

## Chapter 8: Elder Taxation

Elder Planning Issues and Tax Implications .....	297	IRA Distribution Planning .....	313
The Role of Tax Professionals .....	297	Planning Aspects of Working While Receiving Social Security .....	314
Long-Term Care .....	298	The Role of Other Professionals in Elder Planning ....	315
Income Tax Issues for Elder Taxpayers .....	305	Endnotes .....	316

Corrections were made to this workbook through January of 2004. No subsequent modifications were made.

### ELDER PLANNING ISSUES AND TAX IMPLICATIONS

America is an aging nation. In less than 15 years, the segment of our population over 60 will double. The aged, as a group, face a unique set of tax and elder planning challenges. These, in part, are a consequence of interacting with our nation's network of elder programs including: social security, Medicare, and Medicaid. These programs have rules that limit participants' income in the case of social security and both income and assets in the case of Medicaid, requiring planning and accurate information to meet participation requirements. Aging also produces unique interactions in the areas of medical and medically related tax issues. Congress has dealt with these issues legislatively in highly political ways, responding to AARP and other lobbying organizations in an ongoing process that will intensify as senior populations increase. This chapter will address information needs pertaining to some elder programs.

### THE ROLE OF TAX PROFESSIONALS

Most individuals will face a series of decisions and challenges over the last decades of their lives. Their abilities to wisely deal with them will greatly impact their quality of life. Today, family sizes have shrunk, family members live farther apart, and the tradition of taking care of elders has diminished.

**The tax practitioner's main responsibilities will lie in the area of financial and tax planning.** Areas in which services will likely be concentrated are:

- Tax planning relating to elder issues,
- Retirement planning,
- Nursing home planning,
- Social security tax and benefit management,
- Estate planning,
- Pension and IRA distribution planning before and after death,
- Risk management analysis, and
- Transition and succession planning for farm and business owners.

## LONG-TERM CARE

The aging of our society has both state and federal governments fearful and trying to manage their share of long-term care expenditures. Legislative measures have already been enacted, such as the **Health Insurance Portability and Accountability Act of 1996 (HIPAA)**. This piece of legislation lays the foundation for tax treatment of long-term care expenses and insurance premiums. At present, significant restructuring efforts are under way at both state and federal levels. Their goals will be to reduce outlays and increase asset recovery. Asset recovery could include assets retained by the taxpayer and not properly disclosed, or assets that have been divested within the look-back period.

There are four principle ways of paying for nursing home and outpatient care costs:

- Medicare (short stays only)
- Private payment
- Medicaid
- Long-term care insurance

Each category will be briefly discussed.

### DEFINITION OF TERMS

#### Medicare Part A

Medicare Part A (hospital insurance) helps cover inpatient care in hospitals, critical access hospitals, and skilled nursing facilities. It also covers hospice care and some home health care. Participants must meet certain conditions.

#### Medicare Part B

Medicare Part B (medical insurance) helps cover doctors' services, outpatient hospital care, and some other medical services that Part A does not cover, such as some of the services of physical and occupational therapists, and some home health care. Part B helps pay for these covered services and supplies when they are medically necessary.

#### Medicaid

Medicaid is an entitlement program that usually includes both inpatient and outpatient care. Qualification for Medicaid is based on income.

### MEDICARE

#### Qualifications

If a worker has earned **40 credits**, also called quarters, they will **automatically** be entitled to Medicare Part A at age 65. Those on **social security disability** also automatically qualify after 24 months of disability benefits. Coverage is also provided to a dependent spouse of a fully insured worker, one who was married to a fully insured worker for ten years before divorce, or one who was married to a worker for 12 months before the date of the worker's death (9 months in the case of accidental death). Workers exempt from social security taxes because of exempt employment, such as public employees, will usually be covered since they normally pay the Medicare portion of the social security tax. If one is not covered for some reason, it is quite important to secure this coverage. For many taxpayers, this is the most affordable method of obtaining medical coverage.

**Note.** To determine whether a client is covered, advise the client to contact the Social Security Administration.

A **quarter of coverage** for 2003 consists of **\$890 of earnings**, therefore **\$3,560 of wages or self-employment earnings will earn four quarters**.

**Note.** A self-employed person must report a 2003 Schedule C or F profit of at least \$3,855 to earn four quarters of coverage due to the 92.35% fraction on Schedule SE.

**Example 1.** Ann is 60 years old and has had a fairly unstable life and career. Her husband died 10 years ago, leaving her with a teenage daughter and little financial stability. As a self-employed carpet layer, he had made a meager living and had not posted enough quarters to qualify for social security benefits.

Ann decided to return to school to study social work. She completed her college degree at age 54 and secured a position as a social worker.

Prior to her full-time position as a social worker, she worked for 10 years in various part-time positions. At age 60, she has 30 quarters of social security and would like some advice. Her situation is very clear.

She absolutely must gain enough quarters to qualify for social security and Medicare benefits. Three years of work will get this goal met at her \$25,000 salary. Even though her \$25,000 annual salary exceeds \$3,560, she will only receive four quarters of credit per year.

**Note.** For information regarding maximizing social security coverage and other planning considerations, see Chapter 10, Social Security, in the *2002 Illinois Income Tax School Workbook*.

## Part A

Medicare Part A, whose primary focus is hospital coverage, has one option for skilled nursing care coverage, including brief stays in a nursing home.

- For a patient who enters a nursing home directly from a hospital for medically necessary reasons (or within 30 days of a hospital stay that lasts at least 3 days), Medicare pays all the costs for the first 20 days of medically necessary nursing home care.
- From day 21 up to the limit of 100 days, there is a copay of \$105 a day, adjusted annually for inflation.
- After 100 days, the coverage lapses.

Payroll expenses to acquire quarters are not deductible as medical expenses. For those not covered at age 65, the Part A 2003 Medicare premium may be purchased for \$316 a month, with an additional 10% surcharge each year for those who do not apply in the first 12 months of eligibility. This monthly premium cost is adjusted for inflation on an annual basis. Obviously, posting the needed quarters will be much cheaper, especially if the individual is short only a few quarters. An example of a woman close to retirement in this situation will crystallize these issues.

