Chapter 13: Elder Issues

Social Security Issues 449
Strategies for Those Approaching Retirement 449
Factors With the Greatest Influence 450
Business Restructuring as Social Security Benefits are Approached 453
Social Security Impacts on Family Successions.. 453
Strategies for a Spouse Approaching Retirement 455
Disability Coverage Issues 456
Deciding When to Draw Social Security Benefits . 457
Waiting To Draw Benefits Until After FRA ... 460
Taxability of Social Security Benefits 461
Lowering the Taxability of Social Security Benefits 468
Other Strategies for Those in Retirement............. 470
Reverse Mortgages 470
Taxability of Long-Term Care Insurance Contract Payments 477
Qualified Charitable Distributions of IRAs ... 479

Corrections were made to this workbook through January of 2008. No subsequent modifications were made.

This chapter deals with social security and elder planning issues, both for clients in their retirement years and for those approaching them. Besides specific social security issues, this chapter examines the treatment of reverse mortgages, tax reporting of long-term care payments, and IRA donations to charity.

SOCIAL SECURITY ISSUES

The Congressional Budget Office projects that senior entitlements, including social security, Medicare, Medicaid, and supplemental security income (SSI) could produce short falls of $59–73 trillion over the next 75 years. Projected outlays for these programs increase from 1.7% of GNP in 2007 to 6.3% in 2080. Current social security surpluses have approached $200 billion in recent years, but will begin to decline after 2009. By 2017, it will break even as a budget line item, and decline thereafter until the trust funds are exhausted in 2040.[1]

In the midst of these looming financial demands, individuals paying into social security should examine their strategies as they approach retirement. Likewise, those already receiving benefits should closely watch planning options regarding Medicare parts B and D and understand the rules surrounding earnings limits and taxability of social security benefits.

STRATEGIES FOR THOSE APPROACHING RETIREMENT

13

Perhaps the most crucial question for taxpayers, especially the self-employed, is "Are the social security tax contributions I make a good investment?" Most tax and consulting professionals hesitate when asked to give advice on social security strategies. They do so with good reason. More than a dozen variables affect the eventual return on investment (ROI) a taxpayer receives from social security tax contributions. These include:

- Variables unique to the person (i.e., age, gender, marital status, past earnings, earnings consistency, spouse's earnings, type of tax paid, and life expectancy), and
- Variables resulting from the economy and social security rate changes (i.e., cost-of-living increases, inflation in prices, growth of wage earnings, and returns from alternate investments).

1. Social Security Administration: *Board of Trustees Annual Report to Congress* (2007).

Past performance or economic projections allow identification and estimation of these variables. This type of analysis is not an impossible process. The Social Security Administration (SSA) makes hundreds of thousands of estimates each year. However, the SSA considers only the variables needed to calculate benefits. For the individual considering the relative merits of further contributions, all variables listed earlier are important.

The process of determining if future social security taxes will yield a good ROI is not an easy one. As in any analysis involving the future, assumptions must be made. With social security, not just one or two assumptions are involved, but many.

The following variables affect the kind of ROI a person might expect from future tax contributions:

- Past earnings history — how much and when?
- Earnings consistency — how many years of earnings? How low are the lowest years?
- Age — how soon will benefits start?
- Life expectancy — normal, greater, or less?
- Gender — this affects life expectancy
- Marital status — and spouse's past earnings
- Whether the husband and wife are close in age
- Inflation growth in the economy
- The size of cost-of-living adjustments in benefits
- The opportunity cost for tax contributions as compared to social security
- The type of social security taxes to which the worker is subject
- Whether increased earnings result in increased income tax

Individually, any one of these variables has the potential to change the ROI from future tax contributions. These variables also have an influence on each other, making it almost impossible to establish generalizations or rule-of-thumb standards.

FACTORS WITH THE GREATEST INFLUENCE

A logical question to ask is, "Which of these factors will influence my investment returns from social security tax contributions the most?" This is a tricky question to answer. Briefly, the following factors will affect the answer the most.

Magnitude of Past Earnings

The SSA uses descending conversion brackets when transforming earnings into benefits. Whether one is in the 90%, 32%, or 15% conversion bracket from earnings to benefits will change a worker's potential ROI on future social security taxes by as much as 12%.

For perspective, indexing was the mathematical means chosen to create generational equality when the present social security was enacted 30 years ago. All earnings from a worker's lifetime are adjusted to be equivalent in purchasing power to the worker's indexing year. The indexing year is two years before the worker is eligible for benefits. Indexing roughly doubles the magnitude of the actual taxed earnings each worker accrues during his lifetime, with much greater magnification early in life and very little just prior to retirement. The effect of a worker's past earnings magnitude is rewarding low earners and penalizing high earners.

Marital Status and Spouse's Earnings

A married person who draws on his spouse's history may show a ROI of 6–8%. This assumes he is in the 32% conversion bracket. However, when the spousal advantage is taken away, the ROI drops from 3–4% for a woman and 1–2% for a man. These rates of ROI assume no dropping of prior years of earnings by posting further years.

The wages for the worker for each year are indexed according to the following chart:

Average Wage Indexing (AWI) Series

Year	AWI	Annual Increase	Year	AWI	Annual Increase
1951	2,799.16	—	1979	11,479.46	8.75%
1952	2,973.32	6.22%	1980	12,513.46	9.01%
1953	3,139.44	5.59%	1981	13,773.10	10.07%
1954	3,155.64	0.52%	1982	14,531.34	5.51%
1955	3,301.44	4.62%	1983	15,239.24	4.87%
1956	3,532.36	6.99%	1984	16,135.07	5.88%
1957	3,641.72	3.10%	1985	16,822.51	4.26%
1958	3,673.80	0.88%	1986	17,321.82	2.97%
1959	3,855.80	4.95%	1987	18,426.51	6.38%
1960	4,007.12	3.92%	1988	19,334.04	4.93%
1961	4,086.76	1.99%	1989	20,099.55	3.96%
1962	4,291.40	5.01%	1990	21,027.98	4.62%
1963	4,396.64	2.45%	1991	21,811.60	3.73%
1964	4,576.32	4.09%	1992	22,935.42	5.15%
1965	4,658.72	1.80%	1993	23,132.67	0.86%
1966	4,938.36	6.00%	1994	23,753.53	2.68%
1967	5,213.44	5.57%	1995	24,705.66	4.01%
1968	5,571.76	6.87%	1996	25,913.90	4.89%
1969	5,893.76	5.78%	1997	27,426.00	5.84%
1970	6,186.24	4.96%	1998	28,861.44	5.23%
1971	6,497.08	5.02%	1999	30,469.84	5.57%
1972	7,133.80	9.80%	2000	32,154.82	5.53%
1973	7,580.16	6.26%	2001	32,921.92	2.39%
1974	8,030.76	5.94%	2002	33,252.09	1.00%
1975	8,630.92	7.47%	2003	34,064.95	2.44%
1976	9,226.48	6.90%	2004	35,648.55	4.65%
1977	9,779.44	5.99%	2005	36,952.94	3.66%
1978	10,556.03	7.94%			

The highest 35 years for each worker are then added together and divided by 420 to arrive at the average indexed monthly earnings (AIME).

The AIME is then applied to the bend points issued by SSA each year. For 2007 those bend points/conversion brackets are as follows:

1. The first $680 of AIME is multiplied by 90%
2. The AIME between $680 and $4100 is multiplied by 32%
3. Any amount of AIME above $4100 is multiplied by 15%

Example 1. Linda attains age 65 years and 10 months in 2007 and she has AIME of $4,500. Her primary insurance amount (PIA) of $1,766 is computed as follows:

$ 680 × 90%	=	$ 612
3,420 × 32%	=	1,094
400 × 15%	=	60
$4,500		$1,766

Life Expectancy

If a person does not live long enough to draw significant benefits, further contributions show a poor ROI. A person's gender has some influence on life expectancy, giving an advantage to females because of their roughly four year advantage in life expectancy.

Years of Earnings and Magnitude of the Lowest Years

Several analyses include sets of indexed earnings in which the lowest year is greater than $25,000 and the allowable number of computation years has accumulated. In that case, further contributions produce a lower ROI. The greater the dollar amount of prior earnings eliminated, the greater the drop in ROI — usually resulting in a negative ROI. The elimination of years of earnings while the worker is still in the 90% conversion bracket is unlikely. However, it is possible for the worker to be in this position while in the 32% bracket as well as the 15% bracket. This type of worker would likely be blue collar, with a long, consistent, and low to moderate earnings history.

Type of Tax Paid

A FICA worker whose employer pays half the tax has twice the ROI on future tax contributions compared to a self-employed person or a shareholder employee in a closely-held corporation. For example, a worker in the broad 32% bracket doubles his ROI if his employer pays half the tax.

Other isolated situations can also produce large changes in potential ROI, but those listed above are the strongest impacting factors. The only time a greater impact occurs is if several of these combine in a negative or positive manner.

For example, the greatest potential ROI is for a married employee whose spouse draws on his earnings history, and who has an above-average life expectancy, is still in the 90% conversion bracket, and has room for more computation years. This combination can produce an ROI of 30% or more, but is quite rare.

On the other hand, a worker with a very poor potential ROI would be a single, self-employed man (or one whose spouse will draw benefits on her own history), with poor life expectancy prospects, possessing an earnings history strong enough to be in the 15% conversion bracket, and with more than the 35 allowable computation years. This person will not have any ROI on future social security tax contributions. Moreover, he will not get back his contributions.

Factors such as age, discount rate, inflation, and cost of living do not have as great an impact, mainly because they tend to offset each other. For example:

- Discounting future costs and ROI affects both future tax dollars paid and ROI from the higher resulting benefits.
- Higher inflation rates shift benefits higher, but should also increase the appropriate discount rate since interest returns (opportunity costs) also increase.
- Higher national average earnings increase indexing and benefit levels, but also affect inflation and higher discount rates.
- Younger spouses must wait for benefits, but receive more total and present value benefits because of longer potential survivor's benefits.

