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House Passes Estate Tax Bill, No Action in the Senate

H.R. 4154, Permanent Estate Tax Relief for Families, Farmers and Small Businesses Act of 2009

On December 3, 2009, the House of Representatives passed H.R. 4154, Permanent Estate Tax Relief for Families, Farmers and Small Businesses Act of 2009 by a vote of 225-200. H.R. 4154 would make permanent the 2009 estate tax exemption (\$3,500,000) and the highest estate and gift tax rate (45%). H.R. 4154 would take effect starting on January 1, 2010, and would also maintain the “step-up in basis” approach, rather than the carryover basis approach which is currently scheduled to take effect in 2010.

H.R. 4154 does not include many of the provisions that have been included in other estate tax legislation such as indexing for inflation, portability or reunification of the estate and gift tax exemption. H.R. 4154 is expected to cost \$233 billion over ten years and will be subject to the “pay-as-you-go” rules. It also does not include any provisions on Grantor Retained Annuity Trusts (GRATs), valuation discounts, or any provisions other than the estate tax. As of December 21, 2009, the Senate was unable to come to an agreement on this legislation, and further action on the estate tax is unlikely until 2010.

For updates on the estate tax legislation, listen to upcoming John Hancock Advanced Markets (JHAM) Radio broadcasts at www.jhsalesnet.com → click on “Advanced Markets Group” → “JHAM Radio.”

Federal Tax Limits Issued for 2010

Revenue Procedure 2009-50

The IRS has issued many of the tax limits for 2010 in a recent Revenue Procedure. Below are some of the limits for 2010:

- **Annual Exclusion from Gift Tax.** The annual exclusion amount will remain at \$13,000 in 2010.

- **Gifts to Non-Citizen Spouses.** The annual exclusion for present interest gifts to non-US Citizen Spouses will be \$134,000 in 2010 (up slightly from \$133,000).
- **Notice of Large Gifts from Foreign Persons.** Recipients will now have to report gifts from non-resident aliens that exceed \$14,165.
- **Income Tax Standard Deduction.** Married Filing Jointly or Surviving Spouse (\$11,400), Married Filing Separately (\$5,700), Head of Household (\$8,400), and Single (\$5,700).
- **Section 2032A “Special Use” Qualified Real Property Value Reduction Limit.** The limit for 2010 will remain at \$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 Section 6166 will be \$1,340,000 in 2010.
- **Gift, Estate and GSTT Exemptions.** Based on current law, the lifetime gift exemption will remain at \$1,000,000 per person in 2010, and the estate and generation-skipping transfer (GST) tax will be repealed for one year in 2010, with a carryover basis regime for assets transferred at death (each person will have a \$1,300,000 exemption from carryover basis, plus a \$3 million exemption for transfers to a spouse). However, many commentators expect that the estate and GST tax for 2010 will be changed by new legislation.

Pension Plan Limits and Amounts for 2010

News Release 2009-94

Many of the pension plan limits for 2010 will be the same as 2009. Among the important limits for 2010 are the following:

- **Annual Limit for Defined Benefit Plans.** The limitation on the annual benefit under a defined benefit plan under Section 415(b)(1)(A) will remain at \$195,000. This amount will be subject to inflation indexing in \$5,000 increments in future years.
- **Annual Limit for Defined Contribution Plans.** The contribution limit for defined contribution plans will remain at \$49,000. This amount will be subject to inflation indexing in \$1,000 increments.
- **Qualified Plan Income Limits.** The maximum income level to be considered in calculating qualified plan contributions will remain at \$245,000 in 2010. This amount will be subject to inflation indexing in \$5,000 increments.
- **Qualified Plan Contribution Limits.** Employees can defer up to \$16,500 of income for contributions to a 401(k) plan (regular or Roth 401(k)) or a 457(b) plan in 2010. In addition, employees age 50 or over may make additional 401(k) contributions under Section 414(v)(2)(B)(i); the additional 401(k) contribution “catch-up” amount will be \$5,500 in 2010.
- **Definition of Highly Compensated Employee.** The limitation used in the definition of a highly compensated employee will remain at \$110,000.
- **Annual Contributions to Individual Retirement Accounts (IRAs).** The annual contribution limit for IRAs will remain at \$5,000 in 2010, and the “catch-up” contribution amount will remain at \$1,000 for persons age 50 and over.

