TAX FACTS INTELLIGENCE
The National Underwriter Company July 2015
annuities • life/health insurance • investments • retirement plans • estate planning/taxation • employee benefits • federal income tax

In Focus: Case Study—Retirement Accounts

Borrowing from a 401(k) plan can prove to be an option some clients are reluctant to consider even if the circumstances require that a loan otherwise be obtained from an outside source. Others, however, may wish to consider the option in order to finance a major purchase or cover unforeseen emergency expenses—and there are pros and cons that these taxpayers should be apprised of before making the decision to borrow.

Your clients, Ted and Ellen, are a couple in their early 40s who are considering taking out a loan from their 401(k) in order to finance the down payment on their new home. Unfortunately, Ted and Ellen have not yet sold their current home, but have already chosen their new home and want to ensure that they will not lose that home to another buyer. They would like to take a $30,000 loan from Ted's 401(k), which has grown to approximately $450,000 over the years.

While a bank loan could be possible, they would like to receive the funds as soon as possible and are concerned about the impact on their credit scores. Further, they feel that they will sell their current house quickly and think they will be able to repay the loan with the proceeds. They have read that there are many potential downsides to borrowing against a 401(k), however, and would like you to help evaluate the advisability of the strategy. How do you advise?

EXPERT ANALYSIS USING TAX FACTS ONLINE

While 401(k) loans generally have a bad reputation, for a financially responsible individual who has a short-term need for additional funds, a 401(k) loan can provide an appealing option.

Tax Facts Online can help taxpayers like Ted and Ellen who are considering the 401(k) plan loan option. As discussed in Q 3848, a 401(k) plan is not required to provide for plan loans—and even if the plan does, the value of the loan cannot exceed (1) the greater of $10,000 or 50 percent of the account balance or (2) $50,000, whichever is less. As a result, Ted's 401(k) is large enough so that a $30,000 loan would be permissible if the plan itself allows for plan loans. Importantly, however, Q 3852 explains that the full amount of the loan must be repaid in full within five years in order to avoid potential penalties.

See page 5

TABLE OF CONTENTS

Monthly Round-up

ANNUITIES

Tax Facts Q 3999. What fiduciary responsibilities are imposed upon fiduciaries under DOL regulations?
FR Doc No: 2015-08831

The new Department of Labor (DOL) proposed fiduciary rules impact a broad range of individuals, including those who sell fixed annuity products. While the fiduciary rule will apply to this broad range of taxpayers, the new rules also contain several exemptions (PTEs) that can help advisors who provide retirement advice to clients.

The "best interest contract" PTE allows financial advisory firms to continue to set their own compensation practices as long as they put their clients' best interests first and disclose any potential conflicts of interests. This means that commission-based fees, revenue sharing and 12b-1 fees will remain permissible as long as the requirements of the exemption are satisfied.

The best interests contract exemption requires that the advisor enter into a formal contract with the client that commits the advisor to act in the best interests of the client (specifically, to avoid any misleading statements about fees and conflicts of interest). Further, the advisor must "warrant" that the firm has adopted policies designed to mitigate any conflicts of interests (meaning that the firm has identified conflicts and compensation structures that could cause the advisor to fail the best interests standard, and has adopted procedures to mitigate their impact). Any conflicts, including hidden fees, must be clearly disclosed to the client.

A second exemption allows advisors to continue to provide general retirement education to clients without triggering the fiduciary standard. DOL guidance gives the example of an advisor who provides general information about the mix of assets that an average person should have based on age, income and circumstances, but makes clear that discussing specific investments would trigger the fiduciary standard.

The proposal also contains a "lowest fee" PTE that would allow advisors to accept fees that might otherwise create conflicts of interest so long as the product that the advisor recommends is the lowest fee product in the particular product class.

LIFE/HEALTH INSURANCE

Tax Facts Q 8598. What are some of the Medicare taxes to which a taxpayer may be subject?
Medicare Access and CHIP Reauthorization Act of 2015, Public Law No. 114-10

The Medicare Access and CHIP Reauthorization Act of 2015 (informally known as the "doc fix law") includes a provision that will modify the scale for determining the various levels of income-based surcharges that higher income Medicare recipients must pay.

Medicare income-based surcharges are determined based on a sliding scale that uses the recipient's adjusted gross income to determine his or her liability for Medicare premium costs. Five tiers of income levels currently exist, and the amount of an individual's income-based surcharge is determined based upon the tier in which his or her income fell two years prior to the year in which the premium applies.

Currently, the upper income limit for the third tier is $160,000 for a single taxpayer and $320,000 for a married couple filing jointly. Beginning in 2018, those income limits (which are actually based on 2016 income) will set the *lower* limits for the fifth tier, which imposes the highest income based surcharge.

RETIREMENT ACCOUNTS

Tax Facts Q 365. How are benefits provided under an employer-sponsored disability income plan taxed?
PLR 201521009

The IRS recently found that disability retirement benefits paid to a state employee's former spouse pursuant to a domestic relations order were fully taxable because the code and regulations provide that only disability benefits paid to employees and their survivors may be excluded from income.

