ABA CONNECTION

THE RULES CHANGE WITH AGE

Income Tax Issues Get Tougher for an Older Population

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AS IF THE OTHER DRAWBACKS OF AGING WEREN'T ALready bad enough, doing income taxes gets harder, too.

The intuitive conclusion would seem to go in the other direction—that computing taxes should be less complicated for an individual or a couple easing into retirement. But it doesn't always work that way, at least in the context of federal income taxes.

Instead, older taxpayers must grapple with unfamiliar rules and formulas that kick in as they begin collecting Social Security benefits, sell houses, withdraw money from savings vehicles and fine-tune estate plans.

Further complicating things is the fact that many of the long-standing rules in those areas have been replaced under tax laws passed in recent years—but because of sunset provisions, some of those new rules may be in effect for only a few more years, unless Congress acts to extend them.

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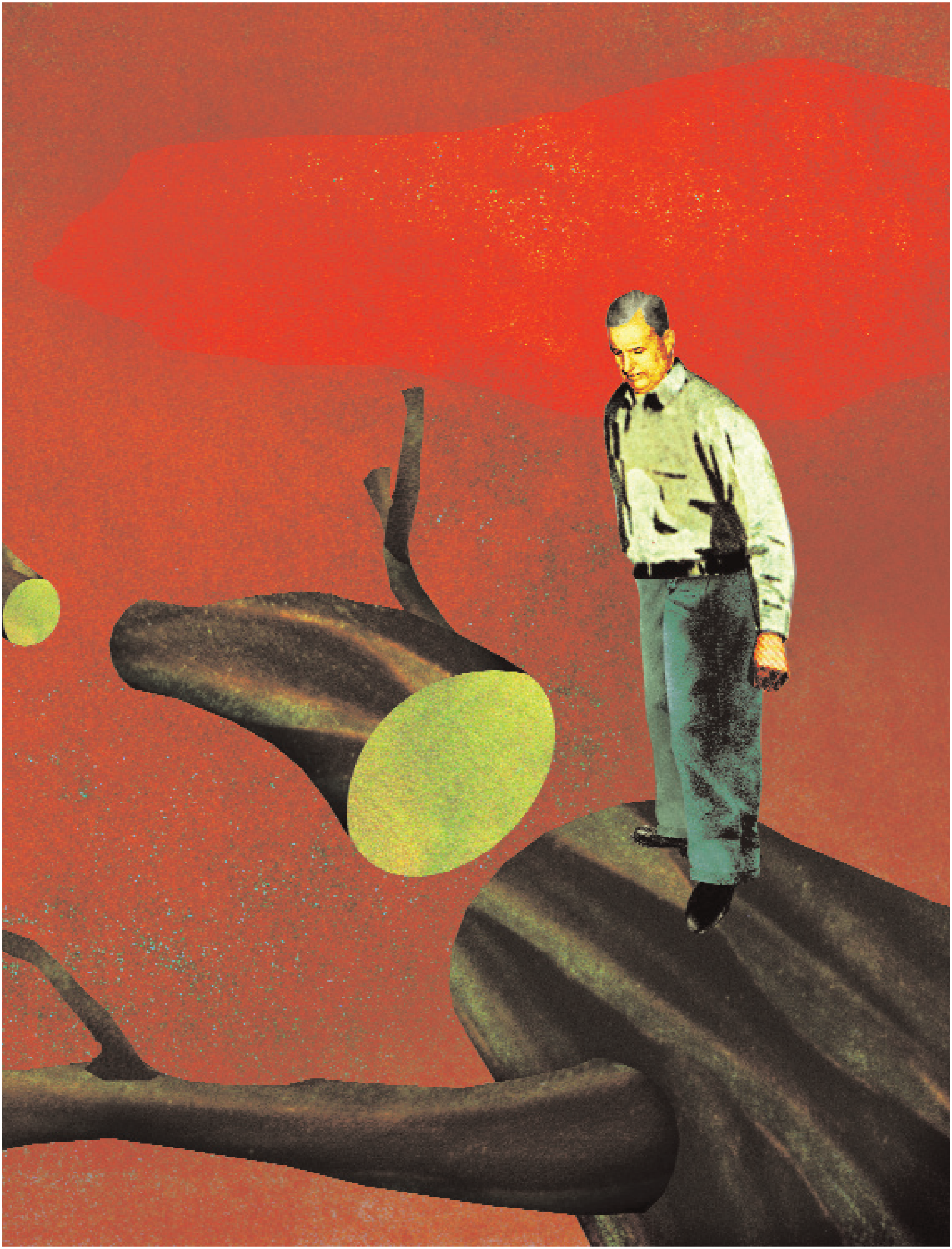

