DISCOUNTING NON-GSD SPLIT-DOLLAR RECEIVABLES

In a typical private split-dollar plan, the insured funds a policy insuring their own life by advancing or loaning funds to an irrevocable life insurance trust (ILIT) and, in exchange, holds a split-dollar receivable.[1] With the December 31, 2025 sunset (halving) of current high gift, estate, and generation-skipping transfer tax (GST tax) exclusions fast approaching, this may be an ideal time to cleanup an in-force split-dollar plan by gifting the receivable and, optionally, future premiums to an irrevocable trust.

Discounting the receivable results in a more efficient wealth transfer through greater leveraging of available gift and GST tax exclusions. In the generational split-dollar (GSD) setting, the split-dollar receivable is discounted because it won't be paid until the death of the insured (G2), that is, statistically a long time in the future. A knowledgeable buyer under a willing buyer/willing seller valuation standard would take this into account.

The *Morrissette* and *Levine* estate tax cases[2] provide a methodology and important guidelines that can, in fact, be used to support the discounting of any split-dollar receivable.[3] Although the 2021 *Morrissette* case had a negative outcome for the family, it was a victory for GSD planning in that it established a valuation methodology followed in the *Morrissette* and the *Levine* estate tax cases. That valuation methodology involves a two-step process. First, each year, the projected value of the receivable is weighted by the probability the insured dies. Second, the present value of that amount is calculated based on a reasonable discount interest rate.

THE IRS "GIFT AT INCEPTION" ARGUMENT

Needless to say, the IRS is not happy with the outcomes of the *Morrissette* and *Levine* decisions and continues to aggressively examine, audit, and, in some cases, litigate the transfer of discounted split-dollar receivables. In GSD cases, the IRS has and continues to assert that there is a "gift at inception". That is, the IRS argues that, from inception, the split-dollar plan was only entered into for its tax avoidance benefits.

> **In the case of GSD and non-GSD split-dollar cases, the IRS can be expected to examine all discounted transfers of split-dollar receivables.**

For those non-GSD in-force split-dollar cases that have been in effect for years where the insurance was originally placed for a valid nontax reason (including to provide for estate taxes), the "gift at inception" argument is without merit. However, for new split-dollar plans, to obviate the IRS position, it is essential to establish and document a legitimate long-term nontax need for the coverage. The *Morrissette* and *Levine* cases provide authority and support for this position.

In the 2016 *Morrissette* gift tax case[4], a Tax Court memorandum decision, the court soundly and directly rejected the IRS' "gift at inception," argument concluding that the only economic benefit conferred on the trust was the one-year term cost and that the receivable provided Mrs. *Morrissette*'s revocable trust with adequate and full consideration for her premium advances. Importantly, in that case, the insurance was placed for a valid nontax reason, that is, to ensure the successful transfer of the family's business interests to grandchildren.

Likewise, disposing of the IRS' argument in *Levine*, the full Tax Court opined that, if the IRS didn't like the outcome, it could rewrite the regulations to support the "gift at inception" position. The IRS has also contended that, if the policy is not fully guaranteed, the parties had no intention of maintaining the coverage to maturity. This position ignores the reality borne out by LIMRA sales statistics that fully guaranteed policies represent a fraction of annual permanent life insurance sales.[5]

TWO REGIMES

Pursuant to the *economic benefit regime* (EB regime) regulations, the insured advances the premiums, retains the right to recover from the cash values or the death benefit the greater of the premiums advanced or the cash values while the ILIT receives the excess death benefit. Each year there is an imputed transfer equal to the one-year term cost (the reportable economic benefit or REB) from the insured to the ILIT or the ILIT must pay the REB to the insured. Assuming that the ILIT is a fully GST tax-exempt trust, sooner or later the REB becomes excessive and either (1) the insured will run out of gift and/or GST tax exclusions to shelter the REB or (2) the ILIT will be paying excessive REB amounts to the insured (moving funds from a GST tax-exempt environment to an estate taxable one). An exit strategy is called for where the receivable will be rolled out to the ILIT, for example, by gift (if there are sufficient remaining GST exclusions) or sale (if there are not).

