A Primer on the Valuation of Hedge Fund and Private Equity Fund Management Interests

By David Rudman, CPA/ABV, CVA
Sigma Valuation Consulting, Inc.

Attorneys who represent clients in estate planning matters or marital dissolution cases may discover that their clients are in the business of owning and/or managing alternative assets. Two of the most common types of alternative assets are private equity funds and hedge funds. While their structures are similar, investment terms and the criteria for compensating general partners vary. Acting as the general partner or investment manager of such funds can represent many millions of dollars in carried interest and incentive fee compensation. As a result, it is important to hire the right expert with experience in valuing these interests who can support efficient planning and case resolution. Most importantly, obtaining a defensible valuation will mitigate risk and help to avoid common mistakes that can lead to challenges down the road.

Alternative Assets Defined

The alternative asset management industry commonly includes hedge funds, private equity funds (“PE funds”), venture capital funds and commodity pool operators. Qualified investors are attracted to alternative asset investments due to the potential for higher returns, often with hedged risks. These investors typically include pension and endowment funds, institutional investors, as well as individual accredited investors.

PriceWaterhouseCoopers predicts that by 2020, investments in alternative assets could grow to between $13.8 and $15.3 trillion. According to Yahoo Finance¹, there are more than 10,000 hedge funds and by some estimates the number could be as high as 15,000. The space has become very crowded.

Steve Cohen, who runs the $11 billion family office, Point72 Asset Management (formerly SAC Capital), recently spoke at the Milken Global Institute Conference, and said there are “too many players” in the hedge fund space. With such a crowded space, many hedge funds are unable to deliver the performance they advertise.

Although hedge funds are self-reporting and do not report to the SEC, according to the data firm, Hedge Fund Research, more hedge funds closed down in 2015 than were opened.

The PE fund space is also very crowded, with many funds having a difficult time deploying capital and finding quality acquisition targets. Larger private equity firms have also experienced challenges in accessing debt financing to close deals in the past year. Like smaller hedge funds, smaller private equity firms also have a higher risk of failure.
So what is the attraction? — Earning a high level of compensation as a general partner or investment manager of a fund through successful performance. Additionally, for most private equity fund managers, the current federal tax code allows the treatment of such compensation as long-term capital gains which are taxed at a lower rate than ordinary income tax rates reported by most taxpayers.

**Fund Structure**

While the organizational structures tend to be similar, there are differences between how general partners (investment managers) are compensated in private equity funds and hedge funds. These differences can be critical when determining the value of their interests.

Though the management compensation structures differ between hedge funds and PE funds, they are similar in one respect. Generally, fund managers are paid through a compensation structure often referred to as the "2 and 20 rule." Under this fee structure, investors are charged management fees of 1.5% - 2% annually of total assets under management. The fund's general partner receives a carried interest (in the case of a PE fund) or performance fee (in the case of a hedge fund) of 20% of any profits once certain performance targets are hit. Fees can vary from fund to fund, with some charging less and others charging more. Carried interests are generally calculated and distributed at the end of each calendar year or reporting period. Presented below is a diagram detailing the typical simplified hedge fund/PE fund structure. As shown, the subjects of valuation are usually interests in the General Partner entity, Management Company, and sometimes, the Master Fund.
Private Equity Funds

*Private equity* is a generic term identifying a family of alternative investing methods. PE firms generally invest in the equity of privately held companies or real estate, as well as vehicles that hold debt investments. These funds are often classified into categories according to the investment strategy of the fund, such as leveraged buyout funds, growth equity funds, venture capital funds, real estate investment funds, and mezzanine or distressed funds. Investments in PE funds tend to be illiquid with a fund life of 3 to 10 years.

Private equity general partners who function as investment managers are responsible for making all decisions surrounding the activities of the fund, including acquisitions, and capital calls and divestitures. In exchange for this oversight, a management fee is received by the management company which is used to fund its operating expenses. As discussed previously, the management fee component usually falls in the range of 1.5 to 2% annually of fund value. Typical expenses incurred by the management company include employee compensation and bonuses, rent, research and data costs, travel, insurance, and professional fees.
The typical fund structure is complex with the management company usually formed as a separate entity. In some cases, the general partner entity will own the management company. In others, the management company and general partner entity will be separate entities owned by the same individuals.

In private equity structures, the distribution of carried interest is directed by a distribution “waterfall” that is spelled out in the fund’s offering documents. Generally, in order to receive carried interest, the manager must first return all of the limited partner investors’ (“LP investors”) contributed capital. In addition to a return of capital, many PE funds also provide for a preferred return (or hurdle rate) to the LP investors before any carried interest will be earned by the general partner. The customary preferred return in private equity is 7–8%. As a result of the distribution waterfall and the long investment horizon, the general partner usually only receives its carried interest upon a successful exit from an investment, which may take years.

As discussed previously, the typical carried interest is 20% of the private equity fund’s profit after hitting certain performance targets. This fee can vary from fund to fund. In many cases, the general partner is also required to own a limited partnership interest, just like other LP investors in the fund. Often, LP investors are more comfortable knowing the general partners have some of their own capital at risk.

<table>
<thead>
<tr>
<th>TYPICAL PRIVATE EQUITY FUND STRUCTURE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Limited Partnership</strong></td>
</tr>
<tr>
<td>Domestic and offshore funds where limited partner investors pool their shares in private companies and other illiquid assets.</td>
</tr>
<tr>
<td>Investors anticipate a return of capital and preferred rates of return. The typical fund life is three to 10 years, with returns realized as assets are sold.</td>
</tr>
</tbody>
</table>

**Hedge Funds**

Hedge funds are investment companies that manage pooled investment funds and generate income by charging management and performance-based fees to the funds under their management. Hedge funds generally invest in marketable securities and attempt to hedge their downside risk. They are less regulated than mutual funds and can invest in a wide range of asset classes while pursuing a variety of investment strategies. In comparison to PE funds, which do not provide investment liquidity,
hedge fund investments are much more liquid, usually allowing redemptions on a quarterly or annual basis following an initial lock-up period of typically one year.

Like PE funds, a hedge fund provides an economic benefit referred to as a performance or incentive fee that accrues to the fund’s general partner as compensation for successful management. As discussed previously, performance fees are usually 20% of fund returns, but there is a key difference. General partners in hedge funds are paid only when the value of the hedge fund hits what is referred to as a “high-water mark” — which represents the greater of 1) the highest net asset value of one’s capital contribution as of the end of any previous reporting period, or 2) the amount of the initial capital contribution. This means that if a fund loses 5% from its previous high-water mark, the manager will not collect a performance fee until he or she has first made up the 5% loss and the fund has moved higher. In contrast to PE funds which must wait until portfolio investments are liquidated, every time the high-water mark in a hedge fund is surpassed, performance fees are earned.

### TYPICAL HEDGE FUND STRUCTURE

<table>
<thead>
<tr>
<th>Limited Partnership</th>
<th>General Partner</th>
<th>Management Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic and offshore funds where limited partner investors pool their capital.</td>
<td>Makes investment decisions and is responsible for achieving fund returns.</td>
<td>Incurs all operational costs of the fund.</td>
</tr>
<tr>
<td>LP investors usually have the ability to redeem their investments quarterly or annually after an initial one-year lockup.</td>
<td>Receives performance fees once the high water mark is surpassed.</td>
<td>Receives a management fee of 1.5% to 2% regardless of fund performance.</td>
</tr>
</tbody>
</table>

### Valuation Approaches

For estate planning or marital dissolution purposes, attorneys are often tasked with finding a valuation expert who has the necessary experience to value interests owned in the multitude of entities that form these complex alternative asset investment management structures.

While the approaches to valuation are no different than those used to value other companies, understanding the complexities of these management structures and the inputs that drive the valuations is critical to achieving a defensible valuation.

For businesses, there are three generally accepted approaches to valuation:

1) the Market Approach;
2) the Asset Approach; and
3) the Income Approach.
The Income Approach focuses on the income-producing capability of the business. The Market Approach focuses on the prices of similar companies, and the Asset Approach focuses on the net asset value of the enterprise.

The Market Approach is generally not appropriate for valuing interests in private equity or hedge fund management companies for several reasons. A typical, privately held management firm lacks diversification and large asset bases typically seen in publicly traded PE and Hedge fund management companies. Unlike private firms, market data is only available on very large, well-diversified managers. Private fund management companies also typically have “key person” issues in which success depends significantly on a single or small number of managers. Using public data to value private firms also presents difficulties as it is often necessary to value certain entities within a larger PE fund or hedge fund structure rather than the entire collective business. When using market data from publicly traded firms, segmented market data simply isn’t available.

