar life insurance agreements because the revocable trust paid part of the premiums and was entitled to recover, at a minimum, all of those premiums paid, and because this recovery would be made from, or at least was secured by, the proceeds of the policies; (2) the dynasty trusts owned the policy but, under the regulations, the economic benefit regime applied because the agreement was donative in nature and the only economic benefit provided under the agreement to the donee was the current life insurance protection. Reg. § 1.61-22(c)(1)(ii)(A)(2); see also TD 9092, § 5, 2003-2 CB 1055, 1062; (3) the value of the economic benefits provided to the nonowner for a taxable year under the agreement is equal to the sum of the cost of current life insurance protection, the amount of cash value to which the nonowner has current access during the year, and any economic benefits not otherwise described that are provided to the nonowner. Reg. § 1.61-22(d)(2).

The court rejected the IRS's contention that the dynasty trusts had a direct or indirect right in the cash values by virtue of the terms of the 2006 amendment to the revocable trust, under which the revocable trust's interest in the cash values of the policies would pass to the dynasty trusts or directly to the sons or their heirs on Clara's death. The court noted that Clara could, at any time during her lifetime, alter the terms of the revocable

trust, so that the dynasty trusts had no legally enforceable right to the cash values of the policies during Clara's lifetime. Also, the split-dollar agreements did not require the revocable trust to distribute the receivables to the dynasty trusts; Clara retained a right to those receivables. Furthermore, the court noted, the regulations look only to current or future rights to cash value "under the arrangement," and provisions of the revocable trust amendments were not part of the split-dollar agreement. Reg. § 1.61-22(d)(1).
The court also rejected the IRS's argument that the "prepaid premiums" paid not only for current insurance protection, but also for future protection, which is a benefit other than current life insurance protection and requires that the agreement be taxed under the loan regime. The court noted that this would require assuming that the dynasty trusts would otherwise be required to pay the premiums, whereas under these split-dollar agreements, the dynasty trusts are not required, but are permitted, to pay any portion of the policies' premiums. Only the revocable trust was obligated to pay all premiums.

The second reported case on point was *Estate of Cahill v. Comm'r,* T.C. Memo. 2018-84 (*Cahill*), in which the decedent, Richard F. Cahill, was the grantor of a revocable trust of which his son, Patrick, was the trustee. Patrick was also Richard's attorney-in-fact, and the executor of Richard's estate. When Richard was already 90 years old and unable to manage his own affairs, Patrick created an irrevocable trust (the MB Trust) on Richard's behalf. Patrick's cousin, William Cahill, was named as trustee and Patrick and his issue were the primary beneficiaries.

The MB Trust and the revocable trust then entered into three split-dollar agreements with respect to three whole life policies in the aggregate face amount of just under $80 million. One policy insured Patrick's life and the other two insured the life of his wife, Shannon. The MB Trust borrowed $10 million from Northern Trust, N.A., and used these funds to pay the premiums on all three policies in a single lump sum. Richard was personally liable for the loan through an agreement signed by Patrick, as his attorney-in-fact. The loan was for five years and provided for annual interest of the greater of (1) 1.5 percent or (2) the sum of 1.14 percent plus the London Interbank Offered Rate (LIBOR) for deposits with a maturity of one month. No principal payments were required during the five-year term. The MB Trust could not sell, assign, transfer, borrow against, surrender, or cancel a policy without the consent of revocable trust.

Each split-dollar agreement could be terminated during the insured's life by written agreement between Richard (through his revocable trust) and the MB Trust. Upon termination, Richard, through his revocable trust, had the following termination rights: (1) the MB Trust could retain the policy, in which case Richard's revocable trust would receive the greater of premiums paid or cash surrender value with respect to the related policy or (2) the MB Trust transfer the policy to Northern Trust in full or partial satisfaction of Richard's liability to Northern Trust.

In addition, when an insured died, Richard's revocable trust had the right to the greatest of (1) the remaining balance on the loan, (2) the total premiums paid by revocable trust with respect to the policy to which the loan related, and (3) the policy's cash surrender value immediately before the insured's death. The MB Trust would retain any excess of the death benefit over the amount paid to revocable trust.