## Part B

If enrolled in Medicare, the 2003 Part B monthly premiums of \$58.70 are deductible as medical expenses on the 2003 Schedule A. For Ann in **Example 1**, major medical coverage at these rates will be unachievable otherwise.

## PRIVATE PAYMENT

Many nursing homes are not Medicaid certified and only accept private pay patients. For a nursing home patient, costs will vary according to their medical condition and the care required, varying from \$100 to more than \$300 a day. Which category a patient falls into is sometimes a matter of dispute between the facility and the family. An initially healthy resident that has an operation or some other medical event will normally move to a higher-paying category. This move is often difficult to reverse, even with substantial recovery. States track the cost of private pay nursing home costs and use a figure called the statewide average cost of skilled nursing facilities. It varies from state to state and is adjusted for inflation each July. In Minnesota, the figure is \$3,848 as of July 2003. As seen in the Medicaid section, this figure is used by the states in several ways. Practitioners in other states will need to research their comparable average costs.

## Deductibility of Individually Paid Nursing Home Expenses

An individual who personally pays for nursing home expenses may deduct them as unreimbursed medical expenses *if the main reason for being there is to get medical care.*<sup>1</sup> More specifically, payments for long-term care services qualify as medical expenses under IRC §213(d)(1)(C) if they meet the following two tests:<sup>2</sup>

- Necessary diagnostic, preventative, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance and personal care services
- Required by a **chronically ill individual** and provided according to a plan of care prescribed by a licensed health care practitioner

IRS Pub. 502, *Medical and Dental Expenses*, further defines a **chronically ill individual** as one who has been certified by a licensed health care practitioner within the previous 12 months as:

- Unable to perform at least two activities of daily living without substantial assistance from another individual, due to loss of functioning capacity, for at least 90 days. Activities of daily living (ADLs) are eating, toileting, transferring, bathing, dressing, and continence.
- Requiring substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

**Note.** The above definitions also are used to determine eligibility for other tax advantages, such as tax-free viatical payments received by a chronically ill person (see the Viatical section in this chapter).

## MEDICAID

Medicaid is a cooperative program between federal and state governments which pays for medical care and long-term care for individuals who cannot afford it. The Medicaid program is administered by states, and states who meet federal regulations receive federal payments to support the program. Medicaid is expected to cost \$277 billion in 2003, of which \$158 billion is the federal share and \$119 billion is the states share.

### Qualifications

Medicaid requires the following before it will cover the medical expense of an individual.<sup>3</sup> The individual must:

- Be a U.S. citizen or resident alien;
- Reside in a state that provides Medicaid benefits;
- Be 65 or older, blind, or disabled and eligible for the Supplemental Security Income (SSI) program or meet other state Medicaid requirements; and
- Have limited resources and income. These limits vary from state to state.

### Income and Asset Limitations

To qualify for Medicaid benefits, the recipient must meet certain income and asset limits. A state may establish its own income limit. One group of states (income-cap states) establishes a maximum income of 300% of the monthly SSI benefit, or \$1,656.<sup>4</sup> A second group of states allow recipients to spend-down their income for medical care before qualifying for Medicaid. Illinois falls within the second group. A third group of states has spend-down programs, but they do not count nursing home care for spend-down purposes.<sup>5</sup>

Asset limits also vary by state. They range from \$2,000 to \$5,000 for a single person and from \$3,000 to \$6,000 for a married couple residing together. However, meeting the asset limitation will not necessarily guarantee qualification for benefits.

Because these rules may cause potential recipients to look for ways to divest themselves of their assets, states have established rules where they can look-back at transfers of assets. The **look-back period** for assets **transferred to an individual may be three years prior to admission to a medical facility**.<sup>6</sup> If assets are **transferred to a trust, the look-back period may be five years**.<sup>7</sup> The look-back period can vary depending on the state in which the recipient resides. The rules for how a state calculates the amount to be recovered from the gift recipient also varies state by state.

**Observation.** The ethics of divesting assets causes considerable debate. Individuals must decide how they will plan for the possibility and cost of nursing home care. If the individual chooses to gift assets, the gifts must be considered final. Consequently, if the gifted asset is needed in the future by the donor, there is no obligation of the gift recipient to return the gift.

## Required Benefits Recovery

States **cannot require the family of the elder to pay for medical expenses**, including long-term care. Similarly, they **cannot consider the assets of the family members**, except the spouse, when making a determination regarding whether the state will pay for the medical expense and long-term care.

The state **may seek recovery for assets transferred** to a joint tenancy, tenancy in common, survivorship, life estate, living trust, or other arrangement before paying for medical expenses. Tax professionals should become aware of rules in their state, since not all states apply the same rules.

Under U.S.C. § 1396p(b)(1), states are **required to seek recovery of benefits** from a recipient's estate at their death if the recipient:

- Received medical services in a hospital or nursing home, and spent substantially all of their income for these services. The state could not reasonably expect the recipient to be discharged and return home.
- Is age 55 or older when receiving the benefits, the state can expand its estate recovery to cover expenses for other services.

Under U.S.C. § 1396p(a)(1)(B), a state **must impose a lien on real property** owned by the Medicaid recipient if he is:

- Institutionalized,
- Required to spend down his assets and income to receive benefits, and
- Is not expected to return home.

## Protection from Benefits Recovery

**No lien is allowed** to be imposed on the individual's home if any of the following reside there.

- The recipient's spouse
- A child under age 21
- A blind or disabled child
- The recipient's sibling, if he has an equity interest in the home and was residing there for at least one year before the recipient's admission to a medical facility.

In addition, if the **recipient returns home**, the lien is removed from the property.

Under U.S.C. 1396p(b)(2), states **cannot recover** from the recipient's estate:

- During the life of the **surviving spouse**,
- While the recipient has a **minor child**, or
- During the life of the recipient's **blind or disabled child**.

Also, the state **cannot recover on a home lien** if the recipient's:

- Sibling has resided in the home for at least **one year immediately before the recipient's admission** to the medical facility, or
- Child has lived in the home for at least **two years before admission** and the child proved he provided care to the recipient enabling the recipient to remain in the home, rather than a medical facility.

