loan, (b) the total premiums paid, and (c) the cash surrender value of the policies. Any excess would be payable to the irrevocable trust. The estate and the IRS both agreed that all assets of the revocable trust on Richard Cahill's date of death were includible in his estate.

Each split-dollar agreement also contained provisions stating that said agreement could be terminated during Richard Cahill's life by written agreement between the trustees of the two trusts, and that the irrevocable trust was not permitted to transfer or cancel the related insurance policy without the consent of the revocable trust. Patrick Cahill, Richard Cahill's' son, was the trustee of the revocable trust, and William Cahill, Patrick Cahill's cousin and business partner, was trustee of the irrevocable trust. At this point, it is common to question why such termination provisions existed in the first place. It is possible, in this case, that the bank demanded such provisions in connection with making the $10 million loan, or that such provisions existed as a safety valve in case repayment of the $10 million loan was in jeopardy at the maturity date. While certainly not unilateral, the IRS posits that these "termination rights" constitute retained rights under 2036(a)(2) and 2038(a)(1).

The policies were purchased and the split-dollar agreements were executed in September 2010. Richard Cahill reported total gifts to the irrevocable trust for 2010 of $7,578, as determined under the economic benefit regime set forth in Section 1.61-22 of the Treasury's Income Tax Regulations. Mr. Cahill died in December 2011, at which time the estate declared a value of $183,700 for its rights in the split-dollar agreements.

IRS issued a notice of deficiency of $6.3 million and is assessing penalties for negligence or disregard of rules or regulations and gross valuation misstatements. The IRS notice adjusts the value of the estate's rights in the split-dollar agreements from $183,700 to $9.6 million. IRS' primary arguments are that (1) the decedent retained a right in conjunction with another person to terminate the split-dollar agreements, thereby designating who could possess or enjoy the assets, and (2) the irrevocable trust's ability to veto termination is a restriction that ought to be disregarded under Section 2703.

In Morrissette, another case involving split-dollar agreements, some of the same facts existed. The split-dollar agreements could be terminated upon the mutual agreement of the two parties to the agreement. Neither had the unilateral ability, but the two parties could mutually agree to terminate. IRS argued that the restriction on termination qualifies as a restriction that should be disregarded for valuation purposes under Section 2703, meaning that decedent should be treated as having ability to access the underlying policy value.

In both Cahill and Morrissette, petitioners' motions for summary judgement were denied, giving strong indication that the Tax Court may sustain IRS' arguments at trial.

Takeaways

The 2017 decision in Powell resurrected the arguments sustained in the 2003 Strangi[4] decision regarding retained rights. With developments in the Cahill and Morrissette cases in 2018, not only is it clear that split-dollar arrangements are under the microscope, but there seems to be a renewed effort by the IRS to use 2036(a)(2) and 2038(a)(1) to include previously gifted assets in a decedent's gross estate on account of retained rights, even when such rights are not held unilaterally. We further understand that similar arguments are being made in a third split-dollar case, which is said to have better facts from the taxpayer's point of view and may go to trial later this year.

The issue of retained rights should be at the forefront of planners' minds as they draft entity agreements or deal with pre-existing agreements. For instance, it is common for operating agreements to allow all owners to vote when it comes to major decisions such as asset sales, termination and liquidation. Might such provisions cause estate tax inclusion within the context of a 2036(a)(2) or 2038(a)(1) challenge? Portions of the Internal Revenue Code that are relevant to this discussion are as follows:

26 U.S. Code § 2036 - Transfers with retained life estate

(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—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(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.

26 U.S. Code § 2038 – Revocable transfers

(a) In general, the value of the gross estate shall include the value of all property:

(1) Transfers after June 22, 1936

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, where the enjoyment thereof

4 T.C. Memo. 2003-145. Estate of Albert Strangi, Deceased, Rosalie Gulig, Independent Executrix, Petitioner v. Commissioner of Internal Revenue, Respondent.

> *was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death.*

Since the recent developments constitute denials for partial summary judgement, we will have to wait for final opinions from the Tax Court. In the interim, it is safe to say that the IRS is actively engaged in identifying transactions that it perceives are aggressive and using all possible tools of the Code and Regulations to thwart them. Practitioners and their clients should always be concerned with the optics of a transaction. To state the obvious, death bed planning and combined strategies that may have the appearance of a step transaction should be avoided, and ownership arrangements must have a legitimate and significant nontax reason. A simple solution to Section 2036 and 2038 inclusion would be to ensure that the transferor does not retain any rights whatsoever.

In addition, practitioners and taxpayers should seek to ensure that an inter vivos transfer meets the bona fide sale exception to Sections 2036 and 2038 so that the "in conjunction with" rule does not apply. When closely held assets and partnership interests are involved, taxpayers are wise to meet the bona fide sale exception by obtaining a qualified business appraisal from a widely recognized firm such as MPI that regularly prepares appraisals for this purpose.

More Information

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