Changes from Pension Protection Act for Long-Term Care

For tax years beginning after December 31, 2009, the Pension Protection Act of 2006 (PPA) changed the rules for annuities and life insurance contracts with riders for long-term care coverage. The long-term care rider will be treated as a separate contract, independent from the underlying life insurance or annuity contract, for purposes of determining whether it is “qualified long-term care insurance” and the taxation of the benefits provided under the long-term care rider. Under the new provisions, any charge against the cash value of an annuity or life insurance contract, or modified endowment contract (MEC) made as a payment for coverage under a qualified long-term care contract that is a rider, will not be included in income. The investment in the contract will be reduced, but not below zero, and no deduction will be allowed as a medical expense for such a payment. In order for a long-term contract to be qualified under the PPA, it must meet the requirements of IRC 7702B(b).

In addition, under the PPA provisions the following types of tax-free Section 1035 exchanges will be allowed after December 31, 2009:

- An exchange from one qualified long-term care insurance contract to another;
- An exchange of an annuity contract, a life insurance contract or a MEC for a qualified long-term care contract;
- An exchange of a life insurance contract for a life insurance contract with a long-term care rider (or vice versa); or
- An exchange of an annuity contract for an annuity contract with a long-term care rider (or vice versa).

IRS Reviews Proposed Beneficiary Defective Trust

Private Letter Ruling 200949012

Facts: A Taxpayer/Grantor proposes to establish a trust that would treat the Beneficiary of the trust (Grantor’s child) as the owner of the trust for income tax purposes. There will be three Trustees of the Trust: Beneficiary will be the Investment Trustee, A (who has no beneficial interest in the trust) will serve as the Distribution Trustee, and Company will serve as the Administrative Trustee of the Trust. Neither Grantor nor Grantor’s spouse may act as a Trustee of the trust, nor will they be able to receive income or principal from the Trust (no more than one-half of the Trustees can be a related or subordinate person to Grantor).

The Beneficiary has the right to withdraw any property transferred to the trust by the Grantor; this power to withdraw will lapse each year up to the greater of \$5,000 or 5% of the value of the trust. The Beneficiary will also have the unilateral power to withdraw from the trust for his/her health, education, maintenance and support (HEMS). The Trust would not be able to purchase life insurance on the life of the Grantor or the Grantor’s spouse. Following Beneficiary’s death, all of the trust assets will be distributed to such persons or charitable organizations as Beneficiary appoints by his/her will, other than Beneficiary, Grantor, their estates, creditors or creditors of their estates.

Ruling: The IRS ruled that based on the proposed trust, the Grantor will not be considered an owner of the trust for income tax purposes under the grantor trust rules (IRC Sections 671-679). Beneficiary will be the owner of the trust for income tax purposes, even after the power to withdraw from the trust fully lapses (there is no end date for the power to withdraw based on the HEMS standard).

Creating a trust that is “defective” with respect to its Beneficiary, rather than the Grantor, is a relatively new planning technique that can allow a Beneficiary to pay income tax for the trust without making a gift, sell assets to the trust without adverse income tax consequences, and if the trust is structured properly, the trust assets will be outside both the Beneficiary and the Grantor’s taxable estates. This technique is sometimes also referred to as a Beneficiary Defective Inheritance Trust or B-DIT; the trust can also be used to purchase life insurance on the life of the Beneficiary or Beneficiary and his/her spouse.

For more information on Beneficiary Defective Inheritance Trusts or B-DIT, listen to the two-part John Hancock Advanced Markets (JHAM) Radio broadcast featuring Richard Oshins, Esq., of Oshins and Associates, and Randy Zipse, VP and Senior Counsel, Advanced Markets. To see all of the JHAM Radio broadcasts, go to www.jhsalesnet.com and click on “Advanced Markets Group” → “JHAM Radio.”

Two PLRs on Life Insurance in Partnership

Private Letter Rulings 200947006 and 200948001

The IRS recently published two Private Letter Rulings (PLRs) in which the IRS ruled favorably on a partnership in which life insurance was the sole asset. Following the transactions described, the insured would not have a limited partnership interest, but he does own stock in the corporate general partner and he is a Co-Trustee of a Trust that owns partnership interests.

