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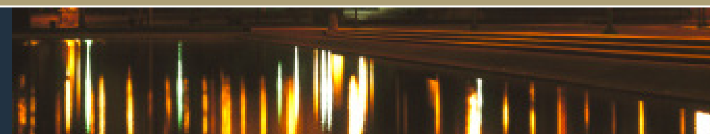
LIFE INSURANCE

ADVANCED MARKETS

CENTRAL INTELLIGENCE



December, 2013

IN THIS ISSUE

New Mexico Supreme Court Holds Ban on Same-Sex Marriage Unconstitutional

Rose Griego, et al. v. Maggie Toulouse Oliver, Clerk, et al., Docket No. 34,306, December 19, 2013.

The New Mexico Supreme Court ruled on December 19, 2013, that New Mexico may neither constitutionally deny same-gender couples the right to marry nor deprive them of the rights, protections, and responsibilities of marriage laws, unless the government can show that the discrimination caused by any legislation that does so is "substantially related to an important government interest." The Court found that although none of the statutes of New Mexico specifically prohibit same-gender marriage, "when read as a whole, the statutes have the effect of precluding same-gender couples from marrying and benefitting from the rights, protections, and responsibilities that flow from a civil marriage." With this ruling, New Mexico joins 16 other U.S. states and the District of Columbia in permitting same-sex marriage under the law. Together with the holdings in the U.S. Supreme Court *Windsor* opinion (see *Central Intelligence*, July 2013) and IRS Rev. Rul. 2013-17 (see *Central Intelligence*, September 2013), this ruling requires that taxpayers in same-sex marriages solemnized in New Mexico be considered married for all federal law purposes.

Grantor Trust Status Prevents Recognition of Losses as Well as Gains

CCA 201343021, August 23, 2013

Facts: LLC is owned by an S Corporation and two partnerships ("LLC Owners"). LLC Owners are owned by various grantor trusts ("GTrusts1") and one individual. LLC sold its interests in certain valuable property to a number of different grantor trusts ("GTrusts2"). On this sale, LLC reported short-term capital losses. The grantors of GTrusts2 are, collectively, the children of the grantor of GTrusts1. Grantor of GTrusts1 requested guidance on several issues from IRS Chief Counsel, primarily (1) whether the so-called grantor trust rules causes the grantor trusts to be disregarded for purposes of IRC §267 (governing losses between related parties) and §707 (governing transactions between a partnership and its partners); and (2) whether losses recognized upon a sale of property to certain grantor trusts may be disallowed under the IRC.

Holding: The Chief Counsel of the IRS concluded that the grantor trust rules do, in fact, call for the disregarding of the grantor trust for all income tax purposes, which includes the provisions of IRC §§267 and 707. Specifically, the Chief Counsel believes that the holding in IRS Revenue Ruling 85-13, read broadly, requires that a grantor trust not be recognized as a separate taxable entity for federal income tax purposes if someone has such dominion and control over it as to create a single identity of interest between the trust and the owner. Citing Rev. Rul. 85-13, the Chief Counsel stated that "it would be anomalous for the existence of a grantor trust [to be] ignored for purposes of attribution of income, deduction, and credit, and yet retain its identity as a separate entity capable of entering into a sales transaction with the owner." The Chief Counsel stressed that the disallowance derived from the grantor trust rules and not from the absence of actual economic loss. It does no work for a taxpayer to argue that the relationship of the parties does not eliminate actual economic loss; even in the presence of actual economic loss to a party, the grantor trust rules may still require us to disregard the distinction between otherwise distinct parties.

Transfer of QTIP Remainder Interest Necessarily a Taxable Gift

Estate of Virginia V. Kite, et al. v. Commissioner, TC Memo 2013-43, February 7, 2013

Facts: Taxpayer was the surviving spouse of Decedent, who had left at his death several irrevocable trusts for the benefit of Taxpayer and their children. Decedent's estate had made the election to qualify the trusts for the unlimited marital deduction as qualified terminable interest property ("QTIP"). Taxpayer had also previously created an inter vivos QTIP trust for Decedent, which reverted to Taxpayer's benefit upon Decedent's death; his estate made the QTIP election for this trust as well. (To qualify as qualified terminable interest property, the property must pass from a donor, the donor's spouse must have the absolute right for life to all the income paid at least annually, and no one may have the power to appoint the property to anyone other than the beneficiary spouse.) Through a complicated series of transactions, the trusts for the benefit of Taxpayer ("QTrusts") created a number of partnerships organized in Taxpayer's jurisdiction and in a neighboring state. A year later, QTrusts sold all of their interests in one of the partnerships ("Partnership") valued at approximately $12,000,000 to Taxpayer's children in return for three private annuities, with the first payment beginning ten years after the sale. If the Taxpayer died before the private annuities began to pay out, then her annuity interest would terminate and Partnership would be effectively removed from her estate. Taxpayer's children would be personally liable for annuity payments to Taxpayer once they began. The record showed that the children would have been bankrupted after three years of such annuity payments. Taxpayer died three years after the sale, and her estate filed a timely estate tax return excluding the value of Partnership and the private annuities. The IRS issued two notices of deficiency, one for approximately $6,100,000 of gift tax in the year of the sale of Partnership and another for $5,100,000 of estate tax at Taxpayer's death. The estate petitioned the Tax Court for review.

