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TAX FACTS INTELLIGENCE

The National Underwriter Company September 2012

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

In Focus:—Case Study on Retirement Planning

ISSUE: Navigating the complex rules governing the Social Security benefit system can be difficult for many clients. But there are a variety of strategies that can help clients maximize their Social Security income to achieve their financial goals during retirement. David and Ellen Walters have come to you for advice regarding their Social Security benefits. David is sixty-six and began collecting Social Security benefits early, at sixty-two. Because Ellen did not work, she did not pay into the system, and so is not entitled to collect benefits. However, Ellen began collecting her spousal benefit, which is 35 percent of David's benefit at the same time that David began to receive benefits.

They have begun to reconsider their decision to collect benefits early, and need advice about whether it is possible to change their minds after so many years. They have discovered that their retirement accounts provide them with sufficient monthly income, and think that their Social Security benefits would be more useful later in life. Further, they are worried that their Social Security benefits are causing them to pay more in taxes. How do you advise?

EXPERT ANALYSIS USING TAX FACTS ONLINE

Those who have reached the age at which they can begin collecting benefits may choose to do so for a variety of reasons, but it is often because they have not been advised that there may be reasons to delay taking benefits. After collecting benefits for a while, it is still possible to suspend collection of benefits until a later point in retirement through a technique called "file and suspend." The strategy can be useful in a variety of circumstances, including situations in which a taxpayer wishes to reduce income for tax purposes, or ensure a higher level of government benefits later in life.

Tax Facts Online can assist in explaining the potentially complicated tax treatment of these Social Security benefits. Tax Facts Online Question 442 explains that Social Security benefits are often—but not always—taxable. If a taxpayer's modified adjusted gross income plus half of their annual Social Security benefits exceed a certain base amount, then the benefits may have to be included in gross income. Question 442 provides the base amount rates, which are $32,000 for a married couple filing jointly and $25,000 for individuals.

Many taxpayers may wish to suspend benefits because they believe they will be able to avoid paying taxes on these benefits if they are received later in life, when the taxpayer may be in a lower income tax bracket.

For a taxpayer who has yet to begin collecting benefits, file and suspend is very simple. Once the

See page 6 for Expert Analysis.

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Monthly Round-up

ANNUITIES

Tax Facts Q: 374. How are payments under a variable immediate annuity 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.

…continued from last month's edition of Tax Facts Intelligence.

The criticisms of annuities that we discussed in last month's article may seem relatively straightforward. Most insurance companies are heavily reliant on making accurate estimates of the cost of the income guarantees that they provide. Failure to estimate these costs accurately could mean, in the face of a severe bear market where the income guarantees suddenly become 'in the money' for almost all policyowners at once, that the annuity company simply will be unable to pay on its promises. Similarly, at a cost that may be two to three times (or more!?) the expense of a standalone mutual fund or ETF, it's hard for many to rationalize the expense of variable annuity guarantees, even if the head-to-head comparison with traditional investments is a bit apples-to-oranges.

The fundamental problem, however, is that almost by definition, if the annuity's expenses and fees are "too expensive," the company should be raking in profits hand over fist… which means it should be so wildly profitable that it cannot possibly be at risk for failing to pay on its guarantees! After all, an annuity being too expensive implies that the costs are too high relative to the benefits that are offered, which directly contravenes the "riskiness" of annuity company guarantees which emerge when the company doesn't charge enough for what it offers to policy owners!

Viewed conversely, if the greatest concern for a variable annuity owner is that the company may not be able to make good on its income or death benefit guarantees, the implicit suggestion is that the company needs to raise its expenses to bring in more money to ensure that it can pay its contractual obligations. Which means if the greatest fear is that the annuity company might be at risk for failing to pay on its income guarantees, the company should be raising its fees further to compensate, because the current expenses would be too low!

Bad Anchors and Short Time Horizons

So how do we account for the common viewpoint that variable annuity guarantees are both too expensive and too risky, when in reality too much of one by definition means the opposite cannot be true? The culprit appears to be a combination of behavioral finance biases: bad anchors, and an excessive focus on recent (and short) time horizons.

