VOLUME 23, ISSUE 7

LAGOS WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

The Enigmatic Tax Code: Things We Can't Answer Revisited

Michael W. Lagos, CFP®
President

Jane M. Roberts
Director of Client Services

Justin P. Boren , PHD
Chief Compliance Officer

Samuel Escobar
Financial Advisor

A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Financial professionals get asked about taxes by their clients all the time. Those who sell life insurance and annuities for a living get used to answering the recurring questions, such as:

- Can I deduct the premium for my life insurance policy?
- Is the transfer of my nonqualified annuity income taxable?
- How can I structure my life insurance so the death benefit will be estate tax free?
- What are the tax consequences of having my life policy become a MEC?

Most questions are simple to answer. Sometimes, the client may add details to the question that make the answer more complicated. Complicated or simple, most questions have definite answers.

Unfortunately, some do not.

Please feel free to contact me to discuss further.

Regards,
Michael W. Lagos, CFP®

The Advisor's Bulletin is provided by Lagos Wealth Advisors and Lagos Financial & Insurance Services, Inc. It is intended to serve as a resource for the advisors which we are associated with. Recent developments in estate, business, and insurance planning are outlined for your reference. Should you wish to receive additional information related to financial planning, estate planning, insurance planning, or investment management, please do

1320 VALLEY VISTA DRIVE, SUITE 202
DIAMOND BAR, CA 91765
866.444.4964
WWW.LAGOSADVISORS.COM

The Enigmatic Tax Code: Things We Can't Answer Revisited

THE ORIGINAL LIST UPDATED

Here are the original questions:

1. When does the age 59 ½ penalty tax apply to business-owned MEC policy distributions?
2. Does the penalty tax ever apply to business-owned NQDAs?
3. Can distributions from a qualified SPIA count toward other RMD obligations?
4. Will life policy chronic illness distributions be tax-free when paid to a third-party owner?
5. Is a rollover of a qualified account in the middle of Section 72(t) distributions allowed?
6. Does a Section 1035 exchange void grandfathering for a split-dollar plan?
7. What rules apply to step transaction and taxable boot in a Section 1035 exchange?
8. How are certain distributions from nonqualified income rider annuities taxed?
9. How are RMDs for qualified income rider annuities calculated?
10. How is the value of a life policy calculated where the insured's health has deteriorated?

Update

The first two on the original list are unanswered questions about life and annuity policies owned by nonnatural owners.

COMPANY-OWNED MECS—APPLICATION OF THE PENALTY TAX

Distributions from a non-MEC life contract are considered a tax-free return of basis first and taxable thereafter. Distributions from a MEC are taxed on a gain-first basis, and the taxable portion of distributions is also potentially subject to a 10 percent penalty tax.

Under Internal Revenue Code Section 72(q), the extra tax does ***not*** apply to a distribution:

> (A) made on or after the date on which the taxpayer attains age 59 1/2,
>
> (B) which is attributable to the taxpayer's becoming disabled . . . or
>
> (C) which is part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his beneficiary.

Here's the question we can't answer: How does the penalty tax apply when a nonnatural person, such as a corporation or a trust, owns the policy? Would the standards of age, disability status, or substantially equal distributions for life be applied based on the insured's status? Or, in the alternative, would they be applied based on the corporation's status—means that the age, disability, and equal distributions for life exceptions would ***never*** be available?

Would the answer be different if the owner of the MEC is a business as opposed to a trust?

When we first wrote about this issue, the IRS had never ruled on this question, and there had been no court cases dealing with it, either. Most carriers had opted for the conservative position—that the penalty tax will always apply to distributions from MECs when there is a nonnatural owner.

Since the original article, the Service published PLR 202031008. That private letter ruling discussed, among other things, the potential application of the penalty tax for trust-owned nonqualified annuities (NQDAs). The IRS decided that the penalty tax will always apply to distributions while the annuitant is alive from an NQDA where a nongrantor trust owns the policy.

