For Trusted Advisors

Summer 2016

Intergenerational split dollar.

Summary.

In Estate of Morrissette,[1] the U.S. Tax Court granted summary judgment, holding that intergenerational split dollar may be permitted under the split dollar regulations.

Overview.

Under the split dollar regulations,[2] there are two basic forms of split dollar taxation: economic benefit regime and loan regime. Split dollar plans may be sponsored by an employer in a work setting, or an individual or trust in a private setting. This article discusses a type of private economic benefit split dollar plan.

Facts.

For buy-sell purposes, three brothers, A, B, and C, each established an irrevocable trust that purchased a life insurance policy on each of the other two brothers.

A's trust owned a policy on B and a policy on C, etc. Their mother's revocable trust (MT) engaged in a private non-equity economic benefit split dollar arrangement with each trust, to which MT made a single, lump-sum premium contribution of nearly $10M, and each trust collaterally assigned the greater of premiums paid or cash values to MT. The trusts were entitled to the death benefit in excess of MT's interests and were required to pay the economic benefit annually or have the donor report the economic benefit as a gift to the trusts.

The mother died three years later, and the personal representative, relying upon a professional service to determine the value of the receivables of each trust, asserted that the amount due the estate was a substantially discounted amount. The valuation issue is not addressed or resolved in this case.

The estate filed a motion for summary judgment, seeking a ruling that under applicable law the premium payments were split dollar payments under the economic benefit regime split dollar regulations of Reg. §1.61-22.

Issues.

The IRS argued that:

(1) The arrangements did not qualify under the economic benefit regime split dollar regulations of Reg. §1.61-22;

(2) The arrangements were loans covered under the loan regime split dollar regulations of Reg. §1.7872-15;

(3) The arrangements were actually reverse split dollar under Notice 2002-59; or,

(4) The payments to the trusts were pre-paid premiums, not split dollar payments.

Ruling.

The Tax Court granted summary judgment, ruling in favor of the estate on each issue.

Comments.

The Morrissette case is the first case that addresses intergenerational split dollar where the donor's interest is subject to a discount.

- The theory regarding the discount is that a deceased donor's interest is merely that of a collateralized receivable that would be paid at the insured child's death; the value of the receivables, therefore, should be reduced by the structure of the economic benefit regime that pays an uncertain amount at an uncertain time, with no current return, coupled with potential current tax liability. It will be interesting to see how the court resolves the valuation issue.
- If the discounted interest attempted here is ultimately sustained by the courts, this intergenerational split dollar technique may become a significant means of transferring wealth from one generation to another.

1 Estate of Morrissette v. Comm'r, 146 T.C. ____ (No. 11) (4/13/2016).

2 Reg. §1.61-22 for economic benefit split dollar, and Reg. §1.7872-15 for loan regime split dollar.

Transferring an existing life insurance policy to an irrevocable trust.

It is not uncommon for advisors to meet a client and discover that the client owns a life insurance policy in his or her individual capacity that was intended to be owned by the trustee of the client's irrevocable trust. In other situations, advisors may be working with a client for whom it may be more desirable to transfer an existing policy to a newly created irrevocable trust instead of purchasing a new policy. In either case, it may become necessary to transfer an existing policy to an irrevocable trust. Transferring an existing life policy to an irrevocable trust is an often challenging proposition that necessitates a basic understanding of certain key tax issues.

The transfer of an existing policy to a trust may be accomplished in one of two ways: by gift or by sale. A combination of the two methods also is possible.

Transfers by gift.

Transfers by gift are subject to the "three-year-rule" which provides that transfers made by gift within three years of death are includible in the decedent's taxable estate (IRC §2035(a)). As a result, if a donor dies within three years of gifting a policy to his or her irrevocable trust, the death proceeds will be includible in the donor's taxable estate. Transfers by sale, on the other hand, are explicitly carved out from the application of the three-year rule. The three-year rule does not apply to any "bona fide sale for an adequate and full consideration" (IRC §2035(d)).

Transfers by gift to an irrevocable trust also may be subject to gift tax. Gift tax may be payable on an amount equal to the fair market value of the policy. The donor may be able to take advantage of his or her annual gift tax exclusion ($14,000 per beneficiary in 2016), provided that the trust is drafted with certain provisions that allow for the use of gift tax exclusions with respect to gifts to the trust (i.e., Crummey withdrawal rights). Otherwise, the donor may utilize his or her lifetime exemption ($5,450,000 in 2016) to shield the transfer from gift tax.

Transfers by sale.

