Chapter 5: Elder Issues

Corrections were made to this workbook through January of 2015. No subsequent modifications were made.

This chapter addresses tax and other issues likely to apply to clients who are age 65 or older. It includes content related to health insurance and deductible medical expenses, long-term care issues, medical care at home, and financial and tax matters associated with retirement income.

MEDICARE COVERAGE

Beginning January 1, 2014, individuals who do not obtain health insurance through a current or former employer must obtain minimum essential coverage (MEC) through another source or face penalties under the Affordable Care Act (ACA). Generally, in order for health insurance to qualify as MEC, it must provide a relatively broad level of health insurance coverage.

Medicare qualifies as MEC.[1] Medicare provides primary health insurance coverage to the vast majority of the U.S. population age 65 and older, as well as to some individuals who are disabled or have end-stage renal disease.[2] Medicare consists of the following parts.

- Part A provides in-patient hospital insurance, short-term nursing home coverage under limited circumstances, some home health care coverage, and hospice care.
- Part B provides insurance coverage for services by health care professionals (including doctors), medical equipment, outpatient medical care, some home health care, and a variety of other health-related services or items.
- Part C (referred to as Medicare Advantage) provides private insurance alternatives to Parts A and B (often called traditional or original Medicare).
- Part D provides prescription drug coverage (through private insurers).

Note. Each year, the Centers for Medicare & Medicaid Services (CMS) publishes a *Medicare & You* handbook that provides a detailed overview of the Medicare program.[3]

1. IRC §5000A(f)(1)(A)(i).
2. 42 USC §1395c.
3. *Medicare & You.* 2014. Centers for Medicare & Medicaid Services. [www.medicare.gov/Pubs/pdf/10050.pdf] Accessed on Mar. 26, 2014.

Although Medicare provides a wide range of coverage, it does not cover everything. As a result, those using Medicare may face significant out-of-pocket medical costs. It was estimated that a couple retiring at age 65 in 2013 will need approximately $220,000 throughout retirement to cover medical expenses not paid by Medicare.[4] This estimate does not include long-term care costs, such as a nursing home.

PARTS A AND B

Most Medicare beneficiaries qualify for premium-free coverage under Medicare Part A as a result of paying Medicare taxes on wages or other compensation earned while working. Wages and other employment compensation are subject to a 2.9% Medicare tax, half of which is paid by the employee[5] and the other half paid by the employer.[6]

> **Note.** Beginning in 2013, higher-income taxpayers are subject to an additional 0.9% Medicare tax on wages and self-employment income above specified threshold amounts. For more information, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update.

Unlike Medicare Part A, beneficiaries must pay a monthly premium if they enroll in Medicare Part B.[7] The base premium amount is determined each year based on the Medicare program's overall Part B costs.[8] Beginning in 2007, individuals with incomes above a specified level are subject to higher adjusted Part B premiums.[9] Although the base Part B premium for 2014 is $104.90, this monthly premium amount is adjusted upward for individuals with modified adjusted gross income (MAGI) greater than $85,000 ($170,000 for MFJ taxpayers).[10]

The relevant 2014 MAGI ranges and Part B adjusted premiums for single, head of household, and qualifying widow/widower (QW) filers are shown in the following table.[11] These adjusted premium amounts also apply to **married filing separately (MFS) taxpayers** if the spouses **have not lived together** at all during the tax year.[12]

MAGI Range	Adjusted Monthly Premium Amount
Greater than $85,000 but less than or equal to $107,000	$146.90
Greater than $107,000 but less than or equal to $160,000	209.80
Greater than $160,000 but less than or equal to $214,000	272.70
Greater than $214,000	335.70

4. *Fidelity Estimates Couples Retiring in 2013 Will Need $220,000 to Pay Medical Expenses throughout Retirement.* May 15, 2013. Fidelity Investments. [www.fidelity.com/inside-fidelity/individual-investing/fidelity-estimates-couples-retiring-in-2013-will-need-220000-to-pay-medical-expenses-throughout-retirement] Accessed on Mar. 23, 2014.
5. IRC §3101(b)(1).
6. IRC §3111(b)(6).
7. 42 USC §1395j.
8. 42 USC §1395r(a)(1).
9. 42 USC §1395r(i).
10. 42 USC §1395r(i)(3)(C); 20 CFR §418.1115.
11. Social Security Act §1839(i).
12. Ibid.

For **married filing jointly (MFJ) taxpayers,** the following MAGI ranges and adjusted premium amounts apply for 2014.[13]

MAGI Range	Adjusted Monthly Premium Amount
Greater than $170,000 but less than or equal to $214,000	$146.90
Greater than $214,000 but less than or equal to $320,000	209.80
Greater than $320,000 but less than or equal to $428,000	272.70
Greater than $428,000	335.70

For **MFS taxpayers who lived together** for part or all of the tax year, the relevant MAGI ranges are as follows.

MAGI Range	Adjusted Monthly Premium Amount
Greater than $85,000 but less than or equal to $129,000	$272.70
Greater than $129,000	335.70

MAGI for purposes of these premium adjustments is generally calculated as follows.[14]

AGI
\+ U.S. savings bond interest excluded by a taxpayer with higher education expenses under IRC §135
\+ Other tax-exempt interest under the Code
\+ Excludable amounts of foreign earned income or foreign housing costs under IRC §911

MAGI

Generally, Medicare calculates MAGI based on an enrollee's tax return for the last taxable year beginning in the second calendar year preceding the year involved.[15] Accordingly, in order to determine a taxpayer's 2014 premiums, the taxpayer's 2012 MAGI is taken into consideration. However, **a beneficiary may request that the MAGI for a more recent tax year be used to determine whether the premium adjustment applies.[16]** Such a request may be made only in cases in which the individual's MAGI for the more recent year is **significantly less** than the MAGI for the year that would otherwise be used due to a major life-changing event such as the following.[17]

- Death of the taxpayer's spouse
- Marriage or divorce of the taxpayer
- A termination or reduction in the number of working hours for the individual or the individual's spouse
- A loss of income-producing property by the individual or the individual's spouse (as long as the loss is neither at the direction of the individual or spouse nor is a result of the ordinary risk of investment)
- A scheduled cessation, termination, or reorganization of an employer's pension plan
- Settlement for the individual or spouse from an employer or former employer because of the employer's closure, bankruptcy, or reorganization

13. Ibid.

14. 42 USC §1395r(i)(4)(A).

15. 42 USC §1395r(i)(4)(B)(i).

16. 42 USC §1395r(i)(4)(C).

17. 42 USC §1395r(i)(4)(C)(ii); and 20 CFR §418.1205.

PART D

In addition to the Part B premium adjustments that are based on MAGI, higher-income Medicare beneficiaries who enroll in Medicare Part D prescription drug coverage must also pay higher adjusted premium amounts.[18] Part D prescription drug plans are available only through private insurers that establish the premiums (and other terms) for their individual plans subject to approval by CMS. Therefore, all taxpayers are not subject to the same Part D base premium. The Part D premium adjustments for higher-income taxpayers, however, are based on the taxpayer's MAGI without reference to their base Part D premiums. Although the MAGI ranges are the same as for the Part B income-related premium adjustments, the **amounts** of the Part D premium adjustments are not the same as the adjustments for Part B.

The Part D adjustment amounts for single, HoH, and qualifying widow or widower taxpayers for 2014 are as follows.[19] These premium adjustment amounts also apply to **MFS taxpayers** if the spouses **have not lived together at all during the tax year.**[20]

MAGI Range	Amount Added to Part D Monthly Premium for Plan Selected
Greater than $85,000 but less than or equal to $107,000	$12.10
Greater than $107,000 but less than or equal to $160,000	31.10
Greater than $160,000 but less than or equal to $214,000	50.20
Greater than $214,000	69.30

For **MFJ filers,** the MAGI ranges and adjustment amounts are as follows.

MAGI Range	Amount Added to Part D Monthly Premium for Plan Selected
Greater than $170,000 but less than or equal to $214,000	$12.10
Greater than $214,000 but less than or equal to $320,000	31.10
Greater than $320,000 but less than or equal to $428,000	50.20
Greater than $428,000	69.30

Example 1. Brenda and Charlie are MFJ filers each year. Their 2012 MAGI for Medicare premium adjustment purposes is $350,000. This amount of MAGI triggers an adjustment to both their 2014 Part B base premium and their 2014 Part D Medicare premium amount. As shown in the table provided earlier in this section, Brenda and Charlie have a 2014 monthly Medicare Part B premium of $272.70.

Brenda and Charlie also have an adjustment to their Medicare Part D premium for 2014. As shown in the preceding table, the Social Security Administration (SSA) will add an additional $50.20 to Brenda and Charlie's monthly premium that they pay for the Part D plan they select.

18. 42 USC §1395w-113(a)(7).

19. Social Security Act, §1839(i) and Centers for Medicare & Medicaid Services. Jul. 30, 2013. [www.cms.gov/Medicare/Health-Plans/MedicareAdvtgSpecRateStats/Downloads/PartDandMABenchmarks2014.pdf] Accessed on Jun. 11, 2014.

20. Ibid.

For **MFS filers who have lived together** for part or all of the tax year, the relevant MAGI ranges and Part D premium adjustments are as follows.[21]

MAGI Range	Amount Added to Part D Monthly Premium for Plan Selected
Greater than $85,000 but less than or equal to $129,000	$50.20
Greater than $129,000	69.30

Example 2. Use the same facts as **Example 1,** except Brenda and Charlie file MFS each year. For 2012, they lived together for two months. For the 2014 tax year, their Part B premium is $335.70 per month and the SSA increases the Medicare Part D premium by an additional $69.30.

Observation. In **Example 2,** it is the 2012 MAGI that is taken into consideration for 2014 premiums. In addition, when determining whether the spouses lived together during the year, it appears that 2012 is the tax year to consider as well. Although the statute is not explicit on this point, this approach seems to make the most sense.

Note. The Social Security Administration publishes an annual guide to the income-related Medicare premium adjustments. The guide, called *Medicare Premiums: Rules for Higher-Income Beneficiaries*, is available through the Social Security website at **www.socialsecurity.gov/pubs/EN-05-10536.pdf.**

SUPPLEMENTING MEDICARE COVERAGE

Most Medicare beneficiaries purchase some type of supplemental coverage to assist with out-of-pocket health care expenses not covered by Medicare. In 2009, only about 9% of Medicare beneficiaries reported not having any type of supplemental coverage.[22] Medicare beneficiaries may have employment-based health insurance that supplements Medicare coverage. A retiree health plan typically wraps around Medicare and pays for health-related expenses to the extent of the plan's limits.

Medicare beneficiaries without access to supplemental coverage through a former employer may obtain private supplemental insurance known as Medigap plans. Even though Medigap plans are offered only through private insurers, their content and marketing is heavily regulated through the Social Security Act.[23]

Note. CMS regularly publishes a guide to Medigap coverage.[24] Many states, including Illinois, also publish Medigap guides for their residents. The Illinois Department on Aging publishes a guide for the Chicago area, which may be found at **www.illinois.gov/aging/ship/Documents/SHIP_2013-2014ChicagoAreaMedSuppGuide.pdf.** Similar Illinois Medigap guides for plans available in the northern central and southern areas of Illinois are available at **www.illinois.gov/aging/SHIP.**

21. Ibid.

22. *Older Americans 2012.* Federal Interagency Forum on Aging-Related Statistics. [www.agingstats.gov/agingstatsdotnet/Main_Site/Data/2012_Documents/Docs/EntireChartbook.pdf] Accessed on Apr. 17, 2014.

23. 42 USC §1395ss.

24. *Choosing a Medigap Policy: A Guide to Health Insurance for People with Medicare.* Feb. 2014. Centers for Medicare & Medicaid Services. [www.medicare.gov/Publications/Pubs/pdf/02110.pdf] Accessed on Mar. 31, 2014.

TAX ISSUES RELATED TO MEDICAL EXPENSES

DEDUCTION OF MEDICAL EXPENSES

Whether covered through an employment-based plan, a new Health Insurance Marketplace policy, private insurance, Medicare, Medicaid, the VA, or TRICARE, most individuals incur health-related expenses that are not paid for by insurance. Depending on the total amount of unreimbursed medical expenses, an individual may be able to deduct some portion of those expenses. IRC §213(a) provides that a taxpayer may deduct on Schedule A of Form 1040 "expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent . . . to the extent that such expenses exceed 10 percent **of adjusted gross income."**

> **Note.** Before 2013, IRC §213 deductible medical expenses were deductible to the extent they exceeded 7.5% of a taxpayer's AGI.

Transitional Rule for Older Taxpayers

An exception applies to taxpayers who are age 65 or older. For 2013–2016, medical expenses are generally deductible to the extent they exceed 7.5% (instead of 10%) of AGI if the taxpayer (or the taxpayer's spouse) is at least age 65 before the end of the tax year.[25] For tax years beginning after December 31, 2016, the 10% floor applies to all taxpayers without regard to age.

Qualifying Medical Expenses

Medical expenses that may qualify for deduction under IRC §213 include the following.

- Expenses paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, and for transportation primarily for and essential to such medical care[26]
- Expenses paid for qualified long-term care services[27] (For these purposes, **qualified long-term care services** are defined in IRC §7702B(c)(1) as necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services, required by a **chronically ill** individual and provided under a care plan prescribed by a licensed health care practitioner.)
- Health insurance premiums, including Medicare Part B premiums[28] and Medicare Part D premiums[29]

Under IRC §7702B(c)(2), a **chronically ill** individual means someone certified by a licensed healthcare practitioner as being unable to perform (without substantial assistance from another individual) at least two activities of daily living (ADL) for a period of at least 90 days due to a loss of functional capacity or someone who requires substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.[30] ADLs include bathing, eating, toileting, dressing, and transferring.[31] A disabled individual with a similar level of disability to the foregoing is also considered a chronically ill person under IRC §7702B.

25. IRC §213(f).
26. IRC §213(d)(1)(A), (B).
27. IRC §213(d)(1)(C).
28. IRC §213(d)(1)(D).
29. IRS Pub. 554, *Tax Guide for Seniors.*
30. IRC §213(d)(1).
31. IRC §7702B(c)(2)(B).

Common types of medical expenses include the following.[32]

- Payments to doctors, dentists, and other types of medical practitioners are deductible. For example, a $20 co-payment for a visit to a physician's office may be deductible even though the majority of the cost of the visit is covered by health insurance and therefore not deductible.
- The taxpayer's cost for prescription drugs and insulin is deductible. Over-the-counter nonprescription medication is not deductible.[33] However, if a physician prescribes a medication, the cost of that medication is deductible even if it could be purchased without the prescription.
- Payments for hospital care or nursing home services, including meals and lodging, are deductible, as long as the primary reason for being in the hospital or nursing home is to obtain medical care.
- Payments for false teeth, hearing aids, crutches, and wheelchairs are deductible.
- Payments for special equipment and improvements to a home to accommodate a medical condition of the taxpayer, spouse, or a dependent are deductible. However, to the extent permanent improvements increase the value of the taxpayer's home, that increase in value must be subtracted from the cost before determining the amount deductible as a medical expense.[34]

Note. The increase in the home's value is sometimes difficult and expensive to calculate.

Example 3. George has a serious lung condition. His house does not have central air-conditioning, and he is generally confined to the one room that has a portable air-conditioning unit. Based on his doctor's advice, George installs an air-conditioning system that cools the entire house. The system cost $2,500 to install. George's house was worth $100,000 before installation of the air-conditioning system. After the system is installed, the value of George's house is $102,000. Only $500 (the cost that exceeds the additional value to the house) is potentially a deductible medical expense.

Because many older individuals wish to age in place, they often retrofit their homes to accommodate physical limitations. According to IRS Pub. 502, *Medical and Dental Expenses,* common types of special equipment or improvements that may be deductible include the following.

- Adding ramps, widening doorways and hallways, and grading access areas, especially around the house's entrances and exits
- Installing handrails, support/grab bars, and similar safety grips in bathrooms and elsewhere
- Lowering or modifying kitchen cabinets and equipment (generally to permit wheelchair access)
- Moving or modifying electrical outlets and fixtures
- Modifying door and cabinet hardware
- Adding various forms of mechanical lifts, such as porch and chair lifts for stairs (Elevators, however, are usually considered to add value to the house and must be evaluated accordingly in determining the amount deductible.)

