TAX FACTS INTELLIGENCE

The National Underwriter Company July 2014

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

In Focus: Case Study—Retirement Accounts

Most clients understand the tax benefits that can be realized by converting traditional retirement funds into Roth retirement funds, but many may not grasp the importance of deciding whether to convert to a Roth IRA or a Roth 401(k). The choice can not only impact the ability of the client to change his or her mind, but can actually determine whether or not the client is able to access the funds as needed prior to retirement. The considerations that must be analyzed in making the Roth IRA vs. Roth 401(k) choice are as varied as are the clients that will make the choice, so expert guidance is especially important in this area.

Your client, Joanne, is a relatively high-income taxpayer with a fairly consistent annual income of about $250,000. Despite this, Joanne is forty years old and has been focusing on paying down student debt, so only has about $75,000 worth of retirement savings in a traditional IRA. She knows that she likely will not retire for at least twenty-five years, but has read about the benefits of Roth conversions and would like to convert at least a portion of her retirement assets. Joanne has also heard of the expanded rules governing Roth 401(k) conversions and is uncertain which type of conversion would be most appropriate for her situation. How do you advise?

EXPERT ANALYSIS USING TAX FACTS ONLINE

Once a client has decided to move traditional retirement funds into a Roth account, choosing whether to convert to a Roth IRA or Roth 401(k) can have significant repercussions. While the typical goal of a Roth conversion—reducing tax liability during retirement—can be achieved with either account, that's where the similarities end and the real analysis into the most appropriate strategy for the particular client begins.

Joanne knows that she wants to contribute to a Roth account, but her income level makes it impossible for her to directly establish a Roth IRA. Tax Facts Online outlines the rules that generally apply to Roth accounts, including the strict income requirements that prevent high-income taxpayers from contributing to a Roth IRA. As discussed in Tax Facts Online Q 3607, in 2014, the ability to make contributions to a Roth IRA begins to phase out for married clients with income over $181,000 ($114,000 for single clients).

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Monthly Round-up

ANNUITIES

Tax Facts Q 7988. What are the tax benefits that can be realized by making a charitable donation using a charitable lead annuity trust?

PLR 201421023

The IRS recently found that distributions of annuity payments by irrevocable testamentary charitable lead annuity trusts (CLATs) that were made pursuant to charitable pledge agreements (funding agreements) that were executed in the past did not result in a finding that the taxpayers (who were disqualified persons) engaged in acts of self-dealing under IRC Section 4941.

In this case, the taxpayers were trustees of a private foundation that agreed to contribute a specified amount to a hospital as an annual annuity pursuant to a funding agreement executed between the foundation and the hospital. The taxpayers funded the CLAT, which was to satisfy the foundation's obligations under the funding agreement.

Because the taxpayers were both trustees of the foundation and substantial contributors to the CLAT, both were disqualified persons for purposes of the self-dealing rules that apply to these types of trust. These rules provide that self-dealing occurs if there is any direct or indirect transfer to, or for the benefit of, a disqualified person of the income or assets of the foundation, an excise tax would be applied to the transaction. This includes payments made to satisfy the obligations of the disqualified persons.

In this case, however, the fund agreement was between the foundation and the hospital, with the taxpayers acting only in their capacity as trustees. Because the payment obligation was actually the foundation's obligation, and did not legally obligate either of the taxpayers, the payment under the CLAT did not constitute self-dealing and no excise tax was imposed.

LIFE/HEALTH INSURANCE

Tax Facts Q 8005. What are the risk shifting and risk distribution requirements that allow a captive insurance arrangement to qualify for favorable tax treatment?

Revenue Ruling 2014-15

The IRS has issued guidance providing that an arrangement whereby an employer uses captive reinsurance funded by tax-deductible contributions to a voluntary employees' beneficiary association (VEBA) in order to fund retiree medical benefits will constitute insurance for purposes of IRC Subchapter L.

The employer's VEBA in this case purchased commercial health insurance. In order to reduce the costs of coverage, the commercial insurance carrier then entered into an agreement with the employer's wholly owned subsidiary pursuant to which the subsidiary would receive a premium and reinsure the commercial carrier's obligations to the VEBA's participants.