In addition, there are undue hardship regulations that may prevent a state from recovering on the lien.

## LONG-TERM CARE INSURANCE

Long-term care insurance is an option with over 3.5 million policies in effect. Individuals have chosen to purchase this insurance because:

- The population is aging rapidly, with greater needs for both home and custodial care.
- Medicaid is becoming more stringent.
- Tax deductions make the insurance more affordable.
- Newer insurance policies are better and more uniform, making them easier to compare.

With nursing home costs escalating, these policies will continue to be considered a major part of estate planning.

## Tax Benefits of Long-Term Care Insurance

To encourage taxpayers to purchase long-term care insurance, Congress has generally given the premiums for these policies similar tax treatment to health insurance premiums. IRS Pub. 502 provides specifications describing what long-term care contracts must contain in order to be tax qualified under HIPAA. In summary, the contract must:

- Only provide long-term care coverage,
- Be guaranteed to be renewable,
- Not allow cash surrender values,
- Not allow refunds, except at death or cancellation of the policy, and
- Not reimburse for items that are reimbursable under Medicare, except as a secondary payor.

These provisions have had the effect of standardizing benefits and improving value for the insured.

Long-term care policies that qualify are eligible for tax treatment similar to health insurance premiums. These premiums may qualify for a 100% deduction in arriving at AGI for the self-employed or the premiums may be deductible on Schedule A as a medical expense or included in IRC §§105 or 125 plans as benefits, funded by either employer or employee. For payroll purposes, neither employer nor employee contributions are subject to income or payroll taxes.

**Example 2.** Doug purchased all the machinery and equipment of the family dairy farm and rents the farmland and buildings from his father, Ed. Ed is semi-retired, but still works every day on the farm and receives a monthly cash wage. Doug established an IRC §105 medical benefit plan that provides Ed with full medical coverage, including long-term care insurance premiums. This allows Doug a tax deductible business expense and Ed a tax-free benefit.

# 2003 Workbook

There are limits on deductions for long-term care insurance premiums. The 2003 per person limitations are shown in the following table.

Age Range	Maximum Deductible Premium
Age 40 or under	\$ 250
Age 41 to 50	470
Age 51 to 60	940
Age 61 to 70	2,510
Age 71 or over	3,130

An individual eligible for employer-subsidized health insurance may still be able to deduct long-term care insurance premiums, provided he isn't eligible for employer-subsidized long-term care insurance.<sup>8</sup>

**Example 3.** Use the same facts as **Example 2**, except Doug works part-time for the local implement dealer. He receives employer subsidized health insurance coverage. Since his employer does not offer long-term care insurance, he is able to deduct his long-term care insurance premiums.

Compare the maximum figures to a June 9, 2003 Wall Street Journal article, quoting the National Health Insurance Association, which stated that the average 2001 premiums were:

Age	Long-Term Care Premiums
40	\$1,001
50	1,369
65	2,988

The policies included a \$150/day benefit, four years of coverage, 90-day elimination period, 5% compounded inflation protection, and nonforfeiture benefit. In comparison, the average 2001 premiums paid exceed the maximum 2003 deductibles.

Generally, periodic payments received under a per diem qualified long-term care contract are excluded from gross income, subject to an annual limit of \$80,300 (\$220 per day) in 2003. To claim this exclusion, the taxpayer must file **Form 8853** with their return. There is no accountability requirement in matching this per diem payment with actual costs of long-term care.

**Example 4.** Troy Truman was admitted to a nursing home on October 12, 2003, the same day he was certified as being chronically ill. Since the benefits he received, \$4,544.00, are less than the \$220 per day allowable in 2003, none of the benefits are taxable. The 2003 Form 1099-LTC and page 2 of Form 8853 for Troy follows.

CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. <b>U.S. Care Insurance</b> <b>111 Towne St</b> <b>Anytown, IL 66666 (555) 555-5555</b>		1 Gross long-term care benefits paid <b>\$ 4544.00</b>	OMB No. 1545-1519 <b>2003</b>	Long-Term Care and Accelerated Death Benefits
PAYER'S Federal identification number <b>99-1234567</b>		2 Accelerated death benefits paid <b>\$</b>	Form <b>1099-LTC</b>	
POLICYHOLDER'S name <b>Troy Truman</b>	POLICYHOLDER'S identification number <b>555-11-2222</b>	INSURED'S name <b>Troy Truman</b>		Copy B For Policyholder This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.
Street address (including apt. no.) <b>449 Smith Road</b>	City, state, and ZIP code <b>Somewhere, OH 44444</b>	Street address (including apt. no.) <b>449 Smith Road</b>		
INSURED'S social security no. <b>555-11-2222</b>	3 <input checked="" type="checkbox"/> Per diem <input type="checkbox"/> Reimbursed amount		Date certified <b>10/12/2003</b>	
Account number (optional)	4 <input checked="" type="checkbox"/> Qualified contract (optional)	5 (optional) <input checked="" type="checkbox"/> Chronically ill <input type="checkbox"/> Terminally ill		

Form **1099-LTC** (keep for your records) Department of the Treasury - Internal Revenue Service

# 2003 Workbook

## For Example 4

Name of policyholder (as shown on Form 1040) **Troy Truman** Social security number of policyholder ▶ **555 : 11 : 2222**

**Section C. Long-Term Care (LTC) Insurance Contracts.** See **Filing Requirements for Section C** on page 6 of the instructions before completing this section.

