

QUARTERLY EDITION: April 2010

IN THIS ISSUE

- HOUSE PASSES LEGISLATION WITH MINIMUM TERM FOR GRATs
- SENATE PASSES BILL WITH CHARITABLE IRA ROLLOVER
- HEALTH CARE BILL BECOMES LAW
- TREASURY REPORT ON CHOLI
- OBAMA ADMINISTRATION BUDGET FY 2011 PROPOSALS
- FISHER: NO ANNUAL EXCLUSION FOR GIFTS OF LLC INTERESTS
- SHURTZ V. COMMISSIONER: TAXPAYER VICTORY IN FLP CASE
- MATTHIES V. COMMISSIONER: VALUATION ISSUE ON POLICY SALE FROM PROFIT-SHARING PLAN
- IRS CLARIFIES APPLICATION OF SECTION 2511(C) TO GRANTOR TRUSTS
- CASE IN POINT: QUALIFIED PLAN MAXIMIZATION

House Passes Legislation with Minimum Term for GRATs

The House of Representatives passed H.R. 4849, "Small Business and Infrastructure Jobs Tax Act of 2010" on March 25, 2010. The bill also includes one transfer tax provision (Section 307) which would limit new Grantor Retained Annuity Trusts (GRATs) to a ten-year term. The same provision was also included in the last two proposed budgets for the Obama Administration and is estimated to raise approximately \$800 million over the first five years and \$4.45 billion over ten years. There are no other transfer tax provisions in this legislation. This provision would be effective for GRATs established after the date of enactment for the legislation.

The Senate will be considering this legislation in their current session. For anyone considering a short-term GRAT with a term of less than 10 years, this legislation increases the urgency for using this planning technique.

Senate Passes Bill with Charitable IRA Rollover

On March 10, 2010, the Senate passed H.R. 4213, "American Workers, State and Business Relief Act of 2010." This legislation was an amended version of the bill that passed the House of Representatives in December 2009, and it has moved in its current version back to the House for consideration. It is not clear when the House will vote on the version of the bill that passed the House.

Section 116 of the Senate version of H.R. 4213 would extend the Charitable IRA Rollover provision through December 31, 2010. This provision expired on December 31, 2009, and if this legislation is enacted, it would again 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 in 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 70 ½ or older can also make a QCD from an inherited IRA.

Health Care Bill Becomes Law

On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act, and on March 30, 2010, he signed into law the Health Care Reconciliation Bill that was passed by both the House of Representatives and the Senate. In addition to the health care overhaul, this new legislation also includes several tax planning provisions, including a new 3.8% surtax on certain types of unearned income. This surtax would take effect starting on January 1, 2013, and is imposed on the lesser of 1) net investment income or 2) the excess of “modified adjusted gross income” (over a threshold amount). The threshold amount is \$250,000 for married taxpayers filing jointly, \$125,000 for married taxpayers filing separately, \$200,000 for single taxpayers and approximately \$12,000 for trusts.

For determining the surtax, investment income includes interest, dividends, capital gains annuities, rents, royalties and passive activity income, but does not include the following items: 1) active trade or business income 2) distributions from IRAs or qualified retirement plans; 3) income taken into account for self-employment tax purposes; or 4) gain on the sale of an active interest in a partnership or S corporation. Although the surtax will not be effective for a few years, taxpayers who may be affected can start thinking now about how to minimize its impact.

Treasury Report on CHOLI

As mandated by the Pension Protection Act of 2006, the Treasury Department has conducted a two-year study on charity-owned life insurance (CHOLI) to determine whether such transactions are consistent with the tax-exempt status of charitable organizations. The report reviews a variety of CHOLI transactions, involving both annuities and life insurance, with the contracts owned directly or indirectly by a charity.

The report reviews both the federal tax code provisions that govern tax-exempt organizations and notes that there are several potential problems with CHOLI transactions: 1) a charitable organization must not violate legal restrictions on inurement, where a private person receives greater benefits from the organization than he/she provides in return; 2) the organization must establish that it is not organized or operated for the benefit of private interests; and 3) unrelated business taxable income (UBTI) derived by a charity will not be exempt from income tax. The report also reviews the tax code provisions that govern life insurance as well as state laws on insurable interest. The IRS also solicited public comment letters on CHOLI transactions, and noted in the report that the incidence of CHOLI transactions has gone down since 2006.

