Hantzmon Wiebel LLP
Certified Public Accountants

P.O. Box 1408 • 818 East Jefferson Street • Charlottesville, VA 22902
Phone: (434) 296-2156 • Fax: (434) 977-4629
www.hantzmonwiebel.com

for over 85 years

Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor[sm]

December 2014

New Regulations Bolster Longevity Annuities

Deferred income annuities (DIAs) recently have become popular. New regulations from the U.S. Treasury Department may increase their appeal, opening the way for so-called "longevity" annuities inside IRAs and employer retirement plans.

Later rather than sooner

With a DIA, you pay an insurance company now in return for a predetermined amount of cash flow in the future.

Example 1: Grace Palmer is age 55, planning to retire at 65. She buys an income annuity now for $100,000. Depending on the specific features Grace requests, if she starts to receive payments immediately, she might get around $400 a month ($4,800 a year) as long as she lives.

Instead, Grace agrees to wait until she retires at 65 to start payments. In return for giving up her money for 10 years, with no return, Grace might get lifelong annual payouts of $800 a month. (Exact amounts will depend on the contract terms and the annuity issuer.)

Even later

Certain DIAs are known as longevity annuities. They begin paying out late in life, so they appeal to people who are concerned about running short of money if they live into their late 80s or 90s or beyond.

Example 2: Instead of starting her DIA payouts at 65, Grace asks for them to begin at 75 or later. Such a delay could increase her payouts to $2,000 a month or more, as her remaining life expectancy would be limited. Grace enters into this arrangement to assure herself that she'll have substantial cash flow if she lives until an advanced age.

Solving the distribution dilemma

Until recently, such longevity annuities were impractical for retirement accounts because required minimum distributions

continued on page 2

What's Inside

1 New Regulations Bolster Longevity Annuities

2 Global Funds Versus International Funds

3 Be Wary of Accumulated Assets

4 Tax Calendar

High growth

Twenty percent of U.S. employees were enrolled in a high deductible health insurance plan in 2013, up from 4% in 2006.

continued from page 1

Trusted Advice

Rules for QLACs

- No more than 25% of an individual's total IRA money can be invested in qualified longevity contracts (QLACs).
- For this purpose, SEP IRAs and SIMPLE IRAs are included. Roth IRAs don't count because there is no reason to hold a QLAC in a Roth IRA, where the owner never has required minimum distributions.
- The 25% limit also applies to each employer plan.
- Counting all QLACs in all plans, an investor cannot invest more than $125,000. That ceiling will increase with inflation.
- QLAC payouts must begin no later than age 85, although they can begin earlier.

(RMDs) typically start after age 70½. Seniors would have to take RMDs on the annuity value even though no cash would be coming from the annuity.

Example 3: Suppose Henry Adams had bought a longevity annuity inside his IRA to begin payments at age 80. At age 70½, when Henry has $500,000 in his IRA, the annuity issuer values the contract at $100,000. Under prior rules, Henry would have had to take RMDs based on a $500,000 value even though he had only $400,000 currently available. Henry would have been required to withdraw (and pay tax on) a relatively large amount, even if he doesn't need all the money he'll withdraw.

This unfavorable tax treatment would continue, year after year, as long as Henry waited for his longevity annuity. Thus, longevity annuities were not attractive for retirement accounts and few people bought them in their IRA.

This situation is about to change. In July 2014, the Treasury Department issued final regulations on qualified longevity annuity contracts (QLACs). If annuities meet certain conditions, they will be considered QLACs. (See the Trusted Advice column "Rules for QLACs.") That way, the account value won't count for RMD calculations.

Pros and cons

Some insurance companies are working on QLACs that are expected to appear in 2015. QLACs might appeal to seniors who are likely to live well beyond normal life expectancy and who are concerned about running short of money. In addition, individuals who would like to trim their RMDs and, thus, leave more to heirs, may consider buying QLACs. The regulations permit QLACs to have a return of premium feature, which would pay beneficiaries the amount invested yet not paid out in annuity payments by the time the annuity purchaser dies.

