Cahill Case Sheds Light on Tax Court's View of Intergenerational Split Dollar Agreements

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On June 18, 2018, the Tax Court issued a memorandum denying a motion for partial summary judgment filed by the Estate of Richard Cahill (T.C. Memo 2018-84). It was the second time in two years that the Tax Court had addressed a taxpayer's use of an intergenerational split dollar agreement as a wealth transfer planning strategy—the first instance being its holding in *Estate of Morrissette v. Commissioner*, 114 T.C. No. 11 (April 13, 2016).

An intergenerational split dollar agreement is intended to allow a grantor to make large premium payments on life insurance policies benefiting the grantor's children without incurring excessive transfer taxes. The strategy typically involves the creation of an irrevocable life insurance trust ("ILIT") by the grantor, which will purchase life insurance policies on the lives of the grantor's children. The grantor will make premium payments to the ILIT, pursuant to an agreement whereby the estate of the grantor will be repaid (at the time of the insured's death) the greater of 1) the total amount of premiums paid, or 2) the cash surrender value of the policy. Because it is actuarially likely that the insured—generally a child of the grantor—will live for many more years after the parties have entered into such an agreement, and therefore unlikely that the grantor's estate will be paid back any time soon, the value of the receivable repayment in the taxable estate of the grantor is subject to a substantial discount. It is the potential for such a discount that simultaneously casts the arrangement in an attractive light for taxpayers and under a cloud of suspicion among agents of the Internal Revenue Service (the "Service").

In *Morrissette*, the decedent grantor's revocable trust had paid $29.9 million in premium payments to dynasty trusts holding life insurance policies on the lives of each of her three children. Under the terms of a split dollar agreement, the decedent would not be repaid for any such payments until a child died. Upon the decedent's death, her estate claimed that only $7.5 million of the $29.9 million actually paid was includable under the terms of the agreement, citing the fact that her children were actuarially likely to outlive her by about fifteen years. The Service asserted that the full $29.9 million was includable as a gift of the decedent.

In its memorandum in *Morrissette*, the Tax Court upheld the taxpayer's argument that the intergenerational split dollar agreement should be taxed under the economic benefit regime as opposed to the loan regime (see Treas. Reg. Section 1.7872-15)—resulting in the taxpayer being permitted to claim the larger discount afforded to the former regime. Under the loan regime, the donee—here, each of the decedent's children—would be considered the owner of the policy, and interest payments would be due to the decedent's estate, thereby reducing any applicable estate tax discount. Under the economic benefit regime, however, the donor (here, the decedent) is deemed the owner of the policy so long as the taxpayer can demonstrate that the only economic benefit accruing to the donee as a result of the donor's payment of premiums is the donee's life insurance coverage. As the Tax Court found that this standard had been met by the taxpayer in *Morrissette*, it granted partial summary judgment to the estate on that point.

The pro-taxpayer position of the Tax Court on intergenerational split dollar agreements has not continued unabated, however. In the subsequent 2018 *Cahill* case, the Court addressed a similar set of facts with a few important variations. The decedent's son, acting under power of attorney on behalf of the decedent, established an ILIT and purchased three life insurance policies on the lives of the son and the son's wife, each owned by the ILIT. The trustee of the ILIT was the son's business partner and cousin. The son, again acting under power of attorney, then entered into three split dollar agreements whereby the decedent's revocable trust (of which the son was the trustee) agreed to make $10 million in premium payments for these whole life policies, whose death benefits would total $79.8 million. To make these payments, the revocable trust borrowed $10 million from a bank. In turn, upon the death of the insured (the son or son's wife), the revocable trust would be repaid for the greater of the remaining amount owed to the bank, the cumulative amount of premiums paid, or the cash surrender value of the policies. Any excess would be paid to the ILIT. The split dollar agreements further provided that while the ILIT could not unilaterally cancel the life insurance policies, the split dollar agreements could be terminated prior to the decedent's death with the written consent of both the ILIT and the revocable trust. At the time of the transaction, the son reported a gift by the decedent of $7,578, and at the time of his subsequent death, the decedent's estate claimed an includable interest under the agreements of just $183,700 (representing a 98% discount). The Service disagreed, asserting includability of $9.6 million.

Specifically, the Service argued that the termination rights under the agreements constituted rights retained by the decedent under Internal Revenue Code ("Code") Sections 2036(a)(2) and 2038(a)(1)—that these rights were held in conjunction with another person and allowed the decedent to designate who could possess or enjoy the assets in question. The Service further asserted that the right of the ILIT to veto the termination of the policies was a restriction that should be disregarded for estate tax purposes under Code Section 2703—in other words, that the interests of the estate under the agreements should not be discounted based on that restriction, which the Service argued was not a "bona fide business arrangement" (Code Section 2703(b)(1)).

In its denial of the taxpayer's motion for partial summary judgment, the Tax Court, while upholding the overall economic benefit regime espoused by *Morrissette*, agreed with the Service that rights were retained by the decedent in the context of Code Sections 2036 and 2038 and that the ILIT's right to veto should be disregarded for valuation purposes under Code Section 2703. The Tax Court stated that the agreements did not constitute "bona fide business arrangements," as no interest was charged, the parties were not "unrelated, independent parties in an arm's length transaction," and full and adequate consideration was lacking in an arrangement purporting to carry such a steep discount.

Although the case has yet to go to trial, such that the Tax Court's thinking has not yet been fully fleshed out, certain practical observations can be made from the Court's remarks in *Cahill*. First, the Court appears mistrustful of the various roles simultaneously held by the decedent's son in this matter—namely, as trustee of the revocable trust, beneficiary of the revocable trust and ILIT, executor of the decedent's estate, attorney-in-fact for the decedent, and insured. This multiplicity of roles was underscored by the fact that another family member—the son's cousin and business partner—served as trustee of the ILIT formed by the son acting as agent for the decedent, contributing to the appearance of an arrangement driven solely by the family's tax concerns rather than any true non-tax objectives. After last year's Tax Court ruling in *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017), taxpayers should be particularly cautious when acting under power of attorney and when engaging in what could be viewed as aggressive "deathbed planning." When engaging in intergenerational split dollar agreements, taxpayers should be careful to avoid allowing any family member to wear too many hats, and should ensure the presence of independent trustees in the transaction.

Furthermore, it is noteworthy that the Tax Court expressed considerable concern about what it classified as retained rights of the decedent causing potential includability of underlying assets in the decedent's estate—and indicated a certain willingness to expand the *Powell* ruling to other estate planning strategies besides family limited partnerships. In this case, the decedent did not retain any unilateral ability to cancel the split dollar agreements; however, the fact that the decedent's revocable trust, acting concurrently with the ILIT, had the power to do so indicated to the court that the decedent had retained "the right… in conjunction with any person, to designate the persons who shall possess or enjoy the property" under Code Section 2036(a)(2). Although tax practitioners will have to wait for this case to go to trial before knowing whether the Tax Court will pursue this line of thinking through to judgment against the taxpayer, it is an indication that caution should certainly be used when considering estate planning techniques such as split dollar agreements that may allow the grantor to retain this kind of ability to terminate the agreement.

Williams Mullen will continue to monitor the *Cahill* case as it progresses to trial. For further information on the case's implications for intergenerational split dollar agreements or other estate planning strategies, please feel free to contact any member of our team.

Related People

- Michelle L. "Shelly" Harris – 757.629.0708 – mharris@williamsmullen.com

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