

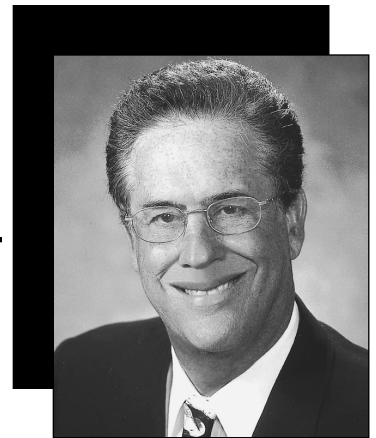
# THE BERNSTEIN TAX LETTER

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**FEBRUARY 2008**

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Dear Reader,

The President and Congress were attempting to finalize an economic stimulus bill at the time this letter had to be sent to the printer. We were hoping to report the final agreement, but couldn't wait any longer to go to print. The House of Representatives would provide rebate checks to specified taxpayers and nontaxpayers. The rebate checks for eligible individuals will be \$300 for individuals (\$600 for married filing jointly). Also, a "child bonus" would add \$300 per child to the rebate amounts. The estimated cost of the rebates is approximately \$100 billion. The Senate's rebate plan has higher amounts, \$500 for an individual and \$1,000 for married taxpayers filing jointly and expands the rebates to those having social security as qualifying income.

But, there are details that will reduce or eliminate the rebates for many individuals or families. The House version provides that rebates will be phased out at a rate of 5 percent for each additional \$1,000 of adjusted gross income above \$75,000 for individuals (\$150,000 for married taxpayers filing jointly). The phase-outs would apply to both the rebates and the child bonuses. In addition to rebates, some low-income taxpayers would have a zero percent rather than a 10 percent income-tax bracket in 2008. The Treasury estimates that the House rebate plan provides approximately \$28 billion in rebate checks to individuals or families that pay no income tax.

There are a couple of immediate problems even if the legislation is passed by the time this letter gets to you. First, the IRS was already behind schedule with its income-tax processing software due to the late passage of the AMT exemption for 2007. Second, the IRS may not have sufficient contact data to find all individuals and families who don't pay income taxes and information from the Social Security Administration will be necessary. In any event, it's unlikely that rebate checks will be received until June.

The Senate's plan also extends the time limit for collecting unemployment insurance. Both chambers included business tax incentives. Significantly, there is a bonus depreciation proposal and a larger immediate deduction under Sec. 179 for current expensing of equipment. When the legislation is passed, we'll provide a more extensive summary.

Cordially,

*Richard S. Bernstein*

**A Second Opinion Costs You NOTHING,  
But Could Save You MILLIONS!**

**WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION,  
SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?**

## **TAX PLANNING IMPLICATIONS OF ANNUITIES**

### **WHAT IS AN ANNUITY?**

An annuity is defined as a systematic liquidation of a principal amount, with interest, over a fixed term or a period of time based on one or more life expectancies. A commercial annuity involves a contract with an insurance company, under which the contract owner pays the insurance company a premium in one or more installments. In return, the company promises to make some form of annuity payment, either immediately or at a determined or undetermined time in the future. Often, the actual annuity payment under the contract is deferred for some period of time at the election of the contract owner. During this period of deferral, the contract will accumulate in one of two ways, depending on the type of annuity. The accumulation could be based on interest rates (a fixed annuity) specified by the insurance company in the form of both current and guaranteed rates. Or, in the case of a variable annuity, the accumulation would be based on investment options selected by the contract owner. The contract owner absorbs the risk associated with the investment decisions in this instance.

### **HOW IS THE ANNUITY TAXED?**

If the annuity is deferred, the contract owner is not taxed on the accumulation of the funds unless some financial transaction (e.g., a withdrawal or policy loan) is performed with the contract. If such a transaction occurs, the proceeds are taxed on an income first or FIFO basis, unless the contract contains an investment made before August 14, 1982.

If and when the contract is annuitized (i.e., contract funds are paid out in the form of an annuity), the beneficiary receiving the annuity payments (the annuitant) is taxed according to an exclusion ratio in which part of each payment is treated as a nontaxable return of the investment in the contract and part as taxable income on the contract funds until the annuitant's life expectancy is reached. If the annuitant lives beyond his or her life expectancy (based on actuarial tables), the remaining payments are subject to ordinary income taxes. The discussion above is based on a simple life annuity and ignores survivorship or refund (period certain) features that might be selected.

Deferred annuities are popular as accumulation vehicles because of the tax-deferred accumulation feature. These contracts are sometimes never annuitized during the contract owner's lifetime. This raises some questions about the estate planning implications that are discussed below.

### **THE NON-NATURAL PERSON RULE**

A deferred annuity contract owned by certain entities will not be eligible for the tax-deferral feature during the accumulation period. In fact, the contract will not be treated as an annuity at all under the Internal Revenue Code. This means that income accumulating within such a contract will be taxed each year as ordinary income to the contract owner. Obviously, this is an undesirable result. How can ownership of an annuity be arranged to avoid this unfavorable rule? In other words, what types of trusts and business entities are permitted to own deferred annuities? Generally, the non-natural person rule applies to contracts that are not owned by human beings. However, there are important exceptions to this rule, including contracts owned by the estate of a deceased contract owner and contracts owned by entities as an agent for a natural person. The agent-for-a-natural-person exception to the non-natural-person rule has been the subject of much discussion and numerous IRS rulings.

