Lally&Co.
CPAs and Business Advisors

The EVERGREEN

Quarterly Journal for Clients & Friends

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- **IRS Final Rules Encourage Longevity Annuity Purchases**
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Contact our office or visit our website for more information.

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Dear Clients and Friends,

As the year nears its end, many clients are asking how they can prepare for the 2014 tax filing season and the 2015 tax year. This newsletter discusses certain tax planning techniques and items to be aware of in the upcoming year.

Additionally, this newsletter contains its first in a series of articles that provide an overview of our government's domestic financial operations, including deficits and sources and uses of its funds. This quarter's article provides an introduction to this series.

We continue to service our clients throughout the calendar year. As you read through *The Evergreen*, please do not hesitate to contact us if you have questions regarding an article or regarding your business or personal tax situation. We would be happy to hear from you! This and past issues of *The Evergreen* are available on our website at http://lallycpas.com/newsletters/.

Understanding Our Country's Finances

There is no question that our country's finances are complicated and complex. The degree to which they are well run impacts each and every one of us from our take home pay to our home values, our investments, and our personal net worth. Attempting to understand them may require you to learn new concepts, terms, and acronyms. As weighty as this subject is, we will attempt to explain the current and recent past of our country's finances in bite sizes and spread this over several issues of *The Evergreen*.

This first installment will address historical budget deficits while subsequent editions of *The Evergreen* will dive deeper into sources and nature of revenues and expenditures, the role of our Federal Reserve System, and other topics yet to be identified. Our goal is to provide you with a basic understanding of the facts while minimizing political commentary that may otherwise cloud your understanding. Let's get started.

Annual Deficits

In their own words, the US Senate Budget Committee defines deficit as "the amount by which the government's total budget outlays [disbursements or expenditures] exceeds its total receipts [revenues] for a fiscal year". Deficits (and surpluses) are affected by spending and taxes but also by economic growth, inflation, employment, and population growth. Deficits are measured in absolute dollars or in relative terms as a percent of the US Gross Domestic Product (GDP), each over a 12-month fiscal year from October 1st to September 30th; the fiscal year ended September 30, 2014 is abbreviated as "FY14". Gross Domestic Product is defined as the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

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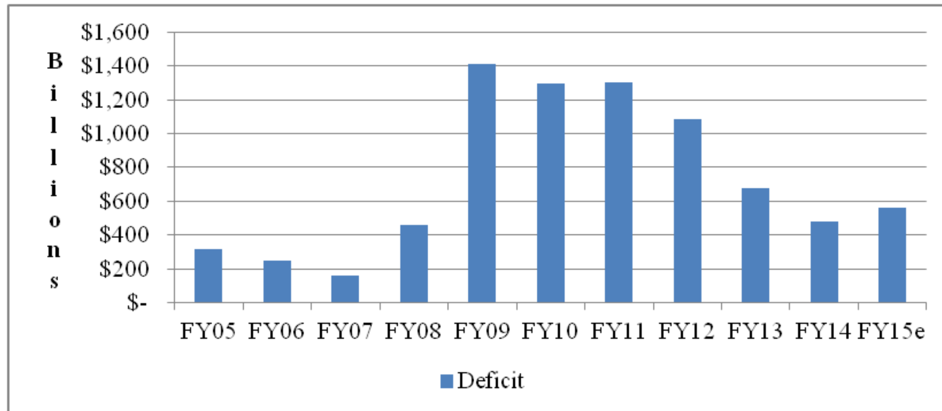
The following chart depicts US Federal deficits for ten fiscal years from FY05 through FY14.