The report notes that there are a wide range of CHOLI transactions, from the charity directly owning a life insurance policy on a donor to a transaction involving multiple life insurance contracts through a trust that includes investors unrelated to the insured or the original policyholder. It states that “there are a number of respects in which CHOLI arrangements may be viewed as inconsistent with the policies underlying the federal income tax benefits for charities and life insurance.” The report notes that in 2005 there were several proposals to impose an excise tax on CHOLI arrangements, although none of them actually became law.

The report concludes by recommending adoption of the provision in the Obama Administration's Fiscal Year 2010 and 2011 budget proposals, which would revise the "transfer for value" rule on life insurance. This provision would change the current safe harbor exceptions to the transfer for value rule so that the safe harbors would not apply to buyers of life insurance contracts, and would ensure that investors in a CHOLI arrangement, as well as investors in other types of arrangements involving the sale of life insurance contracts, do not "inappropriately benefit from the gross income exclusion for death benefits from a life insurance contract."

Obama Administration FY2011 Budget Proposals

The Obama Administration released its budget proposals for Fiscal Year 2011 in February. Many proposals are intended to address perceived abuses that taxpayers employ to avoid taxation. Several of the proposals described below are similar to proposals included in last year's budget.

Transfer Taxes at 2009 Limits. The Administration proposes that the estate tax would be extended at the 2009 limits with a \$3,500,000 exemption per person and 45% as the highest rate for the estate, gift and generation-skipping transfer tax.

Consistent Valuation for Transfer and Income Tax Purposes. This proposal would require that the basis of property for the recipient for income tax purposes would not be greater than the value of the property as determined for estate or gift tax purposes (other than any necessary subsequent adjustments). As a result, the executor of the estate or the donor of a lifetime gift would be required to report the necessary information on the basis of property to the IRS and to the recipient.

Reporting Requirements for Sales of Insurance Policies. The Administration has proposed a requirement that a person or entity who purchases an interest in an existing life insurance contract with a death benefit in excess of \$500,000 report: (i) the purchase price; (ii) the buyer's taxpayer identification number (TIN); (iii) the seller's TIN, (iv) the issuer; and (v) the policy number. The purchaser would have an obligation to report this information to the IRS, the insurer, and the seller. If this proposal were enacted, it would apply to sales of interests in life insurance policies and payments of death benefits for taxable years beginning after December 31, 2010.

Changes to the Transfer-for-Value Rule. The Administration proposes changing the safe harbor exceptions to the transfer-for-value rule to ensure that none of the safe harbors apply to "buyers of policies." When the policy benefits are paid out, the insurer would be required to report, both to the IRS and to the payee, the gross policy benefit, the buyer's TIN, and the insurer's estimate of the buyer's basis. If this proposal were enacted, it would apply to sales of interests in life insurance policies and payments of death benefits for taxable years beginning after December 31, 2010.

Corporate-Owned Life Insurance. The Administration is also seeking to change the tax laws surrounding Corporate-Owned Life Insurance (COLI). Currently, interest on policy loans is generally non-deductible, with limited exceptions. The Administration proposes to remove the limited exceptions that are currently available. The Administration's proposal would disallow otherwise deductible interest by a ratio of the total value of such life insurance contracts to the total business assets (effective for insurance contracts entered into after the date of enactment).

Valuation Discounts and Restrictions. The Administration is also looking to enforce the valuation rules of Section 2704. Under Section 2704(b), “applicable restrictions” on interests in family-controlled entities are disregarded for valuation purposes. The Administration is concerned that restrictions which should be disregarded for valuation purposes are being recharacterized so that they fall outside the scope of Section 2704(b). In order to prevent this abuse, the Administration proposes a new category of “disregarded restrictions,” which would not be taken into account when determining the value of the interest in a family-controlled entity. Disregarded restrictions would include: (i) limitations on a holder’s right to liquidate that holder’s interest that are more restrictive than a standard identified in the regulations, and (ii) any limitation on a transferee’s ability to be admitted as a full partner or holder of an interest in the entity. If enacted, this proposal would apply to transfers after the date of enactment to property subject to restrictions created after October 8, 1990 (the date that Section 2704 became effective).

Minimum Term for GRATs. The Administration has again proposed a change to the length of grantor retained annuity trusts (GRATs). GRATs traditionally come with a fair amount of risk to the taxpayer/grantor because if the grantor does not outlive the GRAT term, the value of the assets will be included in the grantor’s taxable estate. In order to minimize this risk but still take advantage of the wealth-shifting aspects of a GRAT, planners and their clients began adopting short term (2-year) GRATs. The Administration sees this as an abuse of the tax provisions on GRATs and has proposed a minimum term of 10 years for GRATs. If enacted, the proposal would apply to all GRATs created after the date of enactment.

