Morrissette 2: The Sequel We've All Been Waiting For

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(with a little help from their friends)

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On May 13, 2021, a Tax Court Memorandum decision made history last when the U.S. Tax Court released a 120 page opinion that will be known as *Morrissette 2*. In the first *Morrissette* case, the Tax Court ruled that the advancement of funds Mrs. Morrissette made to the irrevocable dynasty trusts created for her sons with the purpose of purchasing life insurance policies was considered to be a legitimate split-dollar arrangement under the economic benefit regime. The first *Morrisette* case did not answer how the courts will value such arrangements, and when and how estate planners should offer split-dollar arrangements to their clients.

According to Howard Zaritsky's Estate Planning Newsletter #2886, the *Morrissette 2* opinion has three major holdings concerning intergenerational split-dollar life insurance agreements that advisors should be aware of.

First, life insurance policy proceeds are not includible in the gross estate of the deceased grantor of the revocable trust because those proceeds are considered a bona fide sale under Internal Revenue Code Sections 2036 and 2038.

Second, the special valuation rules under Internal Revenue Section 2703 do not require that the cash surrender value of the policies in the decedent's gross estate be included.

Third, the fair market value of the decedent's split-dollar rights can be calculated by using the discounted cash value methodology.

The court concluded its analysis by stating that a 40% gross misvaluation misstatement penalty was appropriate.

Many practicioners are concluding that equity split-dollar is no longer safe, because of the severe apparent business purpose/not a devise to avoid taxes burden that appears to be imposed by the court in this decision.

As the result of this, many practicioners will convert economic benefit split-dollar arrangements into loan regime split dollar arrangements, and will no longer reccomend economic benefit arrangements to their clients if and when estate tax exposure is an issue.

Howard Zaritsky in Estate Planning Newsletter #2886 suggests another alternative to economic benefit split-dollar agreement. "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".

Zaritsky acknowledges that "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."

Facts

Clara M. Morrissette lived in Virginia until her death on September 25, 2009. She was married to Arthur E. Morrissette in 1933 and had three sons named Buddy, Don, and Ken. Mr. Morrissette bought a truck in 1943 and started a moving company that would eventually become Interstate Group Holdings, Inc. (Interstate). Interstate is now comprised of 32 companies that operate moving, relocation, and storage businesses.

Mr. and Mrs. Morrissette wanted the company to stay within the family and had their three sons working in the company from childhood. The sons all had executive positions with the company. Buddy was the CEO and president and presided over a successful expansion of Interstate. Eventually, Don and Ken wanted to leave the company and had their father buy their ownership interests. Don and Ken would later return to work for Interstate, but their temporary departure resulted in significant tension among the sons.

Despite fragile familial relations, the Morrissettes still desired to keep the company within the family. To help ensure continued family ownership, Mr. and Mrs. Morrissette implemented an estate plan that included the creation of two revocable trusts; the Clara M. Morrissette Trust (CMM trust) and the Arthur E. Morrissette Trust (AEM trust). The CMM trust held all of Mrs. Morrissette's Interstate stock and the AEM trust held all of Mr. Morrissette's Interstate stock. The trusts held Interstate stock as well as real estate and marketable securities. The trust agreements included provisions that the Interstate stock would be held in trust throughout the lives of all three sons.

After Mr. Morrissette died in 1996, the AEM trust became irrevocable and distributed its assets to the three trusts therein established for the benefit of Mrs. Morrissette. Interstate stock and other assets held under the AEM trust and the CMM trust were to be included in Mrs. Morrissette's gross estate upon her death. However, the family still lacked a definite plan on how to pay the estate tax upon Mrs. Morrissette's death.

The brothers originally anticipated use of a 10 year payment deferral plan under Internal Revenue Code 6166 to pay Mrs. Morrissette's estate tax with Interstate's profits. The deferral plan allows for interest to be paid for only 4 years followed by 10 equal annual payments when a business entity makes up more than 35% of the decedent's gross estate.

Unfortunately, Mrs. Morrissette's assets included significant passive real estate investments that did not qualify for a partial payment deferral under section 6166. In addition, Buddy's two sons, J.D. and Bud (grandchildren of Mr. and Mrs. Morrissette), had also become Interstate executives and opposed using Interstate profits to pay the estate tax.

The foregoing circumstances combined with Mrs. Morrissette being diagnosed with Alzheimer's disease and dementia in 2005 led the sons to seek help from Jim McNair, a tax and estate planning attorney. While presenting various estate tax saving strategies, McNair suggested purchasing life insurance on Buddy, Don, and Ken through split-dollar arrangements. McNair indicated that the estate might be able to save $9.4 million in estate taxes by use of a split-dollar arrangement.

