Advanced Markets Blog

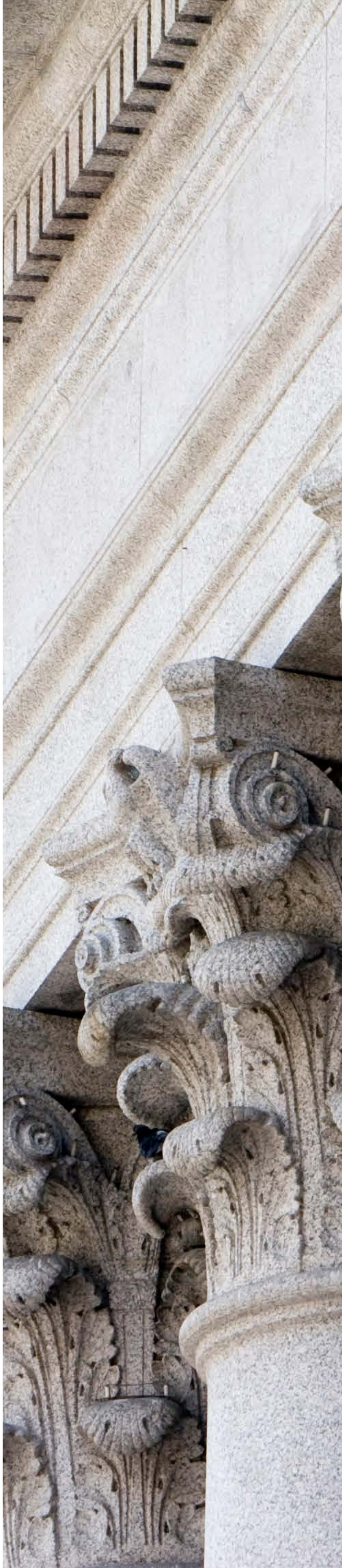
Intergenerational Split Dollar after *Levine v. Commissioner*

Estate planning for high-net-worth clients can often involve many different concepts and tools used to transfer wealth, family property and business interests. Intergenerational split dollar is one such concept to aid in these planning goals. In its simplest form, intergenerational split dollar uses available funding by a senior generation ("G1") to pay for life insurance on the next generation ("G2") for the benefit of future generations ("G3"). In essence, it is an economic benefit regime split dollar arrangement with the family serving as the bank, thereby funding premiums to the life insurance policy owner, typically an irrevocable life insurance trust ("ILIT"). The challenge in these cases centers on how the arrangement is treated for gift and estate tax purposes. These types of arrangements have been under heavy scrutiny by the IRS in recent years.

The *Levine* decision is the latest in a cohort of intergenerational split dollar case law, ultimately decided after several rounds of litigation and pronouncements dating back to 2016. In *Levine*, the Tax Court accepted the taxpayer's valuation of the estate receivable, without penalties – a clear win for the Taxpayers. But, similar to intergenerational split dollar cases before it, the favorable holding was a result of the specific facts of this case.

Case facts

- **G1 had personally built up two fortunes,** first a large chain of grocery stores and then (with the proceeds from the sale of the grocery chain) a broad portfolio of commercial real estate interests and investments.
- **G1 had two children** (collectively "G2") and **five grandchildren** (collectively "G3").
- **For most of her life,** G1 managed all her business and personal financial affairs herself. Over time, she developed a long-term business relationship with L, an accountant and trusted advisor.



Estate planning

- G1 began addressing her estate planning concerns in 1988 and as part of that planning created her Revocable Trust. Over the years, G1 transferred significant properties to her two children, some outright and some in trust, but always retained control of the majority of her wealth and maintained substantial personal income while alive.
- She also sought to provide for her five grandchildren and in 2007 sought out advice from legal counsel. As a result, counsel established Irrevocable Trust for the benefit of G2 and G3. Irrevocable Trust was administered by a trust company but its investments were directed by L, who served as the unrelated one-person investment committee.

