John Hancock
LIFE INSURANCE

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Tax Relief Act of 2010

On December 17, 2010, President Obama signed the "Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010" (hereinafter referred to as the "Act"), which is the legislative embodiment of the controversial compromise struck between President Obama and Republican leaders of the Senate and House of Representatives on the topic of, primarily, the temporary extension of unemployment benefits, the so-called "Bush tax cuts," a reduction of Social Security taxes, and a host of other tax benefits.

The Act comprises 74 pages of legislation broken out into eight separate titles. Primarily, the Act extends until the end of 2012 most of the provisions of two separate tax relief laws that were scheduled to expire at the end of 2010, viz., the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), and the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA"). The provisions of the Act expire on January 1, 2013, and the affected provisions of the IRC revert back to pre-EGTRRA status. This summary will concentrate on the estate tax and individual income tax provisions affected by the Act.

Estate, Gift, and Generation-Skipping Transfer Tax Provisions

The Act begins its estate, gift, and GST tax section by repealing the 2010 repeal of the estate tax and reinstituting the pre-EGTRRA step-up in basis. The Act provides that the estate of a decedent dying during 2010 may elect the EGTRRA provisions (no estate tax, carryover basis) or the Act provisions. Absent such an election, the default rule is that the increased applicable exclusion amount and reduced tax rates below apply for estates of decedents dying during 2010. The deadline for filing any required return or election with respect to an estate of a decedent dying during 2010 is a date not earlier than nine months after the date of enactment of the Act.

Reunification and Applicable Exclusion Amount. Under the Act, gift and estate taxes are reunified (as they were before EGTRRA), minimizing the effect of the choice to make a gift during life or at death. The "applicable exclusion amount" under IRC §2010 is set at $5,000,000, and this amount is indexed by IRC §2505, with the result that beginning January 1, 2011, the so-called "unified credit" for gift and estate taxes is $5,000,000. Although this reunification and increase in exclusion amount is effective under the Act for only two years (2011 and 2012), the $5,000,000 amount is indexed for inflation in multiples of $10,000 beginning in 2012. On January 1, 2013, the applicable exclusion amount will revert back to $1,000,000, as it was scheduled under prior law. (N.B. As noted above, the new $5,000,000 estate and GST exemption amounts are the default rule for 2010, depending on elections made, but the reunification of the gift and estate taxes is effective January 1, 2011.)

Estate Tax Rates. Estate tax rates are simply truncated by the Act at the top marginal rate of 35%. The brackets between 18% and 34% remain exactly the same, and the 35% bracket is imposed as the maximum rate.

Portability. Section 303 of the Act introduces "portability" to the applicable exclusion amount (unified credit), the ability for a surviving spouse to use any applicable exclusion amount left unused by his or her predeceased spouse. Thus, for example, under the Act if Spouse A dies using only $2,000,000 of his $5,000,000 applicable exclusion amount, then upon the subsequent death of Spouse B, she may use her $5,000,000 plus his unused $3,000,000, for a total of $8,000,000. To prevent serial credit collection, the Act allows the portability of the unused applicable exclusion amount of only the last spouse to die.

Generation-Skipping Transfer Tax. The GST exemption under the Act is equal to the applicable exclusion amount, now $5,000,000, as imported by reference by IRC §2631(c). With respect to any generation-skipping transfer made during 2010, the Act extends the deadline for filing a return under IRC §2662 until a date not earlier than nine months after the date of enactment of the Act.

Individual Income Tax Provisions

Individual Income Tax Rates. Very simply, the Act did nothing more than substitute the expiration year of "2012" for "2010" for the temporary income tax rate changes introduced by EGTRRA and JGTRRA, each of which was previously scheduled to expire at the end of 2010 and revert to prior rates. This has the effect of extending, through the end of 2012, the following rate changes made by these acts:

- The lowest income tax bracket is 10% (not 15%);
- The following brackets are 25%, 28%, 33%, and 35% (rather than 28%, 31%, 36%, and 39.6%); and
- Capital gains are taxed at 0% for taxpayers below the 25% bracket and at 15% for those above (rather than 10% and 20%).

Marriage Penalty Relief. The Act extends through 2012 the provisions of EGTRRA that ameliorated (though did not eliminate) the so-called "marriage penalty" that results from aggregating income across graduated rate brackets. These provisions double the size of the 15% income tax bracket (after 2008) and the standard deduction for married filers.

Limitation of Itemized Deductions. The Act extends for two years the 2010 repeal of the so-called "Pease limitation, which reduces by three percent the amount of itemized deductions that a taxpayer may claim above indexed amounts of adjusted gross income.

