TAX FACTS INTELLIGENCE

The National Underwriter Company August 2015

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

In Focus: Case Study—Federal Income Tax

The Supreme Court ruling that legalized marriage in all states for same-sex couples has important financial and tax implications that same-sex couples now need be advised upon in order to avoid any planning surprises down the road. From a federal tax perspective, legally recognized marriage can provide certain benefits to same-sex couples. However, it is equally important that these couples be advised as to the potential tax hikes they could see after marriage.

Your clients, Kristin and Ashley, are a same-sex couple in their thirties who are considering marriage. Both Kristin and Ashley are respected and successful professionals in the medical field, each with an annual income in the low-to-mid six figures and generous employer-provided benefits. Neither are taxed at the highest tax rate yet, however. While Kristin and Ashley are interested in legally marrying, they first want to consider all of the financial issues that they could encounter post-marriage. They know that marriage will simplify their estate planning, but are concerned about potential increases in tax liability, both immediately and in the future. How do you advise?

EXPERT ANALYSIS USING TAX FACTS ONLINE

As with any high-income couple, there are both tax benefits and burdens to marriage, and it is important that Kristin and Ashley evaluate all sides of the issue before filing to avoid surprises. Tax Facts Online can help these clients identify important issues and evaluate their choices. Q 641 discusses the requirements for filing a joint return, while Q 8516 and 8525 discuss the phaseout of personal exemptions and deductions for high-income taxpayers.

Married same-sex couples in all states may now file both joint federal and state income tax returns, rather than two separate returns, for the 2016 tax year, as well as for all other open years. For couples who had filed separate federal returns for simplicity because they lived in a state that did not recognize same-sex marriage, amending a past year's return could lead to higher returns in some cases.

For a high-income same-sex couple like Kristin and Ashley, however, choosing to marry and file a joint return

See page 5

TABLE OF CONTENTS

Monthly Round-up

ANNUITIES

Tax Facts Q 277. What is the insurable interest doctrine and how does it impact the tax treatment of death proceeds?

Western Reserve Life Assurance Co. of Ohio v. ADM Associates LLC, No. 2014-35-M.P.

The Rhode Island Supreme Court recently found that the requirement that an owner of a life insurance policy have an insurable interest in the insured person did not extend to annuity contracts, even if the contract offers death benefits.

The insurable interest doctrine generally requires that, in order to purchase and receive the tax benefits of a life insurance policy insuring a third party's life, the purchaser must have an interest in the continued life of the insured person. This requirement has been established in order to prevent the purchase of life insurance contracts as a wager on the insured's life expectancy.

After the insurance company in this case found that there was no relationship between the owner of the variable annuity with death benefits and the annuitant, it sought to rescind the contract on the grounds that no insurable interest was present. The court rejected this argument, finding that the insurable interest doctrine was solely applicable to life insurance contracts and that the presence of death benefits did not transform the annuity at issue into an insurance contract.

Further, the court upheld the validity of the annuity contract because it contained an incontestability clause, which means that the policy is incontestable from the date of issuance.

LIFE/HEALTH INSURANCE

Tax Facts Q 8747. What is a high deductible health plan for purposes of an HSA?

79 FR 70673

The Health and Human Services Department (HHS) has recently proposed rules that clarify how maximum out of pocket limits apply to certain high deductible health plans (HDHPs) that offer family coverage.

Maximum out of pocket cost limits apply to cap the out of pocket expenses that an individual can be required to pay under his or her health plan above and beyond premium costs. Typically, the maximum out of pocket limit for a family plan is higher than the maximum out of pocket limit for an individual plan, meaning that an individual covered by such a plan would be subject to a higher cap.

The HHS regulations, however, clarify the rules so that the cap applies separately to each individual taxpayer covered within the family HDHP—so that each individual essentially is able to apply the individual cap, rather than the overall family plan cap.

RETIREMENT ACCOUNTS

Tax Facts Q 3871. What are the prohibited transaction rules that apply in IRA transactions?

***Ellis et ux. v. Commissioner,* No. 14-1310**

The Eighth Circuit recently affirmed a Tax Court decision that found that an individual engaged in a prohibited transaction when he caused a business that was owned by his IRA to pay him compensation.

The taxpayer in this case formed a company that was owned by his self-directed IRA and another taxpayer. The taxpayer rolled funds from his employer-sponsored 401(k) into his IRA, and the IRA, in turn, contributed capital in exchange for a 98 percent ownership interest in the company. Because the taxpayer was general manager of the company, it paid him a salary.

The taxpayer in this case was a disqualified person within the meaning of IRC Section 4975 because he was a fiduciary of his IRA, and the IRA was a disqualified person because the taxpayer was the beneficial owner of the IRA's ownership interest in the company. The court found that, because the taxpayer caused the company to pay him wages that, though indirectly, came almost exclusively from his IRA, he engaged in a prohibited transaction so that the IRA account value was deemed distributed and included in the taxpayer's gross income.