While the PLR does not address modified endowment contracts, its logic could certainly be extended there because of the similarity between MEC and NQDA taxation. Likewise, the Service's reasoning regarding trust-owned annuities is likely to be applicable to business-owned MECs.

Status: Still somewhat uncertain, although it seems likely that the penalty tax should always apply to taxable distributions from a business-owned MEC. We consider this question answered.

COMPANY-OWNED NQDAS—APPLICATION OF THE PENALTY TAX

One of the key tax advantages of an individual's owning a nonqualified deferred annuity (NQDA) is that the contract's value grows income tax deferred. However, where the contract is owned by a nonnatural person—a business, for example—Section 72(u) of the Internal Revenue Code says that the growth every year is income taxable.

Traditionally, companies avoided owning NQDAs because of the loss of tax deferral. For a business-owned annuity, we know the annuity carrier should generate a Form 1099-R annually for any increase in cash value in excess of premiums paid that year.

Here's the question: Are those taxable earnings subject to the 10 percent penalty? The IRS has never said for sure one way or the other.

Code Section 72(q) seems to offer some insight into the question in its language:

> If any taxpayer **receives** any amount under an annuity contract, the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income. (Emphasis added.)

So, is the annual growth that ***accrues*** in a business-owned NQDA ***received*** for the purpose of this Code section? If the answer is yes, the penalty tax applies immediately. On the other hand, if the answer is no, will a subsequent distribution of the gain—which was already subject to regular income tax—get hit with the penalty tax later? We can't say for sure.

Status: Still unanswered.

DO DISTRIBUTIONS FROM A QUALIFIED SPIA SATISFY RMDS OUTSIDE THE SPIA?

This question usually arises when a financial professional is trying to help a client manage the RMD obligations associated with multiple IRAs. The question is, if the client purchases an immediate annuity with one of the IRAs, and it pays more than his RMD for that specific IRA, can the excess annuity payments be carried over to satisfy a portion of the RMD obligations for his other IRAs?

While RMDs must be calculated separately for each IRA, the separately calculated amounts may then be aggregated, and the total distribution can be taken from any one or more of the individual's IRAs.

On the other hand, Regulation Section 1.401(a)(9)-6 stated that distributions are required over the life expectancy of the account holder, or over a shorter period. The IRS might have argued that where an account holder annuitized an IRA, she is choosing a shorter period than her own life expectancy. Furthermore, the same regulation seems to imply that an annuitized IRA satisfies the RMD obligation for the IRA that has been annuitized only.

The SECURE ACT 2.0's Section 204 now explicitly permits excess annuitized distributions to count toward the RMD obligation for the rest of the account.

If an account has been annuitized, how much of a particular distribution will be considered to be excess? We are not sure yet. SECURE 2.0 requires the IRS to update its regulations to reflect the change made by the Act and to provide additional guidance.

Status: The Service has said that the answer to this question is yes, so we now know the answer. We do not yet have a safe-harbor method of making a calculation to determine the amount of excess. We consider this question answered.

THIRD PARTY OWNERSHIP—TAXATION OF CHRONIC ILLNESS ACCELERATION

Many modern life insurance policies have terminal and chronic illness features that offer early access to the death benefit in the event the insured is terminally or chronically ill.

Section 101 of the Internal Revenue Code says that life insurance death proceeds are usually income tax free. Section 101(g) goes on to say that life insurance benefits paid will be treated like tax-free death proceeds if paid on a policy insuring a terminally ill insured.

Section 101(g) also says that that benefits paid on account of an insured's ***chronic illness*** should also be treated as tax-free death proceeds. Where the insured is the owner of the contract, it seems clear that the benefits triggered by chronic illness are tax-free when paid to the insured up to $420/day in 2023, or actual long-term-care expenses if greater.

What happens when the insured does not own the contract?