Social Security Tax. The Act provides a one-year 2% reduction in the amount of Old-age, survivors, and disability insurance (OASDI) taxes paid or withheld from an employee's payroll. Thus, employees will have 4.2% withheld and self-employed taxpayers will pay 10.2% in OASDI taxes in 2011.

Alternative Minimum Tax ("AMT"). The Act provides that single taxpayers will be entitled to an exemption from AMT in the amount of $47,450 for tax year beginning in 2010 and $48,450 tax year beginning in 2011 (rather than $33,750 under current law) and married taxpayers filing jointly $72,450 for tax year beginning in 2010 and $74,450 for tax year beginning in 2011 (rather than $45,000).

Land Conservation Easements

The Act also extends through the end of 2011 the charitable deduction limitation and carry-forward provisions under IRC §170(b)(1)(E) relating to "qualified conservation contributions" under IRC §170(h). Under these provisions, generally a taxpayer may take a charitable deduction for a qualified conservation contribution up to 50% of AGI in the year of the contribution (100% of AGI for a contribution by a "qualified farmer or rancher") and may carry forward and apply as a charitable deduction any unused deduction for 15 successive years at the limitation (50% or 100%) first applied until expended.

Conclusion

It is important to remember that the Act is essentially a two-year patch to prevent economic damage from tax provisions that were expiring at an inconvenient time. This will all have to be revisited in two years, when the party balance in Washington may be very different than it is today. It is probably not a coincidence that the provisions of the Act expire in the year of a Presidential election and elections in both the Senate and House.

Listen to our JHAM Radio broadcasts with Randy Zipse discussing Planning Opportunities with Stephan Leimberg (January 11, 2011) and 2010 Tax Act Planning Opportunities with Larry Brody (December 28, 2010). Go to www.jhsalesnet.com and click on "Advanced Markets Group" then "JHAM Radio"

Federal Tax Limits for 2011

Revenue Procedure 2010-40

Below are some of the limits for 2011:

Annual Exclusion from Gift Tax: The annual exclusion amount will remain at $13,000 in 2011.

Gifts to Non-Citizen Spouses: The annual exclusion for present interest gifts to non-U.S. Citizen Spouses will be $136,000 in 2011 (slightly up from $134,000).

Notice of Large Gifts from Foreign Persons: Recipients will now have to report gifts from non-resident aliens that exceed $14,375 (slightly up from $14,165).

Section 2032A "Special Use" Qualified Real Property Value Reduction Limit: The limit for 2011 will be $1,020,000 (slightly up from $1,000,000).

Dollar Amount Used to Compute "2 Percent" Portion of §6166 Calculation: The portion of deferred estate tax eligible for a 2% interest rate under §6166 will be $1,360,000 in 2011 (up from $1,340,000).

Eligible Long-Term Care Premiums: For 2011, the limitations under §213(d)(10) regarding eligible long term-care premiums includible in the term "medical care," are as follows:

ATTAINED AGE BEFORE CLOSE OF TAXABLE YEAR	LIMITATION ON PREMIUMS
40 or less	$340
More than 40 but not more than 50	$640
More than 50 but not more than 60	$1,270
More than 60 but not more than 70	$3,390
More than 70	$4,240

Gift, Estate and GSTT Exemptions: With the enactment of the "Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010", as of January 1, 2011, the applicable credit amount for estate, gift and GST tax will be unified at $5,000,000, with a maximum rate of tax of 35%. These credit amounts and rates will only last for two years unless additional legislation is enacted.

IRS Issues Additional Guidance & Relief for Certain Failures to Comply with 409A

Notice 2010-80

As discussed in December's Central Intelligence, Notice 2010-80 is the latest offering from the IRS providing guidance and relief in limited situations for operational and document failures associated with complying with 409A. The IRS previously issued two limited correction programs, an operational correction program under IRS Notice 2008-113 (as discussed in the January 2009 Central Intelligence) and a plan document correction program under IRS 2010-6 (as discussed in the February 2010 Central Intelligence). Notice 2010-80 (the "Notice") modifies certain provisions of Notice 2008-113 and Notice 2010-6. More specifically, the Notice:

- Clarifies that the types of plans eligible for relief under Notice 2010-6, including nonqualified plans "linked" to a qualified plan or another nonqualified plan, provided that the linkage does not affect the time and form of payments under the plans;
- Expands the types of plans eligible for relief under Notice 2010-6 to include certain stock rights that were intended to comply with the requirements of § 409A(a);
- Provides an additional method of correction under Notice 2010-6 for certain failures involving payments at separation from service subject to the requirement to submit a release of claims or similar document; and provides transition relief permitting the correction of such failures that were in effect on or before December 31, 2010 (including relief from the service provider information reporting requirements);
- Provides relief from the service provider information reporting requirements under Notice 2010-6 for corrections made under the transition relief ending December 31, 2010; and
- Provides relief from the requirement that service recipients provide certain information to service providers under Notice 2008-113 for corrections made in the same taxable year as the failure occurs.

