ADVANCED MARKETS

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Capitalized Interest on Loan Taxable Distribution on Surrender of Life Insurance Policy

Boyd J. Black, et ux. v. Commissioner, TC Memo 2014-27, February 14, 2014

Facts: In 1989, Taxpayer purchased a whole life insurance policy on his own life. Policy contract provided that the owner could borrow against policy values in an amount not in excess of the cash value, that the policy debt consisted of the aggregate outstanding loans and accrued interest, and that unpaid interest would be added to loan principal. Taxpayer could, under policy provisions, surrender the policy at any time and, upon surrender, would be entitled to receive as a distribution an amount equal to the cash surrender value minus any outstanding policy debt. At any time that policy debt equaled or exceeded the cash value of the policy, the policy would be terminated automatically under the contract. Taxpayer took loans against the policy value, over time, in the total amount of $103,548 and neither repaid the loans or the interest. The interest was capitalized as required. In 2009, the policy was terminated when the amount of policy debt overtook the cash value of the policy. Upon termination, the outstanding loans, comprising original loan proceeds, capitalized interest, and unpaid accrued interest, equaled $196,230 and was extinguished against the cash value. Taxpayer's basis, represented by aggregate premiums paid, was $86,663. Insurer issued IRS Form 1099-R reflecting a gross distribution of $196,230 and a taxable amount of $109,567 (gross distribution less Taxpayer's basis). Taxpayer filed his federal income tax return for 2009 and did not report any portion of the policy distribution or make any mention of it. In 2011, Taxpayer prepared an amended return for Taxpayer, showing an increase in taxable income of only the difference between the original loan principal ($103,548) and Taxpayer's basis ($86,663), or $16,885. The IRS did not accept the amended return and filed a notice of deficiency for the unpaid tax on the full distribution, plus interest and penalties. Taxpayer filed for redetermination.

Holding: The Tax Court held entirely for the IRS. After determining that the burden of proof to show error was on Taxpayer, the Court found that the sole substantive issue was a question of law and not fact, i.e., is unpaid and capitalized interest on the policy loans includible in the taxable portion of the distribution received upon termination of the policy. The Court found that it was and, generally, is. The Court found that the loans taken under the policy provisions were "true loans" for federal income tax purposes and subject to the general income tax principles governing loans. IRC §61 provides that gross income for federal income tax purposes includes all income from whatever source derived, and lists, among examples of specific forms of gross income, income from life insurance contracts and income from discharge of indebtedness. Under general tax principles, as are well supported by long-standing case law, when an insurance policy is terminated and all or part of the proceeds are used to satisfy a loan against the policy, the transaction is treated as if the taxpayers received the proceeds and then applied them against the outstanding loan. Additionally, under IRC §72, which specifically governs distributions from a life insurance contract before death, amounts received that are not received as an annuity generally constitute gross income to the extent that the amount received exceeds the investment in the contract. Furthermore, the Court found that Taxpayer did not have good cause or act in good faith in his preparation of the relevant return and therefore Taxpayer is also liable for accuracy-related penalties for substantial underreported income. It apparently mattered to the Court that Taxpayer was a practicing attorney.

President Obama Releases His Budget for Fiscal Year 2015

Revenue Proposals, Budget of the United States Government, Fiscal Year 2015, OMB, March 4, 2014

As happens every year, the President releases the budget for the coming fiscal year of the federal government, and includes in it what might be best called a "wish list" of tax and legal proposals that affect the budget and federal revenue in general, either in that the proposals would, if enacted, create new revenues or spend revenues. The list always contains some proposals that may be enacted and many that stand very little chance, and there are some that show up every year. This year's 297-page Budget is no departure from the norm, although there are a number of items that we have not seen before. Below is a short summary of a few of the items that directly affect life insurance and estate planning (in general).

- Eliminate present-interest annual gift tax exclusion and impose a new $50,000 per donor limitation.
- Impose on Grantor Retained Annuity Trusts a minimum term of 10 years and maximum term of life expectancy, and eliminate zeroing-out of present value of transfer.
- Restore gift, estate, and generation-skipping transfer tax parameters in effect in 2009.
- Limit Generation-Skipping Transfer tax exemption to 90 years, despite state law regarding the Rule Against Perpetuities.
- Include a taxpayer's estate the value of assets in any trust with respect to which the taxpayer is treated as a grantor for income tax purposes.
- Impose a reporting requirement for purchasers of life insurance contracts (purportedly aimed at life settlements with investors unrelated to the insured) with a death benefit of greater than $500,000.

Remember, these are proposals only, which are not solely by inclusion in the proposed budget even before the federal legislature for consideration. The likelihood of any one of the dozens of proposals in the budget being considered and ultimately enacted as law depends on the individual proposal and the political climate into which it is launched. It is probably fair to say that, generally speaking, during the year of campaigning before an election year, fewer risks are undertaken by legislators. On the other hand, see the summary of HR 4061 on the following page.

