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Insurer Ahead Again in Ongoing 412(i) Case

Zarrella v. Pacific Life Insurance Co. (“Zarrella IV”), Case No. 10-60754-CIV

As readers may remember from summaries in the April 2011 and June 2011 Central Intelligence, the ongoing case of *Zarrella v. Pacific Life Insurance Company*, (S.D. FL) has seen the U.S. District Court in Florida hand a number of setbacks to the plaintiff Taxpayer in its action against Pacific Life involving the marketing of 412(i) insurance-funded plans. Here is another. The Taxpayer, Zarrella Construction, purchased life insurance policies from Pacific Life to fund the plaintiff’s 412(i) plan, which is a qualified plan funded exclusively with life insurance policies that is exempt from minimum funding requirements under certain circumstances.

Facts: (For a fuller description of the facts and a chronology of developments, please see Central Intelligence April 2011 and June 2011.) Taxpayer established a 412(i) plan in 2003 with the counsel of its advisors, and funded the plan with nine life insurance policies purchased from Pacific Life. In 2004, the Internal Revenue Service (IRS) published two revenue rulings that set forth numerous conditions that it considered to render a 412(i) plan illegal and abusive. In 2005, Taxpayer’s 412(i) plan was audited by the IRS and found that the plan failed to meet the requirements of IRC §412(i). Taxpayer joined several other plaintiffs in a class action against Pacific Life alleging fraud, misrepresentation, breach of contract and negligence. Upon motion by Pacific Life, the court dismissed all but the breach of contract claims because the Taxpayer had failed to state valid claims. Taxpayer amended its complaints for all the original causes and more under California law, but the court subsequently dismissed, without prejudice, all the amended complaints. Taxpayer then amended its complaints, again, alleging breach of contract, equitable fraud, deceit, fraud, negligence, unlawful business acts and practices under California law, and ERISA violations.

Holding: The court dismissed all claims except the breach of contract and the unlawful business practices under California law for failure to state a claim. (The ERISA claim was dismissed on other procedural bases.) In the remaining claims, the court found allegations sufficient to support legal claims under the law, but the claims have yet to be tried and decided. We will continue to follow this ongoing case and report developments to our readers in this venue.

Termination of Life Insurance Policy Is Taxable Income, Not Loan Forgiveness

Bill S. McGowen et ux. v. Commissioner, 108 AFTR 2d 2011-XXXX, 09/02/2011

The U.S. Court of Appeals (10th Cir.) held for the IRS in a case where value received by a taxpayer from termination of a life insurance policy for reason of excess indebtedness was characterized as nontaxable discharge of indebtedness under insolvency.

Facts: In 1986, Taxpayer purchased a variable life insurance policy for a single premium of \$500,000. The policy allowed Taxpayer to borrow against the cash surrender value of the policy, but the insurer retained the right to terminate the policy at any time that the indebtedness exceeded the cash value of the policy. In 2004, the indebtedness on the policy was \$1,064,785 and exceeded the cash value of the policy by \$2,039. The insurer informed Taxpayer that the policy would be terminated unless a minimum loan repayment was made of more than \$108,000 and that, if terminated, Taxpayer would recognize gain of \$562,746. Taxpayer did not make any loan repayment and received an IRS Form 1099-R from the insurer showing that, in terminating the policy, the insurer had made a distribution of the full value of the policy (then \$1,065,224), of which \$565,224 was taxable to Taxpayer.

Taxpayer, however, reported on its 2004 income tax return that the \$565,224 was discharge of indebtedness that was not taxable under IRC §108 because Taxpayer was insolvent. The IRS did not agree and filed a notice of deficiency, to which Taxpayer responded with the petition initiating this action.

Holding: The court found no substance to Taxpayer's argument. In the first place, Taxpayer was not insolvent at the time that the policy was terminated, although its net worth was only \$3,700 at that time. Additionally, it is difficult to accept that the distribution of the total value in the policy against outstanding indebtedness was a discharge of that indebtedness; the more reasonable characterization is that the full value was distributed to Taxpayer, the distribution would be taxable to the extent of gain and the proceeds of that distribution were subsequently applied against the outstanding indebtedness, extinguishing it. Because the indebtedness was nonrecourse, then the limit of the indebtedness was measured by the value of the policy, leaving no indebtedness left to be discharged after such application.