For a complete summary of Notice 2010-80, please see the Central Intelligence from December 2010.

Policy Loans Exceeding Investment in Life Insurance Contract Taxable

Sanders v. Commissioner, TC Memo 2010-279

Facts: In 1979, taxpayer purchased a policy from New York Life Insurance Co. ("Insurer") with a $25,000 face amount. From 1979 until March 2006 petitioner paid premiums of about $31 per month on the policy. The policy allowed taxpayer to borrow generally up to the policy's cash value, using the policy as security. By its terms the policy terminated if any unpaid loan, including accrued interest, exceeded the sum of the policy's cash value and any dividend accumulations.

Between 1990 and 2004, taxpayer borrowed $7,136 against the policy and did not repay these loans. In 2006, Insurer advised the taxpayer that his outstanding loan balance was $17,203 (including principal and accrued interest) and that this amount exceeded the policy's cash value by $517. Insurer warned taxpayer that his policy would be terminated unless taxpayer paid at least $517 within 30 days. When taxpayer did not make the required payment, Insurer terminated the policy and issued a 1099-R to the taxpayer showing a gross distribution of $17,292 and a "taxable amount" of $7,175 (taking into consideration taxpayer's $10,117 of premiums paid). Taxpayer failed to include this $7,175 in income on his 2006 income tax return and the IRS deemed this amount was improperly omitted.

Ruling: The general rule under IRC §72 is that an amount received in connection with a life insurance contract which is not received as an annuity generally constitutes gross income to the extent that the amount received exceeds the investment in the contract. Although taxpayer tried to argue that he should not be taxed on a "distribution" from the policy in 2006 because he received no cash or other property from the Insurer, the Court noted that the Insurer applied the policy's cash value to the outstanding loan balance, which was the economic equivalent of the Insurer paying the taxpayer the policy proceeds and his using those proceeds to pay off the loan. The court held that this constructive distribution was gross income to the taxpayer in so far as it exceeded his investment in the contract. Without any reasonable evidence to combat the Insurer's numbers reported on the 1099-R, the court ruled that $7,175 of the $17,292 constructively received by the taxpayer was taxable income.

IRS Extends Time to File Statements Regarding Split-Dollar Agreements for Nonrecourse Split-Dollar Loans

PLR 201041006-2010041023

Facts: The taxpayer/employees in question each participated in a split-dollar life insurance arrangement with their Employer, a 501(c)(3) tax-exempt nonprofit corporation. Over the years the Employer's parent ("Parent"), also a 501(c)(3) organization, hired various companies to consult on matters related to the split-dollar program offered to key employees of Parent and its subsidiaries (including Employer).

Parent's current split-dollar program was entered into after the Treasury Department issued its final split-dollar regulations. All premium payments made by the Employer under the program are treated as split-dollar loans and each taxpayer/employee represents that the loans are to have stated interest rate equal to the applicable federal rate so as not to be considered a "below-market split-dollar loan" under the regulations.

A couple of years after the initiation of the current split dollar program, Employer was advised that the loans made under the split-dollar program were nonrecourse loans secured by the life insurance policies. Employer notified taxpayers of the nonrecourse nature of the split-dollar loans and informed taxpayers that a written representation should have been filed by the taxpayers to ensure that payments on the loans were not treated as contingent payments.

In requesting relief from the IRS for not meeting the deadline required for filing the written representation, the taxpayer in each case represented that (i) granting relief would not result in a lower tax liability in the aggregate to all years to which the election applies than it would had the election been timely made, (ii) taxpayer did not knowingly choose not to file the statement, (iii) taxpayer did not use hindsight in requesting relief, and (iv) taxpayer was not seeking to alter a return position for which an accuracy-related penalty had been or could be imposed under IRC § 6662.

Requirement for Written Statement: Treasury Regulation § 1.7872-15(d)(1) provides that if a payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes of § 1.7872-15, except as provided in §1.7872-15(d)(2). Section 1.7872-15(d)(2)(i) provides that an otherwise noncontingent payment on a split-dollar loan that is nonrecourse to the borrower is not a contingent payment if the parties to the arrangement represent in writing that a reasonable person would expect that all payments under the loan will be made.

