Intergenerational Split-Dollar
The Morrissette Case
A Taxpayer Victory

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Jim assists clients in a broad range of industries, including real estate - where he represents developers, investors, general contractors, subcontractors, home builders, property managers and hotel management companies. He regularly advises emerging technology clients, government contractors, retailers, automobile dealers and many other traditionally family-owned businesses.

Jim focuses on enabling clients to preserve and maintain control over their business interests and investments, while minimizing applicable gift, estate and generation-skipping transfer taxes. He employs a number of creative techniques to accomplish his clients' goals, including estate "freezing" transactions, a variety of trusts, insurance arrangements, succession planning for closely held businesses and charitable planning. Jim often represents fiduciaries and family members in litigation involving trusts, estates and closely-held businesses. He also has an extensive transactional practice, which addresses choice of form of organization; preparation of partnership, limited liability company and corporate organizational documents; corporate and partnership reorganizations and recapitalizations; and financing transactions and associated matters.

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AGENDA

WHY IS THIS IMPORTANT?

President Trump's and the Republican leadership's proposals to eliminate the estate tax have resulted in substantial uncertainty in the estate planning community. Many clients recall the Bush administration's failure to repeal the estate tax and are skeptical President Trump's efforts will succeed.

WHY IS THIS IMPORTANT?

Others recall the estate tax has been repealed four times since it was originally enacted 220 years ago, and conclude even if Republican efforts succeed, the estate tax would likely be re-enacted when control of our Government inevitably shifts back to the Democrats.

WHY IS THIS IMPORTANT?

In the current low interest rate environment, young healthy clients may employ a variety of estate planning strategies, including sales of assets to grantor trusts for private annuities or promissory notes, grantor retained annuity trusts ("GRATs"), preferred partnership "freezes", and charitable lead annuity trusts ("CLATs"), all of which are "super charged" by valuation discounts (the prospects for the proposed 2704 regulations are dim). These techniques typically take years to bear fruit.

The estate planning techniques available to older clients are very limited. Fortunately, our victory in the Morrissette case confirms older clients may employ intergenerational split-dollar arrangements to realize substantial, immediate estate planning benefits.

WHAT ARE ECONOMIC BENEFIT ARRANGEMENTS?

1.61-22(B)(1)

General rule. Split-dollar is defined as any arrangement between an owner and non-owner of a life insurance policy that satisfies the following criteria:

(A) Either party to the arrangement pays, directly or indirectly, all or any portion of the premium on the life insurance contract, including payment by means of a loan to the other party that is secured by the life contract;

WHAT ARE ECONOMIC BENEFIT ARRANGEMENTS?

1.61-22(B)(1)

(B) At least one of the parties to the arrangement paying premiums under paragraph (b)(1)(i) of this section is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and

WHAT ARE ECONOMIC BENEFIT ARRANGEMENTS?

1.61-22(B)(1)

(C) The arrangement is not part of a group-term life insurance plan described in section 79 unless the group-term life insurance plan provides permanent benefits to employees (as defined in § 1.79-0).

Important

Many arrangements (particularly in estate planning) have no specific date when the premium payer gets repaid. Inter-generational Split Dollar arrangements typically continue until the death of the insured at which time the premium payer gets what she's entitled to.

WHAT ARE ECONOMIC BENEFIT ARRANGEMENTS?

In a economic benefit arrangement, in order to avoid taxation of additional benefits (equity accruing to the non-owner) the party advancing the funds to pay the premiums is entitled to receive:

The greater of premiums paid, or

The cash surrender value of the policy

WHAT ARE ECONOMIC BENEFIT ARRANGEMENTS?

Non-Equity Arrangement/Reportable Economic Benefit (REB)

The value of the gift attributable to the insurance premium payment is based on the economic benefit to the trust (or other person) receiving the excess death benefit. That is based on the face amount of the death benefit reduced by the amount owed back to the premium payer.

In Notice 2001-10, the IRS created Table 2001, which set new rates to measure the value of the insurance protection (i.e. economic benefit). These rates apply to all new arrangements entered into after January 28, 2002. The rates increase annually as the insured gets older, and are comparable to annual renewable term insurance rates.