Fisher: No Annual Exclusion for Gifts of LLC Interests

Fisher v. United States, 105 A.F.T.R. 2d 20101347 (March 11, 2010)

Facts: Mr. and Mrs. Fisher transferred a 4.762% interest in Good Harbor Partners LLC (Limited Liability Company) to each of their seven children in 2000, 2001, and 2002. They intended the gifts to qualify for the annual exclusion from gift tax under IRC Section 2503(b) and claimed an annual exclusion for each transfer on their gift tax returns. However, upon audit the IRS assessed a gift tax deficiency of \$625,986, stating that the terms of the LLC Operating agreement meant that the gifts were actually “future interest gifts.”

Ruling: The U.S. District Court for the Southern District of Indiana granted summary judgment in favor of the IRS on this case. The Court reviewed the LLC Operating Agreement and determined that under the terms of the Agreement, the gifts did not meet the requirements of Section 2503(b) as a “present interest gift.” The Operating Agreement provided for distributions to the Members only after payment of expenses associated with a Capital Transaction, debts and liabilities of the LLC, as well as payment to establish reserves that “the General Manager deems necessary for future investments, capital improvements, debts, expenses, liabilities or obligations.”

However, in order for a gift to qualify for the annual exclusion as a “present interest gift,” the donee must have “an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property.” The main distinction between present and future interest gifts is whether or not there is “postponement of enjoyment of specific rights, powers or privileges.” Although the Fishers argued that their children possessed the unrestricted right to receive distributions of the LLC’s proceeds, the Court noted that

any potential distribution would be subject to a number of contingencies, all within the exclusive discretion of the General Manager. The Court concluded that the transfers of interests in the LLC were transfers of future interests in property, which did not qualify for the gift tax annual exclusion.

Planning Note: One alternative to this approach is to give donees a temporary “put option” for certain gifts, following a transfer to an LLC or FLP to allow the transfer to qualify as a “present interest gift.” If the general partners/members of the entity want to put significant restrictions on transferability of property or distributions, then it may be better to try to get a valuation discount and use the lifetime gift exemption.

Shurtz: Taxpayer Victory in FLP Case

Shurtz v. Commissioner, T.C. Memo 2010-21 (02/03/2010)

Facts: Decedent (Charlene B. Shurtz) and her family owned and managed a timberland business in Mississippi. In 1993, a family limited partnership (FLP) known as Timberlands LP was established to operate the business with a corporate general partner that owned a 2% general partnership interest. Following the creation of Timberlands LP, the active timber business was kept in Timberlands and the equity ownership of the company was held in several new FLPs, including the Doulos LP, which owned the Shurtz family interest.

Charlene Shurtz contributed her interests in Timberlands LP in exchange for a 1% general partnership interest and a 98% limited partnership interest in Doulos LP (her husband held a 1% general partnership interest in Doulos LP in exchange for a contribution). The purposes of Doulos LP were to: 1) reduce the estate; 2) provide asset protection; 3) provide for heirs; and 4) provide for the Lord's work. The partnership had significant restrictions designed to keep persons outside the Shurtz family from acquiring interests in the FLP.

Between 1996 and 2000, Charlene Shurtz made 26 gifts to her children and to trusts for her grandchildren, and at her death in 2002 she owned a 1% co-general partnership interest in Doulos LP and an 87.6% limited partnership in Doulos. The IRS proposed an estate tax deficiency of over \$4.7 million, along with a \$1.2 million penalty against the decedent's estate.

Ruling: The Tax Court ruled that the transfer of assets to the Doulos LP met the requirements of IRC Section 2036(a) as a “bona fide sale for an adequate and full consideration in money or money's worth” and as a result there was no estate tax deficiency or additional tax due from the estate. The court cited the following factors in support of its decision:

- 1) Charlene and her husband received FLP interests proportionate to what they contributed;
- 2) Assets were properly credited to each partner's capital account;
- 3) A negative adjustment was made in each partner's capital account for distributions from the FLP; and
- 4) There was a legitimate and non-tax business reason for the establishment of Doulos LP (preservation of the family business and management efficiency).

The court used reasoning similar to the Bongard and Bigelow FLP cases and noted that the taxpayer satisfied the guidelines from those cases to satisfy the requirements of IRC Section 2036(a).