32. Ibid.

33. IRC §213(b).

34. Treas. Reg. §1.213-1(e)(1)(iii).

Certain types of medical expenses are **expressly not deductible,** including the following.

- Expenses for cosmetic surgery, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease[35]
- Housekeeping services, even if performed by an attendant who otherwise provides nursing services (For example, if a home health care provider supplies both nursing services and light housekeeping, the amount paid to that provider must be divided between the nursing and housekeeping services. Only the payment allocated to nursing services is a deductible medical expense under IRC §213.)

However, personal care services and maintenance (including housekeeping services) provided to a **chronically ill individual[36] are deductible** expenses.

Limitation on Amount Deductible

For tax years beginning after 2012, potentially deductible medical expenses under IRC §213 are deductible for most taxpayers only to the extent that such expenses exceed 10% of the taxpayer's AGI. A taxpayer must also itemize deductions in order to take advantage of this provision under IRC §213.

Reporting Medical Expenses

Deductible medical expenses are reported on Schedule A, *Itemized Deductions.*

Example 4. In 2014, Mary is age 68 and single. Her 2014 AGI is $36,000. She has the following 2014 expenses that she thinks might be deductible medical expenses.

- Medicare Part B and D premiums (combined): $1,680
- Over-the-counter drug costs: $300 (primarily for allergy medicines, none of which were obtained with a doctor's prescription)
- Co-payments for physician office visits: $800
- New prescription eyeglasses: $900
- Health club dues (following her doctor's recommendation that she get regular exercise): $240

Because Mary is over age 65, she can take advantage of the 7.5% threshold in 2014 under IRC §213. Thus, she can deduct qualifying medical expenses to the extent they exceed 7.5% of her AGI, or $2,700 ($36,000 × 7.5%).

Mary's Part B and D premiums, her co-payments for physician office visits, and her prescription eyeglass costs are all deductible medical expenses under IRC §213. Her over-the-counter drug costs and health club dues are not deductible.[37] Thus, Mary can deduct $680 ($1,680 + $800 + $900 − $2,700) in 2014 if she itemizes deductions.

35. IRC §213(d)(9).

36. IRC §7702B(c)(1).

37. IRS Pub. 554, *Tax Guide for Seniors.*

LONG-TERM CARE CONSIDERATIONS

A major planning consideration for aging taxpayers is the strong likelihood of the need for some degree of long-term care. Although a relatively small percentage of the population 65 years of age or older resides in nursing homes at any given time (for example, 1.3 million resided in nursing homes in 2011), more than 10% are likely to reside in nursing homes after age 85.[38] Much higher percentages of elderly taxpayers may need some kind of assistance with basic living activities. They may need assistance with ADLs; or they may require help with instrumental activities of daily living (IADL), such as meal preparation, driving (or managing other transportation), shopping, and housekeeping. In 2012, 28% of those age 65 or older reported having difficulty with at least one ADL, and an additional 12% reported having difficulty with at least one IADL.[39] The challenges will only increase over the next few decades as the U.S. population ages. An estimated 27 million individuals are likely to need some form of long-term care assistance by 2050, more than double the current numbers.[40]

The need for planning for future long-term care needs is particularly acute for women, who are much more likely to reside in a nursing home at some point in their lives. More than 70% of residents in long-term care facilities are women, and women tend to have higher rates of both functional and physical limitations than men as they age.[41]

Long-term care is expensive. Costs vary greatly, depending on the type of care and the geographic area. The 2012 national average nursing home daily rate was $248 for a private room ($90,520 per year) and $222 for a semi-private room.[42] In Alaska, however, the average nursing home daily rates in 2012 were $687 for a private room and $682 for a semi-private room. The lowest average semi-private room daily rate for 2012 was in Texas (not including the major cities), where the cost was $131. For private rooms, Oklahoma (not including the major cities) offered the lowest average nursing home daily rate, which was $147.

Note. In Illinois, the 2012 average nursing home daily rate, including nursing homes in the major cities, was $216 for a private room and $175 for a semi-private room.[43]

Many individuals only reside in nursing homes for brief periods while they recover from short-term illnesses or injuries. However, many taxpayers become long-term residents in a nursing home. The 2004 National Nursing Home Survey found that, based on current nursing home residents at the time of the survey, the average duration of stay in a nursing home was 835 days.[44] Using 2012 rates, this means an overall cost of $207,080 for an average stay in a private room.

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38. *A Profile of Older Americans: 2012*. U.S. Department of Health & Human Services. [www.aoa.gov/AoARoot/Aging_Statistics/Profile/2012/docs/2012profile.pdf] Accessed on Apr. 1, 2014.

39. Ibid.

40. *Long-Term Care Statistics*. American Association for Long-Term Care Insurance. [www.aaltci.org/long-term-care-insurance/learning-center/long-term-care-statistics.php] Accessed on Apr. 8, 2014.

41. *Medicare's Role for Older Women*. May 16, 2013. Kaiser Family Foundation. [kff.org/womens-health-policy/fact-sheet/medicares-role-for-older-women] Accessed on Apr. 8, 2014.

42. *Market Survey of Long-Term Care Costs: The 2012 MetLife Market Survey of Nursing Home, Assisted Living, Adult Day Services, and Home Care Costs*. Nov. 2012. MetLife. [www.metlife.com/assets/cao/mmi/publications/studies/2012/studies/mmi-2012-market-survey-long-term-care-costs.pdf] Accessed on Apr. 1, 2014.

43. Ibid.

44. *2004 National Nursing Home Survey,* Tbl. 12 (Nursing Home Current Residents). June 2008. National Center for Health Statistics. [www.cdc.gov/nchs/data/nnhsd/Estimates/nnhs/Estimates_PaymentSource_Tables.pdf#Table12] Accessed on Apr. 7, 2014.

Individuals who do not require the level of care provided by a nursing home, but who still need more assistance than is practical to arrange at home, may choose to move into an assisted living facility or other type of residential care facility. Although less expensive than nursing home care, assisted living facilities may still cost more than many individuals expect. The national average monthly cost of assisted living in 2012 was $3,550 ($42,600 per year).[45] The highest average rate for assisted living facilities was in Washington, D.C., with an average monthly rate of $5,933 ($71,196 per year); the lowest average rate was in Arkansas outside major cities, with an average monthly rate of $2,355 ($28,260 per year).

Note. In Illinois, the 2012 average monthly cost of assisted living for the state, including facilities in the major cities, was $3,858. The monthly cost of assisted living facilities in Chicago, however, averaged $4,140.[46]

Another option is to remain at home and hire a home health care aide or homemaker companion. The 2012 average national hourly rate was $21 for a home health care aide and $20 for homemaker companion services.[47] Assuming a home health care aide is hired for 20 hours per week for each of the 52 weeks within a year, home health care services will cost $21,840 per year (calculated using the 2012 average national hourly rate).

As they age, Americans overwhelmingly prefer to remain in their homes and communities. A 2010 AARP survey of individuals age 45 and older found that almost 75% of those interviewed strongly indicated that they would prefer to remain in their homes as long as possible.[48]

The key challenge is how to pay for long-term care and to enable individuals to age in the manner they prefer to the maximum extent possible.

PAYING FOR LONG-TERM CARE

There are various sources of payment for long-term care, with some variation depending on the level of care needed.

Private Pay

Individuals who are disqualified from obtaining Medicaid benefits, who are not veterans, and who do not have long-term care insurance must use their own resources to pay for their long-term care assistance. Many taxpayers begin to pay for their own care until their assets are exhausted. Once they "spend down" their own assets, they may qualify for Medicaid.

Medicaid

The Medicaid program provides funding for a greater percentage of long-term care than any other payment source. In 2011, Medicaid paid for 40% of the $357 billion spent on various types of long-term care services and supports.[49]

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45. *Market Survey of Long-Term Care Costs: The 2012 MetLife Market Survey of Nursing Home, Assisted Living, Adult Day Services, and Home Care Costs*. Nov. 2012. MetLife. [www.metlife.com/assets/cao/mmi/publications/studies/2012/studies/mmi-2012-market-survey-long-term-care-costs.pdf] Accessed on Apr. 1, 2014.

46. Ibid.

47. Ibid.

48. *Home and Community Preferences of the 45+ Population*. Nov. 2010. AARP. [assets.aarp.org/rgcenter/general/home-community-services-10.pdf] Accessed on Apr. 1, 2014.

49. *Five Key Facts about the Delivery and Financing of Long-Term Services and Supports*. Sep. 13, 2013. Kaiser Family Foundation. [kff.org/medicaid/fact-sheet/five-key-facts-about-the-delivery-and-financing-of-long-term-services-and-supports] Accessed on Apr. 1, 2014.

Medicaid is a joint program of the federal and state governments.[50] Title XIX of the Social Security Act lays out the broad framework of the Medicaid program, including eligibility categories,[51] but each state develops the details of its own unique Medicaid plan, subject to approval by CMS. A state's plan must meet certain federal requirements in order to receive federal Medicaid funds.[52]

Before the ACA, the Social Security Act required a state electing to participate in the Medicaid program to cover certain mandatory eligibility categories, and it permitted a state to cover additional optional eligibility categories.[53] Nothing in the federal statute forces a state to participate in the Medicaid program, but all states do. The main eligibility categories covered children, pregnant women, parents of eligible children, individuals age 65 and above, and disabled persons. Many individuals could not receive Medicaid assistance supported by federal funds, particularly nondisabled adults who were neither pregnant nor had qualifying children and who were not eligible for Medicare.

The ACA broadens Medicaid eligibility to cover taxpayers between the ages of 18 and 64 with income at or below 133% of the federal poverty guidelines (FPG).[54] The ACA does not change otherwise existing eligibility categories, but CMS has attempted to streamline eligibility categories through regulations.[55]

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> **Note.** Medicaid eligibility is governed by individual states. Information about the Illinois Medicaid program is available through the Illinois Department of Healthcare and Family Services website at **www2.illinois.gov/hfs/Pages/default.aspx.**

For individuals who qualify for Medicaid benefits within their state, Medicaid generally covers most health-related expenses not otherwise paid by Medicare or other sources.[56] Medicaid also covers long-term care expenses, including nursing home care. Historically, Medicaid's long-term care coverage focused on nursing home care, but this focus was broadened to support community-based long-term care services.[57]

> **Note.** For a detailed discussion of Medicaid eligibility and coverage for long-term care, see the 2011 *University of Illinois Federal Tax Workbook*, Chapter 2: Long-Term Care. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

Although the ACA expands Medicaid eligibility, it does not change eligibility provisions applicable to elderly taxpayers (age 65 or older). Accordingly, the rules remain the same for most taxpayers needing long-term care assistance through Medicaid. Before the ACA, an unmarried individual could not own more than $2,000 in assets in most states. The value of an automobile used for transportation by the Medicaid applicant or household member was excluded from the asset computation, as was the value of the applicant's residence (up to $500,000 in equity value) and most household furnishings, including clothes and other similar personal items. The same basic standard applies after the ACA.

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50. *The Medicaid Program at a Glance.* Mar. 4, 2013. Kaiser Family Foundation. [kff.org/medicaid/fact-sheet/the-medicaid-program-at-a-glance-update] Accessed on Apr. 2, 2014.

51. 42 USC §1396a.

52. 42 USC §1396b.

53. 42 USC §1396a(a)(10)(A)(i).

54. 42 USC §1396a(a)(10)(A)(i)(VIII).

55. Department of Health and Human Services, *Medicaid Program: Eligibility Changes Under the Affordable Care Act of 2010; Final Rule,* 77 Fed. Reg. 17144, 17147 (Mar. 23, 2012). ("The Affordable Care Act did not eliminate or change the requirements of existing Medicaid eligibility groups, except to require the use of MAGI-based financial methodologies for the populations.")

56. *Medicaid: A Primer (2013).* Mar. 2013. Kaiser Commission on Medicaid and the Uninsured. [kaiserfamilyfoundation.files.wordpress.com/2010/06/7334-05.pdf] Accessed on Apr. 2, 2014.

57. *Long-Term Services & Support.* Centers for Medicare & Medicaid Services. [www.medicaid.gov/Medicaid-CHIP-Program-Information/By-Topics/Long-Term-Services-and-Supports/Long-Term-Services-and-Supports.html] Accessed on Apr. 2, 2014.

Special asset determination rules apply when a married Medicaid applicant is (or will be) a nursing home resident while the applicant's spouse remains in the community.[58] The rules attempt to prevent spousal impoverishment.[59] Among other protections, the community spouse is allowed to retain assets up to the maximum community spouse resource allowance (CSRA).

A standard part of Medicaid planning for a married couple is to compute the CSRA, protect assets up to the CSRA for the community spouse, and spend down assets for the current or anticipated nursing home resident spouse. The CSRA varies by state but is subject to maximum and minimum limits established by CMS. For 2014, the maximum CSRA is $117,240, and the minimum CSRA is $23,448.[60]

Special income determination rules also apply to a married Medicaid applicant who is (or will be) a nursing home resident while that applicant's spouse remains in the community.[61] For example, a community spouse's income is deemed "unavailable" to a nursing home spouse for purposes of Medicaid. These rules were not changed by the ACA.

Transfers to Family Members. In order to spend down assets to allow an older person, particularly one who requires nursing home care, to qualify for Medicaid, individuals may wish to gift various amounts to family members, friends, and perhaps even charities. Although such actions may not trigger negative federal income tax consequences, such gifts may be considered disqualifying transfers for purposes of determining Medicaid eligibility.

If an individual seeking Medicaid eligibility has transferred assets for less than fair market value (FMV) during a look-back period to anyone (including a charity) for any reason, the value of the assets transferred is taken into account in determining eligibility. The look-back period for any transfers made after February 7, 2006, is 60 months before the date on which the transferring individual is institutionalized or applies for Medicaid.[62]

Generally, if an individual (or the individual's spouse) makes such a transfer for less than FMV within the look-back period, the individual is disqualified from Medicaid for a period of months determined by dividing the total uncompensated value of the transferred assets by the average monthly private pay cost of nursing home coverage in the applicable state (or, in some cases, in the community in which the Medicaid applicant resides).[63] The disqualification period begins on the first date on which the transferring individual would have been eligible for Medicaid except for the transfer.

There are exceptions to the disqualifying transfer rule. Transfers to a spouse or to a blind or disabled child generally do not count as disqualifying transfers, nor do transfers to a trust established solely for the benefit of a disabled person who has not yet attained age 65.[64]

In addition, Medicaid allows an individual applying for Medicaid to transfer their home to certain family members without the transfer triggering a period of disqualification.[65] Such a transfer can be made to the individual's spouse or the individual's child who is either under age 21 or is blind or disabled.

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58. 42 USC §1396r–5.

59. *Spousal Impoverishment*. Centers for Medicare & Medicaid Services. [www.medicaid.gov/Medicaid-CHIP-Program-Information/By-Topics/Eligibility/Spousal-Impoverishment-Page.html] Accessed on Apr. 2, 2014.

60. *2014 SSI and Spousal Impoverishment Standards*. Centers for Medicare & Medicaid Services. [www.medicaid.gov/Medicaid-CHIP-Program-Information/By-Topics/Eligibility/Downloads/Spousal-Impoverishment-2014.pdf] Accessed on Apr. 2, 2014.

61. 42 USC §1396r–5(b).

62. 42 USC §1396p(c)(1)(B).

63. 42 USC §1396p(c)(1)(E).

64. 42 USC §1396p(c)(2)(B).

65. 42 USC §1396p(c)(2)(A).

Medicare

Medicare pays a significant amount for skilled nursing care. In 2011, Medicare funded 21% of the nation's overall spending on long-term care services and support.[66] Medicare also pays a significant amount for home health care.

Medicare Part A covers short-term skilled nursing care in limited circumstances. The care must be provided in a skilled nursing facility (SNF) that has been approved by Medicare, and the following must apply.

- The beneficiary must be admitted to the SNF within 30 days of discharge from an inpatient hospital stay that extended at least three days, including the day of admission but not the day of discharge.
- Skilled nursing care must be medically necessary on a daily basis to treat a condition related to the preceding hospital stay.