On the downside, QLACs will not be permitted to have any liquidity features for the buyer. If a taxpayer invests $100,000 in a QLAC, all she can get in return will be her annuity payments. ■

Global Funds Versus International Funds

As of this writing, financial markets have been very volatile. Even so, the Standard & Poor's 500 Index, a benchmark for the U.S. stock market, has gained over 70% in the past five years. A common measure of foreign stocks, the MSCI Europe, Australasia, and the Far East (EAFE) Index, has gained less than 10% for that period. Thus, U.S. stocks generally have gained much more than their foreign counterparts since the financial crisis of 2008–2009.

Consequently, some observers believe that foreign stocks offer better value than domestic issues today. You may wish to hold a portion of your investment portfolio in non-U.S. equities. Your strategy might call for investing through a stock fund for broad diversification and professional asset management.

Defining global and international

When investing in foreign stocks, your investment choices include global and international funds. Although the terms might sound similar, they refer to two different types of stock funds.

- Global funds, also known as world funds, typically invest in the shares of any company in the world. That includes stocks of U.S. corporations.
- International funds, sometimes called foreign funds, generally invest only in companies based outside of the United States.

An international fund, for instance, might invest in Germany's Volkswagen, Korea's Samsung, and Royal Dutch Shell, while a global fund might hold Volkswagen, Samsung, and the U.S. company ExxonMobil. Seeing "international" or "global" in a

fund's name usually will indicate how it invests, but you should check its holdings before you invest, so you'll know which path you'll be following.

The case for going global

Investing in a global fund can be a one-stop solution to your quest for stock market exposure. You'll participate in the U.S. market as well as in foreign equities with a single, all-purpose fund.

Moreover, the managers of global funds typically are unconstrained. They can invest in the companies they like best, regardless of where a given company happens to be based. Why exclude an extremely promising stock just because the corporation happens to have a U.S. headquarters?

Investing in what they know

Alternatively, some observers point out that the world is a big place, perhaps too big for one fund manager (or one team of co-managers) to cover adequately. A fund manager who concentrates solely on U.S. stocks may be more likely to find gems here than a manager whose stock scan extends to Australia and Zimbabwe.

Similarly, a fund manager who doesn't have to follow the huge U.S. market might be more able to uncover winners in Europe or Japan. An investor who follows this line of reasoning may prefer to invest in one or more funds focusing on the U.S. market as well as one or more funds that limit their selections to foreign stocks.

There is no right or wrong answer to the global-vs.-international question. There are some global funds with excellent records and some that have not served investors well; the same can be said for international funds. The key is to understand the difference between these modes of investing in foreign stocks, and to make an informed decision about where your dollars will be going. ■

The Surge in Emerging Markets Bonds

While U.S. stocks have outperformed foreign stocks in recent years, some types of foreign bonds have held up well. Taking a slightly longer view, funds holding bonds from emerging markets have topped all of Morningstar's bond fund categories for the 10 years through September 2014, with average annualized returns around 7.6%. By contrast, the average return for all taxable bond fund categories was about 4.5%.

Why have emerging markets bonds done so well? For one reason, they have relatively high yields. The stocks in the J.P. Morgan Emerging Markets Bond Index have a current yield over 5%, which can be appealing in today's low-yield world.

In addition, emerging markets generally have faster economic growth than the U.S. and the developed markets of Western Europe. As their economies expand, emerging nations likely will become more creditworthy, making their bonds more valuable. These trends, which have sparked gains in emerging markets bonds during the last decade, may continue in the future.

Nevertheless, bonds issued in places such as Brazil, Russia, India and China can be risky, so prices may fluctuate. If you are interested in a small portfolio allocation to this asset class, consult with your investment advisor. You might consider a diversified emerging markets bond fund to spread the risks. Funds in this category may be less volatile if they primarily hold government rather than company bonds.