The Morrissette brothers decided to go forward with McNair's suggested estate plan that called for the purchase of life insurance on each of their lives to finance potential buyouts for their children using portions of the death benefits from each policy. The life insurance would be paid for under a split-dollar arrangement where the CMM trust would pay the insurance premiums on behalf of the irrevocable dynasty trusts that would be set up for each brother. The 2006 estate plan also restructured the real estate holdings of the CMM and AEM trusts in order to qualify for a partial payment deferrel under section 6166.

The irrevocable dynasty trusts were established on September 15, 2006 by the CMM trust with an initial contribution of $10,000 to each of the trusts. Each son was cotrustee of his respective dynasty trust and the other cotrustee was the CFO of Interstate. Under the conditions of the dynasty trusts, the CFO had no independent authority and was only able to sign documents. The dynasty trusts were authorized to purchase life insurance policies on the lives of the brothers, and required the dynasty trusts to be the owners of the policies.

Each dynasty trust purchased life insurance on the other two brothers, so that on the death of one brother, the dynasty trusts of the other two brothers would receive a death benefit and could use the benefit to buy the deceased brother's Interstate stock or his trusts. The plan provided an estate tax free dynasty trust for each brother that would eventually own the stock purchased by the other brothers.

The new 2006 estate plan provided included the ability to enter into the split-dollar arrangements and pay the premiums of the life insurance policies. The plan also allowed the trustees, in their sole and absolute discretion, to distribute the CMM trust's split-dollar rights upon Mrs. Morrissette's death to each dynasty trust based upon one-third of Mrs. Morrissette's unused tax exemption, and to transfer the remainder of the rights to the dynasty trust, the son, or the son's children.

It was the allowance for discretion and the post death transfer of such repayment rights to the dynasty trusts that resulted in the court to concluding that happened on Mrs. Morrissette's death was equivalent of a transfer of the amounts owed under the split-dollar plan, as opposed to what a willing buyer would pay a willing seller for the right to be paid when the brothers died.

Split-Dollar Agreement Under the 2006 Estate Plan

Under the 2006 estate plan, the CMM trust advanced funds to the dynasty trusts, which used the funds to pay the premiums on the life insurance policies. Upon the death of one of the brothers, the dynasty trust would have the duty to repay the greater of the premiums paid by the CMM trust or the cash value of the policy back to the CMM trust. Therefore, unless one of the brothers either died before Mrs. Morrissette or terminated the agreement, the repayment was not due until after the estate tax return for Mrs. Morrissette would have been due.

This would have allowed the brothers to claim a discount in estate tax as the value of the future rights to repayment the CMM trust possesses would be lower than the amount the trust originally provided for the policies.

As mentioned above, the dynasty trusts each purchased two policies, one for each brother. For example, Buddy's dynasty trust purchased life insurance policies on Don and Ken. The six policies had a death benefit of $1 million. Each policy included a rider for additional death benefits of $8.73 million. Under each policy, exercise of the rider would require additional premiums of $5 million. Therefore, after exercising the riders, the six policies had premiums of approximately $30 million and total death benefits of $58.2 million.

It was estimated that at the time of the agreement, the AEM and CMM trusts owned approximately $26.3 million worth of stock.

In order to pay the premiums, the AEM trusts distribited $8 million to the CMM trust. The CMM trust then liquidated $18.5 million from an investment account. On November 2, 2006, the CMM trust took a $4 million dollar loan from Interstate, executed a promissory note, and provided collatreral for a 3 year term loan at 4.89% interest.

The dynasty trusts purposely chose policies with a high cash value to help pay for the monthly fees, while having a low death benefit which allowed for a higher rate of return from the cash value.

At the time the split-dollar agreements were executed, the life expectancies of the brothers ranged from 14.6 to 18.6 years, and the policies were expected to earn annual rates of return between 4.75% and 5.4%.

Upon the death of the insured, the dynasty trust that owned the policy would receive the death benefit after paying the amount owed to the CMM trust, which is the greater of the amount of premiums it paid or the cash value of the policy. The agreement expressly barred the CMM trust from canceling the policies, thus giving the dynasty trusts the sole right to cancel the policies and receive the cash value.

The CMM trust was also not allowed to receive payment directly from the insurance policy. The CMM trust could only receive its payment from the dynasty trust if and when the dynasty trust chose to terminate the policy.