With a *loan regime* plan, the insured makes loans to the ILIT to fund the life insurance premiums, and the ILIT owns the policy outright subject to the loans. Loan interest at the appropriate applicable federal rate (AFR) must be either paid by the ILIT to the insured or accrued. Provided the ILIT is a grantor trust with respect to the insured, the interest is not taxable to the insured.

> **Whether an economic benefit or a loan regime split-dollar plan, there are important considerations when discounting a traditional non-GSD private split-dollar plan receivable.**

PROTECTING THE DISCOUNT – ECONOMIC BENEFIT REGIME PLANS

The EBR regulations provide that, a transfer of the receivable where the ILIT becomes "the owner… of the entire contract" is treated as a transfer of the entire life insurance contract.[6] For example, this could occur where the receivable was gifted to the ILIT that owns the policy. As a transfer of the entire contract, the value of the policy could be greater than the insured's interest in the receivable (the greater of the premiums advanced or the policy cash value) and, more importantly, no further discount based on the *Morrissette* and *Levine* cases would be available.

A transfer of the receivable to a new trust other than the ILIT that owns the policy will not be subject to this regulation, in effect protecting the discount of the receivable. As a practical matter, the new trust should be authorized to hold the split-dollar receivable and make imputed distributions to another trust. On death, the policy proceeds will be allocated among the two trusts in accordance with the split-dollar agreement.

Because the split-dollar agreement will continue between the two trusts, the REB will be (1) an imputed distribution from the new trust to the ILIT or (2) the ILIT must pay the REB to the new trust. To avoid GST tax inefficiencies, the new trust and the ILIT should each have the same GST characteristics, for example, both should be fully exempt from GST taxes or fully non-exempt. Assuming that the ILIT is a fully GST exempt trust, the insured should have sufficient GST exclusions equal to the value of the receivable to ensure that, when the receivable is gifted to the new trust, the fully GST exempt status of the new trust is maintained. Otherwise, the imputed distributions would taint the fully GST exempt status

of the ILIT or the ILIT would be distributing fully GST tax-exempt REB payments to the new trust that is not fully GST tax exempt. If there are insufficient GST tax exclusions to shelter the gift of the receivable, then a sale of the receivable (or a part gift/part sale) would be called for.

There is a risk that the IRS successfully asserts a higher value for the receivable, potentially tainting the GST exempt status of the new trust. Therefore, it may be desirable to switch to a loan regime plan prior to the transfer, allowing a transfer of the receivable to a trust for children thus limiting the valuation risk to gift taxes only.

PROTECTING THE DISCOUNT – LOAN REGIME PLANS

In the case of a loan regime plan, if the goal is to transfer the receivable at a discount, transferring the receivable to the ILIT that owns the policy is inadvisable. In valuing a note for gift tax purposes, there is authority that only the note transferred (subject to the split-dollar agreement) is valued. However, the IRS might argue that by transferring the receivable to the ILIT, the note should be appraised at full face value because in extinguishing the split-dollar loan, the ILIT has received the full value of the loan receivable. In fact, although *Morrissette* was an EB regime split-dollar plan, this extinguishment was one of the "bad facts" cited by the Tax Court in the holding.

When discounting, loan regime plans have an advantage over economic benefit plans. As discussed, an EB regime receivable must be transferred to a trust with the same GST characteristics as the ILIT. A loan receivable can be transferred to any trust or, in fact, to anyone. Therefore, even though the ILIT may be fully GST exempt, the receivable can be transferred to a separate trust that is a non-GST exempt trust for the benefit of children only or directly to adult children.