As long as these requirements are satisfied, Medicare Part A generally covers up to 100 days in a SNF for each benefit period or spell of illness. Medicare considers a spell of illness as a period that begins on the first day an individual is admitted for inpatient care and ends 60 days after the last day on which the individual was an inpatient in a hospital, a SNF, or other rehabilitative facility.[67] The first 20 days do not require any coinsurance from the beneficiary. However, the 21st day through the 100th day are subject to a daily coinsurance payment, which is $152 in 2014.[68]

Medicare covers home healthcare services under both Parts A and B. In general, eligibility for home health care services requires the following.[69]

- The Medicare beneficiary must be under a physician's care and receiving health care services under a plan of care established and reviewed regularly by a physician.
- The Medicare beneficiary must require (as certified by a physician) intermittent skilled nursing care, physical therapy, speech-language pathology services, or continued occupational therapy (or more than one of these services).
- The home health agency providing the home health care services to the Medicare beneficiary must be approved by Medicare.
- The Medicare beneficiary must be certified by a physician as homebound. **Homebound** means that the Medicare beneficiary cannot leave home without assistance due to a medical condition, that leaving home requires a considerable and taxing effort, and that leaving home is not recommended due to the medical condition.

> **Note.** Just because a Medicare beneficiary is certified as "homebound" does not mean that the beneficiary can never leave the home. For example, trips for medical care and infrequent other trips, such as to church, are permitted.

- The beneficiary must require no more than part-time or intermittent skilled nursing care. **Part-time or intermittent** skilled nursing care generally means care provided for fewer than seven days each week or less than eight hours each day over a period of 21 days (or less).

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66. *Five Key Facts about the Delivery and Financing of Long-Term Services and Supports.* Sep. 13, 2013. Kaiser Family Foundation. [kff.org/medicaid/fact-sheet/five-key-facts-about-the-delivery-and-financing-of-long-term-services-and-supports] Accessed on Apr. 2, 2014.

67. 42 USC §1395x(a)(2).

68. *Medicare 2014 Costs at a Glance*. Centers for Medicare & Medicaid Services. [www.medicare.gov/coverage/skilled-nursing-facility-care.html] Accessed on Apr. 2, 2014.

69. *Medicare and Home Health Care.* Centers for Medicare & Medicaid Services. [www.medicare.gov/Pubs/pdf/10969.pdf] Accessed on Apr. 6, 2014.

If a beneficiary qualifies for Medicare-covered home health care, Medicare pays for any of the following if considered "reasonable and necessary" for the treatment of the beneficiary's condition.

- Skilled nursing care, which must be provided by a registered nurse (RN) or a licensed practical nurse (LPN) and does not include any care that could safely be provided by a nonmedical person
- Physical therapy, occupational therapy, and speech-language pathology services
- Medical social services, if they are provided under the direction of a physician in connection with the beneficiary's medical care
- Medical supplies

Home health care covered under Medicare Part A is covered 100% (other than the cost of durable medical equipment) with no cost to a beneficiary.[70] Durable medical equipment provided in connection with covered home health care services is subject to a 20% coinsurance payment by the beneficiary. Durable medical equipment includes such items as wheelchairs and walkers.[71]

Home health care not covered under Part A, but that meets the requirements specified earlier for Medicare coverage, is covered under Part B. In addition to an annual deductible ($147 in 2014), services and supplies provided under Part B are generally subject to 20% coinsurance payments.[72]

Veterans' Benefits

The U.S. Department of Veterans Affairs (VA) provides a wide range of health benefits to qualifying veterans, including long-term care. Eligibility for VA long-term care benefits requires enrollment in the VA health benefits system. Any taxpayer who had active U.S. military service and was discharged under conditions other than dishonorable may be eligible for VA health benefits.[73] Whether an individual qualifies for benefits, however, varies depending on when, where, and how long an individual served and whether that individual suffered some sort of service-related injury, among other factors.

In general, a minimum-duty requirement applies in order to qualify for VA health benefits. Most veterans who enlisted after September 7, 1980, or entered active duty after October 16, 1981, must have served 24 continuous months or the full period for which they were called to active duty in order to be eligible. However, numerous exceptions apply, particularly in cases in which a veteran suffers a disability incurred or aggravated in the line of duty.

A veteran who is eligible for VA health benefits is assigned to one of eight priority groups that determine the details of enrollment in VA health coverage.

> **Note.** For further details regarding the eight priority groups, see **www.va.gov/healthbenefits/resources/priority_groups.asp.**

70. *Medicare 2014 Costs at a Glance.* Centers for Medicare & Medicaid Services. [www.medicare.gov/your-medicare-costs/costs-at-a-glance/costs-at-glance.html#collapse-4808] Accessed on Apr. 2, 2014.

71. *Medicare Coverage of Durable Medical Equipment and Other Devices*. Centers for Medicare & Medicaid Services. [www.medicare.gov/Publications/Pubs/pdf/11045.pdf] Accessed on Apr. 6, 2014.

72. *Medicare 2014 Costs at a Glance.* Centers for Medicare & Medicaid Services. [www.medicare.gov/your-medicare-costs/costs-at-a-glance/costs-at-glance.html#collapse-4808] Accessed on Apr. 2, 2014.

73. *Health Benefits.* U.S. Department of Veterans Affairs. [www.va.gov/healthbenefits] Accessed on Apr. 8, 2014.

All veterans who are enrolled in VA health benefits are eligible for long-term care services through the VA.[74] Depending on a veteran's needs, available services range from community-based services (such as adult daycare, respite care, and skilled home health care) to institutional care in nursing homes. This includes nursing homes operated directly by the VA.

In addition to the long-term care assistance available as part of the VA health benefits package, the VA also provides enhanced financial assistance for low-income veterans who receive a VA pension and who are homebound or in need of aid and attendance.[75] Similar financial assistance is available in some cases for the surviving spouses of certain low-income veterans.

> **Note.** Veterans' benefits are very complicated, in part because of the vast number of exceptions that exist. A useful starting point is the VA website: **http://benefits.va.gov/benefits.**

Long-Term Care Insurance

In light of the limitations of government programs to pay for long-term care needs, individuals may decide to purchase long-term care insurance to help pay for their potential future needs. Long-term care policies are available only through private insurance companies and are not standardized. As with any form of insurance, they are regulated by state insurance law in the state in which the policies are sold.

> **Note.** For an extensive discussion of long-term care insurance policies, considerations in selecting a policy, and common concerns with such policies, see the 2011 *University of Illinois Federal Tax Workbook,* Chapter 2: Long-Term Care. The chapter includes a useful "Long-Term Care Insurance Policy Comparison Tool." This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

> **Note.** When originally passed into legislation in March 2010, the ACA included a government-managed long-term care insurance program called the Community Living Assistance Services and Support (CLASS) program. CLASS was structured as a voluntary program intended to allow individuals to buy into the program, either through payroll deductions or direct payments. The CLASS program met significant opposition and was **repealed** as part of the American Taxpayer Relief Act of 2012, effective January 1, 2013.[76]

Tax Treatment of Long-Term Care Coverage. The federal government encourages the purchase of individual private long-term care insurance by providing various tax advantages for certain types of policies. Generally, long-term care insurance is treated by the Code as accident and health insurance and thus receives similar advantageous tax treatment. The tax treatment depends on whether benefits are provided under a qualified long-term care insurance contract, as defined in IRC §7702B.

- IRC §7702B(a) states that "a qualified long-term care insurance contract shall be treated as an accident and health insurance contract" and that "amounts . . . received under a qualified long-term care insurance contract shall be treated as amounts received for personal injuries and sickness and shall be treated as reimbursement for expenses actually incurred for medical care (as defined in IRC §213(d))."[77]
- IRC §104(a)(3) excludes from gross income amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness.

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74. *Geriatrics and Extended Care.* U.S. Department of Veterans Affairs. [www.va.gov/geriatrics/Guide/LongTermCare/Paying_for_Long_Term_Care.asp#] Accessed on Apr. 2, 2014.

75. Ibid.

76. American Taxpayer Relief Act of 2012, §642.

77. IRC §§7702B(a)(1), (2).

This means that the long-term care expenses paid by a qualified long-term care policy are not includible as income to the taxpayer, and the premiums are deductible, subject to the age-based limitations discussed later.

A **qualified long-term care insurance contract** under IRC §7702B means long-term care coverage that satisfies certain requirements, including the following.[78]

- The contract provides coverage only for qualified long-term care services.
- The contract does not pay or reimburse expenses for services or items reimbursable under Medicare (or that would be reimbursable by Medicare but for the application of a deductible or coinsurance). This rule does not apply if Medicare is functioning as a secondary payor[79] (which happens typically only with those who are still working full-time and have insurance through an employer).
- The contract must be guaranteed renewable.
- The contract generally may not provide for a cash surrender value.
- Any premium refunds, policyholder dividends, and similar amounts must be applied either to reduce future premiums or increase future benefits.

IRC §7702B(c)(1) defines **qualified long-term care services** to include necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services provided to a chronically ill individual in accordance with a plan of care prescribed by a licensed health care practitioner. Taxpayers receiving long-term care benefits generally must file Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts*, with their federal income tax returns. The long-term care benefit payor issues Form 1099-LTC, *Long-Term Care and Accelerated Death Benefits,* reflecting the payments made.

In addition to the favorable tax treatment of long-term care benefits received under a qualified long-term care insurance contract, the Code generally treats premiums paid for such coverage as deductible under IRC §213, subject to various limitations, including the 7.5%- or 10%-of-AGI floor discussed earlier in this chapter.

Medical care includes amounts paid for qualified long-term care services (as defined in IRC §7702B(c)).[80] Also included in the definition of medical care are amounts paid for any qualified long-term care insurance contract (as defined in §7702B(b)).[81]

In addition to requirements specified by IRC §7702B, IRC §213(d) further limits the premium deduction by imposing age-based limits.[82] Premiums may not be deducted in excess of the applicable limit, even for qualified contracts. These limits are subject to adjustments for inflation. The following table shows the 2013 and 2014 limits.

Age Attained by End of Tax Year	Maximum Deductible Premium (2013)[83]	Maximum Deductible Premium (2014)[84]
40 or younger	$ 360	$ 370
41–50	680	700
51–60	1,360	1,400
61–70	3,640	3,720
Older than 70	4,550	4,660

78. IRC §7702B(b)(1).
79. IRC §7702B(b)(2)(B)(i).
80. IRC §213(d)(1).
81. IRC §213(d)(1)(D).
82. IRC §213(d)(10).
83. Rev. Proc. 2012-41, 2012-45 IRB 539.
84. Rev. Proc. 2013-35, 2013-47 IRB 537.

Additional special rules apply to taxpayers with high-deductible health plans combined with health savings accounts (HSA) and also to long-term care plans with premiums paid by an employer. Distributions from HSAs may be used to pay qualified long-term care insurance premiums, subject to the age-based deduction limits.[85] HSA distributions are reported on Form 8889, *Health Savings Accounts (HSAs),* and filed with the taxpayer's income tax return.[86]

Per Diem Payments. Benefits paid under a long-term care contract, even if it constitutes qualified long-term coverage, may be taxable if they are in the form of per diem payments.[87] A per diem payment is a fixed amount paid on a recurring basis without regard to actual expenses.

If payments are made under the contract on a per diem basis, the amount excludable from the taxpayer's income is limited to $320 per day in 2013 and $330 per day in 2014.[88] Additional rules apply to the calculation of the excludable amount.[89]

Note. Form 1099-LTC, box 3, generally indicates the amount of long-term care payments made on a per diem basis.

Taxable long-term care payments are calculated on Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts.* This form takes into account the amounts excludable by the taxpayer. The instructions to Form 8853 provide guidance on how to report payments made to multiple payees. The 2013 version of Form 8853, page 2, follows.

85. IRC §223(d)(2)(C)(iii).

86. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans*.

87. IRC §7702B(d)(1).

88. *2014 Long Term Care Insurance Tax Deductions*. American Association for Long-Term Care Insurance. [www.aaltci.org/news/long-term-care-insurance-association-news/increased-long-term-care-insurance-tax-deduction-limits-announced] Accessed on Jun. 27, 2014.

89. IRC §7702B(d)(2).

Form 8853 (2013) Attachment Sequence No. **39** Page **2**

Name of policyholder (as shown on Form 1040) | Social security number of policyholder ▶

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

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

14a	Name of insured ▶ __________ **b** Social security number of insured ▶ __________				
15	In 2013, did anyone other than you receive payments on a per diem or other periodic basis under a qualified LTC insurance contract covering the insured or receive accelerated death benefits under a life insurance policy covering the insured? . . . ☐ **Yes** ☐ **No**				
16	Was the insured a terminally ill individual? . . . ☐ **Yes** ☐ **No** **Note:** *If "Yes" and the* ***only*** *payments you received in 2013 were accelerated death benefits that were paid to you because the insured was terminally ill, skip lines 17 through 25 and enter -0- on line 26.*				
17	Gross LTC payments received on a per diem or other periodic basis. Enter the total of the amounts from box 1 of all Forms 1099-LTC you received with respect to the insured on which the "Per diem" box in box 3 is checked . . .			**17**	
	Caution: ***Do not*** *use lines 18 through 26 to figure the taxable amount of benefits paid under an LTC insurance contract that is not a* ***qualified*** *LTC insurance contract. Instead, if the benefits are not excludable from your income (for example, if the benefits are not paid for personal injuries or sickness through accident or health insurance), report the amount not excludable as income on Form 1040, line 21.*				
18	Enter the part of the amount on line 17 that is from **qualified** LTC insurance contracts . . .			**18**	
19	Accelerated death benefits received on a per diem or other periodic basis. Do not include any amounts you received because the insured was terminally ill (see instructions) . . .			**19**	
20	Add lines 18 and 19 . . .			**20**	
	Note: *If you checked "Yes" on line 15 above, see* ***Multiple Payees*** *in the instructions before completing lines 21 through 25.*				
21	Multiply $320 by the number of days in the LTC period . . .	**21**			
22	Costs incurred for qualified LTC services provided for the insured during the LTC period (see instructions) . . .	**22**			
23	Enter the **larger** of line 21 or line 22 . . .	**23**			
24	Reimbursements for qualified LTC services provided for the insured during the LTC period . . .	**24**			
	Caution: *If you received any reimbursements from LTC contracts issued before August 1, 1996, see instructions.*				
25	Per diem limitation. Subtract line 24 from line 23 . . .			**25**	
26	**Taxable payments.** Subtract line 25 from line 20. If zero or less, enter -0-. Also include this amount in the total on Form 1040, line 21. On the dotted line next to line 21, enter "LTC" and the amount . . .			**26**	

Form **8853** (2013)

LONG-TERM CARE PROVIDED IN THE HOME

When taxpayers arrange for home health care or homemaker services, a number of employment and tax issues can arise regarding compensation for the in-home worker.

The preliminary question is whether an **in-home worker should be characterized as an employee or an independent contractor.** This characterization determines whether there are payroll tax issues under the Code. Although it may be tempting to simply assume that a home health care worker is not an employee, failure to characterize a worker appropriately can have **significant negative consequences.**

Generally, the distinction between an employee and an independent contractor lies in the degree of control exercised over that person in the context of the work at issue. The IRS has long refused to provide a bright-line test in making the determination, instead indicating that the totality of the circumstances should be considered.

The IRS looks at three main types of control.[90]

1. **Behavioral control.** An employer typically tells an employee when, where, and how to do the work at issue, whereas an independent contractor often retains significant control over these matters.

2. **Financial control.** An independent contractor is likely to have unreimbursed business expenses, to have some degree of financial investment in the work, and to be able to make a profit or loss on the work. An employee is much less likely to do so.

3. **Relationship of the parties.** In determining whether an employment relationship exists, the IRS looks to such evidence as written contracts specifying the type of relationship intended, the presence of employee-like benefits such as a retirement plan or paid vacation leave, and the degree of permanency of the relationship.

Note. For further guidance, the IRS established a list of 20 factors that are considered in determining whether a worker is an employee or an independent contractor.[91] These 20 factors reflect the three aspects of control listed. For more information about these factors, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Individual Taxpayer Issues.