Each dynasty trust could terminate its policies and repay the CMM trust with the proceeds of liquidation if it chose to do so.

As required under the economic benefit regime of the split-dollar regulations, Mrs. Morrissette reported the payment of the premiums as gifts for gift tax purposes. The regulations generally provide that the gift element is based on what it would cost to provide term coverage for the death benefit amount under IRS Table 2001. From 2006 to 2008, this gift element totalled $1,443,526. The dynasty trusts were able to pay premiums of $806,869. The remaining $636,657 was deemed to be an economic benefit and required Mrs. Morrissette to report as gifts.

For the convenience of the reader, we have provided Table 2001 at the end of the article, which shows the assumed gift that occurs each year under a split dollar endorsement arrangement per million of life insurance coverage.

The IRS challenged the split-dollar agreements on the grounds that they did not qualify under the economic benefit regime and that the total $29.9 million advanced in premiums should be taxable as gifts. However these arguments contradicted the tax court's 2016 opinion in *Morrissette 1* where the court ruled that the split-dollar agreements did qualify as an economic benefit regime, and that the premiums were not taxable gifts and only the economic benefit needed to be reported.

Roughly a month after Mrs. Morrissette passed away, the CMM trust transferred the right to be repaid under the split-dollar agreements to the dynasty trusts that owned the life insurance policies and had the obligation to make repayment. The court found that this transfer caused the dynasty trusts to no longer owe the split dollar moneies. The court concluded that the valuation of the right to repayment would not be significantly discounted.

On the estate tax return, the CMM trust's split-dollar rights as of October 30, 2009 were valued at $7,479,000. The appraisal was handled by Craig Stephanson who was recommended by McNair. After conceding that Stephanson made an improper deduction in his appraisal, the market value was later changed to $10,449,000.

The Revenue Agent in charge of examining the estate tax return, John Stewart, initially decided that no penalty for gross understatement would be imposed because the value was based on appraisals by qualified appraisers, and this reliance "constitues reasonable cause for not applying the penalties." The report included the electronic signature of Stewart's superior, Miliene McCucheon.

However, it was later determined that McCucheon was not the one who put the electronic signature on the report because McCucheon did believe a penalty should be given for a gross understatement. McCucheon then instructed Stewart to amend the report.

In addition to Stephanson's appraisal, the estate got another expert, Shishir Khetan, who determined that the value of the repayment rights were $7,808,314.

Meanwhile, the Commisioner of Internal Revenue also secured an expert, Francis Burns, who gave a valuation of $17,501,391 if the agreement remained in effect until after the brothers' deaths.

Stephanson, Khetan, and Burns all used the discounted cashflow method to value the repayment rights. This method is done by calculating an expected value of the policy for each year of the insured's life expectancy by determining the expected cash value each year multiplied by the probability of the insured's death. This is known as the probability-adjusted expected value. Then the probability-adjusted expected value is discounted to its present value. The present value of the annual amounts are totaled to determine the fair market value.

The differences in the values reached by the experts is partially due to the differing numbers they assigned for cash value and probability of mortality. However, the main cause for the difference is due to the variation in discount rates used to determine the present value of the probability-adjusted expected value.

The discount rate is the rate of return required to entice an investor to take on the agreement, and is based on the yields of alternative investments with risks comparable to the split-dollar agreements.

Because the experts identified different alternative investments, the discount rate varied considerably, leading to the wide range reached in the fair market values of the split-dollar agreements.

Stephanson and Khetan both used 15% discount rates for the policies, while Burns used 9.35% for Don's policies and 6.9% for Buddy's and Ken's policies.

<u>Analysis</u>

Traditional Split-Dollar Arrangements

With a traditional split-dollar arrangement, a senior family member, hereinafter referred to as "G1", provides funds to a trust that will use those funds to purchase a life insurance policy insuring the life of G1. These trusts are usually grantor trusts for income tax purposes.

Upon the death of G1, the trust receives the estate death benefit and owes G1's estate or G1's successors equal to the funds G1 gave to the trust.

The split-dollar transaction is considered to be for full and adequate consideration under the treasury regulations. The transaction is not a gift, so no gift tax is implemented. The split-dollar transaction also does not use any of G1's estate tax exemption.

The repayment that G1's estate or successors are entitled to upon the death of the insured is referred to as the "reimbursement right." However, because G1 is the insured in a traditional split-dollar arrangement, the reimbursement right is triggered upon the death of G1, so there is no real chance for a discount for estate tax purposes.