If a business is the owner of the policy on the chronically ill person's life, the Code is clear that tax-free benefits should not be expected:

> This subsection shall not apply in the case of any amount paid to any taxpayer other than the insured if such taxpayer has an insurable interest with respect to the life of the insured by reason of the insured being a director, officer, or employee of the taxpayer or by reason of the insured being financially interested in any trade or business carried on by the taxpayer.

Does the preceding excerpt apply to situations where the insured's business partner is the owner of the policy? The language seems ambiguous in that regard.

Also, what is the tax treatment if the chronically ill insured's policy is owned by a parent, a sibling, or another family member? Would a chronic illness benefit paid to that policyowner be tax-free—even when the policyowner is under no obligation to share the proceeds with the insured? Is that what Congress intended when it created the law? It isn't really clear.

Status: Still no answer.

COMPLETE ROLLOVER OF IRA IN THE MIDDLE OF SECTION 72(T) DISTRIBUTIONS

Code Section 72(t) imposes an extra 10 percent penalty tax on pre-59 1/2 IRA and qualified plan distributions.

Code Section 72(t) says that distributions that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and his designated beneficiary are exempt from the penalty tax. These are sometimes referred to as Section 72(t) or SEPL distributions.

Once Section 72(t) distributions have begun, they must continue unchanged for the longer of five years or until the taxpayer reaches age 59 ½. If the taxpayer modifies the series of payments early, he or she will incur a tax equal to what would have been imposed plus interest for the deferral period.

The most common way for a taxpayer to foul up a Section 72(t) distribution stream is to take more or less than the amount required by the Section 72(t) calculation. The IRS had also identified other

ways a taxpayer might void the Section 72(t) strategy. One such way was to do a rollover from or to an account upon which Section 72(t) payments are based.

Here's what Revenue Ruling 2002-62 said:

> (e) Changes to account balance. . . . [S]ubstantially equal periodic payments are calculated with respect to an account balance as of the first valuation date selected in paragraph (d) above. Thus, a modification to the series of payments will occur if, after such date, there is (i) any addition to the account balance other than gains or losses, (ii) **any nontaxable transfer of a portion of the account balance to another retirement plan,** or (iii) a rollover by the taxpayer of the amount received resulting in such amount not being taxable. (Emphasis added.)

Therefore, in the past a partial rollover out of an IRA from which the taxpayer was taking Section 72(t) distributions would have undone the Section 72(t) strategy. That's clear from the Revenue Ruling.

However, SECURE 2.0 now makes it explicitly possible to do partial or complete rollovers from an account from which Section 72(t) distributions are being taken. Section 323 requires that the new accounts continue to meet the obligations imposed by Section 72(t). That means Section 72(t) distributions must continue unchanged for the longer of five years from the start or until age 59½, whichever is longer. The taxpayer is now allowed to mix and match distributions from the post-rollover accounts in whatever proportion so long as the total distributions from both are exactly equal to those required by Section 72(t).

Status: Complete and partial rollovers during Section 72(t) distributions are allowed thanks to the SECURE ACT 2.0. This question has been answered.

SECTION 1035 EXCHANGE AND GRANDFATHERED SPLIT DOLLAR

In general, a split-dollar life insurance arrangement is an arrangement between two or more parties to allocate the policy benefits and, in some cases, the costs of a life insurance contract.

The IRS created regulations to provide rules for the taxation of participants in a split-dollar life insurance arrangement. Those regulations generally apply to any split-dollar life insurance arrangement entered into after September 17, 2003. For this purpose, if an arrangement entered into on or before September 17, 2003, is materially modified after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification.

Split-dollar life insurance arrangements entered into prior to September 2003 are grandfathered under the old split-dollar rules unless they have been materially changed after September 2003. Why is that important? Under the old rules, it was arguably possible to generate equity in a split-dollar life insurance policy without having the recipient of the equity pay extra income tax for it. Certain of these types of old split-dollar plans were referred to as equity split-dollar.

