WEALTH PLANNING>ESTATE PLANNING

Cahill Ruling Makes Split-Dollar Arrangements Less Attractive

Tax Court denies summary judgment to estate after value adjusted from $183,700 to over $9.6 million.

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In the *Estate of Richard E. Cahill, et al. v. Commissioner*, the Tax Court denied partial summary judgment to an estate that contested a deficiency notice in which the Internal Revenue Service adjusted the value of the decedent's rights in three split-dollar life insurance arrangements from $183,700 to more than $9.61 million. The court declined to grant partial summary judgment on the estate's arguments that Internal Revenue Code Sections 2036, 2038 and 2703 didn't apply to the split-dollar arrangement and that Treasury Regulations Section 1.61-22 did apply in valuing the decedent's interest in the split-dollar arrangements for estate tax purposes. The court's decision will make the use of split-dollar policies less attractive as a way to shift wealth from one generation to the next and potentially may impact other estate planning vehicles.

Creation of Split-Dollar Insurance Agreements

In 2010, when Richard Cahill was 90 years old and no longer able to manage his own affairs, his son, Patrick, entered into three split-dollar insurance agreements on his behalf. Richard lived in California at the time of his death in December 2011. Patrick, a Washington state resident, served as executor of the estate.

The decedent had been the settlor of two trusts—the revocable Richard F. Cahill Survivor Trust and the irrevocable Morris Brown Trust. Patrick was trustee of the Survivor Trust and was his father's attorney-in-fact under California law. Patrick's cousin, William Cahill, was trustee of the MB Trust, and the primary beneficiaries of that trust were Patrick and his issue. The MB Trust was formed on Sept. 9, 2010 to take legal ownership of three whole life policies, two insuring the life of Patrick's wife and one insuring Patrick's life. Lump sum premiums for the three policies totaled $10 million; each policy guaranteed a minimum 3 percent return of the invested portion of the premium.

Patrick, as trustee of the Survivor Trust, and William, as trustee of the MB Trust, executed three split-dollar agreements to fund the acquisition of the three life insurance policies. These agreements provided that the Survivor Trust would pay the premiums; the Survivor Trust did so by taking a $10 million loan from an unrelated third party. The obligors on this loan were Richard (with Patrick as his attorney-in-fact) and Patrick as trustee of the Survivor Trust.

As a general matter, the estate's involvement in the three split-dollar life insurance arrangements occurred solely through the Survivor Trust, directed by Patrick. Both the estate and the IRS agreed that all assets in the Survivor Trust on the decedent's date of death were includible in the gross estate.

Provisions of Agreements

Each of the split-dollar agreements provided that when the insured died, the Survivor Trust would receive a portion of the death benefit equal to whichever of the following is greatest (referred to as the decedent's death benefit rights): (1) the remaining balance of the loan; (2) the total premiums the Survivor Trust paid on the policy; or (3) the cash surrender value of the policy immediately before the insured's death. The MB Trust would retain any excess of the death benefit (referred to as the MB Trust's death benefit rights).

Each split-dollar agreement could be terminated during the insured's life if the trustees of the Survivor Trust and the MB Trust agreed in writing. If one of the agreements terminated, the MB Trust could opt to retain the policy or transfer its interest in the policy to a third-party lender (referred to as "termination rights"). The MB Trust couldn't sell, assign, transfer, borrow against, surrender or cancel a relevant policy without the Survivor Trust's consent.

Deficiency Notice

In 2010, the year before he died, the Bill reported $7,578 in gifts to the MB Trust, based on a determination under the economic benefit regime pursuant to Treas. Regs. Section 1.61-22. Following his death, the decedent's estate reported the value of his rights in the split-dollar arrangements totaling $183,700. As of the date of death, the cash surrender value of the

policies exceeded $9.61 million. In its deficiency notice, the IRS adjusted the total value of the decedent's rights in the split-dollar agreements from the reported $183,700 to the aggregate cash surrender value, determining a deficiency of more than $6.82 million plus penalties for negligence and gross valuation misstatements.

Estate's Arguments

The estate argued that because (1) the decedent's right to terminate the split-dollar agreements was held in conjunction with the trustee of the MB Trust; and (2) it would never make economic sense for the MB Trust to allow the split-dollar agreements to terminate as that termination was so unlikely because as of the date of the decedent's death, the termination rights had no value. This meant, the estate asserted, that the value of the decedent's interest in the split-dollar agreements was limited to the value of the decedent's death benefit rights, which were only $183,700 on his date of death because the insureds (Patrick and his wife) were projected to live for many more years, and therefore, the decedent's rights had only a small present value.