Be Wary of Accumulated Assets

Owners of regular C corporations face double taxation. The company's profits are subject to the corporate income tax. If some of those profits are paid to the owner and other shareholders, as nondeductible dividends, the same dollars will be taxed again, on the recipients' personal tax returns.

Double taxation might not have been a major concern when the highest tax rate on qualified dividends was only 15%, as it had been for most of this century. However, recent legislation boosted the dividend tax rate to 20% for some taxpayers; high-income taxpayers also may owe the 3.8% Medicare surtax as well as some indirect taxes on dividends they receive. Therefore, business owners may prefer to retain earnings in the company, rather than pay out double taxed dividends.

Example 1: Craig Taylor owns 100% of CT Corp. The company's profits this year are $400,000, on which CT Corp. pays income tax. Rather than pay himself a dividend, which would be taxed at an effective rate of 25% in this scenario, counting all the various taxes that would be

continued on page 4

continued from page 3

triggered, Craig decides to keep the money inside CT Corp.

Cash crunch

However, CT Corp. might run into a tax problem: the accumulated earnings tax (AET). Retained earnings over $250,000 are subject to this tax ($150,000 for personal service corporations, such as professional practices). Thus, if CT Corp. had $200,000 in retained earnings from prior years, this year's $400,000 makes the total $600,000, which is $350,000 over the $250,000 limit. CT Corp. would owe tax on the $350,000 overage: $70,000, at the current 20% AET rate.

In practice, the AET is not a certainty. The IRS might investigate when CT Corp. reports retained earnings over $250,000 on its corporate income tax return, but it's possible that it won't owe the AET, if the company has a good reason for the large accumulation.

Forward thinking

Earnings in excess of $250,000 will be permitted if the company can show that it had a reasonable need for holding onto cash and other liquid assets. That need could be to provide funding for a specific plan related to the company's business, such as buying expensive equipment or expanding into a new territory.

Solid proof

In order to retain earnings over $250,000, yet avoid the AET, a corporation must be able to show that there really was a plan in place to use the money, and that the reasons for the retention go beyond tax avoidance. Ideally, corporate minutes or other documentation, such as emails, will include a discussion of, for example, the company's intent to upgrade its information technology with an expensive new system.

No matter how well you can show that a plan was in place as a reason for accumulating excess assets, you'll also need to show that the plan has since been executed, or is in some stage of progress.

What's more, court decisions have approved the concept that C corporations can cite working capital as a reason for accumulating earnings over $250,000. Our office can help you determine an acceptable level of working capital for your company, which might raise its permissible level of accumulated earnings.

Simple solution

Regardless of your needs for working capital, there are basic steps you can take to avoid or limit the AET. For instance, you can pay some dividends to shareholders each year, even if that generates double taxation. A company that retains excess earnings while never paying out dividends may be especially vulnerable to IRS scrutiny and assessment of the AET. ■

TAX CALENDAR

DECEMBER 2014

December 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in November if the monthly rule applies.

Corporations. Deposit the fourth installment of estimated income tax for 2014.

JANUARY 2015

January 15

Individuals. Make a payment of your estimated tax for 2014 if you did not pay your income tax for the year through withholding (or did not pay enough in tax that way). Use Form 1040-ES. This is the final installment date for 2014 estimated tax. However, you don't have to make this payment if you file your 2014 return and pay any tax due by February 2, 2015.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in December 2014 if the monthly rule applies.

The *CPA Client Bulletin* (ISSN 1942-7271) is prepared by AICPA staff for the clients of its members and other practitioners. The *Bulletin* carries no official authority, and its contents should not be acted upon without professional advice. Copyright © 2014 by the American Institute of Certified Public Accountants, Inc., New York, NY 10036-8775. Printed in the U.S.A. Sidney Kess, CPA, JD, Editor. For AICPA customer service, call 888.777.7077 or visit *www.cpa2biz.com*.