TAX FACTS INTELLIGENCE

The National Underwriter Company January 2015

annuities • life/health insurance • investments • retirement plans • estate planning/taxation • employee benefits • federal income tax

In Focus: Case Study—Annuities

While many taxpayers have never been offered the opportunity to purchase annuities within their retirement plans, the use of annuities within various types of plans has been in the spotlight frequently lately—prompting taxpayers' questions as to what exactly these new rules permit. Your client, Andrew, has been reading about the many regulatory changes that impact annuities held within retirement plans as they have developed. He is approaching retirement age and is interested in ways in which he can transform his currently existing retirement funds into an annuitized income stream, but isn't quite clear as to how the new regulations will impact his motivations and ability to do so. Andrew currently has rights to an employer-sponsored defined benefit plan, but also still has funds in a 401(k). How do you advise?

EXPERT ANALYSIS USING TAX FACTS ONLINE

In recent months, the regulatory community has repeatedly provided evidence of its commitment to encouraging the use of deferred annuities within retirement plans as a type of longevity insurance for taxpayers—making it very likely that the prevalence of these offerings is about to increase. Andrew is not alone in wondering how the multiple new rules will impact him—the Treasury Department has finalized the regulations governing qualified longevity annuity contracts (QLACs), and has also provided guidance on deferred annuities offered within target date funds (TDFs), while the PBCG has taken steps to ease rollovers into defined benefit plans that can increase a retiree's annuity stream.

Tax Facts Online can help Andrew navigate these emerging rules. Tax Facts Online Q 483 outlines the requirements that an annuity contract must meet in order to qualify as a QLAC and Q 484 discusses the types of retirement plans that are permitted to hold these types of deferred annuities. Q 7850 explains TDFs, while Q 3688 discusses the limitations that the PBGC imposes on defined benefit plans.

As Andrew might know, at the most basic level, QLACs are annuities purchased within retirement plans where payments are deferred until the taxpayer reaches old age (they must begin by the month following the month in which the taxpayer reaches age eighty-five) in order to provide retirement income security late in life. The final regulations exclude Roth IRAs, and further provide that if a QLAC is purchased within a traditional account that is converted or rolled over into a Roth, the contract will no longer qualify as a QLAC after the date of conversion or rollover.

See page 6

TABLE OF CONTENTS

Monthly Round-up

ANNUITIES

Tax Facts Q 477. How are guarantees provided by annuity contracts taxed?

***By Michael Kitces,* MSFS, MTAX, CFP, CLU, ChFC, partner and director of research for Pinnacle Advisory Group, a private wealth management firm in Columbia, Maryland.**

While no one likes to pay more in insurance premiums than they have to, an important fundamental principle of insurance is that in the end, there must be enough premiums (plus growth) to cover potential future claims (plus overhead and profits for the insurance company). Insurance coverage that is "too" cheap is actually risky, and coverage that is "expensive" is actually the most secure!

In fact, one of the most significant caveats to considering any form of insurance (or annuity) guarantee at all is if the insurance is *not* going to lose you money on average, it's actually something to avoid. In other words, insurance guarantees should *never* be expected to make money on average for the policyowner, or the insurance company will lose money until it inevitably goes out of business and the guarantee will be gone anyway!

As a result, decisions to purchase insurance and/or seek out guarantees should always be viewed from the perspective of seeking to trade a small *known loss* to avoid a *big unknown loss* instead. The goal is not to finish with more money on average, but simply to shift the *range* of outcomes in a manner that increases the number of small losses and reduces the exposure to big ones that may be unrecoverable. So the next time you're considering a type of insurance or annuity guarantee with a client, make sure you know why and how the coverage and guarantees are *expected* to lose money… and then decide if the trade-off is worthwhile anyway! And if you can't figure out how the guarantee will lose you money on average, it's a strong indicator that either you're missing a key detail and/or the guarantee is overpromising something it can't deliver, or the guarantee itself may be a mirage that the insurance company cannot possibly make good on in the end!

Fundamentals Of An Insurance Policy - Balancing The Premiums And Claims Equation

There are many types of insurance for an astonishing range of potential risks that can impact us, from the (financial) consequences of death to the danger of having a house burn down to the cost of a severe medical event. And while the potential consequences of such events could be quite financially damaging (or outright catastrophic) to any particular individual, the opportunity to *pool* together the risks of many people – knowing that some will experience the expensive adverse event, but others will not – creates the possibility to turn a large unknown and potentially destructive risk into a more manageable known cost.