Further guidance regarding household employees may be found in IRS Pub. 926*, Household Employer's Tax Guide,* which provides additional details for determining whether a worker is an employee or independent contractor. According to IRS Pub. 926, a household worker is an employee if the taxpayer can control not only what work is done, but how it is done. If the worker is an employee, it does not matter whether the work is full-time or part-time or that the worker is hired through an agency or from a list provided by an agency or association. It also does not matter whether the worker is paid on an hourly, daily, or weekly basis, or by the job.

Example 5. Bill has Parkinson's disease. He is still relatively mobile, but he can no longer manage his house the way he once did. Bill hires Nancy to come to his home every morning for four hours to cook, clean, do laundry, and run any errands he needs. Bill tells Nancy when to arrive and what to do, and he provides all the household equipment and supplies she needs to accomplish the assigned tasks. Nancy is Bill's household employee.

Common types of household employees include the following.[92]

- Babysitters
- Caretakers
- House cleaners
- Domestic workers
- Drivers
- Home health aides and private nurses
- Housekeepers
- Maids
- Nannies
- Yard workers

90. IRS Pub. 15-A, *Employer's Supplemental Tax Guide.*

91. Rev. Rul. 87-41, 1987-1 CB 296.

92. IRS Pub. 926, *Household Employer's Tax Guide*.

Not all workers who typically work in or around a home are household employees. For example, people who watch children in their own homes are not household employees of the children's parents or guardians. Similarly, when a housekeeping business sends someone to a client's home to clean, the maid is the employee of the housekeeping business rather than the client's employee.

According to IRS Pub. 926, if only the worker can control how the work is done, the worker is self-employed. Self-employed workers usually provide their own tools and offer services to the general public as an independent business. If an agency provides the worker and controls the work done, the worker is not a household employee.

Example 6. Rebecca has multiple sclerosis and is bedridden. She depends on home health care aides to assist her with all her activities. She hires her aides through a home health care agency that screens, employs, trains, and equips its aides. When Rebecca has any questions or directions, she contacts the agency owner and explains the issue. The agency owner then determines how the issue will be resolved. Neither the agency nor the aides who assist Rebecca are considered Rebecca's employees.

Note. If Rebecca eventually hired one particular aide to work only for her, with Rebecca paying the aide directly and providing all directions and supplies for the work, the aide would then become Rebecca's employee. A worker's status can thus change over time as circumstances change.

Tax Reporting and Withholding Requirements

There are several major tax obligations that apply to the wages paid to the household employee.

- Federal Insurance Contributions Act (FICA) withholding and payment requirement
- Federal Unemployment Tax Act (FUTA) payments by employers
- State unemployment tax, if applicable

Note. An employer of a household employee may be subject to state unemployment taxes and workers' compensation funding obligations at the state level without regard to whether FICA and FUTA taxes are owed. These requirements vary by state. The employer is subject to the laws of the state in which the taxpayer employs the household employee.

The Illinois Department of Employment Security (IDES) administers the Illinois unemployment tax. Generally, if a taxpayer pays one or more household workers at least $1,000 in wages in any calendar quarter within the current year or any of the preceding four years, that taxpayer must register with IDES as a household employer. More information regarding Illinois unemployment tax requirements may be found at **www.ides.illinois.gov/Pages/Unemployment_Taxes_and_Reporting.aspx.**

An employer of a household employee is **not** required to withhold income tax unless the employee requests income tax withholding and submits a Form W-4, *Employee's Withholding Allowance Certificate,* to the employer.[93]

FICA Requirement. Generally, the employer must withhold and pay FICA taxes to the federal government if the employer pays wages of $1,900 or more to a household employee during 2014 ($1,800 for 2013).[94] FICA taxes include social security and Medicare taxes.

93. Instructions to Schedule H.

94. www.socialsecurity.gov/OACT/COLA/CovThresh.html.

The following percentages apply to wages paid to household workers in 2014.

	Employee Share	Employer Share	Total
Social security	6.20%	6.20%	12.40%
Medicare tax	1.45%	1.45%	2.90%
Total	7.65%	7.65%	15.30%

For 2014, social security taxes are payable on all wages up to a maximum of $117,000. This maximum amount is subject to an inflation adjustment. Wages paid above the maximum are not subject to either the employee or employer share of social security taxes. However, there is no such limit for the Medicare tax component; therefore, all wages paid to household employees who are paid more than $1,900 are subject to the Medicare tax.

Following are additional rules that apply to household employees.[95]

- Wages paid to an employee who is under age 18 at any time during 2014 generally do not count for purposes of triggering the withholding/payment obligation.
- Wages paid to certain family members (spouse, children under age 21, and parents in most cases), even if they otherwise would be characterized as employees, are not subject to the general requirement to withhold and pay FICA taxes. An exception applies in certain circumstances when an individual pays their parent to care for their child.

FUTA Requirement. An employer must also pay FUTA taxes to the federal government if the employer pays (or paid) total wages of $1,000 or more to household employees in any calendar quarter of 2013 or 2014.[96]

- FUTA taxes are generally 0.6% of the first $7,000 of wages paid to each employee.[97] Wages paid in excess of $7,000 per employee are not subject to FUTA tax.
- Wages paid to certain family members (spouse, children under age 21, and parents in most cases), even if they otherwise would be characterized as employees, are not subject to FUTA taxes.[98]

FICA and FUTA taxes paid for household employees are reported on Schedule H, *Household Employment Taxes.* Schedule H is generally filed with the taxpayer's Form 1040. If the taxpayer is not required to file a tax return for the year, Schedule H must be filed separately. Payment of the FICA and/or FUTA taxes owed is made by the taxpayer-employer with their Form 1040 or separately filed Schedule H. Accordingly, the payment generally has the same due date as Form 1040.

> **Note.** For an example that requires the use of Schedule H for a household employee, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Individual Taxpayer Issues. This example includes a completed Schedule H.

> **Observation.** The taxpayer who employs one or more household workers generally is required to obtain an employee identification number (EIN). An EIN may be obtained by completing Form SS-4, *Application for Employer Identification Number.* An EIN may also be obtained using the IRS online system at **www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Apply-for-an-Employer-Identification-Number-(EIN)-Online.**

95. IRS Pub. 926, *Household Employer's Tax Guide*.
96. Ibid.
97. IRC §§3301, 3306(b).
98. IRS Pub. 926, *Household Employer's Tax Guide*.

If the taxpayer employing a household employee owns a business or operates a farm on which that taxpayer's home is located and the taxpayer reports wages for nonhousehold employees of the business or farm, the taxpayer may choose to report and pay taxes due for household employees along with the nonhousehold employees. In such cases, the taxpayer should include the information and taxes for a household employee on Form 940 and on Form 941, 943, or 944, as applicable.

Note. Additional forms may be required to report any applicable state taxes.

Form W-2 Requirement. Form W-2 must be provided to any household employee who receives more than $1,900 in wages subject to FICA taxes in 2014. Even if an employee's wages are less than this amount, the employer must issue Form W-2 if federal income tax was withheld from the wages.[99]

Deducting Wages Paid to Household Employees

A taxpayer who pays household employees for long-term care services may be able to deduct the payments if the services constitute medical care within the meaning of IRC §213.[100] In the context of household employees, the challenge is distinguishing between payments made for nondeductible household help (such as cleaning or cooking) and payments made for deductible medical services.

IRS Pub. 554, *Tax Guide for Seniors*, indicates that a taxpayer generally cannot include in medical expenses the cost of **household help,** even if such help is recommended by a doctor. However, payments made to individuals providing **nursing-type services** may be deductible even if the person providing the services is not a nurse. The services must be of a kind generally performed by a nurse and include services that are connected with caring for the patient's condition, such as giving medication or changing dressings, as well as bathing and grooming the patient.[101] There is also an exception for certain maintenance and personal care services. Even though these services might otherwise resemble nondeductible household help services rather than deductible nursing-type services, maintenance and personal care services provided to a chronically ill person are deductible when the primary purpose of the services is "needed assistance with any of the disabilities as a result of which the individual is a chronically ill individual (including the protection from threats to health and safety due to severe cognitive impairment)."[102]

The same employee may provide both nursing-type services to nonchronically ill individuals that qualify as deductible medical expenses as well as other general household help services that are not deductible. Payments to an employee providing both types of services must be **allocated** between the two types so that only the portion attributable to nursing-type services is deducted. Employment taxes (FICA, FUTA, and any state unemployment taxes, if applicable) paid for an employee who is providing deductible nursing-type services are also deductible medical expenses.[103]

Note. Any deductible expenses under IRC §213 are subject to either the 7.5%- or 10%-of-AGI floor, as explained earlier in this chapter.

Restriction on Deduction of Payments to Family Members. An additional restriction applies under IRC §213 for long-term care services provided by family members. Under IRC §213(d)(11), qualified long-term care service is not treated as medical care for purposes of a deduction if the service is provided by the individual's spouse or certain relatives of the individual.

99. Ibid.

100. IRC §213(d)(1)(C).

101. IRS Pub. 554, *Tax Guide for Seniors*.

102. IRC §7702B(c)(3).

103. Ibid.

A related issue may arise concerning the tax treatment of payments made by state Medicaid programs to family members providing care to an individual in a home setting. Under certain Medicaid waiver programs, a state may direct payments to family members who are providing home-based care to a Medicaid-eligible individual. Typically, in such situations, the Medicaid-eligible individual requires a level of care that qualifies for nursing home placement; if family members were not providing the home-based care, the Medicaid-eligible individual would most likely be placed in a nursing home. Because community-based care usually costs less than institutional care (such as in a nursing home), state Medicaid programs tend to favorably view any option that avoids a nursing home placement. The state may obtain a waiver from CMS that allows home-based care in such situations.

If an individual's physical or mental limitations are sufficient to justify nursing home placement, that individual likely needs full-time custodial care. Family members may want to provide that care but often need to maintain their own incomes. By paying the family caregiver what may be a relatively small portion of the Medicaid funds that would otherwise have been paid to a nursing home, that family member may have the financial ability to stay home and provide the needed caregiving services.

IRC §131 deals with this situation under the umbrella of foster care. In IRS Notice 2014-7,[104] the IRS explains that §131 does not explicitly address whether payments under Medicaid waiver programs are qualified foster care payments. Medicaid waiver programs and state foster care programs, however, share similar oversight and purposes. Historically, the IRS fought taxpayers who attempted to exclude Medicaid waiver payments from their income in reliance on IRC §131. The IRS announced in Notice 2014-7 that it changed its position. To achieve consistent federal tax treatment of Medicaid waiver payments among the states and individual care providers, this notice provides that as of January 3, 2014, the IRS will treat qualified Medicaid waiver payments as difficulty-of-care payments under §131(c) that are excludable under §131. This treatment will apply regardless of whether the care provider is related or unrelated to the eligible individual.

RETIREMENT INCOME

Financial concerns for elderly and/or retired taxpayers often involve the taxation of retirement income, such as income from a retirement plan or IRA. How this income is received, subject to applicable tax rules, largely determines its annual tax treatment and reporting.

A working knowledge of the applicable rules regarding the receipt and tax reporting of social security income is important. Moreover, knowledge about other types of income that may be common among older taxpayers is essential, such as income from a veterans' pension plan. Reverse mortgages have also been popular with many elderly taxpayers, and it is important to understand their tax consequences.

When the social security retirement system was created in the 1930s, the underlying assumption was that workers would fund retirement through a three-legged stool of social security retirement benefits, employment-based retirement benefits, and personal savings. The personal savings leg of this stool has proved the weakest of the three. A 2013 survey found that only 66% of all workers had saved anything toward retirement, including through an employment-based retirement plan.[105] Even more troubling, fewer than 34% of all workers in 2013 reported having more than $50,000 saved for retirement from all sources.[106] Apart from personal savings, there are several possible sources of retirement income, including the following.

- Employment-based retirement plans
- IRAs
- Social security retirement benefits

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104. IRS Notice 2014-7, 2014-4 IRB 445.

105. *Employment Coverage Thresholds.* Social Security Administration. [www.ebri.org/files/Final-FS.RCS-13.FS_3.Saving.FINAL.pdf] Accessed on Jul. 1, 2014.

106. Ibid.

EMPLOYMENT-BASED RETIREMENT PLANS

Employers may offer employees either a qualified or nonqualified retirement plan (or a combination of both). Typically, nonqualified plans are available only to highly compensated management employees, while qualified plans are widely available to an employer's workforce.

In order for a plan to be qualified, it must meet the requirements of IRC §401 and other related Code sections. Plans that meet those requirements enjoy significant tax advantages as compared to nonqualified plans.

> **Note.** For a more detailed discussion of nonqualified and qualified retirement plans, see the 2011 *University of Illinois Federal Tax Workbook,* Chapter 5: Retirement. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

The main **tax advantages of qualified plans** are as follows.

- Contributions to the plans are not treated as compensation to the employee-participant at the time of contribution. This is true even if the benefits are 100% vested, meaning that a participant has a nonforfeitable right to the vested amount. A participant is taxed only on their distributions from the plan.
- Investment earnings are tax-deferred during the time the funds remain in a qualified plan's trust. Qualified plans under IRC §401 always have an associated trust that is tax-deferred under IRC §501.
- Even though contributions to a qualified plan are not taxable to participants at the time of contribution, employers are permitted to treat their contributions as a deductible compensation expense, subject to certain limits as to the amount of deductions.

In addition to being classified as qualified or nonqualified, employment-based retirement plans are further classified as either **defined contribution** or **defined benefit** plans.

In a **defined contribution plan,** the employee, the employer, or both contribute funds into individual accounts for the employee. Funds are invested, typically in accordance with the investment directions of the employee. Each employee's individual account balance is adjusted to reflect the investment earnings and losses of that employee's account. Usually, even if an employee changes jobs, they may leave the account in the plan until a later date (such as retirement). Eventually, when the employee has a distributable event (such as retirement), the employee is entitled to receive the balance of the account to the extent it is vested. The most common form of defined contribution plan is a 401(k) plan.

With a defined contribution plan, an employee is entitled only to the account balance at the time of distribution, no matter what amounts were contributed. If the account was invested poorly, the employee suffers the loss. Thus, the burden of investment risk is on the employee, not the employer.

In a **defined benefit plan,** employees usually do not contribute to the plan. The employer promises a specified benefit amount in the future based on the plan formula. In many traditional defined benefit plans, the formula is based on a participant's years of service and compensation at the time of retirement.

> **Note.** A traditional pension plan is perhaps the most common example of a defined benefit plan. However, under the Employee Retirement Income Security Act of 1974 (ERISA), both defined contribution and defined benefit plans are "pension benefit plans."

In most defined benefit plans, the employer is entirely responsible for funding promised benefits through employer contributions. If the investment performance of a defined benefit plan trust (which holds the employer contributions) fails to meet investment goals necessary for the retirement benefit promised, the employer remains responsible for the promised benefit.

Distributions

The tax treatment of distributions received by participants from a qualified plan depends on the form of distribution. With both defined benefit and defined contribution plans, participants may choose from among different forms of distribution for their benefits. In general, with certain limitations specified by the Code, employers choose which forms of distribution to offer in a plan. Some plans allow only a few optional forms of distribution and others provide a wide range of choice for participants.

The main **types of distribution options** are as follows.

- Lump-sum distributions
- Annuity distributions
- Installment distributions

Defined contribution plans frequently offer only a lump-sum distribution option, but some allow both installment and annuity options. Defined benefit plans may offer lump-sum and installment distribution options, but must offer several types of annuity options, including a single-life annuity for an unmarried participant and joint and survivor annuity options for a married participant.

Many defined benefit plans offer multiple alternative joint and survivor annuity options. A joint and survivor annuity provides a fixed monthly payment to a participant for the duration of the participant's life, with some percentage continuing to a contingent beneficiary for the contingent beneficiary's lifetime. Some of the more common options are as follows.