Richard reported $7,575 in gifts to the MB Trust, as determined under the economic benefit regime of the split-dollar regulations. When Richard died, the cash surrender value of the three policies was $9,611,624. Richard's estate contended that termination of the split-dollar agreements was so unlikely that the termination rights had no value as of Richard's death, because Richard's right to terminate the split-dollar agreements was held in conjunction with the trustee of MB Trust and it would make no economic sense for the MB Trust to allow termination of the agreements. Thus, the estate treated the value of Richard's interests in the split-dollar agreements as limited to the value of the death benefit rights, which it calculated at $183,700. This value was so low because the insureds, Patrick and Shannon Cahill, had long life expectancies, giving Richard's rights a small present value.

The parties agreed that, for income and gift tax purposes, the agreements between the trusts were split-dollar agreements under the regulations, and that they were taxable under the economic benefit regime. The IRS issued a notice of deficiency claiming that Richard's rights in the split-dollar agreements were worth the $9,611,624 cash surrender value, based on the application of Sections 2036 and 2038, and Section 2703.

The Tax Court (Judge Thornton) held that: (a) Richard held on the date of his death the rights to terminate the agreement and to recover at least the cash surrender value, which although exercisable in conjunction with the trustee of the MB Trust, entitled Richard to designate the persons who would possess or enjoy the transferred property under Section 2036(a)(2) and to alter, amend, revoke, or terminate the transfer under Section 2038(a)(1). Citing *Estate of Powell v. Comm'r*, 148 T.C. 392 (2017) and *Estate of Strangi v. Comm'r*, T.C. Memo. 2003-145, *aff'd*, 417 F.3d 468 (5th Cir. 2005); (b) Richard's transfer of $10 million to the MB Trust was not a bona fide sale for an adequate and full consideration in money or money's worth, because there was finding that the facts did not establish a legitimate and significant nontax reason for the transfer. Citing *Estate of Hurford v. Comm'r*, T.C. Memo. 2008-278; (c) the facts showed that the interest received by Richard in the policies was not worth the same amount as the amount transferred, so that the transfer was not for full and adequate consideration in money or money's worth; and (d) the MB Trust's ability to veto Richard's termination of the agreements existed from the moment the agreement was entered into, so that the value of the retained rights was never equal to the $10 million transferred.

The court also held that Richard's and the MB Trust's rights under the split-dollar agreements must be valued under Section 2703(a). Section 2703(a) values any asset includible in a decedent's gross estate without regard to (1) any option, agreement, or other right to acquire or use the property at a price less than its fair market value or (2) any restriction on the right to sell or use such property. Section 2703(b) provides an exception where the restriction is a *bona fide* business arrangement, not a device to transfer property to members of the decedent's family for less than adequate and full consideration, and comparable to the terms of similar arrangements in arm's-length transactions. Here, the court held that the relevant property interests for purposes of valuation under Section 2703(a) were the contractual rights in the cash surrender value, the transfer of which was restricted by the agreements which allowed the MB Trust to prevent Richard's access to that amount and that Richard received rights that were reportedly worth $183,700 and the MB Trust received rights worth over $9 million.

The estate next argued that the difference between the $10 million that Richard paid for the policies and the $183,700 that he received in return would be accounted for as gifts, and that to count it also as part of the estate under Sections 2036, 2038, or 2703 would essentially double count that amount. The court rejected this argument, because Richard never reported the difference as a gift; the parties agreed that only the economic value of the insurance coverage was a gift. The cash surrender value remaining on the date of death represented funds that had not yet been used to pay the cost of current life insurance.

The court also rejected the estate's argument that the difference between the $183,700 and the cash surrender value would be reflected as gifts after Richard's death, because Richard's beneficiaries will receive his interest in the split-dollar agreement. Thus, the estate argued, the cost of current life insurance will continue to be treated as gifts to the MB Trust. Even were this true, the court stated, the gift of current life insurance protection to the MB Trust after Richard's death would not be a gift from Richard, but rather from the persons who succeed to his interests in the agreements. Thus, there would be no double-counting.

Morrissette II

The Tax Court ruled in *Morrissette II* that: (a) the policy proceeds are not includible in the gross estate of the deceased grantor of the revocable trust under Sections 2036 or 2038, because they were made in a *bona fide* sale for adequate and full consideration; (b) the special valuation rules of Section 2703 do not require inclusion of the cash surrender value of the policies in the decedent's gross estate; (c) the fair market values of the decedent's split-dollar rights could be calculated using the discounted cash value methodology; and (d) a 40% gross valuation misstatement penalty under Section 6662(h) was appropriate.

