TAX FACTS INTELLIGENCE

The National Underwriter Company October 2014

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

In Focus: Case Study—Annuities

The fixed indexed annuity trend has been gaining steam in 2014, but the variety of information about these products available today has many taxpayers even more confused about which type of fixed annuity is right for them.

Your clients, Mark and Sue Davidson, are a couple that approaching retirement age and looking to purchase an annuity product. They've read about the troubles that variable annuity providers have experienced in the past year and would prefer to avoid the possibility of a buyback or modification. Further, since the couple is fast approaching retirement age, they are relatively risk adverse and, while the possibility of market participation is attractive to them, they would like to limit their exposure to the risk of a market downturn. Mark has read about the recent uptick in fixed indexed annuity sales and is curious as to the factors driving the recent surge in popularity. He and his wife are also curious as to the types of income guarantees that accompany these products. How do you advise?

EXPERT ANALYSIS USING TAX FACTS ONLINE

As the nation's baby boomer population nears retirement, insurance carriers have seen a surge in popularity among fixed indexed annuity products. These products can provide the type of protection against market downturns that taxpayers like the Davidsons are looking for, while also allowing for a degree of market participation.

As discussed in Tax Facts Online Q 408, fixed annuities offer a variety of tax benefits that make them generally attractive to investors. However, there are many different annuities on the market today that also offer substantial non-tax benefits.

Because the Davidsons are risk adverse as they approach retirement age, they might be particularly interested in what is known as a "hybrid" fixed annuity product. These products have become increasingly popular because they tie the potential for participation in market gains to more than one index. While the traditional fixed indexed annuity bases the performance of the annuity upon a single major index (usually a stock index, such as the S&P 500), a hybrid fixed indexed annuity is able to allocate the risk of loss—and maximize the potential for gain—by combining multiple indices.

Unlike directly investing in an index (or indices), the fixed indexed annuity product itself offers a cushion against investment losses in exchange for a cap on the potential for investment gains. In many cases, the hybrid products are considered to be more favorable investment products because of the fact that they allocate risk between various indices—including nontraditional indices

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ANNUITIES

Tax Facts Q 402. What tax preferences apply when determining the income taxation of payments received under annuity contracts?

***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.**

…continued from last month's Tax Facts Intelligence.

How the "Annuities Should Never go in an IRA" Rule has Become a Myth — New Breeds of Annuity Guarantees and "The No-Annuities-In-IRAs" Rule Becomes A Myth

In the late 1990s, a new breed of variable annuity began to emerge: contracts with so-called "guaranteed living benefit" (GLB) riders. Unlike predecessor contracts that typically just included a (usually return-of-premium) death benefit, the idea of a living benefit was, as the name implied, a guarantee that could be used *while the annuity owner was still alive*. In other words, these riders were about providing income guarantees, while still alive, *and* without annuitizing up front; the first were called Guaranteed Minimum Income Benefit (GMIB) riders, and later came the Guaranteed Minimum Withdrawal Benefit (GMWB) riders as well.

The important distinction of this new breed of variable annuities was that many consumers began to buy the annuities not merely for their tax deferral features, but specifically for the retirement income guarantees they offered. The guarantees might either provide for current guaranteed income, or to secure a guaranteed base of income that would be available to tap in the future as the (baby boomer) accumulator approached retirement. And once variable annuities were primarily about purchasing guaranteed income – for much of the decade, more than 85 percent of all variable annuities purchased had a guaranteed living benefit (GLB) rider attached! – then they were purchased *wherever* the available dollars were to invest, which included retirement accounts. In other words, if your money was in an IRA and you wanted guaranteed income without annuitizing, *the only option was to put those IRA funds into a variable annuity*. Suddenly, it was entirely relevant and appropriate to put an annuity – at least a variable one with income rider guarantees – into a retirement account, because the purchase had nothing to do with tax deferral at all. It was about buying guarantees for retirement assets.