Meanwhile, the portion of the U.S. population that faces these tax issues is growing steadily. The 2000 U.S. Census counted some 35 million people—12.4 percent of the nation's population—age 65 and older. While the percentage of the older population was slightly smaller than in 1990, the older population increased in actual numbers by some 3.8 million people from 1990 to 2000, according to the Census Bureau. And the older population will swell further in the coming years with the aging of the Baby Boom generation (persons born between 1946 and 1964).

It's enough to cause gray hairs.

TAXING SOCIAL SECURITY BENEFITS

THINGS WEREN'T SO COMPLICATED FOR OLDER TAXPAYERS before 1983 because until then Social Security benefits were not subject to federal income tax. But in that year, Congress enacted section 83 of the Internal Revenue Code making Social Security benefits taxable. (Congress further amended section 83 in 1993.)

The ensuing difficulties in figuring those taxes were the result of efforts by Congress and the Internal Revenue Service to soften the blow by implementing formulas to protect portions of Social Security benefits from being counted as part of an individual's taxable income.

Under this formula, once Social Security benefits paid to an individual reach a basic threshold amount, a percentage of those benefits is included in that person's gross income, depending on filing status and income level.

The IRC defines "Social Security benefit" to mean any amount received by the taxpayer as a monthly benefit under Title II of the Social Security Act. That primarily encompasses federal retirement insurance, survivor insurance and disability insurance payments.

As federal tax law now stands, an individual who receives Social Security benefits must count a portion of those benefits as gross income (income derived from all sources) if the recipient's modified adjusted gross income for the year, plus one-half of the Social Security benefits received, exceed a base amount, which is determined by the filing status of the recipient.

Currently, the base amount is $25,000 for unmarried individuals, $32,000 for married taxpayers filing a joint return, and zero for a married taxpayer filing a separate return if the spouses do not live apart at all times during the taxable year.

Tax law defines "adjusted gross income" as what remains after certain allowable expenses and other deductions have been taken out of the taxpayer's gross income. For these purposes, adjusted gross income does not include Social Security benefits; the interest exclusion for savings bond proceeds used to pay qualified educational expenses; the exclusion from gross income of qualified employer adoption-assistance programs; the deduction for interest paid on qualified education loans; the foreign earned-income exclusion and foreign housing exclusion or deduction; the exclusion of income from U.S. possessions; and the exclusion of income from Puerto Rico by bona fide residents of Puerto Rico.

"Modified adjusted gross income" is the taxpayer's adjusted gross income plus tax-exempt interest received during the year.

After determining the taxpayer's modified adjusted gross income, the taxable portion of Social Security benefits received is calculated by comparing the results of two alternate formulas. The general rule is that the taxpayer must include in gross income the lesser of 1) one-half of the Social Security benefits received, or 2) one-half of the total of modified adjusted gross income and one-half of the Social Security benefit that exceeds the applicable base amount—called the provisional amount.

If the provisional amount exceeds an adjusted base amount, more of the Social Security benefits received by the taxpayer during the year must be included in his or her gross income. The adjusted base amount is $34,000 for unmarried individuals; $44,000 for married taxpayers filing a joint return; and zero for a married taxpayer filing a separate return if the spouses do not live apart at all times during the taxable year.