The Tax Court (Judge Goeke) reviewed the facts in even greater detail that he had in the earlier opinion of the court and noted that, while the petitioners agree that the fair market values of the split-dollar rights are includible in Mrs. Morrissette's gross estate because they were held by her revocable trust, the IRS sought to include the $30 million in premium payments or the $32.6 million in cash surrender value in the decedent's gross estate under Sections 2036 and 2038. The IRS argued, as it had in *Cahill*, that the revocable trust, through the split-dollar agreement, had retained the possession, enjoyment, or right to income in the transferred funds under Section 2036(a)(1), a power to designate the beneficial enjoyment of the transferred funds under Section 2036(a)(2), or a power to alter the transferred funds under Section 2038(a). As the Tax Court in *Cahill* had already stated that the rights retained in an intergenerational split-dollar life insurance agreement fell under Section 2036(a)(2) or 2038(a) (the application of Section 2036(a)(1) was not considered in that case), the court did not need to re-evaluate that issue here, but instead focused on the bona fide sale exception to both Sections 2036 and 2038.

The IRS also contended that the transfer was not a bona fide sale for adequate and full consideration, but the Tax Court disagreed. The Tax

Court applied the same analysis in *Morrissette II* that it had applied in *Estate of Powell at* 411 (2017), that the bona fide sale exception requires both (1) a legitimate and significant nontax purpose and (2) adequate and full consideration for money or money's worth. The court rejected the IRS argument that the transfers between the revocable trust and the dynasty trusts were not a "sale" as that term is ordinarily defined, because the dynasty trusts paid no consideration. The court pointed out that Section 2036 and 2038 adopt a broader definition of "sale," that includes transactions that are not commonly categorized as sales. Basically, they require only a voluntary act of transferring property in exchange for something. *Estate of Bongard v. Comm'r*, 124 T.C. 95, 113 (2005). *Estate of Stone v. Comm'r*, T.C. Memo. 2003-309 (treating a contribution of assets to a business entity in exchange for an interest in the entity as a sale for purposes of section 2036(a)). In *Morrissette II*, the revocable trust voluntarily and in good faith transferred money to the dynasty trusts in exchange for a right to repayment. Thus, the split-dollar agreement between the revocable trust and the dynasty trusts was a sale for this limited purpose.

The court then held that Clara had a legitimate and significant nontax motive for advancing the funds to pay the premiums under the split-dollar agreement. The court explained that the nontax purpose must be a genuine purpose that motivates the transaction, rather than a theoretical purpose or justification. *Estate of Bongard*, 124 T.C. at 118. The existence of additional testamentary objectives, however, does not negate the existence of a legitimate nontax purpose, as such purposes are often inextricably interwoven. *Estate of Bongard*, 124 T.C. at 121; *Estate of Black v. Comm'r*, 133 T.C. 340, 362-363 (2009).

The evidence established that Clara sought to maintain control over the company and to pass that control on to her sons and future generations. The split-dollar agreements were instrumental in accomplishing these objectives and assuring the control and succession of an active closely-held business is a legitimate nontax purpose for the *bona fide* sale exception. to ensuring that Interstate's ownership remained in her family after her sons died. Citing *Estate of Bigelow v. Comm'r*, 503 F.3d 955, 972 (9th Cir. 2007), *aff'g* T.C. Memo. 2005-65; *Estate of Strangi v. Comm'r*, 417 F.3d at 481; *Estate of Reynolds v. Comm'r*, 55 T.C. 172, 194 (1970). The court explained that:

The brothers wanted to honor their parents' wish that the three brothers inherit Interstate equally and pass the company on to their children. However, they were also realistic about the need to pay estate tax and the *possibility that they would need to sell part of Interstate to pay it. They believed that there was a significant chance that the family would lose control of Interstate if their families were not given this option . . . . The split-dollar agreements provided each brother's children with the option to exit the business and cash out their interests after the brother's death and at the same time allowed the remaining brothers and their families to purchase the interests by funding the buyout. The buy-sell provision also prevented the brothers from selling their Interstate stock to outsiders as a means to retaliate against one another for past disputes.* T.C. Memo. 2021-60 at *76.

