

GENERATIONAL SPLIT DOLLAR LESSONS LEARNED

Generational split dollar can be a powerful planning tool when it is implemented responsibly, for the right taxpayer, and for the right reasons. This article relates lessons learned from three notable cases — Levine, Cahill, and Morrisette — exploring best practices and points of contention with the IRS.

Generational split dollar (GSD) is a variation on split dollar where the older generation (G1), typically a parent, funds a life insurance policy held in trust insuring a younger generation (G2), typically children, for the benefit of grandchildren and, optionally, future generations (G3+). On its face, GSD is not controversial. However, practitioners have used this as a means of discounting G1's split dollar receivable for gift or estate tax purposes drawing the attention of the IRS. In the three cases available to us, Cahill¹, Morrisette², and Levine³, taxpayers have failed or succeeded in varying degrees and in a variety of ways. Numerous articles have explored the fact patterns and holdings in these cases. In the present instance, we will instead focus on the key takeaways and best practices that can be gleaned from a close reading of those cases.

THE FUNDAMENTALS

WHAT IS SPLIT DOLLAR?

Split dollar is a means of paying premiums on a life insurance policy owned by a third party. In the estate planning context, it is referred to as “private split dollar” and typically involves an irrevocable life insurance trust (ILIT) as legal owner of the policy with the grantor advancing or loaning the premiums to the ILIT. The final split dollar regulations, apply to split dollar arrangements entered into or materially modified after September 17, 2003. They create two mutually exclusive regimes: the economic benefit regime⁴ and the loan regime⁵.

ECONOMIC BENEFIT REGIME

In an economic benefit regime split dollar arrangement, the grantor (or their proxy) will advance premiums to an ILIT for the purpose of purchasing life insurance in exchange for a receivable that provides the grantor with the right to receive the greater of the premiums advanced or policy cash value upon termination of the

¹ Estate of Cahill v. Commissioner (T.C. Memo. 2018-84)

² Estate of Morrisette v. Commissioner (T.C. Memo. 2021-60)

³ Estate of Levine v. Comm'r of Internal Revenue, No. 13370-13 (U.S.T.C. Feb. 28, 2022)

⁴ Treas. Reg. §§ 1.61-22

⁵ Treas. Reg. §§ 1.7872-15

plan or the death of the insured. This receivable is secured by the policy's cash value and death benefit. The ILIT has the right to name the beneficiary for all or a portion of the death benefit in excess of the grantor's interest.

Of course, there is a cost associated with the right to name the beneficiary. Each year, the reportable economic benefit (REB) is either paid by the ILIT to the grantor or imputed as a gift from the grantor to the ILIT. The REB is calculated annually based on the appropriate term insurance rate per thousand as applied to the death benefit protection provided to the ILIT. Note that the REB continues as long as the split dollar arrangement is in place, even after premiums are no longer being paid on the policy.

LOAN REGIME

Loan regime split dollar is similar to many leveraged transactions with which taxpayers may have previous experience. Like the economic benefit regime, the grantor lends premiums to an ILIT to purchase a life insurance policy. In accordance with the loan regime regulations, these loans are secured by the life insurance policy's cash surrender value, death benefit, or both. The interest rate charged will not be less than the applicable federal rate (AFR) in the month of each premium loan and based upon the duration of the loan term. The grantor retains a note, the face amount of which is the gross loan value plus any accrued interest. Any "equity" that is earned on the policy's cash values and death benefit in excess of the face amount of the note are the property of the ILIT. Although all of the litigated GSD cases before us were designed as economic benefit regime arrangements, there are a number of reasons discussed below why loan regime should be considered.

GENERATIONAL SPLIT DOLLAR (GSD)

GSD is a variation on private split dollar. Traditionally, the grantor, premium advancer/lender, and insured are the same person⁶. In a GSD plan, the premium advancer/lender is the wealthy parent (G1). In GSD's most common iteration, G1 advances or lends premiums to the ILIT to insure their children (G2) for the ultimate benefit of grandchildren and more remote generations (G3).