Despite the complexity of the analysis, answers with a high degree of reliability are possible. These may be the basis for a contribution strategy for social security self-employment (SE) taxes.[2] Such a strategy may involve shifting earnings to a spouse or co-owner, shifting to a business entity that allows greater control of social security earnings, or an even more drastic move, such as selling the business.

BUSINESS RESTRUCTURING AS SOCIAL SECURITY BENEFITS ARE APPROACHING

Social security is often the dominating factor that requires adjustments to retirement planning or to a business or farm transfer plan. To receive full benefits, the SSA requires recipients to reduce their participation in, management of, and earnings from any business. Meeting these requirements is easier if a transition begins several years prior to retirement.

For the self-employed, the SSA usually allows 45 hours per month of work in a business. If the SSA deems a worker or corporate officer to have substantial impact on the management of the business, the time is only 10 hours per month. Local SSA offices vary in how strictly they enforce this provision. Some office managers drive past farms of those receiving benefits or quiz neighbors on how much the retired farmer is working. Other offices have their retiring farmers complete a lengthy questionnaire on their involvement in the business, with responses then serving as a basis of comparison for later verbal interview questions. On the other hand, some offices allow farmers to draw benefits without changing their involvement at all, provided their earnings do not exceed the limits for benefit reduction.

To avoid trouble when applying for benefits at retirement, the self-employed should have less involvement in their business at least two years prior to retirement. Then, if a person's involvement is an issue, tax returns can show the transition was already in progress. For those receiving benefits in any calendar year before reaching their full retirement age (FRA), benefits are reduced $1 for each $2 of earnings greater than $12,960 in 2007. For wage earners in the year of retirement, the SSA considers earnings on a month-by-month basis. Months when earnings exceed one-twelfth of allowed earnings may affect benefits. This amount is $1,080 at age 62 until the year they reach FRA, and $2,870 for those reaching FRA in 2007. After reaching normal retirement age, no earnings limit applies.

SOCIAL SECURITY IMPACTS ON FAMILY SUCCESSIONS

Ideally, the transfer of farm or small business assets to the next generation begins well before retirement approaches. Social security plays a key role in these transitions, both from a tax-planning standpoint and in meeting the requirements for drawing benefits.

In a farm business with no successor from the next generation, a spouse may serve as a means to lower the owner's SE earnings. Consider the following example:

> **Example 2.** Chris and Amanda operate a family beef ranch, and have done so for their entire married life. Amanda participates in every aspect of the farm business, which includes feeding cattle, operating equipment, and paying the bills. She never received a wage for her efforts. Their typical farm profit has been approximately $25,000 per year. Now in their early sixties, neither wants to scale back their family operation, but they wish to begin drawing social security. One solution to Chris' earnings problem is to compensate Amanda for her labor in either FICA wages or farm commodities exempt from FICA. Her wage can be accompanied by an IRC §105 plan which gives her medical benefits as a fringe benefit. After deducting the wage and fringe benefits on Schedule F, Chris is under the $12,960 earnings limit.

13

> **Caution.** Making these moves in the year Chris wishes to begin benefits may arouse suspicion on the part of the SSA and cause them to deny his benefits application. Making arrangements several years in advance is advisable. One further caution: the SSA has, in some cases, taken the position that a spouse who receives commodity wages may not apply for social security benefits unless he pays FICA on these wages for up to three years before benefit application. Switching to FICA wages may be the solution.

2. The author's experience comes from authoring and making extensive use of the *Social Security Advisor Pro* software. A free demo copy may be obtained from www.2minus1.com

Family business or farm successions present tremendous opportunities for shifting active income to passive status. These include the following:

- Forming an entity, such as a partnership, LLC, or corporation, which rents real estate or other assets from the senior generation. Beware of share rental arrangements and active involvement rules because SE tax may apply.
- Forming an S corporation and receiving cash distributions as a return on equity to supplement the shareholder's salary. However, the SSA may successfully contest these moves, unless the profits remain inside the S corporation.
- Selling or renting assets to the younger generation, resulting in principal, interest, or lease payments instead of profits.
- Utilizing special retiring partner rules that allow the senior partner to draw out his basis in the partnership without tax. Beware of depreciation recapture or "hot asset" rules.
- Using wages or guaranteed partnership payments to the younger generation as deductions to lower the parents' SE income.
- Using noncash wage compensation for the younger generation.

Example 3. Son or daughter receives half of the heifer calves as part of wages. This barter income is not subject to social security taxes, and reduces social security earnings as a wage deduction on Schedule F.

Observation. In response to business owners adjusting their situation to lower FICA or SE earnings, the SSA has empowered entity specialists in each office to reverse any moves that they believe distort the applicant's earning situation. This is likely to happen if the moves are simultaneous with benefit application, or if the applicant is a corporate officer. Making the transition at least three years in advance of benefit application and removing the applicant from corporate officer status will possibly avoid this problem, as will having legal paperwork in place.

There is great flexibility in the succession process if it is begun early enough. The options become fewer as the parent approaches retirement. At FRA, the practicality of using a growing-in agreement, partnership, or joint venture ends, because typically these will not remove the parent sufficiently from the operation to satisfy social security retirement rules. A sale or complete rental is necessary to shift management completely to the younger generation.

The incentive to move into management transitions early is the money saved by shifting active income to passive. The senior generation can save thousands of dollars, and, in most cases, the younger generation will not make up the difference. Exceptions include the resulting profits from shared ownership, profits made on rented land, and guaranteed payments in a partnership. If the parent wants to remain involved in the business, he may do so, providing the regulations are met. After the first year, earnings rather than time spent determines business involvement.

These transitions should begin when the older generation reaches their late forties. With a farm, operating assets such as cattle, machinery, or feed are typically transferred first, with the farm transitioning last as the senior generation's retirement security. Gradual transitions are always more desirable from a tax saving and management transfer standpoint.

From age 55 to retirement, establishing an action plan for the years prior to age 62 is important. This plan should ease the transition into retirement and include provisions to manage social security taxes. During one's fifties, sharp differences between individuals become evident. For those with consistent past earnings, further contributions are a poor investment. For those with erratic or low past earnings, further tax contributions may be quite a respectable investment. Many scenarios exist, making a detailed analysis a sound move. Inflating earnings a few years prior to retirement is seldom wise, especially considering the lower impact of indexing. A majority of American taxpayers will see 85% to 96% of their accrued benefit by age 50. Expert advice in the areas of social security and other tax planning is crucial for these taxpayers.

STRATEGIES FOR A SPOUSE APPROACHING RETIREMENT

Social security has drawn criticism because it shows a bias towards the traditional family, with the husband as the wage earner and wife as homemaker. This criticism has some validity because a worker whose spouse draws benefits based on his earnings has a greater incentive to increase his social security tax contributions than if his spouse draws based on her own earnings history. At no place in earnings magnitude will a couple be better off splitting the higher spouse's earnings history and each taking half. It comes close only when the husband's total earnings are exactly twice the amount needed for the 90% threshold, but still falls significantly short.

> **Example 4.** Joe and Donna both reached age 62 in 2007. Joe always took all the Schedule C profits as his earnings, and Donna never had a job where she contributed to social security. Joe's average indexed monthly earnings (AIME) are $1,360. His benefit at 66 (before applying COLAs) is $830, and Donna, at 66, can draw half this amount, or $415. Together, they receive $1,245.
>
> If Joe and Donna had been in partnership for tax purposes over the years, each would have an AIME of exactly $680, or the maximum figure translated into benefits at 90%. Each of them would receive a benefit (before applying cost of living adjustments (COLAs)) of $612, or $1,224 combined — $21 lower than if Joe had all of the earnings.

Because of this situation, it rarely pays to shift earnings from one spouse to another when one spouse draws a dependent benefit. This situation occurs when comparing the benefit quotes for both spouses on the Social Security Personal Earnings and Benefit Statement (PEBES) sent out each year. **S**hifting earnings to a spouse who draws a dependent benefit produces no increase in overall benefits until the lower earning spouse's increased benefit exceeds half of her spouse's higher benefit. Shifting this amount of earnings through a spousal wage costs the couple over $60,000 of FICA taxes with no resulting benefit increase.

This situation is reversed when each spouse draws off his/her own earnings history. Consider this example.

> **Example 5.** Ron and Judy operated a consistently profitable family business together for the past 35 years. Judy posted several years of modest earnings from jobs she had in her teens and early twenties before her children were born. When the children reached their teens, she entered the work force again and posted another twenty years of moderate earnings. At 61 and 58, Ron and Judy's PEBES show benefits projected at $1,150 and $600 respectively. Ron posted 42 years of earnings, and shows a sharply negative ROI because his not-yet-eliminated lowest earnings year is just over $26,000 of indexed earnings. Judy, on the other hand, has only 28 years of earnings and shows a likely ROI of 14% because she will not eliminate prior years of earnings, has better life expectancy, and is still in the 90% conversion bracket.

Demographic surveys of younger couples show that as many as two-thirds of younger wives work full time. This ensures a situation where these individuals will likely draw social security benefits as if they were single. The lower number of earnings years for women, however, will continue due to greater child rearing responsibilities. According to the SSA, the average number of earnings years posted by male workers is 37, while the average number of earnings years for women is 27.

A couple in business together should always consider these factors. In **Example 5,** a wage paid to Judy for her work in the business operation, coupled with a §105 medical reimbursement plan, will largely eliminate Ron's future earnings.

DISABILITY COVERAGE ISSUES

When considering a spouse's social security strategy, consideration of whether they are maintaining coverage for social security disability benefits is necessary. A person under 40 is three times more likely to become disabled as they are to die. Considering the added hazards to farmers, as compared to the population as a whole, this figure increases to more than five times the likelihood.

Social security disability benefits are the best buy in the insurance marketplace today. In 2007, a quarter of coverage takes $1,000 of earnings. As little as $612 in social security taxes purchases four quarters of coverage. To let this coverage lapse is a serious mistake because the earnings needed for a quarter of coverage increases each year.

