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Estate of Levine: Intergenerational Split Dollar and More

By

Thomas F. Commito, JD, LL.M, CLU, ChFC, AEP

On February 28, 2022 the Tax Court issued its long-awaited decision in Estate of Marion Levine v. Commissioner [1],the latest in an ongoing saga of Internal Revenue Service challenges in intergenerational split-dollar cases. The result of the case was that the premiums paid for two separate policies with a total face value of approximately $17.25 million was discounted from $6,153,478 to $2,282,195 – a discount of 65%! The parties stipulated that the receivable owed to the estate could be valued at $2,282,195 – if the taxpayer prevailed on the IRS' changes on Internal Revenue Code Sections 2036, 2038 and 2703.The taxpayer prevailed on all these issues.

The decision was a "full" Tax Court Decision meaning all the Tax Court judges could review the final opinion. Previous intergenerational split dollar decisions were all "memorandum" decisions – written by one judge without participation or review by other Tax Court judges. The decision is important because its decision serves as guidance for other estate planning techniques using discounting such as Family Limited Partnerships.

Background on Intergenerational Split Dollar

The facts in the Levine case closely resembled the usual structure of Intergenerational Split Dollar (IGSD):

- The person funding the insurance purchase is usually of advanced age. Marion Levine ('Levine') was born in 1920.
- The funding of the policy occurs with economic benefit split dollar.
- The policy is owned by an irrevocable trust. The premium payer is owed an amount equal to the greater of the cash surrender value or premiums paid. In Levine's case, the receivable was owned by her alter ego, a revocable trust.
- The insurance policy is paid for with a single premium or premiums paid over a brief period e.g., several years as contrasted to a more typical longer period
- The insured is an adult child of the person advancing funds for the policy. The adult child or children are typically middle age, e.g.,40-60. In Levine's case the two insureds were her adult children Nancy and Robert.
- The person advancing the funds, e.g., Levine, often dies within a relatively brief period of time after the plan is implemented.

[1]158 T.C. No. 2

- The key to the plan, and the cause of the valuation dispute is that the estate which owns the split dollar receivable can discount that value. The rationale for the discounting is that the amount owed the estate will be payable at the death of the insureds. Since it may be many years before they die, the current value of the receivable should be discounted for the intervening time.

Issues Before Tax Court

The preceding steps all took place towards the end of 2008. After Levine's death, on January 22, 2009, the IRS challenged her estate tax return and eventually issued a notice of deficiency for a little more than $3 million, plus penalties based on the difference between the value of the receivable listed the estate tax return and the $6.5 million. After stipulations, the Tax Court had to decide the value of the split-dollar receivable in the estate and what the penalties should be if any undervaluation was found. To do this, the court had to decide three key issues:

- Does IRC Section 2036 or 2038 require inclusion of the policies' Cash Surrender Values (CSV) in the gross estate?
- Does IRC Section 2703 and its valuation rules apply to the estate's property interest and, if so, how does that impact the value of the interest?

The Tax Court's Decision

The court's decision provides a clean sweep for the estate, leaving it without a significant deficiency and no penalties.

Code Section 2036(a)(2) states that the estate tax should apply to include in the value of the taxpayer's gross estate the value of all property that the decedent had transferred during lifetime for less than full and adequate consideration in money or money's worth not in a bona fide sale or exchange, over which the decedent retained for life the right, alone or in conjunction with another person, to designate the person or persons who shall possess or enjoy the property or the income therefrom.

This important section is a catchall designed to prevent a taxpayer from avoiding estate tax simply by transferring assets before the taxpayer's death. Pursuant to the related Treasury Regulations, "[a]n interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred." [2]

Code Section 2038 allows for a "claw-back" into a decedent's estate the value of property that was transferred in which the decedent retained an interest or right—either alone or in conjunction with another—to alter, amend, revoke, or terminate the transferee's enjoyment of the transferred property.

As to Code Sections 2036 and 2038 the Tax Court held that it "…was the Insurance Trust that bought the policies and held them. These policies were never owned by the Revocable Trust, and there was no "transfer" of these policies from the Revocable Trust to the Insurance Trust… The "property" is also not the receivable itself. That property belonged to the Revocable Trust and now it belongs to the Estate. It wasn't 'transferred'; it was retained". Since there was no "transfer", neither Code Section 2036, nor Code Section 2038 could apply and result in estate tax includability. The Court further held:

"We find that the "property" at issue cannot be the life-insurance policies, as these policies have always been owned by the Insurance Trust. The split-dollar transaction was structured so that the $6.5 million was paid by the Revocable Trust in exchange for the split-dollar receivable. It was the Insurance Trust that bought the policies and held them. These policies were never owned by the Revocable Trust, and there was no "transfer" of these policies from the Revocable Trust to the Insurance Trust."