In order for a captive reinsurance arrangement to constitute insurance for tax purposes, it must demonstrate that the risk-shifting and risk-distribution elements of traditional insurance are present. In this ruling, the IRS found that these elements were present because it was the risks of the retirees and their dependents who were participating in the VEBA that were shifted and distributed among the larger group of participants.

This was the case because neither the employer nor the VEBA were obligated to provide the retiree medical benefits covered under the arrangement. The captive reinsurer, therefore, provided a benefit to these individual retirees, rather than to the employer or the VEBA itself.

Further, the reinsurance company was able to qualify as an insurance company because more than 50 percent of its annual business during the tax year involved the reinsurance of the retirees covered by the VEBA. As a result, the captive arrangement was entitled to the tax benefits typically afforded to insurance arrangements.

INVESTMENTS

Tax Facts Q 7986. What are the tax consequences if property is characterized as debt-financed property?

PLR 201418061

In general, if property is found to be debt-financed property, which is property held to produce income and with respect to which acquisition indebtedness exists at any point during the taxable year (or during the twelve month period preceding disposition of the property) certain items of income and deductions must be included in a company's calculation of unrelated business taxable income (UBTI).

Generally, a partner's share of interest, dividends or gains from the sale of property attributable to participation as a partner will be excluded from calculation of UBTI, unless the amounts are derived from debt-financed property.

Here, the taxpayer borrowed securities and purchased short and long positions in stock in order to minimize trading risks associated with these holdings. In order to effectuate the short sales, the taxpayer borrowed securities from a third party, but deposited as collateral cash and securities of an equal value to the borrowed securities.

The IRS found that this did not result in the characterization of the securities as debt-financed property because acquisition indebtedness is created through the borrowing of money, rather than property. Because none of the securities were to be purchased using borrowed funds, no acquisition indebtedness was created so that the income received as a result of this strategy would not constitute debt-financed property. Therefore, this income was not required to be included in UBTI.

RETIREMENT ACCOUNTS

Tax Facts Q 3526. What is a supplemental executive retirement plan (SERP)?

***Gill v. Bausch & Lomb*, No. 6:09-CV-6043 (MAT)**

A district court recently held that a company violated ERISA when it eliminated monthly installment payments under a supplemental executive retirement plan (SERP) in favor of lump sum payments because the directors who made the decision lacked authority to either determine the rights and benefits of plan participants or to act as fiduciaries under the plan. Further, in this case, the court found that because the SERP's terms provided for a reversion of excess assets to the company, the decision was impermissibly biased.

A SERP is a type of nonqualified deferred compensation arrangement that, as the name suggests, can be used by a company to provide executives with supplemental retirement income. These plans are often used by companies to help retain employees or to attract top talent, as they permit the company to provide tax-deferred benefits in excess of the contribution limits to which qualified plans are subject.

Unlike other types of plans, SERPs can provide additional retirement benefits to only a select group of highly paid employees. In this case, the three retired executives who brought suit were the only participants in the plan. Their monthly lifetime installment payments were funded by irrevocable secular trusts that the company argued could be terminated upon a change of control of the company. The court disagreed, finding that the company lacked the authority to terminate the SERP upon the change of control.

EMPLOYMENT BENEFITS

Tax Facts Q 3555. Are contributions to, and postretirement payments from, a deferred compensation plan subject to FICA and FUTA taxes?

Balestra v. United States, 2014 U.S. Claims LEXIS 448

The Court of Federal Claims recently found that a taxpayer was liable for FICA taxes imposed upon deferred compensation benefits to which he had a right to receive but, because of his employer's bankruptcy and the discharge of the obligation to pay the benefits, he would never actually receive.

Deferred compensation benefits, which generally create FICA tax liability, may be taxed under the IRC Section 3121(v)(2) special timing rule whereby the benefits are taxed according to their present value, which is calculated based upon the taxpayer's life expectancy and a discount rate to account for the time value of money. Importantly, however, this present value is not discounted to account for possibility that benefits will not be paid because a deferred compensation plan is unfunded.

In this case, the taxpayer's deferred compensation benefits were included in his taxable wage base in the year of his retirement under the special timing rule discussed above. As a result of the employer's bankruptcy, the majority of the benefits were never paid.