To make matters even more complex, there are special rules that apply to the taxation of Social Security benefits. In certain circumstances, for instance, a taxpayer may be required to repay part of the amounts previously received from the government as Social Security benefits. In such cases, the taxpayer is allowed to reduce the amount of current benefit receipts by the amount of the repayment, which affects the amount of Social Security benefit payments applied to gross income calculations.

Another special rule applies to the receipt by a taxpayer of lump-sum Social Security payments. In those cases, the taxpayer may elect to spread out the tax impact by applying the portions of the lump-sum payment to the years in which he or she would receive them if not distributed as a lump sum.

Moreover, for some tax calculations, Social Security benefits are treated as pension or annuity payments. This treatment is given for purposes of reducing amounts received as pensions or annuities, defining earned income, defining compensation relating to deductions for contributions to individual retirement arrangements, and defining foreign earned income.

Are the gray hairs sprouting yet?

Turn to page 59.

MEDICAL EXPENSES

IT IS A BLUNT REALITY THAT YOU ARE likely to need more medical care as you grow older.

From a federal income tax perspective, that means it also is more likely that the deduction for medical care expenses will come into play.

As a general rule, a taxpayer may deduct amounts he or she pays for medical care that are not covered by insurance or some other form of reimbursement.

As defined in section 213 of the IRC, the deduction includes dental as well as medical care, drugs and medicines, nursing care and certain travel expenses for the taxpayer, as well as a spouse and dependents. The deduction also encompasses preventive treatment, qualified long-term-care services and medical insurance, including long-term-care policies. Measures taken for the taxpayer's general health, however, don't qualify for the deduction.

But the deduction is only allowed to the extent that medical expenses exceed 7.5 percent of the taxpayer's adjusted gross income. (The threshold is 10 percent in calculating the taxpayer's alternative minimum tax.)

For many older taxpayers, the cost of premiums for long-term-care insurance is a key facet of their health care expenses. Under the federal tax rules, the cost of premiums for long-term-care insurance may be deducted to the extent that the premiums do not exceed specific amounts based on age brackets.

For 2004, the deduction is limited to $240 for individuals who are 40 or younger at the end of the tax year, and increases to a maximum of $3,250 for persons who are 71 or older at the end of the tax year. The IRS increases the limitation amounts each year through a medical-care cost adjustment.

The tax rules also set forth fairly strict definitions of what qualifies as long-term-care insurance. A qualified long-term-care insurance contract is defined as one that covers an individual and 1) pays for only qualified long-term-care services; 2) does not pay or reimburse expenses reimbursable under Medicare; 3) is guaranteed renewable; 4) does not provide any cash surrender value or other money that can be paid, assigned or pledged as collateral, or borrowed; 5) provides that premium refunds or dividends must only be applied to future premiums or increases in benefits; and 6) contains certain consumer protection provisions.

A deduction also may be allowed when a taxpayer receives coverage under a state-sponsored long-term-care plan and the terms of the arrangement otherwise satisfy the tax rules for a long-term-care insurance contract.

For tax-deduction purposes, qualified long-term-care services include necessary diagnostic, preventive, therapeutic, curing, treating, mitigating and rehabilitative services, as well as maintenance and personal-care services necessary for a chronically ill person. Those services must be provided pursuant to a plan or care prescribed by a licensed health care practitioner who has certified the patient as chronically ill.

In doing so, the medical care provider must have certified the patient within the past 12 months as 1) being unable to perform, without substantial assistance, at least two activities of daily living for at least 90 days due to a loss of functional capacity; or 2) having a disability that amounts to being unable to perform at least two activities of daily living without assistance (as determined under IRS regulations in conjunction with the Department of Health and Human Services); or 3) requiring substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

Long-term care provided by a spouse or relative (either directly or indirectly) does not qualify for a tax deduction unless the provider is licensed to provide the services.

SELLING THE HOUSE

IT'S COMMON FOR OLDER PERSONS TO SELL THEIR PERSONAL residences as they adjust to changes in their living arrangements. When that happens, it's important to take steps to minimize the income tax consequences.