Inclusion Ratio of Receiving Trust Unaltered by Transferred Assets

Private Letter Ruling 201134017

Facts: Taxpayer created irrevocable Family Trust 1 (FT1) in 1985 for the benefit of Taxpayer's spouse and descendants. Taxpayer was the original trustee and Individual was the original "special trustee." The provisions of FT1 direct that upon Taxpayer's death, the assets in the trust are to be divided into equal shares among the descendants of Taxpayer and spouse. FT1 further provided that upon the death of the last beneficiary of a trust for the benefit of a descendant of Taxpayer and spouse, any assets remaining were to be added to the existing trust for the benefit of other descendants, if any. GST exemption was allocated to all assets transferred to the trust, resulting in an inclusion ratio of zero for all assets in the trust under IRC §2642. Taxpayer subsequently died survived by his spouse and two daughters (D1 and D2). Pursuant to the provisions cited above, the trustee divided the trust assets into two equal shares, one for each daughter (and her descendants), TD1 and TD2. Subsequently, D2 died survived by no descendants, leaving assets in TD2. Pursuant to the provisions above, trustee added the assets remaining in TD2 to the assets in TD1 for the benefit of D1 and her descendants. Individual, as special trustee, contemplates transferring assets from TD1 to a "receiving trust" that is similar, but not identical to TD1 for administrative advantages.

Holding: The IRS held that the transfer of all assets from TD1 to the receiving trust does not result in a change of transferor and therefore will not affect the zero inclusion ratio of the assets transferred for purposes of IRC §2642. The provisions of FT1 permit the special trustee to make the transfer for administrative reasons and the receiving trust does not extend the period for which the assets are held. Furthermore, under the circumstances, the power exercised by the special trustee does not constitute a power of appointment of any kind. For these reasons, the transfer will not have any effect on the inclusion ratio of the assets transferred.

Property Passing by Disclaimer Not Taxable Distribution

Estate of Tatum Jr. v. United States, 108 AFTR 2d 2011-5642, 08/08/2011

This case demonstrates the importance of taking state law into consideration in making choices that would otherwise appear to be most affected by federal tax law. The U.S. Court of Appeals (5th Cir.) found in proceedings below that property passing to children as result of deceased Taxpayer's disclaimer of a bequest from a predeceased father was not a taxable distribution. To the extent the disclaimer resulted in a lapsed bequest under Mississippi law, it still would have constituted a qualified disclaimer exempting Taxpayer from gift tax under IRC §2518. Taxpayer's intent regarding subject property is relevant and is clear.

Facts: Taxpayer G1 died testate in early 1987, leaving 60% of the residue of his estate to his only child, taxpayer G2, which included stock in certain corporations. Almost immediately, G2 wrote to himself and the other executors of G1's estate, purporting to disclaim all interest in the stock. By order of the probate court, in answer to G2's petition, the stock was to pass to the children of G2 as if G2 had predeceased G1. This order was reaffirmed by the probate court, upon request, in 1997. The stock was ultimately distributed to the children of G2 in 1997. G2 died in 2003.

In 2008, the IRS provided a notice of deficiency to the estate of G2 (and a nearly identical notice to the estate of G2's wife, who had died in 2001), for failure to pay approximately \$740,000 in gift taxes upon the transfer of the interests in the stock to the children of G2 in 1997. Each estate paid the taxes cited and filed for a refund. The court granted a summary judgment for the IRS and the estate of Taxpayer appealed.

Holding: The court below held that the effect of G2's disclaimer in 1987 on the disposition of the property is determined by the applicable state law at the time. The jurisdiction is the State of Mississippi. Under Mississippi law, "the paramount and controlling consideration is to ascertain and give effect to the intention of the testator." The will of G1 made specific provisions for the disposition of the property if G2 were to predecease him. Furthermore, G2 accomplished what was undeniably a qualified disclaimer for federal tax law purposes. Upon appeal, the U.S. District Court for the Southern District found that Mississippi law specifically provides that when the deceased beneficiary is a child of the testator, the bequest does not lapse, but passes as if the legatee had survived the testator and then died intestate. Thus, the disclaimer is valid and the assets pass directly from G1 to the children of G2 as if G2 had predeceased.