> **Therefore, for clients who have used all of their lifetime gift and GST tax exclusions, a loan regime plan is more attractive than an EB regime plan because, with accrued interest, there is no gift to the trust and, consequently, the receivable need not be transferred to a GST tax-exempt trust.**

Although the best outcome would result from transferring the loan receivable to a new fully GST tax-exempt dynasty trust, in many cases the insured may not have sufficient GST tax exemptions remaining. Consequently, the ability to transfer the receivable to children or a trust for their benefit is an attractive option. If a client has already used all of their gift and GST tax exclusions, gifting the receivable to a trust for the benefit of children only will trigger a gift tax but not a GST tax.[7]

LIFETIME TRANSFER OF THE RECEIVABLE

The existing GSD cases involved transfers of receivables at G1's death while the transfer of a non-GSD receivable by the insured takes place during the insured's lifetime. That distinction should not place the discount of a non-GSD receivable at risk. In the case of a policy that has been in force and subject to a split-dollar agreement for years, as discussed earlier, the IRS' "gift at inception" argument is without merit. Clearly the insurance was placed for nontax reasons, and the subsequent gift of the receivable can be justified in light of steadily increasing REBs or loan interest amounts and the impending sunset of available gift and GST exclusions.

The case of a currently implemented non-GSD split-dollar plan requires a more careful analysis. First, *Morrissette* and *Levine* were transfer-at-death cases (G1's death being an act of independent significance). For both, G1's death was imminent and expected and, in fact, G1 died shortly after implementing the plan. Mrs. Morrissette died within approximately three years of implementation while Mrs. Levine died within one-year of executing the ILIT and within five months of full funding of the life insurance via the split-dollar plan. For the new non-GSD split-dollar plan, the greater the time between implementation of the split-dollar plan and the transfer of the receivable, the better.

Second, the case for the transfer of the receivable can be bolstered to the extent that the transfer is triggered by an act of independent significance. That is, the lifetime transfer of the receivable is not being driven merely by the tax savings due to the discount. For example, as the insured ages, it can be desirable to stem the steadily increasing REBs or loan interest and the inefficient and increasing use of precious gift

and GST exclusions. This is especially important in the case of a survivorship policy on the death of one of the insureds or if there was a change in the tax law, for example, requiring the use of Table 2001 rates on single life EB regime plans. Other examples include the impending sunset of gift and GST tax exclusions or the marriage, change in health, birth or death of a beneficiary.

Finally, comparing to family limited partnership (and LLC) discount cases, many, if not the lion's share of transfers of family limited partnership interests, take place during the client's lifetime. By analogy, the discount of a non-GSD receivable transferred during the life of the insured should not be denied.

ADDITIONAL PLANNING POINTERS

The *Morrissette* and *Levine* cases introduced additional important planning pointers that can help support a discount on the transfer of a split-dollar receivable:

1. The ILIT trustee must unilaterally control all plan decisions, including the right to terminate the split-dollar agreement. The receivable holder can't hold any powers to modify or terminate the agreement unilaterally or participate in any decision with the trustee to do so. The ILIT may need to be modified in advance of the transfer of the receivable to a new trust.
2. The ILIT trustee holds all incidents of ownership in the policy.[8] The trust secures premium advances or loans with a restricted collateral assignment of the policy.
3. The trustee should be a truly independent trustee, that is, the trustee should not be a "related or subordinate party".[9] Institutional trustees are viewed favorably. Neither the insured nor a family member should serve as a trustee or co-trustee.[10]
4. Clients should engage highly qualified legal, tax, and insurance advisors who understand split-dollar plans as early in the planning process as possible.
5. In implementing a split-dollar plan, it is essential to strictly conform to the split-dollar regulations and to adhere to the formalities of the agreement in administering a split-dollar plan.
6. When the receivable is transferred, the arm's length nature of the transaction will be supported if the insured and the ILIT are each represented by independent counsel from different firms. A qualified valuation of the receivable from a professional appraiser is essential. A conservative valuation discount is advisable, for example, in the 30% to 60% range, with the understanding that, the higher the discount, the greater the likelihood that an IRS examination leads to an audit.
7. Document that the policy was originally purchased for legitimate nontax planning purposes and there was a clear intention to maintain the policy to maturity.
8. The policy should be designed to avoid classification as a modified endowment contract (MEC),[11] because the pledge or assignment of a MEC to secure a loan may be treated in each year as a taxable distribution to the extent of gain in the contract as it accrues.[12]
9. It's advisable to file a protective gift tax return on transfer of the receivable. Provided that the return adequately discloses the material elements of the transaction, the three-year gift tax statute of limitations will start to run. Although this may trigger an examination/audit, the exposure to audit is open-ended if a protective gift tax return isn't filed.
10. For an extra layer of protection, consider placing the receivable in an LLC and gifting interests in the LLC.
11. In the case of currently placed policies, best practice is to not to document discount discussions (unless protected by attorney client privilege) because the Service may take those discussions as evidence of a prearranged plan in support of its "gift at inception" argument.