Social Security Publication No. 05-10029 outlines the work credits needed to be currently insured for disability benefits:

> *The number of years of work credits needed for disability benefits depends on your age when you become disabled.*
>
> ***Before 24*** *– You need six credits in the three-year period ending when your disability starts.*
>
> ***24 through 31*** *– You need credits for having worked half the time between age 21 and the time you become disabled.*
>
> ***31 or older*** *– You need the amount of credit contained in the following chart. Also, you generally must have earned at least 20 credits in the ten years immediately before you become disabled. You also need to have as many total work credits as you would need for retirement.*

Born after 1929, Became Disabled at Age…	Number of Credits Needed
31 through 42	20
44	22
46	24
48	26
50	28
52	30
54	32
56	34
58	36
60	38
62 or older	40

A young worker qualifies for disability benefits with as little as 18 months (six quarters) of earnings. Any spouse involved in a farm or small business should receive wages sufficient to maintain this coverage if they do not have other employment that does so.

DECIDING WHEN TO DRAW SOCIAL SECURITY BENEFITS

A frequently asked question is whether a worker should draw benefits at 62, at FRA, some time in between, or even after FRA. The SSA allows anyone who has 40 quarters of social security coverage to apply for benefits once he reaches age 62 and meets the "45 hours of work per month" test if self-employed. In order to draw **full benefits,** they must have reached FRA or been accepted for social security disability benefits at any age. A widow at FRA may also draw full benefits based on the earnings history of her deceased spouse. A provision of the Social Security Reform Act of 1983 raised the FRA and established penalties for drawing benefits before FRA as shown in the following table.

Retirement Insurance Benefit and Full Retirement Age

Birth Date	Full Retirement Age	Age 62 in Year	Months to FRA	Reduction Rate at Age 62	Reduction Rate at Age 65
1/1/38 or earlier	Age 65	1999	36	20.000%	0.000%
1/2/38–1/1/39	Age 65 + 2 months	2000	38	20.833%	1.111%
1/2/39–1/1/40	Age 65 + 4 months	2001	40	21.667%	2.222%
1/2/40–1/1/41	Age 65 + 6 months	2002	42	22.500%	3.333%
1/2/41–1/1/42	Age 65 + 8 months	2003	44	23.333%	4.444%
1/2/42–1/1/43	Age 65 + 10 months	2004	46	24.167%	5.556%
1/2/43–1/1/55	Age 66	2005–2016	48	25.000%	6.667%
1/2/55–1/1/56	Age 66 + 2 months	2017	50	25.840%	7.778%
1/2/56–1/1/57	Age 66 + 4 months	2018	52	26.667%	8.889%
1/2/57–1/1/58	Age 66 + 6 months	2019	54	27.500%	10.000%
1/2/58–1/1/59	Age 66 + 8 months	2020	56	28.333%	11.111%
1/2/59–1/1/60	Age 66 + 10 months	2021	58	29.167%	12.222%
1/2/60 or later	Age 67	2022 or later	60	30.000%	13.333%

When individuals born **prior** to 1938 elect a reduced social security benefit at age 62, benefits are computed by reducing the benefit by $\frac{5}{9}$ of 1% for each month under age 65, which is 36 months. The benefit reduction is computed as follows:

36 months × .00555 ($\frac{5}{9}$ of 1%) = 20.00% reduction in benefits

When individuals born in 1938 reached age 62 in 2000 and elected reduced benefits, the reduction was greater because full retirement age was 65 plus 2 months.

If the worker elects to draw benefits **36 or fewer total months before FRA,** the reduction is at the rate of .00555 (or $\frac{5}{9}$ of 1%) per month.

If there are **more than 36 total months** of reduction, the reduction is .00555 (or $\frac{5}{9}$ of 1%) per month for the first 36 months. Then the reduction is .00417 (or $\frac{5}{12}$ of 1%) per month for months in excess of 36.

13

Example 6. A worker with an FRA of 65 years and 6 months elects to draw benefits 42 months before FRA:

36 months	×	.00555	=	20.00%	reduction in benefits
6 months	×	.00417	=	2.50%	reduction in benefits
		Total		22.50%	

These reduction percentages remain in place for those who have an FRA of 66 and 67, as shown in **Examples 7 and 8.**

Example 7. A worker with an FRA of 66 elects to draw benefits at age 62.

36 months	×	.00555	=	20.00%	reduction in benefits
12 months	×	.00417	=	5.00%	reduction in benefits
		Total		25.00%	

Example 8. A worker with an FRA of 67 elects to draw benefits at age 62.

36 months	×	.00555	=	20.00%	reduction in benefits
24 months	×	.00417	=	10.00%	reduction in benefits
		Total		30.00%	

A number of factors affect the merits of drawing benefits early. These include the following:

1. Earned Income and Prospects of Replacing It in Retirement. For many middle class workers who depend on their earned income for support, early retirement may prove impossible.

Example 9. John Smith earns $60,000 annually and is entitled to social security benefits of $2,000 per month at FRA, which is age 66. At age 62, he can draw 25% less, or $1,500 per month. Unless he has a substantial pension, savings or other income, he will be unable to maintain his standard of living when his income drops by $42,000 per year to $18,000. His only choice may be to work indefinitely. Once he reaches FRA, he can draw social security and still earn as much as he wants.

2. Life Expectancy. A substantial and growing segment of the population has some form of chronic illness or a genetic predisposition to a shorter-than-average life. These individuals are better off drawing social security benefits as soon as permitted. Lowering an individual's life expectancy by five years translates to a clear advantage to early retirement, while raising it by five years means a clear advantage to waiting until FRA. Because gender affects life expectancy, women have almost the same result as men who receive an extra five years of life expectancy.

3. The Presence of Minor Children in the Prospective Retiree's Household. With the trend of waiting longer to have children, there is a greater likelihood of children in the household who might draw dependent benefits. A dependent child may draw up to 50% of his parents' social security if he has not completed secondary school and is not yet age 19. The other parent may draw a similar amount of benefits as the parent of a dependent child until the child reaches age 16. The presence of any potential dependent beneficiaries can sway the decision in the direction of electing to draw benefits earlier because the paid benefits more than compensate for any reduction imposed on the parent.

4. The Break-Even Period for Receiving Benefits Forgone by Waiting. As in prior years, the tradeoff is always receiving several years of up front benefits versus a higher benefit at FRA. Mathematically, the break-even period is normally 12 years.

Example 10. John Smith can draw $1,500 per month at age 62, or $2,000 at age 66. If he draws 48 months early, he receives $72,000 plus COLA before FRA. In return, he gives up $500 per month. Dividing the $72,000 by 500, there is a break even of 144 months, or 12 years.

The break-even point may vary slightly because of the difference in penalty between the first 36 months and the extra months above the first 36. Consider an individual born after 1960, who has an FRA of 67 and a 30% penalty for electing to draw benefits at age 62. Calculation of the break even follows:

Example 11. Ted Young is entitled to $3,000 per month in social security benefits at age 67, or $2,100 per month at age 62. The five years of benefits starting at age 62 total $126,000, which divided by the penalty per month of $900 provides a break even of 140 months, or four months short of 12 years.

For a male worker who reaches age 66, the average life expectancy is approximately 13 more years. A female worker who reaches age 66 has an average life expectancy of 17 more years. At first glance, it looks like it pays to wait. However, the time value of money must figure into the analysis. This shifts more advantage to retiring early, because dollars received at age 62 purchase significantly more than those received 17 to 21 years later. This computation shows men at a slight advantage in present dollars to drawing early. Women show a slight advantage to waiting until FRA, assuming normal life expectancy for both.

5. Retirement Assets and Projected Retirement Income. With 40% of the baby boomer generation having virtually no net worth, many of these individuals will go into retirement with little income besides social security. The best strategy to boost their retirement income may be to work longer and receive a larger social security benefit. If they have modest savings, this strategy also allows more growth and further contributions.

> **Example 12.** John Smith has a salary of $60,000 and a prospective social security check of $2,000 per month at his FRA of 66. He also has $50,000 in an IRA and is contributing $5,000 per year. If he retires today, he will lock in his social security base benefit at $1,500 and can draw another $200 per month from his IRA, withdrawing about 5% of the balance. If John waits four years, he can save $20,000 more, increase his social security benefit to $2,000, and savings draw by $85 per month. By waiting, he increases his monthly income by $585. Because of his modest retirement income, taxes should not be a problem in either scenario. He could also use the extra four years to retire any debt.

6. Health Insurance Benefit Costs. With the high cost of health insurance premiums, many workers who receive health benefits from their employer need to retain these benefits until they are covered by Medicare at age 65. It is common to find retirement-aged couples paying $1,000 per month for health insurance. Quitting a job with health insurance benefits to draw social security will likely result in a substantial portion of the social security check being used to pay health premiums. This may be avoided if the retiree's spouse has family medical benefits from her job, or if the retiree has health insurance continuation for the years before Medicare.

The wisdom of drawing social security early is dependent on the individual's level of income and supplemental retirement assets. Those with low income and those who are self employed may be able to maintain their present operations and add social security as a supplemental source of income. Many family farms fit this scenario. Social security may also provide the extra income needed to close the gap in supporting two generations of the family during a farm transfer. For individuals with middle class incomes and little in the form of supplemental retirement resources, retiring early may not be possible due to a cash flow decrease greater than the individual or family cares to endure. Add a pension, rental property, inheritance, or other significant savings and the decision to retire becomes easier. For those with high earned incomes, electing to draw social security makes no sense, because penalties and taxes consume the benefits. Those with high passive incomes or substantial available assets can draw benefits at any time because the taxability issues are present regardless of the timing of benefits.

