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# Charitable Planning

## Another Win: Defined Value Formula Clauses

The gift of a hard-to-value asset can be problematic if the value used is challenged by the IRS. If the value is ultimately increased, the transferor can owe substantial gift taxes.

One option, for persons who have a charitable intent, is to use a defined value formula clause to set the value of the gift to the family member, and then provide any remainder passes to a charity.

The Tax Court recently upheld a taxpayer's use of such a formula clause. The *Hendrix*<sup>1</sup> decision is the fourth case in which the courts have upheld similar formula clauses since 2006.<sup>2</sup>

Now, with the gift tax exemption at \$5 million, families have a unique opportunity to make substantial transfers and avoid an inadvertent gift if the asset value is later challenged and ultimately increased.

### The most recent case

Mr. and Mrs. Hendrix (Donors) wanted to make gifts of their closely-held S Corporation to their three adult daughters and also wanted to make some gifts to charity.

After meeting with experienced planning attorneys, the Donors engaged in discussions with a local community foundation (Foundation). Ultimately the Donors created several trusts for the daughters and established a donor-advised fund with the Foundation. The Donors then transferred shares to the Foundation and the trusts using a formula clause – shares worth \$14,782,846 were to pass to the trusts, and the Foundation was to receive the remainder.

The trusts and the Foundation had the responsibility to allocate the shares. A professional appraiser was retained by the trusts and set the value at \$36.66 per share.

The Foundation did not conduct a separate appraisal, but did retain independent counsel and an appraiser to review the trusts' appraisal.

The Foundation and the trusts then entered into a Confirmation Agreement and allocated the shares based on the appraised value. The remainder value passing to the Foundation was \$100,000. The Donors filed a gift tax return.

Enter the IRS, asserting that the formula clause was invalid. The IRS claimed the arrangement was not at arms' length and formula clauses are contrary to public policy.

The Tax Court found in favor of the Donors on both points and even stated that such formula clauses "further the fundamental public policy of encouraging" charitable gifts.

### Two formulas

Interestingly, two different methods have been used to determine the value of the asset being transferred.

The *Hendrix* and *McCord* clauses established the transfer amount by using the "fair market value" between a willing buyer and seller as of the date of the transfer, and required the transferees to allocate the shares among themselves.

The price in the *Christiansen* and *Petter* cases was the value as finally determined for estate (*Christiansen*) or gift (*Petter*) tax purposes.

### Guidelines

Regardless of which formula is used, the following guidelines are suggested:

- Retain a reputable qualified appraiser.
- Maintain independence between the grantors and the transferees.
- Consider using entities that owe a fiduciary duty to the beneficiaries, such as trusts and foundations.
- Pass a sufficient amount to charity such to merit the charity conducting an independent due diligence review.
- Use grantor trusts to help minimize tax issues in the event of revaluation or reallocation issues.

### In summary

The future looks promising for gifts using defined value formula clauses, at least with charities as the pour-over recipient.

Some planners have questioned if such clauses could also be used to pass the pour-over amount to non-taxable related parties, such as the donor's spouse.

The courts have stopped short of stating that the pour-over recipient must be a charity; but when discussing why the clauses are not contrary to public policy, each court has cited reasons that would not apply to a non-charitable recipient.

<sup>1</sup> *Hendrix v. Commissioner*, T.C. Memo. 2011-133 (June 15, 2011)

<sup>2</sup> *Christiansen v. Commissioner*, 130 T.C. 1 (2008), aff'd, 586 F.3d 1061 (8th Cir. 2009); *McCord v. Commissioner; Succession of McCord*, 120 T.C. 358 (2003), rev'd by 461 F. 3d 614 (5th Cir.2006); *Commissioner v. Petter*, T.C. Memo 2009-380 (December 7, 2009); Case No. 10-71854 (9th Cir. Oral argument June 14, 2011)



# Taxation - Income

## Congress, IRS Address Annuities

Annuities have been around since Roman times, when they were referred to as *annuas* – annual stipends in Latin. From a simple concept, a whole realm of contracts has developed, and with it, a complex set of rules detailing the tax treatment of annuities.

Annuities are extremely popular, both because of the tax benefits and because of the guarantees many annuities offer. One major benefit of an annuity is that the owner can receive tax deferred growth — the growth accruing inside the annuity is not taxed until the funds are withdrawn.

A second benefit occurs when payments are received over time from an annuity — the taxation can be spread out such that only a portion of each payment is subject to income tax. Precisely because of these tax benefits, many rules exist to make certain that annuities are being used for the purposes Congress and the IRS intend.

Recently, some welcomed clarifications and liberalization of such rules have occurred. The IRS issued a new Private Letter Ruling<sup>1</sup> (PLR) and a Revenue Procedure. Also, the Small Business Jobs Act of 2010<sup>2</sup> was enacted, which added a section to the IRC addressing annuities. Following is a brief explanation of each.

### Private Letter Ruling 201124008

**Facts:** The trustee of an irrevocable trust proposed purchasing individual annuities on each of the trust beneficiaries; each beneficiary would be the annuitant of one annuity.