The "transfer-for-value rule" is generally triggered when a life policy is transferred for "valuable consideration" (IRC §101(a)(2)). Once this rule taints a life policy, only a portion of the death benefit will remain income-tax free. The income-tax free portion will equal the purchase price plus subsequently paid premiums. The remainder of the death benefit will generally be subject to income tax.

There are several exceptions to the transfer for value rule, and it is critical to meet an exception when a policy is sold to an irrevocable trust. The most commonly utilized exception involves a transfer of the policy to the insured. (See IRC §101(a)(2) for a list of exceptions.) When a policy is sold to the insured for valuable consideration, the transfer for value rule no longer applies to the policy and the proceeds are generally income-tax free.

To meet the transfer to the insured exception when a client sells his or her life insurance policy to his or her irrevocable trust, it is important to ensure that the trust is a "grantor trust" with respect to the insured. If a trust is a grantor trust with respect to the grantor/insured, he or she is treated as the owner of the trust for income tax purposes and the transfer to the insured exception is generally met. A trust may be a grantor trust if the grantor (or a third person) has certain powers over the trust (IRC §§673-677). While the rules governing grantor trust status are beyond the scope of this article, the client's attorney should be able to determine whether the trust is a grantor trust with respect to the client/insured.

When a policy is sold, income tax may also be triggered on the gain inherent in the policy. The taxable amount is generally the excess of sales proceeds over the premiums paid less tax-free dividends received. However, where the client sells his or her policy to his or her irrevocable trust that is a grantor trust with respect to the client, no gain is recognized. In other words, a client may sell a policy to his or her grantor trust income-tax free.

Part-gift, part-sale transfers.

When a policy is transferred to an irrevocable trust, a part-gift, part-sale transaction may also result. Part-gift, part-sale treatment may be intended or it may be deemed. An inadvertent part-sale, part-gift transfer may occur if the policy is sold for less than full and adequate consideration. Then, at least a portion of the transfer may be deemed a gift and be subject to the three-year rule or gift tax liability.

Conclusion.

When contemplating a transfer of an existing policy to an irrevocable trust, it is important to realize the gift tax, estate tax and income tax consequences. Recognizing and properly addressing these issues can ensure that the intended tax benefits of the irrevocable trust and the estate plan (such as income and estate tax free death proceeds) are protected.

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Estate Planning

Basics of lifetime gifts.

Many Americans make gifts to their children and other family members for a variety of reasons. Although such gifts are most often made out of a sense of love and caring, lifetime gifts may also have a practical purpose, such as estate planning or to observe how a donee will handle money. Accordingly, the donor can help the recipient learn sound money or business management skills. Making lifetime gifts often requires careful planning in light of gift and estate taxes.

Federal gift tax return.

A donor must file a federal gift tax return for any year in which the donor makes a taxable gift. However, not all gifts are taxable for federal gift tax purposes.

For example, the Internal Revenue Code excludes the following forms of gifts from a donor's taxable gifts: (1) "annual exclusion" gifts under IRC Section 2503(b); and (2) direct payment of qualified educational and medical expenses under IRC Section 2503(e).

Annual exclusion gifts.

A donor can give an inflation-adjusted "annual exclusion" amount (currently $14,000) to an unlimited number of donees without gift taxes. Through "gift splitting," both spouses can use their annual exclusions for a donee, even if only one spouse actually transfers property.

Only gifts of a "present interest" are eligible for the annual exclusion. Gifts of a "future interest" are ineligible. If a recipient receives a gift with no strings attached, the gift is of a present interest. Generally, if there are conditions on the gift or if there is a delay in the enjoyment of the gift, the gift is a future interest gift. A gift to a trust is a gift of a present interest only if it meets certain conditions, such as:

Right to income: If a grantor creates a trust and gives a beneficiary a right to income, the gift of the income interest may qualify for the annual exclusion. The value of the gift will be the actuarial value of the income interest based on the term of the income interest, the size of the gift, and the prevailing interest rates.

However, if the property transferred is not income producing, the IRS may argue that, for annual exclusion purposes, the value of the income interest cannot be measured, or is zero.

Withdrawal rights: A gift to a trust is a gift of a present interest to the extent the beneficiary has a right to withdraw the gift. Named after the case that first established this rule of law, the right to withdraw a gift to a trust is sometimes called a "Crummey right," and the trust a "Crummey trust." The IRS has agreed to the principle of the Crummey case, but imposes several requirements for a Crummey right to be effective. First, the trustee beneficiary should have actual notice of the contribution and his or her withdrawal right. In addition, the beneficiary must have a reasonable amount of time to exercise the right before it lapses. Although there is no set number of days that qualifies as reasonable, the IRS has approved a withdrawal period as short as 30 days.