WAITING TO DRAW BENEFITS UNTIL AFTER FRA

In 1983, Congress added an incentive to delay drawing social security benefits for up to five years after FRA. This incentive is the delayed retirement credit. This credit is based on the individual's year of birth and is awarded as shown in the following table:

Delayed Retirement Credits

Year of Birth	Annual Delayed Retirement Credit	Monthly Credit
1925–1926	3.5%	7/24 of 1%
1927–1928	4.0%	1/3 of 1%
1929–1930	4.5%	3/8 of 1%
1931–1932	5.0%	5/12 of 1%
1933–1934	5.5%	11/24 of 1%
1935–1936	6.0%	1/2 of 1%
1937–1938	6.5%	13/24 of 1%
1939–1940	7.0%	7/12 of 1%
1941–1942	7.5%	5/8 of 1%
1943 and later	8.0%	2/3 of 1%

The question is whether this credit is economically worth delaying benefits. The credit is significant because an increase in benefits up to 40% may result.

Example 13. John Smith decides that he really does not need social security as long as he can work and make a good wage. If his benefit at age 66 is $2,000, he will receive $2,800 if he waits until age 71. He will, however, forgo $120,000 ($24,000 × 5) plus COLAs in exchange for the extra $800 a month. The break-even amount to recover this sum at an extra $800 per month is 150 months, or 12½ years. Adding this number of years to age 71 makes John 83½ before he breaks even. This does not consider the time-value of money, which works against him. John would be better off continuing to work while drawing his full benefit at FRA. The worst case scenario would see John pay about one-third of his social security benefits back as taxes, assuming an overall 40% tax rate and 85% taxability.

SURVIVOR BENEFITS

Social Security survivors benefits can be paid to:

- A widow or widower — full benefits at full retirement age, or reduced benefits as early as age 60
- A disabled widow or widower — as early as age 50
- A widow or widower at any age if he or she takes care of the deceased's child who is under age 16 or disabled, and receiving social security benefits
- Unmarried children under 18, or up to age 19 if they are attending high school full time. Under certain circumstances, benefits can be paid to stepchildren, grandchildren, or adopted children.
- Children at any age who were disabled before age 22 and remain disabled.
- Dependent parents age 62 or older

TAXABILITY OF SOCIAL SECURITY BENEFITS

The formula for determining the taxation of social security benefits is the same for retirement, disability, and survivor benefits. However, supplemental security income (SSI) payments are never included in taxable income.

Whether social security benefits are taxable depends on total income and marital status. Form SSA-1099, *Social Security Benefit Statement*, which social security recipients receive by January 31 each year, shows total benefits. For a quick estimate, one-half of social security benefits can be added to all other income, including tax-exempt interest. If this amount is greater than the first-tier base amount for the recipient's filing status, a part of the benefits is taxable.

Social security benefits are taxed under a two-tier system under IRC §86. If the sum of recipient's income other than social security benefits plus one-half of social security benefits is below the **base amount** of the first tier, none of the benefit is taxable. If the sum is above the **base amount** of the first tier, but below the base for the second tier, up to 50% of the benefit is taxable. If the sum is above the **base amount** of the second tier (also called the **adjusted base amount**), up to 85% of the benefits is taxable.

Computation of Taxable Amount

The first tier **base amounts** are as follows:

- $25,000 for single, head of household, or qualifying widow/widower with a dependent child
- $25,000 for married individuals filing separately, who did not live with their spouses at any time during the year
- $32,000 for married couples filing jointly
- $0 for married persons filing separately who lived together at any time during the year

When making this comparison, do not reduce other income by any **exclusion** for:

- Interest from qualified U.S. savings bonds,
- Interest from tax-exempt municipal bonds,
- Employer-provided adoption benefits,
- Foreign earned income, or foreign housing, or
- Income earned in American Samoa or Puerto Rico by bona fide residents.

Most adjustments to gross income are subtracted. However, modified adjusted gross income (MAGI) does not include the deductions for:

- Student loan interest, or
- Tuition and fees.

If MAGI plus one-half of social security benefits exceeds the **base amount**, individuals must include in gross income the lesser of:

- One-half of the social security benefits received during the tax year, or
- One-half of the excess of the sum of MAGI and social security benefits received for that year.

Up to 85% of benefits can be taxable if the total of one-half of benefits and all other income is more than the following second tier base amounts. The second tier **adjusted base amounts** are as follows:

- $34,000 for single, head of household, or qualifying widow/widower with a dependent child
- $34,000 for married individuals filing separately who did not live with their spouses at any time during the year
- $44,000 for married couples filing jointly
- $0 for married persons filing separately who lived together at any time during the year

In the second tier, if MAGI plus one-half of social security benefits exceeds the **adjusted base amount**, individuals must include in gross income the lesser of:

- 85% of such excess, plus the lesser of
    - One-half of the social security benefits received during the tax year, or
    - One-half of the excess of the sum of MAGI and social security benefits received for that year, or
    - One-half of the difference between the second tier (**the adjusted base amount)** and first tier (**the base amount**) of the taxpayer, or
- 85% of total social security benefits received during the tax year.

Consider the following examples that show the computation of taxable benefits at the 50% and 85% levels:

Example 14. Jeff and Renee both were born in February 1945. They are married and file a joint tax return. They reach age 62 in February 2007. They have $10,000 of interest income and $10,000 of net income from rental property, for a total of $20,000 of unearned income. Their combined benefit is $2,000. The calculation to determine taxability of their benefits follows:

1.	Enter the total amount from **box 5** of **all** your **Forms SSA-1099** and **Forms RRB-1099.** Also, enter this amount on Form 1040, line 20a **1.** 24,000	
2.	Enter one-half of line 1 . . . . **2.**	12,000
3.	Enter the total of the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21 . . . . **3.**	20,000
4.	Enter the amount, if any, from Form 1040, line 8b . . . . **4.**	0
5.	Add lines 2, 3, and 4 . . . . **5.**	32,000
6.	Enter the total of the amounts from Form 1040, lines 23 through 32, line 34, and any write-in adjustments you entered on the dotted line next to line 36 . . . . **6.**	0
7.	Is the amount on line 6 less than the amount on line 5? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. ☑ **Yes.** Subtract line 6 from line 5 . . . . **7.**	32,000
8.	If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2006, enter $25,000 • Married filing separately and you lived with your spouse at any time in 2006, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17 . . . . . . **8.**	32,000
9.	Is the amount on line 8 less than the amount on line 7? ☑ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. If you are married filing separately and you **lived apart** from your spouse for all of 2006, be sure you entered "D" to the right of the word "benefits" on line 20a.	

Because Jeff and Renee's total other income and half of their social security benefits (line 5 above) do not exceed $32,000, there is no tax on their social security benefits. Their gross income is $44,000.

Note. Jeff's FRA (66) benefit is $1,818 per month, while Renee is not eligible for benefits based on her earnings record. Jeff and Renee elected to file for and receive reduced benefits at age 62. Jeff's 25% reduction percentage results in a reduced benefit of about $1,364 per month. Because Renee and Jeff are married, she can receive benefits based on one-half of his original benefit amount ($1,818), which is $909. Renee's benefit is also reduced. However, a different reduction percentage applies to spousal benefits. The reduction for the first 36 months is $^{25}/_{36}$ of a percent, or .006944 per month. The reduction factor is $^{5}/_{12}$ of a percent, or .004166 for each month in excess of 36. For Renee, the total reduction is 30%, or $273. This results in a benefit of $636 for her.

Example 15. Use the same assumptions as **Example 14,** except add $10,000 from a second rental property.

Question 15A. How much of Jeff and Renee's social security benefits are taxable?

Answer 15A. The lesser of one-half the $24,000 of social security benefits ($12,000), or one-half of the $10,000 ($42,000 – $32,000) excess ($5,000) is included in income. For each dollar of unearned income over the $32,000 base amount up to $44,000, $0.50 are included in taxable income until the 50% of social security benefits limit is reached.

1.	Enter the total amount from **box 5** of **all** your **Forms SSA-1099** and **Forms RRB-1099.** Also, enter this amount on Form 1040, line 20a **1.** 24,000		
2.	Enter one-half of line 1	**2.**	12,000
3.	Enter the total of the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21	**3.**	30,000
4.	Enter the amount, if any, from Form 1040, line 8b	**4.**	0
5.	Add lines 2, 3, and 4	**5.**	42,000
6.	Enter the total of the amounts from Form 1040, lines 23 through 32, line 34, and any write-in adjustments you entered on the dotted line next to line 36	**6.**	0
7.	Is the amount on line 6 less than the amount on line 5? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. ☑ **Yes.** Subtract line 6 from line 5	**7.**	42,000
8.	If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2006, enter $25,000 • Married filing separately and you lived with your spouse at any time in 2006, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17	**8.**	32,000
9.	Is the amount on line 8 less than the amount on line 7? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. If you are married filing separately and you **lived apart** from your spouse for all of 2006, be sure you entered "D" to the right of the word "benefits" on line 20a. ☑ **Yes.** Subtract line 8 from line 7	**9.**	10,000
10.	Enter: $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2006	**10.**	12,000
11.	Subtract line 10 from line 9. If zero or less, enter -0-	**11.**	0
12.	Enter the **smaller** of line 9 or line 10	**12.**	10,000
13.	Enter one-half of line 12	**13.**	5,000
14.	Enter the **smaller** of line 2 or line 13	**14.**	5,000
15.	Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	**15.**	0
16.	Add lines 14 and 15	**16.**	5,000
17.	Multiply line 1 by 85% (.85)	**17.**	20,400
18.	**Taxable social security benefits.** Enter the **smaller** of line 16 or line 17. Also enter this amount on Form 1040, line 20b	**18.**	5,000

TIP *If any of your benefits are taxable for 2006* ***and*** *they include a lump-sum benefit payment that was for an earlier year, you may be able to reduce the taxable amount. See Pub. 915 for details.*

Question 15B. What are Jeff and Renee's aftertax income and marginal tax rate as a result of the additional $10,000 rental income?

Answer 15B.

