Q&A

Advanced Markets

2018 Edition

Allianz Life Insurance Company of North America
Allianz Life Insurance Company of New York

For all that's ahead.®

Allianz

P

For financial professional use only – not for use with the public.
Product and feature availability may vary by state and broker/dealer.

AMK-118-N

When business matters leave the realm of the ordinary, you may need to look to a resource that's extraordinary.

Look no further.

The Advanced Markets Q&A book is the first place to look for answers to complex questions that occasionally arise in your business.

With special emphasis on areas such as the federal tax implications of annuities, retirement plans, and contract structuring, this publication provides pragmatic answers to some of the more common questions the Advanced Markets team receives each day.

All examples are hypothetical and do not represent actual clients.

Please note that in order to provide a recommendation to a client about the transfer of funds from an investment product to a fixed insurance product or annuity, you must hold the proper securities registration and be currently affiliated with a broker/dealer or registered investment advisor. If you are unsure whether or not the information you are providing to a client represents general guidance or a specific recommendation to liquidate a security, please contact the individual state securities department in the states in which you conduct business.

This publication does not take into account possible surrender charges in any examples. Please be aware of surrender charges that could apply to your clients.

Purchasing an annuity in a retirement plan that provides tax deferral under sections of the Internal Revenue Code results in no additional tax benefit. An annuity should be used to fund an IRA or other qualified plan based on the annuity's features other than tax deferral. These include guaranteed lifetime income and death benefit options. Other factors to consider include fees, expenses, charges, risks, and limitations that may be associated with an annuity.

This content is for general informational purposes only. It is not intended to provide fiduciary, tax, or legal advice and cannot be used to avoid tax penalties; nor is it intended to market, promote, or recommend any tax plan or arrangement. Allianz Life Insurance Company of North America, Allianz Life Insurance Company of New York, their affiliates, and their employees and representatives do not give legal or tax advice or advice related to Social Security benefits. Clients are encouraged to consult with their own legal, tax, and financial professionals for specific advice or product recommendations, or to go to their local Social Security Administration office regarding their particular situation.

Allianz Life Insurance Company of North America (Allianz) and Allianz Life Insurance Company of New York (Allianz Life® of NY) are affiliated companies.

Products are issued by Allianz Life Insurance Company of North America, 5701 Golden Hills Drive, Minneapolis, MN 55416-1297. www.allianzlife.com. In New York, products are issued by Allianz Life Insurance Company of New York, 28 Liberty Street, 38th Floor, New York, NY 10005-1422. www.allianzlife.com/new-york. Only Allianz Life Insurance Company of New York is authorized to offer annuities and life insurance in the state of New York. Variable products are distributed by their affiliate, Allianz Life Financial Services, LLC, member FINRA, 5701 Golden Hills Drive, Minneapolis, MN 55416-1297. www.allianzlife.com

For financial professional use only – not for use with the public.

Contents

Jointly owned annuities

Question: Does it ever make sense to own an owner-driven nonqualified annuity jointly?

Bottom line: Owning an owner-driven annuity jointly with someone allows clients to take advantage of the death benefit guarantees regardless of which owner passes away first. Particularly for married couples, it may be advantageous to own an owner-driven annuity jointly.

Does Allianz or Allianz Life of NY permit joint ownership of its annuities? Yes. Allianz and Allianz Life of NY allow spousal[1] joint owners on all nonqualified contracts. Nonspousal joint owners are limited to non-income products. Check with your Allianz or Allianz Life of NY representative. Only a spousal joint owner can continue the contract at death because the surviving joint owner is the primary beneficiary under most contracts. A nonspouse joint owner would have to choose a death benefit at first death.

Is there any advantage to owning an Allianz or Allianz Life of NY annuity jointly? Internal Revenue Code (IRC) Section 72(s) provides that the death benefit on a jointly owned annuity is triggered at the death of either joint owner. With most currently issued Allianz or Allianz Life of NY contracts, regardless of which joint owner passes away first, the surviving joint owner is eligible to receive the death benefit as the primary beneficiary. Thus, the maximum death benefit available under the contract at that time would be available at either owner's death (versus having to wait until the death of the sole owner when a contract is owned in one individual's name).

Who receives the death benefit at the first death of a joint owner? The death benefit is paid to the beneficiary. Most currently issued Allianz or Allianz Life of NY annuity contracts provide that the surviving joint owner is deemed to be the primary beneficiary. Thus, if a married couple owns an Allianz or Allianz Life of NY annuity jointly, the surviving spouse is the primary beneficiary and can choose to continue the contract or can select a payout of the annuity proceeds. Most currently issued Allianz or Allianz Life of NY contracts provide that the surviving joint owner is the primary beneficiary even if someone else (such as a child) is named as primary beneficiary. In that situation, the child will be treated as contingent beneficiary.

With nonspousal joint owners, most currently issued Allianz or Allianz Life of NY contracts provide that the surviving joint owner is the primary beneficiary and must decide whether to take a lump-sum payout, annuitization, or a life expectancy payout. Under federal tax law, the surviving nonspousal joint owner does not have the option of continuing the contract. In addition, if annuitization is chosen, the first annuity payment must be received within one year of the date of death.

Example: George (age 65) and Ann (age 61), husband and wife, purchase an Allianz or Allianz Life of NY annuity for $200,000. George dies at age 85, predeceasing Ann. If Ann, the beneficiary, takes a payout of the death benefit proceeds, she could receive a lump-sum payment of the death benefit value.

As George's surviving spouse, surviving joint owner, and primary beneficiary, Ann could also choose to continue the contract.[2]

[1] Throughout this document, the term "spouse" will be based on federal law.
[2] Other options may be available depending on product and state of issue.

Jointly owned annuities

Who should be the annuitant of a jointly owned contract? Allianz or Allianz Life of NY does not permit joint annuitants. Thus, typically one of the joint owners is named as annuitant on a jointly owned contract. However, the annuitant on an owner-driven contract does not come into play unless the contract is annuitized. Upon annuitizing the contract, the owners could choose to annuitize over the joint life expectancy of both owners. In order for joint owners to elect joint annuitization, one of the joint owners must be the annuitant on the contract.

Is there any disadvantage to owning a nonqualified Allianz or Allianz Life of NY annuity jointly? You should be sure to consider the older client's age when evaluating the annuity income and benefits. If there is a significant age difference between the two owners, the individuals may be able to take greater advantage of the contract's income and death benefits by having the younger individual own the contract in his or her sole name. In addition, for estate planning purposes, many attorneys prefer to have their higher net worth married clients own assets in their separate names or through separate revocable trusts. Your client's attorney should be able to help you determine how joint ownership of an annuity would affect the client's estate plan.

Does the 10% federal additional tax apply if the younger owner is under age 59½? Generally, a 10% federal additional tax applies when an annuity owner takes a distribution from his or her nonqualified annuity before attaining age 59½.

Funding credit trusts with annuities

Question: Why would a credit trust purchase a nonqualified annuity?

Bottom line: The income and death benefits of an annuity may be a way to balance the competing interests of trust income beneficiaries and remainder beneficiaries. In addition, if the annuity owned by the trust qualifies for income tax deferral of increases in value, the annuity can provide a means to accumulate income inside the trust without triggering income tax (it takes only $12,500 of trust income in 2018 to trigger the top 37% federal income tax rate).

What is a credit trust? A credit trust (sometimes known as a bypass trust, B trust, or credit shelter trust) is a trust established at the death of one spouse for the benefit of the surviving spouse. The intent is to reduce or avoid estate tax at the death of the surviving spouse. Typically, the credit trust provides income and/or principal to the surviving spouse. At the death of the surviving spouse, remaining assets pass to the remainder beneficiaries (often, children or grandchildren).

Does an annuity owned by a credit trust qualify for income tax deferral of increases in value? Internal Revenue Code (IRC) Section 72(u)(1) provides that a trust-owned annuity will qualify for income tax deferral of increases in value if the trust is an "agent for a natural person." Generally, a trust qualifies for income tax deferral of increases in value as long as all trust beneficiaries are natural persons (meaning living, breathing people rather than charities or corporations). Thus, many trust-owned annuities may qualify for income tax deferral of increases in value just as an individually owned annuity would. The attorney who drafted the trust should be able to determine whether the trust satisfies IRC Section 72(u).

How does the death benefit work since trusts do not "die"? Even though all contracts currently issued by Allianz or Allianz Life of NY are owner-driven, IRC Section 72(s)(6) provides that any death benefit on a trust-owned annuity is paid at the annuitant's death. Similarly, with trust-owned contracts, commissions and any income or death benefit are based on the annuitant's age (rather than the owner's age).

Who should be the annuitant of the credit trust-owned contract? Typically, credit trust assets are distributed at the death of the surviving spouse. Thus, the spouse is often the most appropriate annuitant.

Example: At Husband's death, a credit trust is established for Wife's benefit. Since the trust will be distributed at the Wife's death, it would make sense that the annuity's death benefit is also paid to the trust at that time. In this situation the Wife is probably the best person to name as annuitant.

If the intent is to allow income to accumulate in the trust during the surviving spouse's lifetime, it may make sense to purchase separate contracts for each trust remainder beneficiary. It may be possible to "roll out" these annuities to the remainder beneficiaries at the surviving spouse's death (see PLR 199905015 and PLR201124008[1]). With this strategy, the contracts issued are often identical contracts, to make sure that all contracts are equal in value at the termination of the trust. All aspects of the trust and of the annuity contract(s) should be considered carefully before using this strategy to make sure that no unintended problems are created by the contract structure.

[1] A private letter ruling (PLR) is directed only to the taxpayer who requested it. IRC Section 6110(k)(3) provides that it may not be used or cited as precedent.

Who should be the beneficiary of the credit trust-owned contract? Typically, the credit trust itself is named as beneficiary. This is particularly important if someone other than the surviving spouse is named as annuitant.

Example: Dad passes away and, at his death, a credit trust is established for the benefit of Mom. The credit trust purchases two nonqualified annuity contracts. The couple's daughter Susan is named as annuitant on Annuity #1 and their son Tom is named as annuitant on Annuity #2.

If Susan dies before her mother (the surviving spouse), the trust-owned contract terminates and the proceeds are distributed to the beneficiary.

If the credit trust is named as beneficiary of the trust-owned annuity, the proceeds would be paid to the credit trust. If the annuity beneficiary is not the credit trust, the annuity beneficiary designation will control. However, you could have a situation where an asset of the credit trust is distributed in violation of the terms of the credit trust and is no longer available to the surviving spouse and remainder beneficiaries. For this reason, it is typically best to name the credit trust as beneficiary of any annuity owned by the credit trust.

Assume that Susan is annuitant on Annuity #1 and Tom is annuitant on Annuity #2, and the trust transfers ownership of the annuities to Susan and Tom at Mom's death (upon transfer, accumulated interest in the contract may be subject to income tax). Susan and Tom can then change the annuity beneficiary to name a beneficiary other than the credit trust (which at this point, after Mom's death, no longer exists).

The downside of naming the credit trust as beneficiary of the annuity is that the annuity proceeds will have to be paid to the trust in a lump sum, or within five years of the annuitant's death if the trust qualifies for tax deferral of increases in value. Generally, tax law does not yet permit the option of a life expectancy payout when a trust is named as beneficiary of a nonqualified annuity.

Is an Allianz or Allianz Life of NY nonqualified annuity an appropriate purchase for a credit trust? An Allianz or Allianz Life of NY annuity may be a way to balance the competing interests of the trust's income beneficiary (usually, the surviving spouse) and trust remainder beneficiaries (who typically receive the balance of the credit trust at the death of the surviving spouse). If the surviving spouse is the annuitant, the death benefit can help provide for a certain amount to be available for the remainder beneficiaries at the death of the surviving spouse. Any trust purchase of an annuity should be carefully reviewed by the trustee and his or her financial professional to make sure that an annuity purchase and the guarantees that are selected are appropriate for the particular trust situation.

In addition, if the trust-owned annuity qualifies for income tax deferral of increases in value, the annuity may be a way to avoid confiscatory trust income tax rates. In 2018, an individual would have to have more than $500,000 of taxable income and a married couple filing jointly would have to have more than $600,000 of taxable income to reach the top 37% federal income tax bracket. In contrast, a trust with only $12,500 of income could be subject to the 37% federal income tax bracket. If the intent is to accumulate assets inside the credit trust, the trustee could invest the credit trust in assets where dividends, interest income, and any short-term or long-term capital gains are taxed at trust income tax rates. Or, the trustee could purchase a variable annuity and move in and out of the annuity's

(continued on next page)

allocation options over the years with no income tax due until a distribution from the annuity occurs. If the surviving spouse lives 10, 20, or 30 years, the income tax deferral of increases in value offered by a nonqualified annuity could mean significant tax savings.

Are there any special concerns when a credit trust purchases a nonqualified annuity? When determining whether an annuity is a suitable purchase for a credit trust, surrender charges, timing issues, taxation, and contract terms are among the items that should be considered.

Surrender charges. Some credit trusts require that all income be paid to the surviving spouse or other beneficiaries of the trust. The trustee should consult an attorney to determine what will be considered income under the trust document and/or state law. The trustee should then consider whether the income that must be distributed is likely to exceed the free withdrawal amount, and how any withdrawals from the annuity affect other annuity provisions.

Timing issues. If the trust document requires a distribution before the death of the annuitant (for example, the trust terminates at mother's death but son is named as the annuitant), surrender charges may apply.

Taxation. There is an Internal Revenue Service (IRS) private letter ruling (PLR 199905015[1]) that indicates a trust may be able to transfer ownership of a trust-owned nonqualified annuity to a trust beneficiary without triggering income tax on any increase in the contract. However, before transferring ownership of a trust-owned annuity to a trust beneficiary, keep in mind that PLRs can only be relied upon by the party to whom the specific ruling was issued. The transfer of ownership of an annuity contract may affect contract provisions and riders and generally has tax and legal implications. The trustee should consult his or her tax advisor to determine whether the increase would be taxable in a specific trust situation. If the annuity is taxed at the trust level, it takes only minimal income to reach the top federal income tax bracket. The trustee's tax advisor can help determine whether the annuity will be taxed at the trust level or to the individual beneficiaries in the specific situation.

Contract terms. The trustee should review the terms of the annuity contract to be sure that they are consistent with the trust and trust ownership of the annuity won't cause unintended consequences.

Pre-age 59½ 10% federal additional tax. Allianz or Allianz Life of NY looks to the age of the annuitant when determining whether to report an annuity distribution as premature. If the annuitant is under age 59½, the distribution is reported as premature and subject to the 10% federal additional tax (no known exceptions). Note that the annuitant of a trust-owned contract cannot be changed.

Are there any additional forms that must be submitted when a trust purchases an Allianz or Allianz Life of NY annuity? A credit trust should have its own tax identification number and the trust tax ID should be provided on the application. The Allianz or Allianz Life of NY nonindividual ownership form must be signed by a professional trustee, CPA, or attorney attesting that the trust is an agent for a natural person and the nonqualified annuity does qualify for income tax deferral of increases in value. Allianz or Allianz Life of NY does not determine whether a trust is an agent for a natural person.

[1] A private letter ruling (PLR) is directed only to the taxpayer who requested it. IRC Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pitfalls of naming a minor beneficiary

Question: What happens when a minor is named as beneficiary of an annuity?

Bottom line: Certain states impose restrictions on the distribution of annuity proceeds to minor beneficiaries. These restrictions may be especially problematic for a minor beneficiary of a qualified annuity due to the required minimum distribution (RMD) rules. The restrictions are also problematic for contracts that require annuitization for a beneficiary to receive the highest value. It is typically better to name a Uniform Transfer to Minors Act (UTMA) or where applicable, a Uniform Gift to Minors Act (UGMA) account for the benefit of the minor as beneficiary rather than the minor directly. Alternatively, a trust for the benefit of the minor can be named as beneficiary.

Who is a minor? The age of majority is usually age 18 but this varies by state. Even within the same state, a child might be considered a minor for some purposes and an adult for other situations.

Example: In Minnesota, the age of majority is 18. However, if someone establishes an UTMA account, the child need not be given full access to the UTMA account until age 21.

Should a minor be named outright as beneficiary of an annuity? This depends very much on state law but it can create very unhappy clients and producers!

Why? In certain states, an insurance company is not permitted to distribute funds over a nominal amount (typically $5,000 or $10,000) to a minor without having the parents obtain court documents proving that they have been appointed as guardian of the minor's estate. Parents may not understand the difference between being a guardian for the child's care and being a guardian of the minor's estate, and may believe they have both guardian rights automatically as a parent. The bigger problem is that sometimes the parents must post a bond so that the court can make sure that the minor will be reimbursed if the parents misuse the annuity proceeds.

Example: Timmy is 15 years old and lives in Virginia. Grandpa recently died and Timmy is the named beneficiary of Grandpa's $50,000 Allianz or Allianz Life of NY annuity.

Under Virginia law, Allianz or Allianz Life of NY can distribute $10,000 to Timmy. To distribute the other $40,000, Virginia law requires Timmy's parents to obtain a certificate of qualification as Guardian of Timmy's estate from the local probate court. Timmy's parents have to post a bond in order to receive the certificate. They would also have to file an initial inventory with the court and an annual report until Timmy reaches age 18.

The simple solution? The unnecessary paperwork and expense could have been easily avoided simply by naming an UTMA account for the benefit of Timmy as beneficiary of the annuity rather than naming Timmy outright as beneficiary.

Note: If you name an UTMA account as beneficiary, you also should specifically name a custodian for the UTMA to manage the account until Timmy reaches the UTMA age of majority. Let's assume that Grandpa wants to name Timmy's mother Mary as custodian. He would complete the beneficiary designation as follows: "Mary Smith, as custodian for Timmy Smith under the (state's name) Uniform Transfer to Minors Act."

Another alternative is creating a trust for Timmy's benefit and naming the trust as beneficiary rather than naming Timmy directly as beneficiary.

Uniform Transfer to Minors Act and annuities

Question: Should a minor own an annuity?

Bottom line: Having a minor as owner of an annuity can be problematic. If it is determined that having a minor own an annuity is suitable, it may be better to name a Uniform Transfer to Minors Act (UTMA) or UGMA account as owner of the annuity rather than the minor directly. Alternatively, a trust for the benefit of the minor can be named as annuity owner.

Who is a minor? The age of majority is usually 18 but this varies by state. Even within the same state, a child might be considered a minor for some purposes and an adult for other situations.

Example: In Minnesota, the age of majority is 18. However, if someone establishes an UTMA account, the child need not be given full access to the UTMA account until age 21.

Can a minor own an Allianz or Allianz Life of NY annuity? Yes. If a particular state honors contracts made by a minor of a certain age (often this is 15 or 16), we do permit a minor of the specified age to own an annuity.

What is a Uniform Transfer to Minors Act (UTMA) account? A Uniform Transfer to Minors Act (UTMA) account is a custodial arrangement for the benefit of a minor (Timmy). An irrevocable gift is made to the UTMA account and a custodian is appointed to manage the account until Timmy reaches the UTMA age of majority. When Timmy attains the age of majority, the custodian steps down and Timmy becomes the owner of the UTMA account (and the annuity).

Gift tax return reminder. If you transfer more than the federal gift tax exclusion amount ($15,000 in 2018) to an UTMA account in any particular year, you will need to file a gift tax return by April 15 of the year following the year of the gift.

Example: Grandpa transfers $16,000 to an UTMA account for Timmy in 2018. Grandpa will need to file a gift tax return reporting the gift by April 15, 2019.

Why is it better to have an UTMA account own the annuity for the benefit of the minor? For one thing, an UTMA account can be set up for a minor of any age. Only older minors (typically, age 15 or 16 – depending on the state) are able to own the annuity outright.

An UTMA account also gives the parent (or other donor) more control over the gifted monies. The donor either serves as custodian of the UTMA account or selects a custodian to manage the UTMA account until Timmy reaches the UTMA age of majority (which is usually age 21 or older). Until Timmy reaches the UTMA age of majority, the custodian can make distributions to Timmy as the custodian deems advisable for Timmy's benefit. At the UTMA age of majority, the UTMA account (and the annuity) belongs to Timmy.

Important. Keep in mind that if Timmy is under age 59½, a 10% federal additional tax is going to apply to any taxable distribution (with a nonqualified annuity, this would be any increase on the contract) in addition to income tax and any surrender penalties. Thus, if the intent is to use the annuity for Timmy's college costs, an annuity may not be the most appropriate funding vehicle for the UTMA.

Uniform Transfer to Minors Act and annuities

Is the UTMA age of majority different from the regular age of majority? Remember that under a particular state's law, the age of majority for UTMA purposes may be different from the age of majority for other purposes.

Can you take an UTMA gift back? No. Any money or other asset transferred to an UTMA account is an irrevocable gift. It belongs to the minor. If UTMA funds are used for any purpose other than for Timmy's benefit, Timmy can later sue the custodian for misuse of the funds.

How should an UTMA-owned annuity be structured?
A typical UTMA-owned annuity might be structured as follows:

Owner: John Smith as Custodian FBO Timothy Smith under the (state's name) Uniform Transfer to Minors Act

Tax ID#: Timmy's Social Security number

Annuitant: Timothy Smith

Beneficiary: Will depend on state law – typically this should be the child's estate. In most states, if the child dies before reaching the UTMA age of majority, the child's estate is distributed to the child's children, if any. If the child does not have children, the child's estate is typically distributed to the child's parents in equal shares or all to the survivors of them. Keep in mind that if the child's estate is named as beneficiary of a nonqualified annuity, the annuity will have to be distributed to the estate within five years of the child's death. A probate court proceeding may also be required before the annuity proceeds can be distributed.

What if my clients don't want the minor to have access to the UTMA account at the age of majority? With an UTMA account, ownership of the UTMA account must be transferred to the minor when the minor attains the UTMA age of majority. If the donor wishes to retain control over the funds beyond the point at which the minor attains the UTMA age of majority, the donor may wish to establish a trust for the benefit of the minor and have the trust own the annuity rather than using an UTMA account as owner.

Reminder: Another drawback of naming a young person as the owner of an annuity (whether outright or through an UTMA designation) is the kiddie tax. This taxes the child's unearned income in excess of the $2,100 exemption (in 2018) at the Estate and Trusts tax rate. A "kiddie" is anyone up to age 18, or age 18 provided child's earned income does not exceed ½ of his/her support, or ages 19-23 if a full-time student and earned income does not exceed ½ of support. Other requirements must be met for the kiddie tax to apply.

Trust-owned annuities

Question: Does Allianz or Allianz Life of NY permit trusts to own our nonqualified annuities?

Bottom line: Yes. Most trusts are eligible to own nonqualified Allianz or Allianz Life of NY annuities.

Depending on the specific situation, an annuity is one way for a trust to balance the needs of the current trust income beneficiaries and trust remainder beneficiaries (who will receive the remainder of the trust after the income beneficiaries die).

Does a trust-owned annuity qualify for income tax deferral?

Typically, a trust-owned annuity will qualify for income tax deferral if the trust is an agent for a natural person. Both revocable ("living") trusts and irrevocable trusts can qualify for income tax deferral as long as all trust beneficiaries are natural persons. The attorney who drafted the trust should be able to determine whether the trust is acting as an agent for a natural person (IRC Section 72(u)). For irrevocable trusts, Allianz or Allianz Life of NY require the legal, tax advisor, or professional trustee for the trust to certify that the trust is acting as agent for a natural person under IRC Section 72(u).

Exception for charitable remainder trust. The IRS has ruled that a charitable remainder trust is not an agent for a natural person and does not qualify for income tax deferral of increases in value. However, income tax deferral of increases in value is less important for a charitable remainder trust since the trust itself is a tax-exempt entity.

There are certain types of "trusts," such as welfare benefit trusts and rabbi trusts, that Allianz or Allianz Life of NY does not accept as owners of an annuity. Please check the online ownership/tax plan reference tool at www.allianzlife.com (currently not available at www.allianzlife.com/new-york). This tool can be found on the secure website under Knowledge Center.

How does the death benefit work since trusts do not "die"?

Even though all current contracts issued by Allianz or Allianz Life of NY are owner-driven, any death benefit on a trust-owned annuity is paid at the annuitant's death.

What about the income benefit and commissions?

Although the income benefit and commissions are typically based on the owner's age, with trust-owned contracts, commissions and any income benefit are based on the annuitant's age.

Who should be the annuitant on a trust-owned contract?

Typically, trust benefits are distributed at the death of an individual. This person is usually the most appropriate annuitant. Note that the annuitant of a trust-owned contract cannot be changed.

Credit trust example: At Husband's death, a credit trust is established for Wife's benefit. At Wife's death, the credit trust terminates and assets are distributed in equal shares to the children. If the credit trust purchases an annuity, Wife is probably the best person to name as annuitant. If trust benefits are distributed not at someone's death but instead when the trust beneficiaries reach certain ages, it may make sense to have a separate contract for each trust beneficiary with each trust beneficiary named as annuitant of one trust-owned contract. All aspects of the trust should be considered carefully before using this strategy to make sure that no unintended problems are created by the contract structure and that it is acceptable for a trust to purchase multiple annuity contracts.

Do trust-owned annuities qualify for spousal continuation?

Since the owner of the annuity contract is a trust and not an individual, spousal continuation would not be available. Also, keep in mind that the general rule is that trust-owned annuities should name the trust as beneficiary of the annuity and not the annuitant's spouse.

Caution. If individuals are named as beneficiaries of a trust-owned annuity rather than the trust itself, the individuals named in the annuity designation may not be the same people named in the trust as its beneficiaries. This can become problematic.

Example of potential problem scenario. Assume a revocable trust leaves 50% of trust assets to Wife #2 and 50% of trust assets to Children From First Marriage. Revocable trust purchases an annuity. If the annuity designation names Wife #2 as sole annuity beneficiary, we have a trust-owned asset (the annuity) passing contrary to the terms of the trust. This type of situation could result in unhappy clients and possible litigation.

Is an Allianz or Allianz Life of NY annuity an appropriate purchase for a revocable ("living") trust? If the trustee of a revocable trust determines that an Allianz or Allianz Life of NY annuity is an appropriate purchase for the trust, we permit the trust to own our annuities. However, it may be more advantageous for the client to own the annuity outright – outside of his/her revocable trust.

