TAX FACTS INTELLIGENCE

The National Underwriter Company November 2014

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

In Focus: Case Study—Retirement Accounts

Regardless of the improved conditions that taxpayers have seen in the equity markets recently, for many who are approaching retirement age, the prospect of allowing 401(k) funds to remain exposed to potential fluctuations may seem too great a risk after the losses incurred earlier in the century. For other clients, the limitations that are built into employer-sponsored 401(k) plans may render the vehicles unattractive. While these taxpayers may not be ready to retire, the appeal of turning at least a portion of funds already earmarked for retirement into guaranteed income may be too great to pass up.

Your client, Dean, has recently turned sixty and wishes to retire within the next decade. While he plans to continue working for several more years, he is no longer satisfied with the employer-sponsored 401(k) that houses the bulk of his retirement assets—both the risk of allowing these assets to remain exposed to market conditions and the lack of investment options have him seeking other opportunities. Dean's goal is to allocate a portion of these funds to a vehicle that will guarantee a set level of income once he stops working. Further, he has been reading about the benefits of an inherited IRA and hopes that his children can take advantage of the extended tax-deferral granted to these accounts if retirement funds remain after his death. How do you advise?

EXPERT ANALYSIS USING TAX FACTS ONLINE

Dean's concern is one that is shared by many who have invested retirement funds primarily in employer-sponsored 401(k) plans, which tend to be easily accessible and may allow for employer matching contributions. With time, however, these investments may become less attractive as they remain exposed to market risks and the limitations that generally apply to 401(k)s. Fortunately, there are options that permit taxpayers to reposition these funds without incurring tax penalties.

IRS guidelines generally permit 401(k) plans to offer penalty-free in-service withdrawals, but the first step is for Dean to determine whether his specific 401(k) actually permits pre-retirement withdrawals. Recent studies indicate that approximately 90 percent of 401(k) plans permit in-service withdrawals for non-hardship purposes once the taxpayer reaches age 59½.

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Monthly Round-up

ANNUITIES

Tax Facts Q 423. How is the holder of a variable annuity contract taxed?

PLR 201436005

The IRS recently found, after an insurance company created a new investment fund option for variable annuity contract holders, that it was the insurance company, rather than the individual contract holders, who owned the assets underlying the fund for tax purposes. This was the case because the contract holders themselves did not possess sufficient control over the assets so as to attribute incidents of ownership that would have caused gains and losses on the underlying assets to become immediately taxable to the contract holders.

Here, the annuity contract holders were permitted to allocate and transfer their premium investments among a series of funds managed by an investment advisor engaged by the insurance company issuing the contracts. The annuity contract holders, however, were not permitted to direct the funds to invest in any particular assets and, in fact, were only apprised of the assets underlying the funds after the investment advisor made the investments.

As a result, the IRS found that the annuity contract holders did not possess incidents of ownership over the underlying assets that would justify taxing them currently on the income derived from those assets.

LIFE/HEALTH INSURANCE

Tax Facts Q 390. How does an employer determine whether it is required to provide employees with health insurance under the Affordable Care Act?

Notice 2014–49

New IRS guidance has been released to assist employers in determining how to apply the look-back measurement method for determining full-time employee status under the Affordable Care Act (ACA) in situations where the measurement period with respect to an employee changes.

Under the look-back measurement method generally, the employer uses the employee's average number of working hours per week during one period (the "measurement period") in order to determine whether that employee is a full-time employee during a subsequent period (the "stability period"). Because the ACA rules permit the employer to use different measurement periods for different classes of employees, the situation may arise where the measurement period with respect to an employee changes.

If the employee is transferred to a full-time position during a stability period associated with the first position, the employer would be required to offer health benefits after the end of that stability period, but going forward, the employee would be subject to the look-back measurement period associated with the second position.

If the employee is transferred during the measurement period, then whether the employer is required to offer health benefits depends upon the measurement and stability periods associated with the second position.

The guidance offers many examples to assist employers in determining whether health benefits must be offered depending on a variety of potential situations, and the rules are generally applicable through the 2016 calendar year.