For instance, if there's a 0.1 percent chance that a $300,000 house will burn down next year, then on average 1 out of every 1,000 people will have their house burn down – which means 999 people will be "fine" and the last one will face a catastrophe. To manage this risk, if each of the 1,000 people contributes $300 to a central pool of money (premiums), then collectively there will be $300,000 available to make whole the one person who has their house burn down (a $300,000 claim). Even if we don't know exactly who is going to make the $300,000 claim (and which 999 will just be out their $300 bucks of premiums), as long as the payments in equal the anticipated payments out, we can collectively smooth out the risk for everyone, at a fairly 'modest' cost of $300 per person to insure against a $300,000 risk.

While this potential for risk pooling – where small premiums from a lot of people can provide for large payments to cover the risky events of a few, which in turn can be reliably predicted (on average) by relying on the law of large numbers – is the core principle of insurance protection, in the real world the implementation of insurance is slightly more complex. On the plus side, there is the reality that most risks play out over an extended period of time, which means that not every claim has to be paid directly and immediately with a dollar of premium collected, and instead some premiums can be invested for growth to cover future claims needs (and reduce the required current or future premium obligations). On the minus side, as the network of people and quantity of potential risks being insured grows, there is a need for some administrative overhead cost to manage the arrangement and the organization that implements it – an additional cost over and above just the payout of claims themselves. And in today's modern world, where so many insurance companies are publicly traded companies owned by stockholders who expect the company to generate profits, the reality is that insurance companies need to ultimately have enough to cover claims (and overhead) that add up to at least a little less than they take in premiums (and generate in growth), so that there are no profits remaining. Which means the core identity formula for an insurance company is: premiums + growth – overhead – claims = profits. From the perspective of the person who buys the insurance coverage, this essentially means that their premiums (and the growth thereon) must collectively cover the claims that will be paid on the insurance, the overhead to run the insurance company, and the profits for the insurance company shareholders.

The Savings Opportunity of Self-Insuring

Since the premiums (and growth thereon) must only support the potential for future claims, but *not* the overhead of the insurance company and their desired profits, the formula above demonstrates why self-insurance is fundamentally a less expensive proposition than buying insurance, all else being equal. It saves the policyowner the cost of overhead and the "cost" of profits. *(Michael's Note: This also illustrates* the relative appeal of mutual insurance companies*, where the "profits" are redistributed back to the policyowners in the form of policy dividends that are a return of premiums, reflecting that the insurance can be cheaper in the long run when the policyowner is also the one entitled to the profits.)*

Given the reality that purchasing insurance coverage should always require greater premiums than the "implied" premiums of simply self-insuring (where the insured simply sets aside money from personal assets to have that money, plus growth, cover the potential of the future "claim"), it's generally best to avoid buying insurance coverage unless it's genuinely necessary. Thus, it's typically beneficial to have larger deductibles if you can afford it (e.g., on homeowner's or automobile insurance policies), implicitly self-insuring the "small" risks and just keeping insurance coverage for the "big" ones.

On the other hand, some potential losses are just *so* large that it's not feasible to accumulate enough money to self-insure at all, which means buying insurance really does become the most effective route and skipping the coverage to self-insure is really just "gambling" that the risk won't occur (because if it does, it would be a disaster). Choosing to purchase the coverage *will* be more expensive *on average* given that the risky event usually won't happen (which means you'll simply pay a premium and there's no claim), and there's a cost for overhead and the profits of the insurance company as well… but the trade-off may still be appealing, especially for claims that are potentially very large but with probabilities that are very small, which means the ramifications of being under-insured are severe (if the bad event occurs) but the actual cost of insurance can be rather modest. These scenarios explain why coverage like term life insurance for young people, or homeowner's insurance, is so popular and effective.

To be continued in next Month's Tax Facts Intelligence…

LIFE/HEALTH INSURANCE

Tax Facts Q 8766. What hardship exemptions are provided to taxpayers under the Affordable Care Act?

Notice 2014-76

The IRS has recently provided a list of the hardship exemptions that a taxpayer is entitled to claim without first obtaining a hardship exemption certification from the health insurance exchanges.

The hardship exemptions provided in this notice are available if two or more members of a family have a combined cost of employer-provided health coverage that is deemed unaffordable, an individual's gross income is below the applicable threshold for filing a tax return, or a taxpayer applied for minimum essential health coverage during the periods described in the notice, or applied for coverage and could not complete the process.

Further, the exemptions are also available if (1) the taxpayer applied for coverage under the Children's Health Insurance Program and was found eligible, but had a gap in coverage before the program's effective date, (2) the taxpayer is eligible for services through an Indian healthcare provider or (3) if the taxpayer resided in a state that did not expand Medicaid coverage and that taxpayer's household income is below 138 percent of the applicable poverty line.

