

# EGBL LEGAL REPORT

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## Tax aspects of annuities require careful planning

by DAVID W. BADGER

Annuities – particularly variable annuities – are increasingly popular investment vehicles. Persons purchasing annuities, however, should be careful to avoid adverse tax consequences.

An annuity is a contract between an individual and an insurance company. In the contract's simplest form, the individual pays an amount to an insurance company, and the insurance company agrees to pay a fixed sum to the individual for the remainder of the person's life. In a variable annuity contract, the insurance company either guarantees a certain rate of return on the individual's payment or ties the return to an index, such as a mutual fund. In general, most people prefer the more flexible variable annuity.

An annuity accumulates value over a period of time. During that time, the owner can terminate the policy and liquidate the investment, although most early terminations carry a penalty. At a certain stage, annuities are required to begin annuitiza-

tion. In many cases, however, estate planning includes reviewing annuities before the annuitization has started.

For many people, the guaranteed rate of return of an annuity is particularly appealing. Another advantage of an annuity is that the tax on any increase in the value is deferred until the annuity is paid out, which may be at a time when the owner is in a lower income tax bracket. In some cases, these advantages are significant.

The tax deferral of annuities, however, may result in three tax disadvantages in an appreciating stock market. The first disadvantage is that the appreciation in the value of an annuity, when distributed, is taxed as ordinary income. In contrast, the appreciation realized in a sale of stock is taxed at the individual's capital gains rate, which usually is lower than the ordinary income rate.

The second disadvantage is seen upon the owner's death. If the annuity pays a death benefit to beneficiaries, the appreciation is taxed at the ordinary income tax rates of the beneficiaries when they receive

payment.

In contrast, if a stock were owned by that individual, the beneficiaries would receive a step-up in basis to the value of that stock as of the date of death. As a result, any appreciation from the date of the original purchase to the date of the owner's death would not be subject to income tax.

A third disadvantage can be experienced by beneficiaries of large estates. In such estates, the lump-sum receipt of the annuity's appreciation often pushes beneficiaries into the upper income tax bracket. If this occurs, the combination of the estate tax liability (beginning at a 37 percent rate) and the income tax liability (often at a 28 percent rate) significantly reduces the amount ultimately received by the beneficiaries.

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## General Assembly responds to concerns; modifies State's child support system

by MEGAN G. HEEQ

The Illinois General Assembly has responded to the cries of single mothers and employers struggling under the child support system created on October 1, 1999.

As reported in the last issue of the *EGBL Legal Report*, that legislation established a sweeping new system for employers to pay over child support they had withheld from employees' wages. Under that legislation, many employers were required to submit withheld funds to the State Disbursement Unit (SDU) rather than to the circuit clerk's office where the child support had been ordered.

The bureaucratic nightmare created by this legislation frustrated support recipients and employers. The General Assembly therefore modified the SDU child support system, effective January 5, 2000.

Child support continued on page 2

# Garnishment recipients must protect own interests

by MEGAN G. HEEG

A recent appellate court case reminds banks (and others) that, when served with a wage and/or non-wage garnishment summons, they might need to take an active role in court to ensure their interests are protected.

Under Illinois law, a creditor with a judgment can collect the judgment in a number of ways. In many cases, the creditor files a wage garnishment, which requires the debtor's employer to withhold amounts from the debtor's wages and then pay those amounts to the creditor. In other cases, the creditor files a non-wage garnishment, which requires businesses or persons holding assets of the debtor (such as a bank) to pay some or all of those assets to the creditor.

Recipients of garnishments typically do not involve themselves in disputes between the creditor and the debtor. In some cases, however, these recipients cannot afford to sit on the sidelines.

In *Busey Bank v. Salyards*, for example, the bank sat quietly as a customer and his judgment creditor fought garnishment issues in



court. Pursuant to a garnishment, the bank had frozen over \$18,000 in the customer's account. Before the bank could comply with a state court order to release the funds to the creditor, the customer filed for bankruptcy. After a battle in the bankruptcy court between the creditor and the customer, the bankruptcy court ordered that the frozen funds be returned to the customer. The bank complied with this order but, in doing so, incurred liability.

After the funds were returned to the debtor, the creditor claimed that the bank was in contempt of the state court order because it had not paid the funds to the creditor. The appellate court ruled in favor of the creditor, saying that because the bank did not appeal the state court order, it was required to comply with it, notwithstanding the subsequent bankruptcy order. The bank then was forced to pay to the creditor --from its own funds-- the \$18,000, plus interest.