BONUS FEATURES

The economic benefit amount is typically relatively small compared to the premium payments, especially during the early years of the policy.

INTERGENERATIONAL SPLIT-DOLLAR

In many split-dollar arrangements the premium payer is a closely-held business owned in large part by the insured.

Intergenerational split-dollar arrangements typically involve three parties:

A. Gen 1 – Creates a Dynastic Irrevocable Life Insurance trust (“ILIT”)

B. Insured is Gen 2 (child of Gen 1)

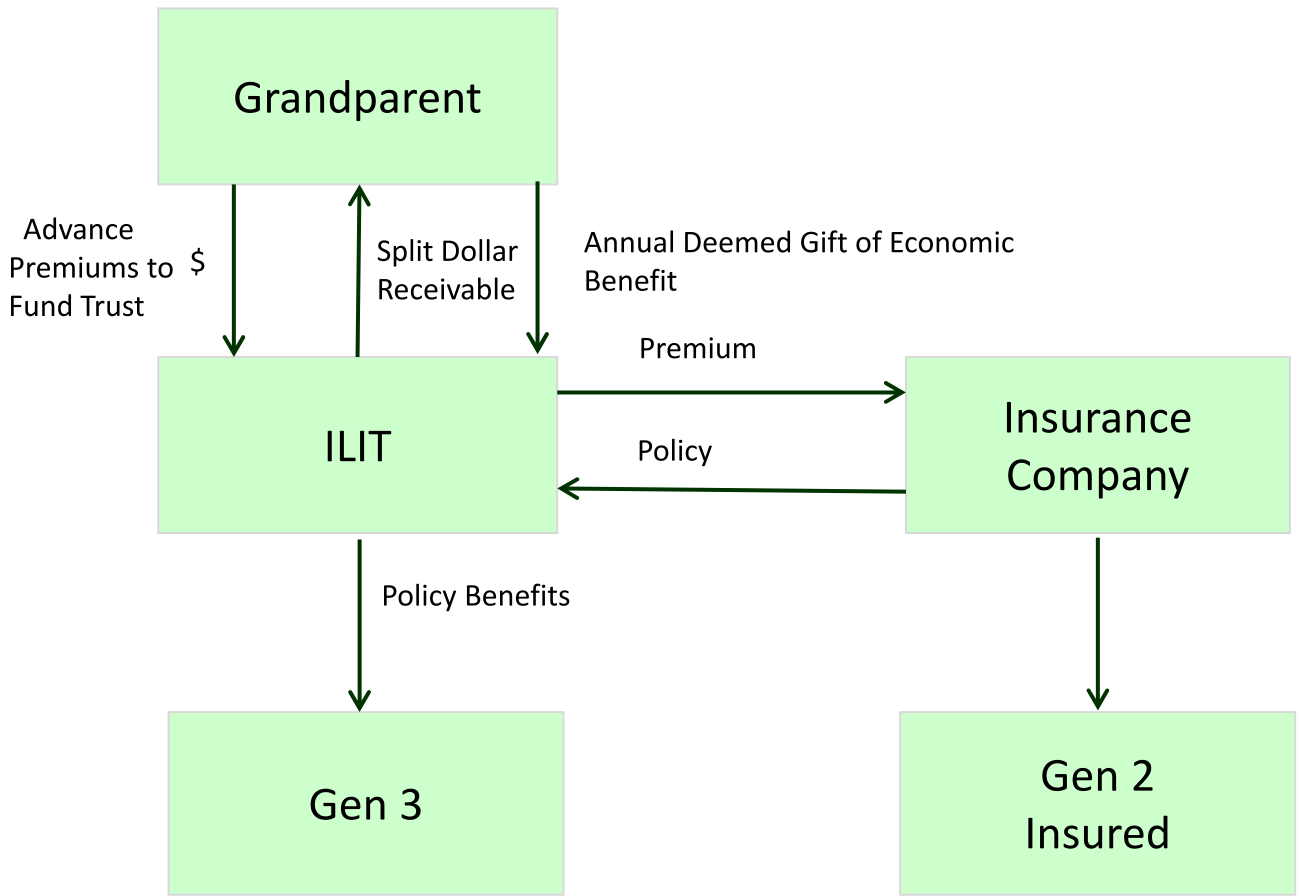
C. ILIT is the beneficiary of the policy

INTERGENERATIONAL SPLIT-DOLLAR

Mechanically, Gen 1 advances funds to the ILIT to allow the ILIT to pay premiums for policy on the life of Gen 2. Premiums can be paid in a lump sum, or in installments over a period of years. Gen 1's right to repayment is referred to as a "Split Dollar Receivable".