- A joint and 50% survivor annuity elected by a married participant pays a benefit to the participant beginning at the participant's retirement, which continues for the remainder of the participant's lifetime. After the participant's death, 50% of the amount that had been payable to the participant is paid monthly to the participant's surviving spouse for the surviving spouse's lifetime. A joint and 100% survivor annuity pays the same benefit amount (100% of the participant's benefit) to the survivor for the survivor's lifetime.
- A life and period certain annuity guarantees payments in the specified benefit amount for a certain number of years. If a participant dies before receiving the guaranteed number of payments, payments in the same amount continue to the participant's beneficiary until the guaranteed amount has been distributed. For example, in a life and 10-year certain annuity, benefit payments are made to the participant for 10 years; if the participant dies before receiving 10 years of payments (the period certain), payments are made to the beneficiary for the remainder of the 10-year period.

All optional forms of benefits are at least actuarially equivalent to a single-life annuity, payable beginning at a participant's normal retirement age and continuing throughout that participant's lifetime. Accordingly, alternative forms of distributions do not result in a different overall value payable to the recipient under each option. When a participant elects an optional form of benefit that includes continuing payments to a survivor, the amount of the monthly benefit payable to the participant decreases (from what would have been payable to that participant in the form of a single-life annuity with no contingent beneficiary payments) to reflect the additional payments that must be made to the contingent beneficiary.

Distributions from qualified plans in the form of annuity payments are fully taxable to the employee-participant if **both** of the following apply.[107]

- The employee-participant did not voluntarily pay anything toward the pension or annuity benefit. Tax-deferred amounts withheld from an employee-participant's pay, as when an employee elects pre-tax contributions of compensation into a 401(k) plan, are not treated as being payments toward the cost of a pension benefit.
- The employer did not withhold contributions from the employee-participant's compensation. Although some contributory defined benefit plans exist, particularly in the public sector, most defined benefit plans are funded entirely by the employer. Special rules apply to contributory defined benefit plans if contributions are returned to participants.

Observation. The preceding two factors are usually applicable to a defined benefit plan.

If a plan does require or permit employee contributions, the tax treatment of annuity distributions from such a plan is governed by IRC §72, which permits a nontaxable return of the individual's investment.[108]

Note. For a more extensive explanation of the tax rules involving annuity payments, see the 2010 *University of Illinois Federal Tax Workbook,* Chapter 13: Elder Issues. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

Installment payments are generally treated as annuity payments,[109] but in most cases this is irrelevant because the entire distribution is taxable to the recipient.

Complications arise when a participant is eligible for a lump-sum distribution from a qualified retirement plan. A participant may elect to receive the distribution directly or may elect to roll over all or part of the distribution to an IRA or other qualified employer retirement plan.[110]

If a participant elects to receive a distribution directly, the entire distribution amount is taxable to the participant. The plan withholds 20% of the distribution amount and forwards it to the federal government as federal income tax withholding.

If a participant elects a direct rollover, the distribution is tax-deferred. The distributing plan forwards the distribution directly to the participant's qualified plan or IRA. No withholding applies, and the amount is not taxed until the individual eventually elects to receive a direct distribution.

TAX PLANNING WITH IRAs

Several IRA strategies are possible for elderly taxpayers, including the use of Roth conversions to take advantage of lower-income years and to take advantage of years with large deductions of qualified medical expenses that include nursing home care costs. Although the strategies available vary as widely as the different circumstances a taxpayer may have, the following two examples show how such strategies may be used.

107. IRS Pub. 575, *Pension and Annuity Income*.
108. Ibid.
109. Ibid.
110. Ibid.

Example 7. Norman is 54 and his spouse, Norma, is 52. Norman retired at age 50 from his high-pressure career in the city and moved to the country. Upon retirement, he had $500,000 in his 401(k). He will eventually receive a monthly pension and social security in addition to drawing from his 401(k). Norma has little or no income.

Norman decides to establish a sole proprietorship business through which he will provide some consulting services until he can begin drawing his work pension. Although the business keeps him occupied, it will likely provide either some initial losses or very little taxable income.

Realizing that Norman will eventually be in a higher tax bracket, his tax advisor, Glenda, suggests that he annually convert enough of his 401(k) into a Roth IRA to fully utilize the 15% tax bracket.

The first two tax brackets for MFJ filers for 2014 are as follows.

Income Bracket	Tax Rate
Income up to $18,150	10%
Income from $18,151 to $73,800	15%

Between Norman's annual business income (or losses), the standard deduction, and the exemption amounts, Glenda estimates that Norman can convert between $90,000–$110,000 annually to fully utilize the 15% bracket. Depending on the growth within his 401(k), he will be able to convert his entire 401(k) to a Roth IRA, have the proceeds taxed at minimal rates, and avoid having to take required minimum distributions (RMD) from the 401(k).

The tax rate upon conversion is a combination of the 0%, 10%, and the 15% tax brackets. Had Norman waited until he was drawing his pension and social security, it is likely that he would have been in a higher bracket.

In 2014, his business showed a loss of $5,000. In December 2014, Norman and Norma meet with Glenda to discuss an appropriate conversion strategy for the year. Glenda calculates the amount that may be converted from Norman's 401(k) to a Roth IRA as follows.

2014 business loss	$ 5,000
15% tax bracket ceiling	73,800
MFJ standard deduction	12,400
Personal exemptions ($3,950 × 2)	7,900
Total 401(k) amount to be converted to fully utilize 10% and 15% tax brackets	$99,100

Glenda and Norman decide to convert $99,000. The income tax liability on the $99,000 after taking into account the business loss, deductions, and exemptions is $10,148. Had Norman and Norma waited until Norman began receiving pension and social security benefits, the tax on this same $99,000 would be subject to higher rates.

Example 8. Oliver and Olivia are an elderly married couple who are both residents of a nursing home. Their combined annual fee at the nursing home is $140,000. They have accumulated approximately $750,000 in their IRA portfolio. Other than their respective RMDs, social security is their only other source of income. Oliver and Olivia have two adult children who earn income from full-time employment. Each child is in the 25% tax bracket.

Oliver and Olivia have RMDs that total approximately $75,000 per year. Taking into account their $25,000 of social security benefits (of which $21,250 is taxable), the couple has $96,250 of AGI for 2014.

Their itemized deductions consist of their nursing home expenses. This itemized deduction is subject to the 7.5%-of-AGI floor. Accordingly, their deductible amount of nursing home expenses is calculated as follows.

Total 2014 nursing home expenses	$140,000
Less: $96,250 AGI × 7.5%	(7,219)
Deductible nursing home expenses	$132,781

After claiming personal exemptions for 2014 of $7,900 ($3,950 × 2) and deducting the $132,781 of nursing home expenses, Oliver and Olivia have taxable income of $(44,431).

Their tax preparer, Larrissa, advises them to withdraw enough from their IRA portfolio to fully utilize the 10% and 15% brackets. Because Oliver and Olivia do not require any additional IRA income, they reinvest the money into an account that is not tax advantaged. This requires more planning because every additional IRA dollar withdrawn increases AGI, further limiting deductible medical expenses.

An IRA withdrawal of an additional $110,000 would increase AGI by $110,000 and reduce their itemized deductions by $8,250, ultimately increasing their taxable income by $118,250. Their taxable income would be $73,819, (enough to barely result in exposure to the 25% bracket).

Having the IRA proceeds taxed at the 0–15% rates as opposed to the 25% bracket that would apply if the IRA proceeds were eventually distributed to the children results in a substantial tax savings.

SOCIAL SECURITY RETIREMENT BENEFITS

The Social Security Old-Age, Survivors, and Disability Insurance (OASDI) program provides retirement and, in some cases, disability income for workers, their survivors, and their dependents. Generally, individuals become eligible for OASDI benefits through their own work or through that of a spouse or parent. Individuals earn entitlement to OASDI benefits by completing a minimum number of quarters (usually 40) of coverage.[111] In most cases, an individual receives credit for a single quarter of coverage (QC) by earning a specified dollar amount in employment compensation covered by social security. A maximum of four QCs can be credited in any calendar year. For 2014, one QC is earned for each $1,200 in earnings, up to the maximum of four QCs per year.[112]

The amount of the social security benefit payable to any worker depends on that individual's earnings on which social security taxes were collected.[113] For individuals drawing social security benefits based on the earnings of another person, the amount of benefit payable depends on the working person's earnings.[114]

111. 20 CFR §§404.140, 404.115.

112. *Quarter of Coverage.* Social Security Administration. [www.ssa.gov/OACT/COLA/QC.html] Accessed on Mar. 13, 2014.

113. 20 CFR §404.201.

114. 20 CFR §§404.333, 404.353, 404.338.

Estimating Social Security Benefits

The SSA offers a variety of online benefit calculators that can be used to estimate an individual's potential benefit amounts using different retirement dates and levels of future earnings. These calculators estimate disability and survivor benefit amounts as well as retirement benefit amounts. The three calculators available at **www.ssa.gov/planners/benefitcalculators.htm** are the following.

1. The **Quick Calculator** gives a simple, rough estimate based on the individual's date of birth and current year's earnings. The individual must be age 21 or older for this calculator to work correctly.
2. The **Online Calculator** requires the user to input their date of birth and complete earnings history to obtain a benefit estimate. The user may project future earnings until their anticipated retirement date.
3. The **WEP Online Calculator** shows the effect that the Windfall Elimination Provision (WEP) has on the benefits of individuals eligible for a pension based on work not covered by social security.
4. The **Detailed Calculator** provides the most precise estimates. It must be downloaded and installed on the user's computer.

None of the above calculators are linked to the user's social security earnings record but instead use the earnings amounts entered.

The **Retirement Estimator,** available at **www.socialsecurity.gov/estimator**, uses social security earnings records and projected future earnings to estimate the individual's retirement benefit. The actual benefit amount cannot be provided until the individual applies for benefits.

Full Retirement Age

It is important to determine the taxpayer's **full retirement age**[115] (FRA) because that determines when they will receive full social security benefits. FRAs are shown in the following table.[116]

Year of Birth	Full Retirement Age
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943–1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

115. The full retirement age is also referred to as the normal retirement age.

116. *Retirement Planner: Benefits by Year of Birth.* [www.socialsecurity.gov/retire2/agereduction.htm] Accessed on Jun. 13, 2014.

Primary Insurance Amount

The **primary insurance amount** (PIA) is the benefit a person receives if they begin receiving benefits at their FRA. At this age, the benefit is neither reduced for early retirement nor increased for delayed retirement.

The PIA is the sum of three separate percentages applied to portions of **average indexed monthly earnings** (AIME).[117] The percentages of the PIA formula are fixed by law, and the dollar amounts in the formula are adjusted annually for changes in the national average wage index. These dollar amounts, called "bend points," govern the portions of the AIME.[118]

The bend points in the year 2014 PIA formula are $816 and $4,917 and apply to workers who first become eligible for retirement benefits in 2014. Their PIA is the sum of:[119]

- 90% of the first $816 of the worker's AIME, plus
- 32% of the AIME over $816 and through $4,917, plus
- 15% of the AIME over $4,917.

Example 9. Meredith retires in 2014 at age 66, which is her FRA. Her AIME is $6,200. Her PIA is calculated as follows.

- 90% × $816 = $734
- 32% × ($4,917 − $816) = $1,312
- 15% × ($6,200 − $4,917) = $192

Meredith's PIA is $2,238 ($734 + $1,312 + $192).

An eligible individual can start receiving social security retirement benefits as early as age 62 or as late as age 70. The individual's monthly benefit is different depending on the age they start receiving it.

Receiving Benefits Early. When an individual starts receiving benefits early (before FRA), the benefits are **reduced** based on the number of months they receive benefits before reaching FRA. Taxpayers born between 1943 and 1954 receive 75% of their PIA if they elect to start receiving benefits at age 62.[120] This percentage gradually decreases for taxpayers born after 1954 but before 1960. Taxpayers born in 1960 and later years receive 70% of their PIA if they elect to start receiving benefits at age 62.

Delaying Benefits. Social security benefits are **increased** by a certain percentage (depending on the date of birth) if a taxpayer delays retirement beyond the FRA.[121] The benefit reaches a maximum once a taxpayer reaches age 70. It will not increase further, even if they continue to delay taking benefits.

117. Up to 35 years of a worker's earnings are indexed to reflect the change in general wage levels that occurred during the worker's years of employment. More information is available at www.socialsecurity.gov/OACT/COLA/AWI.html. Accessed on Jun. 11, 2014.

118. *Primary Insurance Amount.* [www.ssa.gov/oact/cola/piaformula.html] Accessed on Jun. 12, 2014.

119. Ibid.

120. *Benefit Reduction for Early Retirement.* [www.ssa.gov/oact/quickcalc/earlyretire.html] Accessed on Jun. 11, 2014.

121. *Retirement Planner: Delayed Retirement Credits.* Social Security Administration. [www.ssa.gov/retire2/delayret.htm] Accessed on Jul. 1, 2014.

Benefits for Spouses

When a worker becomes eligible for retirement benefits, the worker's spouse may be eligible for a benefit based on the worker's earnings. To be eligible, the spouse must be at least age 62 or have a qualifying child in their care. A **qualifying child** for this purpose is a child who is under age 16 or who receives social security disability benefits.

The spousal benefit can be as much as half of the worker's PIA, depending on the spouse's age. If the spouse begins receiving retirement benefits before reaching the FRA, the spouse receives a reduced benefit. However, the spousal benefit is **not** reduced if the spouse is caring for a qualifying child.

A spouse is paid a retirement benefit based on their own earnings if that benefit is **higher** than the spousal benefit. Otherwise, they receive the spousal benefit.

A spouse can begin receiving benefits as early as age 62, but doing so results in a reduction of the spousal benefit. A spousal benefit is reduced $^{25}/_{36}$ of 1% (0.0069) for each month before FRA, up to 36 months. If the number of months before reaching the FRA is greater than 36, the benefit is further reduced $^{5}/_{12}$ of 1% (0.0042) per month. This reduction factor is applied to the base spousal benefit, which is 50% of the worker's PIA.[122]

Note. Relatively few people can begin receiving social security retirement benefits at exactly age 62 because a person must be 62 throughout the first month of retirement. Thus, most early retirees can begin receiving benefits at age 62 and 1 month.[123]

Example 10. Ralph retires at his FRA, and his PIA is $1,600. His wife, Alice, is a homemaker and is not eligible for a retirement benefit based on her own work record. Alice plans to start drawing her spousal benefit the month after she reaches age 62, which is 47 months before her FRA. Her spousal benefit is calculated as follows.

	Formula	Calculation	Result
Base spousal benefit	PIA × 50%	$1,600 × 50%	$800
Reduction: first 36 months	36 months × $^{25}/_{36}$ × 1% = 25%	$800 × 25%	(200)
Reduction: next 11 months	11 months × $^{5}/_{12}$ × 1% = 4.58%	$800 × 4.58%	(37)
Final spousal benefit			$563

Note. The **base spousal benefit** is 50% of the worker's PIA — even if the worker retired early. Moreover, the worker must file for social security retirement benefits in order for the spouse to be eligible for a spousal benefit. However, an individual who has reached FRA can apply for retirement benefits and then request to have the payments suspended. This entitles the spouse to receive a spousal benefit while the worker earns delayed retirement credits up to age 70.[124]

A spouse who has reached FRA and is eligible for their own retirement benefit can choose to receive only the spouse's benefit. By doing this, the spouse can delay receiving their own retirement benefit until a later date to take advantage of delayed retirement credits.[125]

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122. *Benefit Reduction for Early Retirement.* [www.ssa.gov/oact/quickcalc/earlyretire.html] Accessed on Jun. 11, 2014.

123. Ibid.

124. *Retirement Planner: Suspending Retirement Benefit Payments.* [www.ssa.gov/retire2/suspend.htm] Accessed on Jun. 11, 2014.