The Asset Approach tends to set a lower range to valuation for any business due to the fact that the approach generally doesn’t recognize goodwill. Accordingly, for profitable businesses such as PE fund and hedge fund management companies, the approach is generally not appropriate. The asset approach is appropriate however, for valuing the general partner’s interest in the fund itself, which is necessary when the general partner is required to have some of its own assets at risk.

As a result, the Income Approach is the most commonly applied approach used to value PE and hedge fund GP entity and management company interests. Within the Income Approach, PE carried interests are typically valued in two ways: the Discounted Cash Flow (DCF) Method and Option Pricing Method. For hedge funds, GP interests that receive performance fees are generally valued using the DCF method, as explained later.

In essence, we are valuing the projected cash flows received by the general partner in the form of carried interests (PE funds) or performance fees (hedge funds), and any fees (net of expenses) collected through the management company. As discussed previously, in most cases, the general partner is also required to keep some of its own money at risk as an investment in the fund itself. This investment along with any potential returns must also be considered in the course of valuation.

For both hedge funds and PE funds, the cash flow potential for general partners is a function of the LP investors’ assets under management (AUM) and rate of return generated on the AUM. For GP interests in established funds, it may be possible to look to a fund’s historical rates of return as a starting point to project carried interests or performance fees. For new funds developing projections is more difficult as there is no historical baseline on which one can rely. In both cases, the valuation expert must consider the risk associated with realizing those returns.
Discounted Cash Flow Method

The discounted cash flow method projects future cash flows expected to be generated via carried interests or performance fees and discounts them at a rate of return commensurate with the risk inherent in realizing the cash flows. This method requires making assumptions regarding the hedge fund’s or private equity fund’s required rate of return, investment holding period, and GP cash flows which are then discounted to present value.

The two most important components in a discounted cash flow of valuation are:

- Projected cash flows
- Discount rate

The application of the DCF method to value management interests in PE and Hedge Funds typically involves the following steps:

1. Projecting the funds’ AUM, which considers future expected investment returns, investors’ contributions and redemptions from the fund, fund closures or new fund launches as well as other factors that are known or knowable as of the date of valuation;
2. Projecting management fees (and carried interest distributions) based on the forecast of AUM;
3. Projecting the management company’s operating expenses, based on the analysis of historical costs and expected expense levels, giving proper consideration to reasonable compensation issues;
4. A development of the appropriate discount rate for both the GP entity (receiving carried interest distributions) and for the management company (receiving management fees);
5. Discounting the future expected cash flows to present value to derive the values of the entities that receive carried interest and management fee;

The valuation expert must also consider applicable valuation discounts (such as a discount for lack of control and/or a discount for lack of marketability) necessary to arrive at the value of a non-controlling ownership interest in the general partner entity or management company. Discounts may or may not apply depending on the purpose of the valuation, applicable standard of value, and jurisdiction/venue where the report will be used or submitted.

In the DCF model, the discount rate is highly subjective and should be backed by credible inputs and experienced judgement. The rate of return used to discount the projected cash flows is correlated with the expected/required portfolio return for the entire fund and can be derived in part from this return. In the context of private equity funds, since the fund’s investors receive preferred returns before any net proceeds are paid to the carried interest holders, the projected cash flows attributable to the carried interest are considerably riskier than the projected cash flows associated with
the limited partners’ investments in the fund. As a result, the required rate of return applicable to the carried interest tends to be higher than the gross portfolio rate of return on the PE or hedge fund’s AUM.

The cash flow projections used in the DCF method must also be credible, appropriate and admissible in litigation if necessary.

**Key Differences Between Inputs in Valuing PE Funds and Hedge Funds Using the DCF Method**

*Projection Period Considerations*

Unlike the valuation of traditional operating companies, the assumption of perpetual operation is often not valid in the context of PE fund valuations. PE funds have finite lives and their longevity depends on the size of AUM, the type and diversity of the investor base, and many other factors outlined in the private placement memorandum and operating/partnership agreement. In comparison, the ability of hedge funds to perpetuate their existence depends on the general partner’s ability to raise additional capital and achieve a high level of investment performance. While a PE fund’s carried interest may be valued using a discrete or finite set of projected cash flows over the defined life of the fund, the valuation of a hedge fund’s performance fee will generally be based on a discrete projection of cash flows coupled with a residual period that is capitalized into perpetuity. In other words, the life of a PE fund is limited, while the life of a hedge fund is perpetual.

*Inconsistent Timing of Cash Flow*

Cash flow patterns also vary in that PE funds collect management fees, make capital calls and deploy cash to make acquisitions during the early stages of a fund’s life. Carried interests for a PE fund’s general partner will not be earned until the fund begins liquidating investments, which usually occurs toward the middle or later stages of a fund’s life. In contrast, hedge funds can earn performance fees immediately after the launch of a new fund, but only if the fund generates investment profits for its LP investors.

*Investor Redemptions*

Investments in private equity funds are generally illiquid as most funds forbid the withdrawal of LP investments prior to the termination of the fund. Therefore, for private equity funds, when projecting the returns expected to be generated by the fund, no consideration needs to be given to redemptions of investor capital.

In comparison, most hedge funds tend to remain open to new or additional investments, allowing the general partner to raise additional limited partner capital. As discussed previously, hedge funds also allow investor redemptions after a relatively
short lock-up period. Therefore, a reduction in capital due to investor redemptions must be considered when projecting the future returns of the fund.

**Uncertainty**

Obviously, projecting the future is not an easy task. While generally easier for mature hedge funds that have a proven pattern of historical returns, or private equity funds that have already deployed their capital, valuing management interests in newly formed management structures can be more challenging. Management interests in new funds have additional inputs that need to be modeled such as the potential size of the fund and timing of capital deployment. With a lack of operating history, the risk associated with hitting performance benchmarks is also more difficult to project. As a result, it is not uncommon for valuation experts to use a series of projections, or multiple case scenarios, with different outcomes along the spectrum of possibilities. When multiple scenarios are modeled, it is also necessary to apply probabilities of success to each case scenario. Instead of using static scenarios, the use of Monte Carlo simulation is also a possibility.

**Option Pricing Method**

As stated earlier, the valuation of performance fees in a hedge fund is derived from its expected cash flow after consideration of the risk associated with realizing those cash flows. Unlike private equity, hedge funds do not have specific termination dates, and hedge fund investors can usually withdraw their capital after meeting certain fund-specific requirements. Thus, while the discounted cash flow method is generally used to value the GP entity receiving the performance fee in a hedge fund, the option pricing method tends to not be applicable. The option pricing method does however lend itself to a GP’s carried interest valuation in a PE fund.

Accordingly, a carried interest may be valued using standard option pricing theory as it gives the holder the right to the value of an asset over a specified threshold (i.e., the strike price) for a specified period of time. As it relates to a carried interest, the strike price is the capital contributed by investors plus the preferred return.

Option pricing models were developed using the premise that if two assets have identical payoffs, they must have identical prices to prevent arbitrage or riskless profit. The most common option pricing model used to value carried interests is the Black-Scholes-Merton (“BSM”) model, which considers five variables in calculating the price of a traditional call option:

- asset price
- strike price
- time to maturity
- risk-free rate of return
- price volatility of the underlying asset (i.e., risk)
When applying the option pricing model to value a carried interest, a portfolio of call options (with different strike prices) is modeled. In order to determine the various strike prices, it is first necessary to determine the breakpoints present in the fund’s distribution waterfall. Then, the BSM model is applied to determine the values of the carried interest and limited partnership interests in the fund.

The model is attractive due to its relative simplicity, as it is unnecessary to make assumptions for future fund returns, timing of investments or discount rates. Rather, the main inputs to the model are the volatility of the fund’s future investments and the expected life of the fund. The simplicity of the model is however, also one of its inherent weaknesses. Using a single volatility factor may not accurately capture fluctuations that exist over the life of a private equity fund.

Non-controlling Interests

When valuing non-controlling interests in the general partner entity and/or management entity, the purpose of the valuation, venue, jurisdiction and applicable standard of value are all critical to understanding whether valuation discounts for lack of control and lack of marketability should (or should not) apply.

For tax valuations, the standard of value is *Fair Market Value*. The fair market value standard by its definition, considers valuation discounts when deriving the value of a non-controlling interest. However, in the context of shareholder disputes or marital dissolution actions, state law will dictate whether the appropriate standard of value is *Fair Market Value* or *Fair Value*. Case law will further dictate what has been acceptable to the courts in the past. For example, in New York marital dissolution matters, the appropriate standard of value is fair market value. Under this standard, valuation discounts are applicable. In contrast, for marital dissolution matters in the State of New Jersey, the standard of value is fair value, and valuation discounts are generally deemed to be inappropriate. As shown, understanding the appropriate standard of value and applicable law is critical to achieving the correct valuation opinion.