The court also held that the split-dollar agreements served a second legitimate, nontax purpose, a smooth transition in Interstate's management. The agreements helped assure that those sons who had long worked for the company could remain with the company for their professional futures, preserving both their expertise and institutional knowledge. The court found testimony from these sons about their succession concerns to be credible.

The court acknowledged that the split-dollar agreements were also part of an estate tax saving strategy. Nonetheless, the existence of a tax motivation does not negate the existence of a legitimate nontax motive. As the court explained, "caselaw requires the presence of a legitimate, nontax purpose; it does not require the absence of a tax saving motivation." T.C. Memo. 2021-60 at *78. One son "who made most decisions relating to the split-dollar agreements, credibly testified that he would have engaged in the split-dollar agreements even if they had not provided any estate tax saving because of the nontax financial benefits that they provided." *Id.* Furthermore, the court found that the record showed the sons concerns about the correct inheritance of the company and that these were not merely theoretical justifications for the agreements.

The court rejected the argument that if the sons "stood on both sides of the split-dollar agreements," there could be no legitimate nontax purpose. A taxpayer's standing on both sides of a transaction can indicate there is no legitimate, nontax purpose for the transfer, but it is not conclusive. *Estate of Thompson v. Comm'r*, 382 F.3d 367, 382 (3rd Cir. 2004), *aff'g* T.C. Memo. 2002-246. This is particularly true when the relationship of sons, as here, was occasionally hostile. See *Estate of Stone* (resolving intrafamily disputes that had led to litigation in the past is a legitimate, nontax purpose).

The IRS also argued that the sons had complete control over the policies and could cancel them at any, because the dynasty trusts would inherit the split-dollar rights. The court rejected this argument because, while the sons, as co-trustees, had the discretion to distribute each split-dollar agreement, such distribution was not guaranteed. Moreover, the effects of the possible distribution of the split-dollar agreements after Clara's death were more relevant to the determination of the fair market value of the split-dollar rights then to whether the transfers qualified as bona fide sales. The parties to the buy-sell agreement understood their future obligations and there was credible testimony that there was no prearranged plan to terminate the split-dollar agreements upon Clara's death.

The court rejected the government's argument that purchasing life insurance policies with high initial cash values and modest death benefits proved that tax motivations were primary. The court noted that the sons had credibly testified that they choose those policies to ensure that the revocable trust would be adequately compensated for financing the premiums and that it would earn interest for funding the premiums through inside buildup in the value of the policies.

The court also rejected the IRS argument that the fact that the sons retained their father's stock after his death and the equal distribution of the insurance proceeds among the dynasty trusts showed that the buy-sell provision was not a legitimate reason for the transfer of the premiums. The court stated that it made sense that two of the sons would retain their father's voting stock as they worked for the company and they wanted to protect their careers.

The court also held that the revocable trust had received adequate and full consideration in money or money's worth for its premium payments. The court rejected the estate's argument that the fact that the transaction complied with the requirements of the economic benefit regime should mean that there was adequate and full consideration, because the regulations expressly do not apply for estate tax purposes. The economic benefit regime does not require a comparison of the amount of the premium payment with the value of the rights that the revocable trust received in exchange.

The court noted that, unlike the question of fair market value, the adequacy of consideration is not defined on the basis of a willing buyer and willing seller and is not judged from the perspective of hypothetical persons. *Kimbell v. United States*, 371 F.3d 257, 266 (5th Cir. 2004). The bona fide sale exception does not require an arm's-length transaction and an intrafamily transfer, though requiring heightened scrutiny, can constitute a *bona fide* sale. *Estate of Bongard*, 124 T.C. at 122-123; *Estate of Thompson*, 382 F.3d at 382-383. The question of adequacy of consideration requires that the consideration be similar to that which two unrelated persons would provide after negotiating at arm's length. *Estate of Bongard*, 124 T.C. at 122-123. In *Kimbell*, 371 F.3d at 265-266, the Court of Appeals for the Fifth Circuit acknowledged that an investor received a partnership interest for adequate and full consideration even though the partnership interest had a substantially lower fair market value than the assets contributed to the partnership. The key is whether the exchange is an informed trade, and investors may desire an asset for features other than its fair market value, such as "management expertise, security or preservation of assets, and capital appreciation." *Estate of Thompson*, 382 F.3d at 381. Here, the split-dollar agreements provided financial benefits other than the ability to sell or collect immediately on the split-dollar rights, including repayment plus inside buildup in the value of the policies, management succession, and efficiency and capital accumulation. The court noted that the intervening events between the transfer date, when one determines adequate and full consideration, and the valuation date, when one determines fair market value, which were significant. Clara had been in relatively good health on the transfer date, and one of the sons had been diagnosed with terminal cancer and was no longer even insurable. Clara could have outlived any one of her sons, and the split-dollar agreements were a safe investment with an adequate interest rate.

