Morrissette: Tax Court Clarifies Treatment of Split-dollar Life Insurance Arrangements

In April 2016, the Tax Court entered a summary judgment on Estate of Clara M. Morrissette v. Commissioner of Internal Revenue. The case centered on two split-dollar life insurance arrangements entered into by the decedent's revocable trust and three distinct trusts in 2006. The revocable trust contributed $29.9 million to the trusts. The trusts used these funds to purchase life insurance policies covering the decedent's three sons. In 2013, the IRS issued a notice of deficiency against the estate in the amount of $13,800,179 plus a penalty of $2,760,036.[1] The IRS characterized the $29.9 million contribution as a taxable gift, and classified the split-dollar life insurance arrangements as loans.[2] The estate challenged this classification, arguing that the arrangements should be governed by the so-called "economic benefit" regime.[3] The Tax Court agreed with the estate, issuing a partial summary judgment under Rule 121(a) of the Tax Court Rules of Practice and Procedure that the economic benefit regime applies to the split-dollar arrangements in this case.

By way of background, the decedent's husband founded Ace Van & Storage, a moving company, in 1943. The Morrissette family subsequently acquired or founded ten additional companies, collectively with Ace Van & Storage known as the Interstate Group. All of these entities had identical ownership. In 2009, all shareholders of the Interstate Group companies contributed their shares to Interstate Group Holdings, Inc. (IGH), and received IGH stock in return. Mrs. Morrissette contributed all of her shares in IGH to her revocable trust (known as the CMM Trust). Her three children (Arthur E. Morrissette, Jr., Donald J. Morrissette and Kenneth Morrissette) were named successor cotrustees of the CMM Trust in 2006. Mrs. Morrissette was 93 years old at this point.

Three perpetual trusts were established by Mrs. Morrissette. Each of these trusts, known collectively as the Dynasty Trusts, was set up for the benefit of one of Mrs. Morrissette's three children. As discussed in the Tax Court decision, the CMM Trust was amended on September 19, 2006 to allow the trustee to "enter into split-dollar life insurance agreements" as well as "pay premiums on life insurance policies…" Two days later, the shareholders of the Interstate Group entered into a shareholders agreement that stated that, upon the death of any of Mrs. Morrissette's three children, the two surviving siblings and their respective Dynasty Trusts would purchase equal amounts of the deceased child's stock in the Interstate Group.

Each of the Dynasty Trusts purchased two universal life insurance policies, one to cover the life of each other brother. The intention of these policies was to allow the Dynasty Trusts to have sufficient funds to

---

1. IRC Section 6662.
2. Treasury Regulation Section 1.7872-15(a)(2)(i)
3. Treasury Regulation Section 1.61-22.

fulfill the aforementioned provision in the shareholders agreement requiring the purchase of a deceased sibling's Interstate Group stock. This led to the formation of the split-dollar life insurance arrangements that are the topic of the case, on October 31, 2006. The CMM Trust contributed approximately $10 million to each of the Dynasty Trusts. The Dynasty Trusts used the funds to pay lump-sum premiums on the policies, funding terms that correlated with the life expectancies of the named insured. Upon the death of the insured, the arrangements called for the CMM Trust to receive the greater of the cash surrender value (CSV) of the policy, or the aggregate premium payments on that policy. Any remaining proceeds from the death benefits would go to the Dynasty Trust, which could be used to purchase the deceased's stock in Interstate Group. Any termination of the arrangements prior to the insured's death would entitle the CMM Trust to receive the greater of the total amount of premiums paid, or the CSV. No proceeds would be paid to the Dynasty Trust under this scenario.

Importantly, the split-dollar life insurance arrangements included the following (as excerpted from the Tax Court decision): "WHEREAS, the parties intend that this Agreement be taxed under the economic benefit regime of the Split-Dollar Final Regulations, and that the only economic benefit provided to the [Dynasty] Trust[s] under this arrangement is current life insurance protection." The parties (Dynasty Trusts and the CMM Trust) were not permitted to borrow against a policy. The economic benefit regime is one of two mutually exclusive regimes governing the taxation of split-dollar life insurance policies, as outlined in the IRS's final regulations issued in September 2003. These regulations govern the split-dollar arrangements at hand.

The determination of whether a split-dollar arrangement falls under the economic benefit regime or the loan regime relies on which party is determined to own the subject life insurance policy. According to Treasury Regulation Section 1.61-22(c)(1), the person named as the owner in an insurance contract is treated as its owner, and a non-owner is any other person who has a direct or indirect interest. This language suggests that the loan regime would apply, as the Dynasty Trusts would be the owners of policies in question. In effect, the CMM Trust would be seen as lending the Dynasty Trusts the premiums to fund the life insurance policies. However, the regulations provide an exception whereas the economic benefit regime will apply if it is determined that the only economic benefit provided under the split-dollar arrangement is current life insurance protection. The donor (in this case, the CMM Trust) is the deemed owner of the life insurance contract under this scenario, regardless of the named owner of the policy. If the donees (the Dynasty Trusts) receive any economic benefit other than current life insurance protection, then the loan regime applies.