Conclusion

Private equity and hedge funds management structures have potential to represent a significant source of income and wealth for a fund’s general partners (and often employees) in the form of carried interests or performance fee compensation. Despite this potential, carried interests and performance fees are often not received until some point in the future. As the cash flows associated with these interests are subject to many variables, significant risk exists regarding whether such cash flows will ever come to fruition, especially for new funds that do not have a track record of past performance.
Additionally, with the upcoming presidential election, there is an elevated level of political pressure to increase the tax rates to ensure that income that would otherwise receive long-term capital gains treatment is taxed at ordinary income tax rates.

From an estate planning perspective, the current market environment presents significant opportunities to structure estate plans for general partners of hedge funds and private equity funds at attractive valuations. In the context of divorce, it is essential to engage an expert who understands the complexities of these structures and nuances that must be considered when valuing such interests.

To learn more about the approaches and methods to the valuation of interests in private equity or hedge funds — and common mistakes to avoid — view our next article, “Common Errors in the Valuation of PE and Hedge Fund Interests”

David Rudman, CPA/ABV, CVA is the President of Sigma Valuation Consulting, Inc., a certified valuation analyst, accredited in business valuation by the AICPA. Mr. Rudman has over 20 years of experience valuing companies for purposes including estate and gift tax planning and administration, marital dissolution, shareholder disputes, and financial reporting. He may be reached at drudman@sigmavaluation.com.

Sigma Valuation Consulting, Inc. is a business valuation and forensic accounting firm with offices in New York City, Long Island, Westchester, and New Jersey. The Company has successfully provided services to over 1,200 clients since its founding in 2006. (www.sigmavaluation.com)

---

¹ Yahoo Finance, “Hedge funds — there are too many of them and most of them are lousy”, by Julia La Roche, May 7, 2016.
Estate of Morrissette v. Commissioner, 146 T.C. No. 11 (April 13, 2016)

June 10, 2016

First Court Case Addressing Intergenerational Split Dollar Life Insurance, Partial Summary Judgment Holding That Economic Benefit Regime Applied

Steve R. Akers
Senior Fiduciary Counsel, Bessemer Trust
300 Crescent Court, Suite 800
Dallas, TX 75201
214-981-9407
akers@bessemer.com
www.bessemer.com
TABLE OF CONTENTS

Synopsis .................................................................................................................................... 1
Basic Facts.................................................................................................................................. 2
Issues, Holding, and Basic Significance ..................................................................................... 4
Brief Background About Split Dollar Life Insurance and Discount Intergenerational Split Dollar Life Insurance.................................................................................................................... 4
Court Analysis ............................................................................................................................ 7
Planning Considerations ............................................................................................................10

Important Information Regarding This Summary

This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

Copyright © 2016. Bessemer Trust Company, N.A.
All rights reserved.
June 10, 2016

www.bessemer.com/advisor
Synopsis

The Tax Court, in a “regular” opinion of the full court, approved an intergenerational split dollar life insurance arrangement in which Mrs. Morrissette (actually her revocable trust) paid large lump sum premiums ($29.9 million) for Dynasty Trusts to purchase universal life insurance policies on the lives of her three children. Under the split dollar agreement, as each of the children died, the revocable trust was entitled to receive the aggregate premiums paid (without added interest) on the policies on that child’s life (or the cash surrender value of such policies, if greater [but the cash values may be lower than the aggregate premiums paid, because the cost of insurance and other costs of maintaining the policies in force would be charged against the policies each year]). Following Mrs. Morrissette’s death, her estate included her reimbursement rights under the split dollar arrangements in her estate, at a value of about $7.5 million (compared to the $29.9 million lump sum premiums she had paid), in light of the fact that her revocable trust would not receive the payments for many years in the future (as her children died—actuarially expected to be about 15 years later). The IRS maintained that the full $29.9 million premium advance should be treated as a gift.

The split dollar regulations provide that split dollar arrangements can be taxed under either a loan regime (detailed in Treas. Reg. §1.7872-15) or economic benefit regime. The parties had not structured the arrangement as a loan (with a note bearing interest); that approach would not have resulted in as large of a discount in valuing the receivable at the parent’s death because the loan would have been entitled to interest during the delay before the repayment was made at the children’s subsequent deaths. Instead, the parties had relied on the economic benefit regime applying. Under that system, the parent is treated as making a gift each year of the current value of the life insurance coverage in that year (either from the carrier’s actual rates or Table 2001), less the amount of any premiums paid by the trust-owner of the policy in that year. The court rejected the IRS’s position that the economic benefit regime did not apply; the IRS position was based on an argument that the structure failed to satisfy the technical requirements in the regulations for the economic benefit regime to apply.

The court granted partial summary judgment, holding that the technical requirements in the regulations for applying the economic benefit regime were satisfied. The court’s analysis waded through the hyper-technical details of the split dollar regulations. The loan regime generally applies if the donee is the owner of the policy (assuming the parties properly treat the transaction as a loan), or otherwise “general tax principles” apply. However, the donor will be the deemed owner of the policy (in which event the economic benefit regime applies, Treas. Reg. §1.61-22(d)(1)) if the only economic benefit provided to the donee is current life insurance protection. Reg. §1.61-22(c)(1)(ii)(A)(2). The central issue under the court’s analysis is its conclusion that the Dynasty Trusts had no current access to the cash values of the policies and received no additional economic benefit other than current life insurance protection. Estate of Morrissette v. Commissioner, 146 T.C. No. 11 (April 13, 2016) (opinion by Judge Goeke).

The court did not address the valuation issue; it will be addressed following this partial summary judgment decision.

This is the first court case addressing intergenerational split dollar insurance arrangements; it is a taxpayer victory in recognizing that the economic benefit regime applies to this intergenerational split dollar agreement. Larry Brody (St. Louis, Missouri) says he is aware of at least a half dozen of these inter-generational arrangements where the IRS argued that because a single premium was paid up front, the loan regime applied. McManus, IRS
Stretched Too Far in Split-Insurance Estate Planning Case, BNA DAILY TAX REPORT (April 14, 2016). Many questions remain regarding the tax treatment of intergenerational split dollar insurance; it is not widely used (just by some very wealthy families), and the IRS may continue to address other ways to fight the overall result of a transfer with a huge discount (the IRS’s brief characterized the plan as an effort to “minimize the taxable estate”). Nevertheless, this initial decision is a significant development regarding intergenerational split dollar agreements.

Basic Facts

1. Issues Regarding Closely-Held Business. Mr. Morrissette formed a moving company that grew into a large conglomerate, Interstate Van Lines, which eventually was owned by Interstate Group Holdings, Inc. (IGH). The stock was owned by various family members including Mrs. Morrissette’s revocable trust, trusts created under Mr. Morrissette’s revocable trust following his death, and three sons (as well as others). Mr. Morrissette managed the company to place his three sons in competition with other, which resulted in “deep-seated antipathies among them. They had differing goals for the company and do not get along with each other.” In order to prevent two brothers from ganging up on the third brother, the corporate documents adopted a “fourth brother” provision requiring that if two sons disagreed with the third son regarding a decision, an independent trustee of trusts that owned shares would review the decision, with the expectation that the trustee would side with the minority sibling unless the position of the majority siblings was compelling. Mrs. Morrissette (apparently while she was still competent) was concerned that the “fourth brother” provision may cause deadlock detrimental to the company, and was concerned with the sons’ disagreements regarding their goals for the company. In light of this background, Mrs. Morrissette (through her conservator and agents) created Dynasty Trusts for the three sons (and presumably transferred stock to those trusts), and entered into a Shareholders Agreement regarding the shares. [Observation: These business succession planning aspects of the factual background are included to point out that this overall arrangement had business purposes beyond just reducing the value of Mrs. Morrissette’s estate.]

2. September 2006 Transactions; Dynasty Trusts and Shareholders Agreement. All of the following happened in September 2006, when Mrs. Morrissette was age 93.