Why? Because then the client could name individual beneficiaries of the annuity who would have the option of taking annuity distributions over their life expectancy if the client dies before annuitization. In contrast, if the revocable trust is beneficiary of the annuity (which it should be if the revocable trust is the owner), the annuity may have to be fully withdrawn – and all income taxes paid – within five years of the client's death.

Is an Allianz or Allianz Life of NY annuity an appropriate purchase for an irrevocable trust? Many irrevocable trusts are established at an individual's death or during an individual's lifetime for the benefit of the individual's spouse and children or other trust beneficiaries. An Allianz or Allianz Life of NY annuity can be a way to balance the competing interests of current income beneficiaries of the trust and remainder beneficiaries (who typically receive the balance of the trust at the death of the last income beneficiary). However, each situation must be carefully reviewed by the trustee and his or her financial professional to make sure that an annuity purchase is appropriate for the trust.

Are there any special concerns when an irrevocable trust purchases an annuity? When determining whether an annuity is a suitable purchase for an irrevocable trust, consider surrender charges, timing issues, taxation, and contract terms.

Surrender charges. Some irrevocable trusts require that all income be paid to one or more income beneficiaries of the trust. The trustee should consult an attorney to determine what will be considered income under the trust document and/or state law. The trustee should consider whether the income that must be distributed is likely to exceed the free withdrawal amount and how the distributions will affect other annuity provisions.

Timing issues. If the trust document requires a distribution before the death of the annuitant (for example, the trust terminates at Dad's death but Son is named as the annuitant), surrender charges may apply when the trust cashes in the annuity.

Taxation 201124008.[1] There are IRS private letter rulings (PLR 199905015 and PLR 201124008)[1] that indicate a trust may be able to transfer ownership of a trust-owned annuity to a trust beneficiary without triggering income tax on any increase in the contract. However the trustee should consult his or her tax advisor to determine whether the increase would be taxable in a specific trust situation. In addition, if the annuity income is taxed to the trust because the trust is not acting as an agent for a natural person, or because the trustee takes withdrawals from the annuity, it takes only minimal income to reach the top federal income tax bracket. The trustee's tax advisor can help determine whether the annuity will be taxed at the trust level or to the individual beneficiaries in the specific situation.

(continued on next page)

[1] A private letter ruling (PLR) is directed only to the taxpayer who requested it. IRC Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pre-age 59½ 10% federal additional tax. Allianz or Allianz Life of NY looks to the age of the annuitant when determining whether to report an annuity distribution as premature. If the annuitant is under age 59½, the distribution will be reported as premature and subject to the 10% federal additional tax (no known exceptions).

Are there any additional forms that must be submitted when a trust purchases an Allianz or Allianz Life of NY annuity? A nonindividual ownership form must be submitted for any trust ownership. If the trust is irrevocable or is a nongrantor trust, the form must be signed by a professional trustee, CPA, or attorney attesting that the trust is an agent for a natural person and does qualify for income tax deferral of increases in value.

Note: Even if the trust does not have its own tax identification number, we still require the nonindividual ownership form be used for any trust, including trusts established under a will or revocable trust (largely because these trusts should have a tax identification number even if they do not).

Revocable trusts and annuities

Question: Can my client's revocable trust own my client's nonqualified annuity?

Bottom line: Yes. Your client's revocable trust can own his or her nonqualified annuity. And, yes, a revocable trust-owned annuity typically still qualifies for income tax deferral of increases in value. The more challenging question often is who should be the beneficiary of a revocable trust-owned annuity.

Why do my clients want their revocable trust to own their nonqualified annuity? Clients usually choose a revocable trust-based estate plan over a will-based estate plan primarily so that their estate can be distributed after their death without having to go through a probate court proceeding. (We use the phrase "revocable trust-based estate plan" because most revocable trust-based estate plans also include a "pour-over will," which distributes any assets not owned by the revocable trust at the client's death to the revocable trust.) After signing the revocable trust-based estate plan, the attorney typically instructs the client to transfer ownership of their nonqualified assets to their revocable trust. (Ownership of qualified assets such as IRAs or benefits from participation in employer-sponsored retirement plans cannot be transferred to a revocable trust during the client's lifetime without triggering income tax.) Thus, even though an annuity with a proper beneficiary designation already avoids probate, clients often want to transfer ownership of their nonqualified annuity to their revocable trust.

There may be nonprobate reasons for the ownership change as well. For example, the client may want to use their annuity to fund a trust established under their revocable trust.

Does an annuity owned by a revocable trust qualify for income tax deferral of increases in value? IRC Section 72(u)(1) provides that an annuity contract will not qualify for income tax deferral of increases in value unless the owner is a natural person. However, IRC Section 72(u)(1) specifically states that the section does not apply to an annuity owned by a trust that is an "agent for a natural person." Both revocable trusts and irrevocable trusts can qualify for income tax deferral of increases in value as long as all trust beneficiaries are natural persons (i.e., living, breathing people rather than corporations or charities). Thus, trust-owned annuities may qualify for income tax deferral of increases in value just as individually owned nonqualified annuities do. A client should review their particular trust with their tax advisor to determine if the annuity qualifies for tax deferral of increases in value and to ensure that trust ownership of the annuity is appropriate. For a revocable trust, Allianz or Allianz Life of NY requires only the trustee signature(s) on the nonindividual ownership form. For an irrevocable trust, the form must also be signed by a professional trustee, CPA, or attorney attesting that the trust is an agent for a natural person and does qualify for income tax deferral of increases in value.

(continued on next page)

Revocable trusts and annuities

Who should be the beneficiary of an annuity owned by the revocable trust? Let's review some common choices:

Revocable trust as beneficiary. If a revocable trust owns a nonqualified annuity, trustees often name the revocable trust as beneficiary of the annuity. The reason is that if they name individuals on the annuity beneficiary designation, the individuals named in the annuity may not be the same people named in the revocable trust as its beneficiaries. By naming the revocable trust as beneficiary, the trustee avoids a potential conflict in beneficiaries.

The downside of naming the revocable trust as beneficiary of the nonqualified annuity is that this beneficiary designation may limit death benefit payout options. For example, the life expectancy distribution option is not available if the revocable trust is beneficiary. In addition, there is no spousal continuation when a revocable trust is named as beneficiary of an annuity. Thus, if the revocable trust is named as the owner and beneficiary of the annuity, annuity proceeds would have to be fully distributed to the trust – and all income taxes paid – in a lump sum or within five years of the annuitant's death.

Individuals as beneficiaries. If the client wants to make sure that beneficiaries have the option to take distributions over their life expectancy, he or she may name individuals (for example, the client's children) on the nonqualified annuity beneficiary designation. However, this may create a problem when the nonqualified annuity is owned by a revocable trust.

Example: A trust typically provides what happens if one of the trust beneficiaries dies. Let's assume that if A dies, the trust leaves A's share to A's children. If the nonqualified annuity beneficiary designation lists named individuals (A, B, and C) and A dies, B and C would take A's share. A's children would get nothing. This may be contrary to the provisions in the trust and the trustee may have some liability if assets owned by the trust pass contrary to the terms of the trust.

Is there any disadvantage to owning the nonqualified annuity outside of the revocable trust? If your client is incapacitated, the client's revocable trust typically names someone to serve as a successor trustee and manage trust assets for your client. If a nonqualified annuity is owned outside of a revocable trust and your client is incapacitated, there may not be anyone with the proper authority to transact business that might be necessary in connection with your client's nonqualified annuity. However, this is usually resolved easily if your client has a financial durable power of attorney in place.

In addition, your client's attorney may wish to use your client's nonqualified annuity to fund a subtrust established under your client's revocable trust. In this situation, owning the nonqualified annuity outright may disrupt the intended flow of your client's estate plan. For this reason, it is always wise to involve the client's attorney in any ownership and beneficiary designation decisions.

Traditional and Roth IRA contributions

Who can make an IRA contribution? Anyone who has earned income (from a job) generally can make a contribution to a traditional or Roth IRA. However, anyone who will be age 70½ or older at the end of a year cannot contribute to a traditional IRA for that year. Income limits may prevent a Roth IRA contribution. Roth IRA contributions are not deductible and traditional IRA contributions may not be deductible.

What is earned income? Earned income is what you get paid for a U.S. job – salary, commission, etc. It does NOT include income from investments, rents, a pension, disability payments, or foreign source income.

If I have earned income, how much can I contribute to an IRA? In 2018 you can contribute up to:

- $5,500 if you are under 50
- $6,500 if you are 50 or older before the year ends

This is the combined limit for both traditional and Roth IRA contributions. But you can't exceed your earned income. So, for example, if you work part-time and earn only $3,000 for the year, you cannot contribute more than $3,000 to a traditional or Roth IRA.

Can I deduct my traditional IRA contribution? If you are a single tax filer and do not participate in any other retirement plan like a 401(k), defined benefit plan, profit sharing plan, ESOP, SEP, or SIMPLE, then you can deduct your IRA contribution, regardless of how high your income is. For example, 48-year-old Bo earns $650,000 per year as a consultant, but he does not have any other retirement plan. He can make and deduct a $5,500 IRA contribution.

If you are married, filing jointly, and do not participate in any other retirement plan, but your spouse does, then your ability to deduct an IRA contribution is phased out between $189,000 and $199,000 (in 2018).

If you do participate in a retirement plan, you cannot deduct your contribution unless your modified adjusted gross income is low enough. The ability to deduct a traditional IRA contribution is phased out (in 2018) between:

- $63,000 and $73,000 for single tax filers
- $101,000 and $121,000 for married, filing jointly
- $0-$10,000 for married, filing separately

Example: Sasha, age 30, is single, and participates in her company 401(k) plan.

- If Sasha's income (all income, not just earned income) is less than $63,000, she can make and deduct a traditional IRA contribution even if she fully funds her 401(k).
- If Sasha makes more than $73,000, she cannot deduct any part of a traditional IRA contribution.
- If Sasha's income falls between $63,000 and $73,000, she can deduct a prorated amount. For example, if her income is $68,000 (halfway through the phase-out bracket), she can deduct up to $2,750 (half the $5,500 limit).

Note: You may be a participant in a 401(k) plan even if you choose not to make elective deferrals. Even though you don't contribute to the 401(k) plan, you are still subject to these income limits for deducting a traditional IRA contribution. Note: Allianz annuity products only allow premium to be added for certain period of time after issue. Review contract provisions before submitting contribution requests.

What if I want to contribute to a Roth IRA instead? It does not matter whether or not you participate in a retirement plan. You only need to meet the modified adjusted gross income limits. The ability to contribute to a Roth IRA is phased out (in 2018) with income between:

- $120,000 and $135,000 for single tax filers
- $189,000 and $199,000 for married, filing jointly
- $0-$10,000 for married, filing separately

(continued on next page)

Traditional and Roth IRA contributions

What if my income is too high to deduct a traditional IRA or make a Roth IRA contribution? As we said, if you have earned income and you will not be age 70½ or older at the end of the year, you can make a traditional IRA contribution. If your income is too high to deduct a traditional IRA contribution, or make a Roth IRA contribution, then you can consider making a nondeductible traditional IRA contribution.

However, there are issues to be aware of when making a nondeductible contribution to a traditional IRA. This will give you basis in your IRA, and when nondeductible contributions are later withdrawn they will not be subject to income tax. While that may sound good, the reporting may be too onerous for a client. When a client makes a nondeductible contribution to a traditional IRA, they must file an IRS Form 8606 with their tax return for the year. The client must keep track of basis in all IRAs. Every time a client takes a distribution from any of their traditional, SEP, or SIMPLE IRAs, they will have to file an IRS Form 8606 with their 1040 for the year to allocate some of their basis to the distribution. (You generally can't isolate your basis in just one of your IRAs. The IRS aggregates all of your traditional, SEP, and SIMPLE IRAs when you take a distribution – so a distribution from any IRA will be deemed to have some of your basis in it.) Allianz or Allianz Life of NY does not track basis in IRAs.

If the client can't make a deductible IRA contribution or a Roth IRA contribution, a solution may be to make a contribution to a nonqualified annuity. There are no income limits for contributing to a nonqualified annuity, and you can contribute any amount you want, based on the contract – it's not limited to $5,500/$6,500. The nonqualified annuity has basically the same tax structure as a nondeductible traditional IRA:

- The contributions are nondeductible, and give you basis in the contract.
- The growth is tax-deferred.
- At withdrawal, the taxpayer is only taxed on the gain. Basis is returned income-tax-free.

However, please note that a withdrawal from a nonqualified annuity will generally be considered gain first, while gain in a withdrawal from a nondeductible IRA is determined on a pro rata basis.

Before you buy a nonqualified annuity, consider that an IRA may have better creditor protection than a nonqualified annuity. Rules differ from state to state, so clients should discuss this with their local legal advisor.

What is the best strategy for making a contribution?
Most people like the current income tax deduction. See if they are eligible to make a deductible traditional IRA contribution (i.e., either they don't participate in a qualified plan, or they do participate but their income is low enough). If they aren't eligible for a deductible traditional IRA contribution, see if their income is low enough to make a Roth IRA contribution. If not, then consider a nondeductible traditional IRA or a nonqualified annuity.

Of course, some people would want to use their $5,500/$6,500 IRA contribution for a Roth IRA. This is especially true of young people with low income and older people who don't want to take required minimum distributions during their lifetime.

In all cases, they should discuss their tax situation with their tax advisor first.

Spousal IRAs

Question: Is it possible for your "Soccer Mom" or "Mr. Mom" clients who don't work outside the home to make a deductible contribution to a traditional IRA?

Bottom line: Yes. Just because your clients are not working outside of their home, or earn only minimal compensation, doesn't mean they can't have a deductible traditional IRA. As long as your clients are married, filing a joint tax return, and under the age of 70½, they can make a deductible traditional IRA contribution in the following scenarios.

One or both spouses working – neither spouse covered by a qualified retirement plan at work: In this scenario, both spouses can make a deductible IRA contribution up to $5,500 in 2018 ($6,500 if 50 or older), regardless of adjusted gross income (AGI). (However, the IRA contribution cannot be greater than the couple's joint compensation less any Roth IRA contribution amounts.)

One or both spouses working – one spouse covered by a qualified retirement plan at work: In this case, the noncovered spouse can make a deductible IRA contribution up to $5,500 in 2018 ($6,500 if 50 or older). However, deductibility is phased out when joint AGI is between $189,000 and $199,000. The covered spouse's ability to make a deductible contribution for 2018 is phased out with AGI between $101,000 and $121,000. (The IRA contribution cannot be greater than the couple's joint compensation less any Roth IRA contribution amounts.)

Both spouses working – both spouses covered by a qualified retirement plan at work: If both spouses are working and covered by a qualified retirement plan, they can still make a deductible IRA contribution if AGI is below $101,000. Deductibility is phased out when their joint AGI is between $101,000 and $121,000. However, what if both spouses are working and covered by a qualified retirement plan, but one spouse earns less than the $5,500 IRA contribution limit ($6,500 if age 50 or older)? Using the spousal IRA limits may result in a higher allowable IRA contribution for your clients. The spousal IRA contribution is the lesser of (1) $5,500 ($6,500 if 50 or older), OR (2) the couple's joint compensation less the higher-earning spouse's traditional IRA and Roth IRA contributions.

Example: John and Sue both work outside the home and are covered by a qualified retirement plan at work. John earns $45,000 and Sue makes $4,000. John has already made a $5,500 contribution to his IRA. Sue (age 49) can contribute the lesser of $5,500, OR $43,500 (the couple's joint compensation of $49,000 less John's $5,500 IRA contribution). Thus, Sue can make a $5,500 IRA contribution using the spousal IRA rules even though she only earns $4,000.

Spousal Roth IRA contributions: With spousal Roth IRAs, qualified plan participation is not an issue, nor is age. A spouse who does not work outside the home can make the maximum $5,500 Roth contribution ($6,500 if age 50 or older) as long as the couple's AGI does not exceed $189,000 – regardless of age and regardless of whether the working spouse participates in a qualified plan at work. If the couple has AGI between $189,000 and $199,000, the spouse can still make a reduced Roth IRA contribution. However, if the couple's AGI exceeds $199,000, neither spouse can contribute to a Roth IRA. In addition, a spousal Roth IRA contribution cannot exceed the couple's joint compensation less the working spouse's traditional IRA and Roth IRA contributions.

How do I know if my client is covered by a qualified retirement plan at work? The IRS W-2 form that your client receives from their employer has a box to indicate whether they were covered for the year. The "Retirement Plan" box (Box 13) should be checked if your client was covered.

Where can I get more information? You can figure the spouse's deduction using the IRA Deduction Worksheet for Line 32 in the 1040 Instructions from the IRS.

Roth IRA distributions

Question: How is a distribution from a Roth IRA taxed?

Bottom line: If the withdrawal is a qualified distribution, there is no income tax. If the withdrawal is not a qualified distribution, any earnings distributed will be taxed as ordinary income and may be subject to a 10% federal additional tax. Any conversions (including conversions done as rollovers to Roth IRAs from employer retirement plans) distributed also may be subject to the 10% federal additional tax for early distributions. Ordering rules can work in the taxpayer's favor, however, to help avoid these taxes.

What is a qualified distribution? Qualified distributions from Roth IRAs are income-tax-free and free from the 10% federal additional tax for early distributions. A qualified distribution from a Roth IRA is one in which the owner first funded any Roth IRA more than five years ago (whether or not it's the Roth IRA being drawn from) and has one of these qualifying events:

- Age 59½ or older
- Death
- Disability
- First-time home purchase (up to a $10,000 lifetime limit)

Note that the five-year period starts on the first day of the taxable year in which the owner first funded any Roth IRA, either by contribution or conversion, and did not revoke that Roth IRA.

Example 1: Ethan funds his first Roth IRA in the year he turns age 57. Any distribution he takes out after the year in which he turns age 61 (five taxable years and over age 59½) will be income-tax-free and free from the 10% federal additional tax for early distributions.

Example 2: Janelle funds her first Roth IRA the year after she turns age 62 and dies at age 64. Her beneficiaries want to take minimum distributions with a stretch Roth IRA, so they must begin in the year after Janelle dies. However, the distributions are not qualified distributions until after the Roth IRA five-year period (five taxable years and death). The five-year period ends after the taxable year in which she would have turned age 67.

What if the distribution is not a qualified distribution? Any earnings that are withdrawn will be taxed as ordinary income. They also will be subject to the 10% federal additional tax unless an exception applies. However, ordering rules can help a taxpayer avoid the income tax and 10% federal additional tax.

What are the ordering rules? Nonqualified distributions come out in this order:

- Contributions first (i.e., the $5,500- or $6,500-per-year amounts)
- Conversions (including from employer retirement plans) second, on a first-in, first-out (FIFO) basis
- Earnings last

Note that designated Roth arrangement (such as Roth 401(k) money) that is rolled over to Roth IRAs is considered either contributions or earnings, based on whether the distribution from the employer retirement plan Roth arrangement was qualified or nonqualified. The only funds that will be considered earnings for Roth IRA purposes are the funds that represent earnings in a nonqualified distribution from the plan. Also, note that you aggregate all Roth IRAs to determine the amount of contributions, conversions, and earnings. That is, if Olivia had contributed $8,000 to Roth IRA X and $4,000 to Roth IRA Y, the first $12,000 of distributions from any of her Roth IRAs are contributions. Of course, once your client takes a distribution, they can't count those contributions or conversions the next time. Your client must keep track of how much in contributions and conversions they have remaining.

How are the contributions of a nonqualified distribution taxed? Contributions are the first money to come out and are never subject to income tax or the 10% federal additional tax for early distributions.

How are the conversions (including from employer retirement plans) of a nonqualified distribution taxed? Conversions are the second money to come out and are never income-taxed (they were taxed when they were converted). They may, however, be subject to the 10% federal additional tax if removed within five years of the conversion. This five-year period starts on the first day of the taxable year in which the conversion was made. The 10% federal additional tax is not assessed if one of the exceptions applies. These exceptions are familiar and include:
- Age 59½ or older
- Death
- Disability
- First-time home purchase (up to a $10,000 lifetime limit)
- Substantially equal periodic payments
- Deductible medical expenses
- Health insurance premiums for unemployed individuals
- Higher education expenses
- Military reservists called to active duty

Example 3: Madeline made a $3,500 Roth IRA contribution, and has never had another Roth IRA, and converted a $20,000 traditional IRA into a Roth IRA. Two years later, the $23,500 now includes $1,000 of earnings for a total of $24,500. Madeline, now age 42, takes out $6,000 to go on vacation.

This is not a qualified distribution because the first Roth IRA was funded less than five years ago (and for that matter, the vacation is not one of the qualifying events). Under the ordering rules, the first $3,500 represents contributions, which are not subject to income tax or the additional tax. The rest of the $6,000 distribution comes from conversions. It is not income-taxed, but it is subject to the 10% federal additional tax because the conversion was less than five years ago. No 10% federal additional tax exception applies, so Madeline has to pay a $250 additional tax on the $2,500 she took from conversions.

Example 4: Same as Example 3, except Madeline is now 61 years old. Even though the conversion was less than five years ago, there is no 10% federal additional tax because an exception applies (i.e., she's over age 59½).

How are earnings on a nonqualified distribution taxed? The earnings portion of a nonqualified distribution is subject to income tax and the 10% federal additional tax. However, the 10% federal additional tax may be waived if any of the exceptions (including those listed above) apply.

Example 5: Taylor funded his first Roth IRA in 2000 with a $25,000 conversion. A few years later he made a $2,000 contribution. As of 2018, he has accumulated $8,000 in interest/increases. Taylor, now age 41, takes $30,000 out of his Roth IRA to buy a boat. This is not a qualified distribution because even though the Roth IRA was first funded more than five years ago, buying the boat is not a qualifying event. Going through the ordering rules for nonqualified distributions, we see that:
- The first $2,000 coming out is contribution money (even though it was paid into the Roth IRA after the conversion). Contributions are not income-taxed or subject to the 10% federal additional tax.
- The next $25,000 coming out is conversion money. It is not income-taxed. Also it is not subject to the 10% federal additional tax because the conversion occurred more than five years ago.
- The remaining $3,000 of the withdrawal represents earnings. This portion is income-taxed because it's a nonqualified distribution. It also is subject to the 10% federal additional tax, because Taylor does not have a 10% federal additional tax exception (he's not over age 59½, deceased, disabled, etc.).

(continued on next page)

Roth IRA distributions

Can this be any more complicated? Yes! When your client converts a traditional IRA to a Roth IRA, part or all of the conversion may be basis in rare cases (from making nondeductible contributions to any traditional IRA due to income exceeding the phase-out amounts). Those basis amounts were not taxed on the conversion. Those basis funds stay in the "conversion" category, but as each conversion amount is withdrawn, the taxable amount at the time of conversion comes out first, followed by the basis amount. Only the taxable portion of the conversions will be subject to the 10% federal additional tax if taking a withdrawal within five years of the conversion. In addition, if there has been more than one conversion (including from retirement plans), these are ordered by year starting with the earliest year (first-in, first-out).

What's the best way to approach a distribution? First, determine if it's a qualified distribution. If it is a qualified distribution, you can stop there – there is no income tax or 10% federal additional tax. If it's not, determine if the amount to be withdrawn is less than the total amount of contributions (taking into account prior withdrawals of contributions). If the withdrawal is less than total contributions, you can stop there – there is no income tax due or 10% federal additional tax. If the distribution is not qualified and does exceed the amount of contributions, your client will need to go through the ordering rules to determine what amount of the distribution is subject to income and additional tax.

Will Allianz or Allianz Life of NY track these amounts for my clients? No. It will be up to the client and their tax advisor to figure out how the distribution is taxed, including whether the 10% federal additional tax applies.

Where can I get help? You can find an explanation of these rules in the 2017 IRS Publication 590-B. Also, IRS Form 8606 (and its instructions) will show you the actual calculation of the taxable amount of a nonqualified distribution. And of course, the client should always consult their tax advisor.

Individual 401(k)s

Question: Why are 401(k) plans popular among owner-only businesses?

Bottom line: With a 401(k), a business owner can deduct a contribution of 25% of compensation PLUS $18,500 of salary deferrals or $24,500 if they are age 50 or older (2018). Total annual contributions (including salary deferrals) on behalf of an employee cannot exceed $55,000 (or $61,000 for employees age 50 and older).

Example: Bob is age 42 and owns his own business, an S corporation. In 2018, Bob made $100,000. Bob's accountant indicates he can contribute $43,500 ($25,000 + $18,500) to his 401(k).

Is an individual 401(k) different from a regular 401(k)? Yes, in operation, as long as the plan continues to meet certain requirements. With an individual 401(k) where the business owner(s) and/or spouse(s) are the only eligible employees, they do not need to perform certain nondiscrimination tests. With a regular 401(k) where the business employs eligible employees other than the business owner(s) and/or spouse(s), they will need to perform nondiscrimination tests on an annual basis in addition to filing IRS Form 5500.

What reporting is required if my client doesn't have employees? Generally, if the business owner(s) and/ or spouse(s) are the only employees of their business AND their 401(k) balance(s) does not exceed $250,000, no discrimination testing is required and they do not need to file the IRS Form 5500 Series. (Please note that a simplified version of IRS Form 5500 – called IRS Form 5500-EZ – may need to be filed in certain situations, including the final plan year.) Once their 401(k) plan balance – the total of all eligible employees' accounts – exceeds $250,000, they will need to file IRS Form 5500-EZ each year.

What about part-time employees? Your clients may be able to exclude employees who:

- Are under age 21
- Work less than 1,000 hours per year
- Are nonresident aliens, or
- Are union employees

How does my client establish a contract owned by an individual 401(k) with Allianz or Allianz Life of NY? Your client will need to contact a retirement plan third party administrator (TPA) to obtain a 401(k) plan document. The TPA can assist your client in completing the document and help perform the necessary recordkeeping and tax reporting.

Once the plan is in place, work with your client to complete an annuity application for each eligible employee, with the following contract structure:

Owner: Acme 401(k) plan

Owner's Tax ID#: This should be the federal tax ID number for the 401(k) plan.