If an equity split-dollar plan is materially modified, and the new split-dollar rules apply to the arrangement, the owner of the equity will likely have adverse income tax results.

Section 1.61-22(j)(2)(ii) sets forth a nonexclusive list of changes that are ***not*** treated as material modifications of grandfathered split-dollar plans. Section 1035 exchanges are conspicuously absent from the list.

So, are Section 1035 exchanges of a policy subject to a split-dollar arrangement material modifications, subjecting the plan to the new rules? We don't know for sure. In our experience, most taxpayers who are benefitting from equity split-dollar plans have chosen to avoid a policy exchange for fear it will be treated as a material modification.

Status: Still uncertain.

SECTION 1035 EXCHANGE TAXABLE BOOT IN STEP TRANSACTION

Section 1035 of the Internal Revenue Code allows a taxpayer to exchange life policies for new ones without paying tax on the gain.

However, some policy transfers may not qualify as completely tax-free exchanges. One such transfer is the exchange of a life policy with an outstanding loan. Money or other property received as part of an exchange is known as "boot."

If a policy, in which the owner has a gain, is exchanged for a new one and the loan on the old policy disappears as part of the transaction, the owner must recognize taxable boot. The boot is the lesser of the loan repaid or the gain in the policy.

In Private Letter Ruling 9141025, a taxpayer owned a life insurance policy bought with a single premium of $1 million; there was a $448,000 outstanding loan on the policy. The taxpayer proposed to pay off the loan through a partial surrender (withdrawal) from the policy.

The taxpayer expected to treat the withdrawal as a tax-free return of premium. The plan was to then exchange the remaining cash value for a new policy and treat it as a 1035 exchange.

Wisely, the taxpayer asked the question before doing the act. The Service held the proposed transaction would cause taxable boot equal to the extinguished $448,000 loan; the policy withdrawal would not be an independent transaction but part of a step transaction.

The problem with the IRS's step-transaction doctrine is that, unless you ask for a private-letter ruling, you will only know for sure that it will be applied ***after the fact***. If you have a client who has a life policy subject to a loan, and who wants to take a partial withdrawal to pay off the loan and then do a Section 1035 exchange, how much time needs to pass between the withdrawal and the exchange to be sure to avoid a taxable boot problem?

You guessed it. We don't know.

Status: We still don't know.

TAXATION OF NQDA DISTRIBUTIONS WITH INCOME RIDER

Many modern IRA and NQDA contracts have a special feature that pays the policyowner extra income if distributions from the contract are taken in certain amounts and at certain times. Such features are sometimes referred to as enhanced income riders (EIRs).

If distributions are taken from the contract, the distribution reduces the contract's cash value. For EIR contracts, there may also be an enhanced income value that is higher than the contract's cash value. The full amount of the enhanced income value is generally not available unless its value is accessed exactly as prescribed in the contract.

Distributions from an NQDA are taxed on a gain-first basis. According to Internal Revenue Code Section 72(e)(3), gain is calculated by comparing:

> the cash value of the contract (determined without regard to any surrender charge) immediately before the amount is received, over the investment in the contract at such time.

For a traditional contract, that means gain is gross cash value minus basis. For an EIR contract, is the rule the same? We can't be sure. EIR contracts did not exist at the time Code Section 72(e)(3) was enacted.

How would distributions from EIR contracts be taxed once an NQDA's basis and gain have both been reduced to zero? Here's an example:

Amy has an NQDA with basis of $20,000, gross cash value of $20,000, and an EIR value of $30,000. She takes a distribution of all $30,000 permitted under her EIR.

Applying Code Section 72(e)(3) to the facts in the example, there is no gain in the contract. Is any portion of the $30,000 distribution taxable? It seems like it should be, but we don't know for sure.

Status: We are still not sure.

CALCULATE RMDS WITH INCOME RIDER IRA ANNUITY

Speaking of income riders, they also present some interesting challenges when they are part of IRAs, especially when it comes to calculating required minimum distributions (RMDs) for those older than 73.