The court held that the revocable trust received adequate and full consideration on the basis of the split-dollar agreements' repayment terms that included interest earned in the form of inside buildup of the insurance policies. The minimum interest rates and the actual appreciation in the policies' cash values were higher than the interest rates that the CMM trust had been earning on the money. Respondent does not argue that the repayment terms were inadequate. The split-dollar agreements also provide the additional benefit of deferral of tax on the policies' inside buildup and the tax-exempt payout of the death benefits to the beneficiaries.

The court distinguished the facts in *Cahill*, noting that the decedent in *Cahill* was 90 years of age, while the decedent in *Morrissette II* was 75 years old, and the decedent in *Estate of Cahill* borrowed the entire $10 million premium payments from a bank while Clara had sufficient assets to pay almost 90% of the premiums herself, as well as other sources of income to repay the small loan she did obtain from the company. Perhaps more importantly, *Cahill,* unlike *Morrissette II,* did not involve active business operations and such financial considerations as management efficiency and succession, capital accumulation and family dynamics that put those financial considerations at risk. The split-dollar agreements in *Estate of Morrissette II* provided financial benefits similar to those in *Kimbell* and unlike those in *Cahill*.

The court noted that in this case, the estate tax saving was achieved not through execution of the split-dollar agreements alone, but rather through the undervaluation of the split-dollar rights. In exchange for $30 million, the dynasty trusts agreed to buy life insurance and repay the revocable trust and Clara still held the contract rights at the time of her death. However, she no longer had use of or access to the $30 million. Thus, the split-dollar agreements changed the nature of the revocable trust's relationship with the funds that it had transferred.

The court also held that Section 2703(a) did not apply to this arrangement, in a very rare victory for the taxpayer under this section. The court held that the split-dollar agreements were part of a *bona fide* business arrangement, not a device to transfer property at less than adequate and full consideration, and that its terms were comparable to similar arrangements entered into at arm's length.

The court explained that, for this purpose, a bona fide business agreement must further some business purpose. *Amlie v. Comm'r*, T.C. Memo. 2006-76. Such a purpose was established by the estate, as discussed above.

Regarding whether the agreement was a device to transfer property for less than adequate and full consideration, the court agreed with the government that some facts indicated a testamentary purpose for the split-dollar agreements, but that the mutual termination restriction was not itself a device. Device status depends in part on the fairness of the consideration received by the transferor. See *Estate of True v. Comm'r*, T.C. Memo. 2001-167, <u>aff'd</u>, 390 F.3d 1210 (10th Cir. 2004). Here, split-dollar agreements contained reasonable repayment terms, including an inside buildup at a guaranteed interest rate of 3% (and an actual rate of between 4.75% and 5.4%), which was comparable to long-term bonds and actually higher than the revocable trust had been earning on the transferred funds. In light of these and the other intangible benefits discussed above, the court held that the mutual termination restriction was not a device.

On whether the mutual termination restriction was comparable to split-dollar agreements between or among unrelated persons in an arm's-length transaction, the court rejected the analysis of the IRS expert, who compared the Morrissette split-dollar agreements with those entered into by publicly-traded corporations to compensate executives. The court rejected these as having "little relevance to ascertaining whether a closely held corporation or its majority shareholder would include a mutual termination restriction in a split-dollar agreement." T.C. Memo 2021-60 at *104. Also, the government instructed its expert to consider only policies owned by corporate employers, which were not applicable in this case where the corporation had no interest in the policies; the policies were owned by the dynasty trusts. The court noted that the government could not justify this limitation on the policies considered by its expert.

Additionally, the split-dollar agreements reviewed by the government's expert included some type of restriction on the employer's right to terminate the agreement unilaterally, such as vesting for years of service. Here, the senior executives had worked for the company for over 40 years and the court stated that:

[l]ong-term senior executives would likely demand a mutual termination restriction comparable to the one at issue, and the reviewed agreements provide vesting provisions. The mutual termination restriction would ensure the executives' rights to the net death benefits similar to vesting in employment compensation packages on the basis of years of service. In total, approximately 30% of the public agreements imposed some restriction on the employer's termination rights. The termination rights of another 13% are not as clear as respondent argues. T.C. Memo 2021-60 at *105.