IRS Fails to Show that Trusts Should Be Disregarded as Shams; Income Not Includible by Taxpayers

Christopher C. Close, et ux. V. Commissioner, TC Memo 2014-25, February 10, 2014

Facts: In 2004, Idaho Taxpayer H was convicted of numerous counts of healthcare fraud, money laundering, obstructing justice, and others relating to the conduct of his medical equipment business. Taxpayer H was imprisoned in 2005 for approximately six years. The last federal income tax return that Taxpayers filed before Taxpayer H was imprisoned was in 2001, when the government first executed search warrants in the case against Taxpayer H. In 2003, shortly before his indictment, Taxpayer H and Partner purchased via an installment note a 120-acre property in Idaho (Property A) consisting primarily of timberland, pledging 70% of the proceeds from timber sales toward satisfying the outstanding balance on the note. At the same time, Taxpayer H (together with Partner) formed LLC to manage the logging and farming operations of Property A. Also at about the same time, Taxpayer H and Partner created Trust A for the primary benefit of the children of Taxpayers and Partner. The trustee of Trust A was required to pay to each beneficiary the sum that the trustee deemed reasonable for the "maintenance, education, support, and health" of such beneficiary. Taxpayers had also created a second trust, Trust B, in 1998 which purchased real property with the initial cash gift to the trust. As part of the criminal trial, property owned by the two trusts was pursued by the government, much of which property was ultimately forfeited. The IRS, relying apparently on its own "advice" to Partner during the criminal trial and the success of the forfeitures, then filed notices of deficiency that sought to hold Taxpayers responsible for the federal income tax on the income earned by the Trusts after their creation. Taxpayers, understandably, appealed.

Holding: The Tax Court held that the Taxpayers were in fact not responsible for the tax on the Trusts' income and in a fairly diplomatically written opinion identified numerous tactical and legal mistakes made by the IRS. First of all, an IRS notice of deficiency is entitled to presumption of correctness and the taxpayer ordinarily has the burden of proof of showing that the IRS is not correct. However, in the relevant jurisdiction, the presumption of correctness depends on the IRS establishing some evidentiary foundation in the notice of deficiency. In this case, it did not, and instead introduced the new theory at trial that the Trusts were shams. Because this was a new theory introduced at trial, the IRS had no presumption of correctness, and the burden of proof was on the IRS to show that the Trusts were shams. It did not, and instead relied on its own treatment of the Trusts as shams as fiat "evidence." Furthermore, the IRS attempted to introduce voluminous documentary evidence at trial without first making it available to Taxpayers before trial. While the IRS succeeded on its penalties and interest on claims of failure to file timely returns, it lost on the largest substantive issues.

Bill Introduced to Reform [Raise] Estate, Gift, and Generation-Skipping Transfer Taxes

H.R. 4061, February 14, 2014

Representative Jim McDermott (D-WA-7) introduced HR 4061, the "Sensible Estate Tax Act of 2014" in the House of Representatives, which bill was immediately referred to the House Committee on Ways and Means. You may recognize some of its provisions from the Greenbook proposals reported earlier. Among several other provisions, the bill amends the Internal Revenue Code to establish new estate tax rates of between 41% (for estates with a value in excess of $1,000,000) and 55% (for estates with a value in excess of $10 million); to allow a $1 million estate tax exclusion; and to provide for an inflation adjustment to such amounts for decedents dying after 2014. HR 4061 would also restore the estate tax credit (that expired after 2004) for any estate, inheritance, legacy, or succession taxes paid to a state and would repeal the deduction currently takes the place of the credit. It would also require that the value of the basis in any property acquired from a decedent or by gift be consistent with the basis as determined for estate and gift tax purposes. The bill expands rules for valuing assets in grantor retained annuity trusts to require the GRAT have a term of not less than 10 years and that the annuity not decrease during the first 10 years of the term, and further would require the GRAT remainder interest have a value greater than zero when transferred. (No zeroing-out the GRAT, overriding the Walton case.) Finally, the bill would terminate the generation-skipping transfer tax exemption for long-term trusts (e.g., perpetual dynasty trusts) 90 years after the establishment of such trusts. We will keep you apprised of further developments.

Right to Elect under a Prenuptial Agreement is Property Passing Under Marital Deduction

IRS Private Letter Ruling 201410011, March 7, 2014

Facts: D & W executed a prenuptial agreement in anticipation of their marriage. Under the agreement, each waived their right of election to "take against the will" (so-called spousal share available under most state laws). The agreement also provided that upon D's death, if D& W are married and living together at that time, W would receive a specified amount, $A, outright and free of transfer taxes. The agreement further provided that if D & W are married and living together at the time of D's death, and have been married for at least 10 years at that time, then D's estate would fund a Marital Trust in an amount equal to X% of D's gross taxable estate. D also created a Revocable Trust during life which provided that upon D's death, if W survives and D & W are married and living together at that time, W could elect to take under the prenuptial agreement or an alternative distribution. In either case, the trustee of Revocable Trust is directed to fund the election with shares in LLC.