Treasury Regulation Section 1.401(a)(9)-6, Q&A-12, provides that for purposes of applying the required minimum distribution rules, the contract's cash value plus the actuarial present value (APV) of any additional benefits (such as survivor benefits in excess of the dollar amount credited to the employee or beneficiary) must be taken into account. In general, the year-end value of the IRA annuity is used to calculate the following year's RMD for the taxpayer.

There are certain situations where the regulations permit the taxpayer to ignore the value of a particular rider for RMD purposes. It appears those regulations ***do not*** permit the value of income riders to be ignored. The IRS has not given us clear rules about how to value an income rider for RMD purposes.

Coming up with even an estimate of the value of a particular contract's income rider for RMD purposes almost certainly will require an actuary. Few clients or tax advisors will be up to the job.

It's possible that in some cases the present value of the rider is close to zero, especially in early contract years. We have heard that insurance companies have been considering the value of income riders for RMD purposes in recent years.

If the carrier does not calculate a value for an EIR feature, how should the client and his tax advisor estimate the proper RMD to be taken from the annuity policy? We don't know.

Status: Our sense is that nearly every insurance company that offers qualified annuity contracts with income riders now take the value of such riders into account when calculating RMDs for the contract owner, so the uncertainty over valuation is a less important issue. We now consider this answered.

POLICY GIFT TAX VALUATION WHEN INSURABILITY HAS DETERIORATED

Treasury Regulations Section 25.2512-6 explains specifically how life policies are to be valued for gift-tax purposes:

> [W]hen the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by **adding** to the **interpolated terminal reserve** at the date of the gift the **proportionate part of the gross premium last paid** before the date of the gift which covers the period extending beyond that date. (Emphasis added.)

The gift-tax valuation of a life policy is sometimes given the shorthand description of interpolated terminal reserve plus unearned premium. For the purpose of our discussion, we will simply refer to it as ITR.

The regulations make clear that under the following circumstances different gift-tax-valuation methods are appropriate:

1. When the transfer of the contract is close to the time it was purchased, the value is the contract's purchase price.
2. When the policy is paid up, its value is the cost of a paid-up policy for someone the same age as the insured's current age.
3. Where a policy has accrued dividends or outstanding indebtedness, the ITR value should be adjusted for such dividends or indebtedness.
4. If something is unusual about the policy or the circumstances that would make a different valuation method appropriate, neither the ITR method nor any other method listed above may be used.

The last of these points makes valuation uncertain in many cases. The most obvious example is under the circumstances that the insured is uninsurable or impaired at the time of the gift is made. The IRS does not say what valuation method would be appropriate in those cases.

So, what valuation method should be used when making a gift of a life policy when the insured's health has gotten worse? We don't know.

Status: Still uncertain. It seems likely that at some point the Service will take advantage of the development of the life settlement market to update its valuation rules, but that day has not yet arrived.

NEW QUESTIONS

Four of the original questions have been answered well enough to cause us to remove them from the list. Here are four replacement questions that arise frequently.

Penalty Tax for Jointly Owned Annuities

Producers sometimes have joint ownership titling of a fixed annuity—often with spouses. The question can arise at distribution when the primary owner is over 59 1/2 and the joint owner is not, would they be subject to the 10 percent penalty tax?

The IRS has not said anything about the issue.

Carriers differ on how they report the penalty tax on Form 1099-R in such situations. Just because a carrier reports the taxable distribution as subject to the penalty tax doesn't mean that it's so—or vice versa. It'll be up to the client and the client's tax professional to decide what position to take on the client's income tax return.

If the IRS ever decides the client has done that incorrectly, they'll let the client know. Until then, the answer is uncertain.

