

Tax Planning

This information is meant to be a general introduction to this topic. The purpose is to provide a starting point for you to become more informed about important matters that may be affecting your life as a survivor and to provide ideas about steps you can take to learn more. This information is not intended nor should it be interpreted as providing professional legal and financial advice. You should consult a trained professional for more information.

The amount of money a survivor has to pay the federal government as a tax on income may be affected by the amount of money spent on medical expenses. This document is designed to help you focus on those tax areas that can be affected by a cancer diagnosis. The information may help you become aware of medical deductions, and may even bring up some factors that can reduce the amount of money you have to pay the government. It is not meant to be a complete lesson on the tax system of the United States.

Some of the ideas presented here may be new to you or even too complicated to understand without assistance. Tax rules and instructions are challenging for almost everyone and the act of preparing taxes is not a simple task even under the best of circumstances. After reading about this topic, you might want to apply some of the suggestions or discuss them further with the person who does your taxes, such as a professional tax preparer or a trusted family member or friend.

This document will address some of the most common tax issues that may be affected by a cancer diagnosis and treatment including:

- Allowable and non-allowable medical expense deductions
- Calculating medical expense deductions
- Disability or impairment-related work expenses
- Self-employment considerations for survivors
- Taxation of disability income
- Working with a professional tax preparer
- Items needed for tax preparation

You may use this information as a guide for the types of things to look for, but always check the annual instructions from the Internal Revenue Service (IRS) for specific rules, or consult a tax professional. Remember, tax information changes every year.

The Tax Return

In general, a tax return is divided into two areas:

- The first area is a calculation of your income that is taxable
- The second area concerns deductions you are entitled to take from that income

Things that increase your deductions generally reduce taxable income and may result in a lower tax. Health care expenses can affect both deductions and taxable income and may result in a smaller income tax.

Tax Deductions

The IRS provides guidelines to help you choose whether to itemize deductions, or to use the standard tax deduction. You may benefit from carefully considering your options:

- **Standard deduction** is a dollar amount set by the IRS that reduces the amount of income on which you are taxed:
 - This amount is specified by law, changes from tax year to tax year and varies according to your filing status.
 - This deduction can consist of two parts: 1) the basic standard deduction, and 2) additional amounts for age, or blindness, or both
- **Itemized deductions** are certain expenses that you can use to lower your taxes. The designated categories for itemizing are:
 - Medical and dental expenses
 - State and local income taxes
 - Sales tax
 - Real estate taxes
 - Personal property taxes
 - Home mortgage interest
 - Investment interest
 - Charitable contributions
 - Casualty (liability) losses
 - Theft losses
 - Job and job search expenses
 - Other deductions, such as tax preparation fees and investment expenses

Some taxpayers must itemize deductions because they do not qualify for the standard deduction. They are:

1. Individuals who are not permanent residents or citizens of the United States who are generally taxed on income from U.S. sources (non-resident aliens)
2. Individuals who are dual status aliens (both a nonresident alien and a resident alien)
3. Individuals who file returns for periods of less than 12 months
4. Married couple filing separate returns: if one spouse itemizes deductions, the other spouse must also itemize deductions

While most taxpayers use the standard deduction, survivors may want to add up all of the possible deductions to determine which method results in a lower tax. This is particularly important if you had large medical expenses during the tax year. If your allowable itemized deductions are more than the standard deduction, you could save money by itemizing since you would be taxed on a lower amount of income.

Claiming Medical Deductions

In addition to other deductions claimed in your tax return, you may be able to include certain medical and dental expenses that you paid during the tax year. The allowable deduction is that portion that exceeds 7.5 percent of your adjusted gross income. It does not matter when the services were provided, only that they were paid for during the calendar year for which you are filing your taxes.

- **If you pay by check**, the day you mail or deliver the check usually is the date of payment.
- **If you use a "pay-by-phone" or "online"** account to pay, the date reported on the statement of the financial institution showing when payment was made is the date of payment.
- **If you use a credit card**, the date you made the charge is the date of payment. It does not matter when you actually pay the credit card bill.

Married And Filing Separate Returns

Depending on your circumstances, you will most likely need to calculate your return(s) both as "married filing jointly" and "married filing separately" to determine the more beneficial way for you to file your taxes.

- **If you and your spouse live in a community property state**, where any property the married couple acquired during the marriage must be divided equally between the spouses in the event of a divorce:

Any medical expenses paid out of community funds are divided equally. If the expenses are paid from separate funds, only the spouse who paid the medical expenses can include them.

- **If you and your spouse live in a state that is a non-community property state,** where assets and earnings acquired during marriage are divided fairly, but not necessarily equally in the event of a divorce:

Each of you can only include the medical expenses that you individually paid if you file separate returns. Any expenses paid out of a joint checking account are considered to have been paid equally by each of you, unless you can show otherwise.

Allowable Medical Expenses

Many medical expenses are allowed as tax deductions. The IRS defines medical expenses as the costs of diagnosis, cure, lessening the pain or impact (mitigation), treatment or prevention of disease. This includes the costs for treatments that affect any part or function of the body, including vision and dental expenses. Deductible medical care expenses must be primarily to provide relief for or prevention of a physical illness or serious mental disorder.

According to the IRS, deductible medical expenses include what you paid for yourself, your spouse and someone who was your dependent when the services were provided or when you paid for them. Some examples are fees paid for:

- Ambulance services
- Chiropractic care
- Guide dog expenses
- Health insurance premiums
- Inpatient hospital care
- Medical and dental services
- Prescribed medications
- Psychological or psychiatric care

Allowable medical expense deductions are also likely to include needed equipment, supplies and diagnostic devices. Amounts paid for special equipment installed in your home, or for home improvements if the main purpose is medical care, may also be eligible deductions.

