

Solving the annuity puzzle



Americans hold billions of dollars in annuities, yet they are widely misunderstood. Used properly, an annuity can serve valuable purposes in personal financial planning. On the other hand, some types of annuities are widely criticized, even scorned, by some financial advisers.

Lifelong income

What might be considered the purest type of annuity is a contract with an issuer, often an insurance company, for a stream of cash flow. Such contracts have been called immediate annuities, although they now may be labeled income annuities or payout annuities because those labels may be more appealing to consumers.

Example 1: Marie Jenkins pays \$100,000 to an insurer for an income annuity. Every month thereafter the company sends Marie a check.

That may sound simple, but complications soon arise. Does Marie want to receive those checks for her lifetime, no matter how long that might be? Does she want the checks to continue to her husband Tony if he outlives Marie? A joint annuity will pay less than a single life annuity because the insurer has more risk of an extended payout.

This type of annuity has a great advantage: the promise of lifelong cash flow. More people are living into their 90s and beyond, so a lifetime annuity can help keep them from running short of money in very old age.

At the same time, Marie may worry that she'll pay \$100,000 for this annuity and get run over by the proverbial truck the next month, ending her life and stopping the payments after a scant return. Even with a joint annuity, both Marie and Tony could die prematurely after receiving much less than the \$100,000 outlay.

Adding certainty

Insurers have come up with various methods of addressing these fears. One method is the period certain annuity.

Example 2: Marie pays \$100,000 for a single life income annuity that includes a 10-year period certain. If Marie lives for 25 years, the insurer will keep sending her checks. However, if Marie dies after 3 years of payments, the annuity will continue for another 7 years to a beneficiary named by Marie.

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Annuity sales

Annuity sales in 2017 topped \$200 billion.

Trusted advice

Taxation of annuity payouts

- Periodic annuity payments are amounts paid at regular intervals—weekly, monthly, or yearly—for a period of time greater than one year.
- Between the simplified and general methods of computing income tax on such payments, you must use the general method if your annuity is paid under a nonqualified plan, rather than under a qualified plan such as a 401(k) or an IRA.
- With the general method, you determine the tax-free part of each annuity payment based on the ratio of the cost of the contract to the total expected return.
- The expected return is the total amount you and other eligible recipients can expect to receive under the contract, as per life expectancy tables from the IRS.
- Our office can help you make the required calculation.

Again, an annuity with this type of guarantee will produce smaller checks than a straight life annuity because the insurer has more risk. Other features may be added to an income annuity, such as access to principal, but all of these variations will reduce the amount of the checks paid to consumers.

Annuity taxation can also be complex. If this type of annuity is held in a taxable account, part of each check to Marie will be taxable, but part will be a tax-free return of her investment (see **Trusted advice** box.) Eventually, after Marie has received her full investment tax-free, ongoing checks will be fully taxable.

Later rather than sooner

Some annuities start distributing cash right away, as described, but others are deferred. The deferral could be a wait for some years until an income annuity starts.

Alternatively, there may be some provision for the invested amount to grow untaxed until the payouts start. These annuities may peg growth to a promised interest rate or to results in the financial markets. Often, there

is some type of guarantee from the insurer of a minimum return or protection against loss. The manner of future payouts can be left up to the consumer.

Example 3: Marie invests her \$100,000 in a deferred annuity taxable account. That \$100,000 investment might grow over the years. At some point, Marie can “annuitize” the contract using her account balance to fund an income annuity. As mentioned, Marie’s payments then will be part taxable and part an untaxed return of her investment.

As an alternative, Marie can avoid annuitizing the contract. Instead, she can withdraw money from her account balance for cash flow when she wants it. Some annuities guarantee certain withdrawal amounts. Annuity withdrawals may be fully taxable, and a 10% penalty also may apply before age 59½.

Critics charge that some annuities, especially deferred annuities, can be complex, illiquid, and burdened with high fees. Read the fine print of any annuity before making a commitment.

The new tax law will change divorce tactics

When couples divorce, financial negotiations often involve alimony. The tax rules regarding alimony were dramatically changed by the Tax Cuts and Jobs Act (TCJA) of 2017, but existing agreements have been grandfathered. In addition, the old rules remain in effect for divorce and separation agreements executed during 2018. Next year, the rules will change, and the roles will be reversed.