125. Ibid.

Taxation of Benefits

Social security benefits are subject to special tax treatment under IRC §86. In general, if social security benefits constitute the only income an individual receives during a tax year, that individual likely owes no federal income taxes on those benefits.[126] The Social Security Administration reports the amount of social security benefits paid to an individual each year on Form SSA-1099, *Social Security Benefit Statement.*

IRS Pub. 915, *Social Security and Equivalent Railroad Retirement Benefits*, contains detailed directions to assist a taxpayer in determining whether, and to what extent, social security benefits should be included in that taxpayer's gross income for the year.[127]

Whether social security benefits are taxable depends on total income and marital status. Benefits are taxed using a 2-tier system under IRC §86. If the sum of the recipient's **provisional income** exceeds statutory thresholds, up to 85% of social security benefits can be taxable. "Provisional income" is the total of:

1. Half of social security benefits, plus
2. MAGI. For this purpose, MAGI is calculated by adding the following items to the taxpayer's AGI.[128]
   - **a.** Exclusions for interest from U.S. savings bonds used to pay higher education expenses
   - **b.** Exclusions for employer-provided adoption assistance
   - **c.** Deductions for interest on qualified educational loans
   - **d.** Exclusions for foreign earned income or foreign housing
   - **e.** Exclusions for income earned by bona fide residents of American Samoa or Puerto Rico
   - **f.** Tax-exempt interest

If provisional income is below the base amount of the first tier, none of the benefit is taxable. The first tier base amounts are as follows.

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

If provisonal income is above the base amount of the first tier but below the base amount for the second tier, up to 50% of the benefit is taxable. The second tier **adjusted base amounts** are as follows.

- $34,000 if filing as single, head of household, or qualifying widow or widower
- $34,000 for married individuals filing separately who did not live with their spouses at all during the year
- $44,000 for married couples filing jointly
- $0 for married persons filing separately who lived with their spouse for part or all of the year

Note. None of the preceding threshold amounts are indexed for inflation.

126. IRS Pub. 915, *Social Security and Equivalent Railroad Retirement Benefits*.
127. IRC §86(a)(1).
128. IRC §86(b)(2).

For taxpayers with provisional income between the first and second tiers, the amount of social security benefits subject to taxation is the lesser of:

1. Half of social security benefits, **or**
2. Half of provisional income in excess of the first tier base amount.

If provisional income is above the second tier adjusted base amounts, the social security benefit subject to taxation is the lesser of:

1. 85% of total social security benefits, **or**
2. 85% of provisional income above the second tier adjusted base amount, plus the lesser of:
   a. $4,500 (single, HoH, QW, or MFS individuals who did not live with their spouses) or $6,000 (MFJ taxpayers), **or**
   b. Half of social security benefits.

Example 11. Harry and Meg are both 67 and receive social security retirement benefits. Harry's annual benefits are $12,000 in 2014, and Meg's are $7,000. Harry and Meg file a joint return for 2014. Harry also receives $8,000 in pension benefits from a former employer, and Meg receives $1,000 in interest income that is not tax-exempt. They have no other income in 2014.

Their provisional income (half of their combined social security benefits plus their MAGI) totals only $18,500 (($19,000 social security benefits × 50%) + $8,000 pension + $1,000 interest), which is less than the $32,000 base amount for their filing status. Therefore, none of their social security benefits are taxable.[129]

EFFECT OF GOVERNMENT PENSION ON SOCIAL SECURITY BENEFITS

BACKGROUND

Approximately 96% of all workers in the United States are covered by social security. However, every state has some public employees who are not covered by social security. These public employees predominantly work for state and local governments and also include most federal workers who were hired before 1984.[130]

Many of the public employees who are not covered by social security are nonetheless affected by provisions of the social security system either because they have a spouse contributing to social security or because they worked in a job covered by social security at some point in their careers. The **Windfall Elimination Provision (WEP)** was designed to remove an unintended advantage in the social security benefit formula for some people who receive a government pension. The **Government Pension Offset (GPO)** reduces benefits for certain spouses who receive a government pension.

WINDFALL ELIMINATION PROVISION

The WEP affects the calculation of social security benefits for individuals who receive a pension from work not covered by social security. The pension such individuals receive may reduce their social security benefits.

Rationale for WEP

The SSA benefit formula gives a higher return on lower-paid workers' pre-retirement earnings than that received by highly paid workers. For example, lower-paid workers can get a social security benefit of approximately 55% of their pre-retirement earnings, while the average replacement rate for highly paid workers is 25%.

129. Ibid; and IRC §86(a).

130. Government Pension Offset (GPO) and Windfall Elimination Provision (WEP): Policies Affecting Pensions from Work Not Covered by Social Security. Hearing before the Senate Finance Committee. Nov. 6, 2007.

Before 1983, people who spent most of their careers in jobs not covered by social security had their social security benefit calculated as though they were long-term, low-wage workers. This gave them the advantage of receiving a social security benefit representing a higher percentage of their earnings, while also receiving a pension from a job where they did not pay social security taxes. Congress passed the WEP to remove that advantage.[131]

Application of WEP

The WEP primarily affects individuals who earned a pension in a job where they did not pay social security taxes and who also worked in other jobs long enough to qualify for social security retirement or disability benefits. The WEP may apply to individuals who:

- Reached age 62 or became disabled after 1985, and
- First became eligible for a monthly pension based on work where they did not pay social security taxes after 1985.

The WEP **does not apply** to individuals who fall into one of the following categories.

- They first became federal workers after 1983.
- They were employed on December 31, 1983, by a nonprofit organization that did not initially withhold social security taxes from their pay but later began withholding social security taxes.
- Their only pension is based on railroad employment.
- The only employment in which they did not pay social security taxes was before 1957.
- They have 30 or more years of **substantial earnings** under social security. The annual amounts that are considered substantial earnings are listed in the following table.[132]

Year	Substantial Earnings	Year	Substantial Earnings
1937–54	$ 900	1990	$ 9,525
1955–58	1,050	1991	9,900
1959–65	1,200	1992	10,350
1966–67	1,650	1993	10,725
1968–71	1,950	1994	11,250
1972	2,250	1995	11,325
1973	2,700	1996	11,625
1974	3,300	1997	12,150
1975	3,525	1998	12,675
1976	3,825	1999	13,425
1977	4,125	2000	14,175
1978	4,425	2001	14,925
1979	4,725	2002	15,750
1980	5,100	2003	16,125
1981	5,550	2004	16,275
1982	6,075	2005	16,725
1983	6,675	2006	17,475
1984	7,050	2007	18,150
1985	7,425	2008	18,975
1986	7,875	2009–2011	19,800
1987	8,175	2012	20,475
1988	8,400	2013	21,075
1989	8,925	2014	21,750

131. *Windfall Elimination Provision.* [www.ssa.gov/pubs/EN-05-10045.pdf] Accessed on Jun. 12, 2014.

132. Ibid.

Calculation of Reduced Benefits

As described earlier in this chapter, the PIA is calculated by separating average earnings into three amounts and multiplying these amounts by factors of 90%, 32%, and 15%, respectively. The total of the three products is the monthly PIA.

For workers subject to the WEP, the 90% factor is reduced to 40% for workers who attained age 62 or became disabled in 1990 or later and had no more than 20 years of substantial earnings. However, for workers who have 21–29 years of substantial earnings under social security (see preceding table), the 90% factor is reduced to between 45 and 85%.[133]

Years of Substantial Earnings	Percentage
30 or more	90 percent
29	85 percent
28	80 percent
27	75 percent
26	70 percent
25	65 percent
24	60 percent
23	55 percent
22	50 percent
21	45 percent
20 or less	40 percent

The following table illustrates how the regular benefit calculation and WEP modified formula compare for **a worker who retires in 2014 with AIME of $3,000.**

Regular Formula		WEP Formula	
90% of first $816	$ 734	40% of first $816	$ 326
32% of earnings over $816		32% of earnings over $816	
and through $4,917 ($3,000 − $816 × 32%)	699	and through $4,917	699
15% over $4,917	0	15% over $4,917	0
Total	$1,433	Total	$1,025

The WEP reduces the social security benefit for the worker who retires in 2014 with 20 or fewer years of substantial earnings by $408 ($1,433 − $1,025 in the above table). Because the WEP reduction only applies to the first bracket in the benefit formula (90% versus 40%), the WEP reduction remains a flat $408 for workers whose 2014 AIME amounts exceed the first bend point of $816.

133. Ibid.

As explained earlier, the WEP reduction is affected by the number of years a worker had substantial earnings subject to social security taxes. The following table shows the **maximum** monthly amount that a worker's benefit can be reduced for an eligibility year (ELY) if they had fewer than 30 years of substantial earnings.[134] The table does not reflect the effect of factors such as cost-of-living adjustments or early or delayed retirement.

Maximum Monthly Amount Your Benefit May Be Reduced Because of the Windfall Elimination Provision (WEP)[a]

	Years of Substantial Earnings										
ELY	**<20**	**21**	**22**	**23**	**24**	**25**	**26**	**27**	**28**	**29**	**30**
1990	$178.0	$160.2	$142.4	$124.6	$106.8	$89.0	$71.2	$53.4	$35.6	$17.8	$0.0
1991	185.0	166.5	148.0	129.5	111.0	92.5	74.0	55.5	37.0	18.5	0.0
1992	193.5	174.2	154.8	135.5	116.1	96.8	77.4	58.1	38.7	19.4	0.0
1993	200.5	180.5	160.4	140.4	120.3	100.3	80.2	60.2	40.1	20.1	0.0
1994	211.0	189.9	168.8	147.7	126.6	105.5	84.4	63.3	42.2	21.1	0.0
1995	213.0	191.7	170.4	149.1	127.8	106.5	85.2	63.9	42.6	21.3	0.0
1996	218.5	196.7	174.8	153.0	131.1	109.3	87.4	65.6	43.7	21.9	0.0
1997	227.5	204.8	182.0	159.3	136.5	113.8	91.0	68.3	45.5	22.8	0.0
1998	238.5	214.7	190.8	167.0	143.1	119.3	95.4	71.6	47.7	23.9	0.0
1999	252.5	227.3	202.0	176.8	151.5	126.3	101.0	75.8	50.5	25.3	0.0
2000	265.5	239.0	212.4	185.9	159.3	132.8	106.2	79.7	53.1	26.6	0.0
2001	280.5	252.5	224.4	196.4	168.3	140.3	112.2	84.2	56.1	28.1	0.0
2002	296.0	266.4	236.8	207.2	177.6	148.0	118.4	88.8	59.2	29.6	0.0
2003	303.0	272.7	242.4	212.1	181.8	151.5	121.2	90.9	60.6	30.3	0.0
2004	306.0	275.4	244.8	214.2	183.6	153.0	122.4	91.8	61.2	30.6	0.0
2005	313.5	282.2	250.8	219.5	188.1	156.8	125.4	94.1	62.7	31.4	0.0
2006	328.0	295.2	262.4	229.6	196.8	164.0	131.2	98.4	65.6	32.8	0.0
2007	340.0	306.0	272.0	238.0	204.0	170.0	136.0	102.0	68.0	34.0	0.0
2008	355.5	320.0	284.4	248.9	213.3	177.8	142.2	106.7	71.1	35.6	0.0
2009	372.0	334.8	297.6	260.4	223.2	186.0	148.8	111.6	74.4	37.2	0.0
2010	380.5	342.5	304.4	266.4	228.3	190.3	152.2	114.2	76.1	38.1	0.0
2011	374.5	337.1	299.6	262.2	224.7	187.3	149.8	112.4	74.9	37.5	0.0
2012	383.5	345.2	306.8	268.5	230.1	191.8	153.4	115.1	76.7	38.4	0.0
2013	395.5	356.0	316.4	276.9	237.3	197.8	158.2	118.7	79.1	39.6	0.0
2014	408.0	367.2	326.4	285.6	244.8	204.0	163.2	122.4	81.6	40.8	0.0

[a] Important: The maximum amount may be overstated. The WEP reduction is limited to one-half of your pension from non-covered employment.

The reduction in an individual's social security benefit cannot be more than half of their pension that is based on earnings after 1956. This "guarantee" is designed to help protect workers with low pensions.

> **Example 12.** Doris receives a monthly government pension of $600. She claims her social security retirement benefit in 2014 at her FRA. Her benefit cannot be reduced more than $300 (half of her monthly pension).

The SSA has an online calculator that can be used to estimate the retirement or disability benefits for workers affected by the WEP. The calculator is available at **www.socialsecurity.gov/retire2/anyPiaWepjs04.htm.**

134. *Retirement Planner: How the Windfall Elimination Provision Can Affect Your Social Security Benefit.* [www.ssa.gov/retire2/wep-chart.htm] Accessed on Jun. 12, 2014.

Effect of WEP on Dependents and Survivors

Because dependents' benefits are derived from the worker's benefit, the WEP affects dependents' benefits as well. However, the WEP does not affect benefits paid to survivors.[135]

> **Example 13.** Dallas and Savannah both claim their social security retirement benefits at their FRA. Dallas also receives a pension based on work not covered by social security. His benefit amount using the WEP formula is $1,000 per month. His wife Savannah receives a spousal benefit of $500 per month (half of Dallas' benefit amount).
>
> If Dallas dies before Savannah, the WEP reduction will be removed. Savannah's benefit as a surviving spouse will be refigured using the regular benefit formula.

Although the WEP does not affect survivor benefits, these benefits may be reduced because of the government pension offset, which is explained in the following section.

GOVERNMENT PENSION OFFSET

The GPO reduces social security benefits for certain spouses and surviving spouses who receive a government pension.

Rationale for GPO

Social security spousal benefits were established in the 1930s to compensate spouses who stayed home to raise a family and who were financially dependent on a working spouse. For individuals who qualify for both a social security benefit based on their own earnings and a spousal benefit based on their spouse's earnings, the "dual entitlement" rule caps the benefit at the higher of the worker's own benefit or the spousal benefit.

The GPO has a purpose similar to the dual entitlement provision and applies to individuals who qualify for both a government pension based on their work that is not covered by social security and a social security spousal benefit based on a spouse's work in covered employment. The GPO and the dual entitlement provision have the same intent — to reduce the social security spousal benefit of persons who are not financially dependent on their spouses.[136]

Application of GPO

The GPO applies to individuals who qualify for **both** of the following.

- A government pension based on government employment that is **not** covered by social security
- A social security spousal benefit

Social security benefits as a spouse or surviving spouse are **not** reduced for individuals who fall into one of the following categories.[137]

1. They are receiving a government pension that is not based on earnings.
2. They are a federal, state, or local government employee whose government pension is based on a job for which they were paying social security taxes, and
   a. They filed for and were entitled to spouse's or widow(er)'s benefits before April 1, 2004, or
   b. Their last day of employment (for pension purposes) was before July 1, 2004, or
   c. They paid social security taxes on their earnings during the last 60 months of government service. (Under certain conditions, fewer than 60 months are required for people whose last day of employment was between June 30, 2004, and March 2, 2009.)

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135. *Frequently Asked Questions.* [https://faq.ssa.gov/link/portal/34011/34019/Article/2531/If-my-retirement-or-disability-benefits-are-computed-under-the-Windfall-Elimination-Provision-WEP-will-the-benefits-of-my-dependents-and-survivors-be-affected] Accessed on Jun. 12, 2014.

136. *Social Security: The Government Pension Offset (GPO).* Shelton, Alison M. Feb. 10, 2011. Congressional Research Service. [www.leahy.senate.gov/imo/media/doc/Social%20Security%20The%20Government%20Pension%20Offset%20(GPO)%202.10.11.pdf] Accessed on Jun. 13, 2014.

137. *Government Pension Offset.* [www.ssa.gov/pubs/EN-05-10007.pdf] Accessed on Jun. 13, 2014.

3. They are a federal employee who elected to switch from the Civil Service Retirement System to the Federal Employees' Retirement System after December 31, 1987, and

   a. They filed for and were entitled to spouse's or widow(er)'s benefits before April 1, 2004, or

   b. Their last day of service for pension purposes was before July 1, 2004, or

   c. They paid social security taxes on their earnings for 60 months or more during the period beginning January 1988 and ending with the first month of benefit entitlement.

4. They received or were eligible to receive a government pension before December 1982 and meet all the requirements for social security spousal benefits.

5. They received or were eligible to receive a federal, state, or local government pension before July 1, 1983, and were receiving half of their support from their spouse.

Calculation of Reduction

The GPO reduction in social security spousal benefits is two-thirds of the government pension that is not covered by social security. For individuals who take their government pension in a lump sum, the SSA calculates the GPO reduction as though the individual chose monthly pension payments.