- The three sons became the successor trustees of Mrs. Morrissette’s revocable trust.
- An employee of the company served as conservator for Mrs. Morrissette from August-October, 2006.
- Mrs. Morrissette (presumably through the conservatorship) created Dynasty Trusts for each of the three sons, and apparently conveyed company stock to those trusts.
- The revocable trust was amended to permit the trust to pay premiums on life insurance policies under a split dollar arrangement to fund a business succession plan. In addition, the amendment permitted the revocable trust to transfer each receivable from the Dynasty Trusts under the split dollar arrangement back to the Dynasty Trust owing the receivable or directly back to each son.
- The Dynasty Trusts, the sons, and various other family shareholders entered into a Shareholders Agreement placing various restrictions on the shares, imposing transfer restrictions, and implementing a cross purchase agreement under which the
shares owned by or for a deceased son would be purchased by Dynasty Trusts for the surviving brothers.

3. **October 2006 Transactions; Purchase of Life Insurance on Sons’ Lives Under Split Dollar Arrangement.** In October 2006, each son’s Dynasty Trust purchased life insurance on the other sons’ lives to fund the buy-sell provisions in the Shareholders Agreement. Mrs. Morrissette’s revocable trust advanced $29.9 million to the three Dynasty Trusts, which they used to pay lump-sum premiums on the policies to purchase of the life insurance policies under a “non-equity economic benefit regime split dollar” arrangement. The lump sum premiums were large enough to maintain the policies for the insureds’ respective life expectancies (about 15 years). The following applied under the split dollar agreement.

- When the insured died under each of the policies, the revocable trust had the right to receive the greater of (1) the aggregate premiums advanced, or (2) the cash surrender value of the policies. The revocable trust would not be reimbursed any of the premiums advanced for a particular policy until the insured for that policy dies. The Dynasty Trust that owned a policy would receive the balance of the death benefit payable under the policy (which would be available to fund the purchase the deceased son’s shares as required in the Shareholders Agreement).

- If the split dollar arrangement terminates during the life of a son, the revocable trust would get repaid and the Dynasty Trust owning the policy would receive nothing from the policy.

- No one had the right to borrow against the policies.

- The Dynasty Trusts collaterally assigned the policies to the revocable trust to secure the repayment of amounts due to the revocable trust under the split dollar agreement.

- The split dollar agreement expressly stated the parties’ intent that the arrangement be taxed under the economic benefit regime as described in the split dollar regulations and that the only economic benefit to the Dynasty Trusts regarding the life insurance policies was the current life insurance protection.

4. **Gift Tax Reporting in 2006-2009.** In 2006-2009, Mrs. Morrissette reported gifts each year to the Dynasty Trust consistent with the economic benefit regime of the split dollar regulations. She reported as a gift each year the cost of the current life insurance protection as determined using Table 2001 (less the premium paid by each Dynasty Trust during that year [apparently, the Dynasty Trusts paid some premiums in addition to the large single premium paid at the outset]).

5. **Estate Tax Reporting.** Mrs. Morrissette died September 25, 2009. Her estate tax return reported the receivables from the Dynasty Trusts as having a value of $7.479 million (based on an appraisal of the receivables).

6. **Notices of Deficiency.** The IRS treated all of the $29.9 million transferred to the Dynasty Trusts as gifts, and assessed a Notice of Deficiency for substantial additional gift tax and penalties. In addition, the IRS issued a Notice of Deficiency for additional estate tax, increasing the value of the receivables from $7.479 million to almost $32.061 million. It characterized the split dollar arrangements as loans under the loan regime of the regulations (but it did not calculate the value of the loans).
7. **Court Documents.** Steve Gorin (St. Louis, Missouri) has assembled many of the court documents (including the parties’ briefs, the gift and estate tax notices of deficiency, and the split dollar agreement) that have been filed with the Tax Court in *Morrissette*. They can be accessed at the following link:

http://tcinstitute.com/rv/ff0027b41763b2585644fea38b4d98e739cece38.

**Issues, Holding, and Basic Significance**

The only issue addressed in this partial summary judgment decision is whether the arrangement should be taxed under the economic benefit regime or the loan regime of the split dollar regulations. This decision does not address the valuation of the receivables at the time of the decedent’s death.

The Tax Court (in a regular decision of the court) held that the arrangement was governed by the split dollar final regulations and that the economic benefit regime applied to the arrangement.

This holding is very significant. Taxing “intergenerational split dollar insurance” under the economic benefit regime is helpful to support placing a substantial discount on the value of the receivable at the date of the death of the senior family member holding the receivable (or at the date of a gift or other transfer of the receivable by the senior family member) based on the fact that the repayment would not be made for what could be decades (at the death of the younger insured family member). If the loan regime applied, the loan would be valued under the assumption that interest would be paid on the loan, rather than just paying the aggregate premiums made (or the cash surrender value if greater). Alternatively, if the economic benefit regime did not apply and if the loan regime also did not apply because the parties did not properly treat the advance as a loan, the entire advance may have been treated as a gift under general tax principles. (Whether the loan regime treatment could apply is problematic under the Morrissette facts. The Morrissette split dollar agreement stated in two different places that the intent was that the arrangement be treated as an economic benefit transaction for federal tax purposes, but the Agreement also stated that if for any reason the Agreement was deemed to be a promissory note, the Dynasty Trust as maker promised to pay an amount equal to the total premiums paid by the donor together with an annual rate of interest “that reflects the prevailing market interest rate for both income tax and gift tax valuation purposes, as determined by a qualified independent appraiser.”)

**Brief Background About Split Dollar Life Insurance and Discount Intergenerational Split Dollar Life Insurance**

Split dollar life insurance has been used historically as a way that employers (or senior family members) could help pay for premiums on life insurance to benefit employees (or junior family members). In 1964, the IRS began taxing the death benefit portion of the policy as an economic benefit under Revenue Ruling 64-328. Split dollar arrangements have traditionally be structured as either endorsement arrangements (in which the employer or senior family member owns the policy and endorses some of the death benefits to employees or junior family members) or collateral assignment arrangements (in which the employee or junior family member owns the policy and assigns an interest back to the employer or senior family member to secure the right to be repaid the premium advances). The endorsement or collateral assignment arrangements could be structured as either equity or non-equity arrangements. (In equity arrangements, the employee or junior family member might share in some portion of the
cash value of the policy.) Under the traditional treatment of split dollar policies, changing the structure of the party that owned the policy (i.e., endorsement or collateral assignment) did not fundamentally change the tax treatment of the arrangement. (This would change in 2003 under split dollar regulations, which provide that the tax treatment of the arrangement depends largely on who is the owner of the policy.)

Notice 2002-8 provided transitional rules for the treatment of split dollar arrangements entered into before September 18, 2003. The Notice (1) addressed valuation issues, allowing alternate rates to be used to value the current value of life insurance coverage (i.e., either Table 2001 rates [using a Table included in the Notice] or the insurer’s one-year term rates in certain circumstances), and (2) provided certain safe harbors for avoiding tax on the transfer of the equity element of split dollar policies (either (i) treating the premium advances as a loan arrangement or (ii) continuing to apply the economic benefit approach of treating the current value of life insurance coverage as a transfer each year and not imposing additional taxes as long as the cash value was not accessed).

The split dollar regulations, applicable to split dollar arrangements entered into or modified after September 1, 2003, establish two alternative regimes for taxing split-dollar life insurance arrangements, depending on who owns the policy. Previously, the key factor impacting the tax treatment was whether the arrangement was an equity or non-equity structure. Under the regulations, the key is who owns [or is deemed to own] the policy. If the employer (or senior family member) owns the policy, as in a typical endorsement arrangement, the economic benefit regime applies, taxing the employee (or treating as a gift to the junior family member) on all economic benefits provided through the arrangement. If the employee (or junior family member or trust for a junior family member) owns the policy, as in a typical collateral assignment arrangement, the loan regime will apply under the §7872 rules for below-market loans and the OID rules in §§1271-1275, if the obligation is most appropriately treated as a loan under federal income tax principles (for example, using a note that is intended to be repaid unconditionally). A special ownership rule applies to non-equity arrangements; if the employee or donee is the owner of the policy but has no current access to the cash values of the policies and receives no additional economic benefit other than current life insurance protection, formal ownership designations will not control but the employer or donor will be treated as the owner of the contract, so that the arrangement can be taxed under the economic benefit regime rather than the loan regime. (Life insurance on a donor’s life may be held in an irrevocable life insurance trust (ILIT) to avoid estate inclusion of the insurance proceeds under §2042. In effect [and oversimplified], this special exception provides that life insurance that is held in an ILIT can be taxed under the economic benefit approach that has historically been used for the tax treatment of split dollar insurance as long as the structure is a “non-equity” arrangement.)