At the same time, the market turmoil of the 2000s also led to a dramatic increase in the purchase of equity-indexed annuities, which also provided unique guarantees – in their case, it was not necessarily about retirement income, but the potential to have some market upside while limiting the downside, which was especially appealing in the aftermath of the tech crash (and the financial crisis half a decade later). These contracts – similar to their variable-annuity-with-guarantees brethren – also became increasingly popular to own in a retirement account, for a similar reason: if the goal was to attach certain annuity-based guarantees to the assets, and those assets happened to be in a retirement account, then the retirement funds were used to purchase an annuity. Once again, it had nothing to do with tax deferral, and everything to do with buying (investment or income) guarantees for the assets.

In fact, in the aftermath of the tech crash, even certain fixed annuities became popular in retirement accounts as well, for their own form of 'guarantees' – in this case, the potential to receive a guaranteed CD-like fixed return, with a yield that was better than comparable bonds or CDs as the Federal Funds rate dipped as low as 1 percent in the early 2000s. And once again, if the fixed annuity return was better than available investment alternatives, and the investment dollars were held inside a retirement account… then the annuity was purchased inside the retirement account for investment purposes, regardless of the irrelevant tax preference.

The bottom line: the decade of the 2000s witnessed the simultaneous shift of variable annuities, equity-indexed annuities, and even some fixed annuities, to begin to be purchased within retirement accounts for reasons that had everything to do with their investment and income guarantees, and nothing to do with the ancillary tax deferral benefits that Congress had deigned on deferred annuities. And just because the tax deferral feature wasn't necessary didn't make it *bad* to own an annuity inside a retirement account, any more than it would be improper to own a stock inside a retirement account (given that it, too, is tax-deferred until liquidated!). Instead, the reality for both the annuity and the stock was that they're purchased (inside a retirement account) for other reasons; in the case of the annuity, it's because of the various guarantees and features that had become available, and accordingly it was entirely logical and appropriate for annuities to be purchased within retirement accounts, notwithstanding the implicit redundancy of the preferential tax treatment!

In fact, it appears consumers were already figuring out the irrelevance of the "don't buy annuities inside of retirement accounts" rule all by themselves. According to LIMRA, by 2012, more than 60 percent of deferred variable and equity-indexed annuity purchases were being funded with IRA dollars!

Annuities In IRAs and 401(k)s In Today's Environment

In recent years, shifts in the variable annuity marketplace have made guaranteed living benefit riders somewhat less appealing, and as a result their use with variable annuities has slowed a bit. Nonetheless, the overall election rate for guaranteed living benefit riders still remains fairly high at almost 80 percent, which leaves variable annuities relevant as a potential 'investment' for IRA and other retirement dollars.

Similarly, the emergence of guaranteed living benefit riders on equity-indexed annuities has arguably made them even more popular as a potential fit within retirement accounts, both for the risk/return characteristics of the annuity as an investment and the guaranteed income features for retirement spending (assuming the contract is otherwise desirable as an investment in the first place, which is an important caveat!). And even fixed annuities have seen a recent uptick of retirement accounts as a source of funds as retirees struggle to find investments in retirement accounts with compelling yields!

At the same time, though, it's important to recognize that the onset of new top tax rates for capital gains, qualified dividends, and ordinary income – on top of a new 3.8 percent Medicare surtax on investment income – has made variable annuities a bit more popular once again as a pure tax deferral vehicle, especially given the latest breed of ultra-low-cost annuity wrappers that really do make it possible for the raw tax deferral benefit to exceed the annual annuity cost! In other words, there actually *is* a fresh case to be made for incurring the cost of deferred annuities just to gain access to a tax deferral vehicle, especially to wrap around especially tax-inefficient investments as a part of an overall asset location strategy for higher net worth clients. And in such circumstances, it makes no sense to use already-tax-deferred retirement account assets to fund the strategy, giving credence once again to the old rule of thumb.

Nonetheless, the reality – as evidenced by the incredibly high election rate for buyers of annuities with guaranteed living benefit riders, and the rise of equity-indexed annuities as well – is that the majority of annuity purchases are *still* about buying access to guarantees (whether for retirement income, or a version of today's enhanced death benefit riders as well), and/or to unique investment opportunities (e.g., the risk/return profile of an equity-indexed annuity, or a compelling yield in a fixed annuity). As a result, while a few high-net-worth investors may once again be using annuities primarily for tax deferral alone, in most cases in today's environment the "don't buy an annuity inside a retirement account" rule has become more of a myth than proper advice!