INVESTMENTS

Tax Facts Q 3616. What are the rules governing withdrawals from retirement accounts?

***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.**

Understanding Sequence of Return Risk–Safe Withdrawal Rates, Bear Market Crashes and Bad Decades

Watching a portfolio experience market volatility in the first few years of retirement can be terrifying to a new retiree, raising legitimate questions of whether there's a danger that early declines plus ongoing withdrawals could lead to a retirement spending shortfall. And as the safe withdrawal rate research has shown, that danger is real – in fact, it's been dubbed the "sequence of return" risk to retirement spending, a recognition of the reality that even if returns average out in the long run, it doesn't matter if ongoing withdrawals deplete the portfolio before the "good" returns finally show up.

Yet the caveat is that while sequence of return risk is real, it's not necessarily just about the danger of getting a severe bear market on the eve of retirement. In fact, a deeper look at the data reveals that there is remarkably little relationship between returns in the first year or two of retirement, and the safe withdrawal rate that can be sustained in the portfolio… even if retirement starts out with a market crash. Instead, it turns out that the true driver of sequence of return risk and safe withdrawal rates are the returns that the retiree earns over the first decade – and specifically, the *real* returns over the first decade, that provide an indication of whether the retirement portfolio will have produced enough real growth to keep up with inflation-adjusted spending for the rest of retirement. Fortunately, though, bad decades of returns are not entirely random, and instead can be reasonably predicted by long-term market valuation trends, providing retirees with at least a few tools to manage the dangers of sequence of return risk through adjusting asset allocation in retirement and setting a reasonable initial withdrawal rate in light of the market conditions that exist – and the potential for a bad decade of returns – when their retirement begins.

Defining Sequence of Return Risk

The concept of "sequence of return" risk draws from the research on safe withdrawal rates. It is the idea that, even if short-term volatility averages out into favorable long-term returns, that a retiree could still be in significant trouble if the sequence of those returns are unfavorable – i.e., with the bad returns occurring at the beginning of retirement.

Mathematically, the sequence of returns doesn't matter when there are no cash flows in and out of a portfolio, even when there is extreme volatility. For instance, a $1,000,000 portfolio that experiences returns of –50 percent and +100 percent finishes with the same balance as a portfolio that has returns of +100 percent and –50 percent. In both cases, the portfolios finish with the same $1,000,000 that they started with. The arithmetic average return is 25 percent and the geometric return is 0 percent — the difference is often dubbed "volatility drag" and represents the effect that volatility has on compounding. But regardless of which sequence occurs, the arithmetic average remains 25 percent and the geometric return remains at 0 percent.

Once cash flows occur, though, the results are different. In the logical extreme, imagine a retiree with $1,000,000 who needs to take a big $500,000 withdrawal at the end of the first year. With the "good" sequence, the portfolio grows 100 percent from $1,000,000 to $2,000,000, easily funds the $500,000 withdrawal, and after the 50 percent drop in year two finishes with $750,000. By contrast, with the "bad" sequence, the portfolio falls 50 percent to $500,000, the $500,000 withdrawal completely depletes the portfolio down to $0, and the subsequent 100 percent return is now irrelevant because you can't compound an account balance of zero!

Of course, in the real world most retiree cash flow needs are not as extreme as needing to spend half the portfolio after the first year. Nonetheless, the fundamental point remains: once cash outflows are occurring, it's not enough for returns to average out in the long run, if the portfolio could be complete depleted before the good returns finally show up.

Bad Years Versus Bad Decades

While the safe withdrawal rate research has brought a great deal of visibility to sequence of returns risk and highlighted the dangers of retiring on the eve of a bear market, the caveat is that when spending needs are modest – e.g., "just" an initial withdrawal rate of 4 percent in the first year – the consequences of an early bear market are not necessarily all that severe. After all, with a diversified portfolio, a bear market crash in stocks might simply mean the first year's liquidation will just come from bonds (which in point of fact, will be the natural result with an annually rebalanced portfolio anyway!), and if the portfolio bounces back in the subsequent year, not a single dollar of stocks will have been liquidated while they're down at all!