AVOIDING UNFAVORABLE OUTCOMES

The IRS will continue to closely scrutinize the transfer of any split-dollar receivable. To support a discount, the unilateral control of the policy and the plan by an independent ILIT trustee is essential (it may be necessary to amend the split-dollar documents to give the trustee this unilateral power). The *Morrissette* and *Levine* cases emphasize the importance of careful planning and design, clear communication with the family, strict compliance with the split-dollar regulations, careful administration of the plan in accordance with the plan documents, and documentation of the nontax reasons for the life insurance and the parties' intention to maintain the coverage to maturity. Finally, the discount may place the estate in a better negotiating position with the IRS. For example, as reported in the Cahill[13] case, although the discount was denied on the split-dollar receivable, the estate came out ahead on the valuation of other assets.

1 This article specifically addresses split-dollar plans implemented under the current economic benefit regime regulations (Treas. Reg. Sec. 1.61-22) and loan regime regulations (Treas. Reg. Sec. 1.7872-15) applicable to split-dollar plans issued after September 17, 2003.

2 *Estate of Clara M. Morrissette vs. Comm'r*, TC Memo 2021-60 (May13, 2021) and Estate of Marion Levine vs. Comm'r, 158 T.C. No. 2 (Feb. 28, 2022)

3 Please note that in the discussions below, it is assumed that all trusts are grantor trusts with respect to the insured.

4 *Estate of Clara M. Morrissette vs. Comm.*, 146 TC No. 11 (April 13, 2016)

5 According to LIMRA's U.S. Individual Life Insurance Sales Survey (Years 2018 - 2022):
   1. Just over 4% of $15.6 billion of Indexed UL premiums funded lifetime guarantee policies.
   2. Just over 33% of $5.5 billion of fixed UL premiums funded lifetime guarantee policies.
   3. Combining these two market segments, just under 12% of $21 billion of premiums funded lifetime guarantee policies.

6 Treas. Reg. 1.61-22(c)(3)

7 A lifetime taxable gift of the receivable is more efficient than estate inclusion because estate inclusion is "tax inclusive" (that is, the estate tax is paid on the fair market value of the asset plus the value of funds used to pay the taxes) while the gift is "tax exclusive" (the funds used to pay the gift taxes are not subject to the gift taxes).

8 See Treas. Reg. § 20.2042-1(c).

9 Code Section 672(c).

10 Code Section 2042. In *Morrissette*, incidents of ownership were not an issue because each dynasty trust only held policies insuring the brothers of the trustee, not the trustee.

11 Internal Revenue Code Section 7702A was implemented to discourage the purchase of single premium and "short-pay" life insurance policies. If a life insurance policy fails the 7-pay test of IRC Section 7702A(b), it's classified as a modified endowment contract (MEC). Any distribution from a MEC is taxable to the extent that there's gain in the contract (policy cash value in excess of cost basis). This reverses the usual rule of the tax-free surrender of cash value to the extent of basis and tax-deferred policy loans. A 10% penalty may also apply. IRC Section 72.

12 IRC Sections 72(e)(4)(A)(ii) and (e)(10). On its face, this Code section clearly applies to a loan regime split-dollar plan. Although it's not clear that this IRC section is directed at an economic benefit split-dollar plan, best practice suggests assuming that it does apply, and MEC contracts are best avoided.

13 *Estate of Cahill vs. Comm.*, T.C. Memo 2018-84 (June 18, 2018).

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