Matthies v. Commissioner: Valuation Issue on Sale from Profit-Sharing Plan

Matthies v. Commissioner, 134 T.C. No. 6 (02/22/2010)

Facts: The Taxpayer, Karl Matthies, had a large individual Retirement Account (IRA) and he created a profit-sharing plan to receive transfers of over \$2.5 million from his IRA. The Taxpayer also created an S corporation and assisted by his attorney and an insurance agent, funded the profit-sharing plan in 1999. The profit-sharing plan purchased a last survivor interest-sensitive life insurance policy with a face amount of over \$80 million and total premiums paid of over \$2.5 million.

In 2000, the profit-sharing plan sold the insurance policy to the taxpayer for \$315,023. At the time of the sale, the “account value” of the policy was \$1,368,327, but the insurance policy stated that the surrender charge during the first three years was \$1,062,460.59. In 2001, the Taxpayer transferred the policy to his Irrevocable Life Insurance Trust (ILIT) and the trust then exchanged the policy for a Hartford variable survivorship policy with a face amount of \$19 million. Hartford waived the surrender charges on the exchange and the new policy did not have any surrender charges. Hartford accepted the \$1,368,327.33 account value as payment in full of the single premium due on the replacement policy.

The Taxpayer did not report any income from the sale of the policy from the profit-sharing plan, but the IRS issued a notice of deficiency stating that the Taxpayers had a \$1,053,304 income tax liability and a \$58,985 accuracy related penalty.

Tax Court Ruling: The Tax Court noted that the transfer from the profit-sharing plan to the Taxpayer was pursuant to a prearranged plan for him to use his IRA funds to purchase a policy inside of the profit-sharing plan. Since the expectation was that the plan would soon distribute the policy to the Taxpayer, the transaction was not an “arms-length” transaction. If it was a true arms-length transaction, the sale of the policy to the Taxpayer would not have been subject to taxable gain.

This Court also noted that this transaction was completed before the IRS issued Revenue Procedure 2005-25. However, when reviewing IRC Sections 402 and 72 on valuation of life insurance, the court also noted that the value of the contract should be determined without reference to the surrender charge on the policy. In this case, the disparity between the premiums paid by the Taxpayer and the value of the policy upon the bargain sale clearly indicated that the valuation used by the Taxpayer did not include the “entire cash value” of the contract. The Court affirmed the valuation deficiency of \$1,053,304 on the policy determined by the IRS, which was includible in income, but held that the Taxpayers were not liable for the additional penalty.

IRS Clarifies Application of Section 2511(c) to Grantor Trusts

Notice 2010-19

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 added a new provision to the Internal Revenue Code, Section 2511(c), effective only in 2010. The specific language of Section 2511(c) states that: ***“Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned [grantor trust] by the donor or the donor’s spouse...”*** Section 2511(c) will expire (sunset) on December 31, 2010, unless Congress acts to extend this provision before that date.

Under Section 2511(c), all transfers made in 2010 to non-grantor trusts will be considered completed gifts, regardless of whether under pre-2010 rules such transfers would have been considered incomplete gifts or non-transfers for gift tax purposes. This provision has raised many questions from commentators on its implications and effect, particularly with regard to whether it applies to grantor trusts for income tax purposes. The IRS has released a Notice (Notice 2010-19), which clarifies the effect of Section 2511(c) and states that the Notice does not apply to transfers to grantor trusts, it only applies to transfers to non-grantor trusts in 2010. The Notice states that the rules governing transfers to grantor trusts are not affected by Section 2511(c).

Does Section 2511(c) Apply to Transfers to Charitable Remainder Trusts?

One question that remains unresolved even after Notice 2010-19 was published is the question of whether Section 2511(c) may apply to transfers to Charitable Remainder Trusts (CRTs). Charitable Remainder Trusts are non-grantor trusts, but they are also split-interest trusts with the remainder interest transferring to a charity upon termination. While a literal interpretation of Section 2511(c) may result in a transfer of assets to a CRT being treated as a taxable gift in 2010, applying Section 2511(c) to a charitable trust seems inconsistent with Congress' intent in enacting this provision (to prevent income-shifting during the temporary estate tax repeal).

A number of charitable planning attorneys have asked the IRS for guidance on whether or not Section 2511(c) would apply to transfers to CRTs in 2010. The commentators have generally requested that the IRS guidance state that Section 2511(c) will not apply to transfers to CRTs in 2010. The IRS has indicated that it will publish guidance on this issue in the near future.