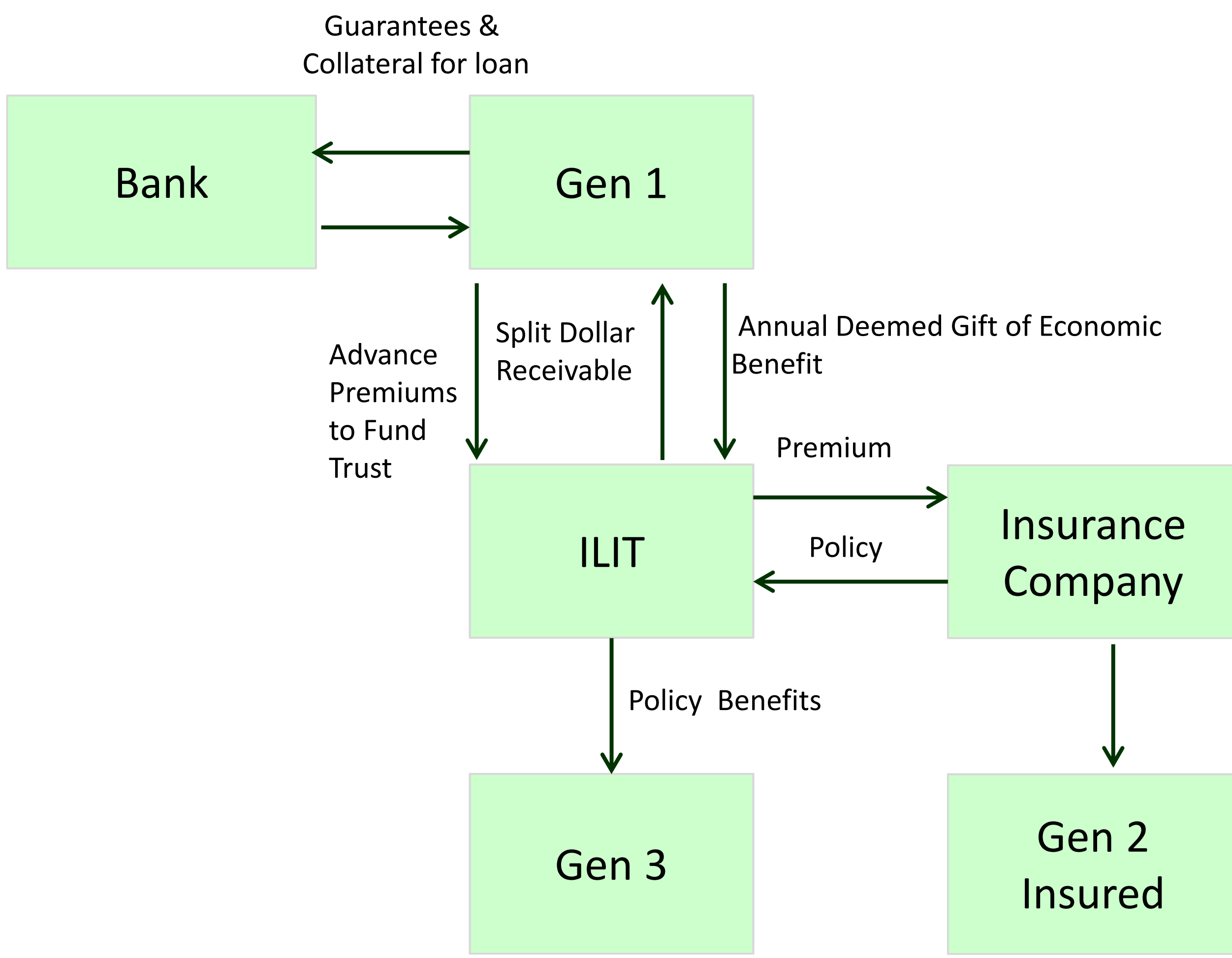
INTERGENERATIONAL SPLIT-DOLLAR

Gen 1 with Substantial Liquid Assets



INTERGENERATIONAL SPLIT-DOLLAR

Gen 1 Grandparent with Substantial Illiquid Assets



INTERGENERATIONAL SPLIT-DOLLAR

The Split-Dollar Receivable is not payable until Gen 2 dies.

If Gen 1 dies before Gen 2, the Split-Dollar Receivable is includable in Gen 1's taxable estate and appraised at fair market value.

Appraisers value Split-Dollar Receivables based on actuarial life expectancy of the insured. Discounts can go as high as 95%.

Issues

Are these arrangements really split-dollar?

How should the Split-Dollar Receivable be valued?

The Morrissette Succession Plan

Arthur Morrissette, Sr. started a moving company in the Washington, D.C., suburbs in 1943 with a single truck, but quickly grew his business to become an industry leader known as Interstate Van Lines. Over the next 70 years, Arthur and his wife, Clara, built a formidable empire.

THE FACTS & CIRCUMSTANCES OF MORRISSETTE

The Morrissette Succession Plan

In 1994, Clara and Arthur Morrissette established revocable trusts, funded in part with their Interstate stock. Under these trust agreements, their Interstate stock passed to QSST trusts for the benefit of their sons, and then passed down to trusts for the benefit of their grandchildren. However, because of the way these trusts are structured, their Interstate stock was includable in the taxable estates of Mr. and Mrs. Morrissette, and would be includable in their sons' taxable estates, and then be includable in their grandchildren's taxable estates.

THE FACTS & CIRCUMSTANCES OF MORRISSETTE

The Morrissette Succession Plan

In 2006, Clara Morrissette – now widowed – set into motion a plan to secure the funds to pay the estate taxes imposed on the Interstate stock passing in the QSST trusts to her sons and, ultimately, to trusts for her grandchildren.

