SENIOR CITIZENS AND ELDER CARE

INTRODUCTION

The American population, like many in the world, is aging. With medical advances, new technologies, better understanding of health issues, and changing life habits, people are living longer. Citizens older than 62 make up 14.6% of the U.S. population. The Internal Revenue Code has provisions that apply to taxpayers in general, as well as special provisions that apply to senior citizens. This chapter discusses planning and other issues regarding tax management for taxpayers in their later years.

I. TAX ISSUES IMPACTING SENIOR CITIZENS

CAPITAL GAINS

Taxpayers fund retirement in a variety of ways. One way is collecting. Collecting stamps, coins, dolls, and commemorative plates are examples of how taxpayers derive enjoyment from a hobby interest over a lifetime, and have a capital asset comprised of collectibles. Retirement cash needs may be funded by the sale of the collection in whole or in part. Collectible capital gains are taxed at a maximum rate of 28%, **not** 20%.

Example 1. Gold Smith collected coins over his lifetime. Gold is retired and wants to take a trip to Europe, and he decides to pay for this trip by selling part of his coin collection. Gold is in the 31% tax bracket. He sells part of his coin collection for $10,000, and he has determined that his basis for this part of his collection is $2,000. Therefore the gain is $8,000. Gold will pay $2,240 (28% × $8,000) federal income tax on that gain, plus any state tax that may apply.

Capital assets and the gains that may be recognized by a taxpayer upon sale is an issue that senior taxpayers must consider. One way a taxpayer may defer tax is to give assets rather than cash to beneficiaries such as children. However, care and thought should be given as to which asset to give away during lifetime and which asset to pass at death.

> **Observation.** Tax practitioners may help clients evaluate sale of other "true" capital assets.

Example 2. Snowy White has been successful in building a closely held family business. Fair market value (FMV) of her shares is $650,000. She owns the majority interest in the company. Her three children own the balance. Snowy has company bonds and debentures that are being paid off as they come due, and these cash flows have been providing Snowy with a supplemental retirement income. Snowy wishes to treat each of her children equitably. However, one son, Bob, has remained with the company and helped to build it to what it is today. Snowy is concerned that if she turns over controlling interest of the business to her children, with Bob receiving the new controlling interest, the bonds and debentures may not be paid in a timely fashion following the transfer. She is concerned that she will not receive the cash needed to maintain her current lifestyle.

Question 2.1. If Snowy sells her stock to her children, what then?

Answer 2.1. If Snowy were to sell her stock to her three children, she would recognize gain on the stock she has held for over one year as long-term capital gains, and the federal tax would be 20%, plus any state tax. Snowy would then have cash to invest and create funds for retirement needs. The control of the company would be in the hands of her children. The issue of paying bonds and debentures in a timely manner needs to be addressed for both the company and Snowy.

Question 2.2. If Snowy gives stock to her children, what then?

Answer 2.2. If Snowy gives her stock to the children, capital gains are not recognized. Snowy's carryover basis becomes the children's basis. However, gifts over the annual gift exclusion ($10,000 for 2001) uses part of the $675,000 (for 2001) applicable exclusion amount. Control is lost similar to a sale, as described in Answer 2.1, with similar questions as to payment of bonds and debentures.

Question 2.3. If Snowy leaves stock to be inherited, what then?

Answer 2.3. If Snowy elects to hold on to her stock and pass it to her children through inheritance upon her death, the stock would receive a basis adjusted to fair market value on date of death. This option provides for possibly the most favorable tax planning for Snowy and her children. Furthermore, Snowy maintains control of the company by her majority ownership, ensuring that bonds and debentures continue to be paid in a timely fashion to provide for retirement needs.

Practitioner Note. Example 2 is simplified to illustrate the planning that should be done for taxpayers who find themselves in similar circumstances. Practitioners can be of invaluable assistance when working with clients who are planning transfers of business ownership. Consideration must be given to the many tax implications present in planning business transfers.

REVERSE MORTGAGES

Senior taxpayers may have increasing needs for cash to pay for living expenses if they are on fixed retirement incomes. Recently, a financial instrument called a *reverse mortgage* has brought a new tool to provide increased cash on a regular basis for persons in need of extra cash.

In the past, taxpayers who wanted to access the equity in their homes and turn it into cash had only two options. The first was to sell, but that meant the taxpayer had to move. The second method was to obtain a home equity loan, but that meant making periodic payments in an already tight cash flow. The reverse mortgage is a new tool that allows taxpayers with equity in their homes to realize cash without having to move or make payments.

A reverse mortgage is a loan against the equity in the taxpayer's home that the taxpayer does not have to pay back as long as the taxpayer lives in the home. The proceeds of the loan may be paid in a lump sum, or by a regular monthly advance, or at times, at an amount that the taxpayer requests. The loan is repaid plus interest when the taxpayer dies, sells the home, or permanently moves from the home.

Who Is Eligible

To be eligible for a reverse mortgage, taxpayers must be at least 62 years of age. Taxpayers must own and occupy the home as their principal residence. Single-family one-unit structures are eligible property for reverse mortgages. Similarly, some programs that offer reverse mortgages will accept up to a four-unit structure if the owner lives in one unit. Likewise condominiums, planned unit developments (PUDs), and manufactured homes are eligible for a reverse mortgage. Generally, cooperatives and mobile homes will not meet the requirements of a reverse mortgage.

How a Reverse Mortgage Works

In general, reverse mortgages do not require repayment of the loan as long as the taxpayer and spouse reside in their principal residence. Reverse mortgages are paid in full, including all charges and accrued interest, when the last surviving borrower dies, sells the principal residence, or moves to another principal residence (typically a long-term care arrangement).

Since the taxpayer does not make payments each month, the amount owed to the lending institution grows larger over the life of the loan. Therefore, as the debt increases, the amount of equity that would be realized upon sale of the principal residence decreases. Taxpayers can never owe more than the value of the principal residence under loan at the time the debt is repaid. This is a safety measure built into the reverse mortgage.

Since the taxpayer still owns the home in which he or she lives, obligations of ownership still exist. Taxpayers must maintain the home in good repair, and pay insurance and property taxes in a timely manner. Should the taxpayer fail to do so, the loan could be called and become payable to the creditor in full.

How Reverse Mortgages Provide Cash Flow

Since taxpayers will never owe to the creditor an amount greater than the value of the home for the total debt, charges, and accrued interest, the amount that can be borrowed is limited by the life expectancy of the borrower(s). Generally, 35 to 55% of the fair market value of equity in the home is available to be used for a reverse mortgage. The older the taxpayer, the greater the amount of equity available to be loaned. The amount that can be borrowed also depends on the type of reverse mortgage a taxpayer chooses. Reverse mortgages are available from both public and private sources. Generally, public sources require specific use of the funds, for example, to make home repairs or pay property taxes. Private sources do not have limitations on the use of loan proceeds.

Reverse mortgages can be paid in lump-sum payment to the taxpayer once the loan is closed. Or, to assist with monthly cash flow for senior citizens, the reverse mortgage can be designed to provide a monthly loan advance. The third option is to have the reverse mortgage arranged as if it were a "credit line," where the taxpayer can choose the loan amount and when it will be advanced. Depending on the product, a combination of the three methods may be employed.

What the Taxpayer Pays for a Reverse Mortgage

As in the case of most loans, there are costs associated with reverse mortgages. Generally, reverse mortgages offered by the public sector have lower loan costs. Costs common to reverse mortgages are application fees that typically cover the appraisal of the property to be mortgaged, and credit report. Other loan costs would include origination fee, insurance, other closing costs, and, if the taxpayer selects a monthly loan advance, possibly a monthly servicing fee applied to the loan.

Taxpayers considering the use of a reverse mortgage to access the equity in their principal residence to provide needed cash flow for retirement funding should evaluate costs of all plans that might be available. Costs associated with reverse mortgages vary greatly across programs.

Other Important Issues with a Reverse Mortgage

If the taxpayer receives Medicaid, Supplemental Security Income (SSI), or any other type of assistance of a public nature with rules similar to Medicaid or SSI, the taxpayer must use the loan advance in the month the loan advance is received. Loan advances from reverse mortgages are treated as "liquid assets." There are limits under public assistance programs as to how much a taxpayer may have in liquid accounts. If the amount goes over the program limit, the taxpayer may lose the benefits of the public assistance program.

Observation. Taxpayers should be aware of the impact of the reverse mortgage on the last borrower's estate and the heirs. The creditor will be paid in full as with every loan.