Minor's trusts: A gift to a trust for the benefit of a minor under age 21 can qualify as a gift of a present interest (and thus qualify for the annual exclusion) even without Crummey rights. The trust must either distribute income to the minor at least annually [as in a so-called "2503(b) Trust," referring to that section of the Code] or distribute principal to the beneficiary upon attainment of age 21 [as in a "2503(c) Trust"].

Gifts for educational and medical expenses.

Direct payment to the provider of qualified educational or medical expenses on behalf of another does not constitute a taxable gift. The definition of educational expenses only includes tuition paid directly to the educational institution, not room and board, books, etc. For medical expenses, IRS regulations describe exactly what types qualify as expenses for medical care.

Applicable exclusion amount.

The "unified credit" allows a donor to avoid tax on a certain amount of gifts during life and transfers at death. After computing the tax on gifts in excess of a donor's annual exclusions, the donor can reduce or eliminate any gift tax due by the amount of any remaining unified credit. At death, the executor of the decedent's estate will then reduce the amount of estate tax due by any unified credit not used during the donor's life.

The amount of assets the credit effectively exempts from federal gift and estate tax is the "applicable exclusion amount." A taxpayer's applicable exclusion amount for federal gift and estate tax purposes is $5,450,000 in 2016.

Business Planning

Taxation of qualified small business stock and built-in gains.

The Protecting Americans from Tax Hikes ("PATH") Act of 2015, signed into law in December 2015, permanently extended many previously expired but popular tax benefits, one of which is the 100% exclusion of capital gains for Qualified Small Business Stock ("QSBS") under Section 1202 of the Internal Revenue Code.

Another is the permanent reduction to 5 years of the built-in gains tax applicable under Internal Revenue Code Section 1374 following the conversion of a C corporation to an S corporation.

Qualified small business stock gain exclusion.

Benefits. The permanent extension of this provision can greatly benefit investors and entrepreneurs alike, especially in light of the increase of the maximum long-term capital gains rate from 15 percent to 20 percent. In addition to the 100 percent exclusion of capital gains, QSBS gain may be excluded for federal alternative minimum tax purposes as well. Moreover, QSBS gain that qualifies for the exclusion may additionally escape the 3.8 percent Medicare tax.

Taxpayer criteria. To qualify for the QSBS gain exclusion, the holder of the stock must not be a corporation. Only individuals and certain pass-through entities may qualify. The holder of the stock also must have acquired the stock at original issuance and have held it for at least 5 years. The taxpayer must also have acquired the QSBS after September 27, 2010, to qualify for the 100 percent capital gain exclusion. A reduced 50 percent or 75 percent exclusion may be available for stock acquired between August 10, 1993, and September 27, 2010, depending on the particular acquisition date.

Qualified small business stock. For a company's stock to qualify for the QSBS gain exclusion, the company must be a C corporation. The corporation must also be an "active business," meaning that at least 80 percent (by value) of the assets of the corporation must be used in the active conduct of one or more "qualified trades or businesses."

A qualified trade or business means any trade or business other than (i) any trade or businesses involving the performance of services in the fields of health, law, engineering, architecture, accounting, performing arts, financial services, brokerage services, etc. and any other trade or business where the principal assets of such trade or business is the reputation or skill of one or more of its employees; (ii) banking, insurance, financing, leasing, investing or similar businesses; (iii) any farming business; (iv) any business involving the production or extraction of certain products; and (v) any business operating a hotel, motel, restaurant or similar business. The corporation must also be a "qualified small business" with aggregate gross assets not in excess of $50 million (generally measured by reference to the tax basis of the corporation's assets). When determining aggregate gross assets, members of the same parent-subsidiary controlled group are aggregated.

Finally, certain stock redemptions (i.e., the purchase by the corporation of its own stock) may also disqualify the corporation's stock from QSBS treatment.

Reduced holding period for the built-in gains tax.

The PATH Act also permanently reduced to 5 years (instead of 10 years) the period for which an S corporation must hold assets following a conversion from a C corporation in order to avoid the "built-in gains" tax. The new 5-year recognition period is effective as of January 1st, 2015.

The built-in gains tax is a corporate-level tax on an S corporation that was formerly a C corporation (or received assets from a C corporation in a carryover basis transaction such as a tax-free reorganization) that disposes of assets with built-in gains that are attributable to the former C corporation. The built-in gains tax is imposed at the highest corporate tax rate (currently 35 percent) if the built-in gain is recognized during the holding period.

Conclusion.

Entrepreneurs, investors and their advisors should be aware of the newly permanent exclusion of gain on QSBS and the reduced holding period for the built-in gains tax. Proper planning before forming an entity or upon a liquidation event may greatly reduce the tax burden.

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