John Hancock LIFE INSURANCE

Advanced Markets
Central Intelligence

June 2010

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House Passes Legislation with GRAT Limitations

HR 5486, "Small Business Jobs Tax Relief Act of 2010"

On June 15, 2010, the House of Representatives passed HR 5486, the "Small Business Jobs Tax Relief Act of 2010," by a vote of 247–170. One of the revenue raising provisions in HR 5486 is the same as the provision contained in HR 4849 on Grantor Retained Annuity Trusts (GRATs), a revenue raising provision that is expected to raise $5 billion. The provision would impose the following limitations on GRATs, effective as of the date of enactment of the legislation:

- the minimum term of the GRAT is ten years;
- the fixed annuity amount cannot be less than the prior year's amount during the first 10 years of the trust term; and
- the remainder interest must have a value greater than zero determined as of the date of the asset transfer to the GRAT.

HR 4849 passed the House in March but has not yet passed the Senate. The same provision on GRATS was also included in the Obama Administration Budget Proposals for Fiscal Year 2011. Now that HR 5486 has also passed the House, it is becoming more likely that the limitations on GRATS will become law this year, which increases the urgency for individuals who may be considering creating GRATs, particularly short-term GRATs.

Senate Considering Extenders Bill

HR 4213, "American Jobs and Closing Tax Loopholes Act"

On May 28, 2010, the House of Representatives passed HR 4213, "American Jobs and Closing Tax Loopholes Act," just before the Memorial Day Congressional recess. HR 4213 includes a number of provisions, including tax relief for businesses, tax cuts for families, extending eligibility for unemployment insurance benefits and closing tax loopholes for investment fund managers and foreign operations of multinational companies. A prior version of this bill passed the Senate in March, but the Senate is now considering the House version and will need to vote on it again.

HR 4213 also includes the extension of two charitable planning tax incentives, which expired at the end of 2009: the Charitable IRA Rollover and the Charitable Conservation Easement.

Charitable IRA Rollover. The Charitable IRA Rollover would allow taxpayers age 70½ and older to make a $100,000 tax-free distribution directly from an Individual Retirement Account (IRA) to a qualified charitable organization through December 31, 2010. A Qualified Charitable Distribution (QCD) cannot be made to a charitable gift annuity or a charitable remainder trust. The transfer can count as a required minimum distribution (RMD), and an IRA beneficiary who is age 70½ or older can also make a QCD from an inherited IRA.

Charitable Conservation Incentive. Under the incentive for charitable conservation easements, the income tax deduction for a voluntary conservation easement would be increased from 30% of the donor's adjusted gross income (AGI) to 50% of the AGI. If the donor of the easement is a farmer or rancher s/he can deduct up to 100% of AGI for the value of the conservation easement. Any value for the conservation easement that cannot be deducted in the current year can be carried forward for 15 years, instead of the normal 5 years for a charitable contribution. Under HR 4213, these changes would be in effect through 2010.

Family Farm Estate Tax Bill Introduced in Congress

HR 5475, "Family Farm Estate Tax Relief Act of 2010"

Representative Mike Thompson (D-CA) has recently introduced a bill in Congress to provide relief from the federal estate tax for family farms (the same bill has been introduced in the Senate by Senator Dianne Feinstein). The bill, known as HR 5475, "Family Farm Estate Tax Relief Act of 2010," targets estates in which a family farm either generates more than 50% of the farm owner's income (but does not exceed $750,000 annually) or comprises more than 50% of the owner's estate at the time of death. The bill would add Section IRC 2033A to the tax code, which incorporates many of the provisions of Section 2032A and would require that the family member inheriting the estate continue to use the land for farming purposes and the decedent must have owned the farm for five years before his death. If all of the requirements of the bill are met, the "qualified farmland" would be exempt from federal estate tax.

Additional Conservation Easement Benefits. In addition, under IRC Section 2031(c), the bill would increase the amount of land that is excluded from the gross estate (for land that is subject to a conservation easement) to $5,000,000 from $500,000, and the percentage in the value of the land, which is excludable from the gross estate, would be increased from 40% to 50%.

Court Finishes Reviewing Transfers to LLC

Pierre v. Commissioner, 133 T.C. No. 2 (2009)("Pierre I"); T.C. Memo 2010-106 (5/15/2010) ("Pierre II")

Facts: The Taxpayer created a single member New York Limited Liability Company (LLC) and then created two New York Irrevocable Trusts, which were then funded with $4.25 million in cash and marketable securities. The Taxpayer then gave 9.5% in LLC interests to each trust and sold the remainder of her LLC interest to the trusts in exchange for secured promissory notes. Based on an appraisal, the Taxpayer claimed a combined 36.55% valuation discount on the gift tax return (10% discount for lack of control and 30% discount for lack of marketability).