On its face, this is not much different than a traditional private split dollar arrangement. The key difference is that the grantor/premium advancer/lender is *not* also

the insured. When the grantor passes, no death benefit is paid, and the receivable is an asset of their estate and must be valued. The value of the receivable is substantially less than the face amount of the receivable because it will not be paid until the death of G2.

In the past, all of the reported GSD cases utilized the economic benefit regime and would claim that under the right circumstances, the receivable could be discounted by as much as 98%. Unsurprisingly, taxpayers who engaged in GSD were (and are) frequently audited, resulting in the cohort of cases that form the basis our analysis.

It is vital to note that our observations are based on the information currently available to us. Although the Levine case is viewed as a rousing success for taxpayers engaged in GSD planning, we must not assume that the IRS will abandon its pursuit of these plans. It is possible that the IRS may devise new challenges to GSD plans in addition to gift and estate tax challenges we have experienced thus far.

With that in mind, it is critical that the taxpayer engage experienced and competent legal counsel, tax advisors, life insurance professionals, and qualified appraisers who are intimately familiar with the GSD strategy.

BEST PRACTICES AND SUGGESTIONS:

While the underlying facts may differ, in the Cahill, Morrisette, and Levine cases, the IRS was fairly consistent in its manner of attack when challenging GSD plans. These challenges were brought under Internal Revenue Code sections 2036, 2038, and 2703.

- IRC Sec. 2036: This code section will include in the decedent's estate the value of any property transferred during life, over which the decedent continued to maintain a right, alone or in conjunction with another person, to designate the person(s) who would possess the enjoyment of the property, or the income derived from it. Critically, there is an exception for transfers constituting a bona fide sale for adequate and full consideration in money or money's worth.
- IRC Sec. 2038: This code section will include in the decedent's estate the value of any property transferred during life, over which the decedent maintained a right, alone or in conjunction with another person, to alter, amend, revoke, or terminate the enjoyment

⁶ The premium payor may be a proxy, such as a corporation, acting on behalf of the insured.

of said property. Similar to 2036, there is a bona fide sale exception.

- IRC Sec. 2703: this code section provides special valuation rules that provide:
 - “...the value of any property shall be determined without regard to – (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property.”
 - Importantly, IRC Sec. 2703(b) provides an exception for “any option, agreement, right, or restriction which meets each of the following requirements: (1) It is a bona fide business arrangement; (2) It is not a device to transfer such property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth; (3) Its terms are comparable to similar arrangements entered into by persons in an arm’s length transaction.”

Levine and Morrisette (particularly when contrasted with Cahill) provide us with a roadmap for navigating the known pitfalls of GSD planning.

GENERAL PRACTICE MANAGEMENT

One of the simplest and most effective decisions that a taxpayer can make when implementing a GSD plan is to seek legal and tax advice as early as possible. The court in Levine went to great lengths to highlight how impressed they were with the efforts of the family’s estate planning counsel, who prepared PowerPoint presentations and sent letters describing the GSD transaction and its mechanics, documenting pros and cons of GSD plans, as well as all conditions and qualifiers. He also engaged the family in all planning decisions. Importantly, the planning considered the taxpayer’s assets and income needs, and only planned with excess capital not needed to support Mrs. Levine’s lifestyle. The importance of a clean file and an informed family that observed the formalities of the plan cannot be overstated.

Similarly, when reviewing the cohort of GSD cases, a valid and long-term need for the life insurance is critical. In both Cahill and Morrisette, the court was convinced that there was no long-term intent to maintain the life

insurance policies, and as a result, the discount granted was either zero or negligible. Contrast this with Levine where the family understood both the role and importance of maintaining the insurance on G2 for the benefit of G3. The result was a substantial discount.

Along those lines, it is wise to document the non-tax reasons for incorporating GSD planning into one’s estate plan. These include but are not limited to: preservation of family assets (e.g., business, and real estate portfolios.), diversification of investments, legitimate estate planning benefits provided to G2, desire to leave a legacy to G3 and more remote generations, and of course, a clear intent to hold the policy to maturity to meet these goals.