Annuitant: Name of participant

Beneficiary: Acme 401(k) plan

In addition to the annuity application, the plan administrator (as named in the plan document) or the plan trustee (if given authority by the plan administrator or plan document) and annuitant will need to review and sign the Allianz or Allianz Life of NY Qualified Plan Acknowledgment form and provide a copy of the signed plan document. Allianz or Allianz Life of NY cannot process the application or accept the purchase payments until the signed Qualified Plan Acknowledgement form is received along with a copy of the plan paperwork.

Allianz or Allianz Life of NY will serve only as a provider of a financial vehicle for the plan. The retirement plan administrator or third party administrator will assist the plan with recordkeeping and any necessary tax reporting. It is important that each party has the same understanding of these rules.

Please note that for a new contract, the minimum applies separately to each plan participant and that each plan participant must have a separate contract. The contribution for each participant must meet contract minimums or we will have to return the entire contribution to the plan.

In-service distributions

Question: Can my client take a distribution from their 401(k) while they're still employed?

Bottom line: The general rule is that individuals cannot take a distribution from their 401(k) until a triggering event occurs (for example, they terminate employment or retire). However, if the 401(k) plan document permits, they may be able to take a distribution of certain employer contributions even while they are still working. Therefore, individuals should consult with their plan administrator to determine what distribution options are available.

Note: The qualified retirement plan document may also permit in-service distributions in the event of financial hardship. However, hardship distributions cannot be rolled over. The information below addresses non-hardship distributions only.

When can my clients take a distribution from their qualified retirement plan? Generally, distributions from a qualified retirement plan are only permitted upon a "triggering event" such as death, disability, attainment of age 59½, separation from service, or plan termination. However, the plan document may allow for a non-hardship distribution even if no triggering event has occurred.

Can my clients take a loan from the 401(k)? Although a 401(k) plan document may permit a loan be taken, loans are not administered by Allianz or Allianz Life of NY. If the loan is made under the qualified plan, it will be treated by Allianz or Allianz Life of NY as a partial surrender subject to partial withdrawal provisions of the contract.

Do all qualified retirement plans permit non-hardship distributions? Typically, only profit-sharing plans or 401(k) plans that are part of a profit-sharing plan or stock bonus plan permit non-hardship withdrawals. Your clients should consult their plan administrator to determine whether a particular qualified retirement plan permits in-service non-hardship distributions.

Can my client take a non-hardship distribution of their entire account? No. Even if the plan document permits in-service non-hardship distributions, there are still typically two limitations on the distribution: (1) only certain employer contributions can be distributed and (2) the monies must have been in the plan for at least two years. If your client is over age 59½, his or her own salary deferrals may also be available for an in-service distribution. Again, consult the plan administrator regarding any limitations that a particular qualified plan may impose on in-service non-hardship distributions.

Will my client owe income tax on the distribution? Your client will owe income tax on the in-service distribution unless they roll the distribution proceeds to an IRA or other eligible employer plan within 60 days of receiving the distribution. Your client should note that rolling over their qualified plan to an IRA does not assure positive results or that sufficient funds will be available for retirement. Also, recent guidance has stressed the need to be fair and balanced when discussing options that include rollovers from plans to IRAs. See AMK-068-N for extensive discussions regarding rollovers in a regulated environment.

Will taking an in-service distribution affect contributions to my client's qualified retirement plan? Have your client check with their plan administrator to determine whether taking an in-service distribution will restrict their ability to contribute to the plan in the future.

My client has not yet attained age 59½. Will they owe a 10% federal additional tax on the distribution? If they are under age 59½ and they do not roll the proceeds to an IRA or other eligible employer plan, a 10% federal additional tax may apply to the distribution in addition to income tax. However, there is no additional tax if one of the IRC Section 72(t) exceptions applies.

In-service distributions

What is the difference between a direct rollover and an indirect rollover? With a direct rollover of a 401(k) distribution into an IRA, the money is paid directly to the IRA. With a direct rollover, no federal income tax withholding is required.

With an indirect rollover, the distribution is paid to your client and the 401(k) plan is required to withhold 20% of the distribution for federal income tax withholding. State income tax withholding also may apply. Keep in mind that the 20% withholding is applied toward the individual's actual income tax. Your client may be able to get a refund when they file their income tax return for the year of distribution, if their total income tax payments (including the withholding) exceed their actual income tax liability. The problem with an indirect rollover is that if your client wants to roll over the entire 401(k) distribution, they will have to use other monies to make up the amount that is withheld. Any amount not included in the rollover is subject to income tax and if the client is under age 59½, the 10% federal additional tax.

Hypothetical example: Joanne is eligible to take a $50,000 in-service non-hardship distribution from her 401(k). She requests an indirect rollover so the 401(k) plan withholds $10,000 (20% of $50,000) and sends a check for the remaining $40,000 to Joanne. If Joanne rolls the $40,000 into an IRA, the $10,000 that was withheld by the 401(k) plan will be treated as a distribution. Joanne will owe income tax on that and, if she is under age 59½, she will also owe a 10% federal additional tax on the $10,000 distribution. Provided that Joanne finds other monies in time to complete the indirect rollover, Joanne could make up the $10,000 shortfall with other monies, thereby rolling over the full $50,000. Before making any decisions regarding in-service distributions, clients should consider advantages and disadvantages of each option and consult a tax advisor.

Options for a qualified individual such as a tax professional to discuss with your clients include: (1) taking the in-service distribution in cash; (2) leaving the funds in the plan (not taking the in-service distribution); (3) taking the in-service distribution and rolling it back into the same or another eligible employer plan within 60 days; (4) rolling the in-service distribution into a traditional IRA; and (5) rolling the in-service distribution directly into a Roth IRA.

Any time the above options are considered, the following should be discussed:

- Comparison of fees and costs if funds are left in a qualified plan and if funds are rolled over to an IRA, including any commissions involved.
- Investment options and services available from the qualified plan sponsor and the IRA provider.
- Differences in exceptions to the federal additional tax. For example, distributions from a qualified plan after termination of employment after age 55 are not subject to the federal additional tax.
- If the client holds employer stock, net unrealized appreciation (NUA), see the Q&A regarding NUA in this booklet.
- Funds may not have the same level of creditor protection as a qualified retirement plan.

However, this is not a complete list of everything that must be discussed with a client. As noted above, recent guidance has stressed the need to be fair and balanced when discussing options that include rollovers from plans to IRAs. See AMK-058-N and AMK-068-N for extensive discussions regarding rollovers in a regulated environment.

Converting to a Roth IRA

Question: Why would your client convert their traditional IRA, SEP IRA, or SIMPLE IRA to a Roth IRA?

Bottom line: IRA funds converted to a Roth IRA can be distributed income-tax-free in retirement if they take "qualified distributions." Either accumulating funds in a Roth IRA or taking income-tax-free qualified distributions in place of taxable distributions might reduce tax on their Social Security benefits.

If they have a taxable estate, converting to a Roth IRA may help reduce estate tax and eliminate income tax that your client's beneficiaries would have had to pay on IRA distributions taken after their death. Keep in mind that they will owe income tax upon converting a traditional, SEP, or SIMPLE IRA to a Roth IRA. Also, for full and partial conversions, all contract provisions must be satisfied, including product minimums.

What are the tax consequences of converting to a Roth IRA? Your client will owe income tax on the taxable portion of any IRA monies that are converted to a Roth IRA. If an annuity is converted to a Roth IRA annuity while maintaining all of the features of the contract, the taxable amount will be based on the fair market value of the annuity. The fair market value is the "entire interest," which is the sum of the cash value and the actuarial present value of additional benefits like living and death benefits. They may recognize this formula as similar to the value now used to figure required minimum distributions on IRAs funded with annuities. The annuity provider should be able to provide this value to them.

Even though the conversion is treated like a distribution from the traditional IRA, it is not subject to the 10% federal additional tax.

Please note the withholding election on the Allianz or Allianz Life of NY Request for Roth IRA Conversion forms. If an election is not made, federal income tax will be withheld from the taxable portion of their distribution at the rate of 10%. State income tax will be withheld if they reside in a state where state tax withholding is mandatory. Any income tax withheld will reduce the amount actually converted. In addition, the amount withheld may be subject to product surrender charges and will be subject to both income tax and the 10% federal additional tax if the taxpayer is under age 59½.

How are Roth IRA distributions taxed? Distributions from their Roth IRA will be income-tax-free as long as they are "qualified distributions." A "qualified distribution" is one that occurs more than five years after the Roth IRA owner first funded any Roth IRA and the distribution is made as a result of a first-time home purchase (up to a $10,000 lifetime limit), reaching age 59½, death, or disability (see the "Roth IRA distribution" Q&A). Thus, a taxpayer may decide to pay income tax now in order to avoid future income tax on the IRA.

Example: Barbara is 50 years old and has an effective income tax rate of 20% when she converts her $100,000 traditional IRA to a Roth IRA. She pays $20,000 of income tax upon conversion. When Barbara reaches age 60, the $100,000 Roth IRA has grown to $175,000. In the meantime, Barbara received a significant inheritance when her mother passed away. The earnings from the inherited assets put Barbara into a higher income tax bracket. Fortunately, any qualified distributions from the Roth IRA to Barbara (or her beneficiaries) will be income-tax-free.

If a client has earned income, Roth IRA contributions can be made after age 70½, unlike traditional IRA contributions.

Another big benefit of converting to a Roth IRA is that unlike a traditional IRA, your clients do not need to take required minimum distributions (RMDs) from their Roth IRA at age 70½. They can accumulate the funds for the rest of their life if they wish. Their beneficiaries are required to receive distributions after their death, but the distributions will be income-tax-free, provided any Roth IRA of the owner was first funded more than five years ago.

Does the client have to report anything to the IRS? Yes. When a client converts a traditional IRA to a Roth IRA, they must fill out Part II of IRS Form 8606 and file it with their taxes. A conversion results in a taxable event.

Can the client undo the Roth IRA conversion? Yes, if completed timely and the conversion took place on or before December 31, 2017. Your client can "recharacterize" a Roth IRA conversion back to a traditional IRA with the Allianz or Allianz Life of NY Request for Recharacterization form. For income tax purposes, the recharacterization treats the transaction as if the original conversion never happened. Generally, a calendar-year taxpayer can recharacterize until October 15 of the year after conversion. For example, if a taxpayer converted to a Roth IRA in 2017, they have until October 15, 2018 to recharacterize that conversion back to a traditional IRA. Even if the taxpayer already filed a 2017 tax return, they can recharacterize and file an amended 2017 return. An individual's tax professional can help determine what adjustments are needed to income tax returns to properly report a recharacterization. Post December 31, 2017 conversion no longer qualify for a recharacterization.

How can a Roth IRA reduce taxation of my Social Security benefits? Social Security recipients who do not exceed certain levels of combined income (single individuals with less than \$25,000 and married couples with less than \$32,000) are not subject to federal income tax on their Social Security benefits. However, as combined income reaches certain income levels, up to 50% – then up to 85% – of Social Security benefits are subject to income tax. Combined income is adjusted gross income plus nontaxable interest plus one-half of Social Security benefits. Taxable distributions from a traditional IRA count toward that income threshold and can trigger income tax on Social Security benefits. With a Roth IRA, the Roth IRA owner is not required to take distributions during their lifetime (certain required minimum distribution rules do apply to Roth IRA beneficiaries). But even if distributions are taken, any Roth IRA qualified distributions are not included in income and so will not affect the taxation of Social Security benefits.

Example: Before reaching Social Security retirement age, Fred converts his traditional IRA to a Roth IRA. Fred pays income tax in the year of conversion. However, at retirement, Fred's sole income consists of qualified Roth IRA distributions and Social Security benefits, neither of which is subject to federal income tax. Fred lives a happy retirement, free of federal income tax.

What happens if your client converts to a Roth IRA and they are already receiving Social Security benefits? There is a trap for the unwary here. When they convert their traditional IRA to a Roth IRA, the IRA "distribution" is included in their adjusted gross income even if they don't keep a dollar and move the entire IRA into a Roth IRA. If the "distribution" pushes their income beyond the threshold levels discussed above, converting to a Roth IRA may trigger or increase the taxation of their Social Security benefits in the year of the conversion and may increase their Medicare Part B premium costs. Make sure they discuss all of the consequences of conversion with their tax advisor before moving their traditional IRA to a Roth IRA.

How does a Roth IRA conversion reduce your client's estate tax liability? An IRA is included in their estate, and to the extent their estate exceeds the federal estate tax exemption (\$11,180,000 in 2018) they will pay estate tax on the IRA. If this

(continued on next page)

is a traditional IRA, their heirs will also eventually pay income tax on the funds as they withdraw them. In effect, they will owe estate tax on assets that are eventually used to pay income tax.

(Note: The income in respect of a decedent (IRD) deduction might help alleviate this double tax.) By converting to a Roth IRA while they are alive, they will pay income taxes which in turn reduces their taxable estate. Another way to look at it is that paying the tax on the conversion is an additional gift to their heirs. However, if the traditional IRA is to be left to charity, it may be preferable not to convert it to a Roth IRA, since the charity would receive the funds income-tax-free without the conversion.

Note that the answer above generally also applies to converting by rolling over funds from an employer retirement plan to a Roth IRA.

What is the deadline for a Roth IRA conversion? Unlike Roth IRA contributions which can be made until April 15 of the year following the year for which the contribution is made, they must complete a Roth IRA conversion by December 31. They can check with a Roth IRA provider to see when a conversion request must be received in good order to complete the conversion by December 31.

Are there situations where it may not make sense to convert to a Roth IRA? If they think that their income tax rate will be significantly lower by the time they take withdrawals from their IRA, it may not make sense to convert their traditional IRA to a Roth IRA. Similarly, if their beneficiaries are in a much lower income tax bracket than they are, they may want to consider carefully whether it would be advantageous to convert to a Roth IRA (and pay income taxes at their higher rate).

Other issues related to conversions include the possible loss of financial aid, a need for additional withholding or estimated tax payments, the need to take any applicable required minimum distribution (RMD) before the conversion, the loss of certain tax deductions or credits, higher taxes on Social Security benefits and higher medicare premiums, the 3.8% Medicare surtax, and more. Also, note that it is generally preferable to pay any taxes due to the conversion from assets other than the IRA – taking distribution from the IRA to pay the taxes may negate some of the benefits of the conversion. Potential consequences such as an assessment of product surrender charges or additional IRS penalties for premature distributions could apply.

Nonspouse beneficiary rollovers

Question: What options does a nonspouse beneficiary of a qualified plan have when the employee dies?

Bottom line: The Pension Protection Act of 2006 allows a nonspouse beneficiary to directly roll a retirement plan balance into an inherited IRA when the employee dies. Once in the inherited IRA, the beneficiary can take required minimum distributions of the funds, effecting a "stretch."

How can a nonspouse beneficiary take advantage of this direct rollover opportunity? A nonspouse beneficiary of a qualified plan (401(k), profit-sharing, defined benefit plan), a governmental 457(b) plan, or a 403(b) plan can directly roll over the balance to an "inherited IRA" when the employee dies.

The funds must be rolled to the IRA provider directly. A nonspouse beneficiary cannot take receipt of the funds and perform an indirect rollover into an inherited IRA. The IRA must be an "inherited IRA," meaning that it is clear that these are the funds of the deceased employee, and the IRA must also identify the beneficiary. For example, the inherited IRA might be titled "Child Smith, beneficiary of Mother Smith, deceased."

Once funds are in the inherited IRA, the nonspouse beneficiary must at least take required minimum distributions (RMDs) from the inherited IRA, beginning no later than December 31 of the year after the year the employee died. By taking only the RMD, the beneficiary can "stretch" the IRA over his or her life expectancy or in some circumstances over the life expectancy of the deceased at the time of death. This allows maximum income tax deferral. (Note: There would be little point to rolling over just to take a lump sum – they could have done that directly from the qualified plan.)

What was the new opportunity in 2007 for nonspouse beneficiaries? Spouse beneficiaries have always been able to roll over retirement plan funds into inherited IRAs or into their own IRAs when an employee died. If the spouse rolled the funds into his or her own IRA, the spouse could defer distributions until age 70½. However, doing a direct rollover to an inherited IRA was a new opportunity starting in 2007 for nonspouse beneficiaries of qualified retirement plans. Prior to 2007, children, grandchildren, friends, partners, etc., had to settle for options provided by the employee's plan – usually a lump sum. Now, the nonspouse beneficiary can directly roll over the retirement plan funds into an inherited IRA and take RMDs. This may avoid a lump-sum distribution at high tax rates as well as allow tax deferral over the beneficiary's life expectancy or in some circumstances, over the life expectancy of the deceased at the time of death.

Note: A nonspouse beneficiary CANNOT roll over the funds into an IRA they own in their own name. A nonspouse beneficiary also CANNOT defer distributions until the IRA owner would have reached age 70½. If a nonspouse beneficiary moves funds into an IRA in their own name, the transaction will be treated as a distribution from the retirement plan and as a contribution to the IRA, which may cause an excess contribution and be subject to a 6% federal additional tax for excess contributions.

(continued on next page)

Nonspouse beneficiary rollovers

Are there any opportunities for me? There may not be the urgency that may have existed prior to the Pension Protection Act of 2006 for people to roll their qualified plans at retirement into an IRA to preserve the stretch. Also, recent guidance has stressed the need to be fair and balanced when discussing options that include rollovers from plans to IRAs. See AMK-058-N and AMK-068-N for extensive discussions regarding rollovers in a regulated environment. The good news is that there may be a much larger market for inherited IRAs – nonspouse beneficiaries who, prior to the Pension Protection Act of 2006, had to take a lump sum from a qualified plan can roll into inherited IRAs or convert to an inherited Roth IRA.[1]

A nonspouse beneficiary who wants to convert a qualified plan distribution into an inherited Roth IRA must roll over the funds to the IRA provider directly. The nonspouse beneficiary must include the amount of the distribution in taxable income in the year of the conversion (certain RMD rules apply to inherited Roth IRAs).

What should I consider in choosing an annuity for the inherited IRA? If you choose an annuity for the inherited traditional IRA or inherited Roth IRA, be sure that it, and any riders available with it, works with the need to take distributions almost immediately, and end distributions by the end of the beneficiary's term certain life expectancy. Please call the FASTeam at 800.950.7372 (or 877.796.6880 for New York) to determine which Allianz or Allianz Life of NY products and riders currently work for inherited IRAs. No additional funds will be allowed to be added to an Allianz or Allianz Life of NY inherited IRA or inherited Roth IRA, even if the additional funds would be a direct rollover from the same source.

[1] Please remind your clients that converting an employer plan account or a traditional IRA to a Roth IRA (including an inherited Roth IRA) is a taxable event. Increased taxable income from the Roth IRA conversion may have several consequences including (but not limited to) a need for additional tax withholding or estimated tax payments, the loss of certain tax deductions and credits, and higher taxes on Social Security benefits and higher Medicare premiums. Encourage your clients to consult with a qualified tax advisor before making any decisions regarding their IRA.

It is generally preferable that your clients have funds to pay the taxes due upon conversion from funds outside their employer plan account or IRA. If they elect to take a distribution from their account or IRA to pay the conversion taxes, please remind your clients to keep in mind the potential consequences, such as an assessment of product surrender charges or additional IRA penalties for premature distributions.

For financial professional use only – not for use with the public.

Product and feature availability may vary by state and broker/dealer.

SEP plan and SEP IRA basics

Question: What is a SEP plan?

Bottom line: The Simplified Employee Pension (SEP) plan was designed with the intent that employers could use their employees' own IRAs to hold the contributions from a pension arrangement that would involve only minimal administrative work once contributions were made to the IRAs. A SEP plan consists of employer contributions (as opposed to employee salary deferrals).

How do I establish a SEP plan? There are three ways to establish a SEP plan:

1. IRS model SEP plan. Your client can go to the IRS website (www.irs.gov) to obtain IRS Form 5305-SEP. The completed form does not need to be filed with the IRS. Allianz or Allianz Life of NY should receive a copy; however, the employer is required to give copies of the completed 5305-SEP to all eligible employees and must retain the original in the employer's files.

Note: In certain situations, the IRS model SEP cannot be used (for example, if the employer maintains a qualified retirement plan). In those situations, a prototype SEP or individually designed SEP must be used.

2. Prototype SEP plan. With a prototype SEP plan, a sponsor (typically, a financial institution, mutual fund company, etc.) drafts a SEP plan document and submits it to the IRS. The IRS issues an opinion letter indicating that the prototype is acceptable. Allianz and Allianz Life of NY should receive a copy of the SEP plan document and the IRS opinion letter. The benefit of a prototype SEP plan is that it can be less restrictive than the IRS model SEP plan. For example, with the IRS model SEP, the plan year must be the calendar year. With a prototype SEP, the employer can base the SEP plan year on a fiscal year rather than being limited to the calendar year.

3. Individually designed SEP plan. An employer can also go to an attorney and have an individually designed SEP plan drafted. This is typically the most expensive and least-used alternative for establishing a SEP plan. Allianz and Allianz Life of NY should receive a copy of the SEP plan document.

What is the deadline for SEP plan contributions?

To make a SEP plan contribution, an employer has until the due date of the business tax return, including extensions, to establish a SEP plan, and make contributions to SEP IRAs. SEP IRAs are usually established by the SEP plan participants. Typically, the tax filing deadline is April 15 for C corporations, and March 15 for partnerships, S corporations, and LLCs. The tax-filing deadline for sole proprietors is also April 15.

Example: Linsey is a sole proprietor, filing a Schedule C. She wants to make a 2018 SEP plan contribution. She can establish a SEP plan and make a plan contribution to a SEP IRA by April 15, 2019. If she gets an extension to file her 2018 tax return, she can establish the SEP plan and make a plan contribution to the SEP IRA until October 15, 2019. Linsey can make the contribution after she files the tax return (taking the deduction) as long as it's before her filing deadline.

Note: The deadline may be different if the plan year is not the calendar year, or if the plan year and tax year are different. In addition, please note that the IRS requires the SEP employer contribution to be reported on IRS Form 5498, in the year the contribution is received, even if the contribution is for a prior year. For example, Linsey mails a SEP employer contribution on December 30 and Allianz or Allianz Life of NY receives the contribution on January 5 of the following year. The IRS requires Allianz or Allianz Life of NY to report the SEP contribution on an IRS Form 5498 in the year they received it, even though Linsey mailed it at the end of the previous year.

How much can an employer contribute to a SEP IRA? The 2018 SEP plan contribution limit is 25% of compensation not to exceed $55,000. All contributions vest immediately.

(continued on next page)

SEP plan and SEP IRA basics

Does the contribution limit change for self-employed individuals? No. The limit for self-employed individuals is 25% of compensation (not to exceed $55,000 in 2018). However, because of how "compensation" is defined, the self-employed person's maximum contribution limit essentially becomes 20% of their net self-employment income less ½ of their self-employment tax. This is an oversimplified example. Your self-employed clients (sole proprietors and partners) will want to consult their tax advisor to determine their specific contribution limit. However, you can alert them to the issue.

What if my client has employees? If a SEP plan contribution is made for a particular year, each eligible employee's IRA must receive a contribution. If the IRS model SEP plan is used, the employer selects a specific percentage and each employee receives the same percentage. The prototype and individually designed SEP plan documents allow the employer to vary the percentage slightly according to a specific IRS-approved formula.

Example: Sandra owns a toy factory. She has two employees: Mark (who makes $30,000/year) and Karen (who makes $40,000/year). Sandra adopts the IRS model SEP plan and decides to make a 10% SEP plan contribution.

Sandra contributes 10% to her own SEP IRA, $3,000 (10% of $30,000) to Mark's SEP IRA, and $4,000 (10% of $40,000) to Karen's SEP IRA.

Does my client have to include all of the employees in the SEP plan? The IRS model SEP plan can be drafted to exclude employees who:
- are under age 21;
- have not worked for the employer for at least three of the preceding five years; and
- in 2018, make less than $600/year.

The employer can also elect to exclude employees who are covered by a collective bargaining agreement and certain non-resident aliens. The SEP plan must cover all other employees. The prototype SEP plan and individually designed SEP plan have a bit more leeway in establishing eligibility criteria, but not much.

Note: The employer needs to be careful when establishing the criteria for eligible employees. For example, if the employer just started the business this year and establishes a three-year service requirement, no one can receive a SEP contribution, including the employer.

Does a SEP IRA operate like a traditional IRA in the hands of an employee? Generally, yes. A SEP IRA is a traditional IRA and follows the same investment, distribution, and rollover rules as traditional IRAs. Because a SEP IRA is a traditional IRA, it can receive a traditional IRA contribution as well as a SEP plan employer contribution. Some IRA rules may differ for the year a traditional IRA or SEP IRA receives a SEP plan contribution.

SIMPLE IRA plans

Question: What is a SIMPLE (Savings Incentive Match Plan for Employees) IRA plan?

Bottom line: A SIMPLE IRA plan is an IRA-based retirement plan for small business employers. As an IRA-based plan, SIMPLE IRA plans are much easier and less expensive to administer than other tax-qualified plans. SIMPLE IRA plans are largely funded with employee contributions from their salaries (salary deferrals), with a modest employer match or nonelective contribution. Therefore a SIMPLE IRA plan resembles a simplified version of a 401(k) plan. Of course, salary deferrals by employees are not included in their income, and contributions by the employer are deductible.

Can any business adopt a SIMPLE IRA plan? No. The SIMPLE IRA plan is available only to businesses with 100 or fewer employees who make more than $5,000 per year (regardless of whether the employees are full time, part time, or seasonal). Also, the employer cannot have any other retirement plan (profit-sharing, SEP, 401(k), etc.) if they want to adopt a SIMPLE IRA plan. And remember that in meeting these rules you must consider all businesses under common ownership. If a business adopts a SIMPLE IRA plan and then has an increase to over 100 employees, the SIMPLE IRA plan must be discontinued.

How do I establish a SIMPLE IRA plan? The IRS can provide you with a model SIMPLE IRA plan on its website (www.irs.gov). Use IRS Form 5304-SIMPLE. The employer does not need to file the form with the IRS. The employer must provide copies of the completed IRS Form 5304-SIMPLE to all eligible employees and must retain the original in its files. Allianz and Allianz Life of NY must also receive a copy.