State regulations had recently been amended to provide that payments made to an alternate payee pursuant to a domestic relations order were taxable to that alternate payee to the same extent as they would be taxable to the participant-employee. The IRS noted that amounts paid to an employee under a workmen's compensation act, or statute in the nature of a workmen's compensation act, were excludable from income if they provide compensation based upon personal injury or sickness that occurred during the course of employment.

Despite this, the IRS found that the benefits were paid as a result of the participant employee's work-related disability or sickness, rather than the work-related disability or sickness of a former spouse. Because the IRC and regulations exclude only amounts paid based upon work-related disability or sickness of participants and their survivors, and do not contain a similar exclusion for former spouses, the IRS required the former spouse to include the entire amount of the benefits received in income.

INVESTMENTS

Tax Facts Q 7543. How are incentive stock options taxed?

ILM 201519031

The IRS has recently issued a memorandum outlining two scenarios involving the conversion of stock and incentive stock options (ISOs), and the tax consequences of the two situations. In general, if an ISO is held by a taxpayer (i.e, no "disposition" is made) for two years after the option is granted and the taxpayer maintains an employment relationship with the granting company or a related company, no income is realized by the taxpayer.

The IRS guidance first examined a situation in which the employee exercises the stock option, and the issuing corporation merges with another corporation in the next year pursuant to an agreement whereby each share of the original company's voting stock will be converted into a share of the resulting company's voting stock in a transaction that qualifies as a Section 368(a) reorganization. The original company continued operating as a subsidiary of the resulting company, and a continuous employment relationship was found to exist.

In the second situation, the facts were substantially similar except that the common stock of the original company was exchanged for common stock in the resulting company, but the transaction failed to qualify as a reorganization under Section 368(a) because the controlling portion of the first company's voting stock was not exchanged for voting stock in the new company (cash was received for a portion instead). In the first scenario, the IRS found that the exchange did *not* constitute a disposition, so that the holding period requirements for nonrecognition treatment were met. In the second scenario, however, the employee was required to recognize gain because a disposition of the ISO stock was found to have occurred.

EMPLOYMENT BENEFITS

Tax Facts Q 3516. What rules govern the deductibility of executive compensation in the publicly traded corporation context?

Regulation S-K

The SEC has recently proposed amendments to Item 402 of Regulation S-K of the Securities Exchange Act that deal with the pay versus performance rules implemented under the Dodd-Frank Act.

The Dodd-Frank Act rules generally require certain publicly traded companies to disclose information relating to executive compensation and the relationship between executive compensation actually paid to its executives and the financial performance of the company. The proposed regulations amend Item 402 to require companies to measure the financial performance of the company using total shareholder return (TSR).

Further, they require the company to disclose executive compensation actually paid, total compensation as disclosed in the summary compensation table, TSR and peer group TSR in a new specific table format. For the chief executive officer, compensation must be provided separately, along with the average compensation of the remaining named executive officers as reported in the summary compensation table. The relationship between executive compensation actually paid and TSR must also be disclosed for the company's five most recent fiscal years.

ESTATE PLANNING/TAXATION

Tax Facts Q 600. How is the basis of property acquired from a decedent determined?

REG-107595-11

Although the modified carryover basis rules applicable under IRC Section 1022 are only applicable for decedents dying in 2010, the IRS has found that these basis determination rules will continue to be relevant until all property that had basis determined under Section 1022 is sold or otherwise disposed of.

As a result, the IRS has proposed regulations that will modify otherwise applicable basis determination rules in order to include appropriate references to Section 1022, which essentially allows the basis of property that is acquired from a decedent to be determined as though the property was acquired by gift. If Section 1022 does not apply, Section 1014(a) generally applies to set the basis of property acquired from a decedent at the property's fair market value on the date of the decedent's death.

For example, the rules would modify Section 83 to provide that if property to which Section 83 applies is acquired while it is substantially non-vested, the basis of the property must reflect any adjustments to basis made under Section 1022. The regulations will also modify the Code to provide that, if basis is determined under Section 1022, that property cannot be treated as though it was acquired by purchase or exchange for purposes of Sections 179, 267, 336 and 355(d).

FEDERAL INCOME TAXATION

Tax Facts Q 8656: Can a casualty loss be spread over more than one year? What is the reasonable prospect of recovery doctrine?

***Hyler v. Commissioner*, T.C. Summ. Op. 2015-34**

The Tax Court recently denied a taxpayer's casualty loss deduction at a time when the taxpayer had a lawsuit pending against his landlord's insurance company in an attempt to recover additional insurance proceeds.

In this case, a fire destroyed the taxpayer's rental property and the personal property contained in the home. The taxpayer's insurance company reimbursed him for $60,000 worth of damages to personal property, but the taxpayer had evidence supporting an actual value of over $2 million in personal property that was destroyed. As a result, the taxpayer sued his landlord's insurance company in an attempt to recover additional funds.