Holding: The Court rejected the IRS arguments that (1) the sale of Partnership for the private annuities was a disguised gift because the private annuities were not adequate consideration to support the sale and (2) the sale was not a bona fide sale and Taxpayer did not intend to enforce her rights under the private annuities. However, the IRS also argued that the sale was, in effect, a disposition of Taxpayer's qualifying income interest under the QTrusts and that any disposition of such an interest is required to be treated as a gift under IRC §2519. The Court found this argument compelling. IRS Reg. §25.2519-1(a) provides in part that if a spouse makes a disposition of all or part of a QTIP interest, "the donee spouse is treated as making a gift under §2519 of *the entire* trust less the qualifying income interest, and is treated for purposes of §2036 as having transferred the entire trust corpus, including that portion of the trust corpus from which the retained income interest is payable. A transfer of all or a portion of the income interest of the spouse is a transfer by the spouse under §2511." [emphasis added] The Court felt compelled to treat the sale of Partnership from QTrusts (under which Taxpayer had an annual qualifying income interest) for a deferred annuity as a disposition under IRC §2519. Therefore, the Taxpayer was treated as making a taxable gift of the corpus (but not the income interest) of QTrust to her children in the year of the sale.

Contribution of Conservation Easement Not Deductible Because Less Than Full Interest

61 York Acquisition, LLC, et al. v. Commissioner, T.C. Memo 2013-18, November 19, 2013

Facts: Taxpayer owned the bottom 14 floors of a large building in Chicago (the McCormick Building on South Michigan Avenue, across from Grant Park) comprising the office space in the building; the top six floors were residential condominiums and owned by another party. Several years before Taxpayer purchased its interest in the building, the owners of both the office space and the condominiums entered into a declaration of rights that provided that the respective owners could grant a façade easement to or for the benefit of an historic preservation organization. In fact, two years after acquiring its interest in the office space portion of the building, Taxpayer granted a façade easement to a national architectural trust ("Trust"), a charitable land trust. Taxpayer claimed a charitable tax deduction with respect to the conservation easement on its federal income tax return for the year of the contribution in the amount of $10,730,000, including an appraisal supporting the valuation of the easement. The IRS disallowed the charitable deduction for failure to meet the requirements of IRC §170 or to establish the value of the easement and charged Taxpayer accuracy-related penalties. Taxpayer petitioned the Court for relief.

Holding: The Court held for the IRS. In their respective arguments, the parties agreed on most matters, but differed on whether the grant of the conservation easement was "exclusively for conservation purposes" under IRC §170(h)(4). IRC §170(h)(4) provides in part that a conservation easement contribution is for conservation purposes if it preserves an historically important land area or a certified historic structure. (In 2006, before these events, the National Park Service classified the McCormick Building as a "certified historic structure" for charitable contribution purposes.) However, IRC §170(h)(4) goes on to provide in part that a restriction with respect to the exterior of a certified historic structure "shall not be considered to be exclusively for conservation purposes unless the interest … includes a restriction which preserves the entire exterior of the building (including the front, sides, rear, and height of the building)." [emphasis added] Taxpayer argued that under Illinois law, a taxpayer ownership of the entire exterior is not required to grant an easement which imposes enforceable restrictions on the *entire exterior of the building*. Because the owner of the residential portion of the building must get Taxpayer's consent before making changes to the exterior of that portion of the building, Taxpayer controlled the entire exterior. The Court was not impressed. It points out that the clear language of IRC §170, which governs the deductibility of a contribution of a conservation easement, requires that the easement contributed impose restrictions that preserve the entire exterior of the building. Because Taxpayer did not own the entire exterior, it could not contribute rights with respect to the entire exterior. Although Taxpayer's consent was required to make changes to the exterior of the portion that it did not own, the conservation easement did not contain restrictions that preserved that portion of the building. (The opinion did not address the matter of accuracy-related penalties.)

