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EQUITY INVESTMENTS AND VARIABLE ANNUITIES

Variable annuities remain a major tax and investment topic. This insurance product is sold (usually with generous commissions) by insurance companies, or banks and mutual fund companies through arrangements with insurance companies. They are sometimes sold to bank customers who are only seeking bank deposit income, but the substantial commissions paid to the sellers influence bank sellers to push the annuities over the requested certificates of deposit etc. Variable annuities are very complex products and are often not adequately explained to or understood by the buyer.

As long-term investment contracts, variable annuities offer several choices of investment options similar to a family of mutual funds. In many cases, they offer sub-accounts managed by some of the largest mutual fund companies. The rates of return on these sub-accounts vary, of course, as opposed to traditional annuities, which have fixed rates of return. Variable annuities are sometimes thought of as being a family of mutual funds, but there are two important differences: (1) they generally have higher expenses, and (2) they are taxed differently.

First, fees and expenses are typically higher for variable annuities than for most mutual funds – sometime as much as 2 percent per year (including "mortality and expenses") or more.

Unlike mutual funds, variable annuities include a life insurance feature and a related life insurance cost. The insurance component is there, but it is not life insurance with a significant death benefit in the common usage of the word. If the investor dies, the heirs will receive at least as much as the investor paid for the variable annuity. In the early years, this feature protects against market declines below the original cost, but only at the annuitant's death. Many annuities, however, offer annual step-ups and/or guaranteed minimum rates of return over the life of the contract.

In addition to the life insurance costs, most variable annuities charge a fixed annual administrative fee and a fee for investment management and/or transaction fees that are charged for each sub-account. The total fees are generally in excess of the total fees charged by equivalent mutual funds. In addition, there is usually a surrender charge if the investor gets out of the annuity in the first five to ten years, unless the investor purchased a "C share" annuity, which is one with no front-end loads or back-end penalties. Further, there is a ten-percent federal tax penalty on accumulated tax-deferred income in the event of most withdrawals before age 59½. There are, however, some limited exceptions to this penalty. The combination of the fees, possible surrender charge, and the threat of the 10 percent federal penalty tax results in an investment with a relatively high expense ratio

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and a lack of liquidity when compared to an equivalent mutual fund investment.

Second, the earnings on variable annuities are tax-deferred. The sub-account earnings (interest, dividends, and capital gains) accumulate tax-deferred until paid out to the owner. At that time, the earnings withdrawn are taxed as ordinary income. In contrast, the total return of equity mutual funds is taxed in part as a dividend at a current maximum federal rate of 23.8 percent, and in part deferred as a capital gain on redemptions, which is also at a current maximum federal rate of 23.8 percent. The income tax basis of an appreciated mutual fund is increased to fair market value at the owner's death (at the death of the first of the owners to die if community property), eliminating the deferred income tax to the heirs or surviving spouse on that appreciation. A variable annuity, however, does not receive such favorable stepped-up tax basis at the owner's death, and distributions to the beneficiary always convert lower capital gains rates on taxable income into the significantly higher tax rate levied on ordinary income.

It is an interesting fact, at least to us, that tax-deferred variable annuities are generally much less favorable to high tax bracket investors than tax-efficient mutual funds, which are not, by law, tax-sheltered. For example, an equity index mutual fund (or any equity portfolio that has low trading activity) usually results in current taxation on the dividend-yield portion of the total return at the tax-favored dividend tax rate. The balance of the total return occurs as capital appreciation, most of which is subject to income tax as capital gains and then usually only at sale, or may never be subject to income tax because of the basis "step-up" at the death of the owner or spouse. The 19.6 percent (or greater) difference between the maximum federal tax rates on ordinary income and the maximum federal capital gains tax rate results in the variable annuity's being a very poor tax choice when compared to tax efficient mutual funds or low turnover stock portfolios. It is almost impossible for the advantage of tax deferral on equity variable annuities to offset the disadvantages of the extra expense load of annuities and the loss of capital gains treatment (and possible tax-free treatment) available in long-term equity investments.

One advantage that annuities do provide is an ability to accommodate changes in risk tolerance as the annuitant ages. In other words, as the owner grows older, he or she may change the asset mix in a variable deferred annuity to a more bond-oriented investment without incurring any current income tax consequences.

Those considering variable annuity investments also need to remember that the annuity owner only owns a contract or an unsecured promise to pay by the issuing company. In the event of the failure of the issuing insurance company, we are told that the owner of a fixed contract would be only an unsecured creditor of the failed company. The prudent owner must, therefore, monitor the creditworthiness of the issuer of the annuity. If the owner becomes dissatisfied with the issuer, the tax laws allow the taxpayer to exchange one annuity contract for another contract, from a different issuer, without adverse income tax consequences.

Finally, in the area of asset protection, we are told by Louisiana lawyers that there is a nontax advantage to variable annuities for Louisiana residents in that the annuity contract is exempt from ordinary creditors in bankruptcy proceedings or in a suit for collection of a debt, malpractice claims, etc.