Income Tax Consequences of a Reverse Mortgage

Funds received by a taxpayer from a reverse mortgage on the taxpayer's principal residence are not taxable to the taxpayer. Loan proceeds are not taxable income by IRS definition.

Example 3. Merle (69) and Linda (65) Jones are retired. They own the home they have lived in for the past 15 years. No debt is against the home; the home's current FMV is $200,000. Recently, the Joneses have developed a need for increased monthly cash flow beyond what their fixed retirement funds are providing. They investigate the reverse mortgage as a tool to help increase monthly cash flow. The Joneses are eligible to use up to 37.2% ($74,410) of their equity as a lump-sum payment. Merle and Linda may also take monthly loan advances against the equity in their home for a term of 21 years. This option will allow for a monthly amount of $565 to be advanced to them ($142,380 over 21 years).

Neither the $74,410 lump sum payment nor the $565 per month is taxable to the Joneses, since they are loan advances under the reverse mortgage program. If Merle and Linda pay out-of-pocket the closing costs at closing, points paid, if any, may be an itemized deduction in the year paid [Treas. Reg. §1.163-10T(j)(2)(I)].

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SCHEDULES A&B (Form 1040) Department of the Treasury Internal Revenue Service (99)	Schedule A-Itemized Deductions (Schedule B is on back) ▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).	OMB No. 1545-0074 2001 Attachment Sequence No. 07
Name(s) shown on Form 1040: Merle & Linda Jones		Your social security number: 111 22 3456

Note. Personal interest is not deductible.			11		
	12	Points not reported to you on Form 1098. See page A-3 for special rules	12	1,116	
	13	Investment interest. Attach Form 4952 if required. (See page A-3.)	13		
	14	Add lines 10 through 13			14

Example 4. From Example 3, Merle and Linda choose to have the monthly loan advance of $565. They continue to reside in the home as their principal residence. Merle passes away three years into the reverse mortgage agreement. Linda continues to live in the home and receive the loan advance payments of $565. Linda dies at the end of the fifth year. The total loan proceeds to Merle and Linda over the five years are $33,900. Interest has accrued at a rate of 7% on the advanced payments. Linda's estate, since she is the last borrower to die, must pay the loan back and any accrued interest. The total that is owed the creditor is $40,444.02, of which $6,544.02 is interest.

Since all the payments to the date of Linda's death were loan advances, there is no taxable income. However, now the loan must be paid back with the accrued interest. The estate may be entitled to the interest deduction of $6,544.02 (assuming that the loan is paid on the date of death).

A second option that might be available is that the interest of $6,544.02 might be deducted as an itemized deduction on Linda's final income tax return as qualified residence interest [I.R.C. §163(h)(3)(A)].

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts 2001

For calendar year 2001 or fiscal year beginning , 2001 and ending , 20 — OMB No. 1545-0092

A Type of entity:	Name of estate or trust (If a grantor type trust, see page 10 of the instructions.)	C Employer identification number
☐ Decedent's estate ☐ Simple trust ☐ Complex trust	Linda Jones Estate	56 1234567 / D Date entity created: June 1, 2001
☐ Grantor type trust ☐ Bankruptcy estate–Ch. 7	Name and title of fiduciary: Bo Jones, Executor	E Nonexempt charitable and split-interest trusts, check applicable boxes (see page 10 of the instructions):
☐ Bankruptcy estate–Ch. 11 ☐ Pooled income fund	Number, street, and room or suite no. (If a P.O. box, see page 10 of the instructions.) 111 Maple	☐ Described in section 4947(a)(1)
B Number of Schedules K-1 attached (see instructions) ▶	City or town, state, and ZIP code: Quincy, IA 74937	☐ Not a private foundation ☐ Described in section 4947(a)(2)

8	Other income. List type and amount	8	
9	**Total income.** Combine lines 1 through 8 ▶	9	
10	Interest. Check if Form 4952 is attached ▶ ☐	10	6,544
11	Taxes	11	

SCHEDULES A&B (Form 1040) Department of the Treasury Internal Revenue Service (99)	Schedule A- Itemized Deductions (Schedule B is on back) ▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).	OMB No. 1545-0074 2001 Attachment Sequence No. 07
Name(s) shown on Form 1040	*Linda Jones*	Your social security number *111 22 3457*

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.		
	1	Medical and dental expenses (see page A-2)	1	
	2	Enter amount from Form 1040, line 34 . 2		
	3	Multiply line 2 above by 7.5% (.075)	3	
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4	
Taxes You Paid (See page A-2.)	5	State and local income taxes	5	
	6	Real estate taxes (see page A-2)	6	
	7	Personal property taxes	7	
	8	Other taxes. List type and amount ▶	8	
	9	Add lines 5 through 8	9	
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	10	*6,544*
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶		

Example 5. Using the same information as in Example 3, after five years, Merle and Linda sell their home and move to a retirement community. Since sale of the principal residence is a condition under which a reverse mortgage is to be repaid, the sale results in the following tax implications. Assuming the house has gained an additional 10% appreciation, the FMV is now $220,000. Merle and Linda net, after sales expenses, $202,400. Basis in the home is $100,000.

The gain of $102,400 is not taxable, as it is excluded up to a maximum value of $500,000 for married taxpayers filing joint returns, or $250,000 for single filers (I.R.C. §121).

The reverse mortgage is paid in full: $33,900 is principal repayment and not deductible, $6,544.02 is accrued interest that is paid at the termination of the mortgage. Merle and Linda may deduct this interest as an itemized item on Schedule A, since they are cash basis taxpayers, and they pay interest at this time on their home equity reverse mortgage loan [I.R.C. §163(h)(3)(A)].

SCHEDULES A&B (Form 1040) Department of the Treasury Internal Revenue Service (99)	Schedule A- Itemized Deductions (Schedule B is on back) ▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).	OMB No. 1545-0074 2001 Attachment Sequence No. 07
Name(s) shown on Form 1040	*Merle & Linda Jones*	Your social security number *111 22 3456*

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.		
	1	Medical and dental expenses (see page A-2)	1	
	2	Enter amount from Form 1040, line 34 . 2		
	3	Multiply line 2 above by 7.5% (.075)	3	
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4	
Taxes You Paid (See page A-2.)	5	State and local income taxes	5	
	6	Real estate taxes (see page A-2)	6	
	7	Personal property taxes	7	
	8	Other taxes. List type and amount ▶	8	
	9	Add lines 5 through 8	9	
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	10	*6,544*
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶		

RETIREMENT ACCOUNT CASH DISTRIBUTIONS

Taxpayers who are receiving payments from retirement accounts, deductible IRAs, SEP IRAs, 401(k)s, pension funds, and so on, receive these cash distributions subject to ordinary tax rates. Two of the major benefits of investing in these type of accounts are the tax deferral of the contribution in the year made, and the tax-deferred growth of the retirement asset account.

Frequently, taxpayers wonder why they may not benefit from preferential capital gains rates of taxation when these retirement account instruments are invested in equities or other capital assets. The answer is simple. The taxpayer has not paid tax on the original contribution, nor has the taxpayer paid tax on the gains that the retirement account has accrued over time. Even though the retirement account has "capital gains" as part of the growth in value, these gains do not retain that character of income to the now retired taxpayer as he or she takes distributions from the accounts. All retirement account distributions are taxed at ordinary income tax rates [I.R.C. §402].

Example 6. Ima Fisching retired from his work at a manufacturing plant at the end of June 2001. Ima begins to withdraw retirement payments from the 401(k) that was part of his benefit package from his former employer. Ima selected that all of his 401(k) funds (both employee and employer contributions) be invested in equities. Over the course of his career, his 401(k) has grown in value above original contributions. His distribution from his 401(k) is expected to be $20,000 annually. All of this income is taxed at ordinary income tax rates.

> **Practitioner Note.** If the pension is fully taxable, do not make an entry in line 16a.

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2001** (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2001, or other tax year beginning , 2001, ending , 20 OMB No. 1545-0074

Label (See instructions on page 19.) **Use the IRS label.** Otherwise, please print or type.

L A B E L H E R E

Your first name and initial	Last name	Your social security number
Ima	*Fisching*	*222 33 4567*
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see page 19. *123 Bass Lane*	Apt. no.	**Important!** You **must** enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 19. *Mackereiel, MI*		

Presidential Election Campaign (See page 19.) **Note.** Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want $3 to go to this fund? You ☐ Yes ☐ No Spouse ☐ Yes ☐ No

If you did not get a W-2, see page 21.

