Finseca

This Finseca Report Marketplace was prepared exclusively for Finseca Influencer members by Jon Forster, Partner, and John F. DeStefano, Of Counsel, at **BakerHostetler**.

Private Split-Dollar: Applying the Tax Court's Lessons in Levine

Market trend: The IRS, clearly interested in intergenerational private split-dollar, attempted to secure a third victory. After *Morrissette* and *Cahill*, it looked like intergenerational split-dollar was trending the way of the dinosaurs. Then in *Estate of Marion Levine*, the Tax Court not only resurrected intergenerational split-dollar life insurance planning, but it also offered a roadmap for successfully structuring traditional private split-dollar plans as well.

Synopsis: In prior cases, *Morrissette* and *Cahill*, the IRS successfully assessed tax and penalties after dismantling intergenerational split-dollar arrangements. As the Tax Court highlights throughout its opinion, *Levine* is different from the prior cases because: (1) Marion Levine had a clear intent and valid purpose to provide a legacy for her descendants using life insurance; (2) the split-dollar plan was not implemented as a "sham" solely to avoid tax; (3) the directed trustee and investment committee of the irrevocable life insurance trust ("**ILIT**") were independent fiduciaries; and (4) Marion Levine retained no ability, either unilaterally or together with anyone else, to terminate the split-dollar agreement or otherwise access the policy's cash value.

Takeaways: While intergenerational split-dollar represents a small fraction of the overall use of split-dollar, the lessons learned from *Levine* may well apply across the board. The Tax Court is clear that execution optics matter. Independent advisors, identifying client needs, and clear client communications all matter. Shortcuts and shortcomings increase audit risk and can lead to undesirable client outcomes. Advisors should take care to follow – and improve upon – the lessons learned from *Levine*, not only with intergenerational plans but with traditional private split-dollar plans as well.

Private Split-Dollar Structures – Background

Traditional Split-Dollar Agreement. Split-dollar premium financing enables a client to purchase and fund a large block of permanent life insurance in a more gift tax efficient manner. Typically, the split-dollar agreement ("**SDA**") is entered into by the client (or his or her revocable trust) and an ILIT. The SDA may be structured under either the "economic benefit regime" or "loan regime."

Under an economic benefit structure, the ILIT owns the policy, but the client agrees to advance the policy premiums in exchange for the ILIT's promise to repay the greater of the premiums advanced or the policy's cash value. As the client-insured pays the premiums, he or she makes a taxable gift to the ILIT equal to the economic benefit of the policy, which is equal to the 1-year term cost of the insurance – a small fraction of the actual premium amount advanced.

The SDA may be terminated during the client's life, at which point the ILIT must repay its obligation to the client (often using borrowed money or other trust assets). If the client passes away while the SDA is in effect, the policy pays out to the ILIT.

Intergenerational Split-Dollar. An intergenerational split-dollar plan offers a unique value arbitrage. Here, the life insurance policy insures the life (or lives) of the client's children, and the ILIT primarily benefits the client's grandchildren. The client serves solely as a lender and advances the policy premiums, but because the SDA does not terminate until the client's children pass away, the client's estate holds merely a *receivable* for the greater of the premiums advanced or the cash value of the policy. To calculate the present value of such receivable as of the client's date of passing, the future repayment amount is discounted over the insured-children's life expectancy, which results in a significantly smaller present value in the client's estate.

The discount in value can be significant and, unsurprisingly, the IRS has taken issue with plans that immediately convert significant wealth into a small taxable amount. For example, in *Cahill*, the taxpayer advanced a $10 million premium but only a year later reported that the $10 million had become a receivable worth $183,700 in the decedent's taxable estate. In *Morrissette*, the IRS successfully argued that a provision in the SDA allowing the split-dollar arrangement to be terminated 3 years after the client's death showed that the receivable should be discounted by only 3 years, not by the children's full life expectancy; the taxpayer's discount of a $30 million premium advance to $7.5 million was disregarded, and the IRS imposed additional tax plus a 40% penalty.

