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LIFE INSURANCE

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Power Retained by Trust Grantor to Substitute Assets of Equal Value for Life Insurance Does Not (Necessarily) Cause Inclusion

Rev. Rul. 2011-28, 2011-49 IRB 830, December 1, 2011

There has long been concern by planning professionals that the retention by a grantor of the power to substitute property in a trust with other property of equal value could cause the value of the assets in the trust to be included in the grantor's estate for estate tax purposes under IRC §§2036, 2038, or 2042. (IRC §2036 includes the value of property in which the grantor has retained a life interest; IRC §2038 includes the value of property transferred revocably; and IRC §2042 includes the value of incidents of ownership in life insurance retained by the grantor.) This type of power is sometimes included in a trust for its own good and sometimes, at least in part, to cause the trust to be treated as a grantor trust under IRC §675(4) as a "general power of administration." In April, 2008, the IRS issued Rev. Rul. 2008-22, which held that such a power, by itself, would not cause all or part of the trust assets to be included in the grantor's estate for estate tax purposes under IRC §§2036 or 2038 so long as (1) the trustee has a fiduciary obligation to ensure that the properties acquired and substituted by the grantor are in fact of equivalent value, and (2) the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. The ruling provides guidance on the second prong by stating that a substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced the trust's investments does not impact the respective interests of the beneficiaries (such as when the trust is administered as a unitrust or when distributions from the trust are limited to discretionary distributions of principal and income). While this was greeted as very good news, we all noticed the conspicuous absence of any mention of IRC §2042. Its omission was interpreted by some as the negative implication that life insurance held in trust would, in fact, be includible in the grantor's estate under IRC §2042 if the grantor retained a right of substitution described under IRC §675(4).

Now comes the other shoe, in the form of the present revenue ruling to allow us repose at long last. Rev. Rul. 2011-28 provides essentially the same holding as Rev. Rul. 2008-22, but with respect to IRC §2042 and repeats the conditions (and the guidance on benefit shifting) introduced in Rev. Rul. 2008-22 set forth above. Very importantly, the negative implication is eliminated, and professionals that draft and administer trusts that own life insurance (and those professionals who advise the grantors of such trusts) finally have clarity on this very important issue.

Summary Judgment Denied Due to Reasonable Reliance on Counsel

***Estate of Liftin v. U.S.*, 108 AFTR 2d 2011-7108,** November 8, 2011

Facts: Decedent died in March, 2003, and Decedent's son was appointed executor. Decedent's surviving spouse was, at the time of his death, a citizen of Bolivia, though a resident of the U.S. Pursuant to IRC §6075(a), the estate was required to file a federal estate tax return within nine months of the decedent's death. Before the filing deadline, the surviving spouse sought legal counsel concerning whether to seek U.S. citizenship in order to qualify for the unlimited marital deduction. The estate applied for and received a six-month extension of time to file the estate tax return. Long before the extended deadline, the estate paid $877,300, intended to be sufficient to pay the estate taxes due if the unlimited marital deduction was not available. About the same time, the surviving spouse informed the Executor of her intention of seeking U.S. citizenship.

Because it was clear that the surviving spouse would not yet have become a U.S. citizen by the extended date that the estate tax return was due, the Executor sought legal counsel to determine whether the estate could file its return late, after the surviving spouse had received U.S. citizenship, so that transfers from the estate to the surviving spouse would qualify for the unlimited marital deduction under IRC §2056. Counsel for the estate advised after research that the estate could file the return late in order to qualify for the deduction and that the delay would not trigger any additional costs, penalties, or fees. After the due date passed, the IRS inquired about the late return, to which counsel for the estate made its argument that the estate was entitled to file late without penalty. Seventeen months later, after the surviving spouse had received U.S. citizenship, the Executor filed the estate tax return, claiming a refund for the overpayment (from the payment made 28 months earlier based on no unlimited marital deduction). The IRS denied the claim and sought to withhold 25% of the assessed estate taxes as penalties and fees for late filing. The estate filed a complaint in the U.S. Court of Federal Claims for the refund; the IRS filed a motion for summary judgment.

Holding: The Court denied the motion for summary judgment and let the case proceed to trial to be determined on its merits. In doing so, the Court considered that the estate had relied reasonably on the advice of counsel, and might prevail at trial on this argument. The Court found that the estate might show at trial that the delay of filing the estate tax return was not unreasonable, that the estate may prevail in its argument that relying on its counsel on substantive questions of law, such as the very existence of a liability, was reasonable, and therefore the delay could be found not to be willful or occasioned by neglect. (N.B. The Court was careful to point out that relying on an "expert" for the ministerial task of merely filing the return would not be a defense of reasonable cause.)