Enclose, but do

13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			13	
14	Other gains or (losses). Attach Form 4797			14	
15a	Total IRA distributions	15a	b Taxable amount (see page 23)	15b	
16a	Total pensions and annuities	16a	b Taxable amount (see page 23)	16b	*20,000*
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			17	
18	Farm income or (loss). Attach Schedule F			18	

RESTITUTION PAYMENTS

Within the Economic Growth and Tax Relief Reconciliation Act of 2001, §803 (not inserted into I.R.C.) provides that Holocaust victims and their heirs receiving restitution payments may exclude these payments from gross income.

II. LONG-TERM CARE INSURANCE

A qualified long-term care (LTC) insurance contract provides coverage only for qualified long-term care services. The contract:

1. Must be guaranteed renewable.
2. Must not provide for a cash surrender value or for other money that can be paid, assigned, pledged, or borrowed.
3. Must provide that refunds, other than refunds upon the death of the insured or complete surrender or cancellation of the contract, and dividends under the contract, must be used only to reduce future premiums or increase future benefits.
4. Generally must not pay or reimburse expenses incurred for services or items that would be reimbursed under Medicare, except where Medicare is a secondary provider, or where the contract makes per diem or other periodic payments without regard to expenses.

Long-term care insurance premiums are deductible as medical expenses subject to the 7.5% of adjusted gross income floor, but the deductions for 2001 are limited further to the following amounts:

Before End of Tax Year	Limit on Deduction for Premium Paid
40 or less	$ 230
41 to 50	$ 430
51 to 60	$ 860
61 to 70	$2,290
71 and above	$2,860

Long-term care insurance that is provided under an employer's plan is typically treated as an accident and health plan, and the value of coverage is excludable from the employee's income.

Per Diem Benefits. Some long-term care insurance contracts pay a specific amount per day, without regard to the actual cost of the long-term care being provided to the patient. This type of benefit can generally be excluded from gross income up to a limit of $200 per day ($73,000 per year) for 2001. The $200 is indexed for inflation. (I.R.C. §7702B).

This limit on the exclusion is ignored if one of the following is true:

1. The actual cost of the long-term care is equal to or more than the per diem payment, even if the per diem exceeds the cap.
2. The taxpayer is terminally ill and has been certified by a physician as having a physical condition that reasonably can be expected to result in death within 24 months of the certification date.

Lifetime Care: Advance Payments. Some retirement homes offer a program whereby an individual pays a lifetime care fee or "founder's fee." The fee is paid either periodically (quarterly, for example), or as a one time payment under an agreement with the retirement home. The part of the payment that is properly allocable to medical care may be claimed as a medical deduction. The agreement must require a specific fee as a condition for the retirement home's promise to provide lifetime care that includes medical care.

> **Practitioner Note.** Generally, medical expenses do not include current payments for medical care to be provided substantially beyond the end of the year. This does not apply, however, in situations where future care is purchased in connection with obtaining lifetime care as described above.

Example 7. Jake Marley purchased a long-term care insurance contract from Wecoveryou Insurance Company early in 1997. Under the terms of the policy, $110 per day was to be paid for any day that he was a nursing home resident. This is a per diem type policy, and the $110 per day benefit is to be paid without regard to the actual nursing home expenses incurred.

Jake became ill in 2001 and was certified by his physician in August of 2001 as **chronically ill** due to a disease (Alzheimer's) that resulted in severe cognitive impairment. He entered Stayewithus Nursing Home on September 26, 2001, and remained there through December 31, 2001. In January 2002 he received a Form 2001 1099-LTC from the Wecoveryou Insurance Company, showing a total paid amount of $7,260 in long-term care benefits.

The insurer paid benefits for the 97 days Jake was in the nursing home in 2001 as follows:

Benefit Month	Days	Rate	Paid	Benefits Check Date
September	5	$110	$ 550	November 5, 2001
October	31	$110	$3,410	November 22, 2001
November	30	$110	$3,300	December 22, 2001
Box 1 on 2001 1099-LTC			$7,260	
December	31	$110	$3,410	January 22, 2002

Jake paid the nursing home a regular rate of $125 per day as follows:

Month	Days	Rate	Paid	Date Paid
September	5	$125	$ 625	September 30, 2001
October	31	$125	$3,875	October 15, 2001
November	30	$125	$3,750	November l5, 2001
December	31	$125	$3,875	December l5, 2001
Total 2000 payments			$12,125	

Jake is 58 years old as of December 31, 2001. He paid premiums of $2,500 to Wecoveryou Insurance Company during 2001. Refer to the completed 2001 Form 8853 (Section C only).

Form 8853 (2001) Attachment Sequence No. 39 Page 2

Name of policyholder (as shown on Form 1040) *Jake Marley* | Social security number of policyholder ▶ *333 44 5678*

Section C. Long-Term Care (LTC) Insurance Contracts.
See **Filing Requirements for Section C** on page 7 of the instructions before completing this section.

If more than one Section C is attached, check here . . . ▶ ☐

16a Name of insured ▶ *Jake Marley* **b** Social security number of insured ▶ *333 44 5678*

17 In 2001, did anyone other than you receive payments on a per diem or other periodic basis under a qualified LTC insurance contract covering the insured or receive accelerated death benefits under a life insurance policy covering the insured? . . . ☐ **Yes** ☒ **No**

18 Was the insured a terminally ill individual? . . . ☐ **Yes** ☒ **No**

Note: *If "Yes" and the **only** payments you received in 2001 were accelerated death benefits that were paid to you because the insured was terminally ill, skip lines 19 through 27 and enter -0- on line 28.*

19	Gross LTC payments received on a per diem or other periodic basis. Enter the total of the amounts from box 1 of all Forms 1099-LTC you received with respect to the insured on which the "Per diem" box in box 3 is checked . . .	**19**	*7,260*
	Caution: *Do **not** use lines 20 through 28 to figure the taxable amount of benefits paid under an LTC insurance contract that is not a **qualified** LTC insurance contract. Instead, if the benefits are not excludable from your income (for example, if the benefits are not paid for personal injuries or sickness through accident or health insurance), report the amount not excludable as income on Form 1040, line 21.*		
20	Enter the part of the amount on line 19 that is from **qualified** LTC insurance contracts . . .	**20**	*7,260*
21	Accelerated death benefits received on a per diem or other periodic basis. Do not include any amounts you received because the insured was terminally ill. See page 6 of the instructions .	**21**	
22	Add lines 20 and 21 . . .	**22**	*7,260*

Note: *If you checked "Yes" on line 17 above, see the instructions for line 17 on page 6 before completing lines 23 through 27.*

23	Multiply $200 by the number of days in the LTC period	**23**	*13,200*
24	Enter the costs incurred for qualified LTC services provided for the insured during the LTC period (see page 6 of the instructions). . .	**24**	*8,250*
25	Enter the **larger** of line 23 or line 24 . . .	**25**	*13,200*
26	Enter the total reimbursements received for qualified LTC services provided for the insured during the LTC period . . .	**26**	

Caution: *If you received any reimbursements from LTC contracts issued before August 1, 1996, see page 7 of the instructions.*

27	Per diem limitation. Subtract line 26 from line 25 . . .	**27**	*13,200*
28	**Taxable payments.** Subtract line 27 from line 22. If zero or less, enter -0-. Also include this amount in the total on Form 1040, line 21. On the dotted line next to line 21, enter "LTC" and the amount . . .	**28**	

Form **8853** (2001)

Calculation of Line 23, Form 8853. The contract period method was used to compute the figure entered on line 23 of the Form 8853 above—the number of days in the LTC multiplied by the allowable amount.

Under this method, the LTC period is the same period the insurance company used under the contract to compute the benefits paid to the insured. Jake's contract computed benefits on a daily basis ($110 for every day he was in the nursing home). Thus, the LTC period for line 23 is the number of days for which the insurer paid during 2001, not necessarily the number of days Jake was in the nursing home.

Box 1 of the 2001 Form 1099-LTC shows that Jake was paid $7,260, or $110 per day, for 66 days in 2001. Therefore, the LTC period (line 23, Form 8853) is 66 days. The entry for line 23 of Form 8853 is calculated as follows:

2001 daily limitation	$ 200
Days in the LTC period	66
Line 23 amount	$13,200

Calculation of Line 24, Form 8853. Line 24 is the cost of qualified long-term care services during the LTC period of 66 days.

Because the payment from the insurer for December 2001 (received in January 2002) was not counted, the amount Jake paid the nursing home for December is also not counted.