The taxpayer was less successful in sustaining a $7.5 million valuation for the decedent's rights under the split-dollar agreements. The court explained that there were two differences between the analyses of the estate's experts and the government's expert: (a) computation of the probability-adjusted expected values of the policies; and (b) the applicable discount rates to determine the present value of those expected returns. The experts differed on both issues, but far more significantly on the second than on the first.

Each expert determined a probability-adjusted expected value for each year of the brothers' life expectancies by estimating an expected cash surrender value for each year and multiplying that value by the brothers' probabilities of mortality that year. On the expected value of the policies, one of the estate's experts valued the split-dollar rights at $7,808,314. The court rejected this valuation because the estate's expert used a blended yield rate that placed too much weight on anticipated decreases in the actual policy yields, and thereby inappropriately decreased the expected cash surrender values. The court also rejected this valuation because the expert used policy illustrations that were not issued close to the valuation date, which the court noted involve subsequent events that were not foreseeable on the valuation date are not, therefore, generally helpful. Citing *Messing v. Comm'r*, 48 T.C. 502, 509 (1967).

Both of the estate's experts used the IRS mortality table for to determine the probability of each insured dying in each year. Actually, the government's expert used tables that provided a lower valuation for the estate, which the court treated as a concession.

The court accepted the discount rates of 8.85% and 6.4% (different rates for different insurers) proposed by the government's expert, finding that they more accurately reflected the risk that the insurers would default on their payment obligations under the policies. That expert used yields that were lower than the average historic yields for both insurers, because interest rates for U.S. Treasury bonds were at a 50-year low. The court held that considering the spot yields on U.S. Treasury bonds more accurately captured the market conditions on the valuation date. The court also held that the actuarial tables negated the argument that it was difficult to determine the timing of the repayments (although a standard actuarial table does little to predict when one of the insured Morrissette sons would actually die).

The estate's experts used life settlement yields as the discount rate, producing a range of yields from 15% to 18% (one expert) or from 9.3% to 23.2% (the other expert). The court rejected these yields because life settlement yields require information regarding the varying sizes of the underlying policies, the financial strength of the insurance companies, the insureds' medical histories, mortality assumptions, and continued obligations to pay premiums. Most of this information was not available to the court. The court stated that, "[w]ithout more information, it is not possible to place the split-dollar agreements accurately within that range." T.C. Memo 2021-60 at *115.

More importantly, the court agreed with the government that the sons likely intended to terminate the split-dollar agreements on December 31, 2013 (when the statute of limitations on estate tax deficiencies regarding Clara's estate return expired), and that this should be deemed to be the maturity date of the policies, producing a fair market value of $27,857,709. The court noted that the revocable trust agreement provided that the split-dollar rights would be allocated to the respective dynasty trusts that owned the underlying policies, which would give the dynasty trusts full control over the policies and allow them to terminate the agreements on December 31, 2013.

The court also sustained a 40% gross valuation misstatement penalty with respect to the valuation of the split-dollar agreement rights held by Clara's estate. It rejected claims that the penalties were never approved by the agent's supervisors, as required under Section 6751(b). While the approval had been done without great formality, such formality is not required and the court found adequate evidence to sustain the penalty as having been approved.

The court also held that the estate had not reasonably relied on the opinions of its valuation experts. Reliance on professional advice may provide a reasonable cause defense if, under all the circumstances, the reliance was reasonable and in good faith. *Neonatology Assocs., P.A. v. Comm'r*, 115 T.C. 43, 98-99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002). The court stated that the estate's $7.5 million appraisal was not reasonable and the sons should have realized it. Despite the business and other nontax purposes for entering into the split-dollar agreements, the sons knew that these arrangements were being marketed as an estate tax saving strategy, and that the tax benefits would be obtained through the low valuation of the split-dollar agreements. The only purpose for valuing the split-dollar rights at $7.4 million rather than the $30 million that the revocable trust actually paid was estate tax saving.

