CPA

Client Bulletin

Smart tax, business and planning ideas from your Trusted Business Advisor℠

February 2018

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.

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.

In this issue

Annuity sales

Annuity sales in the first half of 2017 topped $100 billion.

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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.

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.

Did you know?

Campus costs

The average total cost at private, nonprofit four-year institutions reached $46,950 in the 2017–2018 school year, up from $45,370 a year ago. Those are the published charges for tuition, fees, room, and board. For in-state students living on campus at public universities, comparable average costs this year are $20,770.

Source: The College Board

Deducting employee business expenses

If you work for a business, you might incur certain expenses that are related to your job. In some cases, those expenses can be substantial. As of this writing, in late 2017, Congress is considering legislation that would eliminate miscellaneous itemized deductions, but it appears that they will be available on 2017 returns. That said, you may be able to deduct such expenses incurred last year when you file your 2017 federal income tax return.

The process of claiming this deduction for employee business expenses might not be simple. You must go through several steps, and you'll need relevant records to substantiate the deduction if you're challenged by the IRS.

The broad look

In general terms, here is an explanation of how to arrive at an employee business expense deduction. First, you need to see how much you have spent on items that are ordinary and necessary for your role at work. These must be outlays that were not reimbursed in some manner. Therefore, the amounts you hope to deduct must be your actual out-of-pocket costs.

Once you calculate this number, it is incorporated as a miscellaneous itemized deduction on Schedule A of your tax return. If you take the standard deduction instead of itemizing on Schedule A, you can't deduct your employee business expenses.

Other costs also go into the category of miscellaneous deductions. They might include tax preparation and investment fees. Once you have a total of miscellaneous items, that amount is deductible on Schedule A to the extent it exceeds 2% of adjusted gross income (AGI).

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Example: Al and Bonnie Carson are both employees at different companies. Al has no unreimbursed employee expenses, but Bonnie had $2,500 of such costs in 2017. Together, the Carsons' miscellaneous items total $4,100 for last year.

On their 2017 joint tax return, the Carsons report AGI of $110,500. In this example, 2% of AGI is $2,210. Subtracting $2,210 from $4,100 leaves $1,890, the amount of miscellaneous deductions they can claim on Schedule A.

What's allowed

The most common unreimbursed miscellaneous deductions may be vehicle costs, overnight travel, and business meals and entertainment. The deduction for business meals and entertainment generally is 50% of their total cost.

Beyond those items, the IRS lists many others as acceptable employee business expenses, from business liability insurance premiums to work-related education. They must have a genuine business purpose and be unreimbursed.

What's not allowed

Along with a lengthy list of possible qualified deductions, the IRS also has a list of things that don't belong in this category. Commuting costs are prominent on the do-not-deduct list, which also includes club dues, residential phones, and travel expenses for another individual. If you are going to claim business use of your car here, you'll need good records to show how much the car was used for commuting to and from work versus its use for business trips.

Preparing the paperwork

Generally, employees who claim this deduction use IRS Form 2106, "Employee Business Expenses," to tabulate the total amount for the year, presented in several categories. The total for this form goes onto Schedule A under miscellaneous deductions. A simpler version, Form 2106-EZ, may be used if you have no employer reimbursements and if any vehicle expense claim uses the standard mileage rate—53.5 cents per business mile in 2017.

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.

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,

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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.

Tax calendar

February 2018

February 15

All businesses. Give annual information statements to recipients of certain payments you made during 2017. Payments that are covered include amounts paid in real estate transactions (Forms 1099-S); amounts paid in broker and barter exchange transactions (Forms 1099-B); and payments to attorneys (Form 1099-MISC, if amounts are reported in box 8 or 14).

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

Individuals. If you claimed exemption from income tax withholding last year on the Form W-4 you gave your employer, you must file a new Form W-4 to continue your exemption for another year.

February 16

Employers. Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2017 but did not give you a new Form W-4 to continue the exemption for 2018.

February 28

All businesses. File paper versions of most annual information statements (Forms 1098, 1099, and others) for certain payments you made in 2017 (due date is April 2 if you are filing electronically).

March 2018

March 15

Partnerships. File a 2017 calendar-year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, and so on, or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004 and then file Form 1065 by September 17.

S corporations. File a 2017 calendar-year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, and so on or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporation election. File Form 2553, "Election by a Small Business Corporation," to choose to be treated as an S corporation beginning with calendar year 2018. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2019.

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

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