To support the non-tax reasons for utilizing GSD planning, it is wise to document the evaluation of how split dollar can efficiently fund life insurance for G2, and how this insurance is valuable to the family, irrespective of the availability of a discount.

Finally, it is advantageous to plan in advance. In all three cases, the GSD plan was implemented shortly before G1 died. In Levine, G1’s agents and trustees entered into the GSD agreement approximately six months prior to her passing. While this fact was not determinative, or even viewed by the court in a negative light, it is not a “good fact.” The circumstances were similar in Cahill where the 90-year-old father was not capable of managing his own affairs, and the GSD plan was set up

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between his agents and trustees. In Cahill, this was a decidedly “bad fact.” Why the difference? Facts and circumstances. Going forward, the better question is, why risk it? The Service tends to view “death bed” planning by G1’s agents under a power of attorney as being a bad fact when litigating GSD plans. Best practice dictates incorporating GSD planning while G1 is still capable of making informed decisions and managing their own financial affairs.

SPLIT DOLLAR PLAN DESIGN

The decision in *Levine* was decided on the basis of a series of key facts relating to the structure of the split dollar agreement, the parties/trusts involved, and their fiduciary obligations. As it relates to the split dollar agreement, consider the following best practices.

The split dollar plan should only be used to fund a policy initially purchased and owned by the ILIT. The court in *Levine* found this to be an important point when defining what “property” or “asset” was actually held in the decedent’s estate. The IRS had argued that the decedent had an interest in the policies at issue. Importantly, the court found that since the life insurance policies were always owned by the ILIT, the property being valued in the decedent’s estate could not be the policies, but rather, was the receivable alone. Because the decedent owned all rights and interests in that receivable, IRC Secs. 2036, 2038 or 2702 could not possibly apply. Admittedly, this is a basic point, but one that we should not take for granted when drafting life insurance applications and timing the purchase of policies relative to the ILIT’s creation.

Similarly, the split dollar agreement should be carefully drafted to ensure that all incidents of ownership in the policy are held solely by the trustee of the ILIT. This is further supported through the use of a restricted collateral assignment that gives the grantor a mere security interest in the policy (equal to the receivable) that the grantor cannot unilaterally exercise or participate in a decision to terminate the plan. Other formalities must be carefully followed as well. Loan interest or the REB must be carefully calculated, documented and accounted for, and gifts accurately reported. The documentation itself should be carefully preserved, and the parties’ obligations and rights should be meticulously adhered to as defined by the split dollar agreement (SDA).

One of the critical points raised in the *Levine* case was that the split dollar agreement was drafted so that the trustee of the ILIT was granted unilateral authority to terminate the agreement. The decedent had no right to terminate the agreement or approve termination of the agreement which contributed to the court’s decision that neither 2036 nor 2038 would apply. This fact distinguished *Levine* from *Cahill* and *Morrisette*. In the latter two cases, termination of the SDA by the ILIT trustee required the consent of the holder of the receivable.

This might seem like splitting hairs since the bilateral termination provision inherently provides the trustee with veto power over any termination decision. Nonetheless, this proved to be an important differentiator and one of a handful of significant facts that proved dispositive in favor of the taxpayer in *Levine*.

TRUST DESIGN, TRUSTEES, AND FIDUCIARY DUTY

In *Levine*, the grantor’s revocable trust advanced the premiums to the ILIT. Along with the unilateral right to terminate vested solely in the ILIT trustee, the relationship between the two trusts, the identity of the trustees, and their relatively fiduciary obligations were all considered critical facts in supporting a taxpayer victory in *Levine*.

Specifically, the termination rights in the SDA in *Levine* were vested solely in an independent trustee. This trustee (Larson) was not a beneficiary of the trust or the estate in any form. Although a close family friend and long-standing CFO of the family business, as an independent trustee and sole member of the investment committee, Larson had a fiduciary duty to manage the ILIT for the benefit of all trust beneficiaries. In this instance, Mrs. *Levine*’s revocable living trust holding the receivable had G2 as beneficiaries, whereas, the ILIT had both G2 and G3 as beneficiaries. Were Larson to terminate the SDA, he would have benefited G2 (also beneficiaries of the trust holding the receivable) but would have disinherited G3.