The bad anchor problem is that, even though we may acknowledge the comparison is apples-to-oranges, we are still judging the cost of annuities with guarantees by contrasting them with investment alternatives that don't have those guarantees, such as variable annuities versus traditional mutual funds and ETFs. Sure, compared to an index fund with a cost of less than 0.20 percent, the cost of a 2 percent+ annuity seems quite high. Yet when readjusted to the proper anchor – is the fee appropriate for the guarantees provided—the irony is that a large number of investors and planners seem to think that the fee is too low, such that the annuity company is at risk and might not be able to make good on its contractual obligations! Which means, simply put, the appropriateness of the fee really needs to be judged relative to the annuity guarantees, and not referenced to non-guaranteed alternatives. When we use the right anchor, sometimes we come to the opposite conclusion!

The short time horizon problem is the tendency to extrapolate whatever is going on recently into the indefinite future, and making decisions accordingly. Thus, as markets swing from bull to bear, annuities are varyingly judged to be too expensive (during a bull market when the declines that the annuity is protecting against seem remote, suggesting the fee is too expensive) or that the guarantee is too risky (during a bear market when the declines that the annuity is protecting against are so salient, it creates worry that the annuity company will not withstand the shock).

In reality, the cost of the annuity should be judged against the entire cycle of bull and bear markets (at least, unless the investor is specifically trying to time the annuity purchase to the market cycle and buy in when the guarantee is undervalued), not just whether the market is in the midst of a short-term bull or bear cycle.

In any event, the bottom line is that annuities cannot

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simultaneously be too expensive and too cheap and underpriced; it's one or the other. As long as we compare them to inappropriate anchors and/or over unreasonably short (or recent) time horizons, though, we run the risk of coming up with these mutually exclusive conclusions and making poor decisions as a result. To make a proper decision, it's crucial to really evaluate the value of the guarantees relative to what those guarantees provide – which ensures they're not being evaluated in an apples-to-oranges comparison – and over a reasonable time horizon that acknowledges market up and down cycles.

LIFE/HEALTH INSURANCE

Tax Facts Q: 217. If a corporation takes out a life insurance policy on a person in whose life the corporation has no insurable interest, will death proceeds be exempt from income tax?

***IVF Investment Company vs. Estate of Natofsky**, 2012 N.J. Super Unpub. LEXIS 1105*

The New Jersey Appellate Court recently held that a partnership (in this case) was able to collect the proceeds on a life insurance policy that was taken out on the life of its former shareholder because the partnership had an insurable interest in that shareholder's life at the time the policy was issued, even if no insurable interest was present when the policy proceeds were distributed.

In this case, the partnership agreement required the partnership to repurchase all shares owned by any of its shareholders in the event of their death or withdrawal from the partnership. In order to ensure that the partnership would have sufficient funds to repurchase the shares if the shareholder died, the partnership paid the premiums on, and was named sole beneficiary of, a "key man" life insurance policy on the life of the shareholder. These policies are often used to ensure that a business will be able to meet its obligations in the event that a key executive, or "key man," dies or leaves the company.

While this policy remained in effect, the shareholder withdrew from the partnership and the partnership repurchased his outstanding shares. Years later, he died without removing the partnership as the beneficiary on the policy on which he was technically named as owner. Both the partnership and his estate attempted to collect the death proceeds.

The court disagreed with the estate's argument that the partnership could not collect the death proceeds because it had no insurable interest in the life of its former shareholder, finding that the partnership had the requisite insurable interest at the time that the policy was issued. It was immaterial that the insurable interest had ceased to exist by the time the death proceeds were distributed, because the partnership was still the named beneficiary on the policy.

Because of this, the partnership was able to collect the death proceeds as tax-exempt proceeds on a life insurance policy, rather than as the taxable proceeds of a wagering contract upon a life where the beneficiary holds no insurable interest.

INVESTMENTS

Tax Facts Q: 7810. What expenses paid in connection with the production of investment income are deductible?

