TAX FACTS INTELLIGENCE

The National Underwriter Company June 2014

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

In Focus: Case Study—Health Insurance

It's no surprise that clients today are confused about their health savings options—the wide variety of health savings vehicles that are available, coupled with the evolution of the health care marketplace in general under the Affordable Care Act (ACA), make this planning area complex for even the most financially sophisticated clients.

Your client, Daniel, is an unmarried taxpayer who is evaluating his health care options in light of the new high deductible health plan (HDHP) that he enrolled in during the recent ACA open enrollment period. He currently participates in a health flexible spending arrangement (FSA), but, because this is the first time he has been enrolled in a HDHP, he thinks he may now be eligible to participate in a health savings account (HSA). However, Daniel is confused as to how participation in an HSA will impact his FSA (and vice versa) and has also heard that his employer may be implementing a new carryover provision that will affect his FSA funds. In light of all of the recent changes under the ACA, he comes to you for advice in maximizing the tax benefits that can be achieved through his healthcare planning. How do you advise?

EXPERT ANALYSIS USING TAX FACTS ONLINE

The Affordable Care Act has made the maze of HDHPs, HSAs, HRAs and FSAs more complicated than ever to navigate—especially because of the fact that more taxpayers have recently obtained coverage under HDHPs and, thus, have become eligible to participate in HSAs perhaps for the first time. Contrary to some clients' beliefs, participating in certain types of health savings plans can actually prohibit a taxpayer from participating in other types of plans—so proper advice can be critical to maximizing the tax benefits for any given client.

Both Tax Facts Online and recently issued IRS guidance can help clients in this complex planning area. Tax Facts Online Question outlines the basic HSA contribution rules, and tells us that Daniel is eligible to contribute up to $3,300 tax-free dollars for 2014 (the amount would increase to $6,500 if he maintained family health coverage) to an HSA.

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Monthly Round-up

ANNUITIES

Tax Facts Q 426. When can the holder of a variable annuity be taxed currently on the income generated by the assets underlying the contract?

PLR 201417007

The IRS recently ruled privately that holders of variable annuity contracts would not be taxed on the income generated by the investments underlying those contracts because it was the insurance company, and not the holders themselves, who exercised investment discretion and control so as to be treated as owners of those underlying assets.

While the owner of an asset is generally the entity that holds legal title to that asset, in the case of a variable annuity contract, if the holder of the contract possesses sufficient incidents of ownership over the assets supporting the contract, that holder will be treated as the owner for tax purposes. If the contract holder is treated as owning the underlying assets, the tax deferral benefits generally provided by the variable annuity are lost and the owner is taxed currently on the income generated by those assets.

A contract holder will be treated as the owner of the assets underlying a variable annuity if the holder has investment control over those assets that is similar to the control that would be present if the holder invested directly in the assets, rather than using the variable annuity as an intermediary.

In this case, while the holder had the power to allocate his or her premium between various investment account options, an independent investment advisor made all of the investment decisions involving the actual assets underlying each investment option. As a result, the holders of the variable annuity contracts did not have sufficient investment discretion so as to lose the benefit of the annuity's tax deferral.

LIFE/HEALTH INSURANCE

Tax Facts Q 8005. What risk shifting requirements must be satisfied in order for an arrangement to qualify as "insurance" for tax purposes?

Rev. Rul. 2014-15

According to the IRS, an arrangement whereby a corporation uses a subsidiary as a conduit for funding health insurance benefits paid by a voluntary employees' benefits association (VEBA) constitutes insurance for income tax purposes because the "risk shifting" element of insurance is present.

In this case, the corporation contributed to the VEBA to provide voluntary health benefits to retired employees and their dependents. The VEBA, in turn, entered into a contract with an insurance company that was to reimburse the VEBA for the medical claims it paid. The insurance company then entered into a contract with the corporation's wholly owned subsidiary pursuant to which the subsidiary reinsured 100 percent of the insurance company's liabilities to the VEBA.