Total income		$54,000
Adjusted gross income	$35,000	
Less: standard deduction	(10,700)	
Less: personal exemption deductions	(6,800)	
Taxable income	**$17,500**	
Less: income tax		(1,843)
Aftertax income		**$52,157**

The first $15,650 of taxable income for a married couple filing jointly is taxed at 10% in 2007. Before the added rental income, Jeff and Renee had only $2,500 of taxable income and $250 of federal income tax. This results in tax at the 10% rate on $13,150 of the additional $15,000 taxable income, and a 15% tax on the remaining $1,850 — about a 10.53% blended rate. This is based on an additional $15,000 of taxable income. However, Jeff and Renee did not have an additional $15,000 of aftertax income, so their marginal tax rate on the $10,000 is actually higher:

Aftertax income with $10,000 added rent	$52,157
Less: aftertax income without $10,000 added rent	(43,750)
Aftertax net from $10,000 rent income	**$ 8,407**
Divided by $10,000 added income	84.07%
Marginal tax rate added income	**15.93%**

Effective Marginal Tax Rate for Income in First Tier. The marginal tax rate for additional income above the tier I base is 1.5 times the individual's marginal tax rate until the 50% of social security benefits limit is reached.

Example 16. Assume Jeff and Renee from **Example 15** receive $24,000 of social security benefits, $10,000 of interest, and $22,000 of rental income. This causes $6,000 of their social security benefits to be taxable. The next dollar of income would cause an additional $0.85 of social security benefits to be included in taxable income.

Question 16A. What level of income would cause the maximum 85% of Jeff and Renee's $24,000 of social security benefits to be included in taxable income?

Answer 16A. Total rental and interest income of $48,981 causes 85% of Jeff and Renee's social security benefits to be included in taxable income.

For Example 16

1.	Enter the total amount from **box 5** of **all** your **Forms SSA-1099** and **Forms RRB-1099.** Also, enter this amount on Form 1040, line 20a **1.** 24,000		
2.	Enter one-half of line 1	**2.**	12,000
3.	Enter the total of the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21	**3.**	48,941
4.	Enter the amount, if any, from Form 1040, line 8b	**4.**	0
5.	Add lines 2, 3, and 4	**5.**	60,941
6.	Enter the total of the amounts from Form 1040, lines 23 through 32, line 34, and any write-in adjustments you entered on the dotted line next to line 36	**6.**	0
7.	Is the amount on line 6 less than the amount on line 5? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. ☑ **Yes.** Subtract line 6 from line 5	**7.**	60,941
8.	If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2006, enter $25,000 • Married filing separately and you lived with your spouse at any time in 2006, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17	**8.**	32,000
9.	Is the amount on line 8 less than the amount on line 7? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. If you are married filing separately and you **lived apart** from your spouse for all of 2006, be sure you entered "D" to the right of the word "benefits" on line 20a. ☑ **Yes.** Subtract line 8 from line 7	**9.**	28,941
10.	Enter: $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2006	**10.**	12,000
11.	Subtract line 10 from line 9. If zero or less, enter -0-	**11.**	16,941
12.	Enter the **smaller** of line 9 or line 10	**12.**	12,000
13.	Enter one-half of line 12	**13.**	6,000
14.	Enter the **smaller** of line 2 or line 13	**14.**	6,000
15.	Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	**15.**	14,400
16.	Add lines 14 and 15	**16.**	20,400
17.	Multiply line 1 by 85% (.85)	**17.**	20,400
18.	**Taxable social security benefits.** Enter the **smaller** of line 16 or line 17. Also enter this amount on Form 1040, line 20b	**18.**	20,400

TIP *If any of your benefits are taxable for 2006* ***and*** *they include a lump-sum benefit payment that was for an earlier year, you may be able to reduce the taxable amount. See Pub. 915 for details.*

Effective Marginal Tax Rate for Income in Second Tier. The marginal tax rate for additional income above the tier II base is 1.85 times the individual's marginal tax rate, until the 85% of social security benefits limit is reached.

Example 17. SE Earnings Affect Social Security Benefits. In **Example 14,** Jeff and Renee expected to receive $24,000 of social security benefits, $10,000 of interest, and $10,000 of unearned rental income. None of the social security benefits were expected to be taxable. However, they recognize that economic conditions and the performance of their stock portfolio may cause them to seek employment. A late night infomercial describes an opportunity for highly-motivated individuals to buy into a hot new franchise in Florida. Based on the infomercial, they expect to earn a $75,000 profit the first year.

Question 17A. How will this new employment opportunity affect the taxability of their social security benefits? Assume their combined SE earnings are $71,140.

Answer 17A.

Total received from social security	$ 24,000
Half benefits	× 50%
	$ 12,000
Plus: all other taxable income	91,140
Plus: tax-exempt and excluded income	0
Modified AGI + ½ social security benefits	**$103,140**

Because the result (taxable income + ½ of social security benefits) is above the $60,941 income level, causing 85% of their social security benefits to be included in income (see **Example 16**), the full 85% ($20,400) of Jeff and Renee's social security benefits is added to taxable income. Their total income on Form 1040, line 22, is $111,540. Their SE taxes total $10,052. The SE tax deduction is $5,026, so their adjusted gross income is $106,514.

Question 17B. What are Jeff and Renee's aftertax income and marginal tax rate as a result of the additional $71,140 of SE income?

Answer 17B.

Total income		$115,140
Adjusted gross income	$106,514	
Less: standard deduction	(10,700)	
Less: personal exemption	(6,800)	
Taxable income	**89,014**	
Less: total of income tax ($15,101) + SE tax ($10,052)		(25,153)
Aftertax income		**$89,987**

The additional income above the $2,500 from **Answer 15B** is taxed at 10% ($14,150), 15% ($48,050), and 25% income tax rates ($25,314). Their average income tax rate is 16.68%, plus the SE tax. However, because the SE income results in $20,400 of their social security benefits becoming taxable, their true marginal tax rate is even higher.

Aftertax income with $71,140 added income	$89,987
Less: after tax income without $71,140 added income	(43,750)
Aftertax net from $71,140 SE income	$46,237
Divided by $71,140 added income	64.99%
Marginal tax rate added income	**35.01%**

13

Question 17C. How would $71,140 of earned income affect Jeff and Renee's social security benefits?

Answer 17C. Jeff and Renee elected to receive benefits at age 62. The earnings limit requires repayment of $1 of benefits for each $2 of earned income above the limit before the year they reach FRA. The 2007 limit of $12,960 is used for this estimate. Therefore, Jeff and Renee's social security benefits are reduced by the lesser of:

1.	The total benefits received	$24,000
	or	
2.	Earned income	$71,140
	Less: 2007 threshold	(12,960)
	Excess	$58,180
	Divided by 2	$29,090

All of Jeff and Renee's social security benefits must be repaid or withheld from future benefit checks. Even if all of the SE earnings were Jeff's, Renee's benefit would still need to be repaid because her benefit is based on his earnings history.

Question 17D. How will repayment of benefits affect Jeff and Renee's marginal tax rate on their $71,140 of earned income?

Answer 17D. Unless Jeff and Renee repay the benefits before the end of 2007 (the year of receipt), the benefits are included in their 2007 taxable income. In **Question 17B,** they found they had $46,237 of aftertax income from the $71,140 earnings from self-employment. Repayment of the $24,000 of social security benefits reduces the aftertax earnings to $22,237.

Aftertax net from $71,140 SE income	$46,237
Less: repayment of social security	(24,000)
Net after benefits repayment	**$22,237**
Divided by $71,140 added income	31.26%
Marginal tax rate added income	**68.74%**

Rules That Could Reduce Effective Tax Rate. Three different rules could reduce the 68.74% effective marginal tax rate when future years are factored in:

1. Jeff and Renee may be able to reduce their 2008 income tax by treating the repayment as an itemized deduction or taking an IRC §1341 credit.
2. Payment of SE tax could increase their future social security benefits.
3. Jeff and Renee are treated as not receiving benefits early for the 12 months of repaid benefits. As a result, they see one-fourth of their early retirement penalty rescinded. This results in a benefit increase of 6.25% for Jeff and 7.5% for Renee.

Excluding Repaid Benefits from Form SSA-1099. If Jeff and Renee notified the SSA and repaid the benefits during 2007, the repaid amount would not be included in their 2007 income on Form SSA-1099.

LOWERING THE TAXABILITY OF SOCIAL SECURITY BENEFITS

Avoiding the taxation of social security benefits has become impossible for many retirees. The $32,000 first tier threshold established in 1983, at which 50% of one's social security benefits become taxable, was not indexed for inflation. This level has now fallen close to the poverty line, especially when that threshold includes half of one's social security benefits. For retirees of middle-class means or above, taxation of their benefits is a foregone conclusion. For some, however, this may be an area that merits attention. Lowering income to a level where social security taxes are not applied saves tax dollars on that income.

In managing the taxability of benefits, the basic goal is lowering AGI for social security recipients in ways that the statute cannot add back. This occurs through tax planning for those who have a degree of control, such as those who still own a business, those who can shift taxable income to nontaxable forms, or those who can adjust the mix of dollars they draw on for their income needs.

Strategies for those in **business** include the following:

- Bunch income and deductions to alternate high and low years. With relatively wide tax brackets, the high years may still be within the same bracket. For those in agriculture, farm income averaging can also help avoid paying taxes in higher brackets.
- Take all available deductions; track expenses and mileage closely.
- Pay spouses involved in the business a wage and start a §105 plan that enables deductions for all medical expenses for the entire family. Use other fringes, such as pension contributions and travel to conferences.
- Consider using an entity to manage taxes and provide fringe benefits, especially if single or spousal §105 plans are not in the picture. Pensions may also divert income from the shareholder's tax return.
- Consider using §179 on purchases, possibly technology or vehicles with GVWR over 6000 lbs.
- Minimize taxes when selling a business by structuring the sale with favorable allocations, installment payments, etc.

Strategies for **wage earners** include the following:

- Maximize the use of pretax medical options, such as flexible spending accounts (FSAs), HRAs, or health savings accounts (HSAs).
- Consider establishing a personal HSA if an employer does not offer this option. With contribution levels at $5,650 and $2,850 for married and single filers respectively, opportunities exist to accumulate significant sums that can be brought into retirement and withdrawn tax-free for medical expenses.
- Use deferred compensation plans, if available and practical.
- Use traditional IRAs to lower AGI, if in the deductible range, and under age 70½.
- Use elective pension plans such as SIMPLEs or 401(k)s to lower taxable wages.