***Haury v. Commissioner*, TC Memo 2012-215**

The Tax Court in this case found that loans made from the IRA of an employee to his employer could not be deducted as business bad debts because they were made to protect his investment in the company rather than as a part of his trade or business. Further, the court found that the employee was liable for the early withdrawal penalty because the loans were transferred out of his IRA before he reached age 59 ½.

The employee in this case was both a significant shareholder and CEO of his employer. The employee transferred funds to the employer, which was a relatively small corporation, in order to provide cash

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flow for the struggling business. When it became clear that the employer would be unable to repay the loans, he attempted to deduct the worthless loans as business bad debts.

IRC Section 166(d)(1) allows a taxpayer to deduct bad debt incurred as a part of the taxpayer's trade or business in the year the debt becomes worthless. To be deductible, the debt must also arise from a bona fide debtor-creditor relationship.

While the court here found that the loans were structured as bona fide debts evidenced by interest-bearing notes, it found that the taxpayer's motivation for making the loans was to protect his investment in the small company, rather than making loans that were incidental to his trade or business. His status as an employee of the company was insufficient to overcome this finding.

Therefore, the employee was unable to deduct the worthless loans and was also liable for the penalties for early withdrawal from his IRA. TFI

RETIREMENT PLANS

Tax Facts Q: 3725. What is a lump sum distribution? What special tax treatment is available for a lump sum distribution from a qualified plan?

Private Letter Ruling 201228051

The IRS has ruled that implementing pension plan amendments to provide participants with a lump-sum cash payment instead of traditional annuity payments will not cause the plan to be disqualified for failure to satisfy the IRC Section 401(a)(9) qualification requirements.

Many employers have begun offering the lump sum option in order reduce the risk and burden involved in administering their pension plans. Despite this, employers are legally required to continue to offer traditional annuity payments in addition to the single payment option.

A retiree who chooses to continue collecting monthly annuity payments will be taxed at the rates in effect for ordinary income on those payments. The tax treatment of the lump-sum payment is normally more complicated. The retiree may simply choose to include the entire amount in his or her taxable income and pay taxes at the ordinary rates. A second option, however, is to roll the funds directly into an IRA, which is a nontaxable transfer.

If the retiree was born before 1936, he or she may have the option of using the "ten-year averaging" technique. This means that the retiree recognizes the income over ten years, as if it was the only income he or she received, at 1986 tax rates. In general, the larger the cash payment, the less likely it is that this technique will be advantageous. TFI

ESTATE PLANNING/TAXATION

Tax Facts Q: 3749. When may rollover contributions be made from an IRA by the owner of the plan?

***Beech v. Comm.*, TC Summ. Op. 2012-74**

The Tax Court held that a death benefit distribution from an IRA was taxable income to the beneficiary despite the beneficiary's intention to make a trustee-to-trustee transfer from the initial IRA trustee to a second IRA trustee.

The taxpayer here received a death benefit distribution as beneficiary of her mother's IRA. She then established an inherited IRA and deposited the check for the distributed funds into that inherited IRA.

The court found that this rollover did not allow the taxpayer to avoid paying income tax on the benefits because rollover treatment under IRC Section 408(d) is not available for inherited IRAs. The only way to avoid paying income tax on inherited IRA funds is to transfer the funds directly from one account trustee to another. The beneficiary is not permitted to receive control over these funds at any point in the process. This rule differs from the traditional IRA rollover process, which allows the taxpayer to avoid taxation when he or she deposits the IRA funds into another tax-deferred account within sixty days of the initial withdrawal.

That the taxpayer intended to avoid taxation through a trustee-to-trustee transfer was not controlling. She received a check for the death benefit proceeds as account beneficiary, thereby gaining control over the funds.

This case illustrates the importance of the beneficiary designation on an IRA. If the funds here were transferred directly into the inherited IRA account, the transfer would have been entirely nontaxable. TFI

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EMPLOYEE BENEFITS

Tax Facts Q: 3541. Are contributions to, and postretirement payments from, a deferred compensation account balance or nonaccount balance plan subject to FICA and FUTA taxes?