Under divorce or separation agreements executed in 2018, and for many years in the past, alimony

payments have been tax deductible. Moreover, these deductions reduce adjusted gross income, so they may have benefits elsewhere on a tax return. While the spouse or former spouse paying the alimony gets a tax deduction, the recipient reports alimony as taxable income.

Shifting into reverse

Beginning with agreements executed in 2019, there will be no tax deduction for alimony. As an offset, alimony recipients won’t include the payments in income.

Example 1: Joe and Kim Alexander get divorced in 2018. Joe expects to be in a 35% tax bracket in the future, whereas Kim anticipates being in a 22% bracket. Suppose that the proposed agreement has Joe paying \$3,500 a month (\$42,000 a year) in alimony.

Joe will save \$14,700 in tax (35% times \$42,000), but Kim will owe \$9,240 (22% times \$42,000). Net, the couple will save over \$5,000 per year in taxes. This type of calculation will affect the negotiations, as it has in the

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past. Assuming the relevant rules are followed, it may make sense to tip the agreement toward Joe paying alimony to Kim, perhaps in return for other considerations.

Example 2: Assume that the Alexanders' neighbors, Len and Marie Baker, have identical finances. They divorce in 2019. If Len pays \$42,000 a year in alimony, he will get no deduction and won't get the \$14,700 in annual tax savings that Joe did in example 1. Marie, on the other hand, will pocket \$42,000, tax-free, without the \$9,240 tax bill faced by Kim in example 1.

Moving things along

Just as people shouldn't "let the tax tail wag the investment dog," so taxes shouldn't dominate divorce or separation proceedings. However, it's also true that taxes shouldn't be ignored. If you are in such a situation, our office can help explain to both parties the possible savings available from executing an agreement during 2018, rather than in a future year.

The new rules will be in effect beginning in 2019. With no alimony deduction and a tax exemption for alimony income, it may be desirable to consider after-tax, rather than pre-tax, income when



making decisions. Speaking very generally, there may be less cash for the couple to use after-tax.

Keep in mind that, as of 2019, not all states will have alimony tax laws that conform to the new federal rule. Your state may still offer tax deductions for alimony payments and impose income tax on alimony received. That's all the more reason to look at after-tax results when calculating a divorce or separation agreement.

Getting personal

The impact of the new TCJA on spousal negotiations may go beyond the taxation of alimony. Among other provisions to consider, the TCJA

abolishes personal exemptions. As a tradeoff, the standard deduction was almost doubled (see *CPA Client Bulletin*, April 2018).

In some past instances, divorcing spouses would agree that the high bracket party would claim the children's personal exemptions, which effectively were tax deductions, in return for some other consideration. Now those exemptions don't exist, so they shouldn't be part of divorce negotiations. If you previously entered into an agreement that included the treatment of children's personal exemptions, you may want to consult with counsel to see about possible revisions.

No tax deductions for business entertaining

The good news is that the TCJA of 2017 lowered corporate tax rates from a graduated schedule that reached 35% to a 21% flat rate. The bad news? Many business expenses are no longer tax deductible. That list includes all outlays that might be considered entertainment or recreation.

As of 2018, tickets to sports events can't be deducted, even if you walk away from the game with a new client

or a lucrative contract. The same is true if you treat a prospect to seats at a Broadway play or take a valued vendor out for a round of golf. Those outlays will be true costs for business owners without any tax relief.

Drilling down

Does that mean that you should drop all your season tickets supporting local teams? Cancel club memberships?

Pack away your putter and your tennis racquet? Before taking any actions in this area, take a breath and crunch some numbers.

Example: In recent years, Luke Watson spent about \$20,000 a year on various forms of entertainment, which his company claimed as a business expense. Indeed, these were valid expenses and helped his LW Corp. grow rapidly.

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Assume that LW Corp. paid income tax at a 34% rate. In 2017 and prior years, business entertaining was only 50% deductible. Thus, LW Corp. deducted \$10,000 (half of Luke's expenses) and saved \$3,400 (34% of \$10,000). With \$3,400 of tax savings and \$20,000 of out-of-pocket costs, Luke's net cost for entertaining was \$16,600 under the law in effect during 2017.

Now suppose that Luke has the same \$20,000 of entertainment costs in 2018 and that those costs would have still been 50% tax deductible at the new 21% tax rate. His tax savings would have been only \$2,100, so the net entertainment cost would have been \$17,900. As it is, under the new law his actual entertainment cost would be the full \$20,000 with no tax benefit.

