Mary Vandenack provides the transcript from Legal Visionaries podcast on Estate Planning Lessons From The Levine Case

TRANSCRIPT:

Mary: On today's episode, my guest is Eryka Morehead. Eryka is the president and CEO of Collaborative Planning Group Inc. It's an organization worth following on LinkedIn. It's really done some amazing work. Collaborative Planning consults with clients in regard to life, disability, and long-term care planning. Eryka has participated on previous episodes with me. In our first episode, we talked about life insurance to set the tone for some more complex topics. We also discussed something we're both passionate about, which is long-term care planning generally, and then we did an episode talking about split-dollar life insurance and explaining the general concept. I asked Eryka to come back on this episode to talk about a particular case that has gotten a fair amount of attention, which is the Levine case. This case was a win for taxpayers and also an illustration for practitioners on how to do things right and not just in the split-dollar arena, but in general. Thanks for joining me again today, Eryka.

Eryka: Thanks, Mary. I'm excited to be here again.

Mary: Let's start by chatting about the facts in the Levine case, the case in involved the estate tax consequences of an intergenerational split-dollar life insurance planning arrangement that was entered into shortly before the donor, the decedent died. So can you talk just a little bit about what happened in this case?

Eryka: Yes. So this case involves a split-dollar life insurance estate planning arrangement. Marion Levine entered into a transaction in which her revocable trust paid premiums on life insurance policies that were taken out on her daughter and son-in-law that were purchased and held by a separate and irrevocable life insurance trust that was settled under South Dakota law. The revocable trust had the right to be repaid for the premiums it paid. The decisions for investments within the irrevocable life insurance trust, including its termination, could be made only by its investment committee, which actually consisted of one person, her longtime friend and business partner. So Levine died and the policy had not terminated or paid out at that time as her daughter and son-in-law were still living. The question was, what has to be included in her taxable estate because of this transaction? So you have the value of the revocable trust's right to be paid in the future, which was approximately $2.2 million, or the cash surrender value of those life insurance policies at the time of Levine's death, which were approximately $6.1 million.

Mary: And so the estate's position was that the value to be included was that right to be repaid, but the IRS challenged this and said, "Oh no, you have to actually include the cash surrender value of the policies, which was 6.1 million or the value of the premiums paid." So the estate contended that the value was only that insurance receivable. The IRS challenged under code Sections 2036 and 2038. What happened?

Eryka: Yeah, so the split-dollar arrangement in this case met the specific requirements of the treasury regulations. So the policies and questions were purchased and owned by the irrevocable trusts on the outside, not Levine. And that was incredibly crucial here. We oftentimes see people apply for a life insurance policy like in someone's name individually, and then change it at issue and have it issued in the name of a trust. But it was incredibly important detail here that the application, the policy, was all structured, applied, owned in the name of the trust and not by Levine at any time.

Mary: And I would just emphasize that I learned the importance of that actually from those who are on the life insurance end like yourself saying, because I would've been one who early on would've said, well, can't we just apply for it in John's name and then transfer it to the trust? But the fact is you should get that trust in place as part of the strategy and have the trust apply. Trustee applying on behalf of the trust. Correct?

Eryka: And I think here that created a true wall between the investment committee being in control of the policy, being the one to control everything related to the death benefit, and it also, it kept with the spirit of the plan at hand. Whereas if this policy would've been issued in Levine's name individually and then transferred to a trust, it would've been very easy to argue that, well, maybe the original intention was not how it actually was set up in this structure. So having those details all in line helped continue to validate and support the original intention, which was that these policies benefits were there for the grandchildren.

Mary: And so that helped with the 2036 and 2038 issues in your thought process.

Eryka: Yes. So neither Section 2036, the general catchall statute for estate assets nor 2038, the clawback provisioned for certain estate assets transferred before death. They do not require inclusion of the policies cash surrender values because Levine did not have any right by herself or in conjunction with anyone else to terminate those policies.

Mary: And just as an aside mentioning that 2036 and 2038, in case Marty Shankman is listening, I'm quoting code sections just for him. And anyway, he always teases me about talking about tax topics without mentioning code sections. So I've decided we'd mention those. But those are two of the internal revenue code sections that are commonly litigated by the IRS in an attempt to get assets included in the estate. And in this case it was in the context of a split-dollar arrangement. Were there any other holdings worth mentioning?

Eryka: As of her death, Levine possessed a receivable created by the split-dollar life insurance, which was the right to receive the greater of premiums paid or the cash surrender value of the policies when they are terminated. So contrary to the commissioner's position, the transaction was not merely a scheme to reduce her potential estate tax liability. There was a legitimate business purpose. There was nothing behind the transaction's facade that would suggest that appearance of the express written terms of agreement and arrangement do not match reality. And that's kind of a specific quote, if you will, from the case.

Mary: And I would just note that the concept of legitimate business purpose is really important in not just if you're dealing with a split-dollar arrangement, but in a whole lot of different structures. It happens in the family limited partnership when we're arguing about those type of tax issues and whether this is includable, is there an existence as for a legitimate purpose that other than just trying to avoid estate taxes? And this was structured in a way that the court was able to conclude that there was. So you want to speak a little bit more to the trust investment committee, that was another important factor in this case.

Eryka: Yeah, so the trust investment committee, although it was just one person, owed fiduciary duties to the trusts and beneficiaries that were not

Levine, so Levine's daughter and son-in-law, the evidence illustrated that the written an agreements afforded Levine no power to alter, amend, revoke, or terminate the irrevocable trust such that its assets should be included in Levine's estate. Again, pursuant to Sections 2036 A2 or 2038, the only asset from the split-dollar arrangement that Levine's revocable trust owned at the time of her death was the split-dollar receivable.

