Estate Planning Community Splits Over Consequences of *Cahill*

by Jonathan Curry

The Tax Court's holding in *Estate of Cahill* may reveal an emerging pattern in the court's thinking that some estate tax practitioners fear could fundamentally alter their profession.

The case involves an estate contesting a deficiency notice from the IRS that adjusted the value of the decedent's rights in three split-dollar life insurance arrangements from $183,700 to $9,611,624. The estate had requested partial summary judgment from the Tax Court, essentially asking the court to affirm that issues related to sections 2036, 2038, and 2703 should not apply to their case, but the Tax Court in *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84, denied the estate's motion June 18.

Practitioners told Tax Analysts that the case's implications extend beyond calling into question the validity of the split-dollar arrangements at the heart of it. "The whole underpinning of this decision was that they were going to treat the decedent as having retained control over the property that was transferred in this transaction, because he, together with the other side, could cancel the contract," said Carlyn S. McCaffrey of McDermott Will & Emery. "Well, of course, that's the nature of contracts."

Almost every state has laws stipulating that when an individual grantor creates a trust, even one that's technically an irrevocable trust, the grantor can still revoke the trust if he gets the consent of all of the trust's beneficiaries, McCaffrey explained. Regulations under section 2038 also say that that grantor should not be treated as retaining control, she added. Although technically non-precedential, the court's holding is still "troublesome," McCaffrey said.

> ***Although technically non-precedential, the court's holding is still 'troublesome,' McCaffrey said.***

Bridget J. Crawford, a professor at Pace University School of Law, said the court's view in its decision seemed overbroad. Like McCaffrey, Crawford said the court's thinking has wider applications than just split-dollar arrangements. "Overall, the decision may reflect that taxpayers have just been too successful, and the Tax Court has had enough," she suggested.

Court Doubles Down

Several observers said the *Cahill* opinion looks to be the latest in a series of holdings suggesting a more taxpayer-adverse stance by the Tax Court.

Mitchell Gans of the Hofstra University School of Law traced the pattern to the 1970s, beginning with the Supreme Court case *United States v. Byrum*, 408 U.S. 125 (1972). In that case, the Court held that section 2036(a)(2) — which says that if a taxpayer retains a right to determine who will receive income or possession of property, that property will be included in the taxpayer's estate — can trigger inclusion only if the retained right is legally enforceable.

In *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145, the Tax Court introduced the idea that section 2036(a)(2) could apply in the context of family limited partnerships, and in so doing it loosened the assumption that a taxpayer needs a legally enforceable right "quite considerably in favor of the IRS," according to Gans.

The Tax Court then "really doubled down" on that concept in *Estate of Powell v. Commissioner*, 148 T.C. 18 (2017), and now, in *Cahill*, it has extended the reach of section 2036(a)(2) to include split-dollar arrangements, Gans said. In *Cahill*, the court is "making good on their promise in *Powell* to advance this concept," he said.

Gans said it isn't unusual to see the Tax Court identify a transaction it views as abusive, but not have clear rules with which to strike it down. Instead, the court will find a tool elsewhere in the tax code and use that to "shoehorn it in," he said. "I think in their haste to strike down abusive transactions, they may be, as a result, muddying up the principles of 2036(a)(2) and the way in which the Supreme Court elucidated those principles in *Byrum*," Gans said.

Todd I. Steinberg of Loeb & Loeb LLP agreed that *Cahill* "definitely builds on the *Powell* result," which he said was based on bad facts and could be misapplied to other cases with distinctly different facts. "I think people are concerned . . . that the IRS and Tax Court judges will look at *Powell* and cite it more," he said.

McCaffrey said that although she views the *Powell* and *Cahill* opinions as misguided, they're also inconsistent with the summary judgment given in *Estate of Morrissette v. Commissioner*, 146 T.C. No. 11 (2016), a gift tax case. In *Morrissette*, the decedent also would have had the right to terminate a split-dollar life insurance arrangement at any time, but McCaffrey said that just meant the estate got to value the right as a contract that could be terminated, not lose the discount altogether. "*Morrissette* supports this transaction. *Cahill* shuts it down — or at least shut it down for this particular decedent," McCaffrey said.

A New Weapon

The court's holding in *Cahill* also introduced what some observers considered to be a novel approach in applying section 2703.

The court applied section 2703 to disregard for valuation purposes restrictions that the decedent put on his property, but in doing so, it raised questions about where else it might apply that section, Gans said. "They seem to be interested in using 2703 as a weapon against [intergenerational split-dollar] arrangements, but that raises the question — could you use 2703 in a transaction where I lent my daughter or my son money?" he wondered.