Each employee also must set up a SIMPLE IRA to receive the contributions.

Rollovers or transfers made after December 18, 2015 from a traditional IRA or an employer-sponsored retirement plan (e.g., 401(k), etc.) can be made to a SIMPLE IRA, provided the SIMPLE IRA owner has participated in the SIMPLE IRA plan for at least two years (i.e., it has been at least two years since the first day contributions made by the SIMPLE IRA owner's employer were deposited in a SIMPLE IRA of the owner.)

What is the deadline to establish and fund a SIMPLE IRA plan? A business must generally establish a SIMPLE IRA plan between January 1 and October 1. Sixty days before each plan year (typically, November 2 through December 31) the employees can elect how much they want to defer in the coming year. The employer must notify employees at the beginning of the election period what employer contributions they will offer. During the plan year, the employer must move the elective deferrals into the employees' SIMPLE IRAs as soon as possible but no later than 30 days after the month in which the funds were withheld from paychecks.

What employees must the plan cover? The plan must cover any employee who has had at least $5,000 of compensation during the two preceding years and is expected to make at least $5,000 in the current year. The plan can be more lenient, if it chooses. The plan can exclude union employees if they could negotiate their own plan. There are no age or hours of service requirements.

What contributions can be made into a SIMPLE IRA? An employee can make an elective deferral (in 2018) of $12,500 ($15,500 if age 50 and older), limited to 100% of compensation.

The employer must make either:

- A dollar-for-dollar match of employee contributions up to 3% of compensation (There is some flexibility to modify the 3% match to as low as a 1% match if business needs dictate.)
- A 2%-of-compensation contribution to all employees whether or not they contribute

Note that the maximum compensation to take into account for purposes of the 2%-of-compensation contribution is $275,000 (in 2018). This compensation maximum does not apply for match purposes. All contributions vest immediately.

(continued on next page)

SIMPLE IRA plans

Is a SEP plan better than a SIMPLE IRA plan for a self-employed person? Not necessarily. Assuming that a self-employed person wants to contribute as much as possible to a retirement plan, the SIMPLE IRA plan may be better than the SEP if income is low. A SIMPLE IRA plan allows a self-employed person to make an elective deferral of $12,500 ($15,500 if 50 or older) plus a 3% match. This may be more than the maximum contribution of 25% of compensation allowed in a SEP plan. For example, suppose a semi-retired 52-year-old engineer has $20,000 of net earnings from self-employment while working as a consultant. The SIMPLE would allow her to make a $15,500 elective deferral plus a $600 match. A SEP plan would only allow her to contribute about $5,000. If income is high, however, the SEP plan allows a larger contribution (as high as $55,000 in 2018).

Does a SIMPLE IRA operate like a traditional IRA in the hands of an employee? There are a few things that distinguish a SIMPLE IRA from a traditional IRA:

- Only a SIMPLE IRA can receive SIMPLE IRA plan contributions.
- An employee cannot roll a SIMPLE IRA distribution to other plans or a distribution from other plans to a SIMPLE IRA under the Internal Revenue Code, until they have participated in the SIMPLE IRA plan for two years.
- If the employee takes a pre-age 59½ distribution during the first two years of participating in the SIMPLE IRA plan, a 25% federal additional tax applies rather than the usual 10% federal additional tax (the same exceptions apply).
- Unlike a traditional IRA, the employee can make SIMPLE IRA contributions (salary deferral contributions) after age 70½ (i.e., the SIMPLE IRA plan can't discriminate against an employee based on age).

In other respects, the SIMPLE IRA looks like a traditional IRA. After two years, a SIMPLE IRA distribution can be rolled over to other plans, and a distribution from other plans can be rolled over to the SIMPLE IRA. The employee has to begin required minimum distributions at age 70½, and must aggregate with traditional and SEP IRAs. No loans are allowed. The SIMPLE IRA can be an account or an annuity, and the plan can't invest in life insurance or collectibles.

What makes a SIMPLE IRA plan so simple? Because it is an IRA-based plan, the employer does not have to do nondiscrimination testing or file an annual IRS Form 5500.

Does Allianz or Allianz Life of NY accept SIMPLE IRAs?
Employees can choose an Allianz fixed or fixed index annuity for their SIMPLE IRA. Allianz Life of NY does not offer fixed or fixed index annuities at this time.

Can any of my clients with SIMPLE IRAs benefit from a variable annuity from Allianz or Allianz Life of NY?
Yes. After the employee participates in the SIMPLE IRA plan with their employer for two years, they can roll or transfer some or all of the balance of the SIMPLE IRA into a traditional IRA at Allianz or Allianz Life of NY. They must, of course, meet the products' minimum contribution rules. The employee will want to keep open the SIMPLE IRA to receive further SIMPLE IRA plan contributions. Funds rolled or transferred into a traditional IRA with Allianz or Allianz Life of NY are subject to all normal distribution rules for traditional IRAs.

Why does my client have to wait two years to roll over or transfer their SIMPLE IRA to a traditional IRA from Allianz or Allianz Life of NY? Rollovers and transfers within the first two years are not permitted under the Internal Revenue Code. In addition, if your client takes a distribution from an IRA prior to age 59½, a 10% federal additional tax may apply. During the 2-year period beginning when an individual first participates in any SIMPLE IRA plan maintained by the individual's employer, the usual 10% federal additional tax is increased to a 25% premature withdrawal federal additional tax (the same exceptions apply). A SIMPLE IRA can only be transferred to another SIMPLE IRA during the 2-year period. After the 2-year period, the SIMPLE IRA could be rolled over or transferred to a traditional IRA from Allianz or Allianz Life of NY. (Keep in mind that because of the contribution limits on SIMPLE IRAs, even if the client were interested in rolling over or transferring SIMPLE IRA monies prior to the 2-year period, it is likely that the client may not have sufficient monies accumulated in the SIMPLE IRA to meet the minimum purchase amount for the desired variable annuity from Allianz or Allianz Life of NY.)

When does participation start for the purpose of the 2-year requirement? Participation in a SIMPLE IRA plan for a particular individual starts on the first day that contributions by the individual's employer are deposited into the individual's SIMPLE IRA.

Net unrealized appreciation (NUA)

Question: What is net unrealized appreciation (NUA)?

Bottom line: Tax law provides favorable treatment when company stock is distributed from a qualified plan. Upon distribution of the company stock in the form of shares (not a cash distribution), your client will have to pay income tax on the "basis" of the stock. However, provided certain requirements are met, the gain in the value of the stock since the employer put the shares into the retirement plan is not taxed when the shares are distributed. It is only taxed when the client later sells the stock, and then at lower capital gains tax rates (rather than ordinary income tax rates). This gain on employer stock, which is not included in taxable income at the time it is distributed in kind from the plan, is called "net unrealized appreciation" or "NUA."

How does this tax benefit work? When the client takes the distribution of the company stock in the form of shares (not a cash distribution), they will only have to pay income tax on the basis of the stock – i.e., the value of the stock when the employer put it into the retirement plan.[1] This amount will be taxed as ordinary income, like all distributions from a retirement arrangement. However, provided certain requirements are met, the gain since the employer put the stock into the retirement plan is not taxed at the point of distribution. The gain is taxed only when the client later sells the stock, and then at capital gains rates. Compare that to the original game plan: if instead the client had rolled that stock into an IRA and then took a distribution from the IRA, they would pay ordinary income rates on both the cost of the stock and the subsequent gain in the stock.

This gain on employer stock, which is not subject to tax at the time the stock is distributed in kind from the plan, is called net unrealized appreciation, or NUA.

Hypothetical example: Mrs. Taylor worked for 20 years for Big Three company. When her employer put Big Three stock into Mrs. Taylor's 401(k) all those years ago, the value was $5 per share. Now it's worth $35 per share. Mrs. Taylor chose other investment options in the 401(k) as well. Mrs. Taylor is retiring this year and considering a rollover of a lump-sum distribution from the plan. At her tax advisor's suggestion, Mrs. Taylor takes a distribution of the Big Three stock in kind, and rolls over her other 401(k) funds into an IRA. Her in-kind distribution of the stock will be taxed as ordinary income this year at $5 per share. The $30 per share gain in value in the stock (NUA) is not subject to income tax now. When she later sells Big Three, the $30 per share NUA and any other appreciation in the stock since distribution from the plan will only be taxed at her capital gains rate at the time of the sale. Compare that to if she had rolled over that stock into her IRA: when she takes distributions from the IRA, the entire distribution will be taxed as ordinary income and the potential benefits of NUA will have been lost.

When my client sells the stock, the NUA is taxed as long-term capital gain, but what about gain accrued since the distribution from the retirement plan? Any gain since the distribution will be taxed as short-term capital gain or long-term capital gain, depending on whether the sale is less than or more than one year from the distribution. Think of the ultimate sale proceeds in three parts:

1. Basis – not taxed again because it was taxed as ordinary income when it was distributed from the retirement plan.
2. NUA – taxed as long-term capital gains at 0%, 15% or 20% (in 2018).
3. Gain since the distribution – taxed as short-term capital gains (at ordinary rates) if the sale is one year or less after the distribution, or long-term capital gains (at 0%/15%/20% in 2018) if the sale is more than one year after the distribution.

If my client takes a distribution of the stock instead of rolling to an IRA, do I have to worry about the 10% federal additional tax? Yes. The distribution of employer stock, like any distribution from the retirement plan, is subject to the 10% federal additional tax if the client is younger than age 59½ (and if other exceptions

(continued on next page)

[1] Using the term "basis" helps people understand that we're talking about the original value of stock when contributed to the plan, not the subsequent gain on the value. However, basis is not technically accurate because there is no basis in a retirement account if all contributions were pre-tax.

do not apply). If you have a young client, the 10% federal additional tax might weigh against taking the stock in kind, and in favor of a rollover.

Note: Allianz or Allianz Life of NY cannot accept assets "in kind" into any annuity. Your client must sell the stock or take a distribution of the stock in kind prior to a rollover to an Allianz or Allianz Life of NY annuity.

Other considerations:

- To qualify to be treated as NUA, the distribution must meet certain requirements, such as being part of a lump-sum distribution.
- The more NUA in the stock, the more effective it may be to take a distribution of stock in kind as opposed to rolling to an IRA. Your client will give up the tax deferral they would have received had your client rolled to an IRA, but your client will pay capital gains rates, not ordinary income rates, on the net unrealized appreciation when your client sells the stock. In general, expect an older person to have more NUA and fewer years to benefit from a rollover – pointing to a distribution in kind of the stock. For younger people, the opposite could be true: less NUA and more years to benefit from deferral points to rolling to an IRA.
- The higher your client's marginal tax rate, the more effective the distribution of stock in kind. If your client's marginal rate is very high, your client will potentially save more by having NUA taxed at lower capital gains rates.
- Since Congress increased the top capital gains rate from 15% to 20%, this NUA technique has lost some of its value. There is less of a difference between ordinary rates and capital gains rates.
- Does the client need to diversify this stock? If your client rolls the stock to an IRA, your client would be able to sell the stock and diversify without immediate taxation. By taking the stock in kind, your client will have to pay tax at ordinary income rates on the basis when the stock is distributed from the plan and at capital gains rates on the stock growth when your client sells the shares to diversify (albeit at the lower capital gains rates).
- Does the client have the liquidity to pay tax? There will be ordinary income tax on the stock basis when it is distributed in kind from the retirement plan. Can the client cover this additional tax or do they need to roll over the funds to delay the income taxation?
- Does the client need creditor protection? Assets held in an IRA may have creditor and bankruptcy protection not available for assets held outside an IRA.
- Treatment at death. If the stock is still in the employer's retirement plan when the employee dies, the beneficiaries can take advantage of the NUA if they withdraw the proceeds from the retirement plan in a lump sum. When they later sell the stock, they will pay tax at capital gains rates on the NUA. If the client during life takes the in-kind distribution from the retirement plan but still holds the stock at death, the NUA portion is not stepped up to a new basis – just the gain since the distribution from the plan. The NUA is IRD to the heirs of the stock. While this might look like a drawback, remember that IRAs don't get a basis step-up either.
- NUA treatment is available only to employer stock. Other investments in the plan can't get NUA treatment. This may suggest rolling over these assets.
- NUA treatment is for qualified retirement plans like 401(k)s or profit sharing plans. It does not apply to SEPs, SIMPLEs, or 403(b)s.
- Remember that capital gains rates and/or ordinary income rates could change in the future.
- Roth contributions. If the client made Roth 401(k) contributions to the plan, NUA treatment may not apply. NUA is helpful only in the case of a distribution that is otherwise taxable. If the client's Roth contributions were held for a sufficient period so that the distribution is a "qualified distribution" and not taxable, NUA treatment is not helpful.
- Clients should consult their tax advisors before making a decision regarding NUA.

Stretch distribution strategy

Question: What is an IRA stretch distribution strategy?

Bottom line: A stretch distribution strategy generally means that an IRA owner has named a beneficiary who is eligible under IRS rules and regulations to stretch payments over the beneficiary's life expectancy after the IRA owner's death. A stretch distribution strategy may also mean stretching payments over the life expectancy of the deceased at the time of death, depending on the deceased's age at time of death. A stretch is not a special type of IRA although the particular IRA must permit the life expectancy payout option for the beneficiary. The undistributed portion of the inherited traditional IRA remains tax-deferred until distribution. If the IRA stretch distribution strategy is used with a Roth IRA, the undistributed portion accumulates tax-free if the Roth IRA meets requirements for qualified distributions. Please note that inherited IRAs are also called beneficial IRAs. See the next Q&A about "Beneficial IRAs."

The stretch strategy is most appropriate when used by individuals who do not need distributions from their IRA during life (other than any required minimum distributions) and who are able to pass on their IRA assets to future generations. Changes in tax law, the impact of inflation, and costs and risks of underlying funding vehicles may have a significant impact on the long-term value of an IRA.

What is the benefit of a stretch distribution strategy?
Inherited traditional IRA distributions are subject to income tax as they are distributed to the beneficiary. By stretching out the distributions over the beneficiary's life expectancy, the beneficiary pays income tax only on the amount received from the inherited traditional IRA each year. Keep in mind that any distributions made from the IRA during the lifetime of the IRA owner will reduce the amount available to the beneficiary at the IRA owner's death. For this reason a Roth IRA may be especially appropriate for a stretch. The owner of a Roth IRA does not have to take any RMD during life, and can leave everything for a tax-free stretch by the beneficiaries when qualified distributions occur.

Are there restrictions on who my client can name as beneficiary of this IRA? Your client can name anyone as beneficiary. Often, an IRA owner will name his/ her spouse or children as beneficiary(ies) but the beneficiary does not have to be related to the IRA owner. Certain beneficiaries, however, are generally not eligible to stretch distributions over a life expectancy. For example, for IRA distribution purposes, a charity or a person's estate does not have a life expectancy, and a charitable beneficiary or estate beneficiary would generally not be eligible to elect a stretch payout. Depending on when an IRA owner dies, any beneficiary is able to stretch using the life expectancy of the IRA owner in the year of the IRA owner's death (or no beneficiary is eligible to use the life expectancy of the IRA owner). Generally, if a trust is named as beneficiary of an IRA, the trust is not eligible to elect a stretch payout unless the trust meets certain requirements. If a trust is named as beneficiary of an IRA and meets certain requirements, the IRS will "look through" the trust and permit the IRA to be distributed over the life expectancy of the trust beneficiary. If there are multiple beneficiaries of the trust, the trustee will be required to take distributions based on the life expectancy of the oldest trust beneficiary. In some situations, the trustee will be able to take distributions based on the life expectancy of the deceased IRA owner in the year of death. Allianz or Allianz Life of NY will make all stretch payments payable to the trust. If there are any non-individuals (such as a charity) named as trust beneficiaries, the trust may still be able to qualify for "look-through" treatment as long as the non-individual trust beneficiaries receive their part of the IRA by September 30 of the year after the year of the original IRA owner's death. The trust beneficiaries should consult their attorney regarding the details of this strategy and whether this would make sense in their specific situation.

What requirements must a trust meet in order to use the life expectancy of the oldest trust beneficiary for a stretch payout? In order to qualify for "look-through" (also called "see-through") treatment, the trust must meet the following requirements: (1) the trust must be valid under state law; (2) the trust must be irrevocable or must become irrevocable

(continued on next page)

upon the death of the IRA owner; (3) the trust beneficiaries must all be individuals and must be identifiable from the trust document; and (4) certain documentation must be provided to the IRA provider by October 31 of the year following the year of the IRA owner's death. The client should consult their attorney to determine whether the trust that they wish to name as beneficiary of their IRA qualifies for "look-through" treatment.

What distribution choices does an IRA beneficiary have if the owner dies before age 70½?[1] If an IRA owner dies before age 70½ or if the IRA is a Roth IRA, an individual beneficiary (meaning not an estate, charity, etc.) typically has three distribution choices for the inherited IRA. The beneficiary can: (1) take a lump-sum payout, (2) withdraw the entire IRA by December 31 of the year containing the fifth anniversary of the IRA owner's death (this distribution method is often called the "5-year rule" or "5-year deferral"), or (3) take the required annual (or more frequent, if desired) distributions based on the beneficiary's life expectancy (i.e., the required minimum distribution).

If the beneficiary is the IRA owner's spouse, the spouse has two additional choices: (1) the spouse can roll the decedent's IRA into the spouse's own name and name a new beneficiary or (2) the spouse may choose to defer distributions from the inherited IRA until the deceased spouse would have attained age 70½.

Note: It is important to note that not all IRAs give a beneficiary all three choices. An IRA cannot be a stretch if it does not permit the beneficiary to take distributions over life expectancy. If an IRA owner wants his or her beneficiaries to be able to stretch the IRA after the IRA owner's death, the IRA owner will want to confirm that the life expectancy payout option will be available to his or her beneficiaries.

In addition, some annuity companies require the beneficiary to annuitize the IRA proceeds in order to stretch distributions over the beneficiary's life expectancy. Allianz or Allianz Life of NY offers all three choices (plus the spousal continuation option) discussed above, and allows the beneficiary to take a life expectancy distribution without forcing the beneficiary to annuitize the proceeds. However, Allianz and Allianz Life of NY allow an individual beneficiary to annuitize the proceeds, within certain limits. A beneficiary who wants the annuitization option must start annuity payments from Allianz by December 31 following the year of death.

What distribution choices does an IRA (other than a Roth IRA) beneficiary have if the owner dies on or after age 70½?[1]
If the Allianz or Allianz Life of NY IRA owner dies after starting required distributions from the IRA at age 70½,[1] the beneficiary must do one of the following: (1) take a lump sum, (2) continue required minimum distributions based on the life expectancy of the deceased IRA owner at the time of death (if the beneficiary is older than the original IRA owner or the beneficiary is a non-individual such as a charity), or (3) take the required annual (or more frequent, if desired) distributions based on the beneficiary's life expectancy (i.e., the required minimum distribution).

If the beneficiary is the IRA owner's spouse, the spouse has an additional choice – the spouse can roll the decedent's IRA into the spouse's own name and name a new beneficiary.

Again, your client should verify with the particular IRA provider that the life expectancy payout option will be available for his or her IRA beneficiaries.

Note: IRA providers will generally allow an IRA beneficiary to name a successor beneficiary of the beneficial IRA.

If a beneficiary elects a life expectancy payout, when do the payments begin? The general rule is that if a life expectancy payout is permitted for the inherited IRA, the beneficiary must start taking distributions by December 31 of the year following the year of the IRA owner's death. There is an exception to the general rule if the beneficiary is the spouse of the IRA owner. A spouse beneficiary can choose to defer required distributions until the deceased IRA owner would have reached age 70½.

Does a beneficiary have to annuitize the contract to take advantage of the stretch? If an IRA is funded with an Allianz or Allianz Life of NY annuity, the beneficiary can (assuming the beneficiary is eligible to elect a life expectancy payout) simply take his or her RMD withdrawal without annuitizing. (The beneficiary can also choose to take a lump-sum distribution or, if the IRA owner dies before age 70½,[1] or for a Roth IRA, the beneficiary can select 5-year deferral.) However, Allianz and Allianz Life of NY allow an individual beneficiary to annuitize the proceeds, within certain limits. A beneficiary who wants the annuitization option must start annuity payments from Allianz by December 31 following the year of death.

[1] Age 70½ is used for convenience. The actual date to use (called the required beginning date) is April 1 following the year in which the IRA owner reached or would have reached age 70½. The IRA owner also has not annuitized the IRA before his or her death.

Stretch distribution strategy

What are some common IRA stretch beneficiary strategies? Naming the IRA owner's spouse as sole primary beneficiary can provide significant flexibility while naming a younger beneficiary can maximize income tax deferral after the IRA owner's death.

Spouse beneficiary. Probably the most common beneficiary arrangement for married individuals is naming the spouse as sole primary beneficiary. At the IRA owner's death, his or her spouse can roll the inherited IRA into the spouse's own name and name a new beneficiary (perhaps a child). This provides the IRA owner's child (or other named beneficiaries) the benefit of extended income tax deferral after the IRA owner's death but gives the owner's spouse access to the IRA during the spouse's life.

Child/grandchild beneficiary. If an IRA owner's spouse does not need the IRA proceeds or if the IRA owner is not married, another option for maximizing income tax deferral after death is naming someone significantly younger (such as a child or grandchild) directly as primary beneficiary.

Important. Keep in mind that naming a minor beneficiary can create distribution challenges in states which prohibit payment over a certain amount to minors without court approval. The IRA owner can minimize payment difficulty by naming a trust for the benefit of the minor as a beneficiary, making sure the trust qualified for "look-through" treatment. Another option may involve naming a Uniform Transfer to Minors Act (UTMA) account for the benefit of the minor beneficiary. If an UTMA account is used for this purpose, a tax advisor should be consulted since the RMD regulations do not specifically address whether the minor's life expectancy can be used to stretch the payments within an UTMA account. See the "Pitfalls of naming a minor beneficiary" and the "Uniform Transfers to Minors Act and annuities" Q&As.

What happens when the beneficiary (the one taking stretch payments) dies? If the original beneficiary has elected to stretch distributions over his or her life expectancy, the life expectancy factor is generally determined based on the original beneficiary's age on his or her birthday in the year after the year in which the IRA owner died. The life expectancy for a nonspouse beneficiary is then reduced by one for each subsequent year, or for a spouse beneficiary it's redetermined each year. Thus, the original beneficiary may have a remaining "life expectancy" even after his or her death. If so, and if there is an IRA balance at the death of the original beneficiary, the original beneficiary's beneficiary (Beneficiary #2) may take the remaining IRA proceeds in a lump sum. Alternatively, Beneficiary #2 may elect to take the IRA balance over the original beneficiary's remaining life expectancy reduced by one year each year, even if the beneficiary to the IRA was a spouse beneficiary. If the original beneficiary was using the life expectancy of the original deceased IRA owner, the original beneficiary's beneficiary (Beneficiary #2) may continue using the remaining life expectancy of the deceased. Please note that Allianz or Allianz Life of NY reserves the right to distribute the remaining balance in a lump sum if it does not meet certain minimum amounts.

What additional forms are needed to make an Allianz or Allianz Life of NY IRA a stretch? No special forms are needed during the IRA owner's lifetime. Remember that a stretch is just a basic IRA that allows payments over a life expectancy after the IRA owner's death, generally with a beneficiary designation. For a new contract, the IRA owner would simply complete the beneficiary designation part of the annuity application. To add to or change the beneficiary designation on an existing contract, use the Allianz or Allianz Life of NY Client Contract Update Request form (variable) or the Request to Transfer Ownership and/or Change Beneficiaries form(s) (fixed). A client who is using the stretch distribution strategy within an inherited IRA held outside of Allianz or Allianz Life of NY may transfer that inherited IRA to an annuity contract with Allianz or Allianz Life of NY, provided the specific annuity product and any riders are acceptable for inherited IRAs. In addition to the application and transfer form, this client will need to complete a Beneficial/Inherited IRA RMD Election form (NBAL0036). See the Beneficial IRAs Q&A.

Question: What is a beneficial/inherited IRA?

Bottom line: A beneficial/inherited IRA (also called a stretch IRA, deceased IRA, family IRA, multi-generation IRA or, when a nonspouse is the beneficiary, an inherited IRA) is an IRA inherited by a beneficiary after the death of the original IRA owner. (Note: The term inherited IRA is often used even when the beneficiary is a spouse). The beneficiary is required to take required minimum distributions from the beneficial/inherited IRA, and the remaining IRA balance can remain income-tax-deferred. The IRA must be properly retitled to a beneficial/inherited IRA, meaning that both the beneficiary's name and the deceased's name must appear in the title.

While Allianz does permit the beneficiary of an Allianz IRA to "stretch" distributions over the beneficiary's life expectancy in most situations, please note that beneficial/inherited IRAs transferred to Allianz after the death of the IRA owner are available only in select Allianz fixed index annuities that do not have certain riders, and in the Allianz Index Advantage® Variable Annuity. In addition, if the beneficiary elected a five-year deferral option at another IRA provider, that beneficial/inherited IRA should not be transferred to Allianz. A beneficial/inherited IRA should not be transferred to Allianz if the beneficiary is the original beneficiary's beneficiary (Beneficiary #2). Allianz Life of NY does not offer fixed or fixed index annuities at this time.

Can a nonspouse beneficiary roll a beneficial/inherited IRA into his or her own name? Unfortunately, there is no provision that permits a nonspouse beneficiary to roll a beneficial/inherited IRA into his or her own IRA. In addition, the 60-day rollover is not available when a nonspouse beneficiary inherits an IRA. Frequently, a nonspouse beneficiary will unknowingly ask the beneficial/inherited IRA provider to distribute the IRA assets to the beneficiary who then intends to put the proceeds in a new beneficial/inherited IRA. This is not permitted. If the beneficiary wants to transfer the beneficial/inherited IRA to a different IRA provider, the IRA must be transferred directly from institution to institution.

How should a new beneficial/inherited IRA be titled? The title of the new IRA must reflect that the IRA is a beneficial/inherited IRA. In addition, the name of the deceased IRA owner must be included. A typical Allianz or Allianz Life of NY beneficial/inherited IRA is titled similar to the following: "Martin Smith as beneficiary of Joanna Smith, IRA, deceased." The word "deceased" is not required but is helpful for identification purposes. The beneficiary's Social Security number should be used for the beneficial/inherited IRA.