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

**16a** Name of insured ▶ **Troy Truman** **b** Social security number of insured ▶ **555 : 11 : 2222**

**17** In 2003, 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 2003 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** **4,544**

*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 **Box 4 1099-LTC** qualified LTC insurance contracts **20** **4,544**

**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 7 of the instructions) **21** **0**

**22** Add lines 20 and 21 **22** **4,544**

*Note: If you checked "Yes" on line 17 above, see Multiple Payees on page 7 of the instructions before completing lines 23 through 27.*

**23** Multiply \$220 by the number of days in the LTC period **80 days** **23** **17,600**

**24** Costs incurred for qualified LTC services provided for the insured during the LTC period (see page 7 of the instructions) **24** **see note**

**25** Enter the larger of line 23 or line 24 **25** **17,600**

**26** Reimbursements for qualified LTC services provided for the insured during the LTC period **Box 3 1099-LTC** **26** **0**

*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** **17,600**

**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** **0**



**Note.** In this example, the actual amount of long-term care expenses are immaterial. If the actual expenses exceeded \$17,600, the per diem limitation on lines 25 and 27 would be higher, but the taxable amount would still be \$0. Line 26 is \$0 because Box 3 of Form 1099-LTC indicates the amounts are a per diem, not a reimbursed amount.



## INCOME TAX ISSUES FOR ELDER TAXPAYERS

Certain unique income tax issues affect elder taxpayers.

### FILING REQUIREMENTS

For some taxpayers, the additional standard deduction for those age 65 or older may be sufficient to eliminate the need for filing a tax return. In **2003**, the additional standard deduction amount is:

- \$1,150 for single or head of household filers
- \$950 for married filing separate filers or joint filers with one spouse age 65 or older
- \$1,900 for joint filers with both spouses age 65 or older

These amounts, plus the exemptions and regular standard deduction, constitute the minimum income filing requirements. For **2003**, the gross income filing thresholds are:

Filing Status	Gross Income	
	Under 65	65 or Over
Single	\$ 7,800	\$ 8,950
Head of household	10,050	11,200
Married filed jointly	14,050 (both) 15,000 (one)	15,950 (both)
Married filing separate	3,050	3,050
Qualifying widow(er) with a dependent child	11,000	11,950

### SCHEDULE R

Another tax provision is the credit for the elderly or disabled. Because the income thresholds are relatively low, this credit impacts only a few taxpayers. To qualify for this credit, a taxpayer must meet the definition of a qualified individual and fall under the income limit. A qualified individual is defined as one who is age 65 or older, **or** if under age 65, one who meets all three of the following tests:

- Permanently and totally disabled,
- Receives taxable disability income,
- Has not reached mandatory retirement age on January 1 under a public retirement system.

The taxpayer's income must fall below both the AGI limit and the nontaxable social security or pension limit for the respective filing status to qualify for the credit.

Filing Status	AGI Limit	Nontaxable Social Security or Pensions
Single, head of household or qualifying widow(er) with dependent child	\$17,500	\$5,000
Married filing jointly, one qualified spouse	20,000	5,000
Married filing jointly, both spouses qualified	25,000	7,500
Married filing separately, spouses apart all year	12,500	3,750

# 2003 Workbook

This credit is computed on Schedule R and is 15% of the base amount after certain reductions. It is claimed on Form 1040 or 1040A.

**Note.** See **Example 8** in the Disabilities Chapter in this workbook for more information, including a completed 2003 Schedule R.

## CLAIMING A PARENT AS A DEPENDENT

The rules for claiming a parent as a dependent are similar to those for claiming other dependents, with a few variations. According to IRS Pub. 501, *Exemptions, Standard Deduction and Filing Information*, an individual must meet **all five** of these tests to be claimed as a dependent:

- Must be a member of the taxpayer's household for the entire tax year or be related to the taxpayer. A parent does not have to live in the taxpayer's household.
- Must be a U.S. citizen or resident, or a resident of Canada or Mexico.
- Must not have filed a joint return for the year. An exception to this test applies if the joint return is filed by the dependent and his spouse merely to claim a refund and no liability would exist for either spouse on separate returns.
- Has gross income of less than \$3,050 in 2003.
- The taxpayer who claims the individual as a dependent must provide **more than half of his total support** during the calendar year.

Generally, the first three tests will not be a problem in claiming a parent as a dependent. The joint return test may be an issue in some cases, but generally a parent claimed as a dependent will be a widow(er) who lives with the child in their home. The last two tests, however, merit discussion as several exceptions apply that affect elderly taxpayers.

Normally, the gross income test prohibits the claiming of most parents as dependents. However, an exception provides an opportunity to do so—the exclusion of tax-exempt income, including social security, from the gross income definition.

**Example 5.** Tom and Agnes inquire about claiming Tom's father, David, as a dependent on their 2003 joint return. David receives \$3,000 of interest and dividend income and \$12,000 a year in social security benefits. David's social security benefits are nontaxable and therefore are not included in determining the \$3,050 gross income test. Therefore, the gross income test is met. However, the support test will be difficult to meet assuming that David spends most of his available 2003 income.

In some situations, the parent may want to consider gifting of income-producing assets to reduce income. Investing in tax-exempt securities, such as municipal bonds, may also be wise since tax-exempt interest is also excluded. Obviously, a parent with substantial income is not going to impoverish himself in order to be claimed by another family member.

The **support test** is also one that is not quite as simple as it seems. IRS Pub. 501 includes a worksheet for determining the support. Completing this worksheet will provide the answer to whether an adult child will meet the support test for their parent, but a few key points will illuminate the process of determining the answer.

1. The total funds belonging to the parent is an all-inclusive number, with nontaxable income, savings, and borrowed money included.
2. However, this total figure has little relevance in the support test other than determining the various uses of the parent's funds. The comparison is made between the parent's actual funds **used** for their support and the support provided by another person or persons.

3. The parent's share of joint household expenses is calculated by totaling the expenses of the entire household and dividing by the number of persons who lived in the household.
4. Some expenses are deemed to belong to the individual for whom they are expended, namely clothing, education, medical, dental, travel, recreation, and so on. The parent's expenses for each of these are added to his share of the joint household expenses to determine their total cost of support.
5. If the parent pays less than half of this total, someone else is providing a majority of his support and may claim his exemption.

Due to the mechanics of the support test, if a parent's funds are expended for purposes other than his support, or saved and not spent, this test could be met.

**Example 6.** Assume the same facts as **Example 5**. David's total support is \$25,000. He spent \$11,000 of his own money for his own support. The remainder of his support is provided by Tom and Agnes. David gifts \$4,000 to grandchildren. David passes the support test, thereby qualifying Tom and Agnes to claim him as a dependent.