IRS Releases New Rates Used in Computing Special Use Value Under IRC §2032A

Rev. Rul. 2011-17

This revenue ruling contains a list of the average annual effective interest rates on new loans under the Farm Credit System.

Under §2032A(e)(7)(A)(ii) of the Internal Revenue Code, rates on new Farm Credit System Bank loans are used in computing the special use value of real property used as a farm for which an election is made under §2032A. (See John Hancock Solutions software for an illustration of "Wealth Transfer Planning with Land Preservation," using land conservation easements under IRC §2032A.) The rates in Table 1 of this revenue ruling may be used by estates that value farmland under IRC §2032A as of a date in 2010. The rates in Table 2 of this revenue ruling may be used by estates that value farmland under IRC §2032A as of a date in 2011.

REV. RUL. 2011-17 TABLE 1
TABLE OF INTEREST RATES
(Year of Valuation 2010)

Farm Credit System Bank Servicing State in Which Property Is Located	Rate
AgFirst, FCB	7.48
AgriBank, FCB	6.41
CoBank, ACB	6.07
Texas, FCB	6.45
U.S. AgBank, FCB	6.15

REV. RUL. 2011-17 TABLE 2
TABLE OF INTEREST RATES
(Year of Valuation 2011)

Farm Credit System Bank Servicing State in Which Property Is Located	Rate
AgFirst, FCB	6.97
AgriBank, FCB	6.12
CoBank, ACB	5.78
Texas, FCB	6.04
U.S. AgBank, FCB	5.88

IRS Releases Updated Valuation Tables Reflecting New Mortality Data

The IRS has published more than ten final regulations that set forth updated actuarial tables for valuing annuities, life estates, reminders and reversions valued on or after May 1, 2009. These regulations follow temporary and proposed regulations issued in May 2009 and adopt the proposed regulations with only slight changes.

CASE IN POINT: LEVERAGING GIFTS UNDER THE 2010 TAX ACT

Initial Call to Advanced Markets: May 2011

Client Profile: Male, age 67 and Female, age 65, both Super Preferred Non Smokers, about \$50M net worth

Insurance Need: \$20M survivorship policy for death benefit and estate liquidity purposes

Initial Discussion: In May 2011, producer called into Advanced Markets looking for tax-efficient ways to fund a large life insurance policy needed for death benefit protection and to help pay potential estate taxes for his clients. His clients had recently sold a large clothing manufacturing company, and liquidity was not an issue. The producer was not very familiar with the current estate tax law environment and was looking for guidance on how to fund such a large policy and avoid any potential gift taxes in the process.

Solution: The Advanced Markets Consultant (AMC) explained to the producer that the Tax Act of 2010 allowed for a \$5M gift tax exemption per person which would expire at the end of 2012. This meant that these clients had an available \$10M combined gift tax exemption available for the next year and a half. The AMC suggested a scenario using a survivorship life insurance policy for \$20M with an annual premium of about \$273,000. Using the newly updated Gifting module in JH Solutions estate and business planning software, the AMC illustrated the clients making a lump-sum cash gift of \$5M to an Irrevocable Life Insurance Trust (ILIT). Assuming the ILIT was defective for income tax purposes and enjoyed an overall 6% trust growth rate, the ILIT would comfortably cover the cost of the insurance premium.

Summary: The AMC was able to show the producer that this planning strategy not only avoided gift taxes but provided significantly more wealth transfer to the clients' heirs at life expectancy than doing no planning or simply gifting and investing.

Case Closed: July 2011

ONE YEAR LIBOR RATE

As of September 14, 2011: 0.82%

PRIME RATE

As of September 14, 2011: 3.25%

IRC SECTION 7520 RATE

Month	Year	Rate
September	2011	2.0%
August	2011	2.2%
July	2011	2.4%

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 – SEPTEMBER 2011

	Annual	Semi Annual	Quarterly	Monthly
Short-term	0.26%	0.26%	0.26%	0.26%
Mid-term	1.63%	1.62%	1.62%	1.61%
Long-term	3.57%	3.54%	3.52%	3.51%

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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