There's not a terribly strong relationship between the safe withdrawal rate and just the first year's return. The worst return is associated with a "lower" safe withdrawal rate, but it was still a withdrawal rate of 5.34 percent, well above the "4 percent rule" threshold. Overall, the correlation between the safe withdrawal rate and the first year's return is a mere 0.21.

As noted earlier, the reason that the safe withdrawal rate has little relationship to just the first year's withdrawal is that in the short term, a diversified portfolio has other sources to draw from, and even if a withdrawal must be taken from equities it's *still* only a few percent of the portfolio and is hardly likely to lead to a catastrophic depletion on its own.

The true risk is not merely a bad return in the first year, but a string a bad returns where the cumulative withdrawals add up to something more significant and the portfolio in the aggregate starts to get winnowed down. ten-year returns are at least somewhat more predictive. The correlation between the safe withdrawal rate and the ten-year return is 0.44, more than double the correlation with just 1-year returns. The few extremely bad results are clearly associated with the lower end of the withdrawal rates, and the highest subset of returns consistently lead to moderately higher withdrawal rates. On the other hand, the predictive value is clearly still limited; the safe withdrawal rates in the 4 percent –5 percent range are still occurring with ten-year average annual compound growth rates anywhere between 2 percent and 10 percent!

Given that 10-year returns were more predictive than one-year returns, one might expect that increasing the return time horizon further will improve the predictive value, but it turns out this is not true. In fact, as the time horizon increases further, the results become less predictive. There's virtually no correlation at all between the safe withdrawal rate and thirty-year compounded equity returns! To some extent, this simply reiterates the importance of sequence-of-return risk – long-term returns over thirty years don't matter if the returns are so bad in the first decade that the retiree runs out of money before the good returns at the end show up! In fact, the relationship between safe withdrawal rates and thirty-year returns just looks like a giant blob of randomness, and the overall correlation trend is actually slightly *negative*! The best withdrawal rates come with the middle-ish returns, while the higher 11 percent + returns are actually clustered in the lower half of the safe withdrawal rate results!

This somewhat surprising result – where higher returns are associated with lower withdrawal rates – isn't entirely counterintuitive though. The reason is actually quite simple: because these returns are nominal, and higher nominal returns are often associated with higher inflation, which can be very disruptive for retirees!

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

RETIREMENT ACCOUNTS

Tax Facts Q 3608. What are the rules that apply when a taxpayer rolls traditional retirement funds into a Roth account?

Notice 2014-54

The IRS recently issued guidance that permits the splitting of 401(k) contributions between pre-tax and after-tax contributions for purposes of converting these funds to Roth accounts.

Prior to the release of this guidance, taxpayers who wished to split rollovers of employer-sponsored retirement account assets containing both pre-tax and after-tax contributions between traditional and Roth accounts were required to treat a distribution as two separate distributions—meaning that the rollover to each account would be treated as coming partly from pre-tax contributions and partly from after-tax contributions.

The new IRS rules allow a distribution to be treated as a single distribution even if it contains both pre-tax and after-tax contributions, and even if those contributions are rolled over into separate accounts, so long as the amounts are distributed at the same time. The guidance now allows the taxpayer to allocate pre-tax and after-tax contributions among different types of accounts in order to maximize their future earnings potential—avoiding the pro-rata tax treatment that was previously required.

EMPLOYMENT BENEFITS

Tax Facts Q 3942. What income of a tax-exempt welfare benefit fund is taxable as unrelated business income?

PLR 201440022

A voluntary employees' beneficiary association (VEBA) was permitted to transfer assets from a retiree life insurance reserve into a retiree health insurance reserve without losing its tax-exempt status and without becoming subject to unrelated business income tax.

The IRS found that the transfer did not impact the VEBA's tax-exempt status because both life and health insurance benefits are the types of benefits that may be permissibly provided by a VEBA. Further, income set aside for payment of both life and health benefits constitutes exempt function income that is not subject to the unrelated business income tax, though the amount of income that may be treated as such is generally subject to limitations.