What lessons can we take from this, and what improvements can we make in the future? Consider the following:

First, the ILIT should be managed by an independent trustee. In *Levine*, Larson was a family friend and worked closely with the family business for years. It would be preferable to have a trustee without these connections to the family to protect against an assertion that it was an influenced or prearranged plan. The ILIT in *Levine* utilized South Dakota Trust Company as an

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administrative trustee. Rather than a family friend and employee, might it be safer to have a professional fiduciary or someone like the taxpayer's CPA or attorney serving as independent trustee as well? Code Sec. 672(c) can provide guidance in that the trustee shouldn't be related or subordinate to the grantor.

Second, where a revocable trust advances the premiums, the ILIT should have different beneficiaries from the revocable trust. In Cahill, the beneficiaries of the ILIT and the estate were identical. In Levine, the ILIT's beneficiaries were both G2 and G3. This created a fiduciary responsibility to a new set of beneficiaries who would be harmed if the SDA were terminated in favor of G2. Would it make sense going forward to name only G3 as the beneficiary of the ILIT? Again, it is important to ensure that the party holding the power to terminate the SDA be acting under a fiduciary duty to the ILIT beneficiaries. This mattered in Levine as this duty was deemed sufficient to prevent the ILIT trustee from terminating the SDA and surrendering the policies.

Third, avoid having the same fiduciary on both sides of the transaction. Although Cahill ultimately settled the case with the Service, G1's son's involvement at every turn and the lack of a truly independent ILIT trustee would have been problematic. In Cahill, G1's son was G1's attorney-in-fact, the trustee of G1's revocable trust, and, upon G1's death, executor of G1's estate. On behalf of G1, the son created the ILIT both for the benefit of son and his issue, managed all aspects of the implementation of the GSD plan, and, as executor of G1's estate, valued the receivable. The son's cousin and business partner was the ILIT's trustee. Clearly, the son's involvement in, and control of, all aspects was not a good optic.

It is critical to document the established need for permanent life insurance, the desire to maintain the policy until maturity and that the insurance represents an important part of the family's broader estate plan.

In Levine, Larson acted as both an agent for the taxpayer under a power of attorney and as trustee of the ILIT. While the taxpayer succeeded, nonetheless, this is a

bad fact and should be avoided. It would be safer if independent parties or fiduciaries were on either side of the SDA. Even better if the taxpayer had the capacity to represent themselves instead of through an agent.

OTHER PLANNING CONSIDERATIONS NOT CONTEMPLATED IN LEVINE

LIFE INSURANCE POLICY CONSIDERATIONS

At their core, these cases were about whether a SDA receivable could be valued at a discounted fair market value on transfer. At the risk of oversimplifying, this valuation involves a discounting methodology (e.g., discounted cash flow analysis) and an anticipated time horizon for repayment. While the taxpayer in Morrisette succeeded in defeating challenges under IRC Code Secs. 2036, 2038, and 2703, they failed on the timing of the repayment. Relying on an amendment to G1's revocable trust allowing distribution of the receivable to the ILIT and correspondence between the family and their estate planning attorney, the Court held that the parties would have terminated the SDA after the three-year statute of limitations had run and directed them to value the receivable as such. What steps can be taken in policy design to help defend against this potentiality?

As mentioned above, it is critical to document the established need for permanent life insurance, the desire to maintain the policy until maturity and that the insurance represents an important part of the family's broader estate plan.

It may also be useful to design a policy with a lower cash surrender value to foreclose the IRS' argument that the policy was designed to be surrendered in the early years. In the cases available to us, the policies were designed with high early cash values. This can be a popular choice because it provides the family with long-term flexibility and may provide additional substance in economic benefit regime arrangements (the holder of the receivable has an appreciating asset). In contrast to a commercial premium financing plan where a high early cash value product reduces the need for outside collateral to fully secure the lender, a split dollar loan need not be collateralized beyond the policy values.