First, Mrs. Morrissette created three dynasty insurance trusts ILITs; – one for each of her sons and their families.

The Morrissette Succession Plan

The ILITs and the Morrissette brothers entered into shareholder agreements which set forth arrangements whereby the ILITs would purchase the stock held by the QSST trust established for each of the Morrissette brothers when one of them died.

In order to fund these buyouts, each ILIT secured a life insurance policy on the lives of the two other brothers (known as a cross-purchase buy-sell arrangement). Accordingly, the three ILITs purchased a total of six policies.

THE FACTS & CIRCUMSTANCES OF MORRISSETTE

The Morrissette Succession Plan

Mrs. Morrissette, ever mindful that the only way she could make sure the insurance policies would not lapse and that the proceeds would be available to fund the buy-sell agreements, arranged to pay all the premiums for the policies in lump sums out of her revocable trust.

The lump-sum amounts Mrs. Morrissette advanced to pay premiums on the policies was designed to be sufficient to maintain the policies for her sons' projected life expectancies (which at the time ranged from approximately 15 to 19 years).

THE FACTS & CIRCUMSTANCES OF MORRISSETTE

The Morrissette Succession Plan

Finalizing this plan, Mrs. Morrissette was confident that Interstate stock held by the QSST Trusts for the benefit of her sons would be acquired by the ILITs, and would eventually benefit her grandchildren and future generations of her family, and would be excluded from their taxable estates.

THE FACTS & CIRCUMSTANCES OF MORRISSETTE

The Split-Dollar Life Insurance Policies

Mrs. Morrissette advanced approximately $30 million to make lump sum premium payments on policies insuring the lives of her three sons.

The financing for these life insurance policies was structured as “split-dollar arrangements,” meaning that the cost and benefits would be split between the trusts.