Under traditional split dollar arrangements, a donor funds premiums on a policy on the donor’s life, and the premium advances are repaid at the donor’s death from the policy death proceeds. In contrast, under intergenerational split dollar arrangements, a parent pays premiums on a policy insuring a child (or grandchild’s life), and the premium advances are not repaid until the insured’s death, which could be decades in the future. If the reimbursement right is transferred by the parent (by gift or sale or as an asset of the donor’s estate at her death), a substantial discount may apply in determining the present value of the reimbursement right. (The present value of the right to a set dollar amount, to be paid decades in the future, would obviously be much smaller than the aggregate payment that would be made many years in the future.) Taxing intergenerational split dollar insurance under the economic benefit regime is helpful in supporting a substantial discount on the value of the receivable; under the economic
benefit regime the parent just receives the aggregate premiums paid (or cash surrender value if greater), but under the loan regime the reimbursement right would be for the premiums paid plus interest that would accrue over the many years before the repayment is made. (If the advance is a loan but the note does not provide for interest at the AFR, the IRS may argue that under the §7872 regulations, the person advancing the premiums makes a current gift of the present value all of the foregone interest for the life of the loan. See Alan Jensen & R. Brent Berselli, Estate of Morrissette: Unfinished Business, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2418 (May 23, 2016) (hereinafter “Jensen & Berselli, Unfinished Business”) (citing Treas. Reg. §1.7872-15(e)(5)(iv)(D).)

Alternatively, if neither the economic benefit regime nor loan regime applies (see the discussion below of the requirements to treat the arrangement as a loan), general tax principles apply to the arrangement. In that event, the donor is treated as making a gift of the full amount paid as premiums less the economic benefit that the donor received (and Treas. Reg. §1.61-22(d)(2)(ii) looks to whether the donor has current access to the cash value), and if, as would be typical, the donor does not have current access to the cash value, the donor’s economic benefit is zero and the full amount of premiums paid is a gift. Treas. Reg. §1.7872-15(a)(2) has three requirements for the arrangement to be treated as a loan: (1) payment is made by the non-owner to the owner (including a payment directly to an insurance company with respect to a policy held by the owner); (2) the payment is a loan under general tax principles, or if it is not (for example because of the nonrecourse nature of the obligation or otherwise), “a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest)” ; and (3) repayment of the advance is to be made from or is secured by the policy’s death benefit, the policy’s cash surrender value, or both. Furthermore, Treas. Reg. §1.7872-15(d) provides that a nonrecourse payment under a split-dollar loan and the repayment right is typically nonrecourse under split-dollar agreements is a “contingent payment,” which causes further significant complications under Treas. Reg. §1.7872-15(j), unless the parties represent in writing (by the time for filing the federal income tax return for the borrower or lender for the taxable year in which the lender makes the split dollar loan) that a reasonable person would expect that all payments under the loan will be made (and that representation must be attached to the income tax returns for all parties [which is frequently overlooked]). Thus, in the typical split dollar arrangement, if the economic benefit regime does not apply, the loan regime will apply if the parties have treated the advance as a loan, if there is a reasonable expectation that the premium advance will be repaid, and if the required written representations have been timely made and filed.

Life insurance experts Donald O. Jansen (Austin, Texas) and Charles L Ratner (Cleveland, Ohio) have summarized the application of these general rules regarding split dollar life insurance under the split dollar regulations to intergenerational split dollar insurance in the context of a grandparent funding the purchase of a life insurance policy on a grandchild’s life to be owned by an irrevocable life insurance trust:

Unless the insured is very elderly, the term premium under the economic benefit regime is almost always lower (sometimes significantly lower) than the applicable federal interest rate (AFR) used for a loan regime split-dollar arrangement. With regard to the split-dollar arrangement between the grandparent and the trustee, the economic benefit regime involves smaller payments/gifts than the loan regime. But, to avoid a current gift of cash value of the policy to the trust, the economic benefit regime split-dollar contract must give all of the cash value to the premium payer (the so-called “non-equity split-dollar.”)

The split-dollar economic benefit regime normally requires the premium payer (the grandparent in our example) to be the owner of the insurance policy with the pure insurance allocated to the insurance trust by an endorsement to the policy (the so-called “endorsement split-dollar.”) Generally, if a person other than the premium payer (for example, the trust) owns the policy, the loan regime with its higher AFR would apply. But
if the grandparent owned the policy and all of its cash value, the full cash value of the policy, without discount, would be in the grandparent’s gross estate at death or would be the value of the sale or gift if the policy were later sold or given by the grandparent to the trust.

Discount private split-dollar solves this problem by taking advantage of a special provision in the split-dollar regulations allowing non-equity private split-dollar collateral assignment arrangements. Under the regulations, even though the life insurance policy lists the trustee as the owner, it’s the grandparent who’s treated as the owner—so long as the only economic benefit that the arrangement ever provides the trust is life insurance protection.

Thus, a split-dollar contract between the trust that owns the policy and a grandparent/collateral assignee qualifies as an economic benefit regime arrangement as long as the arrangement gives all of the cash value (a non-equity arrangement) to the grandparent. The favorable basic tax economics of the arrangement then can be strategically customized by (1) obligating the grandparent to pay at least a certain number of premiums, and (2) expressly forbidding the grandparent from unilaterally terminating the split-dollar contract or accessing the policy’s cash value. The hope is that these restrictions will result in a steep discount to the value of the grandparent’s interest when he dies, or gives or sells that interest to the trust (or to another party).


Court Analysis

For excellent analyses of the court’s decisions see Howard Zaritsky, Morrissette v. Commissioner: Tax Court Holds That Economic Benefit Regime Applies to a Family Split-Dollar Life Insurance Arrangement Between Trusts, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2408 (April 19, 2016); Steve Gorin & Howard Zaritsky, Tax Court Approves Some Key Issues with Intergenerational Split-Dollar Arrangements, 28 PROBATE PRACTICE REPORTER 1 (June 2016).

1. **2003 Split Dollar Regulations Apply.** These split dollar arrangements are governed by the 2003 split dollar regulations because they were entered into after September 17, 2003.

2. **Tax Treatment Depends on Owner of Policy.** The 2003 split dollar regulations adopted a new approach of basing the tax treatment on who is the owner of the underlying life insurance policy.

   • **Economic Benefit Regime.** The economic benefit regime applies in a donor-donee context if “the donor is the owner of the life insurance contract (or is treated as the owner of the contract...” Treas. Reg. §1.61-22(b)(3)(ii)(B).

   • **Loan Regime.** If the conditions for applying the economic benefit regime do not apply (based on whether the donor is the owner or deemed owner of the policy), the loan regime may apply if the arrangement is treated as a loan under Treas. Reg. §1.7872-15(a)(2).

[BACKGROUND COMMENTARY NOT IN COURT ANALYSIS: The loan regime does not apply automatically merely because the donor is not the owner or deemed owner of the policy. If neither the economic benefit regime nor loan regime applies, general tax principles apply to the arrangement and the full amount of the premium payment may be treated as a gift. (See the discussion in the Brief Background Regarding Split Dollar Life Insurance Section above.)]
3. **Owner of Policy.**

(a) **General Rule.** The person or entity named as the owner in the insurance contract is generally treated as the “owner,” and any other person with a direct or indirect interest in the contract is the “non-owner.” Treas. Reg. §1.61-22(c)(1)-(2). Under this general rule, the Dynasty Trusts would be considered the owners of the policies.

(b) **Exception—Donor as Deemed Owner.** A special rule applies if the split dollar arrangement involves the performance of services or “is entered into between a donor and donee” if the arrangement provides only death benefit protection (generally thought of as a non-equity arrangement). More specifically, in the donor-donee context:

   A donor is treated as the owner of a life insurance contract under a split-dollar insurance arrangement that is entered into between a donor and a donee (for example, a life insurance trust) if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section. Treas. Reg. §1.61-22(c)(1)(ii)(A)(2).

   If the donee receives any additional economic benefit, other than current life insurance protection, the donee will be considered the owner and the loan regime will apply.

(c) **Key Question—Any Additional Economic Benefit?** Thus, the key question in the case is whether the lump-sum payment of premiums made on the policies generated any additional economic benefit other than current life insurance protection to the Dynasty Trusts.

(d) **Example to Preamble to Regulations.** The preamble to the final regulations includes an example suggesting that a non-equity split dollar arrangement would satisfy the “no additional benefit” requirement so that the economic benefit regime would apply. (The example concludes: “Thus it follows, that where a donor is to receive the greater of the aggregate premiums paid or the CSV of the contract, the possibility of the donee receiving an additional economic benefit is foreclosed.”)

   Preambles to regulations are afforded little weight, but they do reflect the IRS’s interpretation of its own regulations. The court hinted that it would give greater weight to a statement in a Preamble that supports a taxpayer’s position than a self-serving statement that supports the government’s position that is not supported by the actual substantive terms of the regulation itself.