Example 14. Viola receives a monthly civil service pension of $600. Her husband, Reed, receives a social security retirement benefit of $1,000 per month. Before applying the GPO reduction, Viola is eligible for a spousal benefit of $500 (half of $1,000). However, her spousal benefit is reduced by two-thirds of her monthly pension; therefore, Viola receives $100 per month from social security ($500 – ($600 × 2/3)).

The GPO reduction can completely eliminate the social security spousal benefit. In fact, for 74% of those with spousal benefits reduced by the GPO, the reduction is large enough to fully offset any potential spousal benefit. This occurs either because the government pension is relatively large or the potential social security spousal benefit is relatively small.[138]

Example 15. Paul is a retired University of Illinois professor who receives a monthly pension of $6,000. His wife, Mildred, receives a social security retirement benefit of $1,500 per month. Before applying the GPO reduction, Paul is eligible for a social security spousal benefit of $750 (half of $1,500). However, because Paul's GPO reduction is more than the amount of his spousal benefit ($6,000 × 2/3 = $4,000), he does not receive a social security spousal benefit.

The GPO reduction also applies to a surviving spouse's benefit.

Example 16. Use the same facts as **Example 15.** If Mildred predeceases Paul, he would be entitled to a social security survivor benefit of $1,500 per month before applying the GPO reduction. However, because the GPO reduction of $4,000 is more than the amount of the survivor's benefit, he will not receive a social security benefit as a widower.

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138. *Social Security: The Government Pension Offset (GPO).* Shelton, Alison M. Feb. 10, 2011. Congressional Research Service. [www.leahy.senate.gov/imo/media/doc/Social%20Security%20The%20Government%20Pension%20Offset%20(GPO)%202.10.11.pdf] Accessed on Jun. 13, 2014.

ANNUITIES

Individuals may purchase **annuities** to provide a steady stream of income during their lifetimes. Most annuities are fixed annuities, which provide recurring fixed payments throughout an individual's retirement years, however long their life may be. There are, however, variable annuities, in which the exact amount of the recurring payment changes based on some separate marker, such as the performance of the U.S. stock market. Some variable annuities, often referred to as equity-indexed annuities, tie payment amounts to a specific equity index such as the Dow Jones Industrial Average. With such annuities, the beneficiary usually receives a fixed guaranteed amount plus an additional payment that reflects the performance of the relevant equity index.

Federal income tax treatment of annuities is governed primarily by IRC §72. The tax treatment generally depends on:

- The type of annuity (qualified or nonqualified),
- The type of distribution (periodic or lump-sum), and
- The age of the recipient at the time of receiving a distribution.[139]

A **qualified annuity** is a retirement annuity purchased by an employer for an employee under a plan that meets Code requirements[140] (i.e. 401(k), 403(b), SARSEP, SEP-IRA, SIMPLE IRA). These types of annuities are traditionally funded with pre-tax dollars resulting in distributions that are subject to income tax. Conversely, a **nonqualified** plan is a plan other than a qualified plan (such as a private annuity, purchased commercial annuity, or §457 deferred compensation plan of a state or local government or tax-exempt organization) that is traditionally funded with after-tax dollars. Distributions from nonqualified annuities are not subject to income tax in their entirety.

DETERMINING THE TAXABLE PORTION OF THE DISTRIBUTION

> **Caution.** The following rules only apply to annuities purchased on or after August 14, 1982. For annuities purchased before then, see IRS Pub. 575, *Pension and Annuity Income.*

The proper methods of calculating the taxable portion of the distribution depends on whether the distribution is:

1. Part of a series of payments over a period of more than one full year, or
2. A nonperiodic payment.

Periodic Distributions

The taxable portion of **nonqualified plan distributions** made as part of a series of payments is calculated using the General Rule.[141] Under the General Rule, the tax-free part of each annuity payment is based on the ratio of the cost of the contract to the total expected return. **Expected return** is the total amount expected to be received under the contract. If the expected return is not known, the total return must be determined using the actuarial tables prescribed by the IRS.[142]

139. IRS Pub. 575, *Pension and Annuity Income*.

140. Ibid.

141. Ibid.

142. Ibid.

Example 17. In 1993, Lola invested $15,000 in an annuity contract with Antioch Life Insurance. She never received any loans from the annuity. In 2013, when she turns 60, she starts receiving $5,000 annual payments. Based on the terms of the contract, she is guaranteed to receive a $5,000 annual payment for 10 years, then payments cease.

	Calculation	Result
Expected return	$5,000 × 10 years	$50,000
Ratio of investment to return	$15,000 ÷ 50,000	30%
Nontaxable return of principal	$5,000 × 30%	1,500
Annual taxable ordinary income	$5,000 − 1,500	3,500

Lola's 2013 Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* from Antioch Life Insurance follows.

Note. In most cases, determining the total expected return is much more complicated. However, because the insurance company has all the required information, practitioners may request the information from the company.

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city or town, province or state, country, and ZIP or foreign postal code
Antioch Life Insurance Co.
123 Clark Street
Columbus, OH 43228

1 Gross distribution $ **5000.00**

2a Taxable amount $ **3500.00**

OMB No. 1545-0119
2013
Form **1099-R**

Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

2b Taxable amount not determined ☐ Total distribution ☐

Copy 1 For State, City, or Local Tax Department

PAYER'S federal identification number **38-1234567**

RECIPIENT'S identification number **999-99-9999**

3 Capital gain (included in box 2a) $

4 Federal income tax withheld $

RECIPIENT'S name
Lola McMaster

5 Employee contributions /Designated Roth contributions or insurance premiums $ **1500.00**

6 Net unrealized appreciation in employer's securities $

Street address (including apt. no.)
224 St. Botolph Street, #12A

7 Distribution code(s) **7**

IRA/ SEP/ SIMPLE ☐

8 Other $ %

City or town, province or state, country, and ZIP or foreign postal code
Boston, MA 02116

9a Your percentage of total distribution %

9b Total employee contributions $

10 Amount allocable to IRR within 5 years $

11 1st year of desig. Roth contrib.

12 State tax withheld $ $

13 State/Payer's state no.

14 State distribution $ $

Account number (see instructions)
ML-899-8977-36A

15 Local tax withheld $ $

16 Name of locality

17 Local distribution $ $

Form **1099-R** www.irs.gov/form1099r Department of the Treasury - Internal Revenue Service

Nonperiodic Distributions

Generally, the distribution is first allocated to earnings and then to the cost of the contract.[143] Therefore, the taxable portion of a nonperiodic distribution is considered withdrawn first.

Example 18. Art invested $15,000 in an annuity with Antioch Life Insurance in 1993. By 2013, when he is 70, the contract's cash value is $40,000. Art withdraws $20,000 to take his wife on her dream vacation through Europe. The entire $20,000 is taxable in 2013.

Example 19. Venita, age 65, invested $20,000 in an annuity with Northern Life Insurance in 2008. By 2013, the contract's cash value is $26,000. She withdraws $10,000 to publish her memoirs. Since the accumulated earnings are less than the distribution, only the earnings portion of $6,000 is taxable.

Venita's 2013 Form 1099-R from Northern Life Insurance is shown here.

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city or town, province or state, country, and ZIP or foreign postal code **Northern Life Insurance Company** **4568 Northern Blvd.** **North Haven, CT 06473**		1 Gross distribution $ **10000.00** 2a Taxable amount $ **6000.00**	OMB No. 1545-0119 **2013** Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☐	Total distribution ☐	**Copy 1 For State, City, or Local Tax Department**
PAYER'S federal identification number **37-5689741**	RECIPIENT'S identification number **999-99-9999**	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $ **600.00**	
RECIPIENT'S name **Venita Mendez**		5 Employee contributions /Designated Roth contributions or insurance premiums $ **4000.00**	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.) **456 Market Street**		7 Distribution code(s) **7** | IRA/ SEP/ SIMPLE ☐	8 Other $ %	
City or town, province or state, country, and ZIP or foreign postal code **Bridgeport, CT 06604**		9a Your percentage of total distribution %	9b Total employee contributions $	
10 Amount allocable to IRR within 5 years $	11 1st year of desig. Roth contrib.	12 State tax withheld $ $	13 State/Payer's state no.	14 State distribution $ $
Account number (see instructions) **MV-789-888-5AN**		15 Local tax withheld $ $	16 Name of locality	17 Local distribution $ $

Form **1099-R** www.irs.gov/form1099r Department of the Treasury - Internal Revenue Service

Note. Many practitioners compare the previous year's tax return entries to the current year's tax documents to determine if anything is missing. It can be confusing not having a tax statement if the taxpayer reports having received a distribution from an annuity in the previous year. However, this can be quickly resolved if the practitioner knows that the taxpayer receives nonperiodic distributions and that the prior year Form 1099-R for a commercial annuity reported that part of the distribution was not taxable.

An exception[144] to this treatment occurs when:

- The nonperiodic distribution is made after the periodic distributions begin, **and**
- Subsequent periodic payments will be reduced because of the nonperiodic distribution.

143. Ibid.

144. Treas. Reg. §1.72-11(f).

In this situation, the nontaxable portion of the distribution is calculated using the following formula:

$$\textbf{Nontaxable portion} = (\textbf{Cost of contract} - \textbf{Amounts previously recovered}) \times \frac{\textbf{Reduction in future payments}}{\textbf{Original amount of future payments}}$$

Example 20. Lola, from **Example 17,** takes an additional $2,000 in **2014** for a special gift to her granddaughter. At the time she withdraws the $2,000, she had already received the annual payment of $5,000. Previously, each $5,000 annual payment consisted of $1,500 nontaxable return of principal and $3,500 taxable earnings.

Lola's agent informs her that under the contract, her future payments will be reduced to $4,500 per year because of the extra $2,000 distribution in 2014.

Tax Result. Her current unrecovered cost of the contract is $12,000:

Original cost	$15,000
Less 2013 nontaxable portion of periodic distribution	(1,500)
Less 2014 nontaxable portion of periodic distribution	(1,500)
Unrecovered cost at time of nonperiodic distribution	$12,000

The proportionate amount of the unrecovered cost to be allocated to the nonperiodic distribution is 10% (($5,000 original annual distribution – $4,500 future distribution amount) ÷ $5,000 original annual distribution).

Her nontaxable portion of the $2,000 distribution is $1,200 ($12,000 unrecovered cost × 10%). Her 2014 Form 1099-R follows.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, and ZIP or foreign postal code **Antioch Life Insurance Co.** **123 Clark Street** **Columbus, OH 43228**		1 Gross distribution $ **7000.00** 2a Taxable amount $ **4300.00**	OMB No. 1545-0119 **2014** Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☐	Total distribution ☐	**Copy B** **Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.**
PAYER'S federal identification number **38-1234567**	RECIPIENT'S identification number **999-99-9999**	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $	
RECIPIENT'S name **Lola McMaster**		5 Employee contributions /Designated Roth contributions or insurance premiums $ **2700.00**	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.) **224 St. Botolph Street, #12A**		7 Distribution code(s) **7** / IRA/ SEP/ SIMPLE ☐	8 Other $ %	This information is being furnished to the Internal Revenue Service.
City or town, state or province, country, and ZIP or foreign postal code **Boston, MA 02116**		9a Your percentage of total distribution %	9b Total employee contributions $	
10 Amount allocable to IRR within 5 years $	11 1st year of desig. Roth contrib.	12 State tax withheld $ $	13 State/Payer's state no.	14 State distribution $ $
Account number (see instructions) **ML-899-8977-36A**		15 Local tax withheld $ $	16 Name of locality	17 Local distribution $ $

Form **1099-R** www.irs.gov/form1099r Department of the Treasury - Internal Revenue Service

THE SIMPLIFIED METHOD FOR TAX COMPUTATIONS ON ANNUITY WITHDRAWALS

Employees who receive distributions from either **qualified employee plans** under IRC §401(a), employee annuities under §403(a), or annuity contracts under §403(b) must use a simplified method to compute the taxable and tax-exempt portion of the distributions. Under the simplified method, recipients recover their investment in the contract in equal amounts over the expected number of monthly payments determined from the tables in IRC §72(d)(1). If the taxpayer also receives a lump-sum distribution, the payment is taxed as if received before the annuity starting date.

Example 21. Arlo, age 59, began receiving annuity payments from his 401(k) retirement plan in 2013. He received 12 payments totaling $14,000 in 2013. Arlo has invested $31,000 of nondeductible money into the plan. The taxable amount that Arlo received in 2013 was $12,800. This was calculated by using the following worksheet from IRS Pub. 575, *Pension and Annuity Income.*

Worksheet A. **Simplified Method Worksheet** *Keep for Your Records*

1. Enter the total pension or annuity payments received this year. Also, add this amount to the total for Form 1040, line 16a; Form 1040A, line 12a; or Form 1040NR, line 17a	**1.**	**14,000**
2. Enter your cost in the plan (contract) at the annuity starting date plus any death benefit exclusion.* See *Cost (Investment in the Contract)* earlier	**2.**	**31,000**
Note. If your annuity starting date was before this year and you completed this worksheet last year, skip line 3 and enter the amount from line 4 of last year's worksheet on line 4 below (even if the amount of your pension or annuity has changed). Otherwise, go to line 3.		
3. Enter the appropriate number from Table 1 below. But if your annuity starting date was after 1997 and the payments are for your life and that of your beneficiary, enter the appropriate number from Table 2 below	**3.**	**310**
4. Divide line 2 by the number on line 3	**4.**	**100**
5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was before 1987, enter this amount on line 8 below and skip lines 6, 7, 10, and 11. Otherwise, go to line 6	**5.**	**1,200**
6. Enter any amount previously recovered tax free in years after 1986. This is the amount shown on line 10 of your worksheet for last year	**6.**	**0**
7. Subtract line 6 from line 2	**7.**	**31,000**
8. Enter the smaller of line 5 or line 7	**8.**	**1,200**
9. Taxable amount for year. Subtract line 8 from line 1. Enter the result, but not less than zero. Also, add this amount to the total for Form 1040, line 16b; Form 1040A, line 12b; or Form 1040NR, line 17b. **Note:** If your Form 1099-R shows a larger taxable amount, use the amount figured on this line instead. If you are a retired public safety officer, see *Insurance Premiums for Retired Public Safety Officers* earlier before entering an amount on your tax return	**9.**	**12,800**
10. Was your annuity starting date before 1987? ☐ Yes. **STOP.** Do not complete the rest of this worksheet. ☑ No. Add lines 6 and 8. This is the amount you have recovered tax free through 2009. You will need this number if you need to fill out this worksheet next year	**10.**	**1,200**
11. Balance of cost to be recovered. Subtract line 10 from line 2. If zero, you will not have to complete this worksheet next year. The payments you receive next year will generally be fully taxable	**11.**	**29,800**

* A death benefit exclusion (up to $5,000) applied to certain benefits received by employees who died before August 21, 1996.

Table 1 for Line 3 Above

IF the age at annuity starting date was...	AND your annuity starting date was— BEFORE November 19, 1996, enter on line 3...	AFTER November 18, 1996, enter on line 3...
55 or under	300	360
56-60	260	310
61-65	240	260
66-70	170	210
71 or older	120	160

Table 2 for Line 3 Above

IF the combined ages at annuity starting date were...	THEN enter on line 3...
110 or under	410
111-120	360
121-130	310
131-140	260
141 or older	210

The simplified method may not be used if the annuitant is over age 75 and there are five or more years of guaranteed payments under the annuity.[145] Instead, the regular annuity rules apply.

DISTRIBUTIONS BEFORE AGE 59½

Most annuity distributions made before the investor reaches age 59½ are subject to a 10% penalty in addition to the income taxes due on the taxable portion of the distribution. The penalty only applies to the taxable portion of the distribution.[146]

In many cases, the issuer of the Form 1099-R reports the distribution as an early distribution even though one of the exceptions applies. A code 1 in box 7 of Form 1099-R indicates that the payment is an early distribution with no known exception. If an exception does apply, the taxpayer must file Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.* This form allows the taxpayer to identify the applicable exception and quantify the amount of the distribution that qualifies.

> **Observation.** Determining that a code 1 distribution actually qualifies for an exception to the penalty can demonstrate to the taxpayer that using a tax professional is superior to using off-the-shelf software.