Mary: So what do you think the key insight from this case is?

Eryka: I think this case illustrates the importance of careful estate planning when utilizing split-dollar insurance and trust agreements. I think it gave us a really great blueprint for plans moving forward. The state law under which the arrangement and the applicable irrevocable trust is settled, together with the rights, controls and powers of the settler and the trustee, are critical components to determine whether the assets transferred to or purchased by the trust should be included in the settler's gross estate upon death. If created pursuant to the treasury regulations, the determination of whether and to what extent a split-dollar insurance arrangement is includable in a decedent's gross estate is determined by the default rules of the codes' estate tax provisions, taking into consideration the economic benefit regime and the loan regime applicable to these arrangements.

Mary: And I just want to footnote a comment that might not be readily picked up from the content of what you just said, but there's an interplay of applicable state law and Internal Revenue Service regulations. And complying with the IRS regulations in one state versus this case, the trust was South Dakota, and South Dakota has some very specific rules that are not the same in every state. So we basically have three different approaches to trust law in different states. So it's important in the planning process to consider both of those. So I just wanted to mention that we have that interplay of Internal Revenue Service rules as well as your state law considerations. We are going to take a brief break from our episode for a word from one of our sponsors. Okay, let's continue our episode. So what are some of the planning considerations after the Levine case?

Eryka: So it was important here when she transferred that six plus million dollars, you need to make sure that the decedent should have sufficient liquidity to live for the rest of their life without the need of the cash used for the insurance policies, and they have enough liquidity to purchase the policies. In this case, if we would've had to worry about her needing access to that cash or there was some sort of structural provision giving her access to the cash, it likely would not have resulted in the end of favorable ruling because of that. Split-dollar can be used for people who face a substantial tax bill. It's a great strategy that we've previously talked about on another episode. Can be ideal for decedents who have children whose lives would be insurable, who are not insurable themselves, or for people who their children do not have sufficient net worth yet to qualify for the large policies that they may need in the future.

It's great when your kids are healthy enough to navigate the underwriting process and it's important to try to avoid any sort of deathbed crisis planning arrangements. Another important component in this case was the articulation of the purpose for the plan and the purpose for the insurance.

Mary: And what I like to say, and I've heard this while used, is that optics matter, and I heard somebody else say that. I wish I could take credit for it being my original statement, but I think it's a good statement about this case and any type of planning is that optics simply matter, and in this case, those who are involved in putting together the structure got it right. Is there anything else that should be considered structurally?

Eryka: I think it was important the decedent cannot alone or in conjunction with another person be able to unwind it. The policy was also applied for and issued in the name of the trust as a previous mentioned.

Mary: What about the roles of fiduciaries?

Eryka: Yeah, so fiduciaries do not have to be paid, but it must be clear that fiduciaries will not benefit personally from the arrangement and they have to honor their fiduciary obligation. We do kind of prefer to keep relatives out of it. If someone has a strong, close familial tie. It may take a lot of explaining or a lot of defending later on. A friend of mine used the analogy of decanting wine. So when you decant, there's always some gunk left at the end. I could also relate to this type of situation.

Mary: I really like that analogy. I'm going to repeat that one too, if you don't mind me borrowing that from you in the future. What about an institutional trust company?

Eryka: So you really need to vet out the trust company to determine if they have sufficient knowledge of this concept. As you mentioned before, it is very complicated and complex and so it's hard to be a fiduciary if you don't completely understand what the obligations are.

Mary: So let's talk a little bit further. You mentioned a couple times in this episode the importance of ownership of the policies, and in our previous episode, you spoke a little bit about using LLCs to own policies. Can you share some thoughts on best practices about policy ownership?

Eryka: Yeah, so policies, they can be held by an LLC designed for this purpose. It could be held by an islet or an individual acting as an independent manager. The policy just must not be owned by or controlled by the insured. We like having the policies owned by LLCs, kind of creates the result of what you might want in an islet. While islets are designed to be irrevocable, as you mentioned, they can be decanted. Where with an LLC, if the LLC owns the policy, we can always move the ownership of the LLC membership interest in the future if we need to. We like to use an insurance manager, which would be equivalent to the investment committee, like in the Levine case, to control the decisions regarding the estate and to make certain that we don't have any incidents of ownership.

Mary: So different roles and clearly defined. And part of that is done with good legal documents and an overall arrangement. Do you have any thoughts to add to that?

Eryka: Very careful drafting and monitoring. Depending on the structure, a full review of each controlling document must be done to avoid any accidental inclusion as a result of the insured having an incident of ownership.

Mary: And I think I mentioned when we were chatting about doing these episodes, that having done a fair amount of split-dollar, there's what I would call simple split-dollar if there is such a thing, which probably does not really exist, but I got into a really complex split-dollar arrangement, the first thing I did was call somebody who's written the book on split-dollar arrangements by the name of Larry Brody who just generously helped me out with the structure. But I think it's really important if it's not the area of expertise or even if it's something you generally do, but I haven't done this particular arrangement to reach out and make sure that we're collaborating with other professionals to make sure that all the ‘i’s are dotted and ‘t's crossed. Well, do you have any last thoughts on this topic today, Eryka?

Eryka: I think this life insurance planning just becomes simpler if you don't die and you always pay your premiums.

Mary: Yeah, I always say that life insurance is a good investment if you die early, right? Well, thanks so much for being here today. As we reach the end of our episode, I want to thank our sponsors InterActive Legal, Carson Private Client and Foster Group. That's all for now. Thanks for listening to today's episode and stay tuned for our weekly releases.