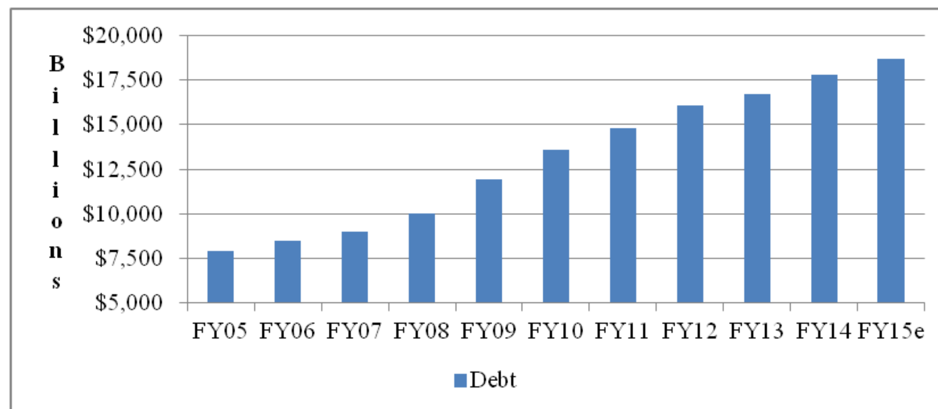
The FY07 deficit of $161 billion grew in just two years to $1,413 billion in FY09. Stated in relative terms, the FY07 deficit was 1.1% of GDP while FY09 was 9.8%. How could this have happened and why so quickly? General consensus identifies the four top contributors to the recent increase in annual deficits are: a) reduced tax payments (remember all the layoffs and bad earnings reports of 2008 and 2009), b) increases in social spending (automatic increases in Social Security Benefits, early retirements due to the poor job market and electing to take Social Security Benefits earlier, and increases in food stamp spending), c) targeted government spending (The Stimulus ($831 billion), TARP (authorized at $700 billion), and "cash for clunkers" ($3 billion), just to name a few), and d) military spending (the wars in the Middle East).

In economic theory, Federal deficits will increase in a recession. That happened in the 1980-82 recession, in the 1990-92 recession, and in the 2000-02 recession. The reason is quite simple: revenues tend to decrease in a recession while spending, including new targeted spending, grows. In FY13 and FY14, the deficits fell due to a recovering economy and increases in tax revenues helped by the higher income tax rates starting in the 2013 calendar year. The Congressional Budget Office projects deficits in each of the next ten years of between $500 billion and $960 billion and these deficits being between 3.0% and 4.0% of GDP.

Federal Government Debt

US Government **debt** grows as annual deficits mount up. The Federal debt is defined as the gross amount of debt outstanding issued by the US Treasury. Debt is necessary to meet spending without immediately increasing taxes or other revenue sources. Like deficits, debt is measured in absolute dollars or in relative terms as a percent of the US Gross Domestic Product (GDP).

The following chart depicts US Federal debt for ten fiscal years from FY05 through FY14.



Debt outstanding at the end of FY05 was $7.9 trillion, in two years it grew to $9.0 trillion, in another two years it grew to $11.9 trillion, and at the end of FY14 it was $17.8 trillion. In seven years, it has doubled and in the nine years it has grown 125%. Yes, scary! At the end of FY05, total Federal debt represented 61.1% of GDP, in less than four years it grew to 82.8% of GDP, and at the end of FY13 it was 101.6% of GDP. Double scary!! From the end of WWII through to FY08, debt as a percent of GDP has averaged 40%.

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Did you know?

- Todd A. Sacco, J.D., CPA/PFS a tax manager at Lally and Co. wrote and published an article that was featured in the Fall 2014 edition of the Pennsylvania CPA Journal. The article entitled "Affordable Care Act Delays Cause Tax Confusion" discusses the implications of the delays in mandating the Affordable Care Act.
- You can find helpful financial tools on our website www.lallycpas.com/financial-calculator/
- This and past issues of *The Evergreen* are available on our website. www.lallycpas.com/newsletter

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Firm Announcements

Christian Crabtree joined our Tax Department in September 2014 as a Staff Accountant

Cathy Paylo joined our Administrative Staff in September 2014

Colin Sherwin joined our Tax Department in September 2014 as a Staff Accountant

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Important Dates

November 17, 2014 - 2013 Extended Foundation Tax Returns Due

December 15, 2014 - 2013 4th Quarter Estimated Tax Payments Due for Corporations

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One side effect of the growing Federal debt is that it "elbows" out competition for debt securities in a market of finite resources. To make itself attractive, corporate debt must raise its coupon rate to attract investors which usually is a driver for future inflation. However, with the large intervention of the Federal Reserve, rates have been managed down for borrowers. More about the Fed in a later edition.

Needless to say, there are disturbing trends of Federal deficits and debt growth that need to be addressed. In certain circumstances, there are solid economic reasons why a country incurs both. However, most all economists agree that the US Government needs to return to historic level trends in both areas of its operations.