**Example 7.** Margaret moves in with her single adult daughter, Nancy, whose two teenage daughters live with her. The total expenses for maintaining Nancy's household are \$2,400 per month, or \$600 per person. Margaret spends another \$700 per month on medical expenses, clothing, and travel to see her other children. Margaret's only income is her \$800 per month social security benefits. If she spends all of it, Nancy will not be able to claim her mother as her dependent since Margaret's contribution of \$800 per month exceeds half of her total support of \$1300 per month.

## Multiple Support Agreement

Sometimes, no single individual provides more than half of the parent's support. Instead, two or more persons together provide more than half of the support. If that is the case, a Form 2120, *Multiple Support Declaration*, should be used. Any one individual who meets the other tests and provides at least 10% of the support may claim the exemption if each of the other individuals (e.g., children) signs a statement agreeing not to claim the parent as a dependent for that year.

**Example 8.** Alice, a widow, is able to live comfortably in an assisted living apartment complex. Of her \$2,500 monthly support, she provides \$1,000 (mostly social security) and each of her sons provides \$500. Her three sons provide more than half her support. Therefore, any of her three sons may claim Alice as a dependent by attaching Form 2120 to his return if the other two sign a statement agreeing not to claim her.

Another issue in determining the support test is support provided by the state, including welfare, SSI, food stamps, subsidized housing, or Medicaid funding for nursing home expenses.

**Example 9.** Ray, a widower, resides in a nursing home. His \$1,200 per month in social security is applied towards his monthly nursing home cost of \$3,500. The balance is paid by Medicaid. His children provide him with some incidentals, but they cannot claim him as a dependent since they do not provide more than half of his support.

## HEAD OF HOUSEHOLD STATUS USING A DEPENDENT PARENT

A single individual who is entitled to claim a parent's exemption may qualify as head of household. This is possible even though the parent does not live in the child's home. However, in that case, the child must furnish more than half the cost of **maintaining the parent's home for the entire year**, rather than more than **half the year if the parent lived with the child**.

# 2003 Workbook

**Example 10.** Julie provided a home for her mother for 2001 and 2002 and claimed her as a dependent. In November 2003, her mother permanently moved into a nursing home. Julie can claim head of household for 2003 since her mother lived with her for more than half the year. In 2004, Julie can claim her mother as a dependent and use head of household status if she provides more than half the cost of maintaining her mother in the nursing home for the entire year.

**Note.** Julie could also claim head of household if she paid more than half of the cost to maintain a separate home for her mother for the entire year.

## CLAIMING MEDICAL EXPENSES PAID FOR A DEPENDENT PARENT

A taxpayer may deduct 2003 medical expenses paid on behalf of a dependent even if the parent's 2003 gross income is \$3,050 or more. A person generally qualifies as a dependent for purposes of the medical expense deduction if the following three tests are met:

- The person lives with the taxpayer for the entire year as a member of the household or is related to the taxpayer.
- The person is a U.S. citizen or resident, or a resident of Canada or Mexico for some part of the tax year.
- The taxpayer provided more than half of that person's total support for the tax year.

**Note.** IRC §213 specifies that medical expenses must be paid by the taxpayer to be deductible. Therefore, if a parent pays her own medical expenses only the parent can deduct them.

**Planning Tip.** Analyze the tax benefits for each party prior to payment of potentially tax deductible medical expenses.

## LOANS TO CONTINUING CARE FACILITIES

Continuing care facilities are designed, under a contractual arrangement, to serve elderly individuals who are more independent than those who reside in nursing homes. If a facility meets the definition of a qualified continuing care facility, loans by an individual and spouse to the facility may provide an exception to below-market interest rate rules under IRC §7872.

Expressed simply, a continuing care facility requires new residents to pay a large lump-sum entrance fee, a portion of which may be refundable. Part of the entrance fee is treated as an interest-free loan to the facility in exchange for future privileges. If the individual or his spouse has reached age 65 by the end of the tax year, the lender won't be treated as receiving interest on the loan. If married, the exception applies to both spouses if one had reached age 65 if both are under a contract to reside in the same facility.

Briefly, the definition of such a facility:

- Provides that the facility is designed to provide services under continuing care contracts,
- Excludes any facility that would normally be considered a nursing home,
- Requires that substantially all of the residents of the facility be covered by a continuing-care contract,<sup>9</sup> and
- Requires that all the facilities used to provide the services under the continuing care contract be owned by the borrower.<sup>10</sup>

A continuing care contract is a written arrangement between an individual and the continuing care facility that allows the individual or spouse to use the continuing care facility for the remainder of one or both of their lives. The individual(s) first reside in an independent living unit that has its own kitchen, bath, and living area similar to a private home. Additional facilities outside the unit may provide meals and various personal care services. Once the individual(s) can no longer live independently, they are provided long-term skilled nursing care at no additional substantial payment.

Assuming the qualifications are met, taxpayers may make interest-free loans up to an annual dollar limit, with prior loans added to present loans to come up with a cumulative total. The dollar loan limit for 2003 is \$151,000. This can be in aggregate between the two spouses, if married, or one, if single.

**Example 11.** Jeff and Mary enter into a qualified continuing care contract in 2003 with ABC Continuing Care, a facility that meets the requirements of IRC §7872. Jeff is age 65 and Mary is age 63. The amount of the loan required by the facility for their care is \$175,000. Of this amount, \$151,000 qualifies as exempt from the below-market interest rules and is allowed tax-free treatment. However, the balance of \$24,000 is subject to the rules and imputed interest must be computed.

**Note.** If the imputed interest rules of IRC §7872 apply, the continuing care facility usually will furnish the lender (Jeff and Mary) with a Form 1099-INT.

Continuing care facilities are becoming increasingly common as our society ages. They are sometimes built in conjunction with medical facilities and nursing homes on a common site, providing a range of options for the elderly. The capital required to build such a complex is quite significant, perhaps giving rise to these tax provisions.