Facts: In this proposed transaction, the Insured/Taxpayer is initially the sole owner of the corporate general partner of Partnership 1 and a second corporation owns limited partnership interests in Partnerships 2, 3, and 4. In addition, Taxpayer’s parents created Trust 1 of which Taxpayer is a discretionary income beneficiary, and he and his Sister are co-trustees. Taxpayer created Trust 2 of which the beneficiaries are the Taxpayer’s wife and children. Trust 2 is the owner and beneficiary of Policy 2, a whole life insurance policy on the life of Taxpayer. Taxpayer has made gifts to Trust 2 to fund premiums on Policy 2.

Following a series of steps (and receipt of a favorable private letter ruling), the Taxpayer proposes that the following structure would result:

- Trust 1 and Trust 2 will own 100% of Partnership 1.
- Partnership 1 will be the owner and beneficiary of the two life insurance policies on Taxpayer’s life.
- Partnership 1 will pay all of the premiums on Policies 1 and 2.
- Taxpayer will release to Sister the power to make any significant decisions on Policy 1.

The Taxpayer requested that the IRS rule on whether or not the proceeds of Policy 1 and Policy 2 would be includable in Taxpayer’s gross estate under IRC Sections 2042 or 2035.

Ruling: The IRS ruled in favor of the Taxpayer on both requests. The Service reviewed the relevant rulings and case law on the Section 2042 question, and noted that since the Taxpayer released the power to make any significant decisions on Policy 1 and he never had any power to make decisions on Policy 2, he would not have incidents of ownership in Policies 1 and 2 and the proceeds will not be included in his gross estate.

On the Section 2035 question, the IRS noted that the Taxpayer will not have incidents of ownership in the policies before or after the transactions, so that even if he dies within 3 years of releasing his powers over Policy 1, the proceeds of Policies 1 and 2 will not be includable in his gross estate under Section 2035(a).

Court Upholds Defined Value Gift Formula in Two Recent Cases

Estate of Christiansen v. Commissioner, 104 AFTR2d 2009–7352 (8th Cir.)

Facts: The decedent left her entire estate to her daughter and her will provided that 25% of any disclaimed amounts would go to a charitable foundation, and 75% would pass to a Charitable Lead Annuity Trust (CLAT). The daughter disclaimed her interest in the estate in a formula disclaimer as to all amounts over \$6.35 million. The IRS challenged the disclaimer and the estate valuation, as well as the charitable contribution that the estate claimed.

Ruling: The Eighth Circuit Court of Appeals affirmed the decision of the Tax Court and ruled in favor of the decedent/taxpayer on allowing the disclaimer for the amount passing to the charitable foundation. The Court noted that changes to the estate valuation and the need to calculate the amount to pass to the foundation did not disqualify the disclaimer from being a qualified disclaimer. The court also rejected the IRS's argument that fixed-dollar partial disclaimers violate public policy. However, the Court did agree with the IRS that the disclaimer was not effective for the portion that was to pass to the CLAT, since the daughter did not disclaim her interest in the CLAT.

This technique is sometimes referred to as a “charitable lid” estate plan, where a fixed dollar amount passes to a noncharitable beneficiary and the residuary estate passes to a charitable organization.

Estate of Petter v. Commissioner, T.C. Memo 2009-290

Facts: Anne Petter owned millions of dollars in UPS stock. She used the stock to fund a Charitable Remainder Trust and a Limited Liability Company (LLC) and then funded two Intentionally Defective Grantor Trusts (IDGTs) with the LLC interest. She made a gift of the LLC units to the two IDGTs equal to 10% of the total value of the LLC units to provide “seed capital”, and then sold the remaining 90% of the LLC units to the IDGTs, in addition to giving LLC units to two charitable organizations.

The division of the LLC units between the charities and the trusts was determined by a formula which maximized the donor's lifetime gift exemption between the trusts and then transferred the excess number of units to the charities. Similar clauses were included in the sale and pledge documents and the units were appraised by a qualified appraiser, with full documentation included on Anne Petter's federal gift tax return. The charities also had separate counsel.

The IRS challenged the transfers, stating that the unit value should be higher than the appraised value and that the defined value gift clause was unenforceable and violated public policy.

Ruling: The Tax Court noted that based on precedent, the use of formula clauses is generally fine, while savings clauses are generally void. The Court disagreed with the IRS and ruled in favor of the taxpayer, noting that the transaction followed the formula outlined in the documents and that the donor gave an ascertainable dollar value of stock. The Court also upheld the charitable deduction that was taken and noted that the transaction was handled in an appropriate arms-length manner.