The benefit of a traditional split-dollar agreement is not a discount for tax purposes, but rather for financial leverage. Loaning the money would traditionally generate a relatively low rate of return, but having the trust invest the funds into a life insurance policy through a split-dollar agreement ends up increasing the rate of the return.

Split-dollar arrangements are classified under two regimes: the loan regime and the economic benefit regime.

Under the loan regime, the senior family member loans money to the trust to pay the premiums. The trust then issues a promissory note for the same amount loaned. This establishes full and adequate consideration and eliminates potential gift tax treatment.

The treasury regulations provide that the interest accrued on the promissory notes does not have to be paid until the death of the insured, causing it to compound. Upon the death of the insured, the original amount loaned and the interest that has accrued becomes due. This is paid for by the death benefit from the policy.

Unlike the loan regime, the reimbursement right under the economic benefit regime is only for the aggregate premiums paid and does not include the accrued interest. Under the economic benefit regime, the benefit comes from an increase in the cash value of the policy. Under the economic benefit regime, the trust, not G1, pays the expenses of operating the policy.

Because the term insurance equivalent cost is paid for by the trust, and not G1, the cash value of the policy increases every year, which is generally equivalent to the interest that would accrue under the loan regime.

Intergenerational Split-Dollar Agreements

Under a traditional split-dollar agreement, G1 is insured which prevents a discount for estate tax purposes. However, when the insured is no longer G1, but rather G1's child, G2, the change in circumstances allows for a discount and may be very substantial.

What is the difference between insuring G2 as opposed to insuring G1?

When the IRS implemented the regulations it was anticipated that the insured would be G1 who advanced the funds to the trust. By having the insured be a child (G2) the trust's obligation is still outstanding at the sponsor's death. If G1 were the insured, the obligation becomes due at G1's death and no discount is available.

As noted above in both the loan regime and the economic benefit regime, the reimbursement right is triggered by the death of the insured. Under the traditional split-dollar agreement, because G1 passes at the same time the repayment right is triggered, the value of the repayment right is generally the same as the amount G1 loaned to the trust.

Under intergenerational split-dollar agreements, because G2 is the one that is insured, it is not guaranteed, and is even rather unlikely, that the estate will be owed the repayment at the same time the insured passes.

Because the child of G1 is insured, even when G1 passes away, the repayment is still not owed to the estate. Rather, the agreement might run for a number of decades depending on how long G2 lives after G1 has died.

When G1 passes away, G1's right to repayment might not be paid out until potentially 20 plus years later. This decreases the value of G1's right and allows for a discount for estate tax purposes.

Intergenerational split-dollar agreements work in a manner similar to other long-term promissory notes, which have seen applications of significant discounts in the 20-40% range.

Some appraisers will provide appraisals with discounts in the 80-90% range and claim that because the discount was determined by a qualified appraiser, there should not be any valuation penalties. This is not true. A discount in this range is unlikely to persuade courts into believing that the reliance was reasonable. Internal Revenue Code Section 26 CFR § 1.6664-4 provides the following language:

(a) **In general.**

> No penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion.

While this language would appear to immunize any taxpayer who relies upon a reputable appraiser and appraisal from penalties, when the situation is aggregious Section 6662 of the Internal Revenue Code provides the following:

(g) Substantial Estate or Gift Tax Valuation Understatement

(1) In General

> For purposes of this section, there is a substantial estate or gift tax valuation understatement if the value of any property claimed on any return of tax imposed by subtitle B is 65 percent or less of the amount determined to be the correct amount of such valuation.

(h) Increase in Penalty in Case of Gross Valuation Misstatements

(1) In General

> To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

An example of a valuation of this magnitude is found in the *Morrissette* case. McNair mentions a story of a grandmother who pays a $10 million life insurance premium. McNair claimed the grandmother had the right to repayment valued at $1,445,000 and discounted the right $565,000 for estate tax purposes upon her death. Thus discounting the $10 million asset by 85.55% and 94.35% respectively.

One distinction that should be made between a traditional split-dollar agreement and an intergenerational split-dollar agreement is that if G2 acquires some sort of economic benefit, it is considered a gift and will be subject to a gift tax.

Morrissette 1 focused on whether the premiums were subject to gift treatment. After determining the premiums are not gifts, the only issue in the *Morrisette 2* case value of the repayment right.

Under the economic benefit regime, the advancing party is guaranteed a minimum amount equal to the funds that the trust used to pay the premiums. In the first few years, because of insurance company charges that are paid out of the premiums, the cash value will be less than the premiums paid. If the policy is terminated before the cash value increases to an amount greater than the premiums paid, the trust needs to make up the shortfall. Because the trust must pay the annual cost of insurance, the cash value will increase faster.