The court rejected the taxpayer's argument that Congress' must have intended this special timing rule to apply to taxpayers who employed the accrual basis accounting method, which would allow the benefits to be taxed prior to receipt, but would also allow for an adjustment upon determination that the benefits would never be received. Though the court recognized that while Congress may choose to adopt such a system, it noted that the statute, which is silent on the issue of adjustments, must be upheld as written.

ESTATE PLANNING/TAXATION

Tax Facts Q 3866. When may a surviving spouse make a rollover contribution?

PLR 201423043

The IRS recently ruled that a decedent's Roth IRA would not be treated as an inherited IRA and, because the decedent's surviving spouse was the sole trustee of the decedent's trust, which was beneficiary of the Roth IRA, she was entitled to roll the Roth IRA funds into a Roth IRA opened in her own name.

Here, the decedent designated his trust as beneficiary of his Roth IRAs. Upon his death, the surviving spouse was given full power to determine both how the decedent's assets were allocated between two newly created trusts and how the assets would be distributed from these trusts.

Generally, if a decedent's IRA funds are paid to a trust, which in turn pays the funds to the surviving spouse as trust beneficiary, the surviving spouse is treated as receiving the funds from the trust and not from the decedent, rendering her ineligible to roll the distributed IRA funds into her own IRA.

However, in this case the general rule did not apply because the surviving spouse was the sole trustee of the trust and had complete authority to distribute the IRA proceeds to herself. As a result, she was entitled to roll the funds into her own Roth IRA pursuant to the general rules that require a trustee-to-trustee transfer be affected within sixty days of the distribution.

FEDERAL INCOME TAXATION

Tax Facts Q 7778. What exclusion is available for gain on the sale of a principal residence?

***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.**

Limits to Converting Rental Property into a Primary Residence to Plan for IRC Section 121 Capital Gains Exclusion

The exclusion of up to $500,000 of capital gains on the sale of a primary residence under IRC Section 121 is one of the most generous tax preferences available under the tax code, due in no small part to the fact that most people only have occasion to sell their home and harvest such gains a few times in a lifetime.

However, for those who also invest in rental real estate, the capital gains exclusion on the sale of a primary residence creates an appealing tax planning opportunity – to convert rental real estate *into* a primary residence, in an effort to take advantage of the capital gains exclusion to shelter *all* of the cumulative gains associated with the real estate. And since the Section 121 exclusion can be used as often as once every two years, the planning opportunity is quite significant for those with large rental real estate holdings.

To prevent abuse of this planning scenario, Congress has enacted several changes to IRC Section 121 over the past fifteen years, preventing depreciation recapture from being eligible for favorable treatment, requiring a longer holding period for rental property acquired in a 1031 exchange, and more recently forcing gains to be allocated between periods of "qualifying" and "nonqualifying" use. Nonetheless, some opportunities remain for real estate investors who do have the flexibility to change their primary residence in an effort to shelter capital gains on long-standing real estate properties.

Rules for Excluding Gain on Sale Of Residence

The Taxpayer Relief Act of 1997 created IRC Section 121, which allows a homeowner to exclude up to $250,000 of gain on the sale of a primary residence (or up to $500,000 for a married couple filing jointly). In order to qualify, the homeowner(s) must own *and also use the home as a primary residence* for at least two of the past five years. In the case of a married couple, the requirement is satisfied as long as *either* spouse owns the property, though *both* must use it as a primary residence to qualify for the full $500,000 joint exclusion.

Notably, the use does not have to be the *final* two years, just any of the past two-in-five years that the property was owned. Thus, for instance, if an individual bought the property in 2010, lived in it until 2012, moved somewhere else and tried to sell it, but it took two years until it sold in 2014, the gains are still eligible for the exclusion because in the past five years (since 2010) the property was used as a primary residence for at least two years (from 2010-2012). The fact that it was no longer the primary residence *at the time of sale* is permissible, as long as the two-of-five rule is otherwise met.

If a sale occurs and it has been less than two years, a partial exclusion may still be available if the reason for the sale is due to a change in health, place of employment, or some other "unforeseen circumstance" that necessitated the sale. In such scenarios, a pro-rata amount of the exclusion is available; for instance, if an individual had to sell the home after eighteen months instead of the usual twenty-four, the available exclusion would be 18/24ths multiplied by the $250,000 maximum exclusion, which would provide a $187,500 maximum exclusion (which will likely still be more than enough, as it's unlikely that the gain would be more than this amount unless it was an extremely large house!).