Gans described a scenario in which he lends money to his daughter for 10 years in exchange for a 10-year promissory note to be repaid at an IRS-approved interest rate. If he were to die, the IRS could now seemingly disregard the terms of the note and deny a discount because it's a restriction that should be set aside under section 2703, he explained.

The court "seems to be at pains to say it doesn't extend to a promissory note, but I'm not sure I find the distinction satisfying," Gans said.

"Despite what the Tax Court claims, the decision basically means that the underlying assets in a partnership are subject to section 2703," Crawford said. "I'm not sure the Tax Court fully understood that implication of its holding."

'Perfectly Reasonable Decision'

Some observers took a more benign view of the court's decision and its possible implications.

"It's a perfectly reasonable decision," said James Repetti, a Boston College Law School professor. "The regs under 2036 and 2038 are clear that, regardless of whether you have a joint power or not . . . you still knew the power in 2036 and 2038 are going to apply," he said, adding that although there is an exception to the application of those two sections when there's been a bona fide sale for adequate and full consideration, the court seems to have rightly decided that that exception didn't apply in this case.

According to Repetti, case law has been developing — largely in the context of family limited partnerships — that for there to be a bona fide sale, there has to be a legitimate nontax reason for the sale, but the court pointed out that the economics of the transaction didn't make sense other than to achieve estate tax planning benefits.

Repetti also said that some case law indicates a taxpayer can't be on both sides of a transaction in a bona fide sale, and that "here, the son was clearly on both sides of the transaction."

James F. Hogan, managing director for Andersen Tax LLC and a former branch chief in the IRS Office of Chief Counsel, likewise disagreed that the court's decision was either unusually harsh to the Cahill estate or part of a pattern of adverse holdings, although he acknowledged that, in the event of a trial, the court "seemed to telegraph that it has already decided that the cash surrender value of the policies at issue would be included in the decedent's estate."

Hogan also acknowledged that the *Powell* and *Cahill* cases suggest the IRS is looking for ways to apply section 2036(a)(2) to strategies beyond transfers through trusts or family limited partnerships, but said the cases primarily seem to indicate that estate tax inclusion will result if a decedent has the ability, in conjunction with others, to control who will possess or control transferred property. He said that post-*Cahill*, he would advise practitioners to be "very cautious in employing intergenerational split-dollar strategies in an effort to transfer wealth to a younger generation."

Gans, although critical of the court's analysis in several areas, still cautioned against overgeneralizing about which planning techniques could come under scrutiny following *Cahill*, because the facts of the case — namely, that the decedent had the ability to terminate the arrangement with the consent of the trustee holding the death benefit — seemed to make the plan "particularly vulnerable to the court's analysis."

Another Day in Court

While it remains to be seen whether *Cahill* will go to trial in the Tax Court, some of the issues presented by the case could take time to be fully resolved.

Steinberg said there are some elements of *Cahill* that the court did not account for in its denial of summary judgment, such as the trustee's fiduciary responsibility to the trust beneficiaries, which would have prevented him from terminating the policy; or that there could have been plausible, legitimate nontax purposes for both the purchase of the life insurance policies and the use of the split-dollar arrangement to finance the payment of premiums.

That suggests that the court's denial of summary judgment likely won't be the end of the road for the Cahill estate, which will pursue a trial, Steinberg said. It "didn't help that the same person was on a lot of sides of the transaction," but section 2036(b) allows a clear exception for a trustee with fiduciary responsibility, he said, adding that even though there's heightened scrutiny when an individual is on both sides of a business transaction, legally there are still two parties present.

Steinberg said it could be at least a year before the *Cahill* or *Morrissette* cases go to trial — assuming they don't settle first — but that for now, *Cahill* is not the "death blow" to intergenerational split-dollar life insurance arrangements that some people are calling it.

Practitioners are already setting up split-dollar arrangements differently than in the past, Steinberg said, noting that there's often a yearslong lag between when a case is first flagged by IRS auditors and when it's brought before the Tax Court. He predicted that intergenerational split-dollar cases will continue to emerge over the next couple of years that will provide more opportunities to better understand the court's thinking.

McCaffrey said that in the meantime, if practitioners want to be certain that transfers to partnerships aren't caught in the section 2036(a)(2) net, they need to ensure that their clients at no point have the right to terminate a partnership. She added that the best way to do that is to make sure transfers are not made directly by the client; rather, the client should transfer the assets to a trust with a third-party trustee and form a partnership that only the trustee, not the client, can terminate. ■