At some point, the cash value will start to be greater than the premiums paid.

If the trust pays the COI from its separate funds, there is no gift because the trust is paying its own contractual obligation.

Mrs. Morrisette advanced about $30 million in funds through the CMM trust in the split-dollar agreement. The appraiser valued the split-dollar agreement at roughly $7.5 million and applied an aggressive discount of 75%.

If we take into account the previously discussed improper deduction by Stephanson, the applied discount is 65%, which raises the valuation to about $10.5 million. The discount is still high, but a bit more reasonable.

If a lender issues a promissory note that satisfies the requirements set forth in the IRS's guidance, the IRS must treat the promissory note as a true loan. The taxpayer is unable to claim the note as anything else. Therefore, a promissory note under split-dollar agreements would be subject to the typical valuation factors that courts use to value other promissory notes.

Typically promissory notes are left in the gross estate. If the promissory note is valued at a discount when included in the gross estate, the IRS is not allowed to return to the date the note was issued in order to assert a deficiency.

One of the main problems with *Morrissette 2* is that when the CMM trust transferred the rights of the agreement to the dynasty trust that owned the policy, it terminated the agreement. Therefore, the period being discounted was not until the brothers died, but rather it was the one month between Mrs. Morrissette passing away and the transferring of the agreement to the dynasty trust, thus increasing the value of the right to repayment.

The takeaway here is that it is absolutely critical that the Senior does not transfer the rights to the trust that owes the repayment, at least not until the IRS is finished auditing the tax return.

The IRS is not very generous when settling these types of cases. They might offer something around the 8% range and rely on *Morrissette* or *Cahill* to impose leverage. However, both *Morrissette* and *Cahill* had fact patterns that contributed to such a low deduction. *Morrissette* had the termination issue. In *Cahill*, the estate tried to claim an aggregious 98% deduction. If the taxpayer stays clear of situations such as these, they could settle for a deduction in the 30-40% range.

This leads us back to the issue of appraisers giving valuation reports in the 70-90% range. It is unlikely these appraisers would start issuing valuation reports in the 40-50% range as that would be akin to the appraisers admitting the earlier appraisals were incorrect. However, finding a proper appraiser that will issue a reasonable valuation significantly improves the liklihood of reaching a considerable settlement and/or discount.

Because split-dollar regulations are only effective for gift tax and employment tax purposes, they are not the controlling law for estate tax purposes. Rather, general estate tax valuation principles govern the valuation of the repayment right in the gross estate.

Court's Opinion

The main issues in *Morrissette 2* are the applicability of Internal Revenue Code sections 2036 and 2038, and the valuation of the split-dollar rights.

Section 2001(a), imposes a federal estate tax on the the transfer of a decedent's taxable estate which is defined under Section 2051 as including "all property, real or personal, tangible or intangible, wherever situated" to the extent provided in sections 2033 through 2045.

IRC Sections 2036 and 2038

Sections 2036 and 2038 dictate that inter vivos transfers must be included in the gross estate where the decedent retained certain rights or powers in the transferred property. The Court explains that sections 2036 and 2038 were meant to protect against inter vivos transfers to avoid estate tax where the decedent has "retained enjoyment of the property."

For the reader's convenience, we are providing Internal Revenue Code Section 2036(a) below and have underlined the language from the statute that was specifically quoted in the opinion:

I.R.C. § 2036(a)

> **General Rule** - The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> **I.R.C. § 2036(a)(1)**
>
> > - the possession or enjoyment of, or the right to the income from, the property, or
>
> **I.R.C. § 2036(a)(2)**
>
> > - the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2036 was designed to reclaim the values of assets transferred during the liftime of the decedent where the decedent has retained the economic benefits of the asset. 2036(a)(2) applies when the decedent has the "right or power to designate the persons who would possess or enjoy the property or receive the income from the property." It is immaterial whether the right is held alone or with another person.

Section 2038(a) deals with revocable transfers including instances where the decedent has the power to "alter, amend, revoke, or terminate the transferee's enjoyment of the property without regard to when or from what source the decedent acquired such power." This section also applies irrespective to whether the decedent has the right alone or in conjunction with another person.

The opinion explains that because the donor of a split-dollar agreement has paid gift tax on the cost of the current protection derived from the agreement, the donee may exclude death benefits received from the policy from the gross estate pursuant to section 1.7872-15(a)(2)(i) of the Income Tax Regulations.