To the extent that a property is *highly* appreciated, and there is a gain in excess of the available exclusion. The gain will be subject to the usual capital gains brackets, including the new top 20 percent rate and the new 3.8 percent Medicare surtax, if total income is high enough for the capital gain to fall across the applicable thresholds.

Example 1. Max and Jenny, a married couple, bought a home decades ago for $250,000, and are now selling it for $900,000. Their total gain is $650,000, and they have easily met the two-of-five ownership-and-use requirement. As a result, they can exclude $500,000 of the capital gains. The remaining $150,000 capital gain – eligible for long-term capital gains treatment, as the holding period is far beyond the twelfth -month requirement – will be reported on their tax return as a normal long-term capital gain, subject to the usual tax rates (and potential 3.8 percent investment income surtax) that may apply.

The capital gains exclusion is only allowed once every two years. Thus, the partial exclusion still cannot be used if another exclusion had been claimed for another sale in the past twenty-four months, and in the event of a married couple the full $500,000 exclusion is only available as long as *neither* spouse has used it in the past two years (if one spouse sold a home recently and the other did not, the second spouse can still use his/her individual $250,000 exclusion). On the other hand, as long as "no more than once every two years" requirement is met, there is no limit on home many times an individual can take advantage of the primary residence capital gains exclusion throughout their lifetime!

Converting a Rental Property into a Primary Residence

For most people, the exclusion of capital gains on the sale of a primary residence is something that only comes along a

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Expert Analysis from page 1

Roth IRA contributions are completely blocked for married clients who earn over $191,000 and single clients who earn over $129,000. As a result, the only way that Joanne could contribute to a Roth IRA is through a conversion.

One important characteristic of a Roth IRA conversion that might be particularly applicable because of the relatively small pool of assets that Joanne currently has invested in her IRA is the client's ability to undo the transaction through a recharacterization transaction. A recharacterization allows her to change her mind and move the funds back into the traditional account, eliminating the tax liability that the initial conversion created. This option is unavailable if Joanne chooses to convert to a Roth 401(k).

If her account performs poorly in the months after the conversion takes place, or if she otherwise finds that she can't pay the tax bill that results from the Roth conversion, she has until October 15 of the year following the conversion to recharacterize the funds. Once a Roth 401(k) conversion takes place, however, Joanne would be required to pay the associated taxes regardless of any events that occur post-conversion—an outcome that could potentially reduce the value of the conversion significantly.

Further, if Joanne converts to a Roth IRA she is able to escape the IRS' required minimum distribution (RMD) rules so that the funds in the account are permitted to grow tax-free over a longer period of time. Because Joanne will not retire for many years, this would allow her to accumulate a powerful nest egg that she could draw upon later in retirement, especially since she has the ability to continue building her traditional retirement accounts for many years before she actually retires.

Clients who use Roth 401(k)s, on the other hand, are required to comply with the RMD rules when they turn 70½, possibly reducing the account's growth potential if the client doesn't need to access the funds. If Joanne plans to use the Roth account as a wealth transfer vehicle, she may also prefer the Roth IRA because the entire account value can be passed to her heirs upon her death.

If Joanne anticipates that she will need access to the funds before retirement, she should also consider how the application of the "five year rule" could impact the tax-free availability of these funds. To access the funds, a qualifying event must have occurred *and* the Roth must be at least five years old before a qualified distribution is permitted. However, if Joanne has multiple Roth IRAs, only *one* of the IRAs must be five years old before a tax-free withdrawal is permitted. With a Roth 401(k), the particular account must be five years old or a penalty tax will apply.

Importantly, when a high-income client such as Joanne converts an IRA to a Roth IRA, post-conversion contributions will be limited or blocked entirely because of the income limits that apply to Roth IRA contributions (but not to Roth 401(k) contributions). Therefore, if Joanne wishes to contribute directly to the Roth account after the conversion, a Roth 401(k) conversion is the only option.

Stronger creditor protection rules also apply to Roth 401(k) accounts. While Roth IRAs are protected under state law, the rules that apply in some states offer much less in the way of creditor protection than can be found in others. Roth 401(k)s are always protected by ERISA-mandated federal creditor protection rules regardless of where the client lives.