Despite the fact that the subsidiary's only business activity was comprised of reinsuring the insurance company in this case, the IRS found that the risk shifting element of insurance was present because the "risk" at issue was the retirees' risk of incurring medical expenses. It is this risk that was shifted in the transaction, rather than the risk to the corporation or the VEBA.

RETIREMENT ACCOUNTS

Tax Facts Q 3776. What special rules apply to plans that are subject to QJSA and QPSA spousal benefit requirements?

Notice 2014-19

The IRS has recently released guidance that clarifies the timing requirements for applying previously issued guidance generated from the *Windsor* decision to retirement plans. Importantly, any necessary amendments to plan documents must be made no later than December 31, 2014.

For the time period beginning on June 26, 2013 through September 15, 2013, plans are required to recognize same sex spouses under the "state of domicile" standard—meaning that same sex couples must only be recognized if they are both legally married and reside in a state that recognizes same sex marriage. On or after September 16, 2013, plans must comply with the "state of celebration" standard, which requires that the plan recognize legally married same sex couples regardless of whether the state of domicile recognizes same sex marriage.

Plan documents must be amended to comply with these timing requirements, and also to remove any distinctions between same sex and opposite sex spouses, including any references to "husband/wife" or Section 3 of DOMA (which defined marriage as a legal union between a man and a woman). Plans can optionally be amended to apply equally to same sex spouses before the deadlines discussed above.

EMPLOYMENT BENEFITS

Tax Facts Q 3958. What benefits can a 501(c)(9) trust ("VEBA") provide?

PLR 201415011

The IRS has ruled privately that a VEBA will not lose its tax-exempt status for providing benefits in the form of health reimbursement arrangement (HRA) participation to employees' non-dependent domestic partners if the amount of such benefits does not exceed 3 percent of the total amount of benefits provided by the VEBA in any tax year.

Treasury Regulation Section 1.501(c)(9)-3(a) provides that a VEBA will not qualify for tax-exempt status if it knowingly provides more than a "de minimis" level of certain impermissible benefits, including benefits to individuals who are not members or their dependents.

Here, the VEBA proposed to (1) provide HRA benefits to non-domestic partners that would not exceed 3 percent of the total amount of benefits paid by the VEBA and (2) pay the corresponding FICA, FUTA and federal income tax withholding resulting from an employee's election of non-dependent domestic partner coverage.

The IRS further ruled that the fair market value of the HRA coverage provided to a non-dependent domestic partner would be included in the employee's gross income. However, payments and reimbursements provided as HRA benefits are not includable in either the employee's or the domestic partner's gross income to the extent that the fair market value of the value of HRA coverage provided to the domestic partner was included in the employee's income.

INVESTMENTS

Tax Facts Q 7517. How does a taxpayer's holding period in an investment impact its tax treatment?

***By Michael Kitces,* MSFS, MTAX, CFP, CLU, ChFC, partner and director of research for Pinnacle Advisory Group, a private wealth management firm in Columbia, Maryland.**

...continued from last month's Tax Facts Intelligence.

Are the Tax Deferral Benefits of Low Turnover Investment Strategies Overstated?

How Dividends Further Reduce Tax Deferral

Of course, a major caveat to the scenario described in last month's Tax Facts Intelligence is that it assumes the stock that is held pays no dividends whatsoever. While this may conceivably be true for certain high-growth stocks, ostensibly most investors will hold a more broadly diversified portfolio (or an index fund outright), which means a portion of ongoing growth will be attributable to dividends, not just capital gains. While dividends can be reinvested over the long run, the caveat to the payment of dividends is that they are taxable immediately. Thus, in essence, an investment that pays ongoing dividends in lieu of simply appreciating grows somewhat more slowly, as the dividends that are paid are taxed before they can be reinvested, not unlike turning over capital gains (and given current qualified dividend treatment, taxed similar to long-term capital gains as well).