This example assumes that LW Corp. pays the corporate income tax on its

profits. If Luke operates his business as an LLC or an S corporation, with business income passed through to his personal tax return, the calculation would be different, but the principle would be the same.

Business entertainment has been done mainly with after-tax dollars. Under the new TCJA, you'll entertain clients and prospects solely with after-tax dollars. You should be careful about how this money is spent and judge the expected benefit. Nevertheless, if business entertaining has paid off for your company in the past, it may still prove to be valuable even without tax breaks.

Fine points

Meal expenses associated with operating a trade or business, including employee travel meals,

generally continue to be 50% tax deductible. However, keep in mind that the rules have changed for meals provided for the employer's convenience. Previously, these were 100% deductible if they were excludible from employees' gross income as de minimis fringe benefits. That might have been the cost of providing free drinks and snacks to employees at the workplace. Now outlays for such meals are only 50% deductible and they're scheduled to become nondeductible after 2025.

On the bright side, the new law doesn't affect expenses for recreation, social, or similar activities primarily for the benefit of a company's employees, other than highly compensated employees. So, your business likely can still pay for holiday office parties with pre-tax dollars.

Two five-year tests for Roth IRAs

The pros and cons of Roth IRAs, which were introduced 20 years ago, are well understood. All money flowing into Roth IRAs is after-tax, so there is no upfront tax benefit.

As a tradeoff, all qualified Roth IRA distributions can be tax-free, including the parts of the distributions that are payouts of investment earnings.

To be a qualified distribution, the distribution must meet two basic requirements. First, the distribution must be made on or after the date the account owner reaches age 59½, be made because the account owner is disabled, be made to a beneficiary or to the account owner's estate after his or her death, or be used to buy or rebuild a first home.

Second, the distribution must be made after the five-year period beginning with the first tax year for

which a contribution was made to a Roth IRA set up for the owner's benefit.

Note that the calculation of a Roth IRA's five-year period is very generous. It always begins on January 1 of the calendar year.

Example 1: Heidi Walker, age 58, opened her first Roth IRA and made a contribution to it on March 29, 2018. Heidi designated this as a contribution for 2017, which could be made until April 17, 2018.

Under the five-year rule, Heidi's five-year period started on January 1, 2017. As of January 1, 2022, Heidi's Roth IRA distributions are tax-free, qualified distributions because they will have been made after she turned 59½ and after the five-year period has ended. The five-year period is determined based on the

first contribution to the Roth IRA; the starting date of the five-year period is not reset for the subsequent contributions.

Note that if Heidi opens her first Roth IRA late in 2018, even in December, the first contribution will be a 2018 Roth IRA contribution and Heidi will reach the five-year mark on January 1, 2023.

Conversion factors

Other than making regular contributions, Roth IRAs may be funded by converting a traditional IRA to a Roth IRA and paying tax on any pre-tax dollars moved to the Roth side. For such conversions, a separate five-year rule applies. There generally is a five-year waiting period before a Roth IRA owner who is under age 59½ can withdraw the dollars contributed

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to the Roth IRA in the conversion that were includible in income in the conversion, without owing a 10% early withdrawal penalty.

Similar to the five-year rule for qualified distributions, the five-year period for conversions begins on the first day of the year of the conversion. However, unlike the five-year rule for qualified distributions, the five-year rule for conversions applies separately to each Roth IRA conversion.

Example 2: In 2018, Jim Bradley, age 41, leaves his job and rolls \$60,000 from his 401(k) account to a traditional IRA, maintaining the tax deferral. If Jim decides to withdraw \$20,000 next year, at age 42, he would owe income tax on that \$20,000 plus a 10% (\$2,000) penalty for an early withdrawal.

Instead, in 2019, Jim converts \$20,000 from his traditional IRA to a Roth IRA and includes the entire amount converted in income. However, if Jim withdraws that \$20,000 in 2019, he also will owe the 10% penalty because he does not meet the five-year rule for conversions; the rationale is that the IRS doesn't want people to avoid the

early withdrawal penalty on traditional IRA distributions by making a Roth conversion.