If a trust establishes a beneficial/inherited IRA, the ownership would be similar to the following: "Joanna Smith Trust U/A dated 1/10/2006 as beneficiary of Joanna Smith, IRA, deceased, Martin Smith, Trustee." The trustee should sign the application when a trust establishes a beneficial/inherited IRA and the trust's Taxpayer Identification Number should be used. Please refer to the discussion on "look-through" trusts below.

How should a custodian-owned beneficial/inherited IRA be titled?
If an IRA custodian establishes a beneficial/inherited IRA, then a typical Allianz or Allianz Life of NY custodian-owned beneficial/inherited IRA is titled similar to the following: "Company XYZ, custodian for Joanna Smith beneficiary, Martin Smith decedent IRA."

What distribution options are available to a nonspouse beneficiary if the owner dies before age 70½ or the IRA is a Roth IRA?[1] If the original IRA owner dies before age 70½,[1] or if the IRA is a Roth IRA, an individual beneficiary (meaning not an estate, charity, etc.) of an Allianz or Allianz Life of NY annuity has three choices as to how the inherited IRA is distributed. The beneficiary can (1) take a lump-sum payout; (2) withdraw the entire IRA by December 31 of the year containing the fifth anniversary of the IRA owner's death (this distribution method is often called the "five-year deferral"); or (3) take the required annual (or more frequent, if desired) distributions based on the beneficiary's life expectancy (i.e., the required minimum distribution).

[1] Age 70½ is used for convenience. The actual date to use (called the required beginning date) is April 1 following the year in which the IRA owner reached or would reach age 70½. The IRA owner also has not annuitized the IRA before his or her death.

Beneficial/inherited IRAs

Note: Not all IRAs give a beneficiary all three choices. The beneficiary should consult the particular IRA provider to determine which distribution options are available. For example, some annuity companies require the beneficiary to annuitize the IRA proceeds in order to stretch distributions over the beneficiary's life expectancy. Allianz or Allianz Life of NY contracts offer all three choices discussed above, and Allianz and Allianz Life of NY also allow the beneficiary to take a life expectancy distribution without forcing the beneficiary to annuitize the proceeds. However, Allianz and Allianz Life of NY allow an individual beneficiary to annuitize the proceeds within certain limits.[1]

What distribution options are available to a nonspouse beneficiary if the owner dies on or after age 70½?[2] If the IRA (other than a Roth IRA) owner dies after starting required minimum distributions from the IRA at age 70½,[2] the beneficiary must either (1) take a lump sum, (2) continue required minimum distributions based on the life expectancy of the deceased IRA owner at the time of death (if the beneficiary is older than the IRA owner or is a non-individual such as a charity), or (3) take required annual (or more frequent if desired) distributions based on the beneficiary's life expectancy (i.e., the required minimum distribution). Again, your client should verify with the particular IRA provider that the life expectancy payout option will be available for his or her IRA beneficiaries.

What additional distributions are available for a spouse beneficiary? A spouse beneficiary has all of the distribution options available to a nonspouse beneficiary. In addition, the spouse has two additional choices: (1) the spouse can roll the decedent's IRA into the spouse's own name and designate a new beneficiary or (2) if the original IRA owner dies before age 70½,[2] or if the IRA is a Roth IRA, the spouse may choose to defer distributions from the beneficial/inherited IRA until the deceased spouse would have attained age 70½. Keep in mind that if the spouse rolls the IRA into his or her own name, the IRA is no longer considered a beneficial/inherited IRA. It becomes the spouse's own IRA and the spouse is then treated as the original IRA owner for required minimum distribution rule purposes.

What distribution options are available to a trust beneficiary? If a trust is named as beneficiary of an IRA and meets certain requirements, the IRS will "look through" the trust and permit the IRA to be distributed over the life expectancy of the trust beneficiary. If there are multiple beneficiaries of the trust, the trustee will be required to take distributions based on the life expectancy of the oldest trust beneficiary. In some situations, the trustee will be able to take distributions based on the life expectancy of the deceased IRA owner. Allianz or Allianz Life of NY will make all stretch payments payable to the trust. If there are any non-individuals (such as a charity) named as trust beneficiaries, the trust may still be able to qualify for "look-through" treatment as long as the non-individual trust beneficiaries receive their part of the IRA by September 30 of the year after the year of the original IRA owner's death. The trust beneficiaries should consult their attorney regarding the details of this strategy and whether this would make sense in their specific situation.

What requirements must a trust meet in order to use the life expectancy of the oldest trust beneficiary for a stretch payout? In order to qualify for "look-through" (also called "see-through") treatment, the trust must meet the following requirements: (1) the trust must be valid under state law; (2) the trust must be irrevocable or must become irrevocable upon the death of the IRA owner; (3) the trust beneficiaries must all be individuals and must be identifiable from the trust document; and (4) certain documentation must be provided to the IRA provider by October 31 of the year following the year of the IRA owner's death. The client should consult their attorney to determine whether the trust that they wish to name as beneficiary of their IRA qualifies for "look-through" treatment.

Note that contracts that are established through transfers from another company or rollovers from a plan will not have annuitization options.

(continued on next page)

[1] A beneficiary who wants the annuitization option must start annuity payments from Allianz or Allianz Life of NY by December 31 following the year of death.
[2] Age 70½ is used for convenience. The actual date to use is April 1 following the year in which the IRA owner reached or would reach age 70½. The IRA owner also has not annuitized the IRA before his or her death.

Can a nonspouse beneficiary directly roll over an inherited 401(k) to a beneficial/inherited IRA after the death of the original 401(k) plan participant? Yes. A nonspouse beneficiary can directly roll funds from an inherited qualified retirement plan (401(k), profit-sharing plan, defined benefit plan, etc.) into a beneficial traditional IRA or a beneficial Roth IRA. Previously, only spouse beneficiaries were allowed to roll funds from an inherited qualified plan to a beneficial/inherited IRA or to the surviving spouse's own IRA. However, a nonspouse beneficiary was limited to the distribution options available under the qualified plan. Often, this meant that the nonspouse beneficiary had no choice but to take a lump-sum distribution and trigger a hefty income tax liability. Keep in mind that a nonspouse beneficiary still cannot roll funds from an inherited qualified plan into their own IRA. Rather, to preserve the income tax deferral, the IRA must be titled as a beneficial IRA (see above for specific titling example). In addition, the funds from the qualified plan must move directly from the plan to an inherited IRA. There is no 60-day rollover rule for beneficial/inherited IRAs for nonspouse beneficiaries.

Why would a spouse beneficiary elect to roll to an inherited IRA rather than to the surviving spouse's own IRA? If the surviving spouse is under age 59½, a distribution from an IRA is subject to the 10% federal additional tax, while a distribution from an inherited IRA is not subject to the additional tax. Also, in some circumstances, the minimum distribution required from a beneficial/inherited IRA may be less than the minimum distribution required from the spouse's own IRA.

Can a nonspouse beneficiary transfer a nonqualified annuity after the death of the original owner? Unfortunately, although an IRA beneficiary may choose to move a beneficial or inherited IRA to another IRA provider, many annuity providers take the position that a nonspouse beneficiary may not transfer nonqualified annuity proceeds to another annuity provider after the death of the annuity owner. Thus, the only distribution options available to the beneficiary are those offered by the annuity provider at the time of the nonqualified annuity owner's death. Allianz and Allianz Life of NY will not accept a transfer of nonqualified annuity proceeds after the death of the annuity owner.

The same rule applies to a spouse; however, a spouse beneficiary may be able to continue the nonqualified annuity in his or her own name and subsequently transfer the annuity in a 1035 exchange subject to any applicable surrender charges.

Beneficial/inherited IRAs are designed for individuals who will not rely on the money in the IRA for their immediate needs. It is important for clients to consult their tax or legal advisors to determine how a beneficial/inherited IRA may affect their financial and estate planning objectives.

Note that after the inherited IRA is first funded at Allianz or Allianz Life of NY, no additional funds will be accepted into that inherited IRA, even if the funds would be coming from the same source as the initial funds.

IRA inherited trusts

Question: Can a trust be named as a beneficiary of an IRA? There are a few basic things to verify first to name a trust as beneficiary of an IRA.

Is the trust a "see through" trust? The first step is to verify if the trust qualifies as a designated beneficiary of an IRA. This is determined by verifying if the trust is considered a see through trust. There are four requirements per Treasury Regulation §1.401(a)(9)-4, Q&A-5 that must be met to be qualified as a see through trust:

1) The trust must be a valid trust under state law.
2) The trust must be irrevocable, or by its terms become irrevocable upon the death of the original IRA owner.
3) The trust's underlying beneficiaries must (all) be identifiable as being eligible to be designated beneficiaries themselves.
4) A copy of trust documentation must be provided to the IRA custodian by October 31 of the year following the year of the IRA owner's death.

If all four requirements are met, the trust can qualify as a designated beneficiary for an IRA. Because it qualifies as a beneficiary, the trust is allowed to "stretch" the required minimum distributions (RMDs) over the oldest identifiable trust beneficiary's life expectancy.

Is the trust considered an "accumulation" trust or a "conduit" trust? The second step is to determine if the trust is a conduit trust or an accumulation trust to determine the oldest identifiable trust beneficiary. According to Treasury Regulation §1.401(a)(9)-5, Q&A-7, a trust that requires all RMDs from an IRA to pass through directly and immediately to the income beneficiary is a conduit trust and need only look to the age of the oldest income beneficiary. The advantage of a conduit trust is a clear picture as to whose life is used to stretch the IRA. The disadvantage is that the RMDs are immediately paid to the income beneficiary who may be prone to spend the money or lose it to creditors.

On the contrary, any trust that has the discretion to accumulate the RMDs is considered an accumulation trust. With an accumulation trust it is necessary to continue down the line of trust beneficiaries until the point where a distribution must be made. The advantages of accumulating the distributions instead of paying them directly could be asset protection and substance or spendthrift issues. However, one potential issue with this type of trust could be identifying the life expectancy used to calculate the RMDs.

Roth 401(k)s, 403(b)s, and governmental Roth 457(b)s

Question: What is a Roth 401(k), Roth 403(b), and governmental Roth 457(b)?

Bottom line: 401(k) plans, 403(b) plans, and governmental 457(b) plans are now allowed to accept "designated Roth contributions." If the plan adopts this provision, employees can allocate some or all of their elective deferral to a Roth-type account. The employee will not be able to deduct these contributions, but qualified distributions of the Roth contributions and any earnings will be income-tax-free.

What is a designated Roth contribution? 401(k) plans, many 403(b) plans, and governmental 457(b) plans allow employees to make elective deferrals of their own salaries into the plan. In 2018, the elective deferral is limited to $18,500 ($24,500 if the employee is 50 or older). If the plan adopts a Roth provision, employees can designate some or all of this deferral as a Roth contribution. The employee can split deferral between Roth and regular (pre-tax) contributions however they wish, as long as they don't exceed their total $18,500 (or $24,500) annual limit.

What are the income tax implications when an employee contributes to a Roth account in the plan? Designated Roth contributions will be taxed to the employee as if the employee had received the contribution as salary. The employer will report the contributions to the employee on the W-2. The contributions and any gains will grow tax-deferred.

How is a qualified distribution from a Roth account taxed? As with Roth IRAs, the employee must take a "qualified distribution" from a Roth account to avoid income tax on the earnings. A qualified distribution is one that occurs (1) after the employee has attained age 59½, or (2) as a result of the employee's death or disability. In addition, the distribution must be at least five years after the initial designated Roth contribution. The five-year period starts with the first tax year in which the participant made a designated Roth contribution to the plan. If the employee rolls a designated Roth contribution from a prior plan that permitted Roth contributions into his or her current plan, the employee can tack the holding period of the old account onto the current account to see if the five-year rule has been met. Other than this rollover, the five-taxable-year period is determined separately for each plan.

Keep in mind that if designated Roth contribution monies are later rolled to a Roth IRA, the Roth IRA rules will determine when the five-year holding period starts, regardless of how long the monies were held inside the plan. Also, see the Roth IRA distributions Q&A for how this type of rollover affects the Roth IRA distribution ordering rules.

Example – Roth 401(k) to Roth IRA rollover. Chuck makes a designated Roth contribution to his 401(k) plan in 2012. He takes early retirement in 2018 at age 57 and decides to roll his Roth 401(k) monies into a new Roth IRA, and he has never had any other Roth IRA. He will not be able to take a qualified distribution from his Roth IRA until 2023. On the other hand, if Chuck had a Roth IRA he first funded in 2012, he would have already met the five-year holding period for the Roth IRA in 2018.

How is a nonqualified distribution from a designated Roth account taxed? If an employee takes a nonqualified distribution of Roth funds from a plan, the distribution is treated as part contribution, part earnings, on a pro rata basis. Any earnings will be subject to income tax. The contribution itself, though, has already been taxed so it will not be taxed again. If an in-plan Roth rollover is included in the distribution within five years of the rollover, the 10% federal additional tax will apply if under age 59½ and no other exception applies. The determination of how much of a nonqualified distribution is contribution, in-plan rollover, or earnings, is done on a pro rata basis.

Example – nonqualified distribution. Mary has a $10,000 Roth 401(k) – $9,400 of designated Roth contributions and $600 of earnings. If Mary withdraws $5,000, the distribution will consist of $4,700 of designated Roth contributions (these have already been taxed so they are not included in Mary's gross income) and $300 of earnings (which are includible in Mary's gross income).

Roth 401(k)s, 403(b)s, and governmental Roth 457(b)s

Must required minimum distributions (RMDs) be made from designated Roth contribution funds? Yes. If the employee has Roth funds in his or her plan at the required beginning date (typically, April 1 of the year after the year in which the employee reaches age 70½ although other rules may apply to a 401(k) plan, a 403(b) plan, or a governmental 457(b) plan), the employee must begin to take RMDs. However, by that time the employee will be over age 59½ and should be eligible to roll designated Roth contribution monies to a Roth IRA provided the rollover is done prior to the year of the RMD. Once the funds are in the Roth IRA, there are no RMDs required during the owner's life (but RMD rules do apply to the Roth IRA beneficiaries).

Is this good for higher-compensated employees? It depends. This will offer a Roth opportunity for people who make too much to contribute to a Roth IRA. The ability to make annual contributions ($5,500/$6,500 for age 50 and older) is phased out in 2018 for single filers between $120,000 and $135,000 or joint filers between $189,000 and $199,000. There are no income limits for designated Roth contributions, so higher-compensated employees have the chance for income-tax-free earnings when qualified distributions occur. On the other hand, Roths tend to be a better deal if you think your tax rates will be higher when you retire. Higher-compensated employees may be reluctant to pay tax today at their current rate (i.e., give up the "deduction") if they think they'll be in a lower bracket during retirement. Also, the higher-compensated employees may be older, which gives fewer years of income-tax-free potential gains.

Is this good for lower-compensated employees? Designated Roth contributions can be advantageous for lower-compensated employees, especially if they think that their income and tax rates will increase in the future. Paying tax on the contribution now may mean these retirement funds will be taxed at a lower rate than their regular salary deferral contributions. Also, they may be younger and have many years to accumulate income-tax-free gains. The "forced savings" of paying the taxes now may be a big help in saving for retirement (i.e., if they made deductible contributions, would they really invest the tax savings?). Of course, lower-income employees may have a more difficult time affording the contributions, especially if it doesn't lower their taxes. Roth contributions may also create a liquidity problem in that employees will have to pay income taxes on funds they don't receive. Also, lower-income people already have the opportunity to make Roth IRA contributions.

What will this mean for the employer's plan?
If the employer decides to allow designated Roth contributions, the plan and company payroll will have to set up separate accounting for Roth contributions and distributions. They will have to amend plan forms and documents. If the employer makes matching contributions, the match on designated Roth contributions will still be pre-tax dollars.

Can an Allianz or Allianz Life of NY annuity be used in a 401(k) plan that has a Roth 401(k) feature? If an Allianz or Allianz Life of NY annuity is a permitted funding vehicle per the 401(k) plan document (i.e., if the document does not restrict funding vehicles or specifically includes Allianz or Allianz Life of NY annuities among the permitted financial products), then such annuities may also be used to fund the 401(k), which may include a Roth portion. Please note that these annuities serve only as funding vehicles with a separate annuity required for each plan participant. They do not track designated Roth 401(k) contributions, so Allianz or Allianz Life of NY will not know if any portion of the annuity value consists of designated Roth funds. The 401(k) plan administrator would be responsible for all recordkeeping and must separately track that portion of the employee's account which consists of designated Roth contributions. A Qualified Plan Acknowledgement form along with a copy of the plan document must be submitted with the annuity application.

Note that Allianz and Allianz Life of NY do not currently accept 403(b) plan or governmental 457(b) plan annuity contracts.

(continued on next page)

Roth 401(k)s, 403(b)s, and governmental Roth 457(b)s

What happens if the employee leaves the company and wants to roll the portion of his or her Allianz or Allianz Life of NY annuity that is Roth 401(k) funds to a Roth IRA funded by an annuity from Allianz or Allianz Life of NY? If the 401(k) annuity for a plan participant includes only Roth 401(k) contributions, the plan trustee can direct Allianz or Allianz Life of NY to change ownership of the contract from the 401(k) plan to a Roth IRA owned by the former employee. This change would not affect contract features or benefits or the surrender schedule. If the plan trustee determines that the 401(k) annuity of the plan participant includes both Roth 401(k) and traditional 401(k) contributions, the plan trustee can direct Allianz or Allianz Life of NY to change ownership of the contract from the 401(k) to a traditional IRA, but the Roth 401(k) monies must first be removed and rolled to a Roth IRA in the same product. This change would not affect contract features or benefits or the surrender schedule. However, this strategy is only available if the Roth 401(k) monies and the traditional 401(k) monies (after removal of the Roth 401(k) monies) separately meet contract minimums. If the Roth 401(k) amount and traditional 401(k) amount do not separately meet contract minimums, the plan, on the participant's behalf, can either: (1) leave the annuity titled as a 401(k), if permitted by the 401(k) plan; or (2) have the Roth 401(k) monies paid to the plan, which can then roll the monies to an outside carrier, subject to applicable surrender charges, before changing ownership of the remaining regular 401(k) contract to a traditional IRA (this change of ownership will only be permitted if the traditional 401(k) contributions – after the Roth 401(k) contributions are removed – meet product minimums).

Please note that rolling over qualified plan funds to an IRA does not assure positive results or that sufficient funds will be available for retirement. There are many considerations, such as comparing investment options available and the fees involved, when deciding whether or not to do a rollover to an IRA. Clients should be sure to consult with a qualified tax advisor before making any decisions regarding an IRA.

Whenever an individual is considering a rollover to a Roth IRA, they should discuss the following options with their tax advisor: (1) taking the distribution in cash; (2) leaving the funds in the plan (not taking the distribution); (3) taking the distribution and rolling it back into the same or another eligible employer plan within 60 days; (4) rolling the distribution into a traditional IRA; and (5) rolling the distribution directly into a Roth IRA.

Any time the above options are considered, the following should be discussed:

- Comparison of fees and costs if funds are left in a qualified plan and if funds are rolled over to an IRA, including any commissions involved.
- Investment options and services available from the qualified plan sponsor and the IRA provider.
- Differences in exceptions to the federal additional tax. For example, distributions from a qualified plan after termination of employment after age 55 are not subject to the federal additional tax.
- If the client holds employer stock, net unrealized appreciation (NUA) – see the Q&A regarding NUA in this booklet.
- Funds may not have the same level of creditor protection as a qualified retirement plan.

However, this is not a complete list of everything that must be discussed with a client. As noted above, recent guidance has stressed the need to be fair and balanced when discussing options that include rollovers from plans to IRAs. See AMK-058-N and AMK-068-N for extensive discussions regarding rollovers in a regulated environment.

Please note that in order to provide a recommendation to a client about the transfer of funds from an investment product to a fixed insurance or annuity, you must hold the proper securities registration and be currently affiliated with a broker/dealer. If you are unsure whether or not the information you are providing to a client represents general guidance or a specific recommendation to liquidate a security, please contact the individual state securities department in the states in which you conduct business. Encourage your clients to consult their tax advisor or attorney.

Entire interest RMD rules

Question: How are required minimum distributions (RMDs) calculated when an IRA or qualified retirement plan is funded with an annuity that has not yet been annuitized?

Bottom line: If a qualified annuity has not yet been annuitized, the RMD must be based on the contract value plus the "actuarial present value" of any additional benefits provided under the contract.

How are required minimum distributions determined for an annuity? If a minimum distribution is required for a particular year, the amount of the RMD is determined by dividing the December 31 balance by the applicable distribution period (the IRA owner's life expectancy, joint life expectancy, etc.). Previously, many annuity companies used the contract value of the annuity on December 31 as the balance for RMD purposes. However, Treasury regulations provide that if a qualified annuity has not been annuitized, the value of the annuity for RMD purposes is the contract value plus the "actuarial present value" of "any additional benefits" that are provided under the contract (Treas. Reg. Section 1.401(a)(9)-6, Q&A-12).

The contract value plus the actuarial present value of any additional benefits equals the "entire interest" of the IRA. The preamble to the regulations provides that the IRS and Treasury Department "believe that it is generally appropriate to reflect the value of additional benefits under an annuity contract, just as the fair market value of all assets generally must be reflected in valuing an account balance under a defined contribution plan."

How is the "actuarial present value" of an annuity determined for RMD purposes? The actuarial present value of an annuity must be determined using "reasonable actuarial assumptions" without regard to an individual's health. The regulations clearly indicate that certain types of death benefits must be assigned a value. Most commentators agree that the regulations presumably also apply to certain lifetime benefits (such as income benefits and contract value guarantees). Each annuity company is responsible for using reasonable assumptions to assign an actuarial present value to the benefits offered under its contracts.

Can any benefits be excluded when determining the "entire interest" of the IRA? Q&A-12 of the regulations provides that certain additional benefits can be disregarded when determining the "entire interest" of an IRA for RMD purposes. There are two exclusions:

120% exclusion. The value of any additional benefits may be excluded if the entire interest under the annuity contract (the contract value plus the actuarial present value of any additional benefits) is no more than 120% of the dollar amount credited to the contract owner AND if the only additional benefits include:
- Additional benefits that are reduced on a pro rata basis in the event of a distribution, and/or
- A death benefit that provides return of purchase payments less any previous withdrawals from the contract

Return of purchase payments. If the only additional benefit under the contract is a death benefit which guarantees the return of purchase payments less any previous withdrawals from the contract, this purchase payment guarantee may be excluded when determining the entire interest of the contract for RMD purposes.

(continued on next page)

Entire interest RMD rules

How will Allianz or Allianz Life of NY notify my client of his or her required minimum distribution? Allianz or Allianz Life of NY will provide affected contract owners the amount of the RMD or information needed to calculate their RMD for the year. Qualified plan administrators will need to request the entire interest value from Allianz since Allianz, in accordance with the Qualified Plan Acknowledgment form, does not calculate RMDs for qualified plans. Inherited IRA owners sign a Beneficial IRA RMD Election Form at the time the beneficial IRA is established, if the beneficial IRA is established through a transfer or rollover.

Will the RMD rules increase my client's RMD? In certain situations, the RMD regulations may mean that your client's RMD is larger than it would have been if based only on contract value. This is true when your client's guaranteed value is higher than the contract value and when the 120% exclusion and return of purchase payment exclusion do not apply.

Where can I find more information on the entire interest RMD rules? You can read Q&A-12 of the regulations directly, beginning on page 13 of the IRS bulletin available at the following link:
http://www.irs.gov/pub/irs-irbs/irb04-26.pdf

In addition, the Society of Actuaries has put together a detailed working paper available at:
http://www.soa.org/
Type "RMD" in search tool.

IRA-to-IRA rollovers

Question: What IRS rules have changed on IRA-to-IRA rollovers?

Bottom line: In a 2014 U.S. Tax Court case, Bobrow v. Commissioner, the Tax Court ruled that all IRAs of a taxpayer should be looked at together when it comes to the one-rollover-per-year rule, which applies to any prior 12-month period. Based on IRS guidance, IRAs include every type of IRA (traditional, Roth, SEP, and SIMPLE). Prior to the Bobrow case, the IRS had applied this only on a per-IRA basis.

When did the IRS announce this rule? Following the court decision the IRS issued Announcement 2014-15, stating its intention of enforcing the new aggregated one-rollover-per-year rule. Enforcement began January 1, 2015, and only applies to distributions after 2014 per IRS Announcement 2014-32.

What happens if my client rolls over more than one IRA distribution into another one of their IRAs after January 1, 2015? If the one-rollover-per-year rule is violated, the funds would be treated as a taxable distribution to the IRA owner and applied to the receiving IRA as a regular contribution rather than a rollover contribution. This may result in an excess IRA contribution for the respective tax year. IRA owners could be subject to a 6% penalty on the excess amounts (any amount above their contribution limits) for each year until removed. Any excess amount would need to be removed through the IRA excess contribution removal process. Also, those violation amounts can never be treated as a rollover contribution back into an IRA. For more information, please encourage your clients to consult their tax advisor.

What alternative options are available?

- An owner can still do unlimited IRA-to-IRA trustee-to-trustee transfers (with correct paperwork).
- An owner can still do unlimited direct or indirect rollovers between an IRA and a qualified plan. Examples: 401(k) to IRA, IRA to 401(k).
- There is no limit on the number of direct or indirect traditional IRA-to-Roth IRA conversions.

What are the impacts to my clients? For IRA owners to retain their right to do a rollover, you should have IRA owners perform trustee-to-trustee transfers of IRA funds, rather than indirect rollovers. You may also want to reconsider using agent-ordered funds without using a transfer form with proper acceptance language. Incoming funds into an Allianz IRA without proper paperwork will be shown in the rollover box on IRS Form 5498. Allianz generally treats funds leaving an Allianz IRA without transfer paperwork and letter of acceptance as a distribution (reported on IRS Form 1099-R), so it's imperative to provide all the transfer paperwork. Note: If IRA owners move funds via IRA trustee-to-trustee transfer using correct paperwork, they avoid the associated risks.