Taxpayers seeking to claim a hardship exemption that is not outlined above are still permitted to apply for an exemption through the health insurance marketplace.

RETIREMENT ACCOUNTS

Tax Facts Q 3688. What protections does the PBGC provide for participants in defined benefit plans?

29 CFR Parts 4001, 4022, and 4044

The Pension Benefit Guaranty Corporation (PBGC) has issued rules that would encourage taxpayers to roll amounts from defined contribution plans into defined benefit plans by clarifying the protection that these funds would receive should the plan be terminated and become subject to PBGC control.

Typically, the PBGC guarantees the payment of non-forfeitable pension benefits up to a statutory maximum that is adjusted each year. Further, if the plan's benefit increase has been effective for fewer than five years, the percentage of the benefit that is guaranteed is phased-in over a five-year period, becoming fully guaranteed only after five years.

Under the PBGC's new rules, amounts rolled from a defined contribution plan into a defined benefit plan will not be subject to the maximum guaranteed benefit limitations or the otherwise applicable five-year phase-in limitations. This will provide taxpayers with greater assurance that their defined contribution plan funds will be protected if they are rolled over into a defined benefit plan.

INVESTMENTS

Tax Facts Q 7538. How is a shareholder taxed when securities are abandoned?

***Pilgrim's Pride Corp. v. Commissioner*, 141 TC 17**

Because the transaction was deemed to be a sale or exchange of capital assets under IRC Section 1234A, the Tax Court disallowed a taxpayer's ordinary loss claimed upon its surrender of securities, finding instead that the surrender gave rise to a capital loss subject to the loss limitations of IRC Sections 1211 and 1212.

In this case, the taxpayer rejected an offer to purchase its securities, finding that it would obtain a greater tax benefit by surrendering the securities instead. The taxpayer abandoned the securities and claimed an ordinary loss of nearly $100 million.

The Tax Court, however, found that Section 1234A, which treats gain or loss arising from the cancellation or other termination of a right or obligation which is a capital asset as gain or loss resulting from the sale or exchange of that asset, applied.

Rejecting the taxpayer's argument that Section 1234A applies only to a contractual or other derivative right to property, rather than to inherent property ownership rights, the Tax Court found that Section 1234A applies to property rights inherent in intangible property, such as securities, as well as any derivative contractual rights. Therefore, the taxpayer was required to treat the loss as a capital loss subject to the otherwise applicable loss limitations.

EMPLOYMENT BENEFITS

Tax Facts Q 409. How do employer contributions to HRAs impact employees under the Affordable Care Act?

TD 9705

The IRS has released final regulations that address the impact of employer contributions to cafeteria plans and health reimbursement arrangements (HRAs) upon the affordability of coverage and the employee's required contribution toward health coverage.

Pursuant to these regulations, an employee's required contribution toward health coverage is reduced by the amount of any employer contribution to an IRC Section 125 cafeteria plan that (1) may not be taken as a taxable benefit, (2) may be used to pay for minimum essential health coverage and (3) may only be used to pay for medical care.

Employer contributions to an employee's HRA are used in determining the level of the employee's required contributions if the HRA is integrated with an employer-sponsored health plan and the employee is permitted to use the contributions to pay premiums. Further, the HRA amounts will count toward the employee's required contribution if the HRA would have been integrated with an employer-sponsored plan if the employee had enrolled in the primary health plan offered by that employer.

The HRA funds are only taken into account in determining the employee's required contribution if both the HRA and the primary health plan are offered by the same employer.

ESTATE PLANNING/TAXATION

Tax Facts Q 779. What gift tax consequences may apply upon the transfer of family business interests?

ILM 201442053

The IRS recently found that the recapitalization of a limited liability company constituted a transfer from a donor to her two sons for gift tax purposes. This was the case because, under IRC Section 2701(e)(5), a recapitalization is treated as a transfer of an interest in the entity if the transferor holds an applicable retained interest before the transaction, surrenders a subordinate interest and receives property other than an applicable retained interest.

An applicable retained interest, for these purposes, is an interest in a family-controlled entity with respect to which there is a distribution right. In this case, the transferor retained an applicable retained interest—an equity interest in the company combined with a distribution right—both before and after the transaction.

The IRS found that the donor's interests were senior to the transferred interests because the transferred interests included the right to distributions based only upon future profits, while the retained interest included a right to distributions based on an existing capital account balance. Further, the IRS found that the donor received property other than an applicable retained interest because her sons agreed to manage the company in connection with the transaction.