In summary, as an equity investment vehicle, variable annuities do provide tax-deferral and asset protection, but their transformation to ordinary income of what might have been capital gain (or tax-free altogether), combined with their relatively high expense, usually makes investing in traditional mutual funds, particularly tax-efficient ones, much more attractive.

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Tax & Business Alert

OCTOBER 2015

TIME TO START YEAR-END TAX PLANNING

The federal income tax rates for 2015 are the same as last year: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. However, the rate bracket beginning and ending points are increased slightly to account for inflation. For 2015, the maximum 39.6% bracket affects singles with taxable income above $413,200, married joint-filing couples with income above $464,850, heads of households with income above $439,000, and married individuals who file separate returns with income above $232,425. Higher-income individuals can also get hit by the 0.9% additional Medicare tax on wages and self-employment income and the 3.8% Net Investment Income Tax (NIIT), which can both result in a higher-than-advertised marginal federal income tax rate for 2015.

What we've listed below are a few money-saving ideas to get you started that you may want to put in action before the end of 2015:

- For 2015, the standard deduction is $12,600 for married taxpayers filing joint returns. For single taxpayers, the amount is $6,300. If your total itemized deductions each year are normally close to these amounts, you may be able to leverage the benefit of your deductions by bunching deductions, such as charitable contributions and property taxes, in every other year. This allows you to time your itemized deductions so they are high in one year and low in the next. However, the alternative minimum tax (AMT), discussed later in this article, should be considered when using this strategy.
- If you or a family member own traditional IRAs and reached age 70½ this year, consider whether it's better to take the first required minimum distribution in 2015 or by April 1 of next year.

- If your employer offers a flexible spending account arrangement for your out-of-pocket medical or child care expenses, make sure you're maximizing the tax benefits during the upcoming enrollment period for 2016.
- If you have a 401(k) plan at work, it's just about time to tell your company how much you want to set aside on a tax-free basis for next year. Contribute as much as you can stand, especially if your employer makes matching contributions. You give up "free money" when you fail to participate with the maximum amount the company will match.

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TIME TO START YEAR-END TAX PLANNING continued from page 1.

- If it looks like you are going to owe income taxes for 2015, consider bumping up the federal income taxes withheld from your paychecks now through the end of the year.
- Between now and year-end, review your securities portfolio for any losers that can be sold before year-end to offset gains you have already recognized this year or to get you to the $3,000 ($1,500 married filing separate) net capital loss that's deductible each year.

Without a multiyear outlook, you can't be sure maneuvers intended to save taxes on your 2015 return won't backfire and cost additional money in the future.

- If you own any securities that are all but worthless with little hope of recovery, you might consider selling them before the end of the year so you can capitalize on the loss this year.
- Don't overlook estate planning. For 2015, the unified federal gift and estate tax exemption is a generous $5.43 million, and the federal estate tax rate is a historically reasonable 40%. Even if you already have an estate plan, it may need updating to reflect the current estate and gift tax rules. Also, you may need to make some changes that have nothing to do with taxes.
- If you are self-employed, consider employing your child. Doing so shifts income (which is not subject to the Kiddie tax) from you to your child, who normally is in a lower tax bracket or may avoid tax entirely due to the standard deduction. There can also be payroll tax savings and the ability to contribute to an IRA for the child.
- If you own an interest in a partnership or S corporation that you expect to generate a loss this year, you may want to make a capital contribution (or in the case of an S corporation, loan it additional funds) before year-end to ensure you have sufficient basis to claim a full deduction.

Remember that effective tax planning requires considering at least this year and next year. Without a multiyear outlook, you can't be sure maneuvers intended to save taxes on your 2015 return won't backfire and cost additional money in the future.

And finally, watch out for the AMT in all of your planning because what may be a great move for regular tax purposes may create or increase an AMT problem. There's a good chance you'll be hit with AMT if you deduct a significant amount of state and local taxes, claim multiple dependents, exercise incentive stock options, or recognize a large capital gain this year.

Again, these are just a few suggestions to get you thinking. If you'd like to know more about them or want to discuss other ideas, please feel free to call us.

TAX CALENDAR

October 15

- Personal returns that received an automatic six-month extension must be filed today and any tax, interest, and penalties due must be paid.
- Electing large partnerships that received an additional six-month extension must file their Forms 1065-B today.
- If the monthly deposit rule applies, employers must deposit the tax for payments in September for social security, Medicare, withheld income tax, and nonpayroll withholding.

November 2

- The third quarter Form 941 (Employer's Quarterly Federal Tax Return) is due today and any undeposited tax must be deposited. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return.
- If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through September exceeds $500.

November 16

- If the monthly deposit rule applies, employers must deposit the tax for payments in October for social security, Medicare, withheld income tax, and nonpayroll withholding.

