TAX TIPS

by Michael A. Lampert

RMD and charity

Upon reaching age 70-1/2, clients must take the required minimum distribution (RMD) from their taxable IRA. Some of those same clients also make charitable contributions. With the income tax law changes over the last few years, many of these clients no longer itemize their deductions on their federal income tax return.

The result? The client reports taxable income on the IRA distribution. The client does not get the benefit of the charitable income tax deduction.

Possible solution: Qualified charitable distribution (QCD). Clients age 70-1/2 or older may make a direct gift from the IRA to charity up to $100,000 per year total.

The QCD:

- Satisfies all or part of the RMD;
- Does not count against the maximum percentage of adjusted gross income allowed for a charitable deduction (helpful for higher-income/large-donor clients); and
- Most critically, the donation from the IRA directly to the charity is not taxed. It does not even count as adjusted gross income. Yes, there is no charitable deduction, but the deduction would only, at best, reduce the taxable gross income amount. Here it is not even in the equation. And, as an added benefit, the income does not count in determining the taxability of Social Security benefits. It also reduces the adjusted gross income for determining Medicare premium as well as, for higher income clients, the net investment income tax.

Trap: The charitable donation needs to be directly from the IRA to the charity. If a client takes a distribution and then donates the distribution, this special rule does not apply.

Employer-provided disability insurance and Social Security: Does the interface make a tax difference?

As part of my tax controversy practice, I often review tax cases that arise as part of a taxpayer's fight against the IRS's attempt to collect an assessed tax. Most of these cases have little unique impact on an elder lawyer's clients. The recent case *Murphy v. Commissioner of Internal Revenue*, T.C. Summ. Op. 2019-32 (Oct. 15, 2019), is an exception. *Murphy* at 7-8 certainly addresses technical procedural tax issues, but it also addresses the basic question:

Should a portion of a taxpayer's Social Security benefits be treated as nontaxable when a portion of the employer-provided disability plan benefits are not taxable and the plan has the right to reduce the taxpayer's disability benefits by the amount of the Social Security benefits?

The court responded no.

As a reminder, Social Security is taxed depending on the taxpayer's other income. The threshold is adjusted annually, but this past tax year (2018), the threshold for single filers was "combined income" between $25,000 and $34,000, after which 50% of the Social Security benefits was taxed, and above $34,000, 85% of the Social Security benefits was taxed. For joint returns, with a combined income between $32,000 and $44,000, 50% of the Social Security benefits was taxed, and above $44,000, 85% was taxed.

Trap: If the tax filing status is married filing separately, it is very likely that all of the Social Security benefits will be taxable.

But what is "combined income"?

It is the adjusted gross income *plus* nontaxable interest income *plus* one-half of the Social Security benefits.

Tip: Roth IRA withdrawals do not count as part of the income calculation.

Tip: The client can choose to pay estimated taxes or have withholding from the client's Social Security benefits (use Form W-4V voluntary withholding request).

Trap: There are approximately 13 states that tax some portion of Social Security benefits. Be careful if the client is not a Florida resident.

There is a potential for very high marginal tax brackets. The July 2018 *Journal of Financial Planning* had an article in which the authors demonstrated how taxpayers in the 12% income tax bracket could end up paying a marginal income tax rate of 22% on a portion of their income, and taxpayers in the 22% bracket could have a marginal rate over 40%. This is because, for some middle-income taxpayers, being just over the threshold for Social Security benefits taxation causes a significant amount (50% or 85%) of the benefits to be taxed. One example, using 2018 tax rates, had a single person with income between $18,751 and $19,000 in the federal tax bracket of 12%, yet having a marginal rate (with Social Security) of 22.2%. For $34,569 to $43,786, the bracket rate of 22% jumped to a marginal rate of over 40% with Social Security. Yet from at least $43,787 to over $145,000, the federal tax bracket and marginal tax rates are almost the same (22% and 24%).

Practice tip: This bump in marginal tax rate provides another reason to delay taking Social Security. In many cases, using income from deferred accounts first, while building a higher Social Security benefit, can result in paying the lower marginal income tax rate in the earlier years. Later, with Social Security benefits at a higher amount, there may be less need to pull income from retirement accounts and, therefore, less taxed Social Security benefits. This is less of an issue for taxpayers that will be in the 85% Social Security bracket regardless (although the client could try and reduce income that determines Medicare Part B and D premiums).

But does it matter what kind of Social Security benefits are received? As the court noted, IRC § 86 for the purposes of establishing "a taxpayer's gross income, there is no distinction between Social Security retirement benefits and Social Security disability benefits, as both are included in the calculation of gross income under section 86." *Murphy* at 8.

Therefore, the court did not allow a proration of the taxability of the Social Security retirement benefits based on some (or any) percentage of the reduction of the nontaxable portion of the disability plan benefits.

Practice tip: This non-reduction of tax of Social Security benefits based on nontaxable disability insurance plan benefits can result in an unexpected tax trap. I have seen this arise in at least two contexts, as discussed below.

First, assume that a client is to receive $2,000 as a tax-free disability insurance benefit. (Remember, not all disability insurance payments are tax free.) This is $2,000 net to the client. This client also receives $2,000 Social Security benefits. If the disability plan, as many of them do, requires that Social Security disability benefits be applied for and have a partial or full benefits offset, the client may find himself with a lower nontaxable disability benefit and a taxable (based on other income) Social Security benefit. This results in the client ultimately having less net "cash in the bank" because of the income tax on the offset Social Security disability benefit.

The second context is when a Social Security disability lump sum recovery occurs a significant time after the disability benefits plan began paying the disability benefits. That lump sum paid, along with other income, may cause 85% of the lump-sum benefit to be taxed. Further, sometimes the disability plan requires repayment of some of the benefits paid while the client was waiting on a Social Security disability award. In some cases, some of the repaid disability plan benefits were already taxed, resulting in the risk of repaid benefits being double taxed. If this second scenario occurs, seek qualified tax counsel.

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