Yet *any* level of portfolio turnover that triggers taxation of ongoing growth - including in the form of stocks that pay ongoing dividends - reduces the pace of tax-deferred growth. Even with a portfolio that will otherwise be held without any sale for thirty years, the mere fact that growth is a combination of a 2.5 percent dividend and 7.5 percent annual appreciation (where dividends are taxed annually by growth is not taxed until the end) reduces the final after-tax account value to only $1,402,622. By contrast, the fully tax-deferred account was worth $1,498,199, a difference of $95,577.

The impact of even a modest rate of ongoing dividends is significant. More than 25 percent of the loss in the value of tax deferral benefits (the difference between the 0 percent no dividend and 100 percent turnover portfolios) is attributable to the mere presence of the 2.5 percent dividend. When including a 10 percent turnover rate, more than 2/3rds of the "damage" has already been done. A portfolio with a 2.5 percent dividend and 20 percent turnover has already foregone almost 85 percent of the entire benefit of tax deferral! Or stated in the context of the 0.9 percent/year of annualized growth benefit of tax deferral over the thirty year time horizon, the benefit drops to only 0.7 percent/year due to the presence of dividends, and a mere 0.33 percent with dividends and a 10 percent turnover rate. Or viewed another way, reducing turnover from 100 percent (annual) to 10 percent (once a decade) still only accrues a benefit of 0.33 percent/year of additional growth even after thirty years!

And of course, part of the benefit attributable to the tax deferral is a result of what some consider to be a "generous" historical market return. If the dividend rate remains 2.5 percent but the appreciation rate is trimmed to only 5 percent (implying an expected equity total return of 7.5 percent/year in the future), the result is changed.

In this scenario, the total wealth is reduced (lower growth rate), as is the benefit of tax deferral is reduced in the first place (with less growth, there's less value to deferred taxation); the difference in wealth between 100 percent and 0 percent turnover is only 0.6 percent/year of annualized growth after thirty years. In addition, the consequences of even just a modest dividend and a small amount of turnover are even more severe. The presence of the dividend alone results in a loss of more than 1/3rd of the entire value of tax deferral, and the inclusion of a mere 10 percent turnover rate results in a loss of almost 3/4th of the entire tax deferral benefit; or viewed from the opposite end, once we include a mere 10 percent turnover and a 2.5 percent dividend, the entire value of tax deferral (over just having 100 percent turnover) is no more than 0.18 percent of annualized growth after thirty years, and only accounts for about 1/4th of the tax deferral benefits in the first place!

Practical Implications For Investors: Low Turnover Is Overrated?

The practical implications of these results are significant: notwithstanding common wisdom, there is remarkably little value to reducing portfolio turnover, unless it can be reduced all the way to *zero*. The presence of even the most modest of turnover - a portfolio that is changed *but once a decade* - forfeits over half the benefit of tax deferral, reduced even further by the presence of dividends, and further still in an environment with lower returns. Similarly, the benefit of shifting from 50 percent turnover to 20 percent turnover - normally considered quite significant, as that would increase the average holding period of an investment from two years to five years(!) - is no more than ten basis points of annualized growth over a multi-decade time horizon. By contrast, a 10bps difference could be made up by one day's worth of relative return improvement by making an investment change, and even just switching to a similar investment with a lower expense ratio every few years can more than recover the entire benefit of tax deferral in the first place!

The significance of the tax drag of *any* level of turnover also potentially impacts decisions like asset location as well. Given how limited the value of tax-deferral actually is for a relatively low turnover dividend-paying portfolio, the results suggest that equities perhaps deserve a greater weighting towards tax-deferred retirement accounts than is commonly acknowledged, as the real benefits of tax deferral in a brokerage account are limited. If the tax deferral period is long enough - and returns are high enough - the benefits of equity tax deferral can even overwhelm the fact that the gains are "converted" to ordinary income, especially given that the benefits of asset locating bonds in a tax-deferred account are even more limited given today's low bond yields.