Section 1035 Exchanges of NQDAs with Simultaneous Transfer between Spouses

Section 1035 of the Tax Code allows for the tax-free exchange of one NQDA for another. The administrative detail the Service has worked out over the years implies that ownership and identity of the annuitant must be consistent before and after for the exchange to be effective.

The transfer of an annuity from one person to another is generally treated as an income-taxable surrender of the contract. However, the Tax Code makes an exception for transfers of NQDAs between spouses, which are tax-free under Section 1041.

Here's the kind of example where ambiguity arises:

> Debra is the owner and annuitant of an NQDA. She and her husband Frank want to exchange the contract for a new annuity owned by Frank at a new company. The reason for the ownership and carrier change is that the new NQDA offers more favorable features.

It seems that by applying the logic of both Section 1035 and Section 1041, a tax-free exchange should be possible, even though ownership is changing during the process. However, in our experience, insurance companies insist that ownership must remain constant during the Section 1035 process. They refuse to process the transaction as a valid tax-free exchange.

Sometimes the agent can help the client work around the refusal, but in other cases practical considerations get in the way. In any event, the real-world answer is that no one can say for certain whether an exchange with a contemporaneous transfer between spouses is possible or not.

Deadline to Start Inherited NQDA Stretch

Clients may ask their agents when they need to start minimum distributions on nonqualified annuities inherited from nonspouse decedents. The rules are not as clear as we would like about this.

Tax Code Section 72(s) says this about stretch for nonspouse beneficiaries:

> If—
> any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary,
>
> such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and
>
> such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe. . . .

If we read the Code by itself, it seems like the deadline is the first anniversary of the annuity owner's death. Having said that, inherited NQDAs borrow most of their stretch rules to those that apply to inherited IRAs. Inherited IRAs may begin stretch distributions for nonspouse beneficiaries who are eligible by the end of the calendar year after the account owner's death.

In our experience, the carriers are divided on how they interpret. Some strictly interpret the one-year rule, while others feel that there is little risk in allowing the NQDA beneficiary's RMD to begin by the end of the year after death—so they permit it.

What is the *correct* answer? We don't know.

Tax-Deductibility of NQDA Loss upon Surrender

Sometime an annuity doesn't perform up to expectations. When a client disposes of a nonqualified annuity at a loss, is the loss tax-deductible?

The IRS's position in the past has been that a loss recognized on the surrender of a deferred annuity was only deductible as a miscellaneous expense—meaning the taxpayer had to itemize and the deduction was available only to the extent miscellaneous expenses were in excess of 2 percent of AGI.

The Tax Cut and Jobs Act eliminated this kind of miscellaneous expense deduction. So is an annuity loss now nondeductible? Some CPAs believe that a loss deduction is still possible, although they do not necessarily agree where on the tax return such losses are reported.

Until we get told otherwise by the Service, it's probably safest to tell our clients that annuity losses are not deductible.

CONCLUSION

The list of things a financial professional must know about in order to provide good help to his clients is pretty long. Expertise is required in various disciplines, including with regard to choice of financial products, company practices, client objectives, alternative approaches to solving family problems, and conducting business.

The financial professional is also required to be something of a tax expert who works in close conjunction with his best clients' CPAs. The list of tax topics on which that advisory team needs to have a good working knowledge is long. As we've seen in this newsletter, the list of tax issues for which there is no final answer is also long.

What does an advisor do when there is no final answer? That type of situation really separates the great professionals from the merely good ones. In ambiguous situations, the best teams will work
together to explain the nuances to the client in a way he or she can understand, and, working together, the team will settle on a way forward that all members of the team—financial professional, tax advisor, and client—are comfortable with.

LAGOS
WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

1320 VALLEY VISTA, SUITE 202
DIAMOND BAR, CA 91765
Phone: 866-444-4964, Fax: 714-940-0889

IN THIS ISSUE OF ADVISOR'S BULLETIN

The Enigmatic Tax Code:

Things We Can't Answer Revisited

Building Protecting and Perpetuating Family Wealth

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.