In retrospect, the bank should have participated in both the state and bankruptcy court actions. By not doing so, it was unable to protect its interests.



## Mortgage escrows can be avoided in some cases

by GARY R. GEHLBACH

Many residential mortgage lenders, particularly when the amount loaned is more than 80 percent of the value of the property, require borrowers to establish an escrow account for the payment of real estate taxes and homeowner's insurance. Applicable law, however, limits lenders' rights to require such escrows.

Lenders, for example, cannot require

that an escrow account be funded with more than 150 percent of the prior year's property taxes, except during the first year of the loan. Moreover, when the balance of the loan has been reduced to 65 percent of the original amount, the lender -- provided the borrower is not in default -- must notify the borrower that the borrower may terminate the escrow account.

Some borrowers avoid the requirement of an escrow account by pledging to the

lender an interest-bearing time deposit in an amount no less than the amount of the real estate taxes. This option, however, is not available when mortgages are guaranteed by the state or federal government or if the borrower fails to pay the real estate taxes when due. If an eligible borrower elects to pledge a time deposit, the lender may not charge an escrow waiver fee.



## Child support . . .

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The new legislation modifies the previous law in several respects:

- Except in cases involving public aid, child support payments are to be sent to the SDU, regardless of when the order for child support was entered. (Under the prior law, child support was sent to the SDU only if the support was based on a court order entered after January 1, 1994.)

- Payments for spousal maintenance are excluded from the SDU process if there is no accompanying child support obligation.

- After June 30, 2000, every employer with 250 or more

employees must use electronic funds transfer to submit funds to the SDU.

- Beginning January 1, 2001, every employer that withheld income from 10 or more employees during December of the prior year must use electronic funds transfer to submit payments to the SDU.

- If an employer submits a payment to the SDU in error, the SDU is required to return the payment to the employer, including, "if possible," instructions detailing where to send the payment.

Problems with this most recent legislation undoubtedly will surface. As modified, however, the child support system appears better able to meet the needs of those it serves.



## Imputed interest rule can surprise borrowers

by GARY R. GEHLBACH

Many people are surprised to learn that the IRS can tax interest they did not even receive. If a person charges less than a market rate of interest, however, the IRS can tax the transaction as if the person had received the market rate.

Congress in 1984 imposed an imputed interest rule. Under this rule, if parties use a below-market rate of interest in a transaction, such as an installment sale, the IRS will recharacterize the transaction by increasing the interest rate for income tax purposes. If this happens, the seller cannot change the contract and charge the buyer a higher rate of interest. Rather, the seller will be charged as if the buyer were paying a higher rate of interest.

To assist taxpayers, the IRS publishes a monthly chart of various Applicable Federal Rates (AFR). If parties use the correct AFR, a higher rate of interest will not be imputed.

Another application of the imputed interest rule occurs when a corporation loans funds to a shareholder. Such loans are fairly common in small corporations, especially when the shareholder or shareholders prefer not to declare a dividend. If the loan does not bear interest or if the interest rate is below the AFR, however, interest will be imputed at the AFR. At the same time, the corporation will be deemed to have made a dividend payment to the shareholder or shareholders (with the accompanying tax consequences), with the shareholder(s) retransferring the "dividend" to the corporation to satisfy the accruing interest.

Fortunately, these onerous income tax results can be avoided by properly using the AFR.



## Annuities . . .

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The careful use of annuities can enhance an individual's financial picture. The indiscriminate use of annuities as a financial investment vehicle, however, can carry adverse tax consequences. An important goal of estate planning is to protect the owner's financial future while minimizing these tax consequences.



## Employers should consider written e-mail policies

by DOUGLAS E. LEE

As the latest in technology finds itself on more and more employees' desks, employers should adopt policies to reduce the risk that employees will misuse these tools.

Although employee e-mail use is increasingly common, recent surveys suggest that only 30 percent of employers have written e-mail policies. Properly drafted, an e-mail policy can minimize an employer's liability and help protect the employer's computer network. E-mail policies, at a minimum, should address the following:



- **Sensitivity.** E-mail messages, like documents and conversations, can result in harassment claims. Employers therefore should prohibit employees from using e-mail to send jokes or other messages that are sexually, racially or ethnically offensive.
- **Privacy.** Employees must be informed that nothing stored or sent from their computers is private and that the employer reserves the right to retrieve any stored or deleted information.
- **Personal Use.** The employer should set forth any restrictions on employees' personal use of office computers. Because "cookies" and e-mail messages typically identify the employer rather than the employee, an employee's use of the Internet can result in the employer's receipt of unsolicited e-mail and target the employer for other unwanted solicitations.