## REVERSE MORTGAGES

A reverse mortgage is designed to allow the elderly to remain at home by borrowing against its value. The amount borrowed may be as much as 80% of the home's value and is typically received in monthly payments.

The loan is repaid only when the eligible loan amount is fully borrowed, the house is sold, or the borrower dies or ceases to use the home as a principal residence. Interest may be added to the loan balance monthly, but it is not deductible as interest expense by the lender until the interest is actually paid when the home is sold.

For the elderly borrower, the loan principal payments received are not reported as income. However, they do reduce the individual's basis in the home. The liberal provisions of IRC §121 apply if and when the home is sold by the reverse mortgage borrower.

- If the homeowner's basis is reduced to result in a gain, when sold, of greater than \$250,000 if single, or \$500,000 for a couple, capital gains will be due on the gain in excess of these amounts. This assumes all other requirements for an IRC §121 sale are met.
- If the homeowner dies still owning the home, the home will receive a stepped-up basis and no income tax should be due. The home could be a factor in estate tax computations depending on the size of the estate.
- If the individual were to move out of the home and sell it after more than three years, the gain would be increased by the reverse mortgage payments received, resulting in greater capital gains. This option is unlikely as moving out may trigger the sale of the home.

Reverse mortgages may be a way to enable an elderly person to stay in their own home rather than entering a nursing home. Home care may provide the needed assistance that makes this option even more attractive. In an aging society, reverse mortgages will likely become more common.

**Note.** Not all states allow reverse mortgages. Check with a local lender if in doubt.

## VIATICAL SETTLEMENTS

Purchasing viatical settlements as investments became popular as the AIDS epidemic grew in the United States in the 80s and 90s. Medical breakthroughs that have allowed many AIDS patients to resume a normal life have curtailed their popularity, but they still are present in the marketplace. The payment received by the policy owner (viator) will generally be between 60% and 80% of the policy face value, depending on life expectancy, the annual premium, and other factors. The policy may be sold to a third party (viatical settlement provider), or an accelerated death benefit may be received from the insurance company itself. Once sold, the new policy owner is responsible for future premium payments and receives the proceeds of the policy when the insured dies.

The tax treatment of policy payments depends on the medical condition of the insured and the policy ownership. **IRC §101(g) governs accelerated death benefits received by policy owners.** The provisions of §101(g) are discussed next.

If the insured is **terminally ill**, any payments received are tax-free. To qualify, a physician must certify that the insured has an illness or condition that can reasonably be expected to result in death within 24 months.<sup>11</sup> The payments may either come from the insurance company or the viatical settlement provider; however, the provider must meet licensing and other requirements.

If a policyholder is **chronically ill**, payments received are tax free **only** if certain requirements are met. These include:

1. The insured must be certified by a physician or other licensed health care practitioner as unable to perform without assistance at least two activities of daily living (ADL) for at least 90 days due to a loss of functional capacity or severe cognitive impairment.<sup>12</sup> These requirements are identical to the requirements for deducting long-term care expenditures as medical expenses.
2. The payments received must be for costs incurred for qualified long-term care expenses.<sup>13</sup> Further, payments must not be for expenses reimbursable by Medicare, other than as a secondary payor.
3. Payments to the **chronically ill** policy owner are tax-free even if they are not linked to expenses; however, there is a \$220 per day cap on periodic payments, which annualizes to **\$80,300 in 2003**.
4. A person who meets the definition of a terminally ill individual is not treated as chronically ill for purposes of this provision.

Regarding the third requirement, a lump sum payment to a chronically ill policy owner will not qualify as tax free if it exceeds the qualified long-term care expenses.

**Example 12.** Tom qualifies as a **chronically ill** individual and arranges to receive a **lump sum payment of \$50,000** on his life insurance policy. His qualified long-term care expenses for **2003** are \$65,000, for which he receives \$25,000 of reimbursements from a long-term care policy.

Only the unreimbursed expenses of \$40,000 (\$65,000–\$25,000) are tax-free under IRC §101(g). The remaining \$10,000 of his viatical settlement is taxable under IRC §72(e) to the extent it exceeds his basis in his insurance policy.

**Note.** If a **terminally ill** individual received the viatical payment described above, the settlement would be tax-free, regardless of the amount or his qualifying expenses. Also, had Tom received the \$50,000 in periodic payments of not more than \$220 per day rather than a lump sum, they would also be tax-free.

If the accelerated death benefits are paid to someone other than the insured, such as an employer in a key person insurance policy, the exclusion from gross income does not apply if the recipient has a business or financial relationship to the insured. Another common exception to tax-free receipt of viatical payments would be life insurance purchased for buy-sell purposes by partners or shareholders in a joint entity.

For the investor who purchases a viatical settlement, their purchase price becomes their basis against the eventual receipt of the insurance proceeds. The tax implications vary depending on whether the settlement is considered to be a capital asset or ordinary property.

**Observation.** Tax professionals, or others who hold investment licenses, should carefully research the policies of their broker dealer and the laws of the state in which they reside. In some states, viatical settlements are considered unlicensed securities and selling them may result in the loss of the registered representative's securities license.

## LAST TO DIE INSURANCE CONTRACTS

In OBRA 89, Congress passed provisions designed to curtail life insurance contracts that attempted to avoid limitations on investment-type life insurance imposed by 1988 legislation. These are called “last to die” contracts because they are payable only on the death of an insured person following the death of, or simultaneously with, another insured individual. The goal with these contracts is to use them as tax-sheltered investments. Congress moved to stop this loophole by changing tax treatment of loans and other amounts received under contracts that met the definition of **modified endowment** contracts.

Under IRC §7702A, to be classified as a **modified endowment** contract, the contract must:

- Be entered into after June 21, 1988,
- Meet the definition of a life insurance contract, and
- Fail to meet the 7-pay test.

The 7-pay test is failed if the cumulative amount paid under the contract for the first seven years is greater than the sum of the net level premiums that would have been paid during this time period, had the contract provided for paid-up benefits after the payment of 7 level annual premiums. For clarification, the goal of IRC §7702 is to **target the abuse of receiving loans** from life insurance contracts. For modified endowment contracts, amounts received from the contract are treated **first as income** and **second as recovered basis**. Loans under or secured by these contracts receive this unfavorable tax treatment. Additionally, some of the contracts withdrawals may be subject to a 10% penalty.