The IRS audited the gift tax return and argued that the LLC should be disregarded for tax purposes since the Taxpayer did not elect to have the LLC taxed as a corporation under the "check the box" regulations, which would result in the gifts being treated as interests in the underlying assets rather than LLC interests for federal gift tax purposes. The Taxpayer argued that for gift tax purposes, New York law, not federal law, determined the nature of the taxpayer's interest in the property interest. Under New York law, the taxpayer argued that a membership in the LLC is personal property, not an interest in specific property of the LLC.

2009 Tax Court Ruling (Pierre I): In its 2009 ruling, the Tax Court agreed with the Taxpayer and ruled that for federal gift tax purposes, New York state law (not federal law), determined what property interest was gifted and sold. As a result, the Tax Court will be valuing the gifts and sales as transfers of LLC interests, instead of transfers of the underlying cash and marketable securities. However, the Tax Court reserved judgment on whether the step-transaction doctrine applied to this case and the appropriate valuation discount.

2010 Tax Court Ruling (Pierre II): In a memorandum opinion released in May 2010, the Tax Court completed its review of the following outstanding issues: 1) whether the step-transaction doctrine applied to the gifts and sales of the LLC member interests to the trusts and 2) the valuation discounts that should be applied to the LLC interests.

Step-Transaction Doctrine. With regard to the first issue, the Tax Court ruled that the step-transaction doctrine would apply to aggregate the gifts and sales of the LLC interests made to each trust, which resulted in a 50% combined interest transferred to each trust (9.5% gift and 40.5% sale). The practical effect of this decision was minimal, since it decreased the lack of control discount applied from 10% to 8%. However, the application of the step-transaction doctrine by the Court does continue an ongoing trend in estate and gift tax cases. The Court cited four reasons for applying the step-transaction doctrine: 1) the transactions occurred on the same day; 2) there was no lapse of time between the gift and sale transactions; 3) the taxpayer had the intent of making transfers without gift taxes and 4) the documentation for the transactions was poor. The step-transaction doctrine is generally used to collapse transfers for gift tax valuation purposes.

Valuation Discount. On the issue of the appropriate valuation discounts that should be applied, the taxpayers used an expert appraiser in support of their case both for the gift tax return as well as a separate expert testifying at the trial, while the IRS did not employ a valuation expert on its behalf. The IRS did not contest the 30% lack-of-marketability discount proposed by the taxpayer's appraiser on the gift tax return. A different appraiser testified at trial in support of the taxpayer and he used a 10% lack-of-control and 35% lack-of-marketability discount, which the IRS argued was too high, and the taxpayer did not advocate for a discount of more than 30%. The court allowed a 30% discount for lack of marketability and an 8% discount for lack of control, with a combined 35.6% valuation discount.

Summary: Although the taxpayer ultimately got a favorable result on the valuation discount for the transfers of the LLC interests, this case also underscores the importance of using correct documentation for transfers of FLP/LLC interests, having a qualified expert appraisal and being aware of issues such as timing of the transfers in the implementation of gifts and/or sales.

Tax Court Rules on Co-Tenancy Discount

Ludwick v. Commissioner, T.C. Memo 2010-104

Facts: Taxpayers, Husband and Wife, owned a vacation property in Hawaii as tenants in common. They each set up two separate Qualified Personal Residence Trusts (QPRTs) in 2004 and then transferred their respective undivided 50% co-tenancy interests to their respective QPRTs.

The transfer of the two separate co-tenancy discounts would generally allow for a valuation discount under IRC Section 2702 and in IRS statutory notices, 15% co-tenancy discounts are generally allowed (known as a "Propstra discount"). In this case, the Taxpayers proposed a discount of 30% and IRS argued for a discount of 11%. Both parties submitted expert appraisals to support their respective conclusions.

Ruling: The Tax Court reviewed expert testimony from both the Taxpayers and the IRS and then conducted its own analysis of how to value the property. The Court noted that it must consider the following factors in order to determine the appropriate valuation discount: 1) the length of the partition process, its costs and the likelihood of partition; 2) the rate of return the buyer would demand; and 3) the value of a 50% interest in the property upon sale. The Court also confirmed that Hawaii law allowed for the partition of real property.

The Judge then referred back to his analysis in a 1997 Tax Court case, Barge v. Commissioner, which also involved a co-tenancy of property. After reviewing all of the relevant factors in this case, the Court determined a value for each co-tenancy with a 17% discount on the property's fair market value. The four factors mentioned above in the opinion are important for appraisers to consider in future co-tenancy cases.

IRS Advises CA Same Sex Couple on Federal Income Tax Filing

CCA 201021050, PLR 201021048 (CCA 200608038 reconsidered)

Facts: A same-sex couple registered as domestic partners in California requested advice from the IRS on how they should file their federal income tax return. Under California law, registered domestic partners have the same rights, protections, benefits, obligations and duties as are granted to and imposed upon spouses. As of January 1, 2007, under California law, the earned income of registered domestic partners has been treated as community property for both property law and state income tax purposes.

