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Taxpayer Wins Big on Insurance Valuation in Estate of Levine

The court discounted an ILIT's $6.5 million receivable by a whopping 65%.

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On Feb. 28, the Tax Court issued its long-awaited decision in *Estate of Marion Levine v. Commissioner* (158 T.C. No. 2), the latest in an ongoing saga of Internal Revenue Service challenges in intergenerational split-dollar cases. The result of the case was that a $6.5 million receivable (the $6.5 million amount refers to the premiums paid. This sum paid the upfront premiums for two separate policies with a total face value of approximately $17.25 million) was discounted to $2,282,195 – a discount of 65%! The parties stipulated that the receivable could

be valued at $2,282,195 – if the taxpayer prevailed on the IRS' changes on Internal Revenue Code Sections 2036, 2038 and 2703.

Background

Here's what happened in *Levine*:

- First, Marion created an irrevocable life insurance trust (ILIT) to own two life insurance policies. The ILIT was signed by Marion's children and a business associate, all as attorneys-in-fact, and had a trust company as an independent trustee.
- The ILIT also had an investment committee in the form of a single individual, the same business associate who signed the ILIT, along with the children. The court found that this committee had a fiduciary duty to direct the ILIT's investments prudently.
- To pay the $6.5 million upfront premiums to purchase the two insurance policies, the ILIT borrowed most of through a split-dollar agreement.
- Under the split-dollar agreements:
    - The ILIT agreed to buy the policies.
    - Marion's also had a revocable trust, which agreed to pay the premiums on the policies (borrowed the money to pay the premiums).
    - The ILIT agreed to assign the policies to the revocable trust as collateral.
    - The ILIT agreed to pay the revocable trust back for its investment – the greater of: (1) premiums paid, or (2) the cash surrender values (CSVs) of the policies either on the death of the insureds or at the date of termination, if the arrangement was terminated prior to maturity.
- Finally, only the ILIT had the right to terminate the arrangements and surrender the policies. This court viewed this last point is viewed as especially important.

Issues Before Tax Court

The preceding steps all took place towards the end of 2008. After Marion's death, on Jan. 22, 2009, the IRS challenged her estate tax return and eventually issued a notice of deficiency for a little more than $3 million, plus penalties based on the difference between the value of the receivable listed the estate tax return and the $6.5 million. After stipulations, the Tax Court had to decide the value of the split-dollar receivable in the estate and what the penalties should be if any undervaluation was found. To do this, the court had to decide:

- Does Treasury Regulations Section 1.61-22 govern the estate tax consequences here? And if not:
- What was the nature of the decedent's ownership interest, as created by the split-dollar transaction?
- Does IRC Section 2036 or 2038 require inclusion of the policies' CSVs in the gross estate?

- Does IRC Section 2703 and its valuation rules apply to the estate's property interest and, if so, how does that impact the value of the interest?

Tax Court's Decision

The court's decision provides a clean sweep for the estate, leaving it without a significant deficiency and no penalties.

1. The court held that Treas. Regs. Section 1.61-22 only governs the gift tax consequences of the transaction and doesn't help the IRS with the estate tax issue.
2. On the issue of what property was transferred, the court held that the property "at issue cannot be the life-insurance policies, as these policies have always been owned by the insurance trust." However, the transferred property also can't be the receivable itself because this asset belonged first to the revocable trust and then to the estate.
3. So what rights were retained? The court found that Marion retained the split-dollar receivable, and nothing else. The court also found that holding this receivable didn't give Marion a right to the CSVs of the policies – only to wait until termination or maturity of the policies and then collect the $6.5 million or the CSV.

Other Cases Distinguished

On this last point, the court found a very significant difference between *Levine* on one hand and *Cahill* and *Morrissette* on the other:

- In *Estate of Morrissette v. Comm'r*, the donor and donee could mutually agree to terminate the agreement.
- In *Estate of Cahill*, the agreement could be terminated only by written agreement of donor and donee, acting unanimously.
- In contrast, in *Levine*, the ILIT, by its investment committee, had the sole right to terminate the arrangement.

The court held that without "any contractual right to terminate the policies, we can't say that Levine had any sort of possession or rights to their cash-surrender values."

Ability to Surrender Policies

The IRS also argued that Marion stood on both sides of these transactions and therefore could unwind the arrangements at will. The attorneys-in-fact, who were trustees of the ILIT, held power over the revocable trust, agreed the court. However, the ILIT had an independent trustee, and the trustee was directed by the investment committee – which was just one of the

trustees of the revocable trust. The court found that the investment committee's sole member had a fiduciary duty to the beneficiaries of the ILIT (which included Marion's grandchildren) that would have prevented him from surrendering the policies.

Therefore, the ability to surrender the policies for their CSV couldn't be characterized as a right retained by Marion, and the IRS' efforts to gain Section 2036 inclusion of the policies in the estate failed. Their arguments for inclusion under Section 2038 failed for the same reasons.

Section 2703 Not Applicable

Finally, the IRS argued that the split-dollar arrangement was Marion's way of placing a restriction on her right to control the $6.5 million in cash paid for the policies and, thus, to reduce its value. By disregarding this restriction according to the valuation rules of Section 2703, the IRS also arrived as its preferred value without any discounts.

The court held that the reference to "any property" in Section 2703 refers to the property of an estate, not some other entity's property. And because the property in *Levine* is the receivable – not the policies – Section 2703 doesn't help the IRS. Because there were no restrictions on the split-dollar receivable (Marion could have sold it or done anything she wished with it), there were no restrictions to disregard.