LIFE/HEALTH INSURANCE

Tax Facts Q 78. What are the incidents of ownership that, if held by an insured, will cause life insurance proceeds to be includable in the insured's estate?

ILM 201328030

The IRS recently ruled that a life insurance policy would not be included in the estate of a decedent-insured because that decedent owned only the right to receive dividends under the policy, which, in and of itself, was not a sufficient incident of ownership to cause the policy value to be included in the estate.

Here, the decedent was required to purchase and maintain a life insurance policy for the benefit of his former wife as a condition to their divorce settlement agreement. While the decedent was required to pay all premiums under the policy, he was not permitted to borrow against the policy and was required to name his former spouse as beneficiary. The decedent was, however, entitled to receive dividends under the policy. Upon the death of the insured, the policy proceeds were paid to the decedent's former spouse.

The IRS noted that an insurance policy is only included in the estate of a decedent-insured who held "incidents of ownership" in the policy upon his or her death. Incidents of ownership include the power to change beneficial ownership of the policy or its proceeds even if the decedent himself has no beneficial ownership to the policy value.

Dividends paid under a life insurance policy are, according to the IRS, nothing more than a reduction in the amount of premiums paid—rather than a right to income from the policy itself. As such, the right to dividends did not convey an economic benefit upon the decedent that would be treated as an incident of ownership so as to require inclusion in the decedent's estate.

INVESTMENTS

Tax Facts Q 7891. What is the 75 percent asset test that applies in determining REIT qualification?

Rev. Proc. 2014-51, 2014-37 IRB 1

The IRS has released guidance to assist REITs that hold interests in loans secured in part by real property, and in part by other assets, in an environment where real estate values are rising. The IRS will not challenge the REIT's characterization if the REIT treats the loan as a real estate asset in an amount equal to the lesser of: (a) the highest principal value of the loan outstanding at any point during the year or (b) the greater of: (i) the current value of the real property securing the loan or (ii) the fair market value of the real property securing the loan as of the date the loan became binding.

Generally, for REIT qualification purposes, 75 percent of its assets must consist of real estate assets, cash and cash equivalents and government securities at the close of each quarter. "Real estate assets" include loans secured by real property. If a loan is secured by both real property and non-real property assets, the REIT must use a formula to apportion the loan between the real property and non-real property assets.

In the past, the loan value of the real property was the fair market value of that real property, determined on the date that the loan becomes binding as to the REIT. This amount was then compared to the highest principal loan amount that is outstanding at any given point during the year. In some cases, the loan value of the real property would remain constant for purposes of apportionment (because it was fixed as of the date of the loan), while the highest principal amount outstanding could rise if the underlying real property assets appreciated in value during that year—actually causing the portion of the loan that is treated as real estate to decrease if the value of the real property increased.

The IRS guidance seeks to prevent this result by allowing the REIT to use the current value of the real property asset in apportioning the loan.

RETIREMENT ACCOUNTS

Tax Facts Q 3610. What is "compensation" for purposes of IRA eligibility rules and deduction limits?

***Halo v. Commissioner*, T.C. Summary Opinion 2014-92**

The Tax Court recently denied a taxpayer's deduction for contributions to an IRA because, although the taxpayer received unemployment compensation and income from both interest and Social Security, he had no "compensation" for the year in question.

Generally, a taxpayer is entitled to a deduction for contributions made to IRAs in an amount equal to the lesser of the contribution limit for the tax year ($5,500 for 2014; $6,500 for taxpayers aged fifty-five or older) or an amount equal to the compensation includible in the taxpayer's gross income for the tax year.

"Compensation" for this purpose includes earned income, but excludes amounts received as a pension or annuity and amounts received as deferred compensation. The definition of compensation also excludes Social Security benefits and interest income that is not received in the course of a taxpayer's trade or business as a securities dealer. Because the taxpayer was not engaged in a trade or business for the tax year in question, and received no wages, salary or self-employment income, his deduction for IRA contributions was denied.