At the termination of the trust, each annuity would be transferred to the annuitant/beneficiary. The transfers are expected to occur before annuity payments begin under the contract.

**Determinations:**

- Trust beneficiaries are considered “natural persons” for the annuity rules. *Result: The income on the annuities will be deferred.*

The general rule is that tax deferral is not allowed if the owner is not a natural person.<sup>3</sup> The PLR determined that the trust holds the annuities as agent for the beneficiaries; therefore, the annuities are considered owned by a natural person.

- Assignment of the annuity to the beneficiary will not be considered a gratuitous transfer. *Result: When the trust distributes the annuities to the beneficiaries, the trust will not be taxed on the gain in the annuity.*

One way the IRC encourages annuities to be used as a retirement savings tool is to tax the annuity owner on the gain in the policy when the owner gifts the annuity policy.<sup>4</sup> A similar rule exists for death time transfers. The PLR reasoned that the distribution will not cause a greater deferral period and thus should not be taxable.

### New IRC § 72(a)(2), effective January 1, 2011

An owner of an existing deferred annuity can annuitize a portion of the contract, if the annuity period selected is at least 10 years or the life of one or more persons. The remainder portion is treated as a separate contract and continues receiving deferral treatment.

Previously, if someone wanted to annuitize a part of an annuity and continue the deferral of the remainder, it was necessary to exchange the existing contract for two new contracts.

The process was cumbersome and the owner had to comply with certain rules. If not properly done, the funds removed from the contract were considered a distribution with resulting taxation of gain, plus a possible 10% penalty.

### Revenue Procedure 2011-38, effective October 24, 2011

An exchange of part of an annuity contract under IRC § 1035 will be tax-free as long as no proceeds are removed from the contract for a period of 180 days after the effective date of the exchange (or the partial annuitization rule discussed above applies).

A subsequent direct transfer is not considered.

If an exchange does not comply, the IRS will apply general tax principles to determine the tax treatment of the transfer.

Annuities can be extremely advantageous. However, certain transfers and withdrawals can produce unintended and costly tax results. These recent developments provide helpful guidance and clarity.

<sup>1</sup> PLRs are binding only on the parties involved, but can provide valuable insight.

<sup>2</sup> Small Business Jobs Act of 2010, H.R. 5297

<sup>3</sup> IRC § 72(u)(1)

<sup>4</sup> IRC § 72(e)(4)(C)



# Life Insurance Planning

## Fiduciary Obligations for ILIT Trustees

Many trustees are appointed by the grantor on account of friendships or business associations; after all, who is more trustworthy than a best friend or business partner? However, more than trustworthiness is required.

A trustee owes a fiduciary duty to the trust beneficiary – in other words, the trustee is legally responsible for prudently managing the trust assets in the *beneficiary's* best interest.

In the past few decades, several factors have combined that serve to put trustees on alert:

- States are providing greater rights to beneficiaries.
- Litigation continues to be a common occurrence in the United States.
- Market returns and interest rates have fallen.

When the trust owns life insurance, the trustee must manage the policy. Following is information pertinent to a trustee.

### Policy Review

The first step to reviewing a life insurance policy is to obtain a current policy statement and in-force illustration. The statement provides current factual information about the policy, and the illustration shows how the policy is expected to perform based on given interest, dividend and other assumptions.

The trustee can state what assumptions to use for the illustration – generally it is advisable to obtain an illustration showing the current interest and dividend rates, the guaranteed rates, and something in between.

### Potential Issues with Policies

**Term policies** are fairly simple. If the premium is paid and the insured's death occurs during the policy term, the death benefit is paid. Primary issues with term policies: Will the policy be in effect when the benefit is needed? Will the premium be affordable as the insured ages? Is the term convertible to a permanent policy?

**Whole life policies** pay the death benefit if all scheduled premiums are paid when due. With such policies, cash may accumulate in the policy over time.

Also the insurance company may pay dividends, although dividends are never guaranteed. If cash value has accumulated and dividends paid, after a few years, it may be possible to pay the premiums from the dividends and/or by taking loans<sup>1</sup> against the cash value. Issues can arise when the

owner is relying on the policy values to cover the premiums. If dividends were being used, the dividend scale may decline which could require that out-of-pocket cash premium payments be made. Or with loans, interest accrues and if not paid, the loan amount is increased. If the loan is not repaid, eventually the policy may lapse, which can result in unexpected income tax repercussions, plus the loss of the death benefit.

In short, premiums must be paid to keep the policy in force; using dividends or loans is an alternative to paying premiums and the owner must continue to monitor the sustainability of the policy.

**Universal life (UL) policies** are extremely flexible, but the flexibility can be dangerous if the policy is not properly monitored. The premium for UL products is an estimate of the amount of money needed to provide the desired coverage. The owner pays money into the policy, the insurance company withdraws mortality charges and administrative expenses, and then the company pays interest on the value remaining.