Under certain circumstances, a distribution from a commercial annuity is not subject to the additional 10% penalty. These exceptions are different from the exceptions related to distributions from qualified retirement plans and IRAs. If one of these conditions applies, the appropriate exception number from the Form 5329 instructions should be entered on the line across from line 2 on the form.

Exception codes and descriptions applicable to nonqualified annuities include the following.[147]

02. A distribution is part of a series of substantially-equal periodic payments made over the life expectancy of the investor or the joint life expectancies of the investor and the beneficiary of the annuity.

03. The distribution is due to the disability of the contract holder.

04. The distribution is due to the death of the contract holder.

12. The portion of an early distribution that is allocable to investments made before August 14, 1982.

12. The annuity is part of a qualified personal injury settlement.

12. The annuity was purchased by the contract holder's employer upon termination of a qualified employee plan and held by the employer until the contract holder's separation from service.

12. The annuity is an immediate annuity contract. (An immediate annuity contract is one purchased with a single premium that provides substantially-equal payments starting within one year from the date of purchase. The payments must be made at least once per year to qualify.)

> **Caution.** If the substantially-equal-periodic-payment exception applies and the taxpayer subsequently makes changes to the payment stream, a recapture tax may be imposed. See IRS Pub. 575 for more information.

145. IRC §72(d)(1)(E).

146. IRS Pub. 575, *Pension and Annuity Income*.

147. Instructions to Form 5329.

Example 22. Kenny, age 35, is totally and permanently disabled as the result of being struck by an ambulance. In 2013, he takes a fully taxable distribution of $7,000 from his commercial annuity. His 2013 Form 1099-R from the insurance company shows a code 1 in Box 7 because he was under age 59½.

His CPA, Wendy, prepares the following Form 5329 and submits it with his 2013 tax return. She enters code 03 on the line across from line 2 to indicate that Kenny is not subject to the 10% penalty because of his disability. This entry is circled on the following form for emphasis.

Form **5329**
Department of the Treasury
Internal Revenue Service (99)

Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts

▶ Attach to Form 1040 or Form 1040NR.
▶ Information about Form 5329 and its separate instructions is at *www.irs.gov/form5329*.

OMB No. 1545-0074
2013
Attachment Sequence No. **29**

Name of individual subject to additional tax. If married filing jointly, see instructions.
Kenny Gladstone

Your social security number
999-99-9999

Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return

Home address (number and street), or P.O. box if mail is not delivered to your home | Apt. no.

City, town or post office, state, and ZIP code. If you have a foreign address, also complete the spaces below (see instructions).

If this is an amended return, check here ▶ ☐

Foreign country name | Foreign province/state/county | Foreign postal code

If you **only** owe the additional 10% tax on early distributions, you may be able to report this tax directly on Form 1040, line 58, or Form 1040NR, line 56, without filing Form 5329. See the instructions for Form 1040, line 58, or for Form 1040NR, line 56.

Part I Additional Tax on Early Distributions

Complete this part if you took a taxable distribution before you reached age 59½ from a qualified retirement plan (including an IRA) or modified endowment contract (unless you are reporting this tax directly on Form 1040 or Form 1040NR—see above). You may also have to complete this part to indicate that you qualify for an exception to the additional tax on early distributions or for certain Roth IRA distributions (see instructions).

1	Early distributions included in income. For Roth IRA distributions, see instructions	1	7,000
2	Early distributions included on line 1 that are not subject to the additional tax (see instructions). Enter the appropriate exception number from the instructions: 03	2	7,000
3	Amount subject to additional tax. Subtract line 2 from line 1	3	0
4	**Additional tax.** Enter 10% (.10) of line 3. Include this amount on Form 1040, line 58, or Form 1040NR, line 56	4	
	Caution: *If any part of the amount on line 3 was a distribution from a SIMPLE IRA, you may have to include 25% of that amount on line 4 instead of 10% (see instructions).*		

Additional Tax on Certain Distributions From Education Accounts

FEDERAL INCOME TAX WITHHOLDING[148]

A recipient may specify the amount of taxes to withhold from an annuity distribution by giving the payer Form W-4P, *Withholding Certificate for Pension or Annuity Payments.* To be valid, the form must include the recipient's social security number (SSN). Absent a valid Form W-4P, the payer must withhold taxes from the taxable portion of any distribution.

For **periodic payments,** the default level of withholding is based on the withholding tables for wages. Tax is withheld as if the recipient were married and claiming three withholding allowances. However, if the recipient fails to provide a valid SSN, the taxpayer is assumed to be single with no withholding allowances.

For **nonperiodic payments** the default level of withholding is 10% of the taxable distribution.

Observation. The default levels of withholding are seldom appropriate for the taxpayer's situation. Practitioners may wish to provide clients with a completed Form W-4P to submit to their annuity providers.

148. Ibid.

Example 23. Kenny, from **Example 22**, has $700 withheld from the $7,000 annuity distribution in 2013. Because he has no federal tax liability, Wendy recommends that he elect to have no taxes withheld from future distributions. She provides him with the following Form W-4P to sign and give to his annuity provider. The line 1 box is circled for emphasis.

Separate here and give Form W-4P to the payer of your pension or annuity. Keep the top part for your records.

Form **W-4P**
Department of the Treasury
Internal Revenue Service

Withholding Certificate for Pension or Annuity Payments

▶ **For Privacy Act and Paperwork Reduction Act Notice, see page 4.**

OMB No. 1545-0074

2014

Your first name and middle initial	Last name	**Your social security number**
Kenny	**Gladstone**	**999-99-9999**
Home address (number and street or rural route) **3121 Caniff Road**		Claim or identification number (if any) of your pension or annuity contract
City or town, state, and ZIP code **Detroit, MI 48221**		**AN-356-89B**

Complete the following applicable lines.

1 Check here if you **do not want any** federal income tax withheld from your pension or annuity. (Do not complete line 2 or 3.) ▶ ☒

2 Total number of allowances and marital status you are claiming for withholding from each **periodic** pension or annuity payment. (You also may designate an additional dollar amount on line 3.) . . . . ▶ (Enter number of allowances.)

Marital status: ☐ Single ☐ Married ☐ Married, but withhold at higher Single rate.

3 Additional amount, if any, you want withheld from each pension or annuity payment. (**Note.** For periodic payments, you cannot enter an amount here without entering the number (including zero) of allowances on line 2.) . . . . ▶ $

Your signature ▶ **Date** ▶

Cat. No. 10225T Form **W-4P** (2014)

TAX CONSEQUENCES OF OWNERSHIP CHANGES

Annuity contracts may allow any of the following ownership changes.

- The addition or deletion of a joint owner
- A transfer to another individual or entity
- An assignment of the annuity

When one of the above transfers occurs, the earnings are subject to income tax. A 10% penalty and/or gift taxes may apply. Exceptions to the imposition of these taxes and penalties include the following.

- Transfers due to divorce
- Transfers between spouses
- Transfers between an individual and their grantor trust

SURRENDERING AN ANNUITY OR SWITCHING FROM ONE ANNUITY TO ANOTHER

If a person buys an annuity and then decides to get out of the contract, the annuity can be surrendered. Most companies charge a surrender fee if a person decides to get out of the annuity contract within the first seven to eight years of owning it. The shorter the length of time the annuity contract is held, the more the person pays in surrender fees. For example, if the annuity has a 7-year surrender period and a person surrenders the annuity in the first year, then 7% of the value of the investment might be surrendered to the company. Surrendering the annuity in the second year might cost the owner 6%, and so on.

A person can switch from one annuity contract to another without paying taxes. Exchanging one contract for another is known as a §1035 exchange. In a §1035 exchange, a person can make a nontaxable exchange of a life insurance policy for another life insurance policy, an annuity for another annuity, or a life insurance policy for an annuity. However, a person cannot exchange an annuity for a life insurance policy without paying taxes on the gains in the contract. To be eligible for tax-deferred treatment, the policies or annuities must be exchanged through the insurance companies. When the owner personally receives any money during the exchange, even if the intent is to apply it to a new policy, it is subject to income tax.

If a person needs to withdraw money before the surrender period, some insurers allow access to a small percentage (10 to 15%) of the investment. This may be allowed under special circumstances, such as serious illness or disability, or simply at the discretion of the owner. After the surrender period, a person can withdraw as much of the annuity as desired. However, if the person withdraws money before attaining age 59½, the withdrawal is subject to a 10% penalty on the taxable portion unless an exception applies.

ANNUITY SUITABILITY ISSUES

The ideal annuity buyer is age 55 or older. Annuities are less attractive to younger investors due to the 10% penalty for withdrawing money before reaching age 59½ for reasons other than death or disability. However, many people who are already retired and need income immediately opt for immediate annuities. These annuities skip the accumulation phase and begin issuing payments as soon as money is invested in the contract. The early withdrawal penalty may severely limit the liquidity of funds for a senior citizen who buys an annuity that is not the immediate type. For this reason, annuity purchases by older individuals are often discouraged by investment regulatory agencies unless the individual is purchasing an immediate annuity.

The ideal annuity buyer is also someone who contributed the maximum amount to an existing tax-deferred retirement plan, such as a 401(k) or 403(b) plan, or an IRA. This investor already has accumulated tax-deferred money in those plans, and the fees associated with those accounts usually are much lower than those for annuities. With the large increases to contribution limits to qualified plans and IRAs in the last decade, few taxpayers have extra funds remaining with which to purchase annuities after funding, for example, a solo 401(k) plan, in which up to $52,000 per person may be deferred in 2014.[149]

CONCLUSION

Annuities have become increasingly popular and more complex because their features have expanded to meet perceived and actual consumer demands. The goal of a tax professional is to handle the tax treatment of these investments correctly and to understand them well enough to competently serve clients.

> **Note.** Annuities are financial instruments created and marketed by private finance companies that have significant flexibility in establishing many of the terms and conditions of the annuities they sell. For a detailed discussion of many of the issues and tax considerations that may arise with annuities, see the 2010 *University of Illinois Federal Tax Workbook*, Chapter 13: Elder Issues. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

149. *One-Participant 401(k) Plans.* [www.irs.gov/Retirement-Plans/One-Participant-401%28k%29-Plans] Accessed on Jun. 12, 2014.

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 115,000 mortgages issued in the fiscal year ending 2009 after steadily gaining popularity since 1990.[150] By 2011, however, the number of reverse mortgages issued dropped to 72,000. A total of 740,000 HECM loans have been originated.[151]

WHAT IS A REVERSE MORTGAGE?

A reverse mortgage is a home equity loan available to persons at least 62 years of age[152] 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 their home.

A reverse mortgage works like a traditional (forward) mortgage, only in reverse. Rather than 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 their 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 their 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 disadvantages of each loan type.

150. Consumer Financial Protection Bureau, *Reverse Mortgages Report to Congress,* (Jun. 2012).

151. Ibid.

152. 12 USC §1715z-20(b)(1).

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
- Monthly loan advances, plus a line of credit

This type of reverse mortgage is not due as long as the borrower lives in their 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 their 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 their 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 a mortgage less than the full value of their 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 they sell the 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.** When considering an uninsured reverse mortgage, taxpayers should carefully consider the amount of money needed, 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 should be asked.

1. Is the owner healthy enough to remain in their home?
2. Do they 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 their home;
- Generally, be at least 62 years old;
- Use the home as their 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 the 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).

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.** A credit line account 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 the payment time period and whether it is for a set number of years or for as long as the borrower lives in their 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 the borrower lives, not where they live. 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 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

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 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 repay 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.

- When the borrower sells the house, the sales proceeds are used to repay 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 their 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 following.

- 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
- 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 the 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 the principal and the interest that accrues each month. Compounded interest causes the outstanding amount to grow at an increasingly fast rate. Accordingly, interest payments use a large part of the home equity.
- **Overborrowing**. The borrower should determine exactly how much is needed to supplement their income prior to borrowing, so interest is not paid 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 their 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. 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, they 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.

> **Note.** More taxpayers each year are asking about reverse mortgages. Tax practitioners may want to share information provided by AARP regarding the pros and cons of reverse mortgages. This is available at **http://assets.aarp.org/www.aarp.org_/articles/money/financial_pdfs/hmm_hires_nocrops.pdf.**

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, a local state agency on aging may be contacted.
- **A qualified personal residence trust (QPRT)**. A senior citizen who wants to pass their 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 their home for a certain amount of time, with ownership eventually passing to any heirs.
- **A sale-leaseback.** The individual sells their home to their 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**. Many retirees have sold expensive homes in California and moved to lower-cost areas. They live on the sales proceeds and purchase a new home.

OTHER TAX AND REPORTING ISSUES

There are several income tax reporting considerations that can have an impact on the tax liability of the older taxpayer each year. These are important issues for the practitioner to keep in mind when preparing a tax return for an elderly taxpayer.

AUGMENTED STANDARD DEDUCTION

Individuals who are at least age 65 and who choose not to itemize deductions on their federal income tax return are eligible for an augmented standard deduction.

In order to qualify for the augmented standard deduction, a taxpayer must have attained age 65 by the end of the taxable year. For this purpose, the Code considers an individual to have attained age 65 on the day before the day of the individual's birthday. For example, an individual with a January 1 birthday who turns age 65 on January 1, 2014, is considered to have reached age 65 on December 31, 2013, and thus is eligible for the augmented standard deduction for 2013.[153]

The augmented standard deduction also applies to individuals who are blind. An individual who is both age 65 or older and blind can take an additional augmented deduction. The following table provides some of the applicable standard deduction amounts for a single filer and for MFJ filers.[154]

	2014 Standard Deduction Amount
Single filer	$ 6,200
Single filer at least age 65 on December 31, 2014	7,750
Single filer at least age 65 on December 31, 2014, and blind	9,300
MFJ couple, both at least age 65 on December 31, 2014, and both spouses blind	17,200

> **Note.** For further information on how to calculate an augmented standard deduction for a taxpayer, see IRS Pub. 17, *Your Federal Income Tax.*

153. IRS Pub. 554, *Tax Guide for Seniors*.

154. IRS Pub. 17, *Your Federal Income Tax*.

A higher standard deduction may be available to an individual whose spouse died during the tax year. If the couple would have been eligible to file a joint return, the surviving spouse may file jointly for the tax year in which the spouse died but not for subsequent years. However, a surviving spouse who does not remarry and who has a dependent child (including a stepchild) who can be claimed as a dependent may be able to file as QW for the two tax years immediately following the death of the decedent spouse.[155] To file as QW, the following conditions must be satisfied.

- The dependent child must live in the taxpayer's home for the entire year. Temporary absences are permitted.
- The taxpayer seeking to file as QW must pay more than half of the expenses of maintaining the home for the year.

Filing as QW allows a taxpayer to use joint filing tax rates and to take the highest possible standard deduction.

> **Note.** Although QW status allows the use of MFJ rates to calculate tax liability, it does not permit the taxpayer to file a joint return.

PARENT CLAIMED AS A DEPENDENT

Some families may determine that it is to their advantage for an older person to be claimed as a dependent on another family member's tax return. Claiming someone as a dependent gives a taxpayer an additional exemption amount.

> **Note.** For federal income tax returns filed for 2013, the exemption amount per person is $3,900. The exemption amount is $3,950 for the 2014 tax year.[156]

In order for a taxpayer to claim an older person as a dependent, the older person must be a "qualifying relative."[157] A qualifying relative is someone who either:

- Lived with the taxpayer all year as a member of the taxpayer's household, or
- Has one of the following relationships with the taxpayer.
  - Father or mother
  - Stepfather or stepmother
  - Grandparent
  - Any other direct ancestor

A person being claimed as a **qualifying relative** may not have taxable gross income for the year in question in excess of the personal exemption amount ($3,950 for 2014).

Finally, the taxpayer seeking to claim another person as a **qualifying relative** must have provided more than half that person's support during the tax year. The determination of support takes into account the entire amount of support that person received from all sources, including amounts the person provided from their own funds.

> **Note.** For a more thorough explanation of the dependency tests for a qualifying relative, see the 2011 *University of Illinois Federal Tax Fundamentals,* Chapter 3: Filing Status and Dependency Exemptions. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

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155. Ibid.

156. Rev. Proc. 2013-35, 2013-47 IRB 537.

157. IRS Pub. 501, *Exemptions, Standard Deduction, and Filing Information.*