In this case, while Mrs. Morrissette paid a lump sum amount to cover the premiums on these policies, the policies themselves were designed to pay out varying amounts to the trusts for both Mrs. Morrissette and her sons.

The Split-Dollar Life Insurance Policies

Specifically, upon the death of each of her sons, Mrs. Morrissette's revocable trust would receive (attributable to her Split-Dollar Receivables) the greater of either (i) the cash surrender value of that policy, or (ii) the aggregate premium payments on that policy. Each ILIT would receive the balance of the policy death benefit.

THE FACTS & CIRCUMSTANCES OF MORRISSETTE

Employing Split-Dollar Arrangements to Fund Life Insurance Policies

In a typical case, a company advances funds to an ILIT to pay premiums on insurance on the life of the owner of the company, and the Split-Dollar Receivable is payable upon the death of that owner.

What was unique in this case is that the Receivable <u>wasn't payable</u> until the death of one of Mrs. Morrissette's <u>sons</u>.

Moreover, the Split-Dollar Receivable was not owned by a company, but instead became assets in Mrs. Morrissette's taxable estate (the "Estate").

THE FACTS & CIRCUMSTANCES OF MORRISSETTE

Employing Split-Dollar Arrangements to Fund Life Insurance Policies

Given her sons' life expectancies (the sons were all in their late 60's and early 70's when the Split-Dollar Receivable was implemented), actuarially, the Estate was not likely to collect the amounts payable with respect to the Split-Dollar Receivables for 15 to 19 years.

So, a seminal issue arose upon filing the estate tax return:

How should the Split-Dollar Receivables be valued for gift and estate tax purposes?

THE FACTS & CIRCUMSTANCES OF MORRISSETTE

Gift and Estate Tax Reporting

From 2006 through 2009, Mrs. Morrissette reported gifts made to the ILITs based upon the cost of the current life insurance protection based on tables published by the IRS determined under the economic benefit regime.

After Mrs. Morrissette's death, her estate retained an independent valuation firm to value the Split-Dollar Receivables includable in her gross estate as of the date of her death. The total value reported on her estate tax return for all the Split-Dollar Receivables was $7.48 million.

IRS Challenges the Morrissette's Agreement

The Internal Revenue Service ultimately issued two notices of deficiency to the Estate.

The first notice of deficiency determined a gift tax liability for the tax year ending December 31, 2006, which concluded the Estate had failed to report total gifts in the amount of approximately $30 million – the amount that Mrs. Morrissette's revocable trust advanced to the ILITs to make lump-sum payments of policy premiums.

The second notice grossed up Mrs. Morrissette's lifetime gifts by approximately $30 million, and determined additional estate tax liability attributable thereto.

THE FACTS & CIRCUMSTANCES OF MORRISSETTE

The Estate Filed a Petition with the US Tax Court

The Estate moved for partial summary judgment on the threshold legal question – specifically, whether the split-dollar arrangements should be governed under the economic benefit regime as set forth in section 1.61-22 of the Income Tax Regulations.

If the split-dollar arrangements were properly governed under the economic benefit regime, then the Estate would have been correct that Mrs. Morrissette made no significant gift in 2006, and the total value reported for the Split-Dollar Receivables should be based on the present value of the right to collect the Split-Dollar Receivables in 15 to 19 years (again, based on the sons' actuarial life expectancies).

THE FACTS & CIRCUMSTANCES OF MORRISSETTE

The Estate filed its motion for partial summary judgment January 2, 2015.

Over the next 11 months, and at the direction of the Tax Court, the parties filed in total five cross pleadings on the Estate's operative motion.

The hallmark of the Internal Revenue Service's pleadings was the argument that the Estate's motion should be denied because it was factually unclear as to whether or not the revocable trust had conferred upon the ILITs an economic benefit in addition to the current cost of life insurance protection.

THE FACTS & CIRCUMSTANCES OF MORRISSETTE

The Estate maintained throughout all of the pleadings that summary judgment was appropriate in this case because the only question in dispute – whether or not any additional economic benefit was provided other than current life protection – was legal, not factual.

The Tax Court ultimately agreed with the Morrissette Estate.