Generally, IRC Section 165(a) allows a deduction for casualty losses caused by fires and other similar disasters in the year that the loss is incurred. However, an exception exists to delay the deduction in cases in which the taxpayer has a reasonable prospect of recovering additional reimbursements in a later year.

The taxpayer here was still actively pursuing a lawsuit to recover additional insurance proceeds, so the loss could not yet be treated as though it had been sustained because it could not be determined with reasonable accuracy whether he would recover additional funds until the suit was resolved. As a result, his claim for a current casualty loss deduction was denied.

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Expert Analysis from page 1

Like Ted and Ellen, many individuals who take out 401(k) loans do so in order to finance a real estate investment. The benefit of this strategy may be most apparent for taxpayers who are in Ted and Ellen's situation, and are buying and selling homes at the same time—the 401(k) loan can be used as a bridge to pay expenses related to the new home until the proceeds from the sale of the old home are received—eliminating the necessity of obtaining additional bank financing.

For many taxpayers who have unforeseen expenses, or wish to finance a large purchase, a 401(k) loan may be attractive because no credit check is required (as would be with a traditional bank loan) and interest rates may be more favorable than other options. Further, the loan will not impact Ted and Ellen's credit rating and can usually be obtained fairly quickly. However, there may be disadvantages that should be carefully considered before Ted and Ellen settle on using the 401(k) loan option.

Importantly, they should consider their ability to repay the loan balance within a short time frame while continuing to make contributions to the 401(k). Generally, the loan balance must be repaid within five years and payments must be made at least quarterly (special rules apply in the case of a 401(k) loan taken out to finance a principal residence). Importantly, Ted and Ellen should consider how repaying the loan balance within five years might inhibit the ability to make further contributions to the plan—thus reducing the eventual overall account value at retirement—if their current home does not sell as quickly as anticipated.

One of the major objections to using a 401(k) loan to finance non-retirement expenses is the opportunity cost of the loan. Because the funds are withdrawn from Ted's 401(k), the available balance is reduced—as is the corresponding growth factor. In a market upturn, Ted and Ellen could miss out on investment growth that would have otherwise increased the overall value of the 401(k).

Further, if Ted and Ellen miss a payment and cannot pay for ninety days or more, the money is taxed as a distribution and can be subject to the additional 10 percent penalty tax (because they are under age 59½). If Ted leaves his job (or is fired), the loan must be repaid within sixty days in order to avoid taxes and penalties.

While a 401(k) plan loan may not be the perfect solution, for financially conscientious taxpayers like Ted and Ellen, it may provide a viable option in order to avoid incurring additional outside debt—if repayment can be accomplished quickly and responsibly.

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OPINION—Thumbs Up/Thumbs Down

What are your thoughts on:

1. The Internet access tax ban, set to expire October 15?
2. The impact of the exemptions to the new DOL fiduciary standards?
3. The impact of the new Medicare income-based surcharge income brackets?

Bloink's Response

1 The ban should be made permanent. Imposing a tax on something as basic and desirable as widespread Internet access makes very little sense—we tax gasoline to promote conservation, we tax cigarettes to discourage their use, but in this digital age the burdens definitely outweigh the benefits of taxing Internet access.

2 The objection is that the various exemptions gut the effectiveness of the fiduciary standards generally, but I don't think this will be the case. Even the best interests contract exemption, which would allow advisors to use existing fee structures if they enter an agreement with the client promising to act in that client's best interests, still requires that the advisor act in the client's best interests and disclose any conflicts of interest—which is the goal of the fiduciary rules themselves.

3 The result of the new modifications is to catch more seniors in the top Medicare income brackets, where the highest surcharge rates apply. These increases can catch seniors by surprise, but since they won't become effective until 2018, there is still time to take steps to reduce income that is counted for these purposes in 2016 (2018 premium costs are based on 2016 income). Apparently these increases were part of a larger compromise to improve the way that Medicare pays doctors—which could lead to an overall increase in the quality of healthcare for seniors.

Byrnes' Response

1 An Internet access tax is one of those taxes that would disproportionately burden lower income taxpayers and could result in an even wider gap between the well-off and the poor. Access to the Internet is simply a necessity—not only is the Internet the go-to place for almost any information that a taxpayer could desire, it's also the standard place to find jobs and career tools. Imposing a tax on that access places an undue burden on lower income taxpayers who may already be at an educational disadvantage.

2 Some of the exemptions are necessary. For example, the exemption for advisors who provide general retirement education is necessary to ensure that everyday, middle class taxpayers still have access to retirement planning advice. Exempting advisors who do not provide advice as to specific investments preserves that access. I worry that some of the other exemptions could be manipulated to avoid application of the fiduciary standards, but that remains to be seen.

3 As Professor Bloink pointed out, there's still time to plan—this means that seniors who are on the border between two income brackets can move money around to recognize less income in 2016 and beyond (say by buying an annuity to provide for income rather than taking higher IRA withdrawals). As a result, this probably isn't going to produce as much revenue as legislators might have anticipated.

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Welcome

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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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