## JOINT TENANCIES SET UP BEFORE 1977

In 2001, the IRS announced it would acquiesce to the decision reached in the *Hahn* Tax Court case.<sup>14</sup> This IRS announcement may result in sizeable tax savings for a surviving spouse who later sells the property. In this case, Mr. & Mrs. Hahn jointly owned shares in a co-op apartment at the time of his death in 1991. Mrs. Hahn reported 100% of the FMV of the shares on his estate tax return and reported no gain on her sale of the shares in 1993, taking the position that the sale price equaled the stepped-up basis.

The IRS countered with the position that she should have used a blended basis with only 50% of the value at his death. Mrs. Hahn's reliance on the fact that her deceased spouse had contributed 100% of the funds for the purchase the joint tenancy prevailed in the 1998 court case cited above.

Congress, in passing TRA '96, added IRC §2040(b)(1), which **creates an automatic rule whereby 50% of the value of a “qualified joint interest” is included in the decedent's gross estate, effective for joint interests created after 1976**. In several court cases, surviving spouses relied on the contribution rule rather than the 50% rule favored by the IRS. All of these involved joint tenancies created before 1976. The announcement by the IRS that the **IRS will no longer challenge the contribution rule** for joint tenancies created before 1977 will affect surviving spouses, resulting in sizeable tax savings.

**Note.** See pages 230–232 and 320–321 in the *2002 University of Illinois Income Tax Workbook* for a thorough analysis of this issue.

## MANAGING THE TAXABILITY OF SOCIAL SECURITY BENEFITS

A basic strategy in attempting to decrease taxability of benefits is lowering the AGI of social security recipients. The income thresholds are \$32,000 for married filing jointly and \$25,000 for all others. Lowering AGI may be accomplished by tax planning for those who are able to control receipt of their income. Taxpayers in this situation include those who:

- Own a business and
- Are employed.

Various options to consider follow.

### For Business Owners:

- Bunch business income and deductions to create alternate high and low years.
- Take all available deductions; track expenses and mileage closely. Deduct home office expenses if facts justify it.
- If a spouse is involved in the business, pay him a wage and establish an IRC §105 plan to pay and deduct all medical expenses of both spouses.
- Consider forming a corporation or LLC to manage taxes and provide fringe benefits.
- Consider using IRC §179 on purchases.
- When selling a business, structure the sale to minimize tax effect.
- Use available pension options, including the new individual 401(k), which, as a qualified plan, allows contributions after age 70½.

### For Employees:

- Maximize use of pretax flexible spending arrangements (FSAs) for medical expenses.
- If funds currently aren't needed, use deferred compensation plans if available.
- Use traditional IRAs contributions to lower AGI if they are in the deductible range and the taxpayer is under age 70½.
- Claim the saver's credit on Form 8880, if available.
- Use elective pension plans such as SIMPLEs or 401(k)s to lower taxable wages.

### For Business Owners and Employees:

- Create recognized investment losses to offset recognized gains resulting in a \$3,000 capital loss deduction to lower AGI.
- Use nonretirement plan assets for current needs and defer taxable retirement plan distributions or bunch traditional IRA distributions into one year (assuming under age 70½) if tax brackets allow.
- Choose after-tax investments with high tax efficiency, such as zero coupon bonds, mutual funds with low turnover ratios, tax-exempt municipal bonds, or tax-deferred I or EE U.S. Savings bonds.
- Prior to drawing social security, convert traditional IRAs to Roth IRAs. In some cases, the conversions may not result in additional tax since credits or various losses may offset the recognition of income.
- Consider contributing to a tax-deferred annuity or a Roth IRA.



These suggested tax planning options can benefit only those with moderate levels of income. Some of these options will not benefit certain taxpayers because of unique circumstances. Taxpayers may be able to lower the taxable percentage of their social security benefits from 85% to 50% by adopting some of these options. For those with higher AGIs, these options are still worth considering because they may make excellent tax sense independent of the social security issue.

**Note.** Due to federal budgetary constraints, any future increases to the current threshold figures are unlikely.

## IRA DISTRIBUTION PLANNING

A key planning area for seniors involves distributions from their IRAs. Recent rulings and tax law changes have increased the flexibility of retirees regarding the amount of distribution. There are two key areas in IRA distribution planning: required minimum distributions (RMDs) and multigenerational or stretch IRAs.

**Required minimum distribution** rules are now easier to apply and more taxpayer friendly. The new IRS Uniform Lifetime Table was available in 2002 and is mandated in 2003. These new RMD rules apply to all IRA owners, regardless of whom they name as beneficiaries, except a spouse who is named sole beneficiary and who is **more than 10 years younger** than the owner. For this exception, the IRA owner will use the **Joint Life and Last Survivor Annuity Table** (Table II in IRS Pub. 590, *Individual Retirement Arrangements*) for the IRA owner and spouse.<sup>15</sup> These life expectancies (and the life expectancies for beneficiaries used to compute post-death payouts) are determined using the expected return multiples in Tables V and VI of Treas. Reg. 1.72-9.<sup>16</sup>

IRA owners must begin taking distributions from their traditional IRA by April 1 of the year after they turn 70<sup>1/2</sup>. The amount of distribution is determined by dividing the year-end IRA by the factor from the new **Uniform Lifetime Table** (Table III in IRS Pub. 590).