This is another area in which the rules have changed. Before 1997, taxpayers ages 55 and older could apply for a one-time exclusion from taxes on the gain realized from the sale of a principal residence (including gains deferred from the sale of previous residences).

The exclusion rule was eliminated by the Taxpayer Relief Act of 1997. Now, a taxpayer may exclude up to $250,000 of gain ($500,000 for certain joint returns) realized on the sale or exchange of a residence, using an adjusted basis formula, as long as the taxpayer owned the property and used it as a principal residence for at least two years during the immediately preceding five years.

If those requirements are not met, or if the taxpayer sells or exchanges more than one principal residence within a two-year period, a reduced exclusion still may be available if the sale or exchange is due to a change in place of employment or health, or certain other circumstances.

On Aug. 13, the IRS issued final regulations regarding factors relevant to determining whether the sale of a residence qualifies for a reduced exclusion from gain. They include the extent to which 1) the sale or exchange and the circumstances giving rise to it are proximate in time, 2) the suitability of the property as the taxpayer's principal residence materially changes, 3) the taxpayer's financial ability to maintain the property is materially impaired, 4) the taxpayer resides at the property while owning it, 5) the circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins

using the property as a principal residence, and 6) the circumstances giving rise to the sale or exchange occur while the taxpayer owned the property and used it as a principal residence.

Several safe harbors are provided in the final regulations. A sale or exchange is deemed to be due to a change in employment if the new place of employment is at least 50 miles from the residence. Also, a sale or exchange is deemed to be due to health if a physician recommends a change of residence. Other safe harbors include involuntary conversion of the residence, and a natural or manmade disaster or act of war or terrorism resulting in damage to the residence.

Events affecting the property owner that will give rise to a partial exclusion include 1) death, 2) qualifying for unemployment compensation, 3) a change in employment or self-employment that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses, 4) divorce or legal separation, 5) multiple births resulting from the same pregnancy, 6) any event deemed by the IRS to qualify as an unforeseen circumstance.

The final regulations also provide that, even without a safe harbor, a taxpayer still may be able to claim a reduced exclusion if the taxpayer can demonstrate that the primary reason for the sale or exchange was a change in health or place of employment, or unforeseen circumstances.

A special exception to the use requirement was added for members of the uniformed services. The final regulations provide that a taxpayer or a spouse serving on qualified official extended duty as a member of the uniformed services or the foreign service may elect, with respect to one property at a time, to suspend the running of the five-year period for up to 10 years.

REQUIRED MINIMUM DISTRIBUTIONS

MANY OLDER PERSONS HAVE PUT SUBSTANTIAL AMOUNTS of money into individual retirement accounts. And soon after they reach the age of 70½, they must start reaping the benefits of their IRAs—whether they like it or not.

The rule is that an individual must begin to receive "minimum distributions" from an IRA starting on April 1 following the year in which he or she reaches 70½. (This rule also applies to retirement plan accounts maintained through employers, although employees may qualify to defer distributions until they retire, as long as they are not owners of at least 5 percent of their companies.)

Generally, minimum distributions are calculated on the basis of the joint life expectancy of an account owner and a hypothetical beneficiary 10 years younger. If the account owner's sole beneficiary is a spouse more than 10 years younger, minimum distributions may be based on the actual joint life expectancy of the account owner and the spouse. The minimum distribution is calculated separately for each account. The total amount may be distributed from any one or more of the owner's IRAs.

Until 2003, an IRA account owner was required to calculate his or her minimum distribution. But starting in 2003, IRA trustees, custodians and issuers must either calculate the minimum distribution for the account owner or advise the account owner that a minimum distribution is required for the year, and offer to calculate the amount if the account owner requests it.

At the same time that this reporting requirement removes a burden from IRA owners, it allows the trustee, custodian or issuer to assume that the beneficiary is not a spouse at least 10 years younger than the account owner. For an account owner whose spouse is the sole beneficiary and more than 10 years younger, the calculations furnished will not be accurate.