Jake paid the regular nursing home rate of $125 per day as follows:

Month	Days	Rate	Paid	Date Paid
September	5	$125	$ 625	September 30, 2001
October	31	$125	$ 3,875	October 5, 2001
November	30	$125	$ 3,750	November 15, 2001
December	31	$125	$ 3,875	December l5, 2001
Total paid for 2000			$12,125	
Less December payment			($3,875)	
Amount for line 24			$ 8,250	

Question 7.1. How much of the 2001 long-term care benefits is taxable on the joint 2001 tax return of Jake and his wife, Judith?

Answer 7.1. None, as shown on line 28 of Form 8853.

Question 7.2. Can Jake and Judith deduct any nursing home related medical expenses on Schedule A of their 2001 joint return?

Answer 7.2. Yes, as shown below, subject to the 7.5% of adjusted gross income floor.

Qualified long-term care premiums—Jake (age 58—see limitations on page 74)	$ 860
Nonreimbursed nursing home expense (see chart below)	+ $1,455
Amount to be included on line 1 of Schedule A	$2,315

The nonreimbursed nursing home expense is calculated as follows:

Line 24, Form 8853	$8,250
Less line 19, Form 8853	(7,260)
Plus Jake's December nursing home expense paid in December	3,875
Less expected insurance reimbursement for December	(3,410)
Total to Schedule A as nonreimbursed nursing home expense	$1,455

Self-Employed Deduction of Long-Term Care Insurance. Senior citizens who continue to work in a self-employed business such as farming may be able to deduct not only medical and health insurance but also long-term care insurance as an adjustment to income on the front of Form 1040. This adjustment is barred if the taxpayer or the taxpayer's spouse is eligible to participate in a subsidized health plan provided as a benefit to employees by the employer. However, the test is applied separately to the medical and health insurance and the long-term care insurance [I.R.C. §162(l)(2)(B)].

Example 8. Frank Furter (66) has retired from his job as a bank executive vice-president. Frank, however, has operated a purebred cattle operation and sells yearling bulls and bred heifers. Frank has developed a good regional reputation and his business is profitable. Franks' wife, Patty, still works as a local schoolteacher. Frank and Patty purchase their medical and health insurance through the school district where Patty is employed. As part of their long-range financial planning, Frank and Patty have purchased a qualified long-term care insurance policy for which they paid $2,300. An LTC policy is **not available** through the school district or as a retirement benefit from the bank.

Question 8.1. Can Frank and Patty deduct the insurance cost of the long-term care policy as self-employed individuals?

Answer 8.1. Yes, applying the code section listed above, Frank and Patty can segregate the premiums that are personally paid and can deduct 60% of the premiums as an adjustment to income (60% of $2,300 = $1,380).

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2001** (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2001, or other tax year beginning , 2001, ending , 20 OMB No. 1545-0074

Label (See instructions on page 19.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial: *Frank*	Last name: *Furter*	**Your social security number**: *444 55 6789*
If a joint return, spouse's first name and initial: *Patty*	Last name: *Furter*	**Spouse's social security number**: *444 55 6790*
Home address (number and street). If you have a P.O. box, see page 19.: *At Home 105*	Apt. no.	**Important!** You **must** enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.: *Alone, NC*		

Presidential Election Campaign (See page 19.) **Note.** Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want $3 to go to this fund? ▶ You ☐ Yes ☐ No Spouse ☐ Yes ☐ No

Adjusted Gross Income

23	IRA deduction (see page 27)	23	
24	Student loan interest deduction (see page 27)	24	
25	Archer MSA deduction. Attach Form 8853	25	
26	Moving expenses. Attach Form 3903	26	
27	One-half of self-employment tax. Attach Schedule SE	27	
28	Self-employed health insurance deduction (see page 29)	28	*1,380*
29	Self-employed SEP, SIMPLE, and qualified plans	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶	31a	
32	Add lines 23 through 31a	32	
33	Subtract line 32 from line 22. This is your **adjusted gross income** ▶	33	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 56. Cat. No. 11320B Form **1040** (2001)

Practitioner Note. Self-employed individuals, partners, and greater-than-2% shareholders of S corporations may deduct 60% of health insurance in 2001, 70% in 2002, and 100% in 2003.

Long-term care insurance policies that are provided as benefits to employees and/or shareholders follow the same rules under I.R.C. §§105 and 106 as health and medical insurance policies.

Who Should Have Long-term Care Insurance? Frequently, income tax practitioners are asked to give planning advice to their clients. During these opportunities, the practitioner may play the role of a "sounding board" and offer suggestions as the client "thinks out loud." The issue of who should have long-term care insurance, and the corresponding financial ramifications to the client, may fall outside of the professional "comfort zone" of the practitioner.

Long-term care insurance is available in many forms, with many options, at various price levels. The financial decision that must be made by the taxpayer is how much risk the taxpayer is willing to accept, and what coverage, if any, can the taxpayer afford. The tax practitioner can explain the tax benefits of long-term care insurance.

Example 9. Granny Brown is a widow who has three children. Lucy the eldest has recently separated from her husband, has gone back to work, and lives in a four-bedroom home with her two children (ages 12 and 14). Jim lives several states away. Nellie, the youngest, is happily married and lives with her three young children in a small but comfortable three-bedroom home. Granny has fallen and broken her hip due to oesteoporosis and requires a long recuperation with medical care. Granny has nearly $80,000 in savings and a comfortable retirement income, thanks to her late husband's life insurance and pension.

The family does not want to put Granny into a nursing home. However, in-home nursing care will seriously deplete Granny's savings during the recovery period. Furthermore, Medicare will not cover many of the medical expenses in full.

One solution is to have Granny move into Lucy's house and hire a private medical aide for the daytime hours. This is not a feasible solution because Lucy is struggling with the changes in her personal life, and the responsibility of an injured parent is more than she is willing to take on.

Jim lives too far away to be of any assistance in the physical care of his mother; he can only offer "moral support" to his sisters.

Nellie, likewise, is unable to accommodate her mother at her home since there is not room for her. The children are greatly distressed at the remaining prospect. Placing Granny in a long-term care facility goes against family values and promises made long ago to Dad.

A long-term care facility is seemingly the only solution that will provide for proper recovery of Granny's injury. However, it comes at a financial burden that has the potential to consume many of the assets and savings that Granny and her late husband have accumulated.

This scenario is not uncommon and illustrates some of the conflicts and issues that families face today regarding long-term care. The authors of this text include this example only for illustrative purposes in conjunction with the discussion of tax issues regarding long-term care insurance. The family must come to some conclusion as to how long-term care insurance fits into the family's financial plans before and after tax considerations.

TRANSFERRING ASSETS AND LONG-TERM CARE ASSISTANCE

Clients often ask their tax preparers about transferring assets in order to qualify for medical assistance. Transfers can be made for this purpose, but the rules that govern such transfers are complex. Both state and federal laws must be studied before a preparer can give good advice on such transfers. That discussion is beyond the scope of these materials.

III. PAYING AND REPORTING FOR IN-HOME AIDES FOR MEDICAL AND PERSONAL SERVICES

Rather than moving into a long-term care facility that provides both medical and residential services, many senior citizen taxpayers hire private-duty nurses to provide required medical services in their homes. If the services provided are those that a medical nurse performs, the wages, employment taxes, employee benefits, and related expenses qualify as a medical expense that may be deducted on Schedule A (Form 1040). These expenses are deductible even if the person performing the services is not professionally licensed. If the individual hired also performs housekeeping and other personal services, the associated costs must be allocated as to deductible and nondeductible expenses.

Senior taxpayers employing medical aides in the home must file annual returns for the medical aide's service employment taxes on a calendar-year basis on or before April 15 of the year following the year in which the services were performed (I.R.C. §3510(a)(1 & 2). This may be more familiar to tax practitioners as the "Nanny tax." The employing senior citizen must report withheld income and employment taxes on Schedule H (Form 1040) and attach it to his or her individual income tax return. Likewise, employing senior citizens must have an employer identification number (EIN), which may be obtained by using Form SS-4.

The dollar amount threshold for payment of FICA and FUTA taxes is $1,300 for 2001. This amount is inflation adjusted annually in increments of $100 [I.R.C. §3121(a)(7)].

Practitioner Note. The dollar amount threshold applies to each medical aide separately. Therefore, if the senior citizen employs three separate individuals as in-house aides and pays each $1,200, no FICA tax is due for any of the three.