Many considerations apply in determining whether a Roth IRA or Roth 401(k) conversion is most appropriate for any given client's situation. It is important to analyze all aspects of the individual client's financial picture and goals before deciding which type of conversion is most appropriate for the particular client.

OPINION—Thumbs Up/Thumbs Down

What are your thoughts on:

1. The pending Supreme Court review of whether one state can tax income earned by a taxpayer in another state?
2. The 2015 budget proposal that would require tax-free RMDs for Roth IRAs?
3. The impact of states' opting out of employee choice for the SHOP exchanges, so that only one tier of health plan would be available through SHOP in those states?

Bloink's Response

1 If a state can tax income earned by its residents in other states, absent a tax credit for out-of-state income taxes actually paid on the income, taxpayers will always be taxed twice at the state level if they earn income in multiple states. It seems much more equitable to only allow taxation in the state where the income was earned.

2 One of the most attractive features of a Roth IRA is that these funds can remain in the account, growing on a tax-preferred basis, for as long as the account owner wishes. Removing this feature eliminates one of the most powerful incentives that taxpayers have to make use of an important retirement planning tool.

3 States are permitted to offer only a single tier of coverage through their SHOP exchanges if the insurance commissioner can show that the limited choice is in the best interest of small businesses and their employees. It seems that many states might opt to offer only one tier of coverage only because it's much more simple to implement, on a technological level. If the technology isn't ready, it might make sense to offer less choice—as opposed to postponing the opening of the SHOP exchanges completely.

Byrnes' Response

1 Allowing a state to tax only income that was actually earned in that state might result in the loss of state tax revenue, but it also results in a system that is simple and fair. Taxpayers avoid paying state taxes twice and don't have to wonder whether their particular state government provides a tax credit for the second state tax on out-of-state income.

2 Roth IRAs are still retirement accounts, but many taxpayers have used these accounts as estate planning vehicles because they're never actually *required* to take distributions. Requiring tax-free distributions still allows taxpayers to plan for tax-free income during retirement, thus making it much more likely that Roths will be used for their intended purpose.

3 The whole point of the SHOP exchanges is to allow small business owners to offer their employees a choice of health plans. Failing to offer multiple tiers of health coverage basically renders the employee's choice meaningless because they're forced to choose between health plans that essentially offer the same level of coverage. Where's the incentive for small business employees to use these exchanges if the most appropriate coverage may be unavailable?

Federal Income Taxation from page 5

few times throughout their lifetime, as individuals and couples move from one home to the next as they pass through the stages of life. However, because the exclusion is available as often as once every two years, some homeowners may even try to sell and move and upgrade homes more frequently, to continue to "chain together" sequential capital gains exclusions on progressively larger homes (presuming, of course, that the real estate prices continue to rise in the first place!). However, in some cases taxpayers decided to go even further, taking long-standing rental property, moving into it as a primary residence for two years, and then trying to exclude *all* of the cumulative gains from the real estate (up to the $250,000/$500,000 limits), even though most of the gain had actually accrued prior to the property's use as a primary residence! The opportunity is especially appealing in the context of rental real estate, as the potential capital gains exposure is often very large, due to the ongoing deductions for depreciation of the property's cost basis that are taken along the way.

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

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Welcome

The National Underwriter Company is proud to present our *Tax Facts Intelligence*. Our focus has always been to bring you the most up-to-date relevant information regarding tax topics relating to the insurance market. Tax Facts continues its long tradition of providing our readers with useful and practical discussion.

FORMAT

Our format is based on what our readers find the most valuable. We include in each new issue a case study based on a real world example. Each case study will be analyzed by tax professionals so that readers may see opposing views with regard to tax planning. Further, each case study will be accompanied by a how-to guide on where to find the answer in Tax Facts print and online versions.

SEVEN TOPICS OF INTEREST

Our format will also include recent tax developments related to seven core subjects. These subjects will always be listed on the first page for easy reference.

OPINION BY BLOINK AND BYRNES

You've probably heard of "thumbs up-thumbs down" in the entertainment context. Tax Facts is an industry leader in tax analysis, and as such is breaking new ground with its dual professor tax debate. Professors Robert Bloink, J.D. and Assoc. Dean William Byrnes, J.D., will provide commentary on various tax topics.

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