INVESTMENTS

Tax Facts Q 8825. What issues are important in determining the tax liability of a C corporation?

***Bell et ux. et al. v. Commissioner*, T.C. Memo. 2015-111**

The Tax Court recently found that a sole proprietor's transfer of assets to a corporation that he formed in order to incorporate his business was a capital contribution, rather than a sale, based on an 11-factor test that applies in determining the substance of such a transaction.

In this case, the taxpayer was a sole proprietorship engaged in real estate activities and wished to incorporate. He formed a corporation and entered into an agreement with that corporation to sell all of his works in progress, customer lists, contracts, goodwill and other assets for $225,000 at a time when the corporation had no other assets, capital or shareholders. The $225,000 was to be paid in monthly installments with a 10 percent penalty for late payments, but no security was given and no promissory note was executed. The corporation then agreed to sell the taxpayer and his wife 500 shares for $500.

The court found that the following factors weighed in favor of treating the transaction as a capital contribution: (1) payment of the monthly installments depended upon the corporation's earnings, (2) no security was provided, (3) the corporation's capitalization was extremely thin prior to the transaction, (4) the taxpayers were the corporation's sole shareholders, (5) payment of interest would only be possible if the corporation generated earnings and profits and (6) the corporation could not have obtained the loan from a third party creditor in an arm's length transaction.

The parties' intent, fixed maturity date of the debt and creation of a purchase agreement evidenced a sale, while other factors were neutral. As a result, the court found that the factors weighed in favor of finding that the transaction was a capital contribution, not a sale.

EMPLOYMENT BENEFITS

Tax Facts Q 3669. How does the IRS treat a cash balance plan?

Rev. Proc. 2015-36

The IRS has expanded its pre-approved plan program to include both cash balance plans and ESOPs, and has also extended the deadline for pre-approved defined benefit plans from June 30 to October 30, 2015.

Employers who wish to adopt pre-approved cash balance plans or ESOPs are advised to complete Form 8905 before the end of their current plans' five-year remedial amendment cycle. The IRS plans to open the pre-approved plan program to cash balance plans by October 30, 2015, and has indicated that it will expand the program to include ESOPs beginning February 1, 2017.

If the employer does not know which type of pre-approved plan it will adopt, the IRS has stated that Part II and line 4 of Part III of Form 8905 can be left blank. Instead, the employer should attach a statement to the form indicating that the employer intends to adopt a pre-approved cash balance plan or ESOP once it has received an opinion or advisory letter.

ESTATE PLANNING/TAXATION

Tax Facts Q 678. Is the estate tax exclusion amount of a first-to-die spouse portable? What is portability?

TD 9725

The IRS has released final regulations clarifying the requirements for electing portability of a deceased spouse's unused exclusion (DSUE) amount. Generally, a surviving spouse may apply the deceased spouse's unused estate tax exclusion amount to the surviving spouse's own transfers if portability is elected by filing an estate tax return within the time frame provided for filing such a return.

The final regulations provide that an extension of time may be available for filing the estate tax return only if the value of the estate otherwise does not exceed the threshold filing levels ($5.43 million per individual in 2015). In other words, an extension of time may be granted if the taxpayer is only required to file an estate tax return because of a desire to elect portability.

Further, portability will be treated as though it was properly elected if the executor of an estate completes and files an estate tax return containing a computation of the unused DSUE amount, but it is later found that adjustments are required in order to recompute the correct amount. The final regulations clarify that the recomputed DSUE amount will be available to the surviving spouse in such a situation, and the originally filed return will be considered "complete and properly prepared" for purposes of the election.

Under the final regulations, a surviving spouse who was not a U.S. citizen may use the DSUE amount if he or she subsequently becomes a U.S. citizen and the executor of the estate has filed an estate tax return properly making the portability election.

FEDERAL INCOME TAXATION

Tax Facts Q 8830: What is the personal holding company tax?

FAA 20152102F

The IRS recently found that a corporation's personal holding company income exceeded 60 percent of its adjusted gross income for the year because income received for granting a negative easement to a related corporation was treated as rental income.

In this case, the taxpayer corporation entered into agreements with a related entity in order to restrict development on the taxpayer's real property in exchange for quarterly payments. The taxpayer argued that the quarterly payments were business income.

The IRS disagreed, however, and found that the amounts were more appropriately characterized as rent because they were received for the use of or right to use, the taxpayer's property and because the taxpayer did not provide any services or activities with respect to the real property subject to the negative easements. Instead, the taxpayer granted the related entity the right to use (i.e., prevent development upon) its property in exchange for rental payments.

Because rental payments are treated as personal holding company income, they caused the taxpayer's personal holding company income to exceed 60 percent of adjusted gross income so that the taxpayer was subject to the personal holding company tax.