Practitioner Note. If medical aide services are performed in the home of a senior citizen by an individual under the age of 18, and the medical service is not the principal occupation of that employee, wages earned are not subject to FICA tax [I.R.C. §3121(b)(21)].

Annual Form 940 (FUTA) is not required to be filed for medical aides employed in the home of the taxpayer. There is no requirement that home-based employers make deposits (monthly or quarterly) of medical aide service employment taxes (I.R.C. §6157).

Medical aides come under the "Domestic service employment" category. Employment taxes for these persons are: (a) any FICA and FUTA taxes owed on the payment for services made by the employer and (b) any income tax on these payments that are withheld under I.R.C. §3402(p), the voluntary withholding agreement rules.

The senior taxpayer who employs a medical aide in his or her home is required to provide a Form W-2 to that employee. The Form W-2 reports wages subject to Social Security (FICA) taxes to the employee and appropriate governmental agencies. Employers must use Form W-3 (transmittal form) to file even one W-2.

Example 10. Jack B. Nymble requires medical assistance during a three-month recovery period from a recent accident. Jack decides against going to live in a long-term care facility during the recovery period. Jack hires a professional medical worker to perform the needed assistance per his doctor's orders. Jack agrees to hire the services of a medical aide, Yew R. Well. Jack will pay $2,000 per month in wages, plus the employer's FICA and FUTA taxes.

Question 10.1. Is Jack required to file Schedule H?

Answer 10.1. Yes, Jack has paid Yew R. Well over $1,300 per year, making the wages subject to FICA and FUTA tax, which he agreed to pay.

SCHEDULE H (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Household Employment Taxes

(For Social Security, Medicare, Withheld Income, and Federal Unemployment (FUTA) Taxes)

▶ **Attach to Form 1040, 1040NR, 1040NR-EZ, 1040-SS, or 1041.**

▶ **See separate instructions.**

OMB No. 1545-0074

2000

Attachment Sequence No. **44**

Name of employer: *Jack B. Nymble*

Social security number: *999 88 7654*

Employer identification number: *41 0234567*

A Did you pay **any one** household employee cash wages of $1,200 or more in 2000? (If any household employee was your spouse, your child under age 21, your parent, or anyone under age 18, see the line A instructions on page 3 before you answer this question.)

☒ **Yes.** Skip lines B and C and go to line 1.
☐ **No.** Go to line B.

B Did you withhold Federal income tax during 2000 for any household employee?

☐ **Yes.** Skip line C and go to line 5.
☐ **No.** Go to line C.

C Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 1999 or 2000 to household employees? (**Do not** count cash wages paid in 1999 or 2000 to your spouse, your child under age 21, or your parent.)

☐ **No.** **Stop.** Do not file this schedule.
☐ **Yes.** Skip lines 1-9 and go to line 10 on the back.

Part I Social Security, Medicare, and Income Taxes

1	Total cash wages subject to social security taxes (see page 3)	1	*6,000*		
2	Social security taxes. Multiply line 1 by 12.4% (.124)			2	*744*
3	Total cash wages subject to Medicare taxes (see page 3)	3	*6,000*		
4	Medicare taxes. Multiply line 3 by 2.9% (.029)			4	*174*
5	Federal income tax withheld, if any			5	
6	**Total social security, Medicare, and income taxes** (add lines 2, 4, and 5)			6	*918*
7	Advance earned income credit (EIC) payments, if any			7	
8	**Net taxes** (subtract line 7 from line 6)			8	*918*

9 Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 1999 or 2000 to household employees? (**Do not** count cash wages paid in 1999 or 2000 to your spouse, your child under age 21, or your parent.)

☐ **No.** **Stop.** Enter the amount from line 8 above on Form 1040, line 56. If you are not required to file Form 1040, see the line 9 instructions on page 4.

☐ **Yes.** Go to line 10 on the back.

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 12187K **Schedule H (Form 1040) 2000**

Part II Federal Unemployment (FUTA) Tax

			Yes	No
10	Did you pay unemployment contributions to only one state?	10		
11	Did you pay all state unemployment contributions for 2000 by April 15, 2002? Fiscal year filers, see page 4	11		
12	Were all wages that are taxable for FUTA tax also taxable for your state's unemployment tax?	12		

Next: If you checked the **"Yes"** box on **all** the lines above, complete Section A.
If you checked the **"No"** box on **any** of the lines above, skip Section A and complete Section B.

Section A

13	Name of the state where you paid unemployment contributions ▶ NC				
14	State reporting number as shown on state unemployment tax return ▶ 78274				
15	Contributions paid to your state unemployment fund (see page 4)	15	360		
16	Total cash wages subject to FUTA tax (see page 4)			16	6,000
17	**FUTA tax.** Multiply line 16 by .008. Enter the result here, skip Section B, and go to line 26			17	48

Section B

18 Complete all columns below that apply (if you need more space, see page 4):

(a) Name of state	(b) State reporting number as shown on state unemployment tax return	(c) Taxable wages (as defined in state act)	(d) State experience rate period From	(d) To	(e) State experience rate	(f) Multiply col. (c) by .054	(g) Multiply col. (c) by col. (e)	(h) Subtract col. (g) from col. (f). If zero or less, enter -0-.	(i) Contributions paid to state unemployment fund

19	Totals			19	
20	Add columns (h) and (i) of line 19	20			
21	Total cash wages subject to FUTA tax (see the line 16 instructions on page 4)			21	
22	Multiply line 21 by 6.2% (.062)			22	
23	Multiply line 21 by 5.4% (.054)	23			
24	Enter the **smaller** of line 20 or line 23			24	
25	**FUTA tax.** Subtract line 24 from line 22. Enter the result here and go to line 26			25	

Part III Total Household Employment Taxes

26	Enter the amount from line 8	26	918
27	Add line 17 (or line 25) and line 26	27	966

28 Are you required to file Form 1040?

☐ **Yes.** **Stop.** Enter the amount from line 27 above on Form 1040, line 56. **Do not** complete Part IV below.

☐ **No.** You may have to complete Part IV. See page 4 for details.

Other Taxes

53	Self-employment tax. Attach Schedule SE	53	
54	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	54	
55	Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required	55	
56	Advance earned income credit payments from Form(s) W-2	56	
57	Household employment taxes. Attach Schedule H	57	966
58	Add lines 52 through 57. This is your **total tax** ▶	58	

Question 10.2. Is Jack required to file a Form W-2 for Yew R. Well?

Answer 10.2. Yes, See Form W-2 and W-3 for Yew R. Well and Jack B. Nymble respectively.

3

a Control number		OMB No. 1545-0008	
b Employer identification number 41-0234567		1 Wages, tips, other compensation 6,000	2 Federal income tax withheld 0
c Employer's name, address, and ZIP code Jack B. Nymble 100 Happy Wonder, NC		3 Social security wages 6,000	4 Social security tax withheld 372
		5 Medicare wages and tips 6,000	6 Medicare tax withheld 87
		7 Social security tips	8 Allocated tips
d Employee's social security number 888-77-6543		9 Advance EIC payment	10 Dependent care benefits
e Employee's first name and initial Last name Yew R. Well 101 Hopefull Wonder, NC		11 Nonqualified plans	12a Code
		13 Statutory employee / Retirement plan / Third-party sick pay	12b Code
		14 Other	12c Code
f Employee's address and ZIP code			12d Code

15 State Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
	6,000				

Form **W-2** **Wage and Tax Statement** 2001

Department of the Treasury—Internal Revenue Service

Copy 1 For State, City, or Local Tax Department

DO NOT STAPLE OR FOLD

a Control number	33333	For Official Use Only ► OMB No. 1545-0008	
b Kind of Payer: 941 ☐ Military ☐ 943 ☐ CT-1 ☐ Hshld. emp. ☐ Medicare govt. emp. ☐ Third-party sick pay ☐		1 Wages, tips, other compensation $ 6,000	2 Federal income tax withheld $
		3 Social security wages $ 6,000	4 Social security tax withheld $ 372
c Total number of Forms W-2	d Establishment number	5 Medicare wages and tips $ 6,000	6 Medicare tax withheld $ 87
e Employer identification number 41-0234567		7 Social security tips $	8 Allocated tips $
f Employer's name Jack B. Nymble		9 Advance EIC payments $	10 Dependent care benefits $
100 Happy Lane Wonder, NC		11 Nonqualified plans $	12 Deferred compensation $
		13 For third-party sick pay use only	
g Employer's address and ZIP code		14 Income tax withheld by payer of third-party sick pay $	
h Other EIN used this year			
15 State Employer's state ID number		16 State wages, tips, etc. $ 6,000	17 State income tax $
		18 Local wages, tips, etc. $	19 Local income tax $
Contact person		Telephone number ( )	For Official Use Only
E-mail address		Fax number ( )	

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature ► Title ► Date ►

Form **W-3** **Transmittal of Wage and Tax Statements** 2001

Department of the Treasury Internal Revenue Service

Send this entire page with the entire Copy A page of Form(s) W-2 to the Social Security Administration. Photocopies are not acceptable.