The Tax Court opinion cites an example from the preamble to the final regulations that includes similar characteristics as the split-dollar arrangements in this case. This example makes a distinction between a donor who is entitled to the greater of the premiums paid into the policy or the CSV, versus a donor who receives the lesser of these two values.[4] Under the former scenario, the donee has no ability to receive an economic benefit beyond the cost of current life insurance protection.

[4] T.D. 9092, Sec.5

The economic benefit regime applies when an owner of a policy provides the following annual benefits to the non-owner, reduced by any amounts the non-owner pays for such benefits: the cost of current life insurance protection, the amount of cash value to which the non-owner has current access during the year and any economic benefits not otherwise described.[5] The IRS explains that the amount of current life insurance protection is the death benefit of the contract reduced by the sum of the amount payable to the owner plus the portion of the cash value taxable to (or paid by) the non-owner. The subject arrangements were structured such that the CMM Trust (the non-owner) provides the benefit of current life insurance protection to the Dynasty Trusts (the owners). As for the determination of cash value to which the non-owner has current access, the regulations state that if the Dynasty Trusts have current access to any portion of the policies' cash values, then the special ownership rule designating the economic benefit regime does not apply. The subject arrangements call for the entire CSV of the policies to be paid to the CMM Trust upon termination of the arrangements, or, upon death of the insured, the Dynasty Trusts are entitled to receive only the portion of the death benefit that exceeds the amount due to the CMM Trust (which, as noted, is the greater of the CSV or the aggregate premium payments). The Tax Court concluded that the Dynasty Trusts lacked current access due to their lack of current or future rights to any part of the policy cash values.

The IRS attempted to challenge the current access point by arguing that a 2006 amendment to the CMM Trust calls for this trust's interests in the cash values of the policies to pass to the Dynasty Trusts or directly to Mrs. Morrissette's sons or their heirs upon her death. However, the CMM Trust is a revocable trust, meaning Mrs. Morrissette retained the ability to alter its terms during her lifetime. In addition, there was no requirement in the split-dollar arrangements for the CMM Trust to distribute the subject receivables. The Tax Court's opinion is that the amendment in question did not provide any direct or indirect right for the Dynasty Trusts to obtain the cash values of the policies.

With regard to any other economic benefits beyond that of current life insurance protection, the IRS argued that Notice 2002-59 applies, which discussed so-called "reverse" split-dollar arrangements. In some cases, the party holding a right to current life insurance protection uses various techniques to provide additional benefits to another party, such as using artificially inflated rates or prepaying premiums. The Tax Court concluded that the subject arrangements were entirely dissimilar from the examples provides in Notice 2002-59. Another argument from the IRS is that prepaid premiums pay for not just current protection, but also future protection (requiring taxation under the loan regime) was dispatched by the Tax Court by noting that the Dynasty Trusts are not compelled to pay any portion of the premiums. The CMM Trust is responsible for all premiums, regardless of the timing of when the premiums are paid.

MPI Commentary:

This case was not decided based on the merits of valuation techniques applied to split-dollar life insurance receivables, but rather on the legal matter of whether the subject arrangements were eligible to be taxed under the economic benefit regime. In fact, the Tax Court noted that Mrs. Morrissette's estate hired a

[5] Treasury Regulation Section 1.61-22(d)(1).

third party firm to value the receivables relating to the split-dollar arrangements that were includable in the estate, but did not render an opinion as to the validity or reasonableness of the approach taken by this firm. Nevertheless, there are important implications for the estate planning community. The tax treatment of a split-dollar arrangement classified under the economic benefit regime may be more favorable to achieve certain objectives. The wording and structure of split-dollar life insurance arrangements are critical to ensure that the desired tax treatment is gained.

Although the Morrissette case did not directly address the valuation of split-dollar life insurance arrangements, it is important to have a qualified appraiser conduct an analysis of receivables related to these arrangements. Such independent conclusions of value provide critical support in the event of an IRS challenge. MPI has experience performing valuations of split-dollar life insurance receivables. We are prepared to defend our results in discussions with the IRS and in Tax Court, if necessary. Please contact us to discuss how we can help you and your clients meet your valuation needs.

More Information

For more information or specific questions on this case, please contact the author, whose contact information follows:

Joseph C. Hassan, CFA, ASA
(609) 955-5725
jhassan@mpival.com

About MPI

MPI is a business valuation and advisory firm that was founded in 1939. MPI provides business valuation and advisory services primarily to closely held companies and partnerships for a variety of purposes including estate and gift tax, income tax, charitable contributions, litigation support, buy-sell agreements, ESOPs, and exit planning. MPI provides fairness opinions, sell-side and buy-side advisory services, intangible asset valuation, purchase price allocations, goodwill impairment testing, valuations for equity-based incentive plans, and blockage and restricted stock studies. MPI conducts every project as if it is going to face the highest level of scrutiny, and its senior professionals have extensive experience presenting and defending work product in front of financial statement auditors, management teams, corporate boards and fiduciaries, the IRS, other government agencies, and in various courts.