R. CHARITABLE SPLIT-DOLLAR INSURANCE TRANSACTIONS

In Notice 99-36, 1999-26 I.R.B. 1, dated June 14, 1999, the Service addressed certain tax issues relating to charitable split-dollar insurance transactions. Notice 99-36 is reproduced in its entirety as follows:

Notice 99-36

Charitable Split-Dollar Insurance Transactions

1999 IRB LEXIS 253; 1999-26 I.R.B. 1; Notice 99-36

June 14, 1999

This notice is to alert taxpayers and organizations described in section 170(c) of the Internal Revenue Code (including charities described in section 501(c)(3)) about certain charitable split-dollar insurance transactions that purport to give rise to charitable contribution deductions under sections 170 or 2522. Taxpayers and these organizations should be aware that these transactions will not produce the tax benefits advertised by their promoters. Furthermore, promoters of these transactions, and taxpayers and organizations participating in them, may be subject to other adverse tax consequences, including penalties.

In general, a charitable split-dollar insurance transaction involves a transfer of funds by a taxpayer to a charity, with the understanding that the charity will use the transferred funds to pay premiums on a cash value life insurance policy that benefits both the charity and the taxpayer's family. Typically, as part of this transaction, the charity or an irrevocable life insurance trust formed by the taxpayer (or a related person) purchases the cash value life insurance policy. The designated beneficiaries of the insurance policy include both the charity and the trust. Members of the taxpayer's family (and, perhaps, the taxpayer) are beneficiaries of the trust.

In a related transaction, the charity enters into a split-dollar agreement with the trust. The split-dollar agreement specifies what portion of the insurance policy premiums is to be paid by the trust and what portion is to be paid by the charity. The agreement specifies the extent to which each party can exercise standard policyholder rights, such as the right to borrow against the cash value of the policy, to partially or completely surrender the policy for cash, and to designate beneficiaries for specified portions of the death benefit. The agreement also specifies the manner in which it may be terminated and the consequences of such termination. Although the terms of these split-dollar agreements vary, the common feature is that, over the life of the split-dollar agreement, the trust has access to a disproportionately high percentage of the cash-surrender value and death benefit under the policy, compared to the percentage of premiums paid by the trust.

As part of the charitable split-dollar insurance transaction, the taxpayer (or a related person) transfers funds to the charity. Although there may be no legally binding obligation expressly requiring the taxpayer to transfer funds to the charity to assist in making premium payments, or expressly requiring the charity to use the funds transferred by the taxpayer for premium payments in accordance with the split-dollar agreement, both parties understand that this will occur.

The structure of charitable split-dollar insurance transactions varies. In some cases, a member of the taxpayer's family, a family limited partnership, or another type of intermediary related to the taxpayer is used as an intermediary rather than an irrevocable life insurance trust. This notice applies to any charitable split-dollar insurance transaction, regardless of whether a trust or some other type of related intermediary is used in the transaction.

Generally, to be deductible as a charitable contribution under section 170 or 2522, a payment to charity must be a gift. A gift to charity is a payment of money or transfer of property without receipt of adequate consideration and with donative intent. See Rev. Rul. 67-246, 1967-2 C.B. 104, which holds that a payment to charity may be deductible, to the extent it exceeds the fair market value of the benefit received, if the excess is paid with donative intent; and section 1.170A-1(h) of the Income Tax Regulations. See also U.S. v. American Bar Endowment, 477 U.S. 105 (1986), in which participants in a group insurance program operated by a charity were denied a charitable contribution deduction for a portion of the premium paid to the charity because the participants failed to show that they knowingly made payments to the charity in excess of the fair market value of the insurance.

However, regardless of whether a taxpayer receives a benefit in return for a transfer to charity or has the requisite donative intent, sections 170(f)(3) and 2522(c)(2) provide that generally no charitable deduction is allowed for a transfer to charity of less than the taxpayer's entire interest (i.e., a partial interest) in any property. Thus, no charitable contribution deduction is permitted when a taxpayer assigns a partial interest in an insurance policy to a charity. See Rev. Rul. 76-1, 1976-1 C.B. 57, which holds that a transfer to charity of an annuity contract constitutes a nondeductible gift of a partial interest where the transferor effectively retains the right under the annuity contract to purchase life insurance at reduced rates; and Rev. Rul. 76-143, 1976-1 C.B. 63, which holds that a transferor's irrevocable assignment of the cash surrender value of a life insurance policy to a charity, while retaining the right to designate the beneficiary and to assign the balance of the policy, is a transfer to charity of a nondeductible partial interest under section 170(f)(3).