The bottom line, though, is simply this: unless equity investments will truly be held indefinitely with 0 percent turnover... and have little or no ongoing dividends... the true economic value of tax deferral for a low-but-not-zero turnover portfolio is quite limited. In turn, this suggests that investors should be highly cautious not to sacrifice prudent investment decisions upon the altar of low-turnover tax efficiency, as even the slightest differences in cost or relative return can easily trump the tax deferral benefit itself (though obviously, racking up transaction costs is still a return drag, and converting long-term capital gains into short-term gains has additional adverse effects. Nonetheless, the next time you're weighing the benefits of tax deferral against a prospective investment change, think twice about whether it's really worthwhile to try to defer those capital gains out to the future if there's a legitimate investment reason to make a change now. In this situation, the tax tail wagging the investment dog is unlikely to be worth it, as the real value of deferring capital gains is actually far less than most people think.

ESTATE PLANNING/TAXATION

Tax Facts Q 617. When will property held in trust qualify for the marital deduction?

ILM 201416007

The Tax Court recently found that a taxpayer is not entitled to claim the marital deduction with respect to her spousal elective share to the extent that the elective share is satisfied by assets held in trust for the benefit of the decedent's child.

In this case, the decedent established a trust for the benefit of both himself and his adult child and transferred all of the shares of several companies that he owned into that trust. Upon his death, the surviving spouse asserted her right to her elective share of the decedent's assets under state law. Assets held in the trust were used to satisfv this elective share.

The court found that a marital deduction is only allowable to the extent that the surviving spouse inherits the property from the deceased spouse as beneficial owner. Here, the decedent's child inherited the interests from the decedent as beneficial owner. As a result, even though the surviving spouse was entitled to a share of the assets under state law, she could not acquire beneficial ownership of the assets because her right to the elective share was enforceable only under state law.

Therefore, she was not entitled to claim the marital deduction with respect to the portion of the elective share that was satisfied using trust assets.

FEDERAL INCOME TAXATION

Tax Facts Q 7716. How are partnership distributions made to a limited partner taxed?

***Seismic Support Services v. Commissioner*, TC Memo 2014-78**

The Tax Court recently ruled that payments received by a taxpayer through his LLC were guaranteed payments, rather than partnership distributions, that gave rise to ordinary income tax liability because the payments were made without regard to the partnership's income and were

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made in exchange for the taxpayer's services, not for the use of partnership capital.

In this case, after the taxpayer's employer refused to treat him as an independent contractor, the taxpayer resigned and formed an LLC through which he could perform the same services as a subcontractor for his former employer. The taxpayer received all payments for these services through the conduit LLC, which was taxed as a partnership, and labeled them as partnership distributions—arguing that the payments were made in exchange for the use of capital.

The IRS disagreed with this characterization and instead reasoned that these payments represented guaranteed payments for services under IRC Section 707(c) and, therefore, generated ordinary income tax liability. The Tax Court agreed with the IRS, finding that the taxpayer here performed all services on behalf of the LLC, employed no employees and could not present any evidence that the payments, which were determined without regard to the partnership's income, were made in exchange for the use of partnership capital. As a result, the taxpayer was required to include the payments in calculating his ordinary income tax liability.

Expert Analysis from page 1

Q 3514 discusses the FSA contribution limit, which is capped at $2,500 per year. Both types of accounts provide for tax-free distributions in order to pay for qualified medical expenses.

However, as Tax Facts Q 352 and new guidance issued by the IRS explain, taxpayers who participate in general purpose FSAs, which are structured to reimburse any of the taxpayer's qualified medical expenses, are ineligible to also contribute to HSAs because participation in the FSA constitutes "other coverage" that is prohibited by the rules applicable to HSAs (see below). This may become confusing because of the new rule permitting $500 of unused FSA funds to be carried over for use in the following tax year—HSA ineligibility continues even if the individual only participates in the FSA during the tax year because of a permitted carryover from the prior year.