COMMENT:

Morrissette II suggests that intergenerational split-dollar life insurance arrangements may work, though only in certain specific situations. First, there must be a bona fide nontax purpose for the arrangement. There was none in *Cahill*, but the business succession issues in *Morrissette II* provided a clear and substantial nontax purpose. Once such a purpose exists, the co-existence of tax motivations may not be a problem.

Second, the planned disposition of the decedent's rights under the split-dollar agreement to the trusts for the insureds and their descendants proved problematic in *Morrissette II*. This was the basis by which the Tax Court valued the retained rights under the split-dollar agreements at a figure far in excess of the actuarial value that the taxpayer reported on the decedent's estate tax return. Had these rights be left to, for example, a separate common trust fund for the descendants of the deceased, rather than to the specific dynasty trusts that owned the policies themselves, a different and more favorable result might have been achieved.

This aspect of the Morrissette II opinion is questionable. Clara's rights under the split-dollar agreements should be valued as of the date of her death based on the price a hypothetical unrelated person would pay for those rights. Instead, the court determined the value of those rights taking into account (a) the specific rights in the split-dollar agreements which the dynasty trusts received from the revocable trust as a result of Clara's death, and (b) the specific rights the dynasty trusts acquired when they entered into the split-dollar agreements. Under that analysis, the split-dollar agreements terminated, and each dynasty trust acquired complete control of the underlying policies which insured the life of the other two Morrissette sons pursuant to the cross-purchase arrangements. A hypothetical unrelated person who purchased the Receivables would not have had the right to terminate the split-dollar arrangements. Moreover, since the court found that one of the insured Morrissette sons was diagnosed with terminal cancer before the estate filed its estate tax return, and a second son died of brain cancer shortly thereafter, it is unlikely that the independent trustees of the dynasty trusts would have agreed to terminate the policies to obtain the cash surrender values.

Third, Section 2703, while devastating in *Cahill*, was surmounted by the taxpayer in Morrissette II principally because of the existence of a clear and substantial nontax business purpose for the agreements. One would, of course, still would have to establish that the terms of the agreement are comparable to similar arrangements entered into by persons in an arms' length transaction, but it seems likely that this will be relatively easy to overcome if there is a substantial nontax business purpose for the agreements.

Fourth, the decedent's arguments in *Cahill* were weakened because the transaction was negotiated between the trustee of the revocable trust (the decedent's son and attorney-in-fact) and his cousin (the trustee of the MB Trust). The transaction would have had far more credibility were the trustees independent and unrelated to each other. Obviously, this increases the cost of the transaction, but it is a small price to pay to give the arrangement a far more bona fide appearance.

Fifth, the use of a third-party loan to pay the life insurance premiums is not inherently inappropriate or disqualifying, but the existence of sufficient personal assets to make these payments was cited favorably by the court in *Morrissette II*. Also, it is likely that the lender required that the decedent in *Cahill* have the right to terminate the agreement, at a minimum with the consent of the trustee of the MB Trust. Also, the existence of the loan raises the presumption that the donor anticipates getting the cash out of the policy not later than when the loan becomes due. Thus, it is better if the premiums are paid from assets already held by the expected decedent, or from money borrowed against assets other than the policy.

Another approach would be to eliminate entirely the right to terminate the agreement that was deemed a power under Section 2036(a)(2) and 2038. In both *Cahill* and *Morrissette*, this power was expressly provided by the split-dollar agreement. A court has reason to be skeptical about any power of the donor to require that the policy be cashed-in, either alone or together with the donee, because the donor no longer owns the policy. The right to cash-in the policy ought to rest with the policy owner. Where a donor borrows to pay the premiums and must use the policy as security for the loan, it is likely that the lender will require that the donor have the ability to reach the cash values. Otherwise, however, such a provision is really not essential to the validity of the split-dollar agreement or the effectiveness of the arrangement. The agreement should provide what happens when the insured dies (that the premiums or cash value are repaid), and it should provide what happens if the policy is cancelled (repayment of the cash value), but it need not provide what happens if the agreement itself is terminated. Generally, contracts presume that they will be implemented, rather than terminated.

The split-dollar agreement could, instead, be silent on termination and assume that the payments by the decedent will be repaid when the insured dies or the policy is cancelled. Moreover, it could grant the right to terminate the policy and the agreement solely to the donee—the irrevocable trust. This seems both reasonable from a business standpoint, because it vests the right to terminate in the policy’s actual owner, and prudent from an estate tax standpoint, because it deprives the donor of any power that could be classified as a right to control beneficial enjoyment under Section 2036(a)(2) or a right to alter or amend beneficial enjoyment under Section 2038.

