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Tax Court Decisions In *Morrissette*

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In several past issues of Practical Drafting, *Estate of Clara M. Morrissette v. Comm'r* has been mentioned. In the most recent decision (T.C. Memo 2021-60), the Tax Court held that IRC Secs. 2036 and 2038 do not apply to *inter vivos* transfers made as part of split-dollar life insurance agreements because (i) the bona fide sale exceptions apply and (ii) the IRC Sec. 2703 special valuation rules do not require the inclusion of cash surrender values of the life insurance policies in the gross estate.

The opinion also dealt with the economic benefit regime which was discussed in a prior opinion (146 T.C. 171) and states:

Before addressing whether the CMM trust received adequate and full consideration, we first address petitioners' [the estate's] argument that satisfaction of the economic benefit regime means that there was adequate and full consideration. Petitioners argue that estate tax consequences of the split-dollar agreements should be consistent with the economic benefit regime. The CMM trust's payment of the premiums was not a gift for gift tax purposes, which means, according to petitioners, the transfer was an exchange for adequate and full consideration.

Compliance with the economic benefit regime does not mean that the adequate and full consideration requirement is met. *Estate of Cahill v. Commissioner*, at *33. Under the plain text of the regulations, the economic benefit regime does not apply for estate tax purposes. The regime is set out in the income tax regulations, and the regulations state that the regime applies for income, gift, employment, and self-employment tax purposes. Sec. 1.61-22(a), Income Tax Regs. Estate tax is not listed. The economic benefit regime does not use the phrase "adequate and full consideration" or otherwise invoke the concept of adequate and full consideration. Rather, it addresses a separate fundamental question of gift tax, whether there is a completed transfer. See sec. 2512 (requiring a completed transfer of property to impose gift tax). The economic benefit regime does not require a comparison of the amount of the premium payment with the value of the rights that the CMM trust received in exchange. Accordingly, petitioners cannot rely on the economic benefit regime to establish that the CMM trust received adequate and full consideration.

Cahill was mentioned on pages 13169-13177 of the July 2018 issue of Practical Drafting.

The court then discussed the IRS contention that adequate and full consideration is based upon a willing buyer and a willing seller who are hypothetical persons intending to achieve maximum economic advantage and rejected the contention.

We hold that the CMM trust received adequate and full consideration on the basis of the split-dollar agreements' repayment terms that included interest earned in the form of inside buildup of the insurance policies. The minimum interest rates and the actual appreciation in the policies' cash values were higher than the interest rates that the CMM trust had been earning on the money. Respondent does not argue that the repayment terms were inadequate. The split-dollar agreements also provide the additional benefit of deferral of tax on the policies' inside buildup and the tax-exempt payout of the death benefits to the beneficiaries.

Respondent argues that *Estate of Cahill* involved "essentially the exact same circumstances". In that case, the decedent, at age 90, obtained a five-year bank loan to pay the entire amount of the $10 million in premiums. Here we have a 75-year-old family business and a decedent with assets sufficient to pay a substantial portion of the premiums. Here also, the decedent owned assets and other sources of income to repay the small loan she did obtain.

In addition, *Estate of Cahill* did not involve active business operations with related financial considerations such as management efficiency and succession, capital accumulation and long-held grudges that put those financial considerations at risk. The split-dollar agreements provided financial benefits similar to those present in *Kimbell* including management expertise, security and preservation of assets, and capital appreciation. *Kimbell*, 371 F.3d at 266. *Kimbell* accepted these types of financial benefits as reducible to a money value.

The CMM trust and Mrs. Morrissette received financial benefits from the split-dollar agreements including retained family control over Interstate, a smooth management succession, organizational stability, and protection of Interstate's capital by providing a source of funding to pay estate tax on the brothers' deaths. Mrs. Morrissette placed a high value on keeping Interstate within the family. The financial benefits were significant and are relevant to ascertaining the consideration received. *Kimbell* accepted similar benefits without quantifying them. *Id*. at 266-267 (finding that partnership interest discounted at 50% of the value of the assets contributed to the partnership was adequate and full consideration without quantifying the value of the other financial benefits present).

Finally, the court dealt with the application of IRC Sec. 2703 and noted that a bona fide business arrangement is not defined in the Code or Regulations. It determined that a business purpose was behind the split-dollar agreements which were intended to address the flaws in the 1996 plan, past family disputes and Interstate's future management while attempting to satisfy Mrs. Morrissette's wish for the company to remain in the family for generations. Based upon all the facts and circumstances, the court determined that the mutual termination restriction was not a device to transfer funds for less than adequate and full consideration.

In applying the comparability with an arm's-length transaction between unrelated parties – the third prong of the IRC Sec. 2703 exception – the court said:

The mutual termination restriction would ensure the executives' rights to the net death benefits similar to vesting in employment compensation packages on the basis of years of service. In total, approximately 30% of the public agreements imposed some restriction on the employer's termination rights. The termination rights of another 13% are not as clear as respondent argues.

As discussed above, on these facts we hold the split-dollar agreements were entered into at arm's length especially in the light of the brothers' acrimonious relationships and disputes over Interstate's ownership. We are satisfied that a split-dollar agreement entered into by a closely held business and its long-term senior executives at arm's length may contain a mutual termination restriction similar to the one in the split-dollar agreements at issue. Accordingly, we hold that the third requirement of the section 2703(b)(3) exception has been met.

To date, no appeal has been filed in *Morrissette*.

The facts of *Morrissette* were unusual. Thus, reliance on the case concerning Sections 2036, 2038 and 2702 would appear difficult for other estates.

An excellent article discussing the case is Adcock, *Estate of Morrissette II – Winning the Battles but Losing the War*, Estates, Gifts & Trust Journal, Bloomberg BNA, pages 117-124, Volume 46, July 8, 2021.

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related professionals

Jerome J. Caulfield / Partner
D 212 238-8809
caulfield@clm.com