In *Morrissette 2*, The Commissioner argues that the CMM trust retained a right to income under 2036(a)(1), a right to designate under 2036(a)(2), and the power to alter under 2038(a) which makes the cash values of the policies includable in the gross estate.

For 2036 and 2038 to apply, the following three conditions must be met:

1) The decedent made an inter vivos transfer of property

2) The transfer was not a bona fide sale for adequate and full consideration and

3) The decedent retained an interest in or a right or power over the transferred property that she did not relingquish before her death, as defined in either section.

The court rejected the Commissioner's argument and ruled that the transfer in *Morrissette* qualified as a bona fide sale exception to both sections. A bona fide sale under both sections is defined as a transfer in which the decedent has received consideration that is "sufficient to protect against the depletion of the estate's assets."

The court also rejects the Commisioner's contention that the lack of consideration provided by the dynasty trusts prevents the payments of premiums by the CMM trust from constituing a 'sale' as defined by Black's Law Dictionary. The court rejected this argument, stating that "the regulations indicate a broad interpretation of the term 'sale' to include transactions that may not otherwise be considered sales in the strictest sense."

The court adds that they have included transfers when defining "sale" for purposes of a bona fide sale in the past.

Both section 2036 and 2038 include exceptions for the recapture of an inter vivos transfer in the gross estate when the transfer is a bona fide sale for adequate and full consideration for money or money's worth. The goal of these exceptions is to hinder the reach of sections 2036 and 2038 to transfers where the decedent recieved consideration sufficient to protect against depletion of the estate's assets.

The court seperates the bona fide sale exception into two required prongs: (1) a legitimate nontax purpose and (2) adequate and full consideration.

Legitimate Non-Tax Purpose

The legitimate nontax purpose must be "an actual motivation, not a theoretical justification" and requires "some objective proof that the nontax reason was a significant factor that motivated the transfer."

Additionally, the court ruled that "[t]he adequate and full consideration requirement is met where the exchange is on terms similar to those that would occur in an arms-length transaction."

The court ruled that both prongs of the bona fide sale exception were satisfied. Observing that intrafamily transfers require heightened scrutiny, the court still found that a legitimate nontax purpose existed. The court acknowledged that "[o]ur caselaw requires the presence of a legitimate nontax purpose; it does not require the absence of a tax saving motivation." The legitimate nontax purpose of the transfer "was to promote the management succession and efficiency and to protect corporate profits for the accumulation of capital to develop the business."

Adequate and Full Consideration

The court also held that the CMM trust recieved adequate and full consideration for the transfer. The court noted that adequate and full consideration may be satisfied by financial considerations apart from obtaining the highest price. One of Mrs. Morrissette's primary concerns was keeping Interstate within the family.

Mrs. Morrissette and the CMM trust derived financial benefits from the split-dollar agreements "including retained family control over Interstate, a smooth management succession, organizational stablility, and protection of Interstate's capital by providing a source of funding to pay estate tax on the brothers' deaths."

After determining that the bona fide sale exeptions applied, the court turned to the valuation of the split dollar amounts.

<u>IRC Section 2703</u>

The court first considers the application of the special valuation rules of section 2703 and found that the Morrissette estate properly established that the section exception should apply. 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."

The court held that the three exception requirements of Section 2703(b) were satisfied and "Section 2703 does not require disregard of the mutual termination restriction for purposes of determining the fair market values of the split-dollar rights".

For the convenience of the reader we have reproduced Internal Revenue Code Section 2703 below, and have underlined the words of the section that were quoted in the decision:

I.R.C. § 2703(a)

General Rule

- For purposes of this subtitle, the value of any property shall be determined without regard to-

2073(a)(1)

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

2703(a)(2)

- any restriction on the right to sell or use such property.

Exceptions

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

2703(b)(1)

- <u>It is a bona fide business arrangement.</u>

2703(b)(2)

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

2703(b)(3)

- Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction

Bona Fide Business Arrangement

While a bona fide business arrangement is not defined in section 2703 or anywhere else in the Internal Revenue Code or regulations thereunder, the Tax Court previously held that a restrictive arrangement must further a business purpose. *Amlie v. Commissioner*, T.C. Memo. 2006-76.

Because the family members credibly testified that the restructuring of the estate was done to ensure that Interstate would remain in the family, the court found that the split-dollar arrangements and the mutual termination restrict furthered the valid business purpose of keeping the company within the family.

Testamentary Device

The second required prong of the test under 2703(b) is that the "restriction must not be a device to transfer property for less than adequate and full consideration in money or money's worth". For this prong, the court analyzed only whether the mutual termination restriction constituted a testamentary device, not the split-dollar arrangements as a whole.