First, the IRS has ruled repeatedly that certain trusts that are taxable as grantor trusts (trusts taxable to the grantor of the trust for income tax purposes) are entities that qualify as an agent for a

natural person (e.g., Ltrs. 9120024, PLR 9316018). However, the private rulings in this area have not covered every type of grantor trust. Therefore, some types of grantor trusts may or may not qualify under the agent-for-a-natural-person exception and therefore be permitted to own an annuity contract without loss of tax benefits. This issue may be important when an annuity is being considered for funding a living irrevocable trust designed to remove assets from the grantor's estate for federal estate tax purposes, yet be taxed as a grantor trust for federal income tax purposes.

Trusts that have only one beneficiary have also been treated under the agent-for-a-natural-person exception (e.g., Ltrs. 9204010, PLR 9204014, PLR 9639057). Such trusts have been treated as agents for a natural person regardless of whether they are grantor trusts. Therefore, trusts with only one beneficiary might be able to own deferred annuities without adverse income tax consequences.

It is significant to note that other income tax problems can arise when an annuity is placed in a trust other than a grantor trust, such as a credit shelter or QTIP marital trust set up for estate planning purposes. For example, in such cases, any taxable income generated by the annuity could be trapped in the trust and taxed at the highly compressed income tax rates applicable to trusts (i.e., taxable at the highest 35 percent bracket for income above \$10,700 in 2008). If the terms of the trust prohibit or substantially restrict principal distributions to the trust beneficiary, this problem could be worse. The application of the non-natural-person rule to annuities held by such trusts is uncertain and would depend on the terms of the particular trust and whether the annuity was tailored to fit the particular trust. In a series of rulings (Ltrs. 200440011-17), trusts were created for a grantor's grandchildren and funded with annuity contracts. The annuities could be distributed (in whole or in part) at certain ages at the request of a beneficiary. The IRS held that the annuities were considered owned by a natural person and that the distribution of all or part of a policy in kind to a beneficiary was not a taxable event. In another private ruling, a testamentary trust with a life beneficiary and other beneficiaries who would receive property after the life beneficiary's death was considered to be an agent for a natural person (see Ltr. 9752035). Even so, it might not be advisable to have an annuity contract pass into an estate planning trust at the owner's death. Rather, naming an individual as a death beneficiary under the contract is less problematical and will generally result in the maximization of tax deferral on the contract funds.

The IRS has ruled privately on the use of a deferred annuity in a charitable remainder unitrust (CRUT). (Ltrs. 9009047 & 9825001) These rulings indicate that a CRUT is not an exception to the non-natural person rule and that the purchase of an deferred annuity is not a prohibited act of self-dealing by the trustee. Note that the CRUT is a tax-exempt charitable entity and the taxation of the annuity's income would generally be deferred until distributions are made to individual beneficiaries other than the charity. It is clear that the use of a deferred annuity in a CRUT is a transaction that must be appropriately designed.

It is uncertain whether the IRS would consider a partnership to be an agent for a natural person and permit tax deferral for annuities owned by partnerships. This question has frequently been posed, but the IRS has not ruled on it. Ownership by corporations, on the other hand, is specifically the type of ownership that the non-natural person rule was designed to cover. Such ownership must therefore be avoided (unless the annuity is an immediate annuity in which annuitization occurs within one year of the purchase of the contract).

## **TAXATION ON THE CONTRACT OWNER'S DEATH**

If an annuity contract is still in the deferral period and the owner wishes to continue tax-deferred accumulation as long as possible (even after his or her death), what are the options? The best option is to name the spouse as the death beneficiary under the contract. If the spouse receives the contract upon the owner's death, the spouse may continue to accumulate the funds on a tax-

deferred basis just as if he or she had originally owned the contract. If an individual other than a spouse is named as the death beneficiary, deferred accumulation of all the funds in the contract cannot continue. The funds must either be paid out over a 5-year period or distributed over the designated beneficiary's lifetime, with payments commencing within one year of the owner's death. In such cases, annuities may be more valuable as asset-accumulation and retirement vehicles than as asset-transfer vehicles, particularly because these contracts do not generally receive a basis step-up at the owner's death. However, it is necessary to examine carefully the benefits of long-term income tax deferral before determining the deferred annuity's efficiency as an asset-transfer vehicle.

For estate tax purposes, the annuity is in the contract owner's gross estate if annuity benefits are payable to a survivor to the extent (proportionately) that the contract owner paid for the contract. The estate taxes payable as a result of the annuity are available as a deduction against the income taxes due when the annuity payments are taxable to the beneficiary.

This has been only a quick overview of the many income and estate tax issues concerning annuity policies. Careful planning should accompany any extraordinary ownership or beneficiary choices.

## RECENT CASES AND RULINGS

### **IRS Accepts Limited Liability Company (LLC) Interest As Collateral For Estate Taxes Deferred Under IRC Sec. 6166**

Estates holding closely held business interests valued at greater than 35 percent of the adjusted gross estate may elect to pay the estate tax caused by the inclusion of the closely held business interests in installments. The statute provides rules for securing the interest of the IRS in the deferred taxes and the IRS has authority to require the filing of a bond. In this ruling (Ltr. 200803016) the business interest held by the estate was a 75 percent stake in an LLC that owns a retail shopping center. The estate agreed to pledge the LLC interest as collateral with the estate's attorney as an escrow agent.

The statute requires that the business interest must be expected to survive the deferral period (approximately 15 years), the individuals with an interest in the collateral must agree to the special lien, and the value of the interest must be sufficient to satisfy the deferred estate taxes. In this case, the IRS agreed to accept the collateral and the IRS must file a Notice of Federal Tax Lien to provide notice to potential purchasers that the LLC interest is collateral for deferred estate taxes.

A membership interest in an LLC is treated as personal property under state law. There was discussion that indicated that it was unclear whether the Notice should be filed in the state of the decedent or the executor. In this instance the state was the same, but it is possible that the IRS would file the Notice in more than one state if the locations of the executor(s) and the residence of the decedent were different.

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This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

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