Promoters of charitable split-dollar insurance transactions contend that a taxpayer participating in such a transaction is entitled to a charitable contribution deduction under section 170 or 2522 for the funds transferred to the charity. First, they contend that the funds transferred to the charity constitute unrestricted gifts because there is no obligation that legally binds the charity to pay the policy premiums with those funds. Second, promoters contend that charitable split-dollar insurance transactions do not violate the partial-interest rule in section 170(f)(3) or 2522(c)(2) because the taxpayer generally is not a party to the split-dollar agreement with the charity and has no interest in the insurance policy.

In analyzing the federal tax consequences of a particular transaction, the Service is not required to respect the form of a taxpayer's transaction when to do so would yield a result that is inconsistent with the substance of the transaction. See Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945); Gregory v. Helvering, 293 U.S. 465, 469-470 (1935). In Blake v. Commissioner, T.C.M. 1981-579, aff'd, 697 F.2d 473 (2d Cir. 1982), a taxpayer contributed appreciated stock to a charity. The charity sold the stock and used the proceeds to purchase the taxpayer's yacht at an inflated price. The Tax Court disregarded the form of the transaction and taxed it in accordance with its substance -- as if the taxpayer had sold the stock and contributed the yacht to the charity. On appeal, the taxpayer contended that the charity had no legally binding obligation to purchase the yacht and that absent such an obligation the transactions must be treated according to their form. The Second Circuit disagreed with the taxpayer and held that there was a legal obligation on behalf of the charity to purchase the yacht, based on the doctrine of promissory estoppel. The court went on to state that "even if [the charity] were not legally obligated, the Tax Court's finding that the transactions were undertaken pursuant to an understanding arrived at in advance is sufficient to sustain the Commissioner's position." 697 F.2d at 474-475. See also Rev. Rul. 76-1, in which a taxpayer is treated, in substance, as retaining a right under an annuity contract to purchase life insurance at reduced rates even though, in form, the taxpayer had transferred complete ownership of the annuity contract to charity.

Similarly, in a charitable split-dollar insurance transaction, the Service will apply the substance-over-form doctrine based on the mutual understanding between the taxpayer, the trust (or other related intermediary), and the charity. The Service will treat the transaction as one in which the taxpayer obtains an insurance policy, pays premiums with respect to that policy, and transfers some of the rights under that policy to the trust and the remaining rights to charity. Because a taxpayer participating in a charitable split-dollar insurance transaction is treated as dividing the rights in the insurance policy between the trust and charity, the taxpayer does not come within the "transfer-of-an-entire-interest" exception to the partial-interest rule of sections 170(f)(3)(B)(ii) and 1.170A-7(a)(2)(i) of the Income Tax Regulations. Thus, the Service will treat a taxpayer's participation in a charitable split-dollar insurance transaction as violating the partial-interest rule in sections 170(f)(3) and 1.170A-7(a)(2)(i), and no income tax deduction under section 170 will be allowed to the taxpayer with respect to such a transaction. Similarly, pursuant to sections 2522(c)(2) and 25.2522(c)-3(c)(1)(i) of the Gift Tax Regulations, no gift tax deduction under section 2522 will be allowed.

Promoters of charitable split-dollar insurance transactions contend that the assumptions used to value current life insurance protection under Rev. Rul. 64-328, 1964-2 C.B. 11, as clarified in Rev. Rul. 66-110, 1966-1 C.B. 12, are relevant in determining the value of benefits received by, and the amount of charitable deduction allowed to, taxpayers participating in these transactions. However, these revenue rulings do not apply to charitable split-dollar insurance transactions. Moreover, because the partial-interest rule does not allow any charitable deduction with respect to charitable split-dollar insurance transactions, there is no reason to determine the value of benefits received by the taxpayer in those transactions.

Depending on the facts and circumstances, the Service may challenge, on the basis of private inurement or impermissible private benefit, the tax-exempt status of a charity that participates in charitable split-dollar insurance transactions. In appropriate circumstances, the Service may assess taxes on excess-benefit transactions under section 4958, or self-dealing under section 4941, against any disqualified person who benefits from the charitable split-dollar insurance transaction and against certain of the charity's managers. The Service may also assess taxes on taxable expenditures under section 4945 against any private foundation that participates in such transactions and against certain of the foundation's managers. In addition, a charity that provides written substantiation of a charitable contribution in connection with a charitable split-dollar insurance transaction may be subject to penalties for aiding and abetting the understatement of tax liability under section 6701. The Service also will consider whether to require charities to report participation in charitable split-dollar insurance transactions on their annual information returns.

In addition, the Service may impose penalties on participants in charitable split-dollar insurance transactions, including the accuracy-related penalty under section 6662, the return-preparer penalty under section 6694, the promoter penalty under section 6700, and the penalty under section 6701 for aiding and abetting the understatement of tax liability.

DRAFTING INFORMATION

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