In order to be eligible to contribute to an HSA, a taxpayer must be covered by a HDHP, but can also have certain other types of permitted insurance and coverage, including preventative care coverage, but not what is deemed "other coverage." For example, a taxpayer is not eligible to contribute to an HSA if he or she is also covered under a health plan that is not an HDHP, but that provides coverage for any benefit covered under the HDHP. Daniel's general purpose FSA, which reimburses him for *all* qualified medical expenses, falls within this prohibition.

This is the result even if he only participates in the FSA for the year because of a carryover of FSA funds from the preceding tax year. The ineligibility for HSA contributions continues throughout the entire tax year, even if the carried over amounts are exhausted early in the year.

Despite this, Daniel may still be eligible to participate in both an HSA and an FSA if he has access to an FSA that is not a general purpose FSA—if he can elect to have unused FSA funds carried over into an HSA-compatible FSA (which is either a limited purpose FSA that covers only specific medical expenses, a post-deductible FSA or a combination of the two), he will also be eligible to contribute to an HSA for the year.

As a result of the contribution limits discussed above, if Daniel is only eligible to participate in a general purpose FSA, he may be best advised to contribute to an HSA instead because of the higher limits applicable to HSAs. However, if he has access to a limited purpose FSA, since he is covered by a HDHP, he may be eligible to contribute to both types of account once the plan year for his general purpose FSA has ended and he has exhausted all remaining funds.

OPINION—Thumbs Up/Thumbs Down

What are your thoughts on:

1. The impact of the expiration of the R&D credit on corporate earnings?
2. A proposal to prohibit retroactive imposition of employment taxes based on guidance from the IRS that clarifies an individual's employment status?
3. The recent IRS announcement that 2014 and 2015 will be a period of "no action" transitioning for purposes of enforcing FATCA?

Bloink's Response

1 Corporations that invest heavily in R&D are unfortunately still left wondering whether this tax credit will be reinstated for 2014, and it's difficult for these companies to grow if they can't be sure how much of their budget must be earmarked for taxes. While the uncertainty surrounding this credit cannot take the full blame for lower than expected growth in Q1 earnings, what is certain is that allowing this credit to expire hasn't helped.

2 It seems like this proposal will remove the "punishment" for wrongly classifying workers that the retroactive imposition of employment taxes accomplishes. The basic rules for establishing employment classification have been around for years, and if there's no incentive for employers to comply with these rules, it seems like worker misclassification could become much more widespread.

3 A transition period is completely necessary for a regime as complicated and far-reaching as FATCA. Full enactment of the rules has already been delayed several times, and at this point, it's likely to be most effective if the rules are put into place—as long as the IRS actually issues constructive guidance during the transition period.

Byrnes' Response

1 Allowing the availability of these extender provisions to remain up in the air creates a burden for corporations and individuals alike. Corporations have been faced with a choice between suspending R&D activities (and cutting the jobs that R&D supports) and slashing some other program in order to make up the difference in their tax bill if the credit isn't extended. It's a guessing game that will almost always result in lost jobs, and that's no way for a corporation to generate reliable earnings.

2 The ACA rules have brought worker classification into the spotlight and the line between an employee and independent contractor is fine—the inquiry is so fact intensive that many genuinely do not know that they've crossed the line. This proposal would give employers an incentive to actually get it right, removing the possibility that they could be liable for years' worth of back taxes.

3 I agree with Professor Bloink on this one. FATCA has met many roadblocks along the way and it's time for the rules to finally become effective. However, once compliance begins, additional complications are bound to arise, and a transition period presents the perfect opportunity for resolving these issues without negative repercussions for institutions and individuals who are genuinely trying to comply.

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Welcome

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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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