In our Winter edition, we will look at where our Federal government spends its money, in our Spring edition, we will discuss its revenue sources, and in our Summer edition we will explain "quantitative easing". Stay tuned.

New Challenges for 2014 Year-End Tax Planning

Before the fast-approaching new year, it's important to take some time and reflect on year-end tax planning. The weeks pass quickly and the arrival of January 1, 2015 will close the doors to some tax planning strategies and opportunities. Fortunately, there is still time for a careful review of your year-end tax planning strategy.

Traditional year-end planning techniques

For many individuals, a look at traditional year-end tax planning techniques is a good starting point. Spreading the recognition of certain income between 2014 and 2015 is one technique. Individuals need to take into account any possible changes in their income tax bracket. The individual income tax rates for 2014 are unchanged from 2013: 10, 15, 25, 28, 33, 35 and 39.6 percent. Each taxable income bracket is indexed for inflation. The starting points for the 39.6 percent bracket for 2014 are $406,750 for unmarried individuals; $457,600 for married couples filing a joint return and surviving spouses; $432,200 for heads of households; and $228,800 for married couples filing separate returns. For 2014, the top tax rate for qualified capital gains and qualified dividends is 20 percent.

For the second year, individuals also need to plan for a potential net investment income (NII) tax liability. The 3.8% tax applies to taxpayers with certain types of net investment income and who fall within the thresholds for liability (AGI of $250,000 for married filing jointly and qualifying widow(er), $200,000 for single and head of household, and $125,000 for married filing separately). Again, spreading income out over a number of years or offsetting the income with both above-the-line and itemized deductions are strategies to consider.

Tax extenders

Many individuals are surprised to learn that some very popular and widely-used tax incentives are temporary. If you claimed the higher education tuition deduction on your 2013 return, you cannot claim it on your 2014 return because the deduction expired after 2013. The same is true for the state and local sales tax deduction, the teachers' classroom expense deduction, the Code Sec. 25C residential energy credit, transit benefits parity, and more. All of these tax breaks expired after 2013 and unless they are extended by Congress, you will not be able to claim them on your 2014 returns.

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Businesses are also affected. A lengthy list of business-oriented tax breaks expired after 2013. They include the Work Opportunity Tax Credit (WOTC), research tax credit, Indian employment credit, employer wage credit for military reservists, special incentives for biodiesel and renewable fuels, tax credits for energy-efficient homes and appliances, bonus depreciation and more.

The good news is that Congress typically extends these tax breaks, probably for two years, and makes the extension retroactive to January 1. We expect to see tax legislation after the November 4th election. If passed, we expect taxpayers can claim these incentives on their 2014 returns. In past years, lawmakers waited until very late in the year, or even until the start of the new year, to vote on an extension of these incentives. Late extension puts extra pressure on the IRS to quickly reprogram its return processing systems. Most likely, the IRS will have to delay the start of the filing season. Our office will keep you posted of developments.

Retirement savings

In 2014, the Tax Court surprised many with its decision that a taxpayer could make only one nontaxable IRA rollover within a one-year period regardless of how many IRAs the taxpayer maintained (Bobrow, TC Memo. 2014-21). The one-year limitation is not specific to any single IRA maintained by a taxpayer, but instead applies to all IRAs maintained by the taxpayer. The IRS, in turn, announced that it would change its rules to reflect the court's decision.

The key point to keep in mind is that the Bobrow decision affects only IRA-to-IRA rollovers. The decision does not limit trustee-to-trustee transfers.

Affordable Care Act

Individuals who obtain health insurance through the Affordable Care Act Marketplace have special tax planning considerations, especially if they are eligible for the Code Sec. 36B premium assistance tax credit. The credit is payable in advance to insurers and it appears that most taxpayers have elected this option. These individuals must reconcile the amount paid in advance with the amount of the actual credit computed when they file their tax returns. Changes in circumstances, such as an increase or decrease in income, marriage, birth or adoption of a child, and so on, may affect the amount of the actual credit.

Remember that the Affordable Care Act requires individuals to have minimum essential coverage for each month, qualify for an exemption, or make a payment when filing his or her federal income tax return. Many individuals will qualify for an exemption if they are covered under employer-sponsored coverage. Individuals covered by Medicare also are exempt.