(e) **Current Access to Cash Values.** One way a policy could afford “additional economic benefits” is if the trust that owns the policy (but that is deemed to be the non-owner) has current access to any of the policy cash value. Treas. Reg. §1.61-22(d)(2)(ii). This could include having a current or a future right to some of the cash value, or if the cash value is “directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner’s general creditors.” Treas. Reg. §1.61-22(d)(4)(ii). The IRS argued that the receivable would pass to the Dynasty Trust or to Mrs. Morrissette’s sons under the terms of her revocable trust. The court concluded that that the Dynasty Trust had no legally enforceable right to the receivables, and that the revocable trust could be revised. Furthermore, the...
court reasoned that it would look only to what the split dollar documents provide and whether they require that some of the cash value will pass to the non-owner (citing Treas. Reg. §1.61-22(d)(1), which refers to “[t]he value of economic benefits provided to the non-owner for a taxable year under the arrangement”).

(f) **Any Other Economic Benefit?**

(i) **Notice 2002-59.** The IRS argued that Notice 2002-59 prohibits the economic benefit regime from applying in some circumstances and that it evidences that that the pre-paid premium represents an “additional economic benefit.” However, Notice 2002-59 deals with “reverse split dollar” arrangements, in which a trust owns the policy; the insured has the right to receive the policy’s death benefit for a particular year, and the insured pays for that current coverage by paying “P.S. 58 rates” that were substantially greater than actual mortality charges incurred by the trust. The arrangement was typically terminated after several years (i.e., the insured stopped “renting” the current coverage), and the trust could pocket the excess cash value that built-up in the trust due to the excessively large premium payments. The court rejected that analogy to an arrangement in which the insured made large upfront premium payments, because this situation was the reverse in that the insured kept the sole access to the cash surrender value of the policies.

(ii) **Prepaid Premium as an Additional Economic Benefit.** The IRS argued that prepaid premiums “pay not only for current insurance protection, but also for future protection, which is a benefit other than current life insurance protection.” The government’s memorandum in support of its position in response to the motion for summary judgment maintains that “the prepayment of the policy provides funds for additional years of coverage, effectively, a permanent fund to pay the cost of insurance.” It draws an analogy to a parent that “irrevocably funds an account to pay current and future property taxes on a child’s house,’ and observes in that situation “the gift is not a gift each year that the tax becomes due and payable, but rather a gift up front. As in this case, the prepayment is a benefit to the Dynasty Trusts distinct from current life insurance protection.” The court rejected this argument, first observing that the government relied on Notice 2002-59 for its position that a premium prepayment confers policy benefits other than current life insurance protection (and the court previously disagreed that the rationale of Notice 2009-59 applied to this totally different situation), and also reasoning that the Dynasty Trusts were not otherwise required to pay the premiums but the revocable trust was obligated to pay all premiums; therefore, the premium prepayment “would not relieve the Dynasty Trusts of any obligation to pay premiums because the Dynasty Trusts were not required to pay any premiums.”

OBSERVE: The argument that the payment of any premium in excess of current year cost of coverage would suggest that almost all split dollar arrangements would have to be treated as owned by the person with legal title (in which event the economic benefit regime would not apply if the donor does not own the policy) because split dollar arrangements almost always involve the advance of premium amounts greatly in excess of just the cost of current year coverage under the policy. Alan Jensen and Brent Berselli (both of Portland, Oregon) indicate they have had a somewhat similar intergenerational split dollar case in which the IRS also made this “prepaid premiums” argument:
The IRS advanced this same “prepaid premiums” argument in our recent litigation, and this was a point that the Service’s appellate conferee made repeatedly during settlement negotiations. Specifically, the IRS asserted: “The permanent setting aside of money in the life insurance policy to pay future life insurance costs is an economic benefit to the donee. The value of the economic benefit is to be determined but might approximate the value of the life insurance policy.”  *Morrissette* addressed this “prepaid premium” argument directly and issued the correct opinion that single premium policies do not provide an additional economic benefit. This is an accurate analysis, as in our case and in *Morrissette*, the only benefit provided to the donees was current life insurance protection. In each instance, the donees had no current or future access to cash value, and all cash value was pledged to the donor under the respective [split dollar agreements].

Jensen & Berselli, *Unfinished Business*.

(g) **Conclusion.** “Because the Dynasty Trusts receive no additional economic benefit beyond that of current life insurance protection, the [revocable trust] is the deemed owner of the life insurance by way of the special ownership rule under section 1.61-22, Income Tax Regs. Thus the economic benefit regime under section 1.61-22, Income Tax Regs., and not the loan regime of section 1.7872-15, Income Tax Regs., applies to the split-dollar insurance arrangements.”

4. **Valuation Not Addressed.** The court specifically noted that it was not addressing the valuation of the receivable.

**Planning Considerations**

For an overview of planning issues in light of *Morrissette*, see Lee Slavutin, *A Post-Morrissette Roadmap for Drafting Intergenerational Split Dollar Agreements*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2414 (May 12, 2016).

1. **Only One Narrow Issue.** *Morrissette* is important because it is the first court case addressing intergenerational split dollar insurance, and it is a taxpayer victory by the full Tax Court. But the court addresses only one narrow issue (on the taxpayer’s motion for partial summary judgment as to that narrow issue), and the IRS is no doubt advancing a variety of other issues in the case (in addition to the valuation issue). The Notice of Deficiency treated most of the approximately $30 million advance of premiums as a gift. That would not have been the case under either an economic benefit regime or loan regime treatment. Apparently, the IRS position is that almost all of the premium advance was a gift, because the Dynasty Trusts were the owners and Mrs. Morrissette’s interest in the cash value was disregarded under Treas. Reg. § 1.61-22(d)(2)(ii).

2. **Other Potential IRS Attacks.** A variety of potential issues, other than whether the economic benefit regime applies, exist regarding intergenerational split dollar arrangements. Some of these other issues are as follows.

   a. **Treatment of Insurance Coverage Following Premium Payer’s Death.** What is the tax treatment of the economic benefit regime arrangement after the client dies (who advanced the premium payments) but before the insured’s death? Is the benefit of current life insurance coverage somehow treated as a future transfer each year by the estate or its successors in interest under the economic benefit regime?
(The IRS noted this issue in its memorandum in response to the summary judgment motion: “One taxpayer has argued that a deceased parent continues to make gifts each year as the cost of insurance became due and payable, irrespective that the parent had died. The National Office has found no authority supporting the position that a deceased person can make gifts, 20 or 30 years after he or she is dead.” Respondent’s Memorandum of Points and Authorities in Opposition to Petitioner’s Motion for Partial Summary Judgment, at 20 n.3 (filed Feb. 11, 2015).)

b. **Section 2703.** Are restrictions on repayment rights under the split dollar agreement treated as restrictions on the right to sell or use property that must be ignored in determining the value of property that has been transferred? A counter argument is that the right to the receivable under the terms of the split dollar contract is the very property that is transferred and the terms of the contract are not merely a restriction on the property transferred. This is similar to the courts’ analysis in rejecting the IRS’s argument that §2703 applies to value the transfer of interests in a partnership. However, the split dollar situation may have more difficulty meeting the comparable arm’s length test under the §2703(b) exception—would an individual enter into one of these split dollar arrangements “with you or me if we weren’t relatives?” Jansen & Ratner, *Discount Private Split-Dollar*, at 23. The IRS made this §2703 argument in a relatively recent intergenerational split dollar cases handled by Alan Jensen and Brent Berselli:

The Service sought to value the [split dollar receivable] without considering any of these limitations, arguing that under IRC § 2703, G-1’s restricted access to the life insurance policies and their cash surrender values are disregarded. The Service’s IRC § 2703 analysis was incorrect. IRC § 2703 disregards certain rights and restrictions in valuing an asset, but it was inapplicable in our case. The assets to be valued in G-1’s estate were the [split dollar] receivables, which contained no restrictions. G-1 could have freely sold or granted options with respect to those receivables. All of the restrictions were contained in the [split dollar agreement] itself and related to G-1’s rights with respect to the policies. The [split dollar agreements] themselves were not valued on G-1’s estate tax return, and IRC §2703 is not relevant to the valuation of the … receivables as G-1 had unfettered control of those assets.