IV. SOCIAL SECURITY BENEFITS

Practitioner Note. This discussion addresses monthly survivor and disability benefits and the equivalent railroad retirement benefits. Supplemental security income payments (SSI) are not taxable and are not considered part of the formula when determining the taxable portion of social security benefits. See the Retirement chapter for further discussion of social security benefits.

Social security benefits are taxed under a two-tier system that taxes up to 50% of the benefits the taxpayer's **combined income** exceeding the first threshold and up to 85% of the benefits of the taxpayer's combined income exceeding a second, higher threshold.

For purposes of calculating taxes on social security benefits, combined income is the sum of two figures:

1. The taxpayer's modified adjusted gross income
2. 50% of the taxpayer's social security benefits

Modified adjusted gross income is the taxpayer's adjusted gross income with the following modifications.

1. The following exclusions are not allowed:
   a. Income from U.S. savings bonds used to pay higher education tuition and fees (I.R.C. §135)
   b. Employer-paid qualified adoption expenses (I.R.C. §137)
   c. Foreign-earned income (I.R.C. §911)
   d. Income from sources within Guam, American Samoa, the Northern Mariana Islands, and Puerto Rico (I.R.C. §§931 and 933)
2. The deduction for interest paid on qualified student loans is not allowed.
3. Tax-exempt interest is included.

The thresholds for 2001 vary by the taxpayer's filing status as follows:

Filing Status	If Combined Income is:	Then up to:
Single	More than $25,000	50% of benefits are taxable but not more than $34,000
	More than $34,000	85% of benefits are taxable
Married filing jointly	More than $32,000	50% of benefits are taxable but not more than $44,000
	More than $44,000	85% of benefits are taxable
Head of household	More than $25,000	50% of benefits are taxable but not more than $34,000
	More than $34,000	35% of benefits are taxable
Married filing separately*	More than $25,000	50% of benefits are taxable but not more than $34,000
	More than $34,000	85% of benefits are taxable

*If taxpayers who are married filing separately live together at any time during the year, then the threshold is zero. Consequently, up to 85% of social security benefits are included in taxable income.

If a taxpayer's combined income exceeds the 50% threshold but not the 85% threshold listed above, then the taxpayer must include in taxable income the lesser of the following:

1. 50% of social security benefits, or
2. 50% of the amount by which combined income exceeds the 50% threshold

If the taxpayer's combined income exceeds the 85% threshold listed above, then the taxpayer must include in taxable income the lesser of the following:

1. 85% of social security benefits, or
2. The sum of the following:
   a. 50% of the amount by which the 85% threshold exceeds the 50% threshold
   b. 85% of the amount by which combined income exceeds the 85% threshold

Tiered System Increases Marginal Tax Rate. Since the taxability of social security benefits is dependent on other income, some taxpayers are surprised to find that a relatively small amount of additional income pushes them over the threshold for taxing social security benefits and increases the incremental rate of tax.

Example 11. Anne A. Belle (66) is single and receives $1,000 per month in social security benefits in 2001. She prepared for her retirement by investing in an IRA, from which she draws $1,500 per month. At this income level, her social security will not be taxed since the $18,000 IRA distribution plus 50% of her social security ($6,000) equals $24,000, which is **below** the threshold for taxing her social security.

Anne's 2001 federal income tax is $1,421 as shown below.

Adjusted gross income (IRA distributions)	$18,000
Standard deduction plus additional $1,100	(5,650)
Personal exemption deduction	(2,900)
Taxable income	$ 9,450
Income tax from Tax Table	$ 1,421

Example 12. Assume the same facts as in Example 11 except that now Anne also has Series EE savings bonds that matured. She cashes them and receives $10,000 of interest income.

The calculation to determine if any of her social security benefits will be taxed has a different result. **Anne's combined income is $9,000 over the 50% threshold as shown below.**

IRA distribution	$18,000
Savings bond interest	10,000
50% of social security benefits	6,000
Combined income	$34,000
Less: 50% threshold	(25,000)
Excess over threshold	$ 9,000

Fifty percent of that excess ($4,500) is added to taxable income. Therefore, Anne's 2001 federal income tax is $3,596 as shown below.

IRA distribution	$18,000
Savings bond interest	10,000
Taxable social security benefits	4,500
Adjusted gross income	$32,500
Standard deduction	(5,650)
Personal exemption deduction	(2,900)
Taxable income	$23,950
Income tax from Tax Table	$ 3,596

Observation. The additional $10,000 of interest income increased Anne's taxes by $2,175 ($3,596–$1,421). **Even though Anne is in the 15% bracket, the effective marginal tax rate on the additional $10,000 is over 21%!**

LUMP-SUM PAYMENTS FOR RETROACTIVE SOCIAL SECURITY BENEFITS

The taxable part of a lump-sum (retroactive) payment of benefits received in 2001 is included in 2001 income, even if the payment includes benefits for an earlier year.

Practitioner Note. Don't confuse this lump-sum benefit payment with the lump-sum death benefit paid by social security to the surviving spouse. That death benefit is not taxable.

Election To Report as Earlier Year. Generally, a taxpayer's 2001 income is used to calculate the taxable part of the total benefits received in 2001. However, **the taxable part of a lump-sum payment for an earlier year may be calculated separately, using the taxpayer's income for the earlier year.** A taxpayer can elect this method if it **lowers** his or her taxable social security benefits.

Under the lump-sum election method, the taxable part of the taxpayer's benefits for the earlier year (including the lump-sum payment) is calculated using that year's income. Then any taxable benefits for that year that were previously reported are subtracted. The remainder is the taxable part of the lump sum payment and is added to the taxable part of social security benefits for 2001.

Practitioner Note. Since the earlier year's taxable benefits are included in 2001 income, no adjustment is made to the earlier year's return. Do not file an amended return for the earlier year.

Worksheets for this calculation are available in IRS Publication 915, *Social Security and Equivalent Railroad Retirement Benefits*. The lump-sum election can be revoked only with the consent of the Internal Revenue Service. Form SSA-1099 shows the lump-sum payment broken down by the applicable years for the settlement. Form RRB-1099 does not show a breakdown by year. Contact the Railroad Retirement Board for the appropriate amount per year.

See the Retirement chapter for a comprehensive example on lump-sum payments of retroactive social security benefits.

REPAYMENTS MORE THAN GROSS BENEFITS

In some situations, Form SSA-1099 or Form RRB-1099 will show that the total benefits repaid (box 4) are more than the gross benefits (box 3) received. If this occurs, the net benefits in box 5 will be a negative figure, and none of the benefits will be taxable. If the taxpayer receives more than one form, a negative figure in box 5 of one form is used to offset a positive figure in box 5 of another form for that same year. If a joint return is filed, the negative and positive figures in box 5 from both spouses' Forms SSA-1099 or Forms RRB-1099 are netted.

Repayment of Benefits Received in an Earlier Year. If the total amount (shown in box 5) of the combination of all a taxpayer's (and spouse's if a joint return) benefits is a negative figure, the taxpayer can take an itemized deduction for the amount of the negative figure that represents benefits included in gross income in an earlier year.

If this deduction is $3,000 or less, it is subject to the 2%-of-adjusted-gross-income limit and is claimed on line 22 of Schedule A (Form 1040).

If the deduction is more than $3,000, the tax should be calculated in two ways:

1. Calculate the tax for 2000 with the itemized deduction. This more-than-$3,000 deduction is not subject to the 2%-of-adjusted-gross-income limit that applies to certain other miscellaneous itemized deductions.
2. Calculate the tax for 2000 as follows:
   - **a.** Figure the tax without the itemized deduction.
   - **b.** For each year after 1983 for which part of the negative figure represents a repayment of benefits, refigure taxable benefits as if the taxpayer's total benefits for the year were reduced by that part of the negative figure. Then recalculate the tax for that year.
   - **c.** Subtract the total of the recalculated tax amounts in (b) from the total of the actual tax.
   - **d.** Subtract the result in (c) from the result in (a).