A low cash value product such as no-lapse guaranteed universal life (UL) or a protection UL policy, makes it unlikely that the policy will be surrendered for its cash

value. This is important for two reasons. First, it can help establish the case for valuation to be based upon the life expectancy of the insured(s) and not on some earlier date. Second, it can help get life insurance carriers comfortable issuing a policy under a GSD arrangement. Notably, early surrender is a financial risk to the carrier and has left some hesitant to engage in certain GSD designs. A low cash value policy may help to assuage this concern.

On the topic of dealing with the issuing carrier, one should consider the underwriting process as well. While the taxpayer directly involved in the planning and funding of the arrangement is G1, the policies are underwritten based on the health and financial status of G2 (the insured).

For these and other reasons, it is critical to engage an experienced and reputable life insurance professional as part of the team that designs and implements a GSD plan.

LOAN REGIME SPLIT DOLLAR

All of the litigated cases before us were designed as economic benefit regime arrangements. However, there are a number of reasons why loan regime should be considered as part of the analysis and presentation to the taxpayer. As a matter of first impression, loan regime arrangements are easier to understand for most taxpayers than the sometimes confusing economic benefit regime.

Assuming this is a valid split dollar loan, it is respected as a bona fide loan for federal tax purposes.⁷ On the topic of validity, even though a split dollar loan may have terms more favorable than a comparable commercial loan, it is still respected for federal tax purposes if “a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner.” Although that representation is not required to be in writing, another unrelated section of the loan regime regulations provides a roadmap for establishing this presumption with a written representation.⁸

This is in contrast to an economic benefit regime split dollar arrangement which is defined as being respected for “...purposes of the income tax, the gift

tax, the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), and the Self-Employment Contributions Act of 1954 (SECA).”⁹ In other words, the economic benefit regime regulations do not control for estate tax purposes. With that in mind, taxpayers may feel safer utilizing the loan regime design since the property involved, a promissory note, should be respected as a loan for federal estate tax purposes.

The minimum interest on a split dollar loan equals the appropriate AFR in the month of loan inception and is based on the duration of the loan. The favorable AFR is locked in for the duration of the loan. The Treasury regulations authorize loans made for the lifetime of the insured, an especially important option where the loan is only secured with the policy death benefit.¹⁰ AFRs will invariably be lower than commercially available loan rates, and the parties may renegotiate or refinance if AFRs drop in the future. Interest on a split dollar loan may be paid in cash or in kind, or may be accrued (the Treasury regulations provide a number of examples of interest accruing to principal).

Traditionally, loan regime split dollar involved multiple premiums, each of which was viewed as its own loan based on a different AFR. However, it is also possible to loan all premiums to the trust in a lump sum with the excess loan proceeds invested in a side fund to pay future premiums. This has the added benefit of rapidly funding the trust up front (particularly in light of the reduced life expectancy of G1) without creating a modified endowment contract (MEC)¹¹, and of establishing one loan interest rate versus several.

When this article was drafted, interest rates were trending higher, and loan regime GSD plans had not been litigated. Thus, loan regime GSD should be given serious consideration, and the best practices outlined above should apply. Finally, it is advisable to present both loan regime and economic benefit regime arrangements to the taxpayer and their planning team as alternative approaches.

⁷ Treas. Reg. 1.7872-15(a)(2).

⁸ Treas. Reg. 1.7872-15(d).

⁹ Treas. Reg. 1.61-22(a).

¹⁰ Treas. Reg. 1.7872-15(e)(5). The maximum duration for non-split dollar loans (intra-family loans) and note sales is less than the lender's life expectancy.

¹¹ In addition to being more carrier-friendly, it is preferential to avoid MEC status on a policy that is pledged as collateral. Collateral assignment of a MEC has the potential for negative income tax consequences. IRC Sec. 72(e)(10).

CONCLUSION

When done responsibly, for the right taxpayer and the right reasons, GSD remains a powerful planning tool. Despite the taxpayer's success in *Levine*, it would be foolhardy to think that this is the final word on GSD. The IRS can be expected to contest and litigate the valuation of the split dollar receivable, and the taxpayer should be apprised of the risks. Careful planning and execution remain critical. Nonetheless, GSD remains a powerful planning strategy, even assuming no or a low discount.

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