Despite this, the IRS noted that the funds in this case were maintained pursuant to a collective bargaining agreement, and were thus subject to the currently existing exception providing that VEBA funds maintained pursuant to a collective bargaining agreement are not subject to the otherwise applicable limits on exempt-function income.

As such, the funds were not subject to unrelated business income tax, though the IRS noted that this outcome was subject to change pending the release of final regulations governing the limitations placed on exempt-function income.

ESTATE PLANNING/TAXATION

Tax Facts Q 550. Are distributions from a decedent's IRA taxable as income in respect of a decedent?

PLR 201438014

Because the terms of a trust required that it pay monetary legacies to charity from inherited IRA assets held within the trust, the IRS found that the trust was required to treat payment of those legacies as taxable sales or exchanges.

In this case, the decedent owned an IRA and designated his trust as IRA beneficiary. He further directed that specific monetary sums would be paid out of his estate to charities. The amount of those charitable legacies exceeded the trust's non-IRA assets, so the trust was required to use IRA assets to satisfy the bequests. The IRS held that these payments to charity constituted transfers of the right to receive income in respect of a decedent and that the trust was required to include the portion of the IRA assets that was used to satisfy the legacies in gross income.

This was the case despite the fact that a state court had reformed the trust so that the distributions of IRA assets to charity would be treated as direct bequests rather than as income in respect of a decedent to the trust. The IRS did not uphold the state court's reformation of the trust because it was made to obtain tax benefits, rather than to resolve any legitimate conflict regarding the payment of the charitable legacies.

FEDERAL INCOME TAXATION

Tax Facts Q 510. What are the income tax consequences when compensation is disguised as a loan?

***Fisher v. Comm.*, TC Memo 2014-219**

The Tax Court recently determined that a taxpayer was required to include payments in gross income, finding that the payments were compensation for services rendered, rather than a loan, because there was no evidence that the parties had intended to create a bona fide debtor-creditor relationship.

While funds received as compensation are included in gross income, funds received pursuant to a loan agreement are excludable from income because an obligation to repay the funds exists. In determining whether payments are a loan, the courts look to several factors, including, among

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others, (1) the ability of the borrower to repay, (2) the existence or nonexistence of a debt instrument, (3) security, interest or a fixed repayment schedule, (4) whether the borrower has made repayments and (5) whether the lender has demanded repayments.

The taxpayer received several payments over time and argued that they represented a loan made pursuant to a debt instrument. However the supposed lender testified that he had never seen the debt instrument at issue and, in fact, did not sign it. The court also found that there was nothing to suggest that the borrower had the ability to repay the funds.

Further, the court pointed to the fact that the borrower had made no repayments, and the lender had not demanded repayment, in finding that the payments were not loans, but rather compensation that was required to be included in gross income.

Expert Analysis from page 1

Tax Facts Online can help Dean evaluate his options for withdrawing and repositioning his 401(k) funds. As Q 3837 explains, a 10 percent penalty may apply to 401(k) distributions unless one of several exceptions applies. The rules allow taxpayers to avoid penalties by directly rolling certain types of 401(k) funds into an IRA within the traditional sixty-day window that applies to tax-free rollovers.

Typically, the 401(k) funds will be eligible if they are employer-matching and profit-sharing contributions, employee after-tax contributions to a traditional 401(k) or pre-tax employee and Roth contributions once the taxpayer reaches age 59½. These rules must be followed carefully in order to avoid the 10 percent penalty tax that typically applies to premature 401(k) distributions.

Transferring 401(k) funds to an IRA can offer a variety of benefits—such as increasing investment options and allowing heirs to take advantage of the rules governing inherited IRAs to stretch the tax-deferral benefits over their lifetime. Qualified plans (such as Dean's 401(k)) are subject to a different set of rules that do not allow the funds to be distributed over time. As a result, when his 401(k) is inherited, the funds may be distributed immediately in a single lump sum payment, resulting in an immediate tax liability for the beneficiary. If the designated beneficiary of an inherited IRA is an individual, however, he or she gains the ability to stretch distributions over his or her life expectancy.