Other options **to lower income** include:

- Take investment losses by selling aftertax investments to trigger recognition. Losses can erase capital gains income and give a net capital loss of $3,000 per year to offset other income.
- Draw down nonretirement plan investments and leave taxable distributions for later. Or, bunch IRA distributions into one year (assuming under age 70½) if tax brackets allow. Alternately, if there are a few years of retirement before electing to draw social security, lower IRA balances before benefits start. Required minimum distributions apply after 70½, but are lower.
- Choose aftertax investments with high tax efficiency, such as zero coupon bonds, mutual funds with low turnover rates, or stocks that do not pay dividends.
- Roll traditional IRAs into Roth IRAs prior to drawing social security, so withdrawals during retirement do not raise income.
- File as married filing separately if the spouse receiving social security benefits has the lower income. However, recall that the income threshold drops to zero if the couple is living together.

The best solution involves planning the best mix of retirement accounts and working over several decades to create a balance. Ten years ago, half the retirement options available today did not exist. Today, there are non-IRA accounts, traditional (pretax) IRAs and related pensions, Roth IRAs and 401(k)s, and the recently established HSAs. Given a choice, entering retirement with a 6-figure balance in more than one of these types of accounts is preferable to holding $500,000 in IRAs and qualified pension plans.

OTHER STRATEGIES FOR THOSE IN RETIREMENT

Once retired, one might think opportunities for planning diminish. However, economic necessity and the desire to ensure economic security, optimize benefits, and save taxes keep strategic planning at the forefront for seniors. Because of its central importance, social security will be the dominant issue for most. However, Medicare, long-term care, reverse mortgages, and IRA issues will also have broad relevance to seniors. These issues are examined in detail, both from a technical and consumer point of view.

REVERSE MORTGAGES

Reverse mortgages are becoming a popular financial planning tool for many seniors. The most popular reverse mortgage, the Federal Housing Administration (FHA) home equity conversion mortgage (HECM), set a record with 27,000 mortgages issued in the fiscal year ending September 2004. This was 49% above the previous year. In comparison, the FHA issued roughly 90,000 HECMs in 2006. Reverse mortgages will become more popular as the baby boomer generation, with a large proportion of their net worth tied up in their personal residence, reaches retirement age.

What Is a Reverse Mortgage?

A reverse mortgage is a home equity loan that permits converting equity in a home into cash while retaining ownership. This can be attractive for senior citizens who find themselves "house rich" but "cash poor." However, it is not right for everyone. A senior citizen considering a reverse mortgage should research them carefully and consult an attorney before making any decision.

Equity is the difference between the appraised value of the home and its outstanding mortgage balance. The equity in the home rises as the size of the mortgage shrinks or the property value grows. In a reverse mortgage, a senior citizen borrows money against the amount of equity in his home.

A reverse mortgage works like a traditional (forward) mortgage, only in reverse. Instead of a borrower paying a lender, the lender pays the borrower. Unlike conventional home equity loans, most reverse mortgages do not require payment of principal, interest, and certain fees as long as the senior citizen lives in his home. Borrowers can use the money for anything, including living expenses, home repairs and renovations, medical expenses, credit card debt, education, or travel. If the taxpayer has an existing mortgage, the lender will require that part of the reverse mortgage be used to pay off the balance of the existing mortgage.

In a traditional mortgage, borrowers reduce their total debt with monthly payments until the debt is paid. In a reverse mortgage, the total debt increases as the lender gives the borrower money. Reverse mortgages are rising-debt loans. This means the lender adds interest to the loan principal each month. Because borrowers do not pay the interest on a current basis, the total amount of interest increases significantly as interest compounds. With a reverse mortgage, the borrower retains the title to his home. Consequently, the borrower remains responsible for taxes, repairs, and maintenance.

A borrower can never owe more than the value of the home with a reverse mortgage. Reverse mortgages are nonrecourse loans. This means that if the borrower defaults on the loan, or it cannot otherwise be repaid, the lender only can look to the house to meet the outstanding balance on the loan.

Types of Reverse Mortgages

There are three types of reverse mortgages:

1. FHA-insured
2. Lender-insured
3. Uninsured

These differ in costs and terms. Although the FHA and lender-insured plans appear similar, important differences exist. The following section discusses advantages and drawbacks of each loan type.

FHA-Insured Reverse Mortgages. This plan offers several payment options:

- Monthly loan advances for a fixed term, or for as long as the borrower lives in the home,
- A line of credit, or
- Monthly loan advances, plus a line of credit.

This type of reverse mortgage is not due as long as the borrower lives in his home. With the line-of-credit option, the borrower may draw amounts as needed. These loans require closing costs, a mortgage insurance premium, and sometimes a monthly servicing. The interest rate is adjustable. Interest rate changes do not affect the monthly payment. Instead, they affect how quickly the loan balance grows.

With an FHA-insured reverse mortgage, the borrower can change his payment plan with little cost. This plan also protects the borrower by guaranteeing loan advances if a lender defaults. However, the downside of FHA-insured reverse mortgages is that they may provide smaller loan advances than lender-insured plans. In addition, loan costs may be greater than uninsured plans.

The most widely available plan is the FHA's government-insured home equity conversion mortgage (HECM) program. To qualify for an HECM loan, homeowners must be at least age 62, and live in a single-family home, or condominium that is their principal residence. Under this program, the amount of equity homeowners may borrow against depends on where they live, and the prevailing interest rates. Counseling is required before homeowners can apply for an HECM loan. This counseling allows homeowners to discover whether a reverse mortgage is really the best solution to their cash-flow problems.

For people who have homes that are more expensive, or who need a larger loan, there are alternatives. A program from the Federal National Mortgage Association (Fannie Mae) grants larger reverse mortgages on home equity.

Lender-Insured Reverse Mortgages. Lender-insured reverse mortgages offer monthly loan advances, or monthly loan advances plus a line-of-credit, for as long as the borrower lives in his home. Interest rates are fixed or adjustable, and additional loan costs can include a mortgage insurance premium. This premium may be fixed or variable.

Loan advances from a lender-insured plan may be larger than advances provided by FHA-insured plans. Lender-insured reverse mortgages may allow the borrower to mortgage less than the full value of his home, thus preserving home equity for later use. However, these loans may involve greater loan costs than FHA-insured or uninsured loans. Higher costs mean that the loan's balance grows faster, leaving the borrower with less equity over time. Some lender-insured plans include an annuity that continues making monthly payments to the borrower, even if he sells his home.

> **Observation. The soundness of the lender is highly important!** Only the strength of the lender backs whatever promises it makes as to payments and other terms. Therefore, if a borrower is looking to a reverse mortgage for future income, rather than a lump sum, a federally insured program is a better choice.

Uninsured Reverse Mortgages. An uninsured reverse mortgage is dramatically different than FHA-insured and lender-insured reverse mortgages. An uninsured plan provides monthly loan advances for a fixed term only — a definite number of years selected when the loan is made. The loan balance becomes due and payable when the loan advances stop. The interest rate is usually fixed, and these loans require no mortgage insurance premium.

For short-term, substantial cash needs, the uninsured reverse mortgage can provide a greater monthly advance than the other plans. However, because payment of the loan must be made by a specific date, it is important to have a source of repayment. Inability to repay the loan may result in having to sell the home.

> **Observation.** If considering an uninsured reverse mortgage, taxpayers should carefully consider the amount of money needed monthly, how many years the money is needed, how repayment will be made when it comes due, and how much remaining equity is needed after paying off the loan.

Is a Reverse Mortgage Right for Someone?

When considering a reverse mortgage, several important questions exist:

1. Is the owner healthy enough to remain in his home?
2. Does he wish to do so?
3. Are alternatives such as selling the home and purchasing a smaller, less expensive home, better for the owner?
4. Are children or other heirs a consideration?
5. Will the homeowners get enough money from the reverse mortgage to enable them to live in their home?

Qualifications for a Reverse Mortgage

In order to qualify for a reverse mortgage, a taxpayer must:

- Own his home;
- Be at least 60 or 62 years old (for some reverse mortgage loans), or at least 70 years of age and have a low income (for other reverse mortgage loans);
- Use the home as his primary residence, living in it for more than half the year;
- Own a home that is a single-family home, a 1 to 4 unit building, a federally approved condominium, or planned unit development (PUD);
- Pay off the debt or existing mortgage against his home; and
- Set aside funds from the reverse mortgage to make whatever home repairs are necessary to qualify for the reverse mortgage.

Maximum Amount for a Reverse Mortgage

The mortgage amount depends on the borrower's age, home value, and current interest rates. In general, loan amounts are larger if the homeowner is older, the home value is higher, and interest rates are lower. Typically, the loan will not exceed 80% of the anticipated home value at loan maturity (or loan-to-value ratio).[3]

Example 18. A 65-year-old homeowner has a home worth $150,000. He can receive a $30,000 lump sum or credit line. A 90-year-old homeowner owning the same home could receive as much as $94,000.

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3. Use the calculator at www.aarp.org/revmort to estimate how much cash one might get from a reverse mortgage.

Payments from a Reverse Mortgage

There are several ways to receive payments from a reverse mortgage.

Immediate Cash Advance. A lump sum is paid to the owner on the first day of the loan.

Credit Line Account. An account exists that allows the owner to withdraw cash whenever desired during the life of the loan. The amount available depends on whether the credit line is "flat" or "growing." With a **flat credit line**, remaining credit decreases with each cash advance. With a **growing credit line**, remaining credit grows larger by a yearly rate.

Monthly Cash Advance. The total amount of cash paid depends on payment time period, whether for a set number of years, or for as long as the borrower lives in his home.

Combination. The borrower receives a combination of a lump-sum payment and monthly payments.

Annuity. If the borrower uses the reverse mortgage to buy an annuity, the amount of cash received depends on how long he lives, not where he lives. The annuity may have options and be partly taxable.