CASE IN POINT: Qualified Plan Maximization

Our monthly *Case In Point* section brings 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: September 2009

Client Profile: Female, Age 83, approximately \$3,000,000 estate

Concern: She wants to pass on as much of her IRA as possible to heirs after income in respect of decedent (IRD) and Estate taxes.

Financial Status: She is currently living on income from her pension, Social Security, and other assets and does not need the income from the IRA.

Initial Discussion: An insurance advisor called the Advanced Markets Group and spoke to one of the Advanced Markets Consultants (AMCs) about ways to leverage his client's roughly \$875,000 IRA (growing at 5%). The client did not need the IRA for income purposes. The AMC explained to the advisor that when these types of accounts are left in the estate, they can be subject to IRD and transfer taxes (i.e., estate and/or generation-skipping transfer taxes). These types of taxes can seriously deplete the value of the account and what ultimately passes to the heirs, sometimes in excess of 70 percent. Although qualified plans are great retirement planning vehicles, they can be poor wealth transfer vehicles if the right planning is not considered.

Solution: After the AMC did his fact finding on the case, he input the client's financial information into the Qualified Plan Maximization module in JH Solutions, the Advanced Markets' proprietary estate and business planning software program. The client was comfortable purchasing a \$700,000 Protection UL-G policy funded by her after-tax required minimum distributions. The annual premium of \$45,000 was within the client's gifting capability as she had 2 children and 2 grandchildren, and was currently not making any gifts. The AMC pointed out to the insurance advisor that at the client's life expectancy of 9 years, the proposed plan of buying life insurance inside of the trust generated more than \$650,000 over her current plan of doing nothing (based on 2009 estate tax law and a 35% IRD tax bracket).

Summary: Because qualified plans do not receive a step-up in basis at death, it is important to plan for the transfer taxes that may apply to the qualified plan asset. The AMC was able to show the insurance advisor how to leverage an unneeded asset and pass on more money to his client's heirs. This case also prompted the advisor to look for other IRD assets that some of his older clients were not using.

Case Closed: February 2010

ONE YEAR LIBOR RATE
As of April 20, 2010: 0.94%

PRIME RATE
As of April 20, 2010: 3.25%

IRC SECTION 7520 RATE		
April	2010	3.2%
March	2010	3.2%
February	2010	3.4%

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 – APRIL				
	Annual	Semi Annual	Quarterly	Monthly
Short-term AFRs – loans (3 years or less)	0.67%	0.67%	0.67%	0.67%
Mid-term AFR – (More than 3 years up to and including 9 years)	2.70%	2.68%	2.67%	2.67%
Long-term AFRs – (More than 9 years)	4.40%	4.35%	4.33%	4.31%

For more information on various planning topics or to request the John Hancock Advanced Markets suite of marketing and educational tools, including the JH Solutions concept software, please call John Hancock's Advanced Markets Group at 1-888-266-7498 and press #4.

REMINDER: Electronic Distribution of Advanced Markets Group Materials is Available.

Central Intelligence and its companion piece, Sales Strategy, are printed on a quarterly basis. If you'd like to receive Central Intelligence on a monthly basis, it is available by e-mail. To receive the monthly e-mail edition of Central Intelligence, please send a request to advancedmarkets@jhancock.com. In addition, monthly editions of Central Intelligence and Sales Strategy are available on our website at www.jhsalesnet.com. The Advanced Markets Group also sends a monthly electronic newsletter which features a popular estate or business planning concept. To be included on this distribution list, please send an e-mail to advancedmarkets@jhancock.com.

Central Intelligence is produced by John Hancock's Advanced Markets Group. We can be reached at (888)266-7498, option 3 or option 4; 197 Clarendon Street, C-07-01, Boston, MA 02116; www.jhsalesnet.com.

This material does not constitute tax, legal or accounting advice and neither John Hancock nor any of its agents, employees or registered representatives are in the business of offering such advice. It was not intended or written for use and cannot be used by any taxpayer for the purpose of avoiding any IRS penalty. It was written to support the marketing of the transactions or topics it addresses. Comments on taxation are based on John Hancock's understanding of current tax law, which is subject to change. Anyone interested in these transactions or topics should seek advice based on his or her particular circumstances from independent professional advisors.

Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.

Guaranteed product features are dependent upon minimum premium requirements and the claims-paying ability of the issuer.

Insurance policies and/or associated riders and features may not be available in all states.

Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02116 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

© 2010 John Hancock. All rights reserved.

IM6053 04/10 MLINY04151012896