Like many taxpayers, one of Dean's primary objectives is to turn his 401(k) into guaranteed income. For him, after completing the in-service withdrawal, the most attractive option may be to invest the IRA assets in a fixed indexed annuity that can provide a level of guaranteed retirement income that is established before he retires.

A fixed indexed annuity is one that bases the performance of the annuity upon the performance of one or more major market indices, capping the gains that can be realized within the product in order to provide a cushion against any investment losses that would be realized if the funds were directly invested in the market. Not all fixed indexed annuities are created equally, however, and it is important that Dean understand the contractual fine print before committing to any particular product. Since he has yet to retire, the annuity should be one that offers flexibility as to the date that annuity payouts will begin.

Further, the rules governing how gains are credited to the account can be important to maximizing the value of the annuity. Also known as a "rollup," the annuity product (or attached rider) will provide a method for determining how frequently gains are credited to the account value. In some cases, the taxpayer will have to wait for a set period of time to begin annuity payouts in order to take advantage of the rollup, but other contracts offer riders that provide for a daily rollup so that the taxpayer has greater flexibility in determining his or her retirement date.

Although the counterargument to the annuity-within-an-IRA strategy is that both vehicles offer tax deferral benefits that can make housing the annuity within the IRA redundant (at least from a tax perspective). For risk adverse taxpayers like Dean who are approaching retirement age, however, the strategy can make all the difference in providing certainty that retirement funds will be safe from another market downturn.

OPINION—Thumbs Up/Thumbs Down

What are your thoughts on:

1. The idea of taxing "cloud" computing and the problems faced by state governments in creating tax rules for the cloud?
2. The impact of the implementation of a carbon tax upon economic growth?
3. The effectiveness of closing of Ireland's "Double Irish" tax loophole used by major multinationals to reduce corporate tax rates into the single digits?

Bloink's Response

1 Cloud computing is only going to become more prevalent in the future—but the problem with taxing the "cloud" is determining *where* the tax should be imposed. The cloud has no fixed physical location. When it comes to taxing technology, the government always seems to be two steps behind—look at the current debates over taxing online retailers—so it's going to take some time before most states develop a system for taxing these cloud vendors.

2 A tax on carbon is going to hurt industries that rely on "old" energy sources—in the short term. Fortunately, if those tax dollars are invested in "clean" energy development, it will create a boom in those sectors. While there might be some short-term economic disruption, in the long-term, the economic results could actually be beneficial in terms of job creation and the growth of new industries.

3 The "double Irish" loophole is a complicated strategy that is likely used only by the most sophisticated of companies with substantial intellectual property assets—basically it involves transferring assets from one Irish subsidiary to another that is in a country without corporate income taxes. In the past, though controversial, the strategy has been legal. Eliminating these types of corporate tax loopholes might be just what we need to get these large companies to really push for comprehensive corporate tax reform here in the U.S.

Byrnes' Response

1 As Professor Bloink pointed out, in many states, the debate over taxing the cloud mirrors the debate over taxing online retailers—but the twist is that these cloud vendors are "physically present" in fewer states, because even when they provide software downloads, there is typically no need to physically ship an object—which is why online retailers such as Amazon have expanded their physical presence. I think the debate for cloud taxation could center upon where the end user is situated as more states begin to realize the size of the market here.

2 It all depends upon how the government *actually* uses those tax dollars! A carbon tax will increase the cost of producing goods—and those costs will be passed on to the American consumer. If the tax revenues were used to, say, reduce the marginal tax rate for lower and middle class taxpayers, this potential negative could be mitigated. All in all, I think the tax would create disruption, though, of course, in the hopes of a more promising future outlook.

3 The very existence of this type of strategy is just a symptom of the fact that the U.S. corporate tax system is out of line with the rest of the world. Treating the symptom does not eliminate the underlying issue—until the U.S. corporate tax system is fixed, these companies will simply search out alternative loopholes.

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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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