In conclusion, the Court found that Levine retained the split-dollar receivable, and nothing else. The court also found that holding this receivable did not give Levine a right to the CSVs of the policies – only to wait until termination or maturity of the policies and then collect the $6.5 million or the CSV.

<u>The Power to Terminate the Agreement</u>

This issue has been the core of all decisions involving IGSD. The IRS argument has been that an ability to terminate the agreement either alone or in conjunction with the other party to the split dollar agreement. To the IRS this represents the opportunity to "designate enjoyment of the property", thus triggering IRC 2036((a)(2).

On this last point, the court found a very significant difference between Levine on one hand and previous cases on the other:

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[2] Treas. Reg. § 20.2036-1(c)(1)(i).

In Estate of Morrissette v. Commissioner, the donor and donee could mutually agree to terminate the agreement. In Estate of Cahill, the agreement could be terminated only by written agreement of donor and donee, acting unanimously. In contrast, in Levine, the ILIT, by its investment committee, had the sole right to terminate the arrangement. The investment committee in essence was a special trustee of the trust who had fiduciary duties to the trust, not Mrs. Levine. The trustee was completely independent from her, so she retained no Code Section 2036 rights.

Ability to Surrender Policies

The IRS also argued that Levine stood on both sides of these transactions and therefore could unwind the arrangements at will. The attorneys-in-fact, who were trustees of the ILIT, held power over the revocable trust, agreed the court. However, the ILIT had an independent trustee, and the trustee was directed by the investment committee – which was just one of the trustees of the revocable trust. The court found that the investment committee's sole member had a fiduciary duty to the beneficiaries of the ILIT (which included Levine's grandchildren) that would have prevented him from surrendering the policies. Therefore, the ability to surrender the policies for their CSV couldn't be characterized as a right retained by Levine, and the IRS' efforts to gain Section 2036 inclusion of the policies in the estate failed. Their arguments for inclusion under Section 2038 failed for the same reasons.

Section 2703 Not Applicable

Finally, the IRS argued that the split-dollar arrangement was Levine's way of placing a restriction on her right to control the $6.5 million in cash paid for the policies and, thus, to reduce its value. By disregarding this restriction according to the valuation rules of Section 2703, the IRS also arrived as its preferred value without any discounts.

The court held that the reference to "any property" in Section 2703 refers to the property of an estate, not some other entity's property. And because the property in Levine is the receivable – not the policies – Section 2703 does not apply.

A Better Approach

All of the IGSD cases involve "economic benefit" regime split dollar. But what if the parties were to utilize "loan regime" split dollar, and the technique would be to discount the loan owed to the older generation funder of the policy, utilizing a long term loan to fund the policy. The Treasury regulations clearly recognize the ability to discount promissory notes. Regulation 25.2512-4 in its entirety states:

"The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value. Unless returned at face value, plus accrued interest, it must be shown by satisfactory evidence that the note is worth less than the unpaid amount (because of the interest rate, or date of maturity, or other cause), or that the note is uncollectible in part (by reason of the insolvency of the party or parties liable, or for other cause), and that the property, if any, pledged or mortgaged as security is insufficient to satisfy it."

Furthermore, the Regulations on loan regime split dollar clearly indicate that it is a true loan. Regulation 1.7872-15(a)(2) states "payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender."

Hence, discounting a loan under loan regime split dollar would seem to be the preferred way to go.

<u>Broader Lessons</u>

The Tax Court was effusive in its praise of Mrs. Levine's advisors. These comments have broad application for all estate planning cases, particularly those that involve discounting techniques which are greatly disliked by the IRS (and some members of Congress). These points include:

- The ILIT trustees were independent – not family members. The administrative trustee was an institution (South Dakota Trust Company) and a special trust protector/ investment committee.
- The ILIT had beneficiaries other than the insureds- the five grandchildren of Marion Levine. The trust protector/ investment committee had a fiduciary duty to all of the beneficiaries – not just the insured children.
- The insureds needed the insurance. They both would be subject to estate tax – and neither had done any estate planning.
- The estate planning attorney created a thoughtful plan for the family. He prepared a powerpoint and went over the details with all family members present. He outlined the advantages and the risks. All parties were fully informed.