The split dollar arrangement

G1's Revocable Trust and Irrevocable Trust entered into a split-dollar agreement that provided that:

1. **Irrevocable Trust** would purchase life insurance policies insuring selected lives of G2
2. **Revocable Trust** would pay the premiums on those policies; and
3. **Upon the death of the insureds (G2) or termination of the policies,** Revocable Trust would be entitled to payment in the amount of the greater of premiums paid or the aggregate cash surrender value of the policies.

Irrevocable Trust collaterally assigned the policies as security for Revocable Trust's payment. Only L, as investment committee of Irrevocable Trust, had the unilateral power to terminate the agreement and accelerate payment to Revocable Trust. G1 died in late January 2009 and her estate valued the receivable held by her Revocable Trust at approximately $2 million. The IRS audited and issued a notice of deficiency of slightly more than $3 million dollars and assessed "gross-undervaluation" penalties of 40%. G1's estate appealed to the Tax Court.

IRS argument and holding

In an opinion that relies heavily on the specific facts of this case, the Court found entirely for the taxpayers.

The IRS had argued that the transfer of $6.5 million to Irrevocable Trust to pay premiums was in essence a gift of the cash surrender value of the policies at the time of G1's death, which was $6.2 million. The IRS argued that because the Irrevocable Trust had the authority to terminate the policies at any time, the estate would have access to those surrender values. But the Court noted that if the Irrevocable Trust were to terminate the policies before the death of the insureds, it would receive nothing at all; and the only party with the authority to terminate the policies was L, who is bound by fiduciary duty to protect the interests of the beneficiaries which included both G2 and

G3. Instead, the Court held that the value of the receivable must be determined according to the split-dollar rules under Treasury Regulation §1.61-22.

The IRS also argued that the full lifetime value of the life insurance policies at the time of G1's death, viz., the cash surrender value, must be included in G1's estate under IRC §§2036 and/or 2038 because, it said, G1 retained rights and powers in those policies that trigger the inclusion of their value. However, G1's estate argued that these sections recapture value only if it is attributable to transferred property but G1 never transferred the policies and therefore could not have retained any powers with respect to them. The Court agreed; the Revocable Trust transferred nothing except cash and then only in return for the receivable. The policies were applied for by the Irrevocable Trust and were never owned by any other party.

The IRS pointed out that L also held a power of attorney for G1 and therefore L's actions must be attributable to G1, but the Court was not convinced. First, L was bound by his fiduciary duty to the beneficiaries of the Irrevocable Trust to take actions only in the interest of those beneficiaries. More importantly, the Court pointed out, the power of attorney does not give L power to do anything that G1 had no power to do.

Finally, the IRS argued that the full value of the policies at G1's death must be included in G1's estate under IRC §2703. This section requires certain rights and restrictions be disregarded when valuing transfer of property interests to related persons. However, the Court noted, G1 never owned or transferred the policies. The only thing includible in G1's estate with respect to the split-dollar arrangement was the future receivable owned by G1's Revocable Trust. It is important to note, that with respect to the valuation of this receivable, the IRS and G1's estate settled before trial that, if applicable, the value of that receivable was to be $2,282,195. Because the estate prevailed on all issues, the Court denied all accuracy-related penalties.

Takeaway

What does *Levine* teach us about intergenerational split dollar going forward? The *Levine* decision was based heavily on the specific facts of the underlying arrangement, so this outcome cannot be expected broadly over the myriad variations that such arrangements can manifest. In distinguishing *Morrissette* and *Cahill*, the Court pointed to the fact that the power to terminate the split-dollar agreement or any of the policies was held exclusively by an unrelated party that was also bound by fiduciary duty to beneficiaries of an irrevocable trust. Also, the valuation of the receivable in the estate of the first generation was the result of settlement among the parties and should not be interpreted as an endorsement of any valuation technique or expectation of discount. This case says only what it says, nothing more. While a favorable outcome for these taxpayers, given the complexity of these techniques, heavy IRS scrutiny and multitude of other factors that come into play, intergenerational split dollar should be approached with caution and through engaging experienced counsel.

For more information, please call Advanced Markets at 888-266-7498, option 3 AMC or option 4 Attorney

1. See *Est. of Levine v. Commissioner,* No. 13370-13., 158 T.C. No. 2, 2022 BL 65826, 2022 US Tax CT Lexis 12, February 28, 2022.

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