New Guidance on Election of Alternate Valuation under IRC §2032

<u>REG-112196-07, 76 Fed. Reg. 71491,</u> November 18, 2011

Generally, under IRC §2031, the value of a decedent's property is determined for estate tax purposes on the date of the decedent's death. However, if the executor so elects under IRC §2032, if estate property is sold, distributed, or otherwise disposed of within six months after the decedent's death, the property must be valued as of the date of the transaction. Under this election, any property that is held for six months or longer must be valued as of that six-month date. In April of 2008, the IRS issued proposed regulations that sought to make clear that the election for alternative valuation under IRC §2032 is available to estates that experience a reduction in the value of the property of the estate during the six months following the date of the decedent's death by reason of market conditions (defined as events outside of the control of the decedent or other person whose property is being valued that affect the fair market value of the property includible in the decedent's gross estate). The new pronouncement withdraws the 2008 proposed regulations and offer new proposed regulation that allow a broader use of the six-month alternative valuation.

The new "reproposed" regulations provide that estates may use the alternate valuation under IRC §2032 (1) where property is exchanged in certain reorganizations, mergers, and similar corporate deals (so long as the property is exchanged for property of equal value) and (2) in certain cases involving distributions from business entities, bank accounts, or retirement trusts. Generally, the proposed regulations apply to the estates of decedents dying after August 16, 1954.

IRS Releases New "Conservation Easement Audit Techniques Guide

Released November 22, 2011. See www.irs.gov/pub/irs-utl/conservation_easement.pdf

<u>Facts</u>: The IRS has released a guide showing how examiners will view charitable contributions of real estate that has restrictions permanently imposed upon it with respect to its use. Such restrictions, which include conservation easements, are employed by sophisticated planners to meet the complex needs of some clients that have both income and estate tax issues and interests in land preservation and conservation. (See John Hancock's Advanced Markets Library at www. jhsalesnet.com for a full range of materials concerning estate planning and land conservation.) The new IRS Guide begins with a full discussion of the statutory and regulatory framework underlying conservation easements and the tax implications of such easements and their contribution to charitable land trusts.

In addition, the new Guide walks the reader through many of the most common errors made by taxpayers and their advisors attempting to structure a conservation easement and its contribution to a land trust, including substantiation of the contribution, qualified appraisals of the values of the land and of the easement (including the form of such appraisals and who is qualified to make them), valid conservation purposes and organizations, and many, many more. Professionals who advise clients concerning the tax advantages of such land conservation easements in estate planning should have a copy of this guide.

CASE IN POINT: CHARITABLE REMAINDER TRUST (CRUT) PLANNING WITH LIFE INSURANCE

Initial Call to Advanced Markets: September 2011

Client Profile: Male, Age 77, Preferred Non Smoker with $23M net worth.

Insurance Need: $4M for death benefit and estate planning purposes as well as to replace a portion of an asset gifted to charity.

Scenario: A producer called Advanced Markets for planning options with a charitably motivated client. The client had $9M in highly appreciated real estate that he was planning to sell eventually. The real estate was generating a total investment return of 6% per year. The client was using a portion of the asset's income to support his lifestyle and had inquired about a charitable income tax deduction.

Solution: The Advanced Markets Consultant (AMC) and the producer considered using a Charitable Remainder Unitrust (CRUT) with a Wealth Replacement Trust (WRT). Using the CRT module in John Hancock's estate and business planning software program, JH Solutions, the AMC illustrated the client making a tax-exempt transfer of the real estate to the CRUT. The trustee of the CRUT would then sell the real estate and provide the minimum 5% annual payment (based on the annual value of the trust asset) to the client for his lifetime. At the client's death, the remainder of the asset would pass to the charity, satisfying the 10% remainder rule. The AMC also illustrated a WRT which would hold a $4M life insurance policy for the client's heirs in order to replace a portion of the value of the real estate that was given away to the charity. This WRT would be funded by a portion of the income that the client was to receive from the CRUT.

Conclusion: The CRUT with WRT provided substantial benefits for the client and the charity. Not only would client receive inflation-adjusted income from the CRUT to maintain his standard of living, but also an income tax deduction based on the present value of the remainder interest passing to the charity. His family would benefit from the life insurance proceeds at his death, and the charity would receive the remainder interest.

Case Closed: November 2011.

ONE YEAR LIBOR RATE
As of December 22, 2011: 1.11%

PRIME RATE
As of December 22, 2011: 3.25%

IRC SECTION 7520 RATE		
January	2012	1.4%
December	2011	1.6%
November	2011	1.4%
October	2011	1.4%

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 – DECEMBER 2011

	Annual	Semi Annual	Quarterly	Monthly
Short-term	0.20%	0.20%	0.20%	0.20%
Mid-term	1.27%	1.27%	1.27%	1.27%
Long-term	2.80%	2.78%	2.77%	2.76%

APPLICABLE FEDERAL RATES – JANUARY 2012

	Annual	Semi Annual	Quarterly	Monthly
Short-term	0.19%	0.19%	0.19%	0.19%
Mid-term	1.17%	1.17%	1.17%	1.17%
Long-term	2.63%	2.61%	2.60%	2.60%

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.

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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.

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