FEDERAL INCOME TAXATION

Tax Facts Q 8560. What is a capital asset?

***Long v. Commissioner*, No. 14-10288**

The Eleventh Circuit recently reversed a Tax Court judgment, finding that amounts that a real estate developer received under an assignment agreement were properly characterized as capital gains, because it was the right to purchase the land, rather than the land itself, that the developer sold.

Capital assets include property owned by the taxpayer, but do not include property held by a taxpayer primarily for sale to customers in the ordinary course of a trade or business. In this case, the taxpayer owned a right to

PUBLISHER
Kelly Maheu, J.D.

SENIOR TAX EDITOR
Richard Cline, J.D.

MARKETING DIRECTOR
Gerry Centrowitz

ONLINE SERVICES SUPERVISOR
Connie L. Jump

AUTHORS
Wealth Mgmt–Thomas Jefferson Law School
Assoc. Dean William H. Byrnes, J.D.
Prof. Robert S. Bloink, J.D.
Alexis Long, J.D.

EDITORIAL ASSISTANT
Patti O'Leary

GRAPHIC DESIGNER
Donna Cozatchy

Published Monthly by
The National Underwriter Company
4157 Olympic Blvd., Suite 225 Erlanger, KY 41018

Annual subscription price $205.00
To subscribe call 1-800-543-0874

purchase certain land pursuant to a court judgment. Here, the Tax Court considered the issue as though the land itself was the relevant asset.

The Eleventh Circuit disagreed, finding that the taxpayer never actually owned the land, but rather only owned a contractual right to purchase the land. Whether

See page 7

Expert Analysis from page 1

By excluding the value of the QLAC from the retirement account's value when calculating required minimum distributions (RMDs), the IRS has created a strong incentive to purchase QLACs. The annuity premium value of a QLAC, however, is limited to the lesser of $125,000 (adjusted annually for inflation) or 25 percent of the account value.

The 25 percent limit is based upon the value of the account as of the last valuation date before the date upon which premiums for the annuity contract are paid. This value is increased to account for contributions made during the period that begins after the valuation date and ends before the date the premium is paid. The account value is decreased to account for distributions taken from the account during this same period. Importantly, the final regulations provide for a "return of premium" feature that allows the QLAC to provide that the premiums that have been paid, but not yet received as annuity payments, will be returned to the account if the taxpayer dies before they have been received.

Further, new IRS guidance has been released to specifically permit 401(k) plan sponsors to include deferred annuities within target date funds (TDFs) without violating the nondiscrimination rules that otherwise apply to investment options offered within a 401(k). This is the case even if the TDF investment is a qualified default investment alternative (QDIA)—which is a 401(k) investment that is selected automatically if Andrew had failed to make his own investment allocations.

The guidance clarifies that TDFs offered within the plan can include deferred annuities even if some of the TDFs are only available to older participants—and even if those older participants are considered "highly compensated"—without violating the otherwise applicable nondiscrimination rules. Similarly, the nondiscrimination rules will not be violated if the prices of the deferred annuities offered within the TDF vary based on the participant's age.

The new guidance will allow plan sponsors to include annuities within TDFs even if a wide age variance exists among the plan's participants, making it more likely that these annuities will gain prominence in the future. Additionally, the new rules allow plan sponsors to provide a participant with guaranteed lifetime income sources even if the participant is not actively making his or her own investment decisions with respect to plan contributions—a situation which is increasingly prevalent as employers may now automatically enroll an employee in the 401(k) plan unless the employee actively opts out of participation.

New PBGC guidance will allow taxpayers who participate in defined contribution plans to roll those balances into defined benefit plans without application of the otherwise applicable maximum guarantee limits or the five-year phase-in period. The maximum guarantee limits essentially place a cap on the guaranteed portion of a defined benefit plan balance. For plans that have existed for less than five years, that guarantee is phased in over a five year period. Rollover contributions will be exempt from these rules, so that they will be added to the otherwise applicable maximum guaranteed limit in the event that the PBGC must step in to guarantee the defined benefit plan benefits. These new rules effectively protect the rolled over amounts in full if the plan terminates. As a result, Andrew could choose to roll his 401(k) funds into his defined benefit plan in order to increase the size of his eventual pension benefit payout.

Because these rules are so new, many clients understandably have questions as to how they can be useful—and the likelihood of seeing a surge in the number of plans offering these types of options only increases as each new set of rules is released.