IRS Info. 2012-0032

The IRS has recently provided guidance on the withholding of FICA taxes on the value of certain deferred compensation benefits. The IRS clarified that withholding FICA taxes in the year an employee begins receiving benefits may be proper, because the present value of the benefit is reasonably ascertainable.

FICA taxes are generally due on wages when they are actually or constructively paid to an employee. Despite this, IRC Section 3121(v)(2) provides an exception in situations involving deferred compensation benefits.

Under Section 3121(v)(2), the deferred compensation benefits become wages subject to FICA taxation either when the employee performs the services for which the deferred compensation benefit is paid, or when the benefit is no longer subject to a substantial risk of forfeiture, whichever is later.

However, there is an additional exception that allows the employer to delay FICA withholding on amounts distributed as monthly annuity payments until the present value of those payments become reasonably ascertainable. Under these types of plans, called nonaccount balance plans, benefits typically become reasonably ascertainable when the employee retires.

Therefore, in this case, it was proper for the employer to wait until the employee retired and began receiving benefits under the deferred compensation plan in order to withhold and pay the related FICA taxes. TFI

FEDERAL INCOME TAX

Tax Facts Q: 437. When does a taxpayer "receive" income? What is the doctrine of constructive receipt?

PLR 201232024

The IRS has recently ruled that the assignment of the right to recover the proceeds of a lawsuit would not result in taxable income to the assignor where there existed a degree of uncertainty as to whether the recovery would be successful.

Typically, income is taxable in the year in which the taxpayer has the right to receive the income, if receipt of the income is "practically certain" to occur. If a taxpayer recognizes a gain based on his or her contingent assignment of a right to income, he or she will be liable for the tax on that gain if the right to receive the income is seen as certain. However, the mere anticipation of the right to receive income is not sufficient to create this tax liability.

In the context of a lawsuit, the income interest does not become sufficiently concrete until a judgment is rendered and all appeals are exhausted. The income interest could become taxable before it is actually received—for instance, where a judgment for money damages was rendered and all appeals denied—but the right to receive the income must be certain. TFI

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Tax News

RENTAL OF A VACATION HOME

Now that summer is just about over, remember that income received for the rental of a vacation home must generally be reported on your federal income tax return.

However, if you rented the property for only a short time each year, you may not be required to report the rental income.

The IRS offers these tips on reporting rental income from a vacation home such as a house, apartment, condominium, mobile home or boat:

Rental Income and Expenses. Rental income, as well as certain rental expenses that can be deducted, are normally reported on Schedule E, Supplemental Income and Loss.

Limitation on Vacation Home Rentals. If you used a vacation home as your residence, and also rented it to others, you must divide the expenses between the rental use and the personal use, and you may not deduct the rental portion of the expenses in excess of the rental income.

You are considered to use the property as a residence if your personal use is more than fourteen days, or more than 10 percent of the total days it is rented to others if that figure is greater. For example, if you live in your vacation home for seventeen days and rented it 160 days during the year, the property is considered used as a residence, and your deductible rental expenses would be limited to the amount of rental income.

Special Rule for Limited Rental Use. If you used a vacation home as a residence, and rented it for fewer than fifteen days per year, you do not have to report any of the rental income. Schedule A, Itemized Deductions, may be used to report regularly deductible personal expenses, such as qualified mortgage interest, property taxes, and casualty losses.

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taxpayer reaches full retirement age, he or she simply files for benefits and then makes another filing to suspend these benefits. During the time that the benefits are suspended, the taxpayer earns delayed retirement credits, which increase his or her eventual benefit level by 8 percent for each year in which the benefits continue to be suspended. The taxpayer must begin to collect benefits by age seventy, by which point he or she can have increased the benefit level substantially.

Those who have taken benefits early, such as David Walters, will receive a reduced benefit that is based upon the number of years that he or she collects benefits before reaching full retirement age. However, David is still eligible to take advantage of the file and suspend strategy. Now that David has reached full retirement age (sixty-six in his case), he can suspend his benefits and begin to earn delayed retirement credits. In his case, the 8 percent per year will simply be added to the lower level at which his benefits began due to his early start.