Fees and Other Costs of Reverse Mortgages

Applying for a Reverse Mortgage. Before closing on a loan, the only charge a lender may collect is an application fee. The application fee may not be a percentage of the principal amount of the reverse mortgage or of the amount financed. Other fees associated with the reverse mortgage may be financed as part of the loan.

At Origination. Origination occurs when the lender qualifies the borrower to get the loan, appraises the home, processes all necessary documents, and advances the money to the borrower. Fees, costs, and payments that a lender may charge are as follows:

- Loan origination fee
- Document preparation and "recording" the loan
- Appraisal or survey of the property
- Title and tax search
- Attorney's fees charged to the lender in connection with the closing of the loan
- Credit report
- Flood zone search
- Inspection fee
- Annuity purchase payment
- Repairs contracted for at or before the loan closing
- Tax reporting service (a one-time fee)
- Mortgage insurance
- Real estate taxes and property insurance
- Mortgage brokerage services, not to exceed three points based on the value of the property

During the Life of the Loan. While the reverse mortgage is outstanding, there are several additional fees and costs that the lender can charge. The lender can ask that the borrower pay these directly, or add them to the loan balance. The only fees, costs, and payments that a lender may charge during the loan are as follows:

- The cost of additional mortgage insurance
- The cost to maintain the structural integrity of the home
- The cost of any appraisal for refinancing or extending the loan
- The cost of real estate taxes and property insurance
- A monthly servicing fee of not more than $30

At the End of the Loan. At the end of the loan, there may be additional fees, costs, or payments. The lender may charge a termination or maturity fee. This fee includes the actual cost of arranging for the sale or foreclosure of the real property securing the loan. It may include broker's fees, advertising costs, moving or storage costs, legal, and other fees incurred. It may not be a flat percentage fee.

Shared Appreciation and Equity Participation. In exchange for a lower interest rate, a lender and borrower may agree to "shared appreciation" or "equity participation." In participation mortgages, a lender "participates," or has the right to a share in any increase in home value as well as interest on the loan.

A shared appreciation mortgage (SAM) takes into account the home's appreciation in value between the time the borrower signs the loan, and the end of the loan term. The lender receives an agreed-to percentage of the appreciated value of the loan at the end of the loan.

Reverse Mortgage Repayments

Timing. The point at which a reverse mortgage is repaid is based on the loan agreement. There are two types of loans:

1. A term loan is repaid after a certain number of years.
2. A tenure loan matures upon an event, such as when the last surviving borrower dies, sells the home, or fails to live in the home for 12 consecutive months.

If the borrower fails to pay property taxes or insurance or lets the home fall into disrepair, lenders can opt to pay for these expenses by reducing the loan advances, provided the borrower has not exhausted all available funds.

The borrower may be required to pay back the loan if the lender determines that a change occurred affecting the security of the loan, like renting part or all of the home, adding a new owner to the title, changing the zoning classification, or assuming new debt against the home.

The total amount owed at the end of the loan includes the total amount borrowed, including any amounts used to pay fees or costs, and all the accrued interest. There are several ways for the loan to be repaid:

- If the borrower sells the house, he uses the sales proceeds to pay the loan. If the loan balance is less than the sale proceeds, then the loan is repaid to the lender, with the remaining balance retained by the borrower or his heirs.
- The heirs to the home can pay the loan.
- The homeowner or heirs can refinance the home with a new forward (standard) mortgage.

The Lender's Responsibilities

The lender must give the borrower a statement, prepared by a local office for the aging, about available independent counseling and information services. The lender must also give the prospective borrower a description of the relevant features of the reverse mortgage. This should include:

- The interest rate charged, and whether it is fixed, variable, or both;
- Whether interest accrues from the time monies are advanced, and if the interest is compounded;
- All fees, costs, and payments that must be paid by the borrower;
- A description of any refinancing features that were discussed;
- Any events that could terminate the reverse mortgage, such as death or moving from the residence;
- A description of any shared appreciation or equity participation features; and
- A toll-free telephone number and the name of a person who can answer any questions that the borrower may have. If there is no toll-free telephone number, they must accept collect calls.

The lender can only charge interest on advances of funds actually made from the reserve account and not on the entire balance in the reserve account. If the lender fails to make any payment required under the loan agreement within 15 days of the due date, the lender must forfeit twice the interest on the outstanding loan principal for the entire period during which payments were suspended, ceased, or delinquent.

Borrower Rights and Responsibilities

If the borrower **does not adhere** to certain requirements, the lender may have **the right to foreclose** on the property. It is extremely important for the taxpayer to have a complete understanding of all aspects of a reverse mortgage loan:

- The borrower must take care of the house. It should be in the same condition as it was at the time of reverse mortgage closing.
- The borrower must directly pay the real estate taxes and insurance premiums on the property if there is no escrow account established.
- The borrower and the lender may agree to establish a reserve account that may be used by either party to keep the house in good condition, or to pay taxes, insurance premiums, or personal expenses.
- The borrower may choose a property insurer, but the lender must approve that choice. If the borrower does not choose an insurer on time, or the insurer is not acceptable to the lender, the lender may choose the insurer.

Potential Risks

There are potential risks to using a reverse mortgage.

- **Compounded interest**. The borrower pays interest on both principal and interest that accrues each month. Compounded interest causes the outstanding amount to grow at an increasingly fast rate. In that regard, interest payments use a large part of the home equity.
- **Overborrowing**. The borrower should determine exactly how much is needed to supplement his income prior to borrowing, so he does not pay interest on money that is not needed.
- **Fewer assets left to the borrower's heirs**. The borrower's equity is consumed to attain a secure retirement.
- **High costs**. All three types of plans (FHA-insured, lender-insured, and uninsured) charge origination fees and closing costs. Insured plans also charge insurance premiums, and some plans charge mortgage servicing fees.

Potential Benefits

Reverse mortgages can be of benefit to those senior citizens who are reasonably healthy, want to remain in their homes, and find that they are "house-rich" but "cash-poor." Some of the benefits include the following:

- There is no financial penalty if the borrower chooses to prepay the loan.
- There are no loan payments for as long as the borrower lives in his home.
- There is a guaranteed monthly income or guaranteed credit line.
- Borrowers can satisfy a previous home debt with an advance from their reverse mortgage. They may not have to pay off other debt against their home if a prior lender agrees to be repaid after the reverse mortgage is repaid. Generally, only state or local government lending agencies are willing to consider subordinating their loans in this way.
- The debt is limited to the value of the home.

Tax Aspects of Reverse Mortgages

A common question taxpayers ask about reverse mortgages is **how income from the reverse mortgage affects taxes.** Proceeds from a reverse mortgage are **not taxable.** The equity is the owner's money which is not taxable income. Likewise, mortgage interest is **not deductible** until it is paid back, which in most cases is at the end of the loan.

If the proceeds of the reverse mortgage are received as a lump sum and used to purchase an annuity that provides monthly income, part of the annuity payments are taxable, just like any nonqualified annuity.

Some HECM reverse mortgages allow the borrower to make payments during the life of the mortgage that restore part of the amount paid to the available credit line. The total loan balance on an HECM generally includes fees, mortgage insurance premiums, interest, and principal. Each payment must be applied against a category (or categories) within the loan balance, and reported on Form 1098, *Mortgage Interest Statement*. The interest portion of the payment (reported on Form 1098) is deductible in the year paid.

Another common question is whether **social security, Medicare, Medicaid, SSI, or any other assistance programs are affected by a reverse mortgage.** The borrower's regular social security or Medicare is not affected. Because the loan payments received are not taxable, they should not affect the taxability of social security benefits or the sliding scale of Medicare premiums that began in 2007.

Annuity payments may be taxable and affect the borrower's eligibility for SSI and Medicaid. If the borrower is single and enters a nursing home, the payments may go towards the borrower's monthly nursing home expenses. A financial advisor or program sponsor should discuss any impact on other federal, state, or local assistance programs.

Conclusion

The reverse mortgage borrower should be as well informed as possible, assess the potential rates on a loan, and decide if the benefits outweigh the risks.[4] After closing on a reverse mortgage, the borrower has **three business days to reconsider and cancel the agreement.** Business days include Saturdays, but not Sundays or legal public holidays. If the borrower decides to cancel, he must do so in writing, using a form provided by the lender, or by letter, fax, or telegram that must be hand delivered, mailed, faxed, or sent before midnight of the third business day. The borrower cannot cancel by telephone or in person.

The borrower should have an attorney, an accountant, a Housing and Urban Development certified counselor, or other counseling service review the reverse mortgage before making any decisions.

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4. For a complete guide to understanding reverse mortgages, visit Fannie Mae at www.fanniemae.com or call 1-800-7FANNIE (1-800-732-6643) to order a copy.

Other Alternatives

Besides reverse mortgages, there are other alternatives to consider:

- **Programs that help with real estate taxes and home repairs.** Many state and local governments have programs that provide special purpose loans to seniors for the deferral of property taxes and making home repairs or improvements. These loans can often prevent retirees from having to sell their homes. To find out whether the state has a special-purpose loan program for property taxes or for home repairs and improvements, contact a local state agency on aging may be contacted.
- **A qualified personal residence trust (QPRT)**. A senior citizen who wants to pass his home to children or other heirs should consider this option. A QPRT protects homes from estate taxes, which is especially important if the home has a high value. The QPRT allows the taxpayer to keep his home for a certain amount of time, with ownership eventually passing to any heirs.
- **A sale-leaseback.** The individual sells his home to his children and continues to live in it, paying the children a fair market rent.
- **A sale of the home and purchase of a smaller, less expensive home**. Thousands of retirees have sold $1 million homes in California and moved to lower cost areas. They live on the sales proceeds and purchase a new home.

TAXABILITY OF LONG-TERM CARE INSURANCE CONTRACT PAYMENTS

Generally, amounts received under a qualified long-term care (LTC) insurance contract are excluded from the insured's income. Benefits received from reimbursement policies, which pay for the actual services the insured person receives, are not included in income. However, payments made on a per diem basis may exclude a limited amount. All policyholders who own qualified LTC insurance contracts for the same insured person allocate the per diem exclusion. The per diem exclusion limit is $260 per day for 2007. Amounts paid over this amount are taxable, with the tax-free portion allocated first to the insured, then the remainder divided on a pro rata basis to any other contract holders. This amount is adjusted annually.