How does this impact Allianz distribution reporting? Generally, Allianz codes funds leaving an Allianz IRA without transfer paperwork and letter of acceptance as a distribution (reported on an IRS Form 1099-R) rather than a transfer (which is not reported). Putting these funds into the same or another IRA would count as an indirect IRA rollover.

(continued on next page)

How will this affect reinstatement of contract values of benefits? A reinstatement of benefits on an existing IRA is treated as an IRA-to-IRA rollover for tax reporting purposes. An owner may not be eligible to reinstate a withdrawal if she/he has already done a previous 60-day rollover within the 12-month period starting the day the owner received the previous distribution. Also, using the reinstatement provision will preclude an IRA owner from taking any other tax-free IRA-to-IRA rollovers for a one-year period.

Does the one-rollover-per year rule apply to all types of rollovers? The one-rollover-per-year rule applies only to indirect (60-day) IRA-to-IRA rollovers. Traditional, SEP, SIMPLE, IRAs, and Roth IRAs will be aggregated for purposes of the rule. Thus, a rollover between an individual's Roth IRAs would mean not being able to do a separate rollover within the same one-year period between the individual's traditional, SEP, or SIMPLE IRAs and vice versa.

Other things to consider:
An owner can still do unlimited IRA-to-IRA trustee-to-trustee transfers (with correct paperwork). An owner can still do unlimited direct or indirect rollovers between an IRA and a qualified plan. Examples: 401(k) to IRA, IRA to 401(k). There is no limit on the number of direct or indirect traditional IRA-to-Roth IRA conversions.

72(t) and 72(q) distribution basics

Question: Can my clients take a distribution from their IRA or nonqualified annuity before age 59½ without triggering the 10% federal additional tax?

Bottom line: Yes, if one of the exceptions to the 10% federal additional tax applies. Note that this section does not cover every exception to the 10% deferred additional tax.

For IRAs, the exceptions (under IRC Section 72(t)) to the 10% federal additional tax include:[1]

1. Death
2. Disability
3. Substantially equal periodic payments ("72(t)" payments)
4. Certain medical expenses
5. Qualified higher education expenses
6. First-time home purchase up to a $10,000 lifetime limit
7. Withdrawals by military reservists called to active duty after September 11, 2001

For nonqualified annuities, the exceptions (under IRC Section 72(q)) to the 10% federal additional tax include:[1]

1. Death
2. Disability
3. Substantially equal periodic payments ("72(q)" payments)
4. Pre-August 14, 1982 purchase payments (and interest allocable to them)
5. Immediate annuity contract

Note: There is no exception under 72(q) for medical expenses, higher education or first-time home purchase. Also, remember that the pre-age 59½ 10% federal additional tax applies only to the taxable portion of the distribution. Thus, for nonqualified annuities, only increase in value (interest or gain) is subject to the 10% federal additional tax.

I. Exceptions to both 72(t) and 72(q)

Death. After the death of your client, when their annuity (qualified or nonqualified) is distributed to their beneficiaries, the 10% federal additional tax does not apply regardless of the age of the beneficiaries.

What if my client's spouse continues the contract after his or her death? If your client's beneficiary is his or her spouse and the spouse continues the contract, the death exception no longer applies. The spouse becomes the annuity owner. Thus, if the spouse (as the new and very much alive owner) takes a distribution prior to age 59½, the 10% federal additional tax applies. If, before turning age 59½, the spouse needs funds from the annuity, it may benefit that spouse to remain the beneficiary rather than take ownership. The spouse can then take ownership after reaching age 59½.

Disability. IRS regulations and Publication 590-B state that if your client is so disabled that he or she is unable to do any "substantial gainful activity" because of a physical or mental condition, your client may be able to avoid the 10% federal additional tax on pre-age 59½ distributions from their annuity (qualified or nonqualified). Your client's physician also must determine that the condition is expected to result in death or is expected to be of "long, continued and indefinite duration." Please note that the actual IRS regulation offers a little more leeway. It states that the "gainful activity" referred to is the activity, or a comparable activity, in which the individual was customarily engaged prior to his or her disability. Note that the definition differs from the definition used for Social Security purposes.

Substantially equal periodic payments ("72(t)" or "72(q)" payments). If your clients have an income need and are willing to take a series of substantially equal periodic payments from their annuity (qualified or nonqualified), they may be able to avoid the 10% federal additional tax. If they have an IRA or qualified annuity, these payments are sometimes called "72(t)"

(continued on next page)

[1] These lists are not intended to be complete.

payments. If they have a nonqualified annuity, the payments are known as "72(q)" payments. The payments must be based on your client's single life expectancy or on the joint life expectancy of your client and a beneficiary. Your client must continue payments until age 59½, or until the end of the five-year period that began with the first payment, whichever is longer.

What is the 10% federal additional tax for modifying 72(t) or 72(q) payments? If your client starts substantially equal periodic payments to avoid the 10% federal additional tax but modifies the payment series before completing the required term, the 10% federal additional tax plus interest applies to all payments in the series taken before age 59½ (even the payments taken prior to the modification). If your client changes the amount of their payment, adds extra funds to – or withdraws additional funds from – the annuity, the payment is considered to be modified. Also, once the client begins equal payments, they cannot transfer part of the contract to another asset. If they do, the IRS will consider that a modification of the payments as well. Even after all of the required payments have been taken, the client must still wait until the later of age 59½ or the end of the five-year period that started on the date of the first payment to avoid a modification.

Example: Your client starts taking 72(t) distributions at age 56. To complete the series of payments, he or she would have to take 72(t) payments until age 61 (remember that your client must continue payments until age 59½, or for five years, whichever is longer). However, your client decides to modify the stream by stopping payments at age 60. Your client will then owe the 10% federal additional tax, plus interest, on all 72(t) payments taken from age 56 through age 59½.

Can 72(t) or 72(q) payments ever be modified without 10% federal additional tax? If the owner dies or becomes disabled, the payments can be modified. If the assets are completely depleted due to the substantially equal periodic payments, the additional tax will not apply. Also, when your clients set up their 72(t) or 72(q) payments, they have to choose one of three methods of calculating the payments (1) amortization; (2) annuitization; or (3) required minimum distribution. If your client elects the annuitization or amortization method, IRS Revenue Ruling 2002-62 allows them to make a one-time switch for 72(t) to the required minimum distribution method. The IRS also issued Notice 2004-15, which indicated that Revenue Ruling 2002-62 applies to 72(q) payments from nonqualified annuities as well. If your client makes the one-time switch, he or she would then use the required minimum distribution method for all subsequent years through the end of the payment series.

If clients make the one-time change, can they ever revert back to the old method? No. This change is irrevocable. Once made, the required minimum distribution method must be used to calculate your clients' 72(t) or 72(q) payments in all subsequent years. Since the required minimum distribution method may provide a lower payment amount, your clients must be sure that changing to the required minimum distribution method will leave them with a payment that is large enough to meet their needs.

Important: Your clients should have their tax advisors calculate any change in the 72(t)/72(q) payment amount. If the one-time modification is not correctly calculated, the 10% federal additional tax plus interest will apply to all payments in the series taken before age 59½ (even the payments taken prior to the modification). See the "SEPP exception to 72(t) and 72(q)" Q&A.

II. Exceptions to 72(t) for IRAs (these exceptions do not apply to nonqualified annuities or to qualified retirement plans)

Medical expenses. If your clients take an IRA distribution before age 59½ for qualified medical expenses, they may be able to avoid the 10% federal additional tax. Essentially, the medical expenses are qualified if they can list them on Schedule A of IRS Form 1040 and if they exceed 10% of their adjusted gross income for the year of distribution.

Note: Schedule A is only used if itemizing deductions. Your clients do not actually have to itemize deductions in order to qualify for this exception to the 10% federal additional tax. The expenses simply need to be of the type that could be listed on Schedule A had they itemized deductions.

Medical insurance. In addition, the 10% federal additional tax does not apply to any IRA distributions your clients take prior to age 59½ as long as they meet all of the following requirements:

1. The distributions do not exceed the amount your client paid for medical insurance for them, their spouse, and their dependents.
2. They lost their job.
3. They have received unemployment compensation for 12 consecutive weeks.
4. They receive the IRA distribution during the year they received the unemployment compensation or during the following year.
5. They take the distributions no later than 60 days after becoming employed again.

Qualified higher education expenses. If your clients take an IRA distribution before age 59½ to pay for certain educational expenses for themselves, their spouse, their children, their grandchildren, or for the children or grandchildren of their spouse, the 10% federal additional tax may not apply. Qualified higher education expenses can include tuition, fees, books, supplies, equipment required for enrollment, and (if the student is enrolled at least half-time) room and board.

First-time home purchase. Clients can take up to $10,000 (lifetime) from their IRA prior to age 59½ without incurring the 10% federal additional tax if they use the distribution to buy, build, or rebuild the main home of a first-time homebuyer. The first-time homebuyer can be (1) your client, (2) your client's spouse, (3) children of your client or your client's spouse, (4) grandchildren of your client or your client's spouse, (5) ancestors of your client or your client's spouse. A person is considered a "first-time homebuyer" if that person has not had a present interest in a main home for two years. For married individuals, both spouses must qualify as first-time homebuyers.

Qualified reservist distribution. If your client is a reservist and was called to active duty after September 11, 2001, the 10% federal additional tax will be waived on their IRA distributions while on active duty. Also, the reservist may repay the funds into the IRA within two years after active duty ends. There is no deduction for the repayment so it creates basis in the IRA, but it does allow the reservist to restore the funds into the IRA.

III. Exceptions to 72(t) for qualified retirement plans only

Separation from service on or after the date the employee attains age 55. If your client separates from service on or after the date the client attains the age of 55, they are allowed access to their qualified retirement plan (QRP) without triggering the pre-age 59½ 10% federal additional tax. This exception is lost if the QRP funds are rolled to an IRA.

Payments under a qualified domestic relations order (QDRO) to an alternate payee are not subject to the pre-age 59½ 10% federal additional tax.

IV. Exceptions to 72(q) for nonqualified annuities

Pre-August 14, 1982 basis and interest/increase. If clients purchased a nonqualified annuity prior to August 14, 1982, their principal and any increase in value (interest or gain) allocable to pre-August 14, 1982 principal can be withdrawn without triggering the pre-age 59½ 10% federal additional tax.

Immediate annuity. Clients also can avoid the 10% federal additional tax if they take distributions from an immediate annuity. An immediate annuity typically is purchased with a single premium. Clients must start receiving payments within one year of when they purchase the annuity.

SEPP exception to 72(t) and 72(q)

Question: What is the substantially equal periodic payment (SEPP) exception to 72(t) and 72(q)?

Bottom line: If your clients take a distribution from their IRA, qualified retirement plan, or nonqualified annuity prior to age 59½, they may trigger a 10% federal additional tax. The SEPP exception is a strategy that can help your clients avoid the 10% federal additional tax if certain requirements are met. Unfortunately, many financial professionals help their clients arrange for substantially equal periodic payments without a full understanding of the applicable requirements. This can make for an uncomfortable situation if the IRS later audits the client and determines that the SEPP payments do not meet the necessary requirements. In that situation, the client may owe the 10% federal additional tax (plus interest) from the start of the payment series. In addition, Allianz or Allianz Life of NY does not automatically generate payments from a fixed annuity, does not monitor payments for continued compliance with the exception, and does not change the tax reporting for any prior years if payments are altered or discontinued. Note: Allianz Life of NY does not offer fixed or fixed index annuities at this time.

What are substantially equal periodic payments? If your client takes a distribution from his or her IRA or qualified retirement plan prior to age 59½, Internal Revenue Code Section 72(t) imposes a 10% federal additional tax on the taxable portion of the distribution. There are a number of exceptions to the 10% federal additional tax, including the exception for "substantially equal periodic payments." For an IRA or qualified retirement plan, these periodic payments are often referred to as "72(t) payments."

Similarly, if your client takes a distribution from his or her nonqualified annuity prior to age 59½, Internal Revenue Code Section 72(q) imposes a 10% federal additional tax on the taxable portion of the distribution. There are a number of exceptions to the 10% federal additional tax, including the exception for "substantially equal periodic payments." For a nonqualified annuity, these periodic payments are often referred to as "72(q) payments."

Important: If your client wishes to take substantially equal periodic payments (SEPPs) from an Allianz fixed annuity, the IRS Form 1099-R that Allianz sends each year will not reflect the payment series. The 1099-R will be coded as "no known exception" to the 10% federal additional tax. Your client will then need to file IRS Form 5329 if they believe that their payments fall within the substantially equal periodic payment exception to the 10% federal additional tax. In addition, Allianz does not automatically generate payments from a fixed annuity, does not monitor payments for continued compliance with the exception, and does not change the tax reporting for any prior years if payments are altered or discontinued.

Important: If your client wishes to take SEPPs from an Allianz or Allianz Life of NY variable annuity, and wants Allianz or Allianz Life of NY to code the IRS Form 1099-R to reflect the 10% federal additional tax exception, Form USA-388N (Certification for IRC 72(t) and 72(q) withdrawals prior to age 59½) must be completed. The form can be found on www.allianzlife.com, then select "Forms & Materials," and may vary depending on which Allianz product you are using. The form must show the method used and the amount of the payment in the first year. Your clients should have their tax advisors calculate the 72(t)/72(q) payment amount.

How long must SEPPs continue? In order to successfully avoid the 10% federal additional tax, your client must continue substantially equal periodic payments until age 59½ or for five years, whichever is longer. Even after all of the required payments have been taken, the client must still wait until the later of age 59½ or the end of the five-year period that started on the date of the first payment to avoid a "modification." If your client stops payments earlier than this, if he or she takes a distribution that is larger or smaller than the payment amount, or if the client adds money to the contract or transfers just a part of the contract to another provider, the client may have modified the payment schedule and may owe a 10% federal additional tax (plus interest) on any taxable distributions from the start of the payment series. Note that the 10% federal additional tax would not apply to distributions taken after age 59½.

How is the SEPP amount determined? Revenue Ruling 2002-62 sets forth three acceptable methods for determining the substantially equal periodic payment amount: (1) amortization; (2) annuitization; and (3) required minimum distribution. Under the first two methods, the payment will be the same each year. Under the RMD method, the payment must be calculated each year. More specific details regarding these three SEPP calculation methods can be found in Revenue Ruling 2002-62 (available at www.irs.gov/pub/irs-irbs/irb02-42.pdf). The IRS website also includes a FAQ regarding Revenue Ruling 2002-62 (available at www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-Substantially-Equal-Periodic-Payments).

Can my client use another method to calculate his or her SEPP amount? One of the last questions in the IRS FAQ regarding Revenue Ruling 2002-62 asks whether the three methods for calculating SEPP payments are the only acceptable methods. The IRS states that these are not the only acceptable methods but, if any other method is used, the IRS urges the taxpayer to request a private letter ruling to determine whether the requested method is acceptable. Thus, if your client wishes to use another method to determine his or her SEPP amount, it is strongly suggested that your client obtain an IRS private letter ruling to make sure that the proposed SEPP amount would qualify as a valid SEPP series.

Will federal or state withholding affect my client's SEPP amount? While withholding does not affect SEPP calculations, it is important to know how withholding will affect the gross distribution amount. For example, a client who requests $100 with 10% withholding may have a gross distribution of $100 or $111 depending on the specific request. The gross distribution amount must equal the SEPP amount.

Does my client use a current value or the prior year-end value to calculate the SEPP amount? Revenue Ruling 2002-62 provides that the account balance used to determine the SEPP amount must be "determined in a reasonable manner based on facts and circumstances."

Example: John uses the required minimum distribution method to calculate the SEPP amount from his IRA and plans to take his first SEPP payment on July 15, 2018. According to the example given in Revenue Ruling 2002-62, it would be reasonable to use the IRA balance on any date from December 31, 2017 to July 15, 2018. For subsequent years (remember that the SEPP amount is redetermined each year with the required minimum distribution method), Revenue Ruling 2002-62 states that it would be reasonable to use the IRA value either as of December 31 of the prior year or "on a date within a reasonable period before that year's distribution."

Note that some commentators believe that the IRS FAQ regarding Revenue Ruling 2002-62 confuses this issue. The FAQ document gives an example suggesting that if the taxpayer values the IRA as of December 31 for his or her initial SEPP amount, the IRA must be revalued each December 31 to determine the SEPP amount for subsequent years. Many financial professionals request illustrations based on the client's current contract value. Allianz or Allianz Life of NY does not take a position on when to value your client's IRA, qualified retirement plan or nonqualified annuity for purposes of determining a SEPP amount. Your client should consult his or her tax advisor to determine what value should be used in the client's specific situation.

Can IRAs be aggregated to determine a SEPP amount? Many clients own several IRAs and wish to base their SEPP amount on all of their IRAs. Or, perhaps the client wishes to base the SEPP amount on some of the IRAs but exclude their remaining IRAs from the SEPP calculation. Revenue Ruling 2002-62 does not specifically address this issue. However, there are IRS private letter rulings (PLR 9801050, PLR 9816028[1]) suggesting that it may be possible to base the SEPP amount on all of a client's IRAs or some of the client's IRAs. However, there is also a PLR that states that if your client has already begun a SEPP on an IRA, they cannot divide it and transfer part of it to a different asset. That would be considered a modification. Keep in mind that an IRS private letter ruling can only be relied upon by the taxpayer who requested the ruling. Thus, your client should consult his or her tax advisor to determine which IRAs should be used to support the desired SEPP series. Also, note that Allianz will not code IRS Form 1099-Rs to reflect the 10% federal additional tax exception if the SEPP series is based on more than one IRA.

(continued on next page)

[1] A private letter ruling (PLR) is directed only to the taxpayer who requested it. IRC Section 6110(k)(3) provides that it may not be used or cited as precedent.

SEPP exception to 72(t) and 72(q)

It is important to note that although your client may be able to base a SEPP series on one or more IRAs, PLR 9705033[1] prohibits basing a SEPP series on part of an IRA. If a client wishes to establish a SEPP series on part of an IRA, the client may wish to transfer that part to a new IRA, and then establish the SEPP series from the new IRA. Be sure to remind your client that once they begin SEPPs, they cannot take distributions in excess of their SEPP amount nor can they make additions to any IRA on which they based their SEPP amount.

Can nonqualified annuities be aggregated to determine a SEPP amount? The private letter rulings mentioned above apply only to IRAs and did not address nonqualified annuities. Presumably, much of the guidance for SEPPs from IRAs also applies to SEPPs from nonqualified annuities; however, the client should always consult their tax advisor regarding their specific situation.

Can my client base their SEPP amount on two IRAs but take the SEPP out of only one of the two IRAs? In IRS Private Letter Ruling 9816028,[1] the taxpayer bases his SEPP amount on seven of his IRAs. The ruling comments that the taxpayer could take the SEPP amount from any one or more of the seven IRAs on which the payment series was based. However, remember that an IRS private letter ruling can only be relied upon by the taxpayer who requested the ruling. From a practical standpoint, if your client consults with his or her tax advisor and decides to base the SEPP amount on two IRAs but take the actual SEPP out of only one of the IRAs, be sure to emphasize with your client that he or she will not be able to access either of the IRAs during the SEPP series (other than taking the required SEPP amount) without risking a modification of the payment series. Often, clients remember that they cannot take additional distributions from IRA #1 (the IRA from which the SEPP amount is made), but forget that they based the SEPP series on both IRA #1 and IRA #2.

Again, keep in mind that PLR 9816028 addresses 72(t) payments from IRAs. While the same rationale may apply to 72(q) payments from nonqualified annuities, the IRS has not yet issued a similar ruling for nonqualified annuities, and a client should consult their tax advisor for their specific situation.

Can my client transfer an IRA or nonqualified annuity to Allianz or Allianz Life of NY if he or she is already taking SEPPs from the account? Revenue Ruling 2002-62 states that a modification to the series of payments will occur if, after the date that the account is valued for SEPP purposes, 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 an amount not being taxable." The IRS has not provided specific guidance on whether transferring (1) an entire IRA to another IRA or (2) an entire nonqualified annuity to another nonqualified annuity would be deemed a modification of the SEPP series. However, as recently as PLR 200616046,[1] the IRS gave tacit approval to the transfer of an entire IRA to another IRA during a SEPP series.

Assume you are working with a client's tax advisor who is comfortable with having the client transfer an IRA or nonqualified annuity while the client is taking SEPPs, but the transferring financial institution reports the transfer or exchange as a taxable event and modification of the 72(t) or 72(q) payment series. In that situation, the client can file IRS Form 5329 (available at http://www.irs.gov) with their tax return indicating that 72(t) or 72(q) payments are continuing out of the new IRA or nonqualified annuity and that the client believes that they are still complying with the SEPP rules. The client should see his or her tax advisor for additional detail on IRS Form 5329.

Before starting a SEPP series, your client should make sure that the required payment amount will not exceed the contract's free withdrawal amount and should check to see how the SEPP distributions will affect other annuity provisions. **In addition, if you are doing a 1035 exchange of an existing annuity or a transfer of an IRA with an ongoing SEPP series, the withdrawal provisions of most Allianz fixed annuities do not accommodate a pre-existing SEPP series.** Your client should carefully review the desired contract's products and features before proceeding with the transfer. Allianz Life of NY does not offer fixed or fixed index annuities at this time.

[1] A private letter ruling (PLR) is directed only to the taxpayer who requested it. IRC Section 6110(k)(3) provides that it may not be used or cited as precedent.

One-time change of 72(t)/72(q) payment

Question: Once I start pre-age 59½ substantially equal periodic payments (SEPPs) from an annuity, is there any way I can change the stream of income?

Bottom line: If you are taking distributions using the annuitization or amortization methods, you can make a one-time change to the life expectancy method (also known as the required minimum distribution (RMD) method). This typically reduces your payment. The change will not be considered a modification to the series of payments, and will not trigger a 10% federal additional tax on past distributions.

What is a substantially equal periodic payment?

Code Sections 72(t) and 72(q) provide that there will be a 10% federal additional tax for pre-age 59½ distributions from a qualified or nonqualified annuity (respectively). There is an exception to the 10% federal additional tax if the owner takes a "series of substantially equal periodic payments" made for the life of the contract owner, or the owner and a beneficiary. However, once a contract owner starts that stream of income, he or she cannot modify the payments until age 59½ or for a five-year period starting on the date of the first payment, whichever is later. Even after all of the required payments have been taken, the client must still wait until the later of age 59½ or the end of the five-year period that started on the date of the first payment to make any changes. If payments are modified, the IRS will assess a 10% federal additional tax on all payments previously taken (before age 59½).

Example: Tyrone retires at age 57 and wants to take distributions from his IRA to meet expenses until he receives Social Security. Tyrone has his tax advisor calculate a withdrawal amount that constitutes a "substantially equal periodic payment." He withdraws this amount each year from his IRA. When he is age 62 (i.e., five years after the date of his first payment and after age 59½), Tyrone can reduce the stream of income without a 10% federal additional tax. However, if he modified at age 61, after only four years or at age 62 but before the end of the five-year period, he must pay the 10% federal additional tax plus interest on all the distributions he took before age 59½.

The IRS sanctions three methods for taking substantially equal periodic payments. The annuitization and amortization methods give a flat dollar amount which must be withdrawn each year. The life expectancy method is calculated like a required minimum distribution: The prior year-end contract value, or the value on another date within a reasonable period before the distribution, is divided by the owner's remaining life expectancy each year. Typically the life expectancy method begins with a much lower withdrawal than the annuitization and amortization method, but the withdrawal will increase each year as life expectancy shortens and the contract value grows.

Why does the IRS allow a change to the life expectancy method? The bear markets of 2000 and 2008 revealed a potential problem with the annuitization and amortization methods. Since people had to withdraw a fixed dollar amount, the percentage they had to withdraw grew larger and larger as IRA balances fell during the bear market. IRA owners who began these SEPPs were faced with a bad choice: Keep taking ever-increasing percentage withdrawals and possibly deplete their IRA, or modify the stream of income and owe a 10% federal additional tax plus interest on all prior withdrawals before age 59½. This risk was repeated with the 2008 decline in stock market value. Note that the federal additional tax does not apply if the IRA is depleted due to taking the SEPP withdrawals.

(continued on next page)

One-time change of 72(t)/72(q) payment

Example: Jane had a $100,000 IRA in 2006. She was 50 years old and wanted to begin distributions without the 10% federal additional tax. Jane decided to use a SEPP, and chose the amortization method. Her advisor calculated that each year she must withdraw $7,236. That was only 7.2% of the IRA in 2006. But by the end of 2008 the annual distributions plus the loss in value left only $30,000 in the IRA. Now $7,236 is 24% of the IRA. At that rate, the IRA could be completely depleted. If Jane modified the stream of income to slow it down, she would owe the 10% federal additional tax.

In acknowledging this problem, the IRS provided a one-time change from an annuitization or amortization method to a life expectancy method, and they won't consider it a modification which would trigger the 10% federal additional tax. Under the life expectancy method, the IRA can't be depleted because a percentage is taken each year based on a recalculated life expectancy instead of a set dollar amount. Your client will never take more than a fraction of what's in the IRA each year.

Note that the change from an annuitization or amortization method to the life expectancy method usually results in a substantial drop in the withdrawal amount. Your client should consider their income needs before using the one-time change.

If they make the one-time change, can they ever revert back to the old method? No. This change is irrevocable. Once made, the life expectancy method must be used to calculate all payments until age 59½ or for the five-year period, whichever is later. Before changing methods, clients should make sure that the life expectancy method will provide sufficient income.

How can the change be made to a fixed annuity at Allianz? If your client wishes to take SEPPs from an Allianz fixed annuity or to make a one-time change, the IRS Form 1099-R that Allianz sends each year will not reflect the payment series. The IRS Form 1099-R will be coded as "no known exception" to the 10% federal additional tax. Your client will then need to file IRS Form 5329 if they believe that their payments fall within the substantially equal periodic payment exception to the 10% federal additional tax. If your client wishes to make a one-time change to their SEPP series, they should consult their tax advisor. Allianz would continue to code the distribution as "no known exception" on IRS Form 1099-R. In addition, Allianz does not automatically generate payments from a fixed annuity, does not monitor payments for continued compliance with the exception, and does not change the tax reporting for any prior years if payments are altered or discontinued. Allianz Life of NY does not offer fixed or fixed index annuities at this time.