Expert Analysis from page 1

can actually increase tax liability. In the past, same-sex couples generally had the opportunity to file two single (or two head-of-household) tax returns without worrying about the "marriage penalty" for filing separately that applies to a legally married couple.

As a result of the Supreme Court's ruling, same-sex couples now must make the same cost-benefit analysis that applies to opposite-sex couples in determining whether to file jointly. A single taxpayer crosses the earnings threshold into the 39.6 percent tax bracket when he or she earns more than $400,000 for the year—meaning that Kristin and Ashley could live together and earn almost $800,000 before entering the highest tax bracket. If they choose to marry, on the other hand, they will become subject to this rate when they have combined earnings of only around $450,000 for the year.

Similarly, if a couple is not married, they can earn about $400,000 ($200,000 each) before their itemized deductions and personal exemptions become subject to the phaseout rules that gradually reduce their value. Once Kristin and Ashley are married, the penalties kick in at $250,000—total.

The investment income tax, discussed in Tax Facts Online Q 8577, will also apply to a married couple earning a combined $250,000 (while two unmarried taxpayers could earn $400,000 before crossing the threshold).

Same-sex couples who marry may find that a greater portion of their Social Security benefits may be subject to taxation, as the couple's combined income could cause them to pass the thresholds that apply in determining whether (and to what extent) these benefits are taxable.

However, if Kristin and Ashley marry, they may take advantage of Social Security spousal benefits in the future. A married spouse who never worked (or who is not ready to begin claiming benefits) is still entitled to claim Social Security spousal benefits when his or her spouse uses the "file and suspend" strategy. Under this strategy, one spouse files for benefits and immediately suspends those benefits after the second spouse begins claiming spousal benefits. This allows the couple to claim some Social Security benefits while allowing their earnings-based retirement benefits to grow.

While federal tax is not the only area that couples like Kristin and Ashley should be advised upon, these issues can have a major impact on many aspects of the couple's financial picture. Making sure higher income same-sex couples understand the costs and benefits is critical to avoiding surprises down the road.

PUBLISHER
Kelly Maheu, J.D.

SENIOR TAX EDITOR
Richard Cline, J.D.

MARKETING DIRECTOR
Gerry Centrowitz

ONLINE SERVICES SUPERVISOR
Connie L. Jump

AUTHORS
Prof. William H. Byrnes, J.D., Texas A&M Law School
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

OPINION—Thumbs Up/Thumbs Down

What are your thoughts on:

1. The impact of the Supreme Court *King v. Burwell* decision on state-run health exchanges?
2. Recent moves by cities, including Chicago, to impose new taxes on web-based subscription services like Netflix and LexisNexis?
3. The impact of the Supreme Court same-sex marriage decision on the continued availability of employer-provided domestic partner benefits?

Bloink's Response

1. If the decision had gone the other way, it would have provided a strong motivator for states to establish their own exchanges to ensure that taxpayers had access to federal subsidies. Without that motivation, many states are cash-strapped enough that the costs of establishing a state-run health exchange are likely to exceed the benefits.

2. Chicago's new tax on streaming-type subscription services is based on its currently existing amusement tax—9 percent—meaning that the tax will be higher than the sales tax imposed in most states. What's most confusing, however, is that who's responsible for the tax depends on whether the company has a physical presence in the area. So if Netflix is physically present in the area, it will tack the 9 percent on to the customer's bill—but if Netflix isn't, the customer is responsible for computing and paying the tax. Given the prevalence of these services, saying that there will be confusion is an understatement, to say the least.

3. Some spousal benefits are federally mandated—but domestic partner benefits can be completely optional. Now that employers are required to provide spousal benefits to a wider range of individuals—*all* of whom have the right to legally marry—its less likely that they will continue to provide optional domestic partner benefits for either same or opposite sex partners, especially because many employers may have provided those benefits solely to provide equal benefits to same-sex couples.

Byrnes' Response

1. The states that have established their own exchanges have experienced problem after problem—from massive computer glitches to long-term funding issues. In fact, only a handful of states have bothered to establish their own exchanges, and there are rumors that some will be dropping those exchanges in favor of the federally managed exchange system. If the state can give its citizens access to the same benefits without incurring the associated costs, why wouldn't they let the federal government take over?

2. Taxes on web-based goods and services are meant to help brick-and-mortar businesses remain competitive. If these services aren't subject to any kind of tax regime, it makes it nearly impossible for traditional business owners to compete—as we've seen with the downfall of the local video rental store. Those tax revenues have gone away, and now Chicago and other major cities are trying to replace it, looking to a source that is only logical.

3. I agree with Professor Bloink that domestic partner benefits will likely be less common in the future. Many employers currently only offer them to same-sex domestic partners. Now that everyone can marry, it seems that employers would have to offer these benefits to all employees in a domestic partnership to avoid discrimination claims. Employers might find it easier to discontinue the practice entirely.

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.