Compare the tax calculated in methods (1) and (2). The tax for 2001 is the smaller of the two amounts. If method (1) results in less tax, take the itemized deduction on line 27, Schedule A (Form 1040). If method (2) results in less tax, claim a credit for the applicable amount—the amount calculated in 2(c)—on line 63 of Form 1040 and write "I.R.C. §1341" in the margin to the left of line 63. If both methods produce the same tax, deduct the repayment on line 27, Schedule A (Form 1040).

> **Practitioner Note.** See page 305 in the 1996 Farm Income Tax Workbook for an example of this issue.

RAILROAD RETIREMENT BENEFITS

Part of the tier 1 railroad retirement benefits are treated the same as Social Security benefits. They are the part of tier 1 benefits that a railroad employee or beneficiary would have been entitled to receive under the social security system. They are commonly called the social security equivalent benefit (SSEB) portion of tier 1 benefits.

The Form RRB-1099 reports as separate items both the SSEB portion and the other portion of railroad retirement benefits, which is taxed as normal retirement income.

VOLUNTARY WITHHOLDING

Taxpayers who receive social security benefits or tier 1 railroad retirement benefits may request that federal income tax be withheld by completing Form W-4V, Voluntary Withholding Request.

The taxpayer may choose to have federal income tax withheld at 7%, 15%, 28%, or 31% of benefits received. The form is filed with the payer of the benefits.

UNDER 65—EARNINGS STILL RESTRICTED FOR 2001

Although the earnings cap for those working and drawing social security benefits was eliminated as of January 2000 for those age 65 and over, the restriction still applies to workers under age 65.

In 2001, a retiree under 64 years old may earn $890 a month ($10,680 a year) without affecting social security benefits. Taxpayers under 64 lose $1 of benefits for every $2 of earnings above the ceiling.

During the months a retiree is 64 **in the year** the retiree turns 65 he or she can earn income of $2,084 per month ($25,000 a year). There is no longer a limit on earnings beginning the month the retiree turns 65.

WHEN IS A TAXPAYER CONSIDERED TO BE AGE 65?

A taxpayer must be age 65 or over to receive various tax benefits intended for older Americans. Taxpayers are considered 65 on the day **before** their 65th birthday.

Example 13. A taxpayer born January 1, 1937 will actually "turn 65" on January 1, 2002. However, for federal income tax purposes, that taxpayer is considered to be 65 as of December 31, 2001—and eligible for the benefits available to older taxpayers on his or her 2001 federal income tax return.

Special Payments after Retirement. In some cases, special payments are received for work done prior to the time that the individual began drawing benefits. Usually these payments do not affect benefits if the Social Security Administration knows that the payments are for work done prior to retirement. Bonuses, vacation pay, commissions, accumulated sick pay, and carryover crops might fall in this category. Although such payments are taxable for federal income tax purposes, they normally do not count as earned income toward the earnings limit for drawing full benefits.

To eliminate confusion concerning carryover grain sales made by retired farmers, the following rule has been established:

Grain sales are excluded from earnings from self-employment for purposes of reducing social security benefits if both of the following conditions are met:

1. The grain was produced and in storage before or during the first month the individual begins drawing benefits.
2. The grain is sold in a year after the first year the individual draws social security benefits [see 20 CFR 404.429(b)(2)(ii)(A)].

> **Practitioner Note.** These carryover grain sales must be reported on Schedule F (Form 1040) and are subject to self-employment tax. Similarly, the rules apply to self-employed professionals relative to accounts receivable that are collected following retirement.

WHEN WILL TAXPAYERS BE ELIGIBLE TO DRAW FULL BENEFITS?

If a taxpayer was born in 1937 or earlier, he or she is part of the last group of people who can retire with full benefits at age 65.

Worker Born in:	Age to Collect Full Benefits:
1938	65 years, 2 months
1939	65 years, 4 months
1940	65 years, 6 months
1941	65 years, 8 months
1942	65 years, 10 months
1943 through 1954	66 years, 0 months
1955	66 years, 2 months
1956	66 years, 4 months
1957	66 years, 6 months
1958	66 years, 8 months
1959	66 years, 10 months
1960 and later	67 years, 0 months

QUICK POINTS ON SOCIAL SECURITY

Timing of benefit checks. Individuals already receiving benefits prior to May 1997 are paid on the third of the month. If the third falls on a Saturday, Sunday, or Monday holiday, the payment is made on the preceding Friday. For individuals who begin drawing benefits after April 1997, checks are paid based on the birth date of the individual on whose account the checks are based.

Date of Birth:	Benefits Paid on:
1st–10th	Second Wednesday
11th–20th	Third Wednesday
21st–31st	Fourth Wednesday

1. Social security provides the equivalent of a $198,000 disability policy and a $313,000 life insurance policy for the average earner with a family of four.
2. The average monthly Social Security benefits being received for 2001 are:

Retired worker	$ 845
Retired worker & spouse	1,410
Disabled worker	786
Disabled worker, spouse, & children	1,310
Widow(er) of worker	811
Widow(er) with two children	1,696

3. The social security toll-free number is: 800-772-1213.

Wage earners and self-employed individuals earn one-quarter credit for each $830 of earnings in 2001, for up to four quarters per year.

V. MEDICARE BENEFITS

MEDICARE BASICS

The Health Care Financing Administration (HCFA) administers Medicare, the nation's largest health insurance program, which covers 39 million Americans.

Medicare is a health insurance program for people 65 years of age and older, some disabled people under 65 years of age, and people with end-stage renal disease (permanent kidney failure treated with dialysis or a transplant). Medicare coverage includes Part A (Hospital Insurance) and Part B (Medical Insurance). Taxpayers should account for medical expenses that were not reimbursed by or paid by Medicare or third-party health insurance that may allow a medical deduction subject to the 7.5% floor on Schedule A.

Part A (Hospital Insurance) covers the following:

Hospital stays. Semiprivate room, meals, general nursing, and other hospital services and supplies.

The patient is responsible for

- First $792 as a deductible for a hospital stay of 1–60 days
- $198 per day for days 61–90 of a hospital stay
- $396 per day for days 91–150 of a hospital stay
- All costs for each day beyond 150 days

Skilled nursing facility care. Semiprivate room, meals, skilled nursing, rehabilitative services, and other services and supplies (after a three-day hospital stay).

The patient is responsible for

- No additional charge for the first 20 days
- Up to $99 per day for days 21–100
- All costs beyond the hundredth day in the benefits period

Home health care. Part-time skilled nursing care, physical therapy, speech-language therapy, home health aide services, and durable medical equipment and supplies.

The patient is responsible for

- No additional charge for home health care services
- 20% of approved amount for durable medical equipment

Hospice care. Medical and support services from a Medicare-approved hospice, drugs for symptom control and pain relief, short-term respite care, and care in a hospice facility, hospital, or nursing home when necessary.

The patient is responsible for

- A co-payment of up to $5 for outpatient prescription drugs and 5% of the Medicare payment amount for inpatient respite care (short-term care given to a hospice patient by another care-giver so that the usual caregiver can rest)

Blood. Given at a hospital or skilled nursing facility during a covered stay.

The patient is responsible for

- The first three pints of blood

Part B (Medical Insurance) covers the following:

Medical and other services. Doctor's services (except for routine physical exams), outpatient medical and surgical services and supplies, diagnostic tests, ambulatory surgery center facility fees for approved procedures and durable medical equipment, and outpatient physical and occupational therapy including speech-language therapy and mental health services.

The patient is responsible for:

- $100 deductible (paid once per calendar year)
- 20% of approved amount after the deductible, except in the outpatient setting
- 20% for all outpatient physical and speech therapy services and 20% for all outpatient occupational therapy services
- 50% for most outpatient mental health services

Clinical laboratory services. Blood, urinalysis, and so on.

The patent is responsible for

- No additional charge for services

Home health care. Part-time skilled care, home health aide services, durable medical equipment when supplied by a home health agency while getting Medicare-covered home health care, and other supplies and services.

The patient is responsible for

- No additional charge for services
- 20% of approved amount for durable medical equipment

Outpatient hospital services. Services for the diagnosis or treatment of an illness or injury.

The patient is responsible for

- 20% of the charged amount (after the deductible); during the year 2000, this will be changed to a set co-payment amount

Blood. Pints of blood needed as an outpatient, or as part of a Part B-covered service.
The patient is responsible for

- The first three pints of blood, then 20% of the approved amount for additional pints of blood (after the deductible)

VI. TAX CREDITS

CREDIT FOR THE ELDERLY OR DISABLED

The credit for the elderly or disabled is for low-income taxpayers age 65 or older, or for permanently and totally disabled persons.