Also, there is no reporting requirement for minimum distributions after an account holder has died, so in most cases beneficiaries are responsible for calculating their own minimum distributions.

Starting in 2004, IRA trustees, custodians and issuers must report to the IRS (on Form 5498) that a minimum distribution is due to an account owner, although the amount of the distribution does not have to be disclosed.

The timing of required minimum distributions after the death of an IRA account owner depends on whether the owner died before or after distributions commenced, and on whether the owner had a designated beneficiary.

If the account owner died before minimum distributions commenced, and there is no designated beneficiary, then the account must be distributed in full (and income taxes paid) within five years of the account owner's death. But if the account owner died after minimum distributions commenced, the account must be distributed in full (and income taxes paid) over the account owner's remaining life expectancy (reduced by one each year).

If there was a designated beneficiary, the account may be distributed over the life or life expectancy of the designated beneficiary. On the other hand, allowing the income tax deferral to continue after the death of the IRA owner may result in significant additional growth in the value of the account, particularly when the designated beneficiary is young.

Not all beneficiaries qualify as "designated," and it is important that the IRA account owner understand the implications when filling out beneficiary designation forms furnished by the trustee, custodian or issuer. Only an individual or a qualified trust in which all of the beneficiaries are individuals may be a designated beneficiary. An estate may not be designated as an IRA beneficiary. Doing so would most likely reduce the benefits available from continued income tax deferral. A charity also may not be a designated beneficiary, but if the charity's interest is paid out by Sept. 30 of the year following the year of the account owner's death, the account may be "cured" if all remaining beneficiaries qualify as designated beneficiaries.

Normally, distributions after death made over the life or life expectancy of a designated beneficiary must start no later than the end of the year immediately following the year in which the account owner died. When the spouse is the sole designated beneficiary (including the sole designated beneficiary of a trust), however, distributions may be deferred until the end of the year in which the account owner would have reached age 70½. A spouse who is a sole beneficiary with unlimited right to withdraw amounts from the IRA also may elect to treat an inherited IRA as his or her own. A spouse who makes this election may defer distributions until he or she reaches 70½, and may designate new beneficiaries who could take future distributions over their own lives or life expectancies after the spouse's death. This election, however, may not be made if the designated beneficiary is a trust, even if the spouse is the sole beneficiary. Accordingly, designating a standard marital or "QTIP" trust as beneficiary makes this election unavailable.

The rules are in flux in two other areas of particular interest to older taxpayers: estate planning and tax treatment of dividends and long-term capital gains. Before Congress adopted the Jobs and Growth Tax Relief Reconciliation Act of 2003, for instance, long-term capital gains were taxed at rates of 10 percent or 20 percent, depending on the taxpayer's tax bracket. Those rates were reduced further when the capital asset had been owned for at least five years. The act reduced both rates and eliminated the five-year rule altogether for capital gains realized after May 5, 2003. Further rate drops will go into effect after 2007, but all new rates are scheduled to expire after 2008, when previous higher rates will be reinstated.

Dividends from domestic corporations and qualifying foreign corporations are taxed at the same lower rates as capital gains, but those rates also will expire after 2008.

Similar uncertainty exists in estate planning because increases in the federal estate tax exemption amount are not permanent. Currently, the exemption amount stands at $1.5 million, enough to eliminate the impact of federal estate taxes in many cases, and will increase to as high as $3.5 million in 2009. The estate tax will be repealed during 2010. But in 2011, when the Tax Relief Reconciliation Act sunsets, the estate tax exemption amount will drop back down to $1 million unless Congress acts to extend the higher exemptions.

Meanwhile, some states have "decoupled" from the federal rules and are imposing their own taxes on estates too small for the federal tax. New York, for example, has a state estate tax exemption of $1 million; in New Jersey, the exemption is only $675,000.

Developing plans to provide for these variables effectively is difficult, and any predictions as to what Congress will do in these areas are educated guesses at best. In light of all these tax complexities facing older persons, it might be easier to just stay young—if only we could. ■