In addition to arguing that the total value of the decedent's rights in the split-dollar agreements exceeded $9.61 million, the IRS presented theories in the alternative under IRC Sections 2036(a)(2), 2038(a)(1), and 2703(a)(1) and (2). The estate sought summary judgment on these issues, applying Treas. Regs. Section 1.61-22.

Sections 2036(a)(2) and 2038(a)(1)

The IRS and the estate disagreed over the cash surrender component of the policies, with the estate asserting that Sections 2036(a)(2) and 2038(a)(1) didn't apply to include the cash surrender value in the gross estate because the decedent retained no rights with respect to the amounts transferred sufficient to justify applying these IRC sections.

The court found, however, that "the rights to terminate and recover at least the cash surrender value were clearly rights, held in conjunction with another person (MB Trust), both to designate the persons who would possess or enjoy the transferred property under section 2036(a)(2) and to alter, amend, revoke, or terminate the transfer under section 2038(a)(1)." The court rejected the estate's contention that the decedent's right to terminate was negated by the fact that the MB Trust could prevent the decedent from terminating the split-dollar agreements, noting that this reasoning would mean that the words "in conjunction with any person" in Section 2036(a)(2), and "in conjunction with any other person" in Section 2038(a)(1), would have no meaning. The court cited to the recently issued *Estate of Powell v. Comm'r* from May 18, 2017, which applied Section 2036(a)(2) with respect to that decedent's limited partnership interests in a family limited partnership and cited to the *Estate of Strangi v. Comm'r*. The court rejected the estate's argument that for Section 2036(a)(2) to be applicable, the decedent would need complete control, indicating that the language of the statue doesn't require unilateral control under the statute or case law.

Section 2703

The IRS argued in the alternative that the MB Trust's ability to veto termination of the split-dollar agreements should be disregarded under Section 2703(a)(1) or (2) for purposes of valuing the decedent's rights in those agreements. The court declined to grant the estate's summary judgment motion on this issue as well.

The court found as lacking merit the estate's suggestion that the IRS was attempting to ignore the split-dollar arrangement and treat the policies themselves as assets of the decedent so as to look through the split-dollar arrangement to the underlying insurance policies. The court clarified that both parties agreed that the decedent's rights under the split-dollar arrangement were the interests being considered and concluded that the ability of the trustee of the MB Trust to restrict the decedent's access to the cash value of the policies by way of his termination right was a restriction that was subject to Section 2703 as "agreements to acquire or use property at a price less than fair market value."

The court concluded that under Section 2703(a)(1), the split-dollar agreements, particularly the provisions that prevented the decedent from withdrawing his investment, constituted agreements to acquire or use property at a price below fair market value. Further, the court noted that, under Section 2703(a)(2), the MB Trust's ability to prevent termination significantly restricts the decedent's right to use the termination rights. The court found that the split-dollar agreements "clearly restrict decedent's right to terminate the agreements and withdraw his investment from the arrangements." Concluding that the requirements of Sections 2703(a)(1) and (2) were each met, the court denied the estate's summary judgment motion with respect to Section 2703(a).

Treas. Regs. Section 1.61-22

The estate sought summary judgment arguing that, under Treas. Regs. Section 1.61-22, the economic benefit regime applies to the split-dollar agreements. But the court concurred with the IRS observation that these are gift tax rules, not directly applicable to estate tax. The court rejected the estate's contention that it "should modify the approach required by sections 2036, 2038 and 2703 so as to avoid inconsistency between these statutes and the regulations," finding no inconsistency between the estate tax statutes and Treas. Regs. Section 1.61-22.

Implications

Although this case only denies the estate partial summary judgment regarding the IRS' arguments under Sections 2036, 2038 and 2703, it does lay out the framework that the court will probably use in ultimately determining that the cash surrender value of the policies at the time of the decedent's death will be includible in the decedent's estate. This conclusion will certainly make the use of split-dollar policies less attractive as a way to shift wealth from one generation to the next. One might also determine that this is a bad facts case because of the deathbed planning involved and the fact that Patrick, the decedent's attorney-in-fact, essentially effectuated the creation of the MB Trust and the execution of the split-dollar life

insurance arrangements within a year of the decedent's death (that is, the decedent stood on both sides of the transaction).

As we saw in *Powell*, the court again determines that the mere ability of the decedent, in conjunction with others, to determine who will possess or enjoy the property or income from the property will trigger estate tax inclusion under Section 2036(a)(2). The court went further to state similar language in Section 2038(a)(1) that would have the same result. The court's growing willingness to use these provisions to affect estate tax inclusion should serve as a further cautionary note to estate advisors to be careful about the rights retained by a transferor of property—especially with regard to rights in entities wherein some control, however minute, is retained. The *Cahill* opinion however suggests that the reach of Section 2036(a)(2) isn't limited to family entities such as family limited partnerships, but rather, can be applicable to other types of arrangements.

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