The good news is that, in this example, Jim will have started the five-year clock with his 2019 Roth IRA conversion. Therefore, he can avoid the 10% early withdrawal penalty on the conversion contribution after January 1, 2024, even though he will only be age 47 then. Jim will owe income tax on any withdrawn earnings, though, until he reaches age 59½ or he meets one of the other qualified distribution criteria.

Note that various exceptions may allow Jim to avoid the 10% penalty before the end of the five-year period. Altogether, the taxation of any Roth IRA distributions made before five years have passed and before age 59½ can be complex. If you have a Roth IRA, our office can explain the likely tax consequences of any distribution you are considering. Generally, it is better to wait until the age 59½ and five-year tests are passed before making Roth IRA withdrawals, to avoid taxes.

Trusted advice

Roth IRA distributions

- Roth IRA distributions after age 59½ (and five years after you set up and make a contribution to your first Roth IRA) qualify for complete tax-free treatment.
- Distributions that do not qualify for this tax-free treatment may be subject to income tax, a 10% early withdrawal penalty, or both.
- Ordering rules apply to non-qualified distributions.
 - First come regular contributions, rollover contributions from other Roth IRAs, and rollover contributions from a designated Roth account.
 - Next come conversion contributions, on a first-in, first-out basis. The taxable portion comes before the nontaxable portion.
 - Earnings on contributions are the last dollars to come out.

Insuring key people at small companies

At a multinational corporation, the loss of any single employee may hardly cause a ripple in its ongoing business. That's often not true for a small business. If you're the prime mover, your inability to work could have severe consequences. The same is true if you have partners or other vital personnel who can no longer do their jobs.

Building a strong team can hedge against this risk. Even so, your company may want to acquire insurance that will provide needed

cash in a worst-case scenario. These policies have been called "key man" insurance, but today a more apt description is "key person" or "key employee" coverage.

Life insurance for your business

Key employee coverage usually includes life insurance. The insured individual probably would be you, the business owner, if you're actively involved in operations. Partners or co-owners also could be covered;

the same is true for, say, a sales or production employee whose absence would create a huge gap in profitability.

The typical structure of key employee life insurance is to have benefits paid to the company in case of the insured individual's death. The cash flow could help keep the company viable while a replacement employee is sought and installed. In another situation, key employee insurance can be part of a buy-sell agreement.

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Example: Diane Edwards and Frank Grant are co-owners of EG Corp. The company buys life insurance on both Diane and Frank. If Diane dies while her life is covered, the proceeds will go to EG, which can buy Diane's shares from her heirs, leaving Frank as the principal owner. The reverse will happen if Frank is the one to die.

Coverage choices

As is the case with any type of life insurance, some decisions must be made. Should key employee insurance be term or permanent? Term policies tend to have much lower premiums; they may make sense if the coverage will be needed only for a certain amount of time. A business owner who expects to sell the company or retire within 10 years might prefer a 10-year term policy, for example.

Permanent insurance (which might be known as *whole life*, *universal life*, or *variable life*) generally has much higher premiums. These policies usually have an investment account called the cash value. As the owner of the policy, the company might be able to tap the cash value via loans or withdrawals, if necessary. As the label indicates, permanent life could be worth buying for long-lasting coverage.

In addition to the type of policy, a small company buying key employee life insurance must decide how much



coverage to acquire. Ideally, the amount should be sufficient to keep the company going until it recovers from the individual's death, perhaps with a new hire or new owner. If such an amount is difficult to determine, you might go by a rule of thumb, such as buying coverage equal to 8 or 10 times the insured individual's salary. The amount of insurance should be reviewed periodically and changed when appropriate.

Dealing with disability

If a key individual gets sick or injured and becomes unable to work, the impact on the company can be as serious as that person's death. Therefore, key employee disability insurance also should be considered. Disability policies have many moving parts: the definition of *disability*, the waiting period before benefits begin, the length of time benefits will be paid,

and so on. An experienced insurance professional may be able to help your company find effective disability coverage at an affordable price and also assist with key employee life insurance.

For both life and disability key employee policies, the premiums your company pays probably will not be tax deductible. Any life insurance benefits on an employee's death that are payable to the company may be taxable income to the extent the benefits exceed the premiums and other amounts paid by the company for the policy. On the other hand, because key employee disability premiums are not deductible, benefits received from a policy generally are tax-free. Our office can explain the likely tax treatment of any key employee insurance you are considering.



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