Taxpayer and his partner requested advice from the IRS on whether they should report one-half of their community income on their federal income tax return, in light of the California state law change which extended full community property treatment to registered domestic partners. Previously in CCA 200608038 (before the state law change), the IRS indicated that an individual who was a registered domestic partner in California must report all of his or her earned income on the income tax return.

Ruling: The IRS and its Chief Counsel's office issued both Chief Counsel Advice (CCA) and a Private Letter Ruling to address this issue. In the CCA and the PLR, the Chief Counsel's Office and the IRS ruled that federal law "generally respects state property law characterizations and definitions." Since California community property law is designed to give each spouse an equal interest in each community asset, regardless of which spouse is the holder of record, it follows that federal tax treatment of community property should also apply to California registered domestic partners.

New Federal Tax Guidance for CA Registered Domestic Partners. Following this PLR and CCA, for tax years beginning after December 31, 2006, a California registered domestic partner must report one-half of the community income (earned income or income from property) on his or her federal income tax return. In addition, for tax years beginning before June 1, 2010, California registered domestic partners may, but are not required to, amend their federal income tax returns to report income in accordance with CCA 201021050.

CASE IN POINT: Retain a Key Executive with a REBA

Our monthly *Case In Point* section will bring you actual, recent Advanced Markets cases. Check in each month for examples of the ways that our team's focus on client and advisor concerns, case design expertise, consultation process, and software capability translate into real-life solutions.

Initial Call to Advanced Markets: January 2010

Client Profile: Male, Age 48, Preferred Non Smoker

Concern: Employer wanted to provide a key executive with a benefit plan to keep him at the company with little or no plan administration costs.

Initial Discussion: A producer called into the Advanced Markets Group looking for ways to reward one of his client's most talented executives. This key executive was well sought after by the company's competitors, and the company was concerned that it may lose him if it didn't put a rewarding and generous plan in place to retain him. The client was 48 years old, making well over $100,000 per year and already maxing out on his retirement plan contributions. Because he was the breadwinner of his family, the key executive was also concerned about providing for his family if something were to happen to him before his planned retirement at age 65.

Solution: An Advanced Markets Consultant (AMC) discussed with the producer the different types of non-qualified benefit plans available including a Salary Deferral Plan, Supplemental Executive Retirement Plan (SERP), and Key Person coverage but the producer ultimately decided to go with an executive bonus/ Section 162 bonus plan with a vesting schedule, also called a Restricted Endorsement Bonus Arrangement, or REBA, for multiple reasons.

First, the employer had a higher income tax bracket than the executive and wanted the benefit of an up-front tax deduction on the bonus payment to him. In this situation, the company would pay an annual premium of $20,000 per year up until retirement age 65 on a permanent John Hancock life insurance product using the minimum non-MEC (modified endowment contract) death benefit to build up the most cash value. The company would also double bonus to the executive, i.e., gross up the bonus so that the executive would not have to pay any income taxes on the bonus. For an executive in the 35% income tax bracket, the company's bonus amount would be $30,769. The non-MEC death benefit of approximately $664,000 provided the additional life insurance coverage that the executive's family needed if something happened to him before retirement.

Second, the employer wanted minimal administration costs and also wanted to completely avoid having to follow ERISA requirements. The AMC explained that a REBA arrangement is one of the simplest of the non-qualified benefit plans to set up and administer. Third, the company wanted to implement a vesting schedule to give the executive an incentive to stay at the company until retirement. The company was considering either a five-year rolling vesting schedule or percentage per year vesting, which would provide a certain degree of "golden handcuffs" to retain the executive.

Summary: In conclusion, the AMC and the producer were able to show the client a simple and cost effective way to reward and retain his key executive. Based on an assumed 8% gross rate of return, they were also able to show a supplemental retirement distribution via tax-favored withdrawals and loans from the policy of over $50,000 for 15 years. Target premium on this case was almost $13,000.

Case Closed: March 2010

ONE YEAR LIBOR RATE
As of June 14, 2010: 1.18%

PRIME RATE
As of June 14, 2010: 3.25%

IRC SECTION 7520 RATE		
June	2010	3.2%
May	2010	3.4%
April	2010	3.2%

The §7520 rate is used to value GRITs, QPRTs, CRATs, CLUTs, CLATs, private annuities, life interest, remainder and reversionary interests. To value a charitable gift for income, gift, or estate tax charitable deduction purposes, use either the rate for the month of the actual gift/transfer or the rate from either of the two previous months (use the highest of the three months for the largest charitable deduction).

APPLICABLE FEDERAL RATES – JUNE				
	Annual	**Semi Annual**	**Quarterly**	**Monthly**
Short-term AFRs – loans (3 years or less)	0.74%	0.74%	0.74%	0.74%
Mid-term AFR – (More than 3 years up to and including 9 years)	2.72%	2.70%	2.69%	2.68%
Long-term AFRs – (More than 9 years)	4.30%	4.25%	4.23%	4.21%

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MLINY06151013203