How does my client make the one-time change on 72(t)/72(q) payments from an Allianz or Allianz Life of NY variable annuity contract? When initially requesting a 72(t) or 72(q) payment series, your client completed an Allianz or Allianz Life of NY form titled "Certification for IRC 72(t) and 72(q) withdrawals prior to age 59½." To make the one-time change, simply complete a new form reflecting the new 72(t) or 72(q) payment amount and the new RMD method of calculation. The form may vary depending on which Allianz product you are using. Indicate on the form that your client is making a one-time election under Revenue Ruling 2002-62 (for qualified contracts) and/or Notice 2004-15 (for nonqualified contracts).

Important: Clients should have their tax advisor calculate any change in the 72(t)/72(q) payment amount. If the one-time modification is not correctly calculated, the 10% federal additional tax plus interest will apply to all payments in the series taken before age 59½ (even the 72(t)/72(q) payments taken prior to the modification).

Are there any other ways to modify the stream of income without incurring the 10% federal additional tax? You can also modify 72(t) or 72(q) payments if the owner dies or becomes disabled. In that situation, you can increase, slow down, or even stop payments. And if the payments stop due to complete depletion of the IRA or nonqualified annuity because of the substantially equal periodic payments, the federal additional tax will not apply.

1035 exchanges

Question: What is a 1035 exchange?

Bottom line: Internal Revenue Code Section 1035(a) provides for an income-tax-free method of exchanging an existing life insurance policy or a nonqualified deferred annuity contract for a new nonqualified deferred annuity contract with a different company. Provided that certain requirements are met, a 1035 exchange permits a contract owner to exchange an existing contract for a contract that may have more desired benefits and features while deferring income tax on any increase in the existing contract.

Example 1. Bill purchases a nonqualified deferred annuity contract from Company X for $100,000. The current value of the annuity contract is $150,000. If Bill surrenders the Company X contract and uses the proceeds to purchase a new annuity contract from Allianz or Allianz Life of NY, he will owe income tax on the $50,000 of interest in the existing contract. Instead, Bill decides to 1035 exchange his Company X nonqualified deferred annuity for an Allianz or Allianz Life of NY nonqualified deferred annuity. Bill owes no income tax on the exchange and his cost basis in the new contract remains at $100,000 (equal to his basis in the Company X annuity).

What are the basic requirements for a 1035 exchange? The exchange must be "like-to-like," meaning that the owner and insured (in the case of a life insurance policy) must be the same on the original nonqualified deferred annuity contract or life insurance policy and the new nonqualified deferred annuity contract or life insurance policy.

For the sending company to report a transaction as a 1035 exchange, it must have proper paperwork from the receiving company. Therefore, it is recommended that an individual intending to do a 1035 exchange have any check sent directly to the receiving company. It is also recommended that an individual doing a 1035 exchange verify that the sending company provides cost basis information to the receiving company. Without cost basis information, the receiving company will generally use a cost basis of zero for withholding purposes and will report distributions as "taxable amount not determined."

Can a 1035 exchange be used to add funds to an existing annuity? In Revenue Ruling 2002-75, the IRS permitted an annuity owner to consolidate two nonqualified deferred annuity contracts into one. Thus, many companies now permit a 1035 exchange of an entire annuity contract into an existing contract with a different company.

How are gain and basis determined in a partial 1035 exchange? The gain and basis in each annuity contract are determined on a pro rata basis.

Why is the IRS concerned about partial 1035 exchanges? A partial 1035 exchange of an annuity occurs when an individual transfers a portion of an existing nonqualified deferred annuity contract into another existing nonqualified deferred annuity contract or into a new nonqualified deferred annuity contract. The IRS has indicated a concern that some taxpayers may do a partial 1035 exchange in advance of a planned distribution from the contract for purposes of attempting to minimize income tax on the distribution.

Example 2. Bill wants to take a distribution from his nonqualified deferred annuity contract to purchase a new $50,000 BMW. Assume again that Bill purchased a nonqualified deferred annuity for $100,000 and that his annuity has a current contract value of $150,000. If Bill takes a $50,000 distribution from his annuity, interest (gain) is distributed first from the contract so the entire $50,000 will be subject to ordinary income tax.

(continued on next page)

Bill has an idea. He decides to do a partial 1035 exchange of 50% of the contract, moving $75,000 from his $150,000 annuity contract (Contract A) to a new annuity (Contract B). Immediately after the exchange, both annuity contracts have a contract value of $75,000 and a cost basis of $50,000 (50% of the original $100,000 purchase premium). Then, Bill takes a $50,000 distribution from Contract A. Contract A only has $25,000 of interest (gain) ($75,000 contract value less the $50,000 cost basis) so Bill would owe income tax on the first $25,000 coming out of the contract, but the next $25,000 is an income-tax-free return of basis.

This is exactly the type of situation that concerns the IRS. In 2008, the IRS issued Revenue Procedure 2008-24, which said that if you do a partial 1035 exchange and within one year take a withdrawal from either resulting contract, the "exchange" will not be valid. Instead, it will be treated as a taxable distribution from the original contract followed by a purchase of the second contract. However, the exchange will remain a valid nontaxable exchange if the withdrawal was due to a 72(q) event (death, disability, age 59½) or other big life changes such as divorce.

In 2011, the IRS issued Revenue Procedure 2011-38 which modified the rules and applies to exchanges completed on or after October 24, 2011. For those partial exchanges on or after that date, if the taxpayer takes a withdrawal from either resulting contract within 180 days after the partial exchange, the exchange will be characterized by the IRS in a manner consistent with its substance, based on general tax principles and all the facts and circumstances. The rule was eliminated that allowed tax-free exchange treatment if a withdrawal occurred due to a 72(q) event (death, disability, age 59½), or other big life event such as a divorce. The new guidance allows the taxpayer the ability to take annuitization payments right away – with no need to wait 180 days – as long as the contract is annuitized for 10 years or more, or over life expectancy.

Is every partial 1035 exchange problematic? No. Many clients who do not plan to take a distribution from their annuity contract do a partial 1035 exchange in order to obtain the benefits and features of a new contract without giving up some of the benefits (primarily the death benefit) available in their existing contract. For partial exchanges completed on or after October 24, 2011, as long as the client does not take a distribution from the old or new contract within 180 days of the partial exchange, the exchange will not be included in income.

If the client were to take a distribution from the surviving contract or new contract within 180 days of the partial exchange and did not qualify for an exception, the contracts would have to be treated as one contract when determining whether the distribution was a taxable distribution of interest and/or an income-tax-free return of basis. In summary, Revenue Procedure 2011-38 allows a partial exchange, but any distribution within the first 180 days may be taxed as if the old and new contracts were aggregated.

Partial 1035 exchanges are allowed only for nonqualified annuities. 1035 exchanges of life insurance or endowment contracts must be full 1035 exchanges.

Note: Your clients may 1035 exchange a nonqualified deferred annuity contract for another nonqualified annuity contract, but not for a life insurance policy. Your clients may 1035 exchange a life insurance policy for another life insurance policy or a nonqualified deferred annuity contract, or an endowment contract. Since 2010, your clients are able to 1035 exchange a life insurance policy, an endowment contract, or an annuity contract for a qualified long term care insurance policy. In general, your clients are not able to 1035 exchange annuitized or immediate annuity contracts. Some companies, including Allianz and Allianz Life of NY, generally do not allow 1035 exchanges by beneficiaries after the death of the original owner. A spouse beneficiary would be able to do a 1035 exchange after continuing the contract as their own, subject to any applicable surrender charges.

Income tax and Social Security benefits

Advanced Markets Q&A

Question: Is there anything my retired clients can do to reduce income taxes on their Social Security benefits?

Bottom line: Nonqualified deferred annuities, traditional IRAs, and Roth IRAs might give your client flexibility to reduce income, thus keeping the income tax on Social Security benefits down.

How are Social Security benefits taxed? Generally, the more income your clients have, the more income tax they will pay on Social Security benefits. If your clients' income is low, none of their Social Security benefits will be taxed. But people with moderate to high incomes can have up to 50% or up to 85% of their benefits taxed. Income deferred in nonqualified deferred annuities or IRAs, or even income distributed income-tax-free from Roth IRAs when a qualified distribution occurs, can keep your clients' income low. Lower income can reduce or eliminate the taxes on their Social Security benefits.

Explain the 0%,up to 50%, and up to 85% levels. Work with a tax advisor to compare your clients' income to the Social Security income threshold to determine whether they will owe income tax on their Social Security benefits:

- If your clients' income is less than $32,000 for joint filers ($25,000 for singles), they have not reached the threshold. None of their Social Security benefits will be taxed as ordinary income.
- When income falls between $32,000 and $44,000 for joint filers ($25,000 to $34,000 for single), up to 50% of your clients' Social Security benefits may be taxed as ordinary income.
- Above $44,000 for joint filers ($34,000 for single), up to 85% of their Social Security benefits may be taxed as ordinary income.
- If your clients are married filing separately, they have a threshold of $0 if the couple lived together at all during the year. If your client lived apart from his or her spouse the entire year, the single filer's threshold would apply to your client.

For more details, refer to the Social Security worksheet found on p. 30 of the IRS instructions for the 2017 IRS Form 1040 (also available at www.irs.gov).

What makes up the income to reach the threshold? The income used is called combined income. For purposes of reaching the threshold, most income is included, but only half of your clients' Social Security benefits for the year. Surprisingly, even municipal bond interest is counted, even though it is otherwise tax exempt. Income still deferred inside a nonqualified deferred annuity, IRA, or retirement arrangement is not included, nor are Roth IRA qualified distributions.

Example 1 – before. Jack Roberts files a joint income tax return with his wife, Margaret. They receive the following combined income:

	$ 27,500	other income
	$ 10,000	municipal bond interest
+	$ 2,500	½ Social Security benefit
=	$ 40,000	combined income

$40,000 is $8,000 over the $32,000 threshold. This means that the Roberts pay income tax on 50% of their Social Security benefits (i.e., $2,500 of their $5,000 benefit is included in taxable income). If other income had been $20,500, the combined income would have been $33,000 and only $500 (10%) of the Roberts' $5,000 benefit would have been included in taxable income.

Example 2 – after. What would change if, instead of the municipal bond investment, Jack and Margaret had purchased a nonqualified deferred annuity or contributed to a Roth IRA? With a nonqualified deferred annuity, the $10,000 interest on the nonqualified deferred annuity would not count as taxable income until withdrawn. Alternatively, with a Roth IRA, even if the Roberts withdrew the $10,000 of Roth IRA income, the amount would be income-tax-free (assuming the Roth IRA distribution was a qualified distribution).

	$ 27,500	other income
	$ 0	$10,000 income-tax-free Roth IRA qualified distributions or deferred income
+	$ 2,500	½ Social Security benefit
=	$ 30,000	combined income, which is $2,000 under the $32,000 "up to 50%" threshold

In Example 2, the Roberts would not have reached the "up to 50%" threshold and none of their Social Security benefits would have been taxed. The impact of this technique is even greater when your clients can minimize up to 85% inclusion at higher income tax rates.

Facts to keep in mind:

- While municipal bond income remains income-tax-free, it can have the unexpected effect of raising income taxes. This happens when municipal bond interest pushes total income over the Social Security thresholds.
- While Roth IRA income can remain income-tax-free with a qualified distribution, nonqualified deferred annuity, IRA, or qualified retirement plan income will be subject to income tax at some point. The tax will occur when your client (or their beneficiaries after client's death) takes distributions. And for traditional IRAs and qualified plans, required minimum distribution rules may force them to take distributions that will affect taxation of Social Security benefits.
- The rules on taxing Social Security benefits apply not just to retirement benefits, but Social Security disability benefits as well. If your client's Social Security disability benefit is reduced because they receive workers' compensation, the workers' compensation is included as Social Security when calculating how much of their Social Security benefit is taxed.
- It does not help to increase "below the line" itemized deductions such as charitable contributions, mortgage interest, property taxes or medical expenses. The thresholds are based on modified adjusted gross income, before your clients take itemized deductions.
- A financial professional can provide information, but not advice related to Social Security benefits. Clients should seek guidance from the Social Security Administration or www.ssa.gov regarding their particular situation.

IRD and the 691(c) deduction

Question: What is IRD and why is it subject to double taxation?

Bottom line: When you inherit an IRA, qualified retirement plan funds, or a nonqualified annuity, you typically receive income that the decedent had a right to during his or her lifetime but was not taxable to the decedent because the income was not distributed. That income is known as income in respect of a decedent (or IRD). IRD may be subject to both income tax AND estate tax; however Internal Revenue Code Section 691(c) offers some relief. Under 691(c), your beneficiaries are entitled to an income tax deduction for the estate tax paid on IRD. IRD and the 691(c) deduction are relevant only for a decedent whose estate was large enough to incur estate tax. When dealing with these estate tax calculations and the 691(c) deduction, a client should always be advised to consult their tax professional or attorney for more details on how these concepts apply to their individual situation.

What is income in respect of a decedent (IRD)?

Generally, if you inherit property, you do not owe income tax on the inherited property. However, certain assets (such as IRAs, qualified retirement plans, and nonqualified annuities – both deferred and annuitized) are an exception to this general rule because they include the right to receive income in respect of a decedent (IRD). IRD is income that the decedent had a right to during his or her lifetime but which was not taxable during the decedent's lifetime because the income was not distributed.

IRA example: Grandpa rolled over $100,000 (pre-tax) to an IRA several years ago. At his death, he left the IRA (now valued at $125,000) to Sara. If Sara withdraws the entire IRA, she will owe income tax on the full $125,000 IRA. The entire $125,000 is IRD.

Nonqualified deferred annuity example: Grandpa purchased a $100,000 nonqualified deferred annuity several years ago. At his death, he left the annuity (now valued at $125,000) to Sara. If Sara withdraws the entire annuity, she will owe income tax on the $25,000 ($125,000 current value less $100,000 Grandpa's initial purchase premium) of annuity earnings. The $25,000 of annuity earnings is IRD.

Why is this double taxation? Income in respect of a decedent can be subject to both income tax and estate tax. So to answer this, let's take a look at another example. George has a taxable estate that includes a $200,000 IRA and will owe estate tax of approximately $80,000 ($200,000 x 40% estate tax = $80,000).

Estate tax. After subtracting his $11,180,000 estate tax exemption for 2018, only $200,000 of George's $11,380,000 estate is subject to estate tax.

	$11,380,000	Taxable estate
-	$11,180,000	Estate tax exemption
=	$200,000	

George's estate will owe estate tax of approximately $80,000 ($200,000 x 40% estate tax = $80,000).

Income tax. Keep in mind that George's IRA is also subject to income tax. Assuming that the beneficiaries of George's IRA are in the 37% federal income tax bracket, they will owe $74,000 of federal income tax on George's IRA, in addition to any state income tax that may apply.

How does the 691(c) deduction work? 691(c) to the rescue! Internal Revenue Code Section 691(c) gives beneficiaries an income tax deduction for the estate tax paid on IRD. To determine the amount of this deduction, first calculate the estate tax due on the estate. Then, determine the estate tax liability if the IRD were excluded from the estate.

(continued on next page)

IRD and the 691(c) deduction

George's estate tax liability. George's estate tax liability was $80,000 (discussed earlier).

George's estate tax liability without IRD. If the $200,000 IRA were subtracted from George's estate, federal estate tax would not have applied since George's estate would not have exceeded his $11,180,000 estate tax exemption for 2018.

The deduction amount. George's beneficiaries are entitled to an income tax deduction for the $80,000. Thus, whoever receives the IRA and pays the income tax on the IRA distributions would receive an income tax deduction of $80,000. If George's beneficiaries are in the 37% federal income tax bracket, the 691(c) deduction could put $29,600 ($80,000 x 37% income tax deduction) back into their pockets.

What if the IRD is divided among multiple beneficiaries?
If George were to leave his IRA to his two children in equal shares, each child would be entitled to ½ of the $80,000 691(c) deduction.

Are there limitations on the 691(c) deduction?
Yes. This deduction is typically claimed on Schedule A (IRS Form 1040) as a miscellaneous itemized deduction. Note that this deduction was not affected by the Tax Cuts and Jobs Act of 2017. If the beneficiary does not have sufficient deductions to itemize (in other words, if the beneficiary takes the standard deduction), the 691(c) deduction is of no use. In addition, if the beneficiary has significant income, a portion of his or her itemized deductions (including the 691(c) deduction) may be phased out. Since itemized deductions do not affect modified adjusted gross income (MAGI), it will not help toward determination of Social Security benefit taxation or other determinations that use MAGI.

Are state death taxes deductible? Any state death tax paid is not deductible on an individual's federal income tax return. The 691(c) deduction applies only to federal estate tax paid on IRD.

Taxation of nonqualified annuities

Question: How are nonqualified annuities taxed?

Bottom line: There are two ways to take funds from a nonqualified deferred annuity: through withdrawals or annuitization. (By definition, the only way to take funds from a nonqualified immediate annuity is through annuitization). For withdrawals, any contract interest or gain that has exceeded the owner's investment in the contract (also commonly known as cost basis) is distributed first, followed by basis (basis consists of the client's after-tax contributions to the nonqualified deferred annuity). Interest is taxed as ordinary income, while return of basis is income-tax-free. If your client elects to annuitize their contract, each annuitization payment is considered part taxable interest and part income-tax-free return of basis. Exceptions to this general rule may apply if any funds are from contracts issued prior to August 14, 1982.

What is a nonqualified annuity? A nonqualified annuity is an annuity that is not inside an IRA or qualified retirement plan. Qualified plan and IRA contributions are based on the income an employee earns at a job, and contributions are limited. In contrast, anyone can buy a nonqualified annuity in almost any amount, regardless of whether or not they have a job. People buy nonqualified annuities with funds from various assets, but NOT from IRAs or qualified plans.

Can my client deduct their premium payments to a nonqualified annuity? No. Unlike traditional IRA contributions, they cannot deduct their payments for a nonqualified annuity.

Do they have to pay tax on the increase in value in their nonqualified deferred annuity each year? No. Unlike many other assets, there is no annual income tax on the interest earnings inside of a nonqualified deferred annuity for individual owners. Generally, increase in value is only taxed when they remove it in a distribution or complete a transaction that results in a taxable event.

Example: Vaughn puts $100,000 into a nonqualified deferred annuity in February. By December 31, it had increased $5,000 in value. Vaughn will not receive an IRS Form 1099-R on the $5,000 during the year. He will only be taxed on the interest when he withdraws the funds, which will likely be during retirement.

Tax deferral is one of the chief advantages of nonqualified deferred annuities over other nonqualified assets. However, in exchange for tax deferral, Uncle Sam wants them to keep the funds in the annuity until retirement. There will be a 10% federal additional tax if they remove the funds before age 59½ (discussed below) and no exception applies.

Note that non-natural owners such as corporations, LLCs, and charities are not eligible for income tax deferral of increases in value of a nonqualified deferred annuity. They must pay tax on the interest each year, or for charitable owners, report the interest on the informational return they file each year.

How are distributions from a nonqualified annuity taxed? The Internal Revenue Code recognizes two ways to take funds from a nonqualified deferred annuity: through withdrawals or annuitization. These are taxed differently.

A regular withdrawal or distribution is taxed as interest out first, followed by basis (basis is total of the premiums paid for the annuity, including premiums paid before any 1035 exchange). Interest is taxed as ordinary income, but the return of basis is income-tax-free. Exceptions to this general rule may apply if any premium payments were made prior to August 14, 1982.

Example: After eight years, Vaughn's $100,000 nonqualified deferred annuity is now worth $150,000. Vaughn withdraws $60,000. The first $50,000 of the distribution represents the interest earned on the contract, which is subject to ordinary income tax and may be subject to the 10% federal additional tax if he is under age 59½. The other $10,000 of the withdrawal is income-tax-free return of basis. Vaughn will receive an IRS Form 1099-R for $60,000, with $50,000 reported as taxable. Immediately after the distribution, Vaughn will have $90,000 in basis and no interest earnings in the contract. This example does not take into consideration any possible surrender charges on the annuity.

(continued on next page)

Old contracts entered into before August 14, 1982 have a different ordering rule for withdrawals. It may be possible to withdraw basis before interest earnings on pre-August 14, 1982 money.

Order of distribution:

- Pre-August 14, 1982 contributions (nontaxable)
- Interest on pre-August 14, 1982 contributions (taxable)
- Interest on post-August 13, 1982 contributions (taxable)
- Post-August 13, 1982 contributions (nontaxable)

What if the contract was initially issued before August 14, 1982 but it has been "1035 exchanged" since then? That older contract retains the pre-August 14, 1982 tax benefits and the client will want to make sure that the prior carrier supplies Allianz or Allianz Life of NY with the appropriate basis and interest information. Without complete prior cost basis and interest information from the other company, Allianz or Allianz Life of NY will treat the contract as having no cost basis for withholding purposes and will report distributions as "taxable amount not determined."

The other way to remove funds from a nonqualified deferred annuity is to annuitize the contract. When a contract is annuitized, the cash value of the annuity is changed into a stream of income that lasts for life or a guaranteed period. This stream of income is a systematic liquidation of the basis and expected interest on the contract. There generally is no cash value left in the contract after it is annuitized.

Each annuitization payment is considered part taxable interest and part income-tax-free return of basis. If the payment is a fixed amount, each payment has an "exclusion ratio" of basis to interest. If the payment amount can vary, each payment has an "excludable amount" that will be considered basis. Again, the basis portion is not taxed, and the interest portion is taxed as ordinary income.

Example: Let's say after eight years Vaughn annuitizes his $150,000 contract over a 10-year guaranteed period. The insurance company promises an annual payment of $18,200 annually for 10 years. Each payment consists of $10,000 income-tax-free basis (that is, the $100,000 basis liquidated over 10 years) and $8,200 interest (from the $50,000 gain at the beginning of the annuitization and the promised return during the upcoming 10 years of the annuitization). This gives an exclusion ratio of about 55%. That is, 55% of each $18,200 payment is income-tax-free return of basis. If Vaughn takes an annuitization for life instead of a guaranteed period, the basis is liquidated over his life expectancy. If he lives longer than that and has therefore collected back all of his basis, all payments after that will be taxable interest. The actual exclusion ratio calculation is based on IRS guidelines and can be complex for certain annuitization options.

Again, all interest on annuities is ordinary income. They do not generate any capital gain income.

How are payments from lifetime income withdrawal options treated? Since lifetime income withdrawal options are a way of guaranteeing lifetime income without annuitizing, these payments are taxed as distributions. If the contract value is depleted prior to death, all future payments will be treated as annuitization payments and will be fully taxable.

What happens if I take a distribution before age 59½? As stated earlier, Uncle Sam gives you tax-deferred accumulation on nonqualified deferred annuities provided that you are saving for retirement. There is a 10% federal additional tax to "disincent" you from withdrawing early. If a nonqualified deferred annuity owner takes a distribution before age 59½, Code Section 72(q) will impose a 10% federal additional tax for a "premature distribution" unless an exception applies. The 10% federal additional tax is only applied against the taxable part of the distribution, that is, the interest earnings (increase in value).

Example: Suppose Vaughn took his $60,000 distribution (described earlier) when he was only 55 years old and no exception applies. In addition to paying income tax on the $50,000 interest, he will also pay a 10% federal additional tax ($5,000). He does not have to pay the additional tax on the $10,000 of basis he took out, because that amount is not taxable.

Congress saw that this additional tax could be onerous, so it carved out several exceptions. There is no 10% federal additional tax if the owner dies or becomes disabled.

There is no 10% federal additional tax if you receive annuity payments from a nonqualified **immediate** annuity (assuming the purchase is not part of a 1035 exchange). Note that it is generally not possible to 1035 exchange an immediate or an annuitized annuity. There is also no additional tax if the owner withdraws through a series of "substantially equal periodic payments" over their life expectancy. This latter exception allows someone who retires early to take distributions from their nonqualified deferred annuity without additional tax. See the "SEPP exception to 72(t) and 72(q)" Q&A.

Aggregation of gain within multiple contracts

Code Section 72(e)(12) provides that multiple nonqualified deferred annuity contracts issued within the same calendar year to the same owner by one company or its affiliates are treated as one annuity contract for purposes of determining a distribution's tax consequences. If a distribution is taken from any such contract, the taxable amount reported will be based on earnings of all such contracts. This treatment may result in adverse tax consequences, including more rapid taxation of distribution from combined contracts. For purposes of this rule, contracts received in a Section 1035 exchange are considered issued in the year of the exchange. Your client should consult a tax advisor before purchasing more than one nonqualified deferred annuity contract in any calendar year period. Note: A contract that would otherwise be aggregated is not aggregated if it is annuitized or is involved in a 1035 exchange to another company.

Does your client have to recognize interest on their contract if they exchange it for another one? No. They don't have to pay income tax on their interest earnings when they exchange their annuity contract for another, provided they follow certain rules. To be a nontaxable 1035 exchange the exchange must be made in a company-to-company transfer, and the parties to the contract must not change from the old contract to the new contract in the course of the exchange. See the 1035 exchanges Q&A.

Example: Vaughn's contract has $100,000 in basis and $50,000 in interest (increase in value). Vaughn is owner and annuitant on his nonqualified deferred annuity. Vaughn is unhappy with his current contract, and has found a competitor's contract that he likes better. Vaughn can exchange his $150,000 contract by arranging a company-to-company transfer into the new $150,000 nonqualified deferred annuity. The new annuity names Vaughn as owner and annuitant. This is therefore a valid 1035 exchange. Vaughn does not have to recognize his $50,000 interest earnings in the first contract. His new annuity carries over the $100,000 basis and the $50,000 interest earnings (increase in value) from the old contract. Even though Vaughn paid $150,000 for the new annuity, he still has a $100,000 basis because it carried over from the old contract in an exchange. This does not take into account any possible surrender charges. To be sure both companies treat the transaction as a 1035 exchange, it is recommended that the individual not receive anything at their own address.