Levine marks the first time the Tax Court ruled against the IRS on all counts related to an intergenerational split-dollar plan. Pursuant to an SDA, Marion Levine advanced $6.5 million to purchase a single-premium survivorship policy on the lives of her daughter and son-in-law. The Tax Court upheld the value of both the $2,644 taxable gift (i.e., the split-dollar economic benefit) and the present value of the $2.1 million receivable, making this case unique because the court effectively provided a favorable ruling on the most relevant tax aspects of the planning approach. The Tax Court attributed the outcome in *Levine* to a number of critical differences from *Morrissette* and *Cahill*, and the lessons learned may be applicable when structuring traditional private split-dollar arrangements as well.

Lessons from Levine

Client Goals. A split-dollar plan should be structured to accomplish specific and compelling non-tax goals. Marion Levine wanted to provide a financial benefit to her grandchildren using life insurance. There were multiple memoranda prepared by her lawyer explaining how the insurance plan would provide a legacy for her grandchildren, especially since her children had sufficient wealth in their own right. The client understood the structure, and the plan was created with a valid purpose, not as a pure tax avoidance "sham transaction." In *Morrissette*, the judge noted the dialogue around the structure largely serving as a tax play, and in *Cahill*, the optics of converting $10 million into $187,000 made it obvious. The genesis of split-dollar planning should be to achieve family legacy or business planning goals, not merely to avoid tax.

Financial Suitability. Private split-dollar plans are generally suitable for clients with a current or projected net worth greater than the estate tax exemption.

Levine highlights that detailed financial modeling is an integral part of the legacy planning process. Generally, only family wealth in excess of lifestyle capital needs should be allocated to advanced legacy planning. Without evidence that the client does not personally need any of the capital used in the plan, the IRS may argue the client retained rights to the asset and then include the value in the client's taxable estate (a much debated area in most IRS victories). Marion Levine had a net worth of $25+ million, annual income of $1+ million, and wanted a succession plan around her illiquid real estate. The Court noted that her advisors made sure she had enough money to maintain her lifestyle, and only used "excess capital" to implement the split-dollar insurance plan.

Modeling the facts of *Levine*, an advisory team should work together to calculate the present value of the client's living expenses, planned gifts, expected liquidity needs, and income tax liability over the client's life expectancy before entering into a split-dollar transaction, and even then, use only "excess capital" for advanced planning. Clients should demonstrate they have sufficient outside capital to cover personal living expenses for their lifetime to help avoid an IRS argument that the client had an implied agreement to access the cash value (or other assets) involved in the plan.

No Strings Attached. Clients should not retain a right to cancel or surrender a life insurance policy owned by an ILIT, either alone or with the trustee's consent.

Generally speaking, tax law operates to include an asset in a client's taxable estate if the client retains legal rights or an economic interest. The SDAs in *Morrissette* and *Cahill* permitted the client to modify and terminate the split-dollar arrangement with the ILIT trustee's consent. Marion Levine, however, retained no such rights, either unilaterally or together with anyone else; her SDA specifically stated that only the ILIT (through its independent investment committee) had such a power.

The difference could prove important to successful traditional split-dollar planning as well. The IRS has shown a proclivity for scrutinizing SDAs; could the IRS argue that retaining such a right under a standard split-dollar plan constitutes an "incident of ownership" and include the entire death benefit in the client's taxable estate? The degree of audit risk isn't clear, but such an argument by the IRS is foreclosed if the client heeds the advice from *Levine* and does not retain any ability to terminate the SDA, surrender the policy, or otherwise access its cash value.

Independent Fiduciaries. The ILIT trustee (and investment director, in the case of a directed trust) should be an independent person who owes fiduciary duties to the ILIT beneficiaries.

Even though Marion Levine did not have an ability to terminate the SDA, the IRS argued such power could be attributed to her because the sole member of the ILIT's investment committee was also her attorney-in-fact under a durable financial power of attorney. In *Cahill*, the IRS successfully argued that an attorney-in-fact and trustee were not independent persons and ultimately were not "real" fiduciaries. But the IRS's similar argument failed in *Levine*. The appearance of true independence and genuine fiduciary duties proved critical.