EMPLOYMENT BENEFITS

Tax Facts Q 7717. Is a limited partner's distributive share of partnership income subject to the self-employment tax?

ILM 201436049

In this legal memorandum, the IRS found that Congress did not intend to allow service partners in a service partnership to avoid paying self-employment taxes, finding instead that income earned by these partners is not investment-type income that is excluded from self-employment tax liability.

The partners in this case provided investment management services to a group of investment partnerships. The partnership treated all of its partners as limited partners not subject to self-employment tax on their distributive shares that were not guaranteed payments.

The IRS disagreed with this categorization, finding that the partners provided services, including trade and analysis services and operational and support services. Performance of these services precluded the partners from being treated as limited partners under IRC Section 1402(a)(13), so that their partnership income was subject to self-employment tax.

ESTATE PLANNING/TAXATION

Tax Facts Q 613. What deductions for charitable bequests are allowed from the gross estate when payments to a charity are designed as a guaranteed annuity paid by a charitable lead annuity trust?

PLR 201433023

The IRS recently found that when two spouses created three charitable lead annuity trusts (CLATs) under revocable trusts that would begin annuity payments upon the death of the second-to-die spouse, the estate of the second-to-die spouse would be entitled to a charitable deduction for assets passing to the CLATs, including the assets passing from a marital trust created under the first-to-die spouse's trust.

This was the case because each of the revocable trusts set forth a formula for determining the amount of the annuity payment from each CLAT that was sufficient to render the amount of the annuity determinable, because it could be ascertained at the valuation date of the surviving spouse's estate.

When the first-to-die spouse died, his or her estate was to pass to a marital trust for the surviving spouse. Upon the death of the surviving spouse, 55 percent of the assets in the marital trust and 55 percent of the remainder of the surviving spouse's estate were to be transferred to the CLATs.

Each CLAT would then pay an annuity to one of three private charitable foundations annually for a term of twenty years. The annuity payment would be made from CLAT income and, if insufficient, principal. If the income of any CLAT exceeded the annuity amount produced by the formula in any given year, the excess would also be distributed to the private foundation. Further, the parties represented that the annual annuity payment would be calculated based on a formula that results in a charitable lead annuity interest in each CLAT that is as close to possible, but not in excess of, 60 percent of the value of the trust assets of each CLAT.

Therefore, because the annual annuity amount was ascertainable at the surviving spouse's death, his or her estate would be entitled to a charitable deduction for the assets passing to the CLATs.

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

FEDERAL INCOME TAXATION

Tax Facts Q 7946. What rules apply in determining whether a taxpayer is eligible for a charitable tax deduction? **PLR 201437004**

The IRS recently found that an LLC was not entitled to a charitable tax deduction for contributions made to a non-profit organization, but rather was entitled to a general business expense deduction because the contributions had a direct relationship to the LLC's business and were made with an eye toward receiving a financial return, rather than for charitable purposes.

In this case, the LLC offered certain services in a state where that state required taxpayers offering those services to contribute a certain percentage of revenue to qualified nonprofit organizations. The LLC-taxpayer here made the

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that might not otherwise be available in a standard fixed indexed annuity.

For example, in some cases the hybrid index might consist of both a major stock index and a bond index to minimize the risk of loss. In this case, the carrier is able to maximize growth potential while hedging against downside risk, because weight is shifted (often on a daily basis) between the stock and bond indices based on market volatility.

However, while some hybrid fixed indexed annuity products are marketed as employing an "uncapped" indexing strategy, this does not mean that the products allow for 100 percent participation in any market gains. In order to offer protection against downside risk, the carrier imposes a cap on the level of participation.

Often, gains are credited to the taxpayer's contract annually—a crediting method often referred to as "annual point-to-point"—or even monthly in some cases. However, these gains may be subject to a rate cap that limits the participation to a certain percentage of market gains. In other cases, a "spread" may be used to minimize the risk to the carrier. A spread is essentially a fixed percentage that is subtracted from any gain that the indices generate within a set period. For example, a 4 percent spread would simply reduce a 10 percent gain for the year, so that the taxpayer's account is actually credited with a 6 percent gain.