THE US TAX COURT'S DECISION IN MORRISSETTE

With respect to the arguments raised by the Estate and the IRS, the IRS maintained its position in its pleadings that the lump-sum premium payments made by the revocable trust should be treated as loans owed back to the Estate and valued under the Internal Revenue Regulations referred to as the loan regime.

The Estate relied on the Internal Revenue Regulations issued in 2002 on how to treat, for tax purposes, split-dollar arrangements.

THE US TAX COURT'S DECISION IN MORRISSETTE

Notably, the Estate reasoned that since the split-dollar arrangements at issue were executed in accordance with provisions in the Regulations under the economic benefit regime, the split-dollar arrangements were not governed by the loan regime, and the Estate was not liable for the 2006 gift tax deficiency determined by the IRS.

The Tax Court sided with the Morrissette Estate as a matter of law.

THE US TAX COURT'S DECISION IN MORRISSETTE

On the specific legal question of whether the split-dollar arrangements were governed by the loan regime or the economic benefit regime, the Tax Court applied the final Income Tax Regulation 1.61-(1)(ii)(A)(2),which provides that if

"the only economic benefit provided under the split-dollar life insurance arrangement to the donee is current life insurance protection, then the donor will be the deemed owner of the life insurance contract, irrespective of actual policy ownership, and the economic benefit regime will apply."

THE US TAX COURT'S DECISION IN MORRISSETTE

Then, in order to determine if any additional economic benefit was conferred by the revocable trust to the ILITs, the Tax Court considered whether or not "the dynasty trusts had current access to the cash values of their respective policies under the split-dollar life insurance arrangements or whether any other economic benefit was provided."

Because the split-dollar arrangements were carefully structured to only pay the ILITs that portion of the death benefit of the policy in excess of the Split-Dollar Receivables payable to the revocable trust, the Tax Court concluded that the ILITs could not have any current access to the cash surrender values of the policies under the final regulations.

THE US TAX COURT'S DECISION IN MORRISSETTE

The Tax Court also agreed with the Estate that no additional economic benefit was conferred by the revocable trust to the ILITs

(i) the lump sum premium payment advanced by the revocable trust assured the revocable trust had sole access to the cash surrender value of the life insurance policies (which was essential to accomplish Mrs. Morrissette's goal to assure that life insurance proceeds would be available to buy the stock held by each of her sons at death) and;

(ii) the fact that the revocable trust advanced the funds to make the lump sum premium payments did not obviate the ILITs from any obligation to pay the premiums on an ongoing basis because the ILITs were not required to do so.

THE IMPACT OF MORRISSETTE

The Tax Court's decision marks a groundbreaking moment in estate tax jurisprudence and is most welcomed by the wealth planning and insurance communities for its beneficial application to high-net-worth individuals and owners of closely held businesses like the Morrissette family.

The Tax Court's resounding affirmation that the final regulations would control under these facts provides practitioners with the assurance that similarly structured split-dollar arrangements would be governed by the economic benefit doctrine.

THE IMPACT OF MORRISSETTE

Second Motion for Partial Summary Judgment
On December 6, 2016, the Morrissettes filed a Second Motion for Partial Summary Judgment, asking the US Tax Court to rule that IRC 2703(a) does not apply to the Split-Dollar Receivables, because the Split-Dollar Receivables were not subject to any restriction on the Revocable Trust's rights to sell or use the Split-Dollar Receivables. The IRS filed a Response on February 6, 2017. The Morrissettes filed a Reply on March 27, 2017. The IRS filed a further Response on May 22, 2017. The Motion is fully briefed and pending Judge Goeke's review and Decision. (At the same time, a similar Motion has been filed in *Estate of Cahill* (see below).)

The Morrissettes are optimistic the US Tax Court will rule in their favor.

Top Take-Aways from Morrissette

We now know that compliance with the economic benefit split-dollar regulations protects clients from gift tax liability, with the result that the value of the Split-Dollar Receivables would be determined based on typical valuation principles (i.e., the amount a third party would pay to purchase the Split-Dollar Receivables).