Jensen & Berselli, *Unfinished Business.*

c. **Sham Transaction; Lack of Business Purpose.** Is the full amount of the premium payment a gift on the creation of the arrangement under the theory that the arrangement is a “sham” transaction that lacks a business or non-tax purposes (other than generating a valuation discount on the ultimate transfer of the receivable)? In *Morrissette*, the life insurance arrangement had a clear business purpose of funding a buy sell agreement. In other situations, the taxpayers may be able to point to the life insurance as a way to provide necessary liquidity at the death of the insured.

d. **Step Transaction.** If the client makes a gift or sale of the receivable under a planned arrangement, the IRS might argue that the client had intended all along to make a gift or sale of the receivable. The client-premium payer may be treated as gifting the premium payment or the life insurance policy directly to the donee. The step transaction argument may be weaker if the client holds the receivable until his or her death (perhaps unless the client is very elderly at the time of the advance under the split dollar arrangement). See Jensen & Ratner, *Discount Private Split-Dollar*, at 23. Even aside from a gift, sale or bequest of the receivable, the IRS may use a step transaction theory to argue that the entire amount of premiums advanced
constitutes a gift. This is the position that it is taking in Estate of Levine v. Commissioner, T.C. No. 9345-15 (petition filed April 8, 2015) (“transfer ... constituted gifts ... in a series of interrelated steps with a value equal to the cost of the ... premiums paid”).

e. **Modification Under Split Dollar Regulations.** A gift or sale of the receivable might be treated as though the donor transferred the entire life insurance policy that had been deemed to be owned by the donor. The split dollar regulations provide that if the split dollar arrangement is modified and the donor is no longer the owner under the split dollar arrangement, the donor “is treated as having made a transfer of the entire life insurance contract to the [trust] as of the date of such modification.” Treas. Reg. §1.61-22(c)(1)(ii)(B)(2); see Jansen & Ratner, Discount Private Split-Dollar, at 23-24.

f. **Section 2036 and 2038.** Is the transfer of the premium a transfer with a retained right of enjoyment or the retained right to control beneficial enjoyment? (The IRS is making that argument, as well as the §2703 argument, in Cahill v. Commissioner, discussed below.) In the case handled by Messrs. Jensen and Berselli, the “appellate conferee analogized the valuation of a [split dollar] receivable to that of a family limited partnership or limited liability company holding cash or marketable securities.” Jensen & Berselli, Unfinished Business. The IRS’s primary argument in the FLP/LLC cases has been under §§2036 and 2038. A sale of the receivable during the donor’s life should avoid the §2036/2038 risk at the donor’s death (assuming §2035 does not apply).

g. **Duty of Consistency.** The IRS may argue, under the “duty of consistency” analysis used in some cases, that the taxpayer owes a duty of consistency in valuing the receivable for gift and estate tax purposes. The IRS made this argument in the recently settled intergenerational split dollar insurance case that was handled by Messrs. Jensen and Berselli:

> The Service contends that, if the taxpayer, under the economic benefit regime, reports a relatively minor gift amount at the outset of the arrangement, then the remaining value of the premiums advanced, without discount, should be included in the decedent’s gross estate.

> Whereas, the Service’s consistency argument has the benefit of simplicity, it fails to account for the economics of the arrangement. In our litigation, we continually pressed the appellate conferee to tell us how the [split dollar agreements] failed to comply with the Regulations. Our appellate conferee dismissed these questions out of hand without authority. In our view, provided that we complied with the Regulations (which we did), the valuation standard should be that of a debt instrument with no fixed term, not subject to payment on demand, and with no annual principal or interest payments.

Jensen & Berselli, Unfinished Business.

3. **Estate of Cahill v. Commissioner.** A new case that has been filed in the Tax Court is illustrative of additional issues that arise with intergenerational split dollar insurance. Estate of Cahill v. Commissioner, T.C. No. 10451-16 (petition filed May 3, 2016). Issues raised by the IRS in that case include:

- Property paid to the trust (to pay premiums) is included in the decedent’s gross estate under §2036(a)(1) and 2036(a)(2), and the transfer was not a bona fide sale for adequate and full consideration;
• Certain provisions of the split-dollar agreement constitute a restriction on the right to use or sell the decedent’s property, or an option, agreement, or other right to acquire or use decedent’s property at a price less than fair market value under §2703;
• Property paid to the trust is included in the gross estate under §2038;
• Under §2043, the excess of the fair market value at the time of death of property otherwise included under §2038 or §2035 over the value of the consideration received by decedent was included in the gross estate;

4. **Valuation of Receivable.** The court in *Morrissette* made clear that it was not addressing the value of the receivable in the partial summary judgment decision; that will be addressed subsequently. However, at least one commentator predicts that “*Morrissette* will not proceed to a decision on the merits of the valuation of the [split dollar] receivable. There is simply too much at stake to be wrong—for the taxpayer and the IRS. We faced a similar dilemma and ultimately settled on a discount of 35% as opposed to our claimed 95%.” Jensen & Berselli, *Unfinished Business*.

In the case referenced by Jensen and Berselli, G-1 advanced premiums to life insurance trusts to purchase life insurance on the lives of G-1’s children (G-2). The split dollar receivables were reported on the decedent’s estate tax return on the basis of independent valuations of the split dollar receivable, which considered the decedent’s restricted access to repayment as well as the actuarial life expectancy of each of the insureds. The receivables were reported with a 95% discount—and the parties settled at a 35% discount.

In *Cahill*, the values reported on the estate tax reflected about a 98% discount compared to the value asserted by the IRS. An independent appraiser (WTAS, LLC, now Anderson Tax) valued the receivable using the discounted cash flow method using a discount rate of 15%.

5. **Loan Regime Arrangements.** Some intergenerational split dollar arrangements are structured using the loan regime with notes documenting the advances with an AFR interest rate. The discounts may not be as large as under the economic benefit regime, but planners suggest that significant advantages may still be available. (For example, significant discounts may still apply because the interest rate on the loan may be much lower than the discount rate that an appraiser will apply in valuing the note.) The *Morrissette* holding will not be directly relevant to loan regime split dollar arrangements (because it addresses how the loan regime can be avoided if that is what the parties prefer in structuring the arrangement).

6. **Endorsement vs. Collateral Assignment Arrangement.** Under the classic endorsement split dollar arrangement in a family (donor-donee) context, the donor owns the policy, pays some or all of the premiums, and endorses to a donee the right to the death benefit to the extent that it exceeds the greater of the premiums paid by the donor or the cash surrender value of the policy. The endorsement approach is not typically used in a family context with a classic split dollar arrangement for a policy on the donor’s life because the donor’s rights as owner of the policy would constitute incidents of ownership under §2042 causing the insurance death proceeds to be in the donor’s gross estate. Using a
collateral assignment approach, with an irrevocable life insurance trust owning the policy and the donor merely having a “bare-bones” right to be reimbursed for the premium advances, avoids estate inclusion of the policy proceeds. (See Rev. Rul. 76-274.)

Eliminating incidents of ownership in the donor is unnecessary when the donor is not the insured. Therefore, intergenerational split dollar arrangements could be structured as endorsement plans, with the donor owning the policy, and thereby avoid the issues raised in Morrissette (as to whether the donor is the deemed owner of the policy, because the donee has no benefits other than current life insurance protection, so that the economic benefit regime can apply) without risking estate inclusion of the policy death proceeds in the donor’s estate.

The collateral assignment approach may result in greater discounts on the value of the receivable than with an endorsement approach under which the donor owns the policy. For example, the donor that owns the policy can control investments (which is very important for a variable life policy), and may have rights to borrow the cash value (with the caveat that the donor cannot borrow enough to endanger the policy). Those rights may blunt the “lock-in” aspect of the arrangement that supports very large discounts. Perhaps that is the reason that some planners continue to use the collateral assignment approach even though the endorsement approach is safer from a gift tax risk standpoint (although the gift tax risk has been greatly ameliorated by the Morrissette decision).

7. Sale of Receivable. A sale of the receivable during the donor’s life may reduce the likelihood of the IRS raising other arguments summarized in Paragraph 2 above on an audit of the donor’s estate tax return if the return merely includes cash or another note that makes no reference to a life insurance policy.
First Tax Court Opinion to Endorse Economic Benefit Regime for Private Split-Dollar Life Insurance

By Peter F. Culver

Summary:

In a case of first impression, the Tax Court held that where a split-dollar life insurance arrangement provided only current life insurance protection to the donee, the donor is deemed the owner, and the transaction is governed by the economic benefit regime under IRS Regs. 1.61-22. Estate of Morrissette, 146 T.C. 11 (4.13.2016).