Essentially, it is important for taxpayers to realize that the potential for growth in these new indexed annuities is not unlimited, and that it is important to read the fine print in order to determine the particular limitations that do apply.

Indexed annuities with income guarantees are also popular among taxpayers who, like the Davidsons, intend to retire within a relatively short timeframe. Guaranteed lifetime withdrawal benefits (GLWBs) attach to the base annuity product and generally guarantee that the taxpayer will be able to withdraw a certain percentage of the value of the taxpayer's benefit base, which has been growing by a guaranteed amount over the course of the annuity deferral period for the taxpayer's lifetime. The indexed annuity itself provides a guaranteed growth rate, but also ties the level of growth to the performance of one or more stock index. While this allows the taxpayer to participate in market gains, insurers cap the return a taxpayer can receive in order to offer guaranteed benefits regardless of any market downturns.

For taxpayers nearing retirement age, GLWBs can combine with indexed annuities to provide a stable stream of retirement income while still providing growth opportunities that exceed those currently available in traditional bank-sponsored investment products, such as a certificate of deposit. While both types of product are popular with taxpayers approaching retirement because they offer concrete downside protection, indexed annuities with GLWBs will also offer the potential for participation in market growth and, generally, a higher rate of return as a result.

OPINION—Thumbs Up/Thumbs Down

What are your thoughts on:

1. The debate over the ability of taxpayers to deduct uniform expenses vs. nondeductible "dress code" expense items that was initiated by Walmart's new employee dress requirements?
2. The recently broadened REIT "real estate" definition that allows more companies to take advantage of corporate tax-friendly REITs?
3. The growing number of employers who now offer a $500 carryover provision to FSA participants, rather than a 2 ½ month grace period?

Bloink's Response

1 Ironically, this is actually an issue that's impacting over a million U.S. Walmart employees who are now required to wear a blue or white collared shirt under their Walmart vests. Unfortunately for them, the deduction will never be allowed—if it were, everyone from Applebee's employees to attorneys who are required to wear business casual to the office would be standing in line for a new deduction.

2 The new regulations significantly expand what is "real estate" for REIT qualification purposes—so that now even property as seemingly tangential as fiber optic networks used by a telecommunications company can qualify. While this might seem like a stretch, the regulations are extremely specific in listing what constitutes real estate—maybe this is the IRS' way of giving corporations a break, which the new wave of corporate inversions indicates that they sorely need.

3 My guess is that this trend is a reflection of employers' recognition that most FSA participants have $500 or less to use in the grace period. No one likes to think that they could lose their hard-earned FSA contributions if their medical expenses are relatively low, so this should encourage more employees to take advantage of these potentially valuable tax-preferred benefits.

Byrnes' Response

1 Professor Bloink is right—work clothes can only be deducted if they're required on the job and otherwise unsuitable for general, everyday wear. Maybe the Walmart-specific vest could qualify—but I hear the vest is Walmart's treat.

2 Interest in REITs has increased greatly in recent years. I think the expansive (and specific) new definition is a recognition of this expansion. Besides, when you think about it, a telecommunications network or telephone pole would likely meet the "permanence" tests that would otherwise apply in determining whether an asset is a real estate asset for REITs.

3 It's always a guess when employees are deciding how much to contribute to an FSA. With the carryover provision, if you're uncomfortable guessing, you just contribute $500 and rest assured that every penny will carry over to the following year. The grace period still requires guesswork, and I predict it will eventually go by the wayside.

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required contributions and attempted to claim a charitable deduction.

The IRS disagreed with this characterization, finding that the payments were not entirely voluntary, as required for a deduction under IRC Section 170. Further, because the payments were made in compliance with the state's regulatory authority and failure to make the payments would jeopardize the LLC's ability to conduct business within the state, the payments were made with an expectation of financial return and were not, therefore, gratuitous and voluntary charitable gifts.

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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.

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