Though David's benefits will increase by 8 percent each year, Ellen's spousal benefits will remain the same. She is currently receiving 35 percent of David's benefits because they began collecting benefits early (had they waited until full retirement age, Ellen would be entitled to 50 percent of David's benefits). Using the file and suspend strategy won't change this, because spousal benefits do not include any delayed retirement credits that David can earn through suspending his benefits.

Despite this, Ellen is entitled to continue collecting her 35 percent spousal benefit even while David has suspended his benefits. This way, he can earn delayed retirement credits while the couple continues to collect a portion of their Social Security benefits. This approach is often useful in situations where couples disagree as to when they would like to begin receiving benefits. If David had wanted to wait, but Ellen disagreed, he could use file and suspend so that she could collect her spousal benefits while he allowed his benefits to grow. TFI

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OPINION–Thumbs Up/Thumbs Down

1. What are your thoughts on proposals for a so-called "insourcing" tax credit?
2. How do you feel about Congress extending tax code provisions rather than making them permanent?
3. What's your take on proposals to impose corporate tax rates on entities that currently elect passthrough tax status as S corporations?

BYRNES' RESPONSE:

1 I'm all for encouraging multinationals to keep employees stateside, but I don't really see how this tax credit is going to do the job. The current corporate tax rates provide such an incentive for corporations to invest in countries with lower rates—I don't think a 20 percent credit for the expense of moving employees back home is going to make a dent. It might generate some additional votes for the Democrats in November because "insourcing" certainly has a nice ring to it, but I think we need to focus on the real problem—our high U.S. tax rates.

2 I agree with Professor Bloink on this one. It's far too easy for the government to become bogged down in other areas and neglect the tax code. Revisiting its provisions on a regular basis prevents the code from becoming antiquated, and ensures that the tax system reflects the economic realities of the times.

3 I understand Professor Bloink's position, but taxing S corporations and C corporations in the same manner would be a reasonable compromise position for those who oppose reduced corporate taxes on the basis of the related revenue reduction. Decreasing taxes for C corporations could spur these more common entities to invest and create jobs on a much larger scale than that which can be accomplished in the world of S corporations.

BLOINK'S RESPONSE:

1 The proposed 20 percent tax credit for moving jobs back to the U.S., when coupled with the elimination of the tax deduction for moving employees overseas, could go a long way toward motivating multinational corporations to keep employees stateside. With corporate tax rates as high as they are, if we want to see jobs and investment moving back to the U.S., we need to provide these kinds of incentives.

2 I'm all for impermanence in this area. Extending provisions for a couple of years at a time forces Congress to reexamine the tax code on a regular basis. Though it might promote uncertainty, frequent reexamination of the code generates discussion and leads to innovation in how we raise revenue in the US.

3 Eliminating passthrough tax treatment would be a bad move all around—it would eliminate much of the motivation that S corporations currently have to invest and expand. In all likelihood, the higher rates would simply lead to downsizing at the employee level, creating higher unemployment rates and a weaker tax base. TFI

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Tax Tip

WHAT TO DO WHEN CLIENTS RECEIVE AN IRS NOTICE

Receiving a notice from the Internal Revenue Service is no cause for alarm. Every year the IRS sends millions of letters and notices to taxpayers. In the event one shows up in a client's mailbox, here are some things to know:

1. There are a number of reasons that the IRS sends notices. The notice may request payment of taxes, notify a client of a change to his or her account, or request additional information. The notice normally covers a very specific issue about an account or tax return.
2. Each letter and notice offers specific instructions on what to do to satisfy the inquiry.
3. If a client receives a notice about a correction to a tax return, you should review the correspondence, and compare it with the information on the return.
4. If you agree with the correction to the account, usually no reply is necessary unless a payment is due.
5. If you do not agree with the correction the IRS made, it is important that you respond as requested. Respond to the IRS in writing to explain why you disagree. Include any documents and information you wish the IRS to consider, along with the bottom tear-off portion of the notice. Allow at least thirty days for a response.
6. Keep copies of any correspondence with the client's tax records.

About the Authors

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Courses may be followed via web-conferencing

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.

NEW 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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