**Table for Determining Minimum Distribution  
Table III in Appendix C in IRS Pub. 590**

Age	Period	Age	Period	Age	Period	Age	Period
70	27.4	78	20.3	86	14.1	94	9.1
71	26.5	79	19.5	87	13.4	95	8.6
72	25.6	80	18.7	88	12.7	96	8.1
73	24.7	81	17.9	89	12.0	97	7.6
74	23.8	82	17.1	90	11.4	98	7.1
75	22.9	83	16.3	91	10.8	99	6.7
76	22.0	84	15.5	92	10.2	100	6.3
77	21.2	85	14.8	93	9.6	101	5.9

The new RMD rules benefit IRA owners in the following ways:

- In nearly all cases, the new RMD amount is less than the amount calculated under the old rules.
- The owner can change beneficiaries any time without affecting the RMD amount.
- The designated beneficiary may be determined as late as the end of the year following the year of the owner's death if a disclaimer is used within the required nine months of the owner's death. Under prior rules, a beneficiary had to be named by April 1 of the year following 70<sup>°</sup>.
- All designated beneficiaries have the ability to "stretch" out their IRA distributions based on their age.

**Note.** Disclaimers are used by the primary beneficiary to reject an inherited IRA. The primary beneficiary can disclaim all or part of the inherited IRA, but it must be done within nine months of the IRA owner's death. When disclaimed, the IRA becomes the property of other primary beneficiaries, or if none, contingent beneficiaries.

**Stretch IRAs, sometimes called generational IRAs,** allow the IRA assets to continue to grow tax deferred after the owner dies, regardless of whether the beneficiary is the spouse or a nonspousal beneficiary. Ultimately, an IRA may be passed down several generations since *Letter Ruling 199936052* confirmed that an IRA beneficiary may have his own beneficiary. For even greater flexibility, if an IRA is left to several beneficiaries, each of the beneficiaries may receive distributions based on their individual ages. To realize the potential in stretch IRAs, consider this example:

**Example 13.** A \$300,000 IRA is left to a 43-year-old beneficiary. She starts RMDs based on a first year life expectancy factor of 40.7. Since the RMD would be less than 2.5% of the accounts balance each year, the beneficiary could take RMDs for 25 years and still grow the IRA to \$851,686 if the IRA earned 8% annually.

Any IRA owner could take advantage of this stretching process by minimizing distributions while living and leaving a large IRA balance to the next generation of beneficiaries. This concept is important as both an estate planning and income tax planning option. However, this tax planning option has a potential downside if the IRA owner's estate is subject to federal estate tax.

## PLANNING ASPECTS OF WORKING WHILE RECEIVING SOCIAL SECURITY

If a person works after starting to receive benefits, her wages are subject to social security and Medicare taxes regardless of age. Taxpayers who work beyond Normal Retirement Age (NRA) without applying for benefits receive delayed retirement credits of up to 8% per year for a maximum of five years. However, since there are no earnings limitations for those who have reached NRA, it is usually not logical to delay drawing benefits. Even considering the top income tax bracket and 85% taxability, the recipient will retain approximately  $\frac{2}{3}$  of her social security benefits after taxes.

**In 2003, taxpayers between ages 62 and 65 who receive social security benefits can earn \$11,520 without losing them.** For each \$2 earned above the annual threshold, \$1 of benefits is lost. For those reaching 65 in 2003, from January until the month the taxpayer reaches NRA, \$2,560 per month can be earned without losing benefits. Beginning in 1990, the penalty was reduced to \$1 for every \$3 earned, but only for those between the years they turn 65 and their NRA.

The normal retirement age increases beginning in 2003. The NRA, which is the age at which full social security benefits can be received, increases gradually from ages 65 to 67. The following chart summarizes the new NRA rules effective in 2003.

Year of Birth	Normal Retirement Age
Prior to 1938	65 years
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
1943–1954	66 years
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 or later	67 years

The window of time when a worker may earn this higher monthly amount (\$2,560 for 2003) will thus steadily lengthen as NRA increases. These earnings limits are increased each year.

In the **first year of retirement**, a taxpayer can receive a benefit for any month he does not earn more than the monthly limit, regardless of total annual earnings. **In 2003, a person who retires before reaching NRA will be paid a full benefit for any month in which he neither earns more than \$960 nor is substantially self-employed.** At NRA or beyond, benefits are paid regardless of how much is earned. A self-employed person may receive a monthly benefit check for any month in his first calendar year of benefits in which he does not work more than 45 hours.

Workers with substantial earnings may find it advisable to delay drawing benefits until NRA or at least the year they reach NRA. For those who will not exceed the earnings limit, it may be advisable to draw benefits early, especially if life expectancies are lower than the average of 80.1 for a man of 62 or 83.5 for a woman of 62. The break even for most workers comes between ages 77 and 78. The removal of the earnings limit for those reaching NRA makes delaying the receipt of benefits more logical for those with incomes of \$50,000 or more.

## THE ROLE OF OTHER PROFESSIONALS IN ELDER PLANNING

To fulfill client needs beyond the tax practitioner's knowledge, consider utilizing:

- Attorneys with appropriate specialties
- Tax resource persons specializing in elder tax planning issues
- Social security experts, either with SSA or in private practice
- Investment and pension experts
- Medicaid specialists dealing with nursing home issues
- Health care experts
- Insurance professionals
- Family therapists
- Retirement planning experts
- Advice on dealing with family challenges: children, divorce, conflicts.

## ENDNOTES

- 1 IRS Pub. 502, *Medical and Dental Expenses*
- 2 IRC §7702B(c)(1)
- 3 42 U.S.C. §1396a(b)
- 4 Alabama, Alaska, Colorado, Delaware, Idaho, Mississippi, Nevada, New Mexico, Oregon, South Carolina, South Dakota, Wyoming
- 5 Arizona, Arkansas, Florida, Iowa, Louisiana, Oklahoma, Texas
- 6 42 U.S.C. §1396p(c)(1)
- 7 42 U.S.C. §1396p(c)(1)(B)(i)
- 8 IRC §162(1)(2)(B)
- 9 IRC §7872(g)(4)(B)
- 10 IRC §7872(g)(4)(C)
- 11 IRC §101(g)(4)(A)
- 12 IRC §7702B(a)(4)
- 13 IRC §7702B(c)
- 14 *Therese Hahn v. Commr.*, 110 T.C. 140 (1998), Action On Decision, CC 2001-06
- 15 Prop. Reg. §1.401 (a) (9)-5 Q&A 4(b)
- 16 Prop. Reg. §1.401 (a)(9)-5 Q&A 6