IRS Loses on Foundation Deduction Despite Control

Foxworthy, Inc. v. Commissioner, T.C. Memo 2009-203

Facts: The IRS disallowed the charitable contribution deductions for contributions to a private foundation because the donor/founder, Mr. Bell, controlled the foundation. Mr. Bell provided substantiation for the contributions of stock that he made to the foundation.

Ruling: The Tax Court rejected the IRS' position and allowed the income tax deduction stating that "control alone is not sufficient to defeat the deduction to the Bells." In some cases, control of private foundations can become an issue in determining whether there is any self-dealing on the part of the foundation or any other violation of the rules governing private foundations. If the donor is acting as a fiduciary of the foundation such as a director or officer, then he/she has a legal fiduciary duty to only act to further the tax-exempt purposes of the foundation and cannot use contributions for his/her personal benefit. In this case, there was no evidence or allegation of self-dealing or any other activity that would impinge on the foundation's exempt status, so the deductions were allowed up to the amount that was substantiated.

CASE IN POINT:

Maintaining Flexibility with a Spousal Access Trust

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: September 2009

Client Profile: Married Couple: Male, Age 50 and Female, Age 50, both Preferred Non Smokers. Two Children.

Net Worth: \$8,000,000

Insurance Need: \$4.5 million in survivorship life insurance for estate liquidity purposes and a desire for supplemental retirement income.

Initial Discussion: In September 2009, a producer called Bill Vigor in the Advanced Markets Group to discuss a potential opportunity for one of his clients. The client's estate was largely comprised of his business and a couple of vacation properties. He had 2 children and had maxed out his qualified retirement plan contributions. The client had also just received a settlement of \$500,000 and had mentioned that he'd like to leverage some of this money, but was concerned about not having access to the funds inside the trust especially as he was approaching retirement. The producer felt that it would be a good opportunity to discuss estate planning with his client. Although the client was young, his estate was growing rapidly and he wanted to start planning sooner than later.

Solution: Bill explained to the producer that the annual exclusion in 2009 per recipient is \$13,000. So, in this case the client could gift up to a maximum of \$52,000 per year if he gift splits with his wife (\$13,000 x 2 children x 2), without having to utilize his \$1 million lifetime gift exemption. The client liked the idea of making gifts, which reduced his taxable estate, and being able to leverage those gifts with life insurance.

Bill used the Spousal Access Trust module in the JH Solutions software to show the producer how he could compare 3 scenarios: 1) no lifetime gifting, 2) gifting to an irrevocable trust and investing the gifts at a 3% after tax rate of return inside the trust, and 3) gifting to an Irrevocable Life Insurance Trust (ILIT) and having the trustee purchase a \$4.5 million Protection Survivorship Variable Universal Life (SVUL) policy. Bill funded the Protection SVUL policy with the No-Lapse Guarantee (NLG) annual premium of \$28,199, at an assumed 8% gross rate of return. With this design, he pointed out that the client had over \$500,000 in cash value at retirement (age 65) which his wife could access for health, education, maintenance, and support, as well as the guaranteed death benefit protection. Based on a hypothetical extension of 2009 estate tax law (as requested by the producer), Bill showed that the net to heirs at life expectancy (age 83) with the purchase of life insurance was almost \$3 million more than a gifting and investing scenario, and almost \$4 million more than doing nothing at all.

Summary: By leveraging gifts, Bill was able to show the producer and his client how he could reduce his potential estate tax liability and still have the flexibility of access to the funds during retirement with a Spousal Access Trust.

Case Closed: October 2009

ONE YEAR LIBOR RATE
As of December 15, 2009: 1.00%

PRIME RATE
As of December 15, 2009: 3.25%

IRC SECTION 7520 RATE		
December	2009	3.2%
November	2009	3.2%
October	2009	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 – DECEMBER				
	Annual	Semi Annual	Quarterly	Monthly
Short-term AFRs – loans (3 years or less)	0.69%	0.69%	0.69%	0.69%
Mid-term AFR – (More than 3 years up to and including 9 years)	2.64%	2.62%	2.61%	2.61%
Long-term AFRs – (More than 9 years)	4.17%	4.13%	4.11%	4.09%

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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