Per § 1.7872-15(d)(2)(ii), the written representation must be signed by both the lender and the borrower not later than the last day (including extensions) for filing the Federal income tax return of the borrower or lender, whichever is earlier, for the taxable year in which the lender makes the first split-dollar loan under the split-dollar arrangement. A copy of the representation should be attached to the parties' income tax returns for each year that the lender makes a loan to which this section applies.

Ruling: In reaching its determination, the Service reviewed Treasury Regulations §301.9100-1 through §301.9100-3, which provide standards to determine whether to grant an extension of time to make a regulatory election. Where an automatic extension of time is not available (as in the case of the taxpayers discussed herein), the taxpayer must provide evidence satisfactorily establishing that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the Government.

A taxpayer will be deemed to have acted reasonably and in good faith if the taxpayer satisfies at least one of the following five criteria: (i) the request for relief was made before the Service discovered the failure to make the regulatory election; (ii) the failure to make the election was due to intervening events beyond the taxpayer's control; (iii) after exercising reasonable diligence, the taxpayer was unaware of the necessity for the election; (iv) the taxpayer reasonably relied on the written advice of the Service; or (v) the taxpayer reasonably relied upon a qualified tax professional, including a tax professional employed by the taxpayer, and that tax professional failed to make or failed to advise the taxpayer to make the election.

On the facts presented by taxpayers, the Service concluded that the requirements for granting a reasonable extension of time to file the written representations, as required under the split-dollar regulations, were met. Each taxpayer was granted a period of time, not to exceed 30 days from the date of the PLR, to prepare and have both parties to the loan sign the representation. The Service also stated that so long as the written representation is filed with the taxpayer's next tax return, the written representation will be deemed to be effective for all years the split-dollar arrangement has been in effect. Under § 1.7872-15(d)(2)(ii), a copy of the written representation should be attached to taxpayers' tax returns for any subsequent year in which Employer makes a split-dollar loan to the taxpayers to which the representation applies.

CASE IN POINT: PRIVATE FINANCING

Initial Call to Advanced Markets: October 2010

Client Profile: Female, Age 62, Preferred Non Smoker

Concern: High-net-worth client needed substantial insurance coverage for estate liquidity purposes.

Initial Discussion: In August of 2010, Producer called Advanced Markets Group to discuss estate planning techniques for his client whose estate of over $35 million consisted mostly of real estate and other illiquid assets growing at about 3% annually. Client's lifetime gift tax exemption had already been exhausted. Client had $5.4 million in liquid assets that was available for estate planning. Client's advisors were considering suggesting either Premium or Private Financing to fund life insurance.

Solution: The Advanced Markets Consultant (AMC) suggested that a Private Financing scenario might be preferable for these reasons:

First, given the low-interest-rate environment, the existing long-term applicable federal rate (AFR) for intra-family loans was a low 3.32%. By making a lump-sum loan of about $5M and creating a sinking fund inside the client's trust (with an assumed 6% return) to pay the life insurance premium, the client could lock in this low rate.

Second, unlike Premium Financing where interest must be paid during life, the client would be able to defer interest for life and repay the note principal and interest net of estate tax at death from the life insurance proceeds. In this case, the AMC recommended that a return of premium rider to help maintain more of the original death benefit might be appropriate.

Third, because it was an intra-family loan, there were no third-party loan costs, collateral requirements or loan call risks associated with this technique.

Summary: Using John Hancock's Private Financing module in JH Solutions, the AMC illustrated the Private Financing technique, taking advantage of the arbitrage between the low loan interest rate and the trust's investment return. This enabled the producer to show his client how to pass on more of her estate to her heirs cost-effectively. Client also liked the idea of not having to pay gift taxes on the loan interest.

Case Closed: December 2010

ONE YEAR LIBOR RATE
As of January 12, 2011: 0.78%

PRIME RATE
As of January 12, 2011: 3.25%

IRC SECTION 7520 RATE		
January	2011	2.4%
December	2010	1.8%
November	2010	2.0%

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 – JANUARY 2011				
	Annual	**Semi Annual**	**Quarterly**	**Monthly**
Short-term AFRs – loans (3 years or less)	0.43%	0.43%	0.43%	0.43%
Mid-term AFR – (More than 3 years up to and including 9 years)	1.95%	1.94%	1.94%	1.93%
Long-term AFRs – (More than 9 years)	3.88%	3.84%	3.82%	3.81%

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Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½. Cash value available for loans and withdrawals may be more or less than originally invested. Withdrawals are available in the [2nd] policy year.

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