December 15

- Calendar-year corporations must deposit the fourth installment of estimated income tax for 2015.
- If the monthly deposit rule applies, employers must deposit the tax for payments in November for social security, Medicare, withheld income tax, and nonpayroll withholding.

SHARED EQUITY FINANCING ARRANGEMENTS FOR HOME OWNERSHIP

Adult children may be able to acquire a more expensive home than they might otherwise afford by using a shared equity financing arrangement, under which parents or other relatives share in the purchase and cost of maintaining a house used by the children as a principal residence. The nonresident owner rents his or her portion of the home to the resident owner and obtains the annual tax benefits of renting real estate if the statutory requirements are satisfied. Since the child does not own 100% of the home, he or she is the relative's tenant as to the portion of the home not owned and rents that interest from the relative at a fair market rate.

One drawback to shared equity arrangements is that the nonresident owners will not qualify for the gain exclusion upon the sale of the residence.

A shared equity financing arrangement is an agreement by which two or more persons acquire qualified home ownership interests in a dwelling unit and the person (or persons) holding one of the interests is entitled to occupy the dwelling as his or her principal residence, and is required to pay rent to the other person(s) owning qualified ownership interests.

Under the vacation home rules, personal use of the home by a child or other relative of the property's owner is normally attributed to the owner. However, an exception to the general rule exists when the dwelling is rented to a tenant for a fair market rent and serves as the renter's principal residence. When the tenant owns an interest in the property, this exception to the general rule applies only if the rental qualifies as a shared equity financing arrangement.

Example: Shared equity financing arrangement facilitates child's home ownership.

Mike and Laura have agreed to help their son, Bob, purchase his first home. The total purchase price is $100,000, consisting of a $20,000 down payment and a mortgage of $80,000. Mike and Laura pay half of the down payment and make half of the mortgage payment pursuant to a shared equity financing agreement with Bob. Bob pays them a fair rental for using 50% of the property, determined when the agreement was entered into.

Under this arrangement, Bob treats the property as his personal residence for tax purposes, deducting his 50% share of the mortgage interest and property taxes. Because his use is not attributed to his parents, Mike and Laura, they treat the property as rental. They must report the rent they receive from Bob, but can deduct their 50% share of the mortgage interest and taxes, the maintenance expenses they pay, and depreciation based on 50% of the property's depreciable basis. If the property generates a tax loss, it is subject to, and its deductibility is limited by, the passive loss rules.

One drawback to shared equity arrangements is that the nonresident owners will not qualify for the gain exclusion upon the sale of the residence. The result will be a taxable gain for the portion of the gain related to the deemed rental. The gain may also be subject to the 3.8% Net Investment Income Tax (NIIT). Parents should consider guaranteeing or co-signing the mortgage, instead of outright joint ownership, if excluding potential future gain is a major consideration.

If it is anticipated that the resident owner will ultimately purchase the equity of the nonresident owner and the rental will generate losses suspended under the passive loss rules, special care must be taken when the lease terms are agreed to because suspended passive losses normally allowed at disposition are not allowed when the interest is sold to a related party. This problem can be minimized by making a larger down payment that decreases mortgage interest expense, or by charging a rent at the higher end of the reasonable range for the value of the interest being rented to the resident owner. ■

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DUE DATE CHANGES FOR PARTNERSHIP AND C CORPORATION RETURNS

On July 31, 2015, the President signed the "Surface Transportation and Veterans Health Care Choice Improvement Act of 2015" (the Highway Act) into law, providing a three-month extension of the general expenditure authority for the Highway Trust Fund (HTF). Part of the HTF extension was paid for by changes to tax compliance provisions, the most significant of which is a change to the longstanding due date for C corporation [Form 1120 (U.S. Corporation Income Tax Return)] and partnership [Form 1065 (U.S. Return of Partnership Income)] returns.

For tax years beginning after 2015, the Highway Act switches the Form 1120 and Form 1065 initial due dates. Thus, beginning with 2016 returns—

- The Form 1065 due date will be accelerated by a month to two and a half months after the close of the partnership's tax year (March 15 for calendar-year partnerships). A six-month extension (through September 15 for calendar-year partnerships) will also be allowed.
- The Form 1120 due date will generally be deferred by a month to three and a half months after the close of the corporation's tax year (April 15 for calendar-year corporations). However, under a special transition rule, for C corporations with fiscal years ending on June 30, the change won't apply (it will continue to be September 15) until tax years beginning after 2025. An automatic six-month extension will generally be allowed. However, until 2026, an automatic five-month extension (to September 15) applies to calendar-year corporations and an automatic seven-month extension (to April 15) applies to June 30 fiscal year corporations.

Note that the filing deadline for S corporations has not changed. So, for years beginning after 2015, S corporations and partnerships will have the same March 15 filing deadlines. Also, for calendar-year entities, the revised deadlines will first apply to 2016 returns filed in 2017. ■