Background:

A split-dollar life insurance arrangement occurs when two or more parties or entities split the costs and benefits of permanent life insurance. The IRS issued final regulations in 2003 that govern all split-dollar arrangements entered into after 9.17.2003.1 The final regulations define a split-dollar arrangement as an arrangement between an owner and a non-owner of a life insurance contract in which (1) either party pays all or a portion of the premiums, and (2) the party paying the premiums is entitled to recover all or a portion of the premiums, and the recovery is made from, or secured by, the life insurance proceeds.2

The final regulations provide two different regimes for taxing split-dollar arrangements: (1) the “economic benefit” regime and the “loan” regime. Under the economic benefit regime, taxation of the transaction is based on IRS Table 2001, which values the gift based on the the cost of one-year renewable term insurance; under the loan regime, taxation is governed by the less-favorable IRS rules on below-market loans in Section 7872.3

The determination of which regime applies to a particular split-dollar arrangement depends on which party owns the life insurance. Generally, if the donee owns the policy, and the policy premium is paid by the donor, the arrangement is governed by the loan regime.4 However, the regulations create a special exception, which provides that if the only economic benefit provided to the donee is current life insurance protection, then the donor will be deemed to be the owner, and the economic benefit regime will apply. Conversely, if the donee receives any additional economic benefit, then the donee will be considered the owner, and the loan regime will apply.5

The Facts in Morrissette

In 2006, Clara Morrissette’s Revocable Trust entered into a split dollar arrangement with three trusts established for the benefit of her sons (the “Dynasty Trusts”). The Revocable Trust contributed a total of $29.9 Million to the Dynasty Trusts to purchase
life insurance on her three sons. The purpose of the life insurance was to fund buy-sell agreements between the three sons relating to the family business.

The split-dollar agreement provided that, upon Mrs. Morissette’s death or the termination of the split-dollar arrangement, the Revocable Trust would receive the greater of the cash surrender value of the policies or the aggregate premium payments. The split-dollar agreement specifically stated that “…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 Trusts] … is current life insurance protection”.

From 2006-2009, Mrs. Morissette reported annual gifts to the trusts under the economic benefit regime. The amount of each gift was reported as the cost of the insurance, based on Table 2001, less the amount of the premiums paid. These amounts ranged from $64,249 (2006) to $206,419 (2009). When Mrs. Morissette died in 2009, the Estate included in the total value of the Estate its appraised (discounted) value of the receivable due to the Estate($7,479,000).

After Mrs. Morissette’s death, The IRS issued two notices of deficiency: 
(1) a gift tax liability for the year of the original gift, in the amount of $13,800,179 and a penalty of $2,760,036; and 
(2) an estate tax liability, in the amount of $32,060.070.

The basis for these deficiencies was the claim by the IRS that the split-dollar arrangement was not entitled to treatment under the economic benefit regime in the Regulations and should instead be governed by the loan regime.

**Tax Court Decision**

The Estate filed for summary judgment in the Tax Court, arguing that the issue of whether the split-dollar arrangement in question was entitled to treatment under the economic benefit regime was strictly a question of law. The Tax Court agreed, and found in the Estate’s favor based on the following analysis:

1. The preamble to the final split-dollar regulations includes an example that is structured exactly the same as the split-dollar arrangement under review. In the example, the donor is entitled to receive an amount equal to the greater of the aggregate premiums paid or the cash surrender value of the policy. In this situation, the possibility of the donee receiving any additional economic benefit is foreclosed, and therefore the split-dollar arrangement is entitled to treatment under the economic benefit regime.6
2. To determine whether the Dynasty Trusts received any any additional economic benefit, the relevant inquiry is whether the Dynasty Trusts had current access to the cash value of the policies, or whether there were any other economic benefits.6
   a. **Current Access to Cash Value.** The split-dollar arrangements here were structured so that (i) upon termination of the split dollar arrangement
during the lifetime of the insured, 100% of the CSV would be paid to the
donor; (ii) if the split-dollar arrangement terminated because of the death
of the insureds, the Dynasty Trusts would only be entitled to receive
the portion of the death benefit
that exceeded the receivable payable to the donee. “Accordingly, under
the split-dollar life-insurance arrangements the Dynasty Trusts had no
current or future right to any portion of the policy cash value, and thus, no
current access under the Regulations.”

b. **Other Economic Benefit.** The IRS argued that the split-dollar
arrangements under review should be governed by Notice 2002-59, which prohibits the application of the economic benefit regime in the case of “reverse split-dollar” arrangements. In a reverse split-dollar arrangement, the insured is entitled to the death benefit, in return for payment to the donee of the greater of the actual cost of the insurance or the P.S. 58 rate.) The court dismissed this argument on the grounds that the split-dollar arrangements under review "bear no resemblance" to the transactions in Notice 2002-59, because the receivable payable to the donor received in exchange for its advances to the Dynasty Trusts provided the donor with sole access to the CSV of the policies.

**Implications**

*Estate of Morrissette* provides welcome confirmation for the treatment of a properly structured private split-dollar arrangementsunder the economic benefit regime, thereby providing its favorable transfer tax treatment. There are two caveats. First, the Tax Court expressed no opinion on the valuation of the receivable claimed by the Estate, leaving resolution of that factual issue for further litigation. Second, the case could be appealed, so watch for future developments on that front.

**The Author**

Peter Culver, JD, TEP, is a wealth advisor with 25 years of experience counselling families on sophisticated investment, planning and governance issues. Most recently, he served for 15 years as Senior Wealth Advisor at BNY Mellon Wealth Management in New York City.

**Endnotes**

2. IRS Regs. 1.66-22(b).
3. IRS Regs. 1.66-22(b)(3)(i).
4. IRS Regs. 1.66-22(c)(1)(i).
5. IRS Regs. 1.66-22(c)(1)(ii)(A)(2).
6. 146 T.C. No. 11 at 15.
7. Id. at 17-18.
8. Id. at 18-21.
10. 146 T.C. No. 11 at 21-24.
Benefit Plans Find it Harder to Recover Funds from Participants

By Charles H. Thulin, Ekman Thulin, P.S., Seattle

In *Montanile v. Board of Trustees*, the Supreme Court held that the trustees of an ERISA-governed self-insured health plan could not recover on the plan’s claim for reimbursement of medical benefits paid from a plan participant’s general assets.

The participant had been injured by a third party. The plan paid medical expenses for treatment of the participant’s injuries. The plan document required any amounts the participant recovered from a third party be applied first to reimburse the plan. The participant sued the third party, and recovered funds in a settlement of the lawsuit. The settlement fund was held by the participant’s attorney, who gave the trustees 14 days’ notice that the participant’s share of the settlement would be released to the participant. The trustees did nothing in response until six months later, when they sued the participant. By that time the participant had dissipated the settlement funds on nontraceable assets.

The trustees had sought recovery under ERISA section 502(a)(3), which authorizes a fiduciary to seek “to obtain … appropriate equitable relief … to enforce … the terms of the plan.” Under prior decisions by the Court, the plan’s reimbursement provisions created an “equitable lien by agreement,” which provided an equitable “basis” for the trustees’ claim. The Court held, however, that recovery from the participant’s general assets was not an “equitable remedy” under section 502(a)(3). Had the trustees sued immediately to enforce the lien against the settlement fund while in the participant’s possession or control or against traceable items participant purchased with the settlement funds, the trustee would have sought an equitable remedy cognizable under section 502(a)(3).

The primary lesson that the fiduciaries of self-insured health plans draw from the *Montanile* decision is that they must more rapidly pursue enforcement of equitable liens created under the terms of their plan documents in order to recover their claims for reimbursement. This will require closer cooperation between the third party administrators (who typically initiate inquiries to participants about potential third party liability for a participant’s injuries and often handle the plan’s initial efforts to recover reimbursements) and the health plan’s legal counsel, who won’t be aware of the potential need for legal action until the third party administrator brings the matter to counsel’s attention. Absent a procedure to routinely notify counsel of potential reimbursement claims, the opportunity to recover settlement funds before dissipation may be lost.

For the fiduciaries of pension or disability plans, the *Montanile* decision raises the question whether they are similarly restricted when seeking recovery of benefit overpayments. Often pension or disability benefit payments are made on a monthly basis as replacement for incomes the participants no longer earn after retirement or disability. Those benefits often will used by the participant to pay his or her ongoing living expenses. If the retirement or disability plan fiduciary’s only avenue for recovery
is under ERISA section 502(a)(3), the fiduciary may be unable to enforce a demand for reimbursement of prior overpayments, as the only source of recovery may be the participant’s general assets.

* * *

1 Montanile v. Board of Trustees of the National Elevator Industry Health Benefit Plan, 136 S. Ct. 651, 577 US __, 193 L. Ed. 2d 556 (January 20, 2016)