Value of Property Included in Estate Modified by Tax Court as Full LLC Membership

Estate of Diane Tanenblatt, et al. v. Commissioner, T.C. Memo 2013-263, November 18, 2013

Facts: Decedent dies a domiciliary of Pennsylvania in 2007, and Decedent's estate ("Taxpayer") filed a timely federal estate tax return. On the return, Taxpayer elected for alternate valuation of an interest included in the estate under IRC §2038, which includes in the taxable estate revocable transfers made during a decedent's lifetime. The interest to which the election was applied was a 16.66% interest in an LLC that Decedent had transferred to a revocable trust during her lifetime and at the time of her death Decedent retained the right to revoke the transfer. Taxpayer reported on the estate tax return that the value of the 16.66% interest, as prepared for Taxpayer by a professional appraiser, was $1,788,000 based on an appraisal of the whole building adjusted for other assets and liabilities and reduced by discounts of 20% and 35% for lack of control and marketability, respectively. The IRS examined the return and the attached appraisal and filed a notice of deficiency of underpaid taxes due to undervaluation. Taxpayer petitioned the Tax Court for review of the deficiency, claimed an overvaluation resulting in a refund due, and attached a copy of the appraisal by a new appraiser ("Appraiser").

Holding: The Court held for the IRS (with some adjustment of numbers). Initially, the position of the IRS was that valuation of the whole building was correct, but the IRS disagreed as to the amount of discount properly attributable to the control and marketability issues; the IRS applied discounts of 10% and 20% respectively. In its petition, Taxpayer alleged that the original appraisal was flawed, but that Appraisal submitted with the petition was a good appraisal. The IRS refused to recognize the new appraisal base on the absence of supporting information. At the same time, at trial Taxpayer offered the testimony of neither the original appraiser nor the new Appraiser. Taxpayer attempted to force the acceptance of the appraisal of Appraiser, but failed to qualify Appraiser as an expert and to satisfy the procedural rules for expert testimony. As a result, the report of Appraiser was not in evidence and could not be considered by the Court. Odd as it sounds, the only expert testimony that the Court heard was that of an appraiser called by the IRS. Taxpayer went on to argue that the interest should be valued lower as an assignee's interest and not as a member's interest; such an interest has a lower value under the operating agreement of the LLC (of which the value of the 16.66% interest is at issue here) that owns the building. The Court disagreed, and held that the relevant value at the time of valuation was the value in the hands of the trustee of Decedent's trust, which was a member of the LLC at the time of valuation and, therefore, valuation as a member interest is appropriate.

Case in Point: SERP Plans – Sales grow as the business grows

Client Profile: A specialized building company in North Dakota experienced much more growth than they expected over the past 10 years. In 2008, the company implemented a SERP plan for its top executives. Since then, they have added at least one new executive to the plan every year except one.

Background: The Advanced Markets Consultant (who worked on the original SERP case in 2009) and the producer who sold the case have established a good working relationship. This year, another new executive was hired by the building company and he was eligible to participate in the SERP plan. The producer contacted the Advanced Markets Consultant with information about the new executive. The Advanced Markets Consultant ran the SERP plan illustration and proposal and supplied it to the producer. This information was relayed to the SERP plan administrator for ongoing administrative purposes.

Result: The producer generated about $6,000 in life insurance sales commission for adding the new executive to the SERP plan in 2013. In total, the producer has generated about $25,000 in new life insurance sales commission over the five years since the plan was implemented. The client has been very happy with the plan, in large part because the producer is consistent with regular service work for the company. Providing good service and maintaining good communication with the client has provided the producer with ongoing opportunities for new sales.

Resources used:

(1) **Advanced Markets Consultant:** Gathered applicable data and designed illustration using the specific design of the existing plan.

(2) **JH Solutions:** Our proprietary estate and business planning software used to illustrate case

ONE YEAR LIBOR RATE
December 1, 2013: 0.58%

PRIME RATE
As of December 1, 2013: 3.25%

IRC SECTION 7520 RATE		
December	2013	2.0%
November	2013	2.0%
October	2013	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 – DECEMBER 2013

	Annual	Semi-Annual	Quarterly	Monthly
Short-term – loans (3 years or less)	0.25%	0.25%	0.25%	0.25%
Mid-term – (More than 3 years up to and including 9 years)	1.65%	1.64%	1.64%	1.63%
Long-term – (More than 9 years)	3.32%	3.29%	3.28%	3.27%

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.

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MLINY122013102

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