- **Viruses.** Many computer viruses find their way into networks when employees unwittingly open executable files. Employees should be advised how to recognize an executable file and how to respond when such a file is found.

Although having an e-mail or technology policy will not guarantee that employees will use employers' computers only for business-related purposes, such a policy might help protect the employer if the technology is misused.



## Some small businesses can reduce work comp rates

by GARY R. GEHLBACH

Companies faces rising workers' compensation insurance rates should be aware that they might be able to reduce those costs.

In Illinois, employers generally are required to carry workers' compensation insurance for their employees. Certain persons, however, are not considered "employees." Sole proprietors, for example, need not carry workers' compensation insurance on themselves. Similarly, a partnership is not required to carry workers' compensation insurance on its partners. Although many sole proprietorships and partnership elect to carry such insurance, others purchase short- and long-term disability insur-

ance or take other steps to protect against injury-related wage loss.

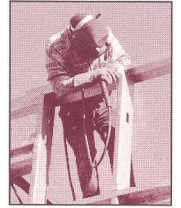
An additional statutory exemption from the requirement of carrying workers' compensation insurance applies to "corporate officers" of small businesses.

In light of this exemption, it might make sense for some small businesses to incorporate and then designate certain key personnel as corporate officers. Typically, the officers of a corporation are its president, vice-president, secretary and treasurer, although more or fewer officers can be specified.

Certain liabilities and risks are inherent in appointing a person as a corporate officer. In most cases, for example, the corporation will be responsible for the actions of

the corporate officer, especially when performed in the course of the officer's duties. A corporation also will generally be liable for acts of an officer who has the apparent authority to perform functions on behalf of the corporation. The corporation therefore should be discerning about the persons it appoints as corporate officers.

Workers' compensation insurance rates are just one issue that should be considered when a business is deciding whether to incorporate. Before incorporating, a business owner should discuss the advantages and disadvantages of forming a corporation with appropriate legal counsel and a qualified accountant.



## In Print and At the Podium

**Mrs. Heeg**, a member of the Board of Directors of Forreton Mutual Insurance Company, joined other state farm mutual company representatives in Springfield to brief state legislators on issues affecting the state property/casualty insurance industry . . . **Mr. Lee's** two most recent commentaries for the web site of The Freedom Forum First Amendment Center ([www.freedomforum.org/first/welcome.asp](http://www.freedomforum.org/first/welcome.asp)) concerned the propriety of allowing televised coverage of trials and a precedent-setting decision of the

Illinois Supreme Court that required two newspaper reporters to divulge their confidential sources . . . **Mr. Ehrmann** recently was reappointed as legal counsel for the Lee County Council on Aging . . . **Mr. Gehlbach** presented a comprehensive estate planning seminar for a local accounting firm . . . **Mrs. Heeg** has been named legal counsel to Dixon Main Street. As counsel, she sits on the organization's Advisory Board . . . **Mr. Ehrmann** has been elected vice-president of the Dixon Rotary Club.



## Deals and Decisions

**Mr. Ehrmann** obtained a major victory for women's rights in the Illinois appellate court. In the decision, the court held that alimony cannot be substituted for a proper division of the former husband's pension. As a result, the pension was divided, and the woman's portion was placed solely in her name. . . **Mr. Gehlbach**, **Mr. Badger** and **Mr. Lee** have in recent months represented physicians in contract negotiations with hospitals and clinics . . . **Mr. Lee** recently has been retained by counsel in Nebraska, Arkansas and Texas to represent clients with matters pend-

ing in northern Illinois . . . **Mr. Ehrmann** successfully reopened an eight-year-old case of a man alleged to be wrongfully convicted of murder solicitation . . . **Mrs. Heeg** continues to represent creditors in a variety of bankruptcy matters . . . **Mr. Gehlbach** assisted a client in gifting property to a local college in exchange for a gift annuity to be paid for the rest of the client's life . . . **Mr. Lee** recently has advised employers on several policy issues, including workers' compensation/disability, harassment and termination.