The court found that the mutual termination was not a device to transfer funds at less than adequate and full consideration. The court stated that the split-dollar agreements contained repayment terms that a reasonable investor would have accepted and the split-dollar agreements were stable investments that also provided for tax deferral on the inside buildup.

The court also stated that the CMM trust received other financial benefits besides the premium payments which supported the proposition that the transfer was for "full and adequate consideration". The CMM trust received the value of continued family control over Interstate when it relienquished rights over the transferred amounts.

Comparable to Similar Arms' Length Transactions

The final prong of the test requires the court to ask whether a similar transaction between unrelated parties would also include a mutual termination restriction.

The court's analysis with respect to this part of the test focused mainly on the Commissioner's production of corporate filings that showed split-dollar agreements entered into as employee compensation. The court found numerous differences between the presented agreements and present case ultimately ruled that they were not comparable.

The court further cited the Morrissette brother's animousity towards each other as further proof that the split-dollar agreements and mutual termination restriction were comparable to similar arms-length transactions.

For the reader's convenience, we have provided the following chart that compares the language and requirements of Section 2036 and Section 2703.

Specific Language of 3 Prong Requirements under 2036(a) and 2703

	Section 2036(a)	**Section 2703**
Prong 1	"bona fide sale"	"bona fide business arrangement"
Prong 2	"adequate and full consideration in money or money's worth"	"Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction"
Prong 3	"Legitimate nontax purpose"	"not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth"

Morrissette 2 Court Findings on Each of the Above 6 Prongs

	Section 2036(a)	**Section 2703**
Prong 1	**“**The regulations indicate a broad interpretation of the term “sale” to include transactions that may not otherwise be considered sales in the strictest sense”	“...the family members credibly testified that the split-dollar agreements were entered into for valid business purposes and the mutual termination restriction was added so that no brother could jeopardize the valid business purposes of the agreements.”
Prong 2	“We hold that the CMM 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.”	“On these facts we hold the split-dollar agreements were entered into at arm's length especially in the light of the brothers’ acrimonious relationships and disputes over Interstate's ownership. We are satisfied that a split-dollar agreement entered into by a closely held business and its long-term senior executives at arm's length may contain a mutual termination restriction similar to the one in the split-dollar agreements at issue.”
Prong 3	“Morrissette's desire to keep Interstate in her family is a legitimate, nontax reason for purposes of the bona fide sale exceptions”	“The CMM trust received adequate and full consideration when it executed the split-dollar agreements. The CMM trust relinquished rights over the transferred amounts for additional certainty about Interstate's future.”

Fair Market Value

After determining that Section 2703(b)’s exception requirements were satisfied, the court conducted an analysis of different valuations given by the experts. The court ultimately directed the parties to “determine the annual probability-adjusted expected value for each policy on the basis of the estate’s expert’s expected cash surrender values and the IRS’s probabilities of mortality. The court further instructed the parties to apply discount rates of 8.85% and 6.4% for the two life insurance policies to the annual probability adjusted expected values.

What Does This Mean?

Many of us had hoped that this opinion would simply provide that advancing money to an irrevocable life insurance trust to enable it to buy permanent life insurance in a manner compliant with the loan regime or economic benefit regime provisions of the split-dollar Treasury Regulations will be sufficient to assure that the right to be repaid when the policy is cashed in, barred upon, or pays a death benefit on the death of an insured will sufficient evidence to support the conclusion that the retention of the right to be repaid, based upon the above, should not be considered to be an Internal Revenue Code 2036(a) retained interest, or an arrangement that would otherwise suppress value under Internal Revenue Code Section 2703.

While the court did reach the conclusion that the arrangement was an "bona fide sale" for purposes of Section 2036(a), and was a bona fide arrangement with a legitimate business purpose under Section 2703, the decision goes into significant detail with respect to the business purposes and family history that support the proposition that these arrangements do not cause more than the lesser of the amount advanced, plus any interest charged if the loan regime is being used, or the cash value of the policy as of the date of death of the split-dollar advance holder.

As stated by Howard Zaritsky in his Estate Planning Newsletter #2886, *Morrissette 2* suggests that intergenerational split-dollar life insurance arrangements can work, but only in certain situations.

The Morrissette family would have been better off simply investing in a conventional stock and bond portfolio under a limited liability company or limited partnership that would have provided more significant discounts than were permitted under this case. The family would have also avoided sales charges and any surrendered charges that may have applied under the life insurance policies. The court pointed out that the life insurance agent who referred the family to Jim McNair earned a $1 million dollar commission and urged the family not to terminate the policies early.