Are there income tax consequences if a client gifts their nonqualified annuity to someone else? Yes. The original owner (or transferor) will pay tax on any interest earnings, unless an exception applies. The new owner will take the annuity with a new, stepped-up basis.

Example: Vaughn has his $150,000 annuity, $50,000 of which is interest. Vaughn gives the annuity to his daughter Sophie. Vaughn pays income tax on the $50,000 interest earnings, and Sophie takes a new $150,000 basis in her contract.

(continued on next page)

There is an exception if your client gifts their annuity to their spouse. There is no tax on gifting their annuity to their spouse. The spouse keeps the same basis.

Can my client borrow against their nonqualified deferred annuity or put it up for collateral? It depends upon the business rules of the annuity provider. However, if they are allowed to borrow against the contract or use it as collateral, it will be treated like a distribution from the contract. They will be ordinary income-taxed (and perhaps subject to the 10% federal additional tax) to the extent of interest earnings in the "distribution."

Do they have to take required minimum distributions (RMDs) from a nonqualified deferred annuity? No. Unlike qualified annuities, there are no RMDs required from nonqualified deferred annuities. Nonqualified deferred annuities do have a maximum annuity date, though, at which point the owner must take a lump sum or annuitize.

How is their nonqualified deferred annuity taxed after they die? Nonqualified deferred annuities do not receive a basis step-up at death, because they are not capital gain assets. Instead, they have income in respect of a decedent (IRD). That is, the beneficiary steps into the shoes of the decedent for tax purposes, taking over the decedent's basis and interest. When a beneficiary takes a distribution or annuitizes, it is taxed in the same manner previously described.

Example: Vaughn never took a distribution from his nonqualified deferred annuity during life. He died with $100,000 of basis, and $120,000 of interest earnings. After his death, the contract gains an additional $5,000 before his daughter Sophie takes a lump sum of the entire amount. She pays income tax at her ordinary rates (not Vaughn's) on the $125,000 of interest, and receives income-tax-free the $100,000 return of basis. If Vaughn paid estate tax on the annuity, Sophie may be eligible for an income tax deduction for the estate taxes that Vaughn paid. This is called the IRD deduction. We have more detail on IRD and the deduction in the "IRD and the 691(c) deduction" Q&A listed elsewhere in this booklet.

What options does a beneficiary have after the owner dies (and the nonqualified deferred annuity contract has not been annuitized)? If the beneficiary is the spouse, they can continue the contract in their own name and assume the deceased owner's tax basis and interest. Or, they could take one of the options available to nonspouse beneficiaries when death occurs before annuity payments have begun: distribution of the entire contract within five years of the owner's death, or distributions over the beneficiary's life expectancy or a guaranteed period not exceeding the life expectancy. (This option may not be available in all states and for all contracts. If the beneficiary elects life expectancy distribution, the first distribution must be taken by the first anniversary of the owner's date of death.) If the beneficiary does not receive the first distribution by then, the entire value must be distributed within five years of the owner's death. The beneficiary can also take a lump sum.

If the owner had annuitized the contract before death under an annuity option other than "life-only," the beneficiary can take any remaining payments or commute the contract, if the provider and contract provisions allow.

Where can I find out more about some of the topics discussed? This booklet has more detailed Q&As on the following topics:

- 1035 exchanges (page 56)
- 72(t) and 72(q) distribution basics (page 48)
- IRD and the 691(c) deduction (page 60)

The Alternative Minimum Tax (AMT)

Question: What is the Alternative Minimum Tax (AMT)?

Bottom line: The AMT is a separately figured tax that is generated by modifying one's regular taxable income and then applying different tax brackets. Basically, the AMT eliminates selected deductions and credits, and includes certain types of income that are not included in the regular tax calculation. The income tax determined under the AMT is then compared to the income tax under the regular tax rules and the client pays the greater of the two.

Who's most at risk for the AMT? Generally, those most at risk for the AMT are married taxpayers with more than two children, who own a home, and live in a state with high income taxes. That's because the AMT won't consider certain items that would otherwise lower taxes – things like certain personal exemptions and deductions for state income taxes and property taxes.

While this list is not complete, some of the common AMT adjustment items are/may be:

- Personal exemptions are not allowed
- The standard deduction is not allowed
- Mortgage interest from refinancing may not be allowed
- The Schedule A deduction for state and local income taxes is not allowed
- Tax-free interest from private activity bonds may be subject to AMT
- The bargain element of incentive stock options (that is, the difference between the option price and fair market value at the time of exercise) is income when the option is exercised
- Accelerated depreciation is not allowed

If your clients are at risk for the AMT, here are a few items to consider when preparing for the upcoming tax season:

- The first thing your clients should do is talk to a competent tax professional to understand how the AMT affects them. They should try to project their AMT exposure as early as possible. This gives your clients more time to think through and create an AMT strategy.
- It's important for your clients to know that some of the year-end tax strategies that are commonly used for the regular income tax calculation – like accelerating your state tax payments so you have more itemized deductions (Schedule A) – can actually hurt you when it comes to AMT. Because state income taxes are not a deduction in the AMT structure, reducing your regular tax this way can actually increase AMT exposure.
- Long-term capital gains can move your clients into the AMT because capital gains are included in alternative minimum taxable income. This can, in effect, increase the marginal rate on long-term capital gains and dividends to over 20 percent.
- Contributions to qualified plans like 401(k) are pre-tax under both the regular tax and the AMT systems. If your clients are subject to AMT, the pre-tax contributions they make actually carry a greater tax benefit than if they were subject to the regular income tax alone.
- While there can be good reasons to convert a traditional IRA to a Roth IRA, be careful of the AMT. Because the conversion amount is added to income in the year of conversion, this additional income may move your clients into an AMT scenario and cost more than anticipated. Encourage your clients to discuss with their tax advisor whether a Roth IRA conversion may be appropriate for their situation.
- If your clients intend to transfer employer stock out of a retirement plan to take advantage of the income tax benefits for net unrealized appreciation, remember that the "basis" amount on the employer stock is taxed in the year of transfer. This additional income may move your clients into an AMT scenario and cost more than anticipated.
- If your clients are in retirement and facing the AMT because their income is from fully taxable sources like a pension, 401(k), and IRA, your clients could consider using nonqualified assets like a money market account or possible income-tax-free qualified distributions from a Roth IRA to supplement their income. This will reduce their taxable income and possibly their exposure to an AMT scenario.

Clients should discuss the ideas outlined here with their tax advisor. The ideas may help to transform your clients' tax to a lower rate and step down their total tax bill. Cutting back on tax bills leaves more potential to power up their financial situation.

How is life insurance taxed for income tax purposes?

Generally, premium payments are not income-tax-deductible and the death benefit is not taxable to a beneficiary. If distributions are taken during the life of a policy with cash value, taxation depends on whether or not the policy is a modified endowment contract (MEC). A life insurance policy becomes a MEC when it is funded with too much premium too early in the contract – i.e., front-loaded (for instance, if premium payments exceed the seven-pay premium limits). A MEC can still take advantage of the tax deferral aspects of a life insurance policy as long as it qualifies as life insurance under IRC rules. If it is not a MEC, tax-free basis comes out first, followed by taxable gain. Distributions from non-MECs are not subject to the 10% federal additional tax for premature distributions (prior to age 59½). Loans on non-MECs are income-tax-free. However, if the policy lapses, any outstanding loans become subject to income tax (see "phantom income" below). If the policy is a MEC, a distribution or a loan is taxed as gain-out-first, subject to income tax and the 10% federal additional tax for premature distributions (prior to age 59½), followed by tax-free return of premium. If loans are not repaid, the policy may lapse.

Is a life insurance premium tax-deductible?

Generally, no – life insurance premiums are not income-tax-deductible. Life insurance premium payments are considered a nondeductible personal expense. Premiums are not deductible even if you are paying premiums on someone else's policy. For example, you cannot deduct premiums you pay on your own life insurance policy, nor can you deduct the premiums you pay on your mother's life insurance policy.

There is an exception, though. When a corporation pays a premium on an employee's life insurance policy as a benefit, and the employee owns the policy and names someone other than the corporation as the beneficiary, the corporation can generally deduct the premium. The premium paid is compensation to the employee, and like all compensation, it is generally deductible to the corporation as long as it is reasonable. And like all compensation, the premium is taxable income to the employee.

Does the owner of a life insurance policy pay tax on the annual increase in the cash value of the policy? No. The "inside build-up" or cash value of a life insurance policy is tax-deferred. That is, the cash value accumulations are not taxed while inside the policy and even while they are accumulating. Note that some corporations might be subject to the corporate Alternative Minimum Tax on annual cash value increases.

What is a modified endowment contract and how will my client know if their policy is a MEC? It is important to know if the life insurance policy is classified as a modified endowment contract (MEC), because withdrawals and loans from MECs are generally subject to less favorable tax treatment. Death proceeds from a MEC are generally income-tax-free as usual (see below).

A life insurance policy is a modified endowment contract if it fails the "seven-pay" test. A policy fails this test if the accumulated (or total) premiums paid at any time during the first seven years exceed the sum of the net level premium that would have been paid if the policy provided paid-up future benefits. If death benefits are reduced during the first seven years of the policy, the policy is tested again using the new lower death benefit. For second-to-die policies, if death benefits are reduced at any time during the policy, even past the seven-year period, the policy is tested again.

The life insurance company can tell you if the policy is a MEC. The MEC rules apply to all policies entered into or materially changed on or after June 21, 1988.

Generally, the life insurance company's policy illustration pages and system will indicate whether the policy being illustrated and ultimately sold is or is not a MEC. Most often producers wish to illustrate a policy with a maximum premium that avoids the MEC status.

If the policy is not a MEC, how are loans, withdrawals, and surrenders taxed? Loans on a non-MEC policy are income-tax-free transactions.[1] There is no taxable income when the owner receives the loan, nor is there an income tax deduction when the loan is paid back. Note that the loan and any accumulated interest on the loan will reduce the death benefit. Withdrawals and surrenders from a life insurance policy are treated as a nontaxable return of premiums paid. Withdrawals or surrenders in excess of premiums paid are subject to ordinary income tax, but are not subject to the 10% federal additional tax, even if the owner is under age 59½.

"Phantom income" may result when a policy is surrendered or lapses with an outstanding loan and there was gain in the policy. Phantom income is taxable. The formula to determine whether there is taxable income on a policy surrender or lapse is as follows:

[outstanding loans + cash received upon policy termination] – cost basis = taxable income

Note: "Outstanding loans" includes all accumulated unpaid interest on the loan.

Note: "Cost basis" is generally defined as the total of all premiums paid into the policy less all prior withdrawals of premiums from the policy.

If the policy is a MEC, how are loans, withdrawals, and surrenders taxed? If the policy is a MEC, loans, withdrawals, and surrenders are taxed as a nonqualified annuity would be taxed. Gain in the cash value comes out first, subject to income tax. If the owner is under age 59½, the 10% federal additional tax applies to the gain. Premium, or basis, is returned last and is income-tax-free.

Are there any other rules about withdrawals to be mindful of? Yes. Besides the MEC rules, the Deficit Reduction Act of 1984 (DEFRA) instituted rules that apply to withdrawals of policies issued after 1984 and still apply now. These rules apply to withdrawals if the face amount is reduced after the withdrawal. If the face amount of the policy remains level after the withdrawal, which normally requires additional underwriting, then these DEFRA rules do not apply. First it must be determined whether the policy has a gain before the withdrawal. Then a formula is applied to determine whether that gain is taxable. Different formulas are applied to years 1-5 and years 6-15. After 15 years, under DEFRA, a withdrawal is taxable only if it exceeds the client's remaining cost basis. The issuing company's actuaries can provide additional help with DEFRA rules. Keep in mind that if the policy is a MEC, the MEC rules would apply instead.

Is the death benefit on a life insurance policy taxed? Generally, no. The beneficiaries of a life insurance policy do not have to pay income tax on the death benefit. This is true whether they take the death benefit as a lump sum or receive it over a period of time (however, any interest or any other amount paid considered to be in excess of the death benefit earned would be taxable to the beneficiary). Payments received over time may be considered to include amounts in excess of the death benefit. Once they take the funds, any returns the beneficiaries make on later investments may be subject to income tax, depending on how the death benefit is used.

There is an exception to this general rule of nontaxation that usually occurs in a business setting. The Transfer-for-Value Rule applies when someone buys a life insurance policy from another policyholder (i.e., not directly from the insurance company) or transfers the policy in a business situation. Under this rule, the

(continued on next page)

[1] Policy loans and withdrawals will reduce available cash values and death benefits, and may cause the policy to lapse or affect any guarantees against lapse. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. Tax laws are subject to change. Encourage your clients to consult a tax professional.

Policy loans are not usually subject to income tax unless the policy is classified as a modified endowment contract (MEC) under IRC Section 7702A. However, withdrawals or partial surrenders from a non-MEC policy are subject to income tax to the extent that the amount distributed exceeds the owner's cost basis in the policy. Loans, withdrawals or partial surrenders from a MEC policy are subject to income tax to the extent of any gains in the policy, and if the payment occurs prior to age 59½, a 10% federal additional tax may apply.

death beneficiary generally will have to pay income tax on the death benefit to the extent it exceeds the purchase price and additional premiums the buyer paid.

The Transfer-for-Value Rule is designed to discourage an overactive secondary market in life insurance policies. As a matter of public policy, states do not want people "gambling" on other people's lives. Congress prohibits the tax-free death benefit to people or entities who purchase a policy from the prior policy holder. That is why a death benefit paid to a life settlement company is taxable income for the life settlement company. Many states have enacted specific stranger-owned life insurance or STOLI legislation to discourage sales of policies to entities who lack an insurable interest in the insured's life. Allianz and Allianz Life of NY do not approve of STOLI transactions.

Please note that purchases or transfers are not subject to the Transfer-for-Value Rule and the death benefit is still income-tax-free, if the policy was sold or transferred to:

1. The corporation where the insured is an officer or shareholder
2. The insured person
3. A business partner of the insured when the entity is taxed as a partnership (e.g., if the entity is a partnership or an LLC taxed like a partnership)
4. A partnership if the insured is a partner (or if the entity is an LLC taxed as a partnership)
5. If the policy has been gifted and the cost basis carries over to the transferee.

Another problem area where the death benefit could be taxable is under IRC Section 101(j). This section applies to employer-owned life insurance or almost any business-owned life insurance policy. Before the policy is issued, the employer must give the insured a written notice and obtain a written consent from the insured. If the employer does that before the policy is issued, then the death benefit should be income-tax-free.

Please note that for businesses, there could be reasons other than IRC Section 101(j) which could tax the death benefit – such as under the Transfer-for-Value Rule, the corporate Alternative Minimum Tax (AMT), or other applicable IRS rules.

Is exchanging a life insurance policy for another life insurance policy a taxable event? Generally, no. Your client can do a tax-free 1035 exchange of a life insurance policy for another life insurance policy, an endowment contract, a nonqualified annuity, or a qualified long term care insurance policy. To be a valid exchange, the transfer must be made company-to-company (they cannot surrender and take the cash to purchase the next policy). Also, the owner and insured on the new policy must be the same as the owner and insured on the old policy. Second-to-die policies have special issues when it comes to tax-free exchanges. They must have the same insureds on both the old and the new policy. The IRS has privately ruled (in PLR 9248013)[1] that it is possible to exchange a second-to-die policy after one insured dies to a single-life policy on the survivor. The new policy will carry over the tax characteristics of the old policy – the holding period, basis, and MEC status of the policy. Keep in mind that IRS private letter rulings can only be relied upon by the party to whom the specific ruling was issued.

Clients should consult with their tax advisor to discuss their specific situation.

[1] A private letter ruling (PLR) is directed only to the taxpayer who requested it. IRC Section 6110(k)(3) provides that it may not be used or cited as precedent.

Estate planning

What is estate planning? Estate planning is a process in which an individual determines their goals with respect to transferring property upon death, or even earlier, during their lifetime. It may involve efforts to reduce federal and state estate and gift taxes. The client may also hope to transfer as few assets as possible through the probate process. The client may also want to be sure that beneficiaries have the knowledge needed to get the maximum value available in an inherited asset. The client usually hires an estate planning attorney to discuss goals, draft appropriate wills, trusts, and/or powers of attorney and arrange property titles to effect the goals.

Transferring property to an heir after death

Property can transfer in several ways:

- An ownership designation or title on the property (such as joint tenancy with right of survivorship)
- Through a beneficiary designation on specific property like life insurance, annuities, IRAs, and qualified retirement plans like 401(k)s, profit-sharing plans
- Through a trust arrangement
- Through a designation in a will

Probate. Probate is the court supervised process of validating a decedent's will and approving the transfer of the decedent's (i.e., the deceased person's) property subject to probate. Only assets that pass by will or intestacy (when someone dies without a will) go through probate. Assets which don't go through probate include those assets which pass to the heir by beneficiary designation, joint tenancy, payable on death (POD) or transfer on death (TOD) designations, or through a trust. Many people like to avoid probate because probate fees can be high and the assets may be unavailable to the heir for months after the death. Also, probate documents are open for inspection by the public.

Transferring assets through asset ownership. By naming two or more persons as joint tenants with right of survivorship (JTWROS) the property will pass automatically to the surviving joint tenant(s) at death, outside of probate. JTWROS is typically used between spouses. The gift tax implications of establishing JTWROS with someone besides a spouse vary by state.

In titling assets, you may also be able to indicate that they transfer on death (TOD) or are payable on death (POD) to a named beneficiary. The beneficiary can assume ownership or collect the proceeds at the owner's death, outside of the probate process (assumes the estate was not the beneficiary).

Transferring assets through death beneficiary designations. Several types of assets allow you to name death beneficiaries: life insurance, nonqualified annuities, IRAs, and qualified retirement plans. At the owner's death, the beneficiary can collect the death proceeds outside of the probate process (assumes the estate was not the beneficiary).

Does an Allianz or Allianz Life of NY annuity avoid probate when the owner dies? Yes, if it passes to a named beneficiary other than the estate at death. If someone dies with an Allianz and Allianz Life of NY annuity where they have not named a death beneficiary, or if that beneficiary has died before the owner and there is no contingent beneficiary, the annuity will go to the estate. In that case the annuity must go through the probate process to be distributed to the heirs according to the decedent's will.

Note that Allianz and Allianz Life of NY nonqualified annuities offer co-ownership. This is not quite the same as joint tenants with rights of survivorship. The surviving co-owner is the primary death beneficiary (this provision can vary by contract). If the co-owner is the spouse, she or he can continue the contract. If the co-owner is not a spouse, the survivor must take a death benefit at the first death. Note that a spouse beneficiary who continues the contract becomes subject to any applicable surrender charges. If a spouse beneficiary is planning to take a distribution from the contract, surrender charges may be avoided by taking the distribution as a beneficiary.

It is important for beneficiaries to be aware that the annuity contract may provide different values depending on how the beneficiary receives the funds. Some annuities require annuitization to provide a beneficiary with maximum value available.

(continued on next page)

Trusts. A trust is a legal document written by an attorney for an individual which names someone (a trustee) to manage trust property and indicates when and how that property should be transferred to trust beneficiaries. The grantor/trustor/settlor is the person who established the trust. After creating the trust, the grantor transfers property into the trust by changing the ownership on assets into the name of the trust. The grantor can be very specific in the trust document about who receives income or assets and when, or the grantor can give the trustee broad instructions and leave it up to the trustee's discretion.

Trusts often have two kinds of beneficiaries: 1) income beneficiaries who receive trust income, and 2) remainder beneficiaries who receive trust assets at the end of the trust's term, often upon a death. If the grantor moves assets into the trust during life, the assets will avoid probate at the grantor's death. Such a trust, established while the grantor is still alive, is called a "living trust" or "inter vivos trust." A grantor can also establish a trust in his will, and have his executor move assets into the new trust when he dies. Such a trust is called a "testamentary trust." Assets put into the trust at death will still have to go through probate, unless they passed to the trust as a death beneficiary.

In general, a trust can own a nonqualified annuity (although you should check the annuity provider's business rules). A trust-owned nonqualified annuity will generally be eligible for income tax deferral if all the beneficiaries of the trust are people (as opposed to corporations, charities or other non-natural entities). The attorney for the trust will make this determination. When a trust owns a nonqualified annuity, the annuity becomes annuitant driven. The annuitant will be the measuring life for issue age, commission, annuitization and death. The annuitant cannot be changed.

Note that a trust can be named as a death beneficiary of a qualified annuity or a nonqualified annuity. However, doing so may limit the payment options under the contract.

Wills. A will is a legal document in which a person expresses their wishes for who should receive their property at death. It only disposes of property that does not otherwise transfer to people by joint ownership, POD, TOD, beneficiary designation or trust. A will may also name an executor or executrix to wrap up the estate, designate a guardian for minor children and establish trusts to benefit heirs. Any adult can write a will, usually with the help of an attorney. The will can be changed any time until death, as long as you are competent. The person who writes a will is a "testator," and having a will at death is also known as "dying testate." The probate court oversees the distribution of assets according to the will.

Intestacy. If a person dies without a will, they have "died intestate." State intestacy laws will say who is to receive the property which does not otherwise transfer by title, death beneficiary designation, or trust. Typically, the law will pass the assets to relatives of the closest degree – first the spouse, then children, then grandchildren, parents, siblings, etc. If you die with no family at all (which is rare) your assets could "escheat" to the state. The state can then dispose of them and keep the money. The probate court oversees the distribution of assets according to intestacy.

Estate and gift taxes. The federal government imposes a tax on the transfer of wealth from one person to another. If the transfer happens during life, it is a gift and may be subject to the gift tax. If the transfer happens at death, the transfer is subject to the estate tax. However, the government is only interested in large transfers of wealth. There is no need to report gifts of less than $15,000 per person per year (in 2018). This free amount is called the annual exclusion. Transfers above this amount are subject to gift or estate tax and must be reported to the IRS. However, each individual has an exemption from the gift and estate tax. In 2018, the exemption for lifetime gifts and transfers at death is $11,180,000. So even if a gift is subject to the estate or gift tax, your clients don't have to pay the estate or gift tax until they exceed their $11,180,000 exemption. If they do make transfers totaling over $11,180,000, their estate will have to pay tax on the excess with a current maximum rate of 40%. At death, both lifetime gifts and the transfer at death must be counted. One additional part of the estate law that was permanently adopted is the concept of “portability.” Portability is available to married couples after one spouse (A) dies and the other spouse (B) survives. The executor of the estate of the deceased spouse A may elect to give any of the deceased spouse A's unused estate tax exemption to the surviving spouse B. When the surviving spouse B later dies, that spouse B's estate would have a total federal estate tax exemption equal to his or her own ($11,180,000 in 2018) plus the unused amount provided by the estate of the spouse A who died first.

Keep in mind portability can occur only from the estate of the last deceased spouse. So if the surviving spouse B remarries, portability from the first deceased spouse A is lost if the new spouse C of the surviving spouse B dies before the surviving spouse B dies.

The rules are complicated and you should always encourage your clients to see their local estate planning professional. State rules for estates are also complicated and generally differ from federal rules.

Implication of transferring ownership of a nonqualified annuity. If the owner of a nonqualified annuity gives their annuity to another person (other than their spouse), it is subject to gift tax to the extent the transfer exceeds the $15,000 annual exclusion in 2018. Unlike other assets, though, the transfer also triggers an income tax. The original owner will have to pay income tax on all the gain in the contract at the time of transfer (and perhaps the 10% federal additional tax if the gifting owner is under age 59½). The recipient will take the annuity with a stepped-up basis.

Note that your client cannot transfer the ownership of their IRA or other qualified annuity contract while they are alive. The only exception is that they may be able to transfer to a spouse pursuant to a court order – usually in a divorce. Check with the specific annuity company for what can be done with an annuity contract in a divorce situation.

Please note that Allianz Life Insurance Company of North America and Allianz Life Insurance Company of New York, their affiliated companies, and their representatives and employees do not give legal or tax advice. In addition, please note that certain qualifications are required to officially create an estate plan. Encourage your clients to see their local estate planning attorney and tax advisor.

When the questions are complex, finding the answers should be simple. The Advanced Markets Q&A book.

Call the Sales Desk at 800.542.5427 or the FASTeam at 800.950.7372 and ask for Advanced Markets for more information about what's covered in this book.

Notes

Notes

Notes

True to our promises … so you can be true to yours.®

As leading providers of annuities and life insurance, Allianz Life Insurance Company of North America (Allianz) and its subsidiary, Allianz Life Insurance Company of New York (Allianz Life® of NY), base each decision on a philosophy of being true: **True to our strength** as an important part of a leading global financial organization. **True to our passion** for making wise investment decisions. And **true to the people we serve**, each and every day.

Through a line of innovative products and a network of trusted financial professionals, Allianz and Allianz Life of NY together help people as they seek to achieve their financial and retirement goals. Founded in 1896, Allianz, together with Allianz Life of NY, is proud to play a vital role in the success of our global parent, Allianz SE, one of the world's largest financial services companies.

While we are proud of our financial strength, we are made of much more than our balance sheet. By being true to our commitments and keeping our promises we believe we make a real difference for our clients. It's why so many people rely on Allianz and Allianz Life of NY today and count on us for tomorrow – when they need us most.

Guarantees are backed by the financial strength and claims-paying ability of the issuing company. Variable annuity guarantees do not apply to the performance of the variable subaccounts, which will fluctuate with market conditions.

Products are issued by Allianz Life Insurance Company of North America, 5701 Golden Hills Drive, Minneapolis, MN 55416-1297. www.allianzlife.com. In New York, products are issued by Allianz Life Insurance Company of New York, 28 Liberty Street, 38th Floor, New York, NY 10005-1422. www.allianzlife.com/new-york. Only Allianz Life Insurance Company of New York is authorized to offer annuities and life insurance in the state of New York. Variable products are distributed by their affiliate, Allianz Life Financial Services, LLC, member FINRA, 5701 Golden Hills Drive, Minneapolis, MN 55416-1297.

• Not FDIC insured • May lose value • No bank or credit union guarantee
• Not a deposit • Not insured by any federal government agency or NCUA/NCUSIF

For financial professional use only – not for use with the public.
Product and feature availability may vary by state and broker/dealer.

(R-6/2018)