Taxpayers D & W requested two rulings: (1) that any amount that W received after the election granted her under the Revocable Trust would qualify for the unlimited marital deduction under IRC §2056; and (2) the marital deduction would be allowed for the transfer from the Revocable Trust notwithstanding the trustee is required to fund the transfer with shares of LLC.

Holding: The IRS was able to provide both rulings as requested. At issue in the first request was the limitation imposed by IRC §2056(b)(1), which provides in part that no marital deduction is allowed if the property may pass to a non-spouse upon the occurrence (or not) of a contingency (which is the "terminable interest" that QTIP attempts to save). The IRS found ample support in the regulations, its own revenue rulings, and in case law for the proposition that an interest in property subject to a precedent condition that does, in fact, pass to a surviving spouse qualifies for the marital deduction. The contingency of IRC §2056 and its regulations lives on the other side of the transfer; the election available under the Revocable Trust is not a contingency as described by the statute. At issue in the second request was whether the property required to be used to fund the surviving spouse's election, viz., share in LLC, would necessarily qualify as marital deduction property. Again, the IRS was able to find its way to yes. Although the marital bequest was required to be funded with shares of LLC, there was no requirement imposed on the trustee of the marital trust to retain the shares if under given market conditions the shares did not produce adequate income. Consistent with the requirements of IRC §2056, W has the power to require the trustee to make the assets productive, and the trustee faces no restrictions on sale or conversion of the assets to other, more productive ones. Consequently, the requirement that W's election be funded with shares of LLC should not prevent the transfer of that property from qualifying for the marital deduction.

Case in Point: Using Life Insurance as a Supplemental Retirement Income Vehicle

Initial Call to Advanced Markets Consultant: December 2013

Client Profile: A male business owner, age 51, Preferred Non Smoker.

Background: A producer called into the Advanced Markets department looking for another way to show his client how he could supplement his retirement income. The client planned to retire at age 65. In addition, the client needed approximately $900,000 more in life insurance protection. The client was already contributing the maximum to his 401(k) including the catch-up, but he was still concerned that he would not be able to sustain his current standard of living in retirement based on his existing retirement portfolio.

Solution: After the initial discussion with the producer, the Advanced Markets Consultant (AMC) recommended that the client consider setting up a personal retirement plan using life insurance. The AMC then helped the producer enter the client's information into John Hancock's Retirement Needs Analysis Calculator to determine his retirement shortfall, which was approximately $100,000. (He assumed that this would be inflated by 2% annually to take inflation into consideration). Using this tool, the AMC was able to illustrate how much premium would be needed to cover this shortfall and also determined that the death benefit would be enough to cover the client's desired death benefit shortfall as well. Using an Indexed UL product, a premium of approximately $68,000 paid until age 65 would generate about $110,000 in after-tax withdrawals and loans (with 2% inflation) from age 66 to age 90.

In speaking with the AMC, the producer was able to show his client how he could cover his retirement income shortfall as well as provide him with the death benefit protection he needed.

Resources Used:

1) **Advanced Markets Consultant:** Discussed the case, supplied marketing material, recommended a solution, and ran illustration/presentation.
2) **Retirement Needs Analysis Calculator:** Our online easy-to-use tool to help a producer and client determine a retirement shortfall.

Loans and withdrawals will reduce the death benefit and the 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. Withdrawals in excess of the cost basis (premiums paid) will be subject to tax and certain withdrawals within the first 15 years may be subject to recapture tax. Additionally, 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 59 1/2. Withdrawals are available after the first policy year.

The figures used in this case study are hypothetical, for discussion purposes only, are not guaranteed and may not be used to project or predict results. Actual results may be more or less favorable. Specific product and policy elements would be found in a policy illustration provided by an insurer. With any decision regarding the purchase of life insurance, a client would need to determine which type of life insurance product is most suitable for their specific needs.

ONE YEAR LIBOR RATE	PRIME RATE
March 3, 2014: 0.55%	As of March 3, 2014: 3.25%

IRC SECTION 7520 RATE		
March	2014	2.2%
February	2014	2.4%
January	2014	2.2%

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 – MARCH 2014				
	Annual	Semi-Annual	Quarterly	Monthly
Short-term – loans (3 years or less)	0.28%	0.28%	0.28%	0.28%
Mid-term – (More than 3 years up to and including 9 years)	1.84%	1.83%	1.83%	1.82%
Long-term – (More than 9 years)	3.36%	3.33%	3.32%	3.31%

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.jhadvancedmarkets.com.

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 tax). Failure to do so could result in adverse tax treatment of trust proceeds.

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