In *Morrissette 2*, there were concerns about keeping Interstate within the family for future generations, which created a legitimate non-tax purpose for the purpose of overcoming Section 2036 and 2038. In addition, this non-tax purpose, along with the familial tension, contributed to the court's conclusion that the mutual termination restriction was one that would also be entered into by other nonrelated parties.

It is somewhat surprising that the IRS chose this as a test case because the family had a long history of conduct and issues that made financing life insurance for buy-sell purposes among the children and their descendants both reasonable and logical. The brothers were not even on speaking terms despite occupying offices adjacent to one another.

Given that the gift tax and income tax implications of split-dollar are made very clear in the Treasury Regulations, it is somewhat disappointing that 18 years after the issuance of these regulations there is a possibility that the IRS could successfully convince a court to include life insurance subject to a legitimate split-dollar arrangement in the estate of the grantor.

The court's discussion also took into account the possibility that the estate might be repaid for its advances almost immediately after Mrs. Morrissette's death. Given that this is generally equivalent an interest free or low interest loan, it would not make sense for a trust with limited assets other than a life insurance policy that is yielding a rate of return greater than what is owed under the split-dollar arrangement to pay back the advancing party before the life insurance policy matures. The court noted in its decision that the gift amount would be reduced to the extent that the trust paid premium amounts

While it may turn out that it was a fatal error to have Mrs. Morrissette's documents authorize the trustees to simply assign the right to repayment to the trusts that owed the repayment, subsequent court decisions or IRS rulings may analyze whether the beneficiaries who directly or indirectly receive the right to repayment from a life insurance trust and the beneficiaries of the life insurance trust are substantially the same.

Planners may wish to have the split dollar repayment rights devises to a trust that would be for different beneficiaries, such as being allocated solely for the use and benefit of descendants of the second generation, as opposed to being held for the children of the second generation and their descendants.

It is also noteworthy that the Court did not appear to have any problem with the fact that the split dollar equity arrangement put into place caused Mrs. Morrisette to file annual gift tax returns based upon the Table 1 IRS published gift values that correspond to the death benefit of a permanent insurance policy.

The opinion points out that the dynasty trusts apparently received cash from an unspecified source and paid some of the premiums, thus reducing the gift element by the amount of premiums not paid by Mrs. Morrisette's revocable trust.

It is also noteworthy that the court had no apparent problem with concluding that this could be considered to be a "bona fide sale for good and valuable consideration" notwithstanding that it was clearly an economic bargain for the benefit of the life insurance trust.

In particular, the court differentiated between a true arms length transaction and a "bona fide sale for good and valuable consideration", citing the *Bongard* case, for a situation where a tax payer puts assets into an entity and receives a pro rata ownership interest without voting rights or a situation similar to the *Stone* case, where decedent spouses operating a family business created five family limited value partnerships for the purpose of managing potential conflict among their children.

Interim Table of One Year Term Premiums for $1,000 of Life Insurance Protection

Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates
2	0.27	51	2.52
3	0.19	52	2.81
4	0.13	53	3.20
5	0.13	54	3.65
6	0.14	55	4.15
7	0.15	56	4.68
8	0.16	57	5.20
9	0.16	58	5.66
10	0.16	59	6.06
11	0.19	60	6.51
12	0.24	61	7.11
13	0.28	62	7.96
14	0.33	63	9.08
15	0.38	64	10.41
16	0.52	65	11.90
17	0.57	66	13.51
18	0.59	67	15.20
19	0.61	68	16.92
20	0.62	69	18.70
21	0.62	70	20.62
22	0.64	71	22.72
23	0.66	72	25.07
24	0.68	73	27.57
25	0.71	74	30.18
26	0.73	75	33.05
27	0.76	76	36.33
28	0.80	77	40.17
29	0.83	78	44.33
30	0.87	79	49.23
31	0.90	80	54.56
32	0.93	81	60.51
33	0.96	82	66.74
34	0.98	83	73.07
35	0.99	84	80.35
36	1.01	85	88.76
37	1.04	86	99.16
38	1.06	87	110.40
39	1.07	88	121.85

40	1.10	89	133.40
41	1.13	90	144.30
42	1.20	91	155.80
43	1.29	92	168.75
44	1.40	93	186.44
45	1.53	94	206.70
46	1.67	95	228.35
47	1.83	96	250.01
48	1.98	97	265.09
49	2.13	98	270.11
50	2.30	99	281.05

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