The credit is claimed by filing Schedule R, Credit for the Elderly or Disabled. Nontaxable social security must be less than $7,800 for married filing jointly if both spouses are eligible. Adjusted gross income may not exceed the following:

Filing Status	Amount
Single, Head of Household, Qualifying Widow(er)	$17,500
Married Filing Jointly (one spouse eligible)	20,000
Married Filing Jointly (both spouses eligible)	25,000
Married Filing Separately (lived apart entire year)	12,500

Who Qualifies for the Credit?

1. Persons age 65 or older.
2. Persons under 65 who are retired because of permanent and total disability and meet the following criteria:
   a. Received taxable disability income
   b. Did not reach mandatory retirement age before the tax year (mandatory retirement age is the age set by the employer at which the individual would have had to retire had he or she not been disabled)
3. Must be a U.S. citizen or resident (in most cases)
4. If married at the end of the year, must normally file a joint return, unless the taxpayers did not live together at any time during the year

What is Permanent and Total Disability? A taxpayer is permanently and totally disabled if he or she cannot engage in any substantial gainful activity because of a physical or mental condition. A physician must certify that the condition has lasted or can be expected to last continuously for 12 months, or that the condition can be expected to result in death.

What is Substantial Gainful Activity? Substantial gainful activity is the performance of significant duties over a reasonable period of time while working for pay or profit, or in work generally done for pay. Full-time work (or part-time work done at the employer's convenience) in a competitive work situation for at least the minimum wage conclusively shows that the taxpayer is able to engage in substantial gainful activity.

Substantial gainful activity is not work the taxpayer does to take care of himself or herself or to take care of the taxpayer's home. It is not unpaid work on hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities. However, doing this kind of work may show that the taxpayer is able to engage in substantial gainful activity.

Example 14: Miss Ima Jean Teacher (69) is a retired school teacher. Her income is derived from the following:

- $1,000 interest
- $11,000 teacher's retirement
- ($3,000) capital loss from sale of a mutual fund
- $2,400 social security benefits

See completed Schedule R. Miss Teacher has a maximum credit of $278. Miss Teacher's taxable income is $450 and her income tax liability is $45, which is "paid" by the Credit for the Elderly. The balance is not refundable.

Schedule R
(Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Credit for the Elderly or the Disabled

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule R (Form 1040).**

OMB No. 1545-0074
2001
Attachment Sequence No. **16**

Name(s) shown on Form 1040: *Ima Jean Teacher*

Your social security number: *888 | 66 | 3456*

You may be able to take this credit and reduce your tax if by the end of 2001:

- You were age 65 or older **or**
- You were under age 65, you retired on **permanent and total** disability, and you received taxable disability income.

But you must also meet other tests. See page R-1.

TIP In most cases, the IRS can figure the credit for you. See page R-1.

Part I **Check the Box for Your Filing Status and Age**

If your filing status is:	And by the end of 2001:	Check only one box:
Single, Head of household, or Qualifying widow(er) with dependent child	**1** You were 65 or older **1**	☒
	2 You were under 65 and you retired on permanent and total disability **2**	☐

Schedule R (Form 1040) 2001 Page **2**

Part III **Figure Your Credit**

10 **If you checked (in Part I):** **Enter:**
Box 1, 2, 4, or 7 . . . . $5,000
Box 3, 5, or 6 . . . . $7,500
Box 8 or 9 . . . . $3,750 } **10** *5,000*

Did you check box 2, 4, 5, 6, or 9 in Part I?
Yes ▶ You **must** complete line 11.
No ▶ Enter the amount from line 10 on line 12 and go to line 13.

11 **If you checked:** • Box 6 in Part I, add $5,000 to the taxable disability income of the spouse who was under age 65. Enter the total. • Box 2, 4, or 9 in Part I, enter your taxable disability income. • Box 5 in Part I, add your taxable disability income to your spouse's taxable disability income. Enter the total.	11	
TIP For more details on what to include on line 11, see page R-3.		
12 If you completed line 11, enter the **smaller** of line 10 or line 11; **all others,** enter the amount from line 10	12	*5,000*
13 Enter the following pensions, annuities, or disability income that you (and your spouse if filing a joint return) received in 2001:		
a Nontaxable part of social security benefits and Nontaxable part of railroad retirement benefits treated as social security. See page R-3.	13a	*2,400*
b Nontaxable veterans' pensions and Any other pension, annuity, or disability benefit that is excluded from income under any other provision of law. See page R-3.	13b	
c Add lines 13a and 13b. (Even though these income items are not taxable, they **must** be included here to figure your credit.) If you did not receive any of the types of nontaxable income listed on line 13a or 13b, enter -0- on line 13c	13c	*2,400*
14 Enter the amount from Form 1040, line 34	14	*9,000*
15 **If you checked (in Part I):** **Enter:** Box 1 or 2 . . . $7,500; Box 3, 4, 5, 6, or 7 . . . $10,000; Box 8 or 9 . . . $5,000	15	*7,500*
16 Subtract line 15 from line 14. If zero or less, enter -0-	16	*1,500*
17 Enter one-half of line 16	17	*750*
18 Add lines 13c and 17	18	*3,250*
19 Subtract line 18 from line 12. If zero or less, **stop;** you **cannot** take the credit. Otherwise, go to line 20	19	*1,850*
20 Multiply line 19 by 15% (.15). Enter the result here and on Form 1040, line 45. But if this amount is more than the amount on Form 1040, line 42, minus any amount on line 43, **or** you are filing Form 2441, see page R-3 for the amount of credit you may take	20	*278*

Schedule R (Form 1040) 2001

CHILD AND DEPENDENT CARE CREDIT

Care for a Dependent Parent. The same credit that is available for parents who pay someone to care for a child or children under age 13 so that the parents can work is available for the care of a spouse or dependent (possibly an elderly parent) who is not able to care for himself or herself.

The credit can be up to 30% of the expenses paid so that the taxpayer can work or look for work. The individual for whom the taxpayer provides care must live in the same home as the taxpayer. The credit is not available for money paid to the taxpayer's spouse, a person the taxpayer can claim as a dependent, or to the tax- payer's child who is under age 19 at the end of the year.

The individual for whom the taxpayer provides care for must be eligible to be claimed as a dependent on the taxpayer's return. There is an **exception** for a person who is physically or mentally unable to care for himself or herself and could be claimed as a dependent on the taxpayer's return were it not for the gross income limitation.

To claim the credit, **file Form 2441** with the tax return and include the care provider's name, address, tax identification number, and the amount paid, as well as the name and tax identification number of the person for whom care is provided.

Note that the dependent care credit is available to married couples living together in the same household only if they file jointly.

The credit on which the expense is based is limited to the earned income of the lower-earning spouse. There is an exception for a student or disabled spouse: If one spouse is a full-time student or one spouse is disabled, you can count that person as having made $200 per month with one qualifying individual and $400 per month with two or more qualifying individuals to care for.

EARNED INCOME CREDIT

Although we do not normally think of the earned income credit (EIC) in connection with older taxpayers, there are at least two possible applications.

1. Many grandparents are now raising grandchildren. If they qualify for the earned income credit, the same rules will apply to them as apply to parents.
2. If there are no qualifying children, the couple may be eligible for the limited earned income credit if the following conditions are met:

- Modified AGI and earned income must be less than $10,710 (2001 figure).
- Taxpayer must be at least 25 years old but **less than 65** at the end of the year.
- Taxpayer cannot qualify as a dependent on any other return.
- On a joint return, only one spouse must be under age 65 to qualify for limited EIC.

SOURCES OF INFORMATION

IRS publications

Older American's Tax Guide–Publication 554
Insurance Proceeds–Publication 525
Annuities–Publication 575
Social Security and Equivalent Railroad Retirement Benefits—Publication 915

Web sites

Medicare Web site: www.medicare.gov
Medicaid Web site: www.hcfa.gov
Social Security Web Site: www.ssa.gov
AARP Web Site: www.aarp.org

Private publications

RIA Federal Tax Handbook 2001
Tax Analyst OneDisc
Tax Facts 1, Publication of the National Underwriter Company
The Long Term Care Handbook by Jeff Sadler
Long-Term Care Insurance Tax Guide, TransAmerica Insurance
Long Term Care Insurance: A Guide to Tax Issues, UNUM Life Insurance