Employers Prepare for Employer Mandate and Code Sec. 6056 Reporting

As January 1, 2015 draws closer, many employers are gearing up for the "employer mandate" under the Affordable Care Act. For 2015, there is special transition relief for mid-size employers. Small employers (employers with fewer than 50 full-time employees, including full-time equivalent employees) are always exempt from the employer mandate and related employer reporting.

Employer mandate

Under Code Sec. 4980H, an applicable large employer must make a shared responsibility payment if either:

- The employer does not offer or offers coverage to less than 95 percent (70 percent in 2015) of its full-time employees and their dependents the opportunity to enroll in minimum essential coverage and one or more full-time employee is certified to the employer as having received a Code Sec. 36B premium assistance tax credit or cost-sharing reduction ("Section 4980H(a) liability"); or
- The employer offers to all or at least 95 percent of its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan and one or more full-time employees is certified to the employer as having received a Code Sec. 36B premium assistance tax credit or cost-sharing reduction ("Section 4980H(b) liability").

For purposes of the employer mandate shared responsibility provisions, an employee is a full-time employee for a calendar month if he or she averages at least 30 hours of service per week. Under final regulations issued by the IRS earlier this year, for purposes of determining full-time employee status, 130 hours of service in a calendar month is treated as the monthly equivalent of at least 30 hours of service per week.

The IRS has provided two methods for determining whether a worker is a full-time employee: the monthly measurement method and the look-back measurement method. The monthly measurement method allows an employer to determine each employee's status by counting the employee's hours of service for each month. The look-back measurement method allows employers to determine the status of an employee as a full-time employee during a future period, based upon the hours of service of the employee in a prior period.

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In September 2014, the IRS clarified the look-back method in certain circumstances. The IRS described application of the look-back method where an employee moves from one measurement period to another (for example, an employee moves from an hourly position to which a 12-month measurement period applies to a salaried position to which a 6-month measurement period applies). The IRS also described situations where an employer changes the measurement method applicable to employees within a permissible category (for example, an employer changes the measurement period for all hourly employees for the next calendar year from a 6-month to a 12-month measurement period).

Transition relief for mid-size employers
Mid-size employers are exempt from the Code Sec. 4980H employer mandate for 2015 under special transition relief. Employers qualify as mid-size if they employ on average at least 50 full-time employees, including full-time equivalents, but fewer than 100 full-time employees, including full-time equivalents.

The IRS has placed some restrictions on this transition relief for mid-size employers. During the period beginning on February 9, 2014, and ending on December 31, 2014, the employer that reduces the size of its workforce or the overall hours of service of its employees in order to satisfy the workforce size condition is ineligible for the transition relief. A reduction in workforce size or overall hours of service for bona fide business reasons will not be considered to have been made in order to satisfy the workforce size condition, the IRS explained.

Information reporting
Code Sec. 6056 requires certain employers to report to the IRS information about the health insurance, if any, they offer to employees. The IRS has posted draft forms and instructions about Code Sec. 6056 reporting on its website: Form 1094-C, Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns, and Form 1095-C, Employer-Provided Health Insurance Offer and Coverage.

Information reporting encompasses (among other things):

- The employer’s name, address, and employer identification number;
- The calendar year for which information is being reported;
- A certification as to whether the employer offered to its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer-sponsored plan;
- The number, address and Social Security/taxpayer identification number of all full-time employees;
- The number of full-time employees eligible for coverage under the employer’s plan; and
- The employee’s share of the lowest cost monthly premium for self-only coverage providing minimum value offered to that full-time employee.

Code Sec. 6056 reporting for 2015 is mandatory. Although mid-size employers may be exempt from the employer mandate, they are not exempt from Code Sec. 6056 reporting for 2015. The IRS is requiring all Code Sec. 6056 information returns to be filed no later than February 28 (March 31 if filed electronically) of the year immediately following the calendar year to which the return relates.

IRS Final Rules Encourage Longevity Annuity Purchases

Life expectancies for many Americans have increased to such an extent that most taxpayers who retire at age 65 expect to live for another 20 years or more. Several years ago, a number of insurance companies began to offer a new financial product, often called the longevity annuity or deferred income annuity, which requires upfront payment of a premium in exchange for a guarantee of a certain amount of fixed income starting after the purchaser reaches age 80 or 85. Despite the wisdom behind the longevity annuity, this new type of product did not sell especially well, principally for tax reasons. These roadblocks, however, have largely been removed by new regulations.