Issues can arise with UL products when: amounts paid into the policy are insufficient, the interest rate or sub-accounts decline, or the projected costs and expenses increase. Another product, guaranteed UL, promises a death benefit as long as premiums are paid when due.<sup>2</sup> With guaranteed UL, a missed or even late payment can affect the policy guarantees.

Following are questions an ILIT trustee should be able to answer. If not, a thorough review of the trust and the policy should be completed.

### About the Trust and Beneficiaries:

- Does the trustee have a signed copy of the trust and understand what it says?
- What is the purpose of the trust? Who are the current beneficiaries of the trust?
- Does the current policy still meet the needs of the trust?

### About the Insured:

- What is the insured's current life expectancy?
- Has the insured's health changed since the policy was issued?

### About the Insurance Policy:

- How long will the policy stay in force with the current premiums?
- Have all premiums been paid in a timely manner?
- Have any loans been taken?
- What is the financial strength of the insurance company?

### The Sooner the Better

If a policy no longer meets the needs of the trust and its beneficiaries, the trustee needs to consider changing or replacing the policy.

<sup>1</sup> Loans accrue interest, and unpaid loans and interest will reduce the death benefit.

<sup>2</sup> All guarantees are subject to the claims paying ability of the issuing company.



# Retirement Planning

## Planning for the Potential Costs of Living Long Lives

Most individuals need to plan for retirement, and an integral part of such planning is estimating one's likely expenses. Health care costs should, of course, be a consideration. And these days, the need for care over an extended period of time is becoming more frequently discussed. In general, Americans are living longer, more fulfilling lives; but at some point, many people become frail and need a helping hand.

While the concept of aging and needing care is rather common knowledge, many people do not fully understand the potential costs of such care, and how the care will be financed.

The purpose of this article is to provide some basic information about expenses for periods of care that are beyond the coverage that health care or a governmental program can provide.

### What is an extended period of care?

As people age or have chronic illnesses, certain services are required for an extended period. Care may be continuous or provided on an intermittent basis over longer periods of time; and can include both medical and non-medical care provided by caregivers to individuals. A typical caregiver provides assistance to an individual to help him or her perform basic day-to-day activities, such as getting dressed for the day, preparing meals or helping with other activities. Such care may be provided in one's home or in numerous types of facilities.

### Who needs this type of care?

Americans are living longer than ever before— the longer one lives, the more likely one may need such services. It is predicted that in the year 2020, some 12 million Americans may need care or services for extended periods of time.<sup>1</sup> Most of these types of services are provided for seniors. However, the U.S. Government Accountability Office estimates that 40% of the 13 million people receiving these services are between ages 18 and 64.<sup>1</sup>

### How much does this type of care cost?

Costs vary depending on the amount and type of care provided. Following are the average costs<sup>2</sup> in the United States in 2009. However, in some regions the costs are higher.<sup>3</sup>

- \$198/day for a shared room (\$72,270/year), and a private room even more
- Approximately \$20/hour for in-home medical or homemaker assistance

- \$67/day for centers that provide day care services for adults (\$24,455/year)

### Who provides/pays for extended periods of care?

Many people mistakenly believe that health insurance will cover the necessary expenses of care on an ongoing basis for extended periods of time. Others believe that Medicare or Medicaid<sup>4</sup> will cover these expenses.

- **Medicare:** Medicare provides health coverage for seniors. Medicare will pay for medically necessary skilled nursing care, however the coverage is limited and certain conditions must be met. The maximum stay for any benefit period is 100 days, and a person must re-qualify to begin a new benefit period. Some of the requirements are: a 3-day qualifying hospital stay, a doctor's order, and entry into facility within a short time. Additionally, a co-pay is generally required after a certain number of days. In short, Medicare does not pay for the services that comprise the majority of expenses required when the care provided is less than a skilled level of care.
- **Medicaid:** Medicaid focuses on assisting people with limited income and assets, and will pay the cost of long-term care in Medicaid approved facilities. The individual must qualify by meeting strict income and asset eligibility requirements. State laws differ as to how much money and assets one can retain and still be eligible for benefits. Additionally, Medicaid may be able to seek reimbursement from the recipient's estate after death.
- **Self pay:** Many individuals rely on personal resources to pay for any needed care.
- **Family:** Some individuals rely on family members to provide the care, if and when needed.
- **Insurance:** Long-term care insurance may also be an option. Policies differ broadly, so it is important to carefully review and understand the benefits, eligibility requirements, and limitations of any policy being considered.

### Planning for the future

With long life comes long-term planning. Whatever one's circumstance, planning for potential costs associated with extended periods of care should be a part of one's retirement objectives.

<sup>1</sup> Health Insurance Association of America. A Guide to Long-Term Care Insurance, 2007, Page 2

<sup>2</sup> [http://www.longtermcare.gov/LTC/Main\\_Site/index.aspx](http://www.longtermcare.gov/LTC/Main_Site/index.aspx)

<sup>3</sup> See New York Life Insurance Company, Survey of Nursing Home Costs, 2008

<sup>4</sup> Medi-Cal in California

## NAUTILUS NAVIGATOR

### Charting Your Financial Future

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