OPINION—Thumbs Up/Thumbs Down

What are your thoughts on:

1. The potential impact of the pending Supreme Court of the ACA tax credit provisions?
2. The impact of growing start-up companies, such as Uber and Lyft, upon the issue of independent contractor versus employee classification?
3. The recent tax bill that would restore mass transit tax breaks to their pre-2014 levels?

Bloink's Response

1 This review could have a much wider impact than most might realize—if the tax credits disappear in a given state, the employer mandate also disappears in that state—which would obviously severely hinder the effectiveness of the ACA. If the tax credits were the only issue, the state itself would simply establish its own exchange should the Supreme Court find that a state-run exchange is a requirement for the availability of tax credits.

2 These are growing companies that characterize nearly all of their workers as independent contractors—and because the employment classification is receiving so much attention, these companies will have to be more careful than ever in making sure that those workers truly are independent contractors. The fact that a lawsuit alleging improper classification is already pending makes me think these companies will have to change their employment practices.

3 It's clear that the tax breaks afforded to mass transit users should be on par with those granted for parking. Parking might be more expensive in some areas, but if mass transit is a viable option, there's no reason workers should be discouraged from using it.

Byrnes' Response

1 As Professor Bloink pointed out, if the ACA tax credits are unavailable in a given state, employers whose workers all reside in that state can escape the employer mandate. Therefore, a decision that conditions the availability of tax credits upon the existence of a state-run exchange could actually *discourage* states from establishing their own exchanges—in hopes of allowing their in-state employers to escape the ACA requirements and penalties.

2 The spotlight is on Uber right now because it has been firing "independent contractors" at will, and appears to have no clear policies for when a driver can be fired. This is going to create problems for the company because the ability to fire a worker at will is a strong indicator that an employment relationship exists—and such widespread misclassification could prove costly if the court does find that these drivers are employees.

3 It makes sense to keep the two sets of benefits relatively equal. I think the issue is purely political and will eventually be resolved in favor of the mass transit users.

Federal Income Taxation from page 6

the taxpayer primarily sold land in the course of his trade or business was, therefore, irrelevant, and the dispositive issue was whether the taxpayer held the right to purchase land primarily for sale to customers in the ordinary course of his business.

Because there was no evidence that the taxpayer entered into the agreement with the intent to assign his right to purchase the land in the ordinary course of his trade or business, the court held that the proceeds were more appropriately characterized as capital gains.

About the Authors

Assoc. Dean William H. Byrnes, J.D., Prof. Robert S. Bloink, J.D., Benjamin S. Terner, Thomas Jefferson School of Law, Alexis Long, J.D.

Dean Byrnes served as an Associate Director of International Tax at Coopers & Lybrand, authored fourteen top-selling books and information services, over 400 articles, and is the leader of Summit Business Media's Financial Advisory Publications (Professional Publishing Division).

Prof. Bloink served as Senior Attorney in the IRS Office of Chief Counsel, and put into force in excess of $2B of death benefits.

Fellow Benjamin Terner is a managing member of an alternative risk transfer insurance brokerage firm.

Alexis Long, J.D. is a graduate of the University of Michigan Law School. She has worked as an editor at a legal publishing company and practiced corporate and securities law in New York.

The Master's program of Thomas Jefferson School of Law (San Diego) offers a wealth management and a tax concentration for non-lawyers, such as advanced market specialists.

Courses may be followed via web-conferencing.

Webinars-Coming Soon

Please be sure to watch for upcoming Tax Facts Online demos and webinars provided by our Tax Facts experts.

Welcome

The National Underwriter Company is proud to present our *Tax Facts Intelligence*. Our focus has always been to bring you the most up-to-date relevant information regarding tax topics relating to the insurance market. Tax Facts continues its long tradition of providing our readers with useful and practical discussion.

FORMAT

Our format is based on what our readers find the most valuable. We include in each new issue a case study based on a real world example. Each case study will be analyzed by tax professionals so that readers may see opposing views with regard to tax planning. Further, each case study will be accompanied by a how-to guide on where to find the answer in Tax Facts print and online versions.

SEVEN TOPICS OF INTEREST

Our format will also include recent tax developments related to seven core subjects. These subjects will always be listed on the first page for easy reference.

OPINION BY BLOINK AND BYRNES

You've probably heard of "thumbs up-thumbs down" in the entertainment context. Tax Facts is an industry leader in tax analysis, and as such is breaking new ground with its dual professor tax debate. Professors Robert Bloink, J.D. and Assoc. Dean William Byrnes, J.D., will provide commentary on various tax topics.

ONLINE

Tax Facts Online represents the latest information available to wealth managers. Our update of information allows users to access relevant source material anytime, anywhere. For more information log on to Tax Facts Online.