Clients may object because they fear that circumstances may change and they may need to recover cash from the policy. This is not a serious problem, however, because general contract law provides that all of the parties to a contract can agree to terminate it by mutual consent. See, e.g., 29 Williston on Contracts § 73—Elements of Rescission (4th ed.). Thus, the provision in *Cahill* did not really give the donor anything that he did not already have. A right afforded by state law, however, is not a retained right to alter, amend, revoke, or terminate or to control beneficial enjoyment for estate tax purposes. *Helvering v. Helmholz*, 296 U.S. 93 (1935).

In light of the current low applicable federal rates (AFR), one could also consider replacing an economic benefit split-dollar agreement with a simple promissory note, providing for annual payments of interest at the relevant AFR, until the death of the insured, and for repayment of the entire principal at that time. The Tax Court in *Cahill* recognized that Sections 2036 and 2038 did not apply to a simple promissory note and took pains to distinguish a split-dollar agreement from a promissory note. The taxpayer may thus accept this analysis and, instead, lend the irrevocable trust an amount sufficient to pay the premiums on the insurance policies. The parties should also comply with the safe harbor under Reg. § 1.7872-15, by filing the IRS statement for each nonrecourse loan that a reasonable person would expect repayment in full.

Of course, arrangements would have to be made for paying the interest on the loan currently. Such arrangements could involve additional gifts, withdrawals from the policy cash values, or annual deemed gifts of the unpaid interest. The discount for the promissory note is likely to be less than comparable to that for a split-dollar agreement, but it should still be significant because (a) the term of the note is both uncertain (the death of the insured) and far into the future, and (b) the AFR rates are currently substantially below market interest rates. This approach also has the double benefit of simplicity and clarity. It is far less complex to draft than an intergenerational split-dollar agreement, and the parties are far more likely to understand its terms than they are those of an intergenerational split-dollar agreement.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Howard Zaritsky

CITE AS:

CITES:

Estate of Morrissette v. Comm'r, T.C. Memo. 2021-60 (May 13, 2021) (*Morrissette II*); *Amlie v. Comm'r*, T.C. Memo. 2006-76; *Estate of Black v. Comm'r*, 133 T.C. 340, 362-363 (2009); *Estate of Bigelow v. Comm'r*, 503 F.3d 955, 972 (9th Cir. 2007), *aff'g* T.C. Memo. 2005-65; *Estate of Bongard v. Comm'r*, 124 T.C. 95, 113 (2005); *Estate of Cahill v. Comm'r,* T.C. Memo. 2018-84; *Estate of Hurford v. Comm'r*, T.C. Memo. 2008-278; *Estate of Morrissette v. Comm'r,* 146 T.C. 171 (2016) *(Morrissette I)*; *Estate of Powell v. Comm'r*, 148 T.C. No. 18 (2017); *Estate of Reynolds v. Comm'r*, 55 T.C. 172, 194 (1970); *Estate of Stone v. Comm'r*, T.C. Memo. 2003-309; *Estate of Strangi v. Comm'r*, T.C. Memo. 2003-145, *aff'd*, 417 F.3d 468 (5th Cir. 2005); *Estate of Thompson v. Comm'r*, 382 F.3d 367, 382 (3rd Cir. 2004), *aff'g* T.C. Memo. 2002-246; *Helvering v. Helmholz*, 296 U.S. 93 (1935); *Kimbell v. United States*, 371 F.3d 257, 266 (5th Cir. 2004); *Neonatology Assocs., P.A. v. Comm'r*, 115 T.C. 43, 98-99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002); *Estate of True v. Comm'r*, T.C. Memo. 2001-167, aff'd, 390 F.3d 1210 (10th Cir. 2004); Reg. § 1.61-22(c)(1)(ii)(A)(2); Reg. § 1.61-22(d)(1); Reg. § 1.61-22(d)(2); TD 9092, § 5, 2003-2 CB 1055, 1062; Slavutin, Harris & Shenkman, "Intergenerational Split Dollar, Recent

Adverse Decisions in Morrissette and Cahill—Where Do We Go from Here?" LISI Estate Planning Newsletter No. 2651 (July 17, 2018); 29 Williston on Contracts § 73—Elements of Rescission (4th ed.).