Treasury and the IRS recently released final regulations (TD 9673) to encourage taxpayers to purchase "qualified longevity annuity contracts" (QLACs) with a portion of their retirement savings held in IRAs or in retirement accounts held under a 401(k), 403(b) or other defined contribution plans that are subject to the rules for required minimum distributions (RMDs). The final regulations are meant to remove or mitigate some of the tax concerns new retirees may face when deciding whether or not to purchase a deferred income annuity.

Longevity Annuities—Generally
Purchase of a longevity annuity provides for a deferred income stream. Although the terms of specific longevity annuity contracts differ from plan to plan, the arrangement generally requires the purchaser to pay the premium as a lump sum to the insurer. The purchaser could be 65 years of age, 55, 50 or some other age, and the insurer would not begin to

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make payments under the longevity annuity contract until the purchaser had reached the specified age (of no more than 85 years for the tax benefits contained in the final regulations). The amount of the annuity depends on a number of factors, among them: the age at which the contract is purchased; the amount of the premium paid; the contractual interest rate; and the age at which payments begin.

RMDs

Not every individual who reaches retirement age possesses enough spare cash outside of his or her IRAs or other retirement accounts to purchase an income annuity, let alone a longevity annuity that does not begin to pay out for many years. In such cases individuals can purchase an annuity from within an IRA or defined contribution plan account. Prior to the final regulations, however, the RMD rules requiring taxpayers who reach age 70 ½ to begin taking distributions from these accounts would have forced taxpayers to factor the premium amounts into the calculation of their annual taxable distribution. This would have depleted the account funds more quickly than the actual balance, without premium payment, warranted.

QLACs

The final regulations provide that only qualified longevity annuity contracts (QLACs) are eligible for account balance exclusion from the RMD calculation. The regulations define a QLAC as:

- A longevity annuity whose premium payment does not exceed the lesser of $125,000 or 25 percent of the employee's account balance;
- A contract that provides for payouts to begin no later than the first day of the month following the purchaser's 85th birthday;
- A contract that does not provide any commutation benefit, cash surrender right, or other similar feature;
- A contract under which any death benefit offered meets the requirements of paragraph A-17(c) of Reg. §1.401(a)(9)-6 (see below for more details);
- A contract that states when issued that it is intended to be a QLAC; and
- A contract that is not a variable contract under Code Sec. 817, an indexed contract, or a similar contract.

The total value of all QLACs held by one person cannot exceed the lesser of $125,000 (indexed for inflation) or 25 percent of all qualified retirement accounts put together. This limitation does not extend to funds held in non-retirement accounts or to funds held in Roth IRAs.

In addition, the amount used to pay the QLAC premium is not taxable when the QLAC is purchased. This means the account holder has a zero basis in the QLAC. Distributions from the QLAC are fully taxable.

Death Benefit

Most longevity annuities do not provide any death benefit for the purchaser's beneficiaries. While some longevity annuity plans do offer a death benefit for the beneficiaries of annuity purchasers who die prematurely, plans that maximize the annuity payment generally provide that the insurer keeps the entire premium amount, plus interest, if the purchaser dies before payouts begin or the contract basis is exhausted.

Return of premium. The final regulations attempt to mitigate some of the risk retirees face when deciding to purchase a QLAC by allowing a QLAC to provide certain death benefits in limited circumstances. Notably, the final regulations add a feature missing from the proposed regulations: return of premium. Under the final rules, a QLAC is authorized to guarantee the return of a purchaser's premium if the purchaser dies before receiving benefits equal to the premium paid.

The final regulations provide that, where the purchaser's sole beneficiary under the QLAC is his or her surviving spouse, generally the only benefit permitted to be paid after the purchaser's death is a life annuity that does not exceed 100 percent of the annuity that would have been paid to the employee. The final regulations also allow QLACs to provide the return of premium feature if a surviving spouse who receives a life annuity under the contract dies before the payments equal the premium.

QLACs may also provide a lifetime annuity to designated non-spouse beneficiaries, but the annuity would likely be reduced. Calculation of an annuity payable to a non-spouse beneficiary would be calculated based on the applicable percentage provided in one of the tables in the final regulations. However, if the QLAC provides a return of premium feature, the applicable percentage that the beneficiary would receive is zero.

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