THE IMPACT OF MORRISSETTE

Top Take-Aways from Morrissette

An insurance policy is a valuable asset, as long as you own both the death benefit and the cash surrender value. The split-dollar regulations realign this bundle of rights, separating the death benefit from the cash surrender value, and imposing significant gift and income tax liabilities on the parties attributable to the reallocation of the death benefit.

These rules benefit the Government through the income and gift tax treatment of economic benefit split-dollar arrangements. However, the estate tax treatment benefits taxpayers.

THE IMPACT OF MORRISSETTE

Top Take-Aways from Morrissette

The Tax Court's decision opens the door to intergenerational split-dollar arrangements – providing a blueprint for the wealth management community for passing family assets (like closely held businesses) through the generations, with predictable estate and gift tax consequences for the original owners.

THE LINE OF CASES FOLLOWING MORRISSETTE

***Estate of Marion Levine v. Commissioner,* T.C. No. 9345-15 (Petition filed April 8, 2015).**

Facts:

- The Estate took out two life insurance policies in 2008 for a third-party couple. For the first, with John Hancock, the estate put $2 million and then $500,000 in an irrevocable trust to cover premiums for the life of the policy.
- For the second, with Pacific Life, the Estate transferred $4 million from a revocable trust to an irrevocable trust to cover the insurance premiums, according to the suit.
- The IRS took the position that the transfer of the funds into the trusts was a gift, or alternatively, a below-market split-dollar loan.

Motion for Summary Judgment:

The Tax Court entered summary judgment in favor of the taxpayer on July 13, 2016, resulting in no gift tax deficiency or penalties, on the basis of the *Morrissette* opinion.

THE LINE OF CASES FOLLOWING MORRISSETTE

***Estate of Cahill v. Commissioner,* T.C. No. 10451-16 (Petition filed May 3, 2016).**

<u>Key Case Fact:</u>

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

<u>IRS Arguments:</u>

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

THE LINE OF CASES FOLLOWING MORRISSETTE

***Estate of Cahill v. Commissioner,* T.C. No. 10451-16 (Petition filed May 3, 2016).**

<u>IRS Arguments:</u>

- Property paid to the trust is included in the gross estate under § 2038;
- Under § 2043, the excess of the fair market value at the time of death of property otherwise included under § 2038 or § 2035 over the value of the consideration received by decedent was included in the gross estate.

<u>Case Update:</u>

- A Motion for Partial Summary Judgment was filed on March 13, 2017, asking the Tax Court to rule that (i) the split-dollar arrangements are governed by the economic benefit regime, (ii) IRC 2703(a), 2036 and 2078 do not apply.

- Briefing for this Motion concluded on May 4, 2017. (Remains whether the USTC will decide *Morrissette* II or *Cahill* first or together; § § 2016 and 2038 were raised in *Cahill* but not in *Morrissette*.)

THE LINE OF CASES FOLLOWING MORRISSETTE

***Estate of Gettler v. Commissioner,* T.C. No. 21532-16 (Petition filed October 3, 2016).**

Interestingly, the IRS refused to allow the Estate to go to Appeals after the USTC Petition was filed.

<u>Key Facts:</u>

- Decedent contributed $5M to pay premiums for three split-dollar life insurance policies owned by a Trust. In consideration for Decedent's contribution of $5M for the premium payments, the Trust executed split-dollar agreements dated March 23, 2012 in favor of the Decedent to secure Decedent's right to repayment.

- Decedent made a gift of the split-dollar receivables on June 23, 2012, three months after entering into the split-dollar agreements. There is no mention of any family business in the Petition.

THE LINE OF CASES FOLLOWING MORRISSETTE

Estate of Gettler v. Commissioner, T.C. No. 21532-16 (Petition filed October 3, 2016).

Interesting Notes:

- IRS Notice of Deficiency does not raise § 2036 or § 2038, rather the IRS looks to re-litigate the result in *Morrissette* I.
- IRS filed its Answer on November 18, 2016. The Service refused to allow the Petitioners to go to Appeals.
- Case is 'informally stayed' until the resolution of the *Morrissette* II and *Cahill* Motions.

Final Observations and Predictions