The degree of fiduciary independence needed isn't clear, but more facts showing independent control of the ILIT are better. Unlike in *Cahill*, the fiduciaries in *Levine* were neutral, independent parties, not beneficiaries, or related or subordinate persons. Marion Levine structured her ILIT with an out-of-state trust company as trustee, and a sophisticated, independent professional (who was a decades-long advisor and close family friend) as sole member of the ILIT's investment committee. The trust agreement clearly stated that the ILIT's investment committee operated in a fiduciary capacity, and the

facts of the case supported that reality. The beneficiaries of Marion Levine's estate (her children) and the beneficiaries of the ILIT (her grandchildren) were not the same people, and thus her attorney-in-fact and sole member of the ILIT's investment committee – though the same individual – owed fiduciary duties to different beneficiaries.

Practically speaking, clients may prefer to appoint an ILIT trustee who is a family member, employee, or other "friendly individual" who will serve without compensation and abide by the client's instructions. According to *Levine*, doing so may be a mistake. The benefits of a split-dollar plan stewarded by an independent professional trustee may outweigh the audit risk and cost "savings" of using a non-independent trustee.

Timing. Designing and executing a private split-dollar plan takes time and thoughtful planning by a cooperative advisory team. Advisors should set a client's expectations accordingly.

To avoid red flags around last-minute death-bed tax planning, such plans should be developed and implemented while the client is in good health, to the extent possible. The ILIT should be created before the insurance application is prepared and signed, and the ILIT should be the applicant, purchaser, and owner from the start to avoid an argument that the client owned the policy at some point. Marion Levine began her insurance planning toward the end of 2007, created the ILIT in 2008, and passed away in 2009. The timing of her death in fairly close proximity to the plan's enactment is not an ideal fact pattern. But unlike *Cahill*, where a 90-year-old client implemented the plan through agents under a durable power of attorney and died a year after the plan was implemented, the Tax Court in *Levine* noted the care taken to ensure the insurance plan was done correctly, with its steps in the proper order, and with attention to detail in every way. As a result, the overall optics of Marion Levine's plan were not suspect.

Takeaways

While intergenerational split-dollar represents a small fraction of the overall use of split-dollar, the lessons learned from *Levine* may well apply across the board. The Tax Court is clear that execution optics matter. Independent advisors, identifying the need, and client communications all matter. Shortcuts and shortcomings increase audit risk and can lead to undesirable client outcomes. Advisors should take care to follow – and improve upon – the lessons learned from *Levine*, not only with intergenerational plans but with traditional private split-dollar plans as well.

Disclaimer: The information contained herein is provided solely for Finseca. The content herein is not intended nor written for, and cannot be used as, the basis of any legal or tax advice by anyone else or any other organization. Such taxpayers should consult with their own legal or tax advisors for specific legal or tax advice. Reference to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by the authors or Finseca.

BakerHostetler does not provide investment or insurance related advice.

Lessons from Levine – Checklist

- ✓ **Goals**. The client has a valid, well-articulated, non-tax purpose for the split-dollar plan, such as providing a family legacy or funding a business buyout.
- ✓ **Financial Suitability**. Based on financial models, the client has sufficient wealth outside of the split-dollar plan to cover liquidity needs for the client's lifetime. Advanced planning only utilizes excess capital.
- ✓ **No Retained Rights to Modify or Terminate the SDA**. The client should not have a right, either alone or in conjunction with anyone else, to modify or terminate the split-dollar agreement. Only the ILIT trustee should have such right.
- ✓ **Independent Fiduciary**. The ILIT trustee (and investment director, in the case of a directed trust) should be an independent person who owes fiduciary duties to the ILIT beneficiaries. The client's attorney-in-fact under a durable power of attorney and the ILIT fiduciaries should be different.
- ✓ **Timing**. Implement advanced legacy plans sooner rather than later. Last minute, death-bed planning may be a red flag.