Amounts paid as **accelerated death benefits** are fully excludable from the insured's income if he has been **certified by a physician as terminally ill.** Accelerated death benefits paid on behalf of **certified chronically ill individuals** are excludable from income to the same extent they would be if paid under a qualified LTC insurance contract. The IRS defines these two terms as follows:[5]

1. **Accelerated Death Benefits**. An accelerated death benefit is any amount paid under a life insurance contract for an insured individual who is terminally or chronically ill. It also includes any amount paid by a viatical settlement provider for the sale or assignment of a death benefit under a life insurance contract for a chronically or terminally ill individual.
2. **Chronically Ill Individual**. A chronically ill individual is someone who has been certified by a licensed health care practitioner as:
    - **a.** Being unable to perform, without substantial assistance from another individual, at least two daily living activities (eating, toileting, transferring, bathing, dressing, and continence) for at least 90 days due to a loss of functional capacity, or
    - **b.** Requiring substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment.

13

5. IRC §101(g)

Reporting 1099-LTC

A payer, such as an insurance company or a viatical settlement provider, must provide Form 1099-LTC, *Long-Term Care and Accelerated Death Benefits*, to a recipient for payments made under a LTC insurance contract, or for accelerated death benefits. Payments include those made directly to the insured individual and those made to third parties. A LTC insurance contract provides coverage of expenses for LTC services for an individual who has been certified by a licensed health care practitioner as chronically ill. A life insurance company or viatical settlement provider may pay accelerated death benefits if the insured has been certified by either a physician as terminally ill, or by a licensed health care practitioner as chronically ill.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.		**1** Gross long-term care benefits paid $ **2** Accelerated death benefits paid $	OMB No. 1545-1519 **2007** Form **1099-LTC**	**Long-Term Care and Accelerated Death Benefits**
PAYER'S federal identification number	POLICYHOLDER'S identification number	**3** ☐ Per diem ☐ Reimbursed amount	INSURED'S social security no.	**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.
POLICYHOLDER'S name Street address (including apt. no.) City, state, and ZIP code		INSURED'S name Street address (including apt. no.) City, state, and ZIP code		
Account number (see instructions)	**4** Qualified contract ☐ (optional)	**5** (optional) ☐ Chronically ill ☐ Terminally ill	Date certified	

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

Shown above is the 2007 Form 1099-LTC. The key items include the following:

Box 1. Shows the gross benefits paid under a LTC insurance contract during the year

Box 2. Shows the gross accelerated death benefits paid during the year

Box 3. Reports whether the amount in box 1 or 2 was paid on a per diem basis, or was a reimbursement of actual LTC expenses. If the insured was terminally ill, this box may not be checked.

Box 4. May indicate the benefits were from a qualified LTC insurance contract

Box 5. May indicate the insured was certified as chronically ill or terminally ill, and the latest date certified

Account number. May indicate an account or other unique number the payer assigned to distinguish the account

Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts*, part C is used to:

- Report taxable payments from LTC insurance contracts, or
- Report taxable accelerated death benefits from a life insurance policy.

As LTC contracts become more common, reporting payments received from LTC providers will become a more important task. Watching closely to see that per diem limits are not exceeded will save senior taxpayers from tax liabilities.

QUALIFIED CHARITABLE DISTRIBUTIONS OF IRAS

The Pension Protection Act (PPA) of 2006 allows individuals to make qualified charitable distributions (QCD) of IRAs to nonprofit organizations in 2006 and 2007. Although this provision expires after December 2007, the House and Senate have introduced bills to extend and change the current IRA rollover rules. These changes include making them permanent, removing the current $100,000 annual limit on donations, making all charities eligible to receive donations, and providing IRA owners with a planned giving option starting at age 59½. According to the National Committee on Planned Giving, Americans made more than $50 million in QCD donations before the end of 2006.

Under IRC §408(d)(8), if the requirements are met, a QCD is nontaxable, and therefore not deductible as a charitable contribution. The requirements include the following:

- QCDs for the year cannot total more than $100,000 per person.
- Distributions must be made directly from the IRA trustee to one or more public charities or private operating foundations as described in IRC §170(b)(1)(A).
- Only outright gifts are eligible. Distributions to charitable gift annuities, charitable remainder trusts, pooled income funds, and other split-interest arrangements do not qualify for special tax treatment.
- Contributions to nonoperating private foundations, donor-advised funds, and supporting organizations do not qualify.
- At the time of each distribution, the taxpayer must have reached age 70½.
- The distributions must otherwise qualify for a full charitable contribution deduction.
- Donors who do not itemize their federal income tax returns may make qualified IRA gifts and exclude such gifts from their reportable income.
- The sum of each year's QCDs can be used to satisfy the taxpayer's required minimum distribution (RMD) requirements. That sum need not be taken into account, however, in calculating whether the taxpayer has reached any of the percentage limitations on deductibility.

Distributions from employer-sponsored retirement plans, such as 401(k)s, 403(b)s, 457s, SIMPLE IRAs, and SEPs **do not qualify,** even though they are similar to IRAs in many ways.

Who Most Likely Benefits?

Individuals who are most likely to benefit from making QCDs are those:

- Who take mandatory minimum withdrawals, but do not need additional income,
- Who wish to give more than the deductibility ceiling (50% of AGI),
- Who are subject to the 2% rule that reduces their miscellaneous itemized deductions,
- Whose major assets reside in their IRAs and who wish to make a charitable gift during their lifetime,
- Who intend to leave the balance of their IRA to charity at death, and
- Who might see less social security taxed by keeping IRA income out of the computation.

Maximizing Benefits

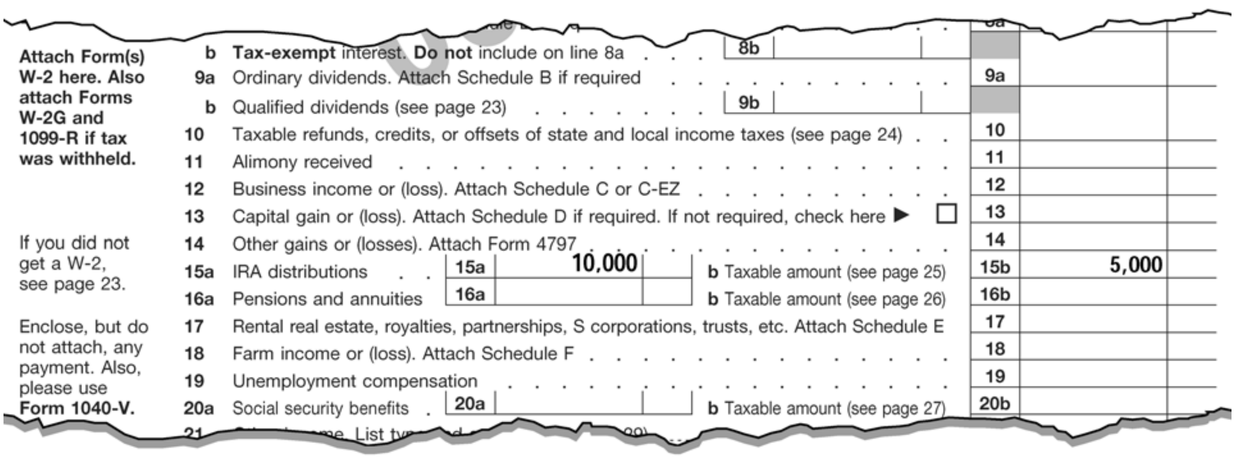
There are several strategies to maximize benefits for making QCDs:

- Lowering AGI below $100,000 by making a QCD of RMD allows the rollover of other IRA funds to a Roth IRA.[6]
- Sellers of assets subject to capital gains treatment might use QCDs in combination with accelerating the receipt of this income to optimize use of the lower capital gains rates in 2007–2010, assuming this provision is extended.
- The use of a QCD might provide the means to offset other unexpected investment or other income.
- Making a QCD might lower the taxpayer's exposure to AMT.

Tax Reporting for the QCD

The entire IRA distribution for the year is reported on Form 1040, line 15a. If the entire IRA distribution was sent to a charity, 0 is entered on line 15b to indicate the taxable amount. If a portion of the distribution was sent to the taxpayer for personal use, then only this amount is included on line 15b. See the IRS instructions for Form 1040 for more information.

Example 19. Troy is 76 and must withdraw a minimum of $10,000 from his IRA this year, all of which is subject to income tax. However, he decides to give $5,000 to a qualified public charity and keep $5,000 for his use. He instructs his IRA custodian to send his $10,000 distribution in two checks. One for $5,000 is payable to him, and a second check for $5,000 is payable to his favorite charity. Troy collects both checks and sends the charity the $5,000 payable to them with his instructions on how he wants his gift to be used. At the end of January, Troy's IRA custodian sends him a Form 1099-R indicating the full distribution for $10,000. Troy then reports the full IRA distribution on his Form 1040, line 15a. However, only $5,000 is reported on 15b as the taxable amount.



Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.	b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
	9a	Ordinary dividends. Attach Schedule B if required		9a	
	b	Qualified dividends (see page 23)	9b		
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 24)		10	
	11	Alimony received		11	
	12	Business income or (loss). Attach Schedule C or C-EZ		12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
If you did not get a W-2, see page 23.	14	Other gains or (losses). Attach Form 4797		14	
	15a	IRA distributions	15a 10,000	b Taxable amount (see page 25) 15b	5,000
	16a	Pensions and annuities	16a	b Taxable amount (see page 26) 16b	
Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
	18	Farm income or (loss). Attach Schedule F		18	
	19	Unemployment compensation		19	
	20a	Social security benefits	20a	b Taxable amount (see page 27) 20b	

One can readily see that this recent tax provision offers significant tax-saving advantages and merits planning to optimize its use. If these provisions are made permanent, then even more interest on the part of taxpayers may result.

6. IRC §401(a)(9)(A)