Transportation and lodging expenses during trips that are necessary (essential) and primarily for medical care are also deductible as medical expenses. This may include the expenses for a person who must accompany the individual seeking treatment. In this case, the lodging deduction is limited for each person and meals are not included.

There are a variety of programs designed to give individuals tax advantages to offset health care costs including:

- Flexible Spending Account (FSA)
- Health Savings Account (HSA)
- Health Reimbursement Arrangement (HRA)
- High Deductible Health Plan (HDHP)
- Medical Savings Accounts (MSA) including Archer MSAs and Medicare Advantage MSAs

Some employers offer a "cafeteria plan" that allows employees to choose from a pool of benefits that could offer tax advantages such as cash, retirement plan contributions, vacation days and insurance.

The IRS provides extensive information about each of these programs that provides a good starting place to understand the tax deduction benefits and the IRS requirements related to contributions, distributions and claiming deductions for each option.

Non-Allowable Health-Related Deductions

Be aware that there are also expenses related to health and insurance services that the IRS currently does not consider deductible. Examples include:

- Premiums for life insurance
- Premiums for loss of earnings policies
- Nonprescription drugs or medicines
- Nutritional supplements
- Health club dues

In addition, if a medical expense was paid for by someone else such as an insurance company, your employer or a friend, you cannot include that payment as your deduction. This is true whether the payments were made directly to you, or to the provider of the medical service. However, if you pay a portion of the medical expense (co-payment), you can deduct that amount.

Example:

If a doctor charges \$100 for an office visit, but you only pay a \$25 co-payment, then only the \$25 co-payment counts toward your medical expenses that are deductible on your tax return. The amount that your insurance company pays toward your medical expenses does not count.

If you pay the \$100 to the doctor up front, and your insurance company reimburses you with a check for \$75, then you still can only deduct \$25 on your tax return. You cannot deduct the amount your insurance company paid regardless of when, how, or to whom it was paid.

Disability or Impairment-Related Work Expenses

For tax purposes, you are disabled if you have a physical or mental disability that functionally limits your employment, or if your physical or mental impairment substantially limits one or more of your major life activities, such as walking.

According to the IRS, to qualify as deductions, impairment-related work expenses meet the following requirements:

- Be necessary for you to do your work satisfactorily
- Be for goods and services needed to do your work due to a disability
- Be for items not specifically covered under other income tax laws

An example of an impairment-related work expense would be the cost to have attendant care services that are necessary for you to be able to work at your place of business. These impairment-related expenses cannot be deducted as medical expenses, but can be taken as a miscellaneous itemized deduction and are NOT subject to the 7.5 percent limit that applies to medical expenses.

Disability Income and Taxes

Whether or not the disability income is taxed depends on the source of the income. Each type of disability income is taxed differently. Common situations include:

- **Employer-sponsored disability income plan:** Tax on this type of payment depends on who paid the premiums:
 - If the employer paid the premiums, the income is taxable.
 - If the employee paid the premiums with after-tax dollars, the income is not taxable.
- **Sickness and disability plans:** If the employer, rather than an insurance company, pays a disability income or health expenses, the payments are taxable because they are usually a substitute for taxable wages.
- **Social Security Disability Insurance (SSDI):** Part of the SSDI income is taxable, depending on the amount of your total income. If you receive a retroactive payment for past years of disability, then that amount can be included in your current tax return or, if better for you, it can be calculated based on the tax effect if reported on the previous year's tax returns. This only affects the current tax year and only the current year's income will be adjusted. You should not file an amended return for the earlier years.
- **Supplemental Security Income (SSI):** Not taxable.
- **State Social Security payments:** Taxability varies by state.

- **Accelerated death benefit or viatical settlement:** If you have a life insurance policy and receive part of the death benefit while you are alive, or if you sell the policy in what is called a viatical settlement, the income is not subject to tax if you are the insured and are terminally or chronically ill.
- **Long-term care insurance:** Reimbursement payments received under a long-term care insurance contract are generally excluded from income. With per diem contracts, payments up to a specified amount are tax-exempt. Payments received from accelerated benefits of life insurance policies can be considered to be qualified long-term-care benefits. The benefit payments, if paid to a person who is chronically ill, are usually tax-free.

Self-Employed Survivors

In addition to the medical expenses described earlier in this document, you may be able to deduct up to 100 percent of the amount you paid for medical and qualified long-term care insurance for yourself, your spouse and your dependents. This applies if you:

- Were self-employed, and had a net profit for the year
- Were a general partner, or a limited partner receiving guaranteed payments
- Received wages from an S corporation in which you were a more than two percent shareholder

A self-employed survivor may be able to deduct a portion of their disability insurance premiums depending on their policy's rules and regulations.

Important Tax Considerations

Sometimes survivors have financial needs that require taking actions such as withdrawing money early from a retirement account. There are some things to consider before making this decision:

- **Early withdrawal from retirement plans**

Usually, any money withdrawn before taxes have been deducted (**pre-tax**) has to be included as income on your tax return. An example is money taken from a 401(k) plan before the retirement date specified in the plan.

In most cases, unless you are permanently disabled or have allowable medical expenses that exceed 7.5 percent of your adjusted gross income, you will be subject to a penalty tax for early withdrawal up to that amount.

The IRS defines a person to be permanently and totally disabled if both of the following conditions apply:

- 1) An individual is unable to engage in any substantial gainful activity (work) because of a physical or mental condition,

and

2) A doctor determines that the condition has lasted or can be expected to last continuously for at least a year or that the condition can lead to death.

If you have a retirement plan that was funded with money after taxes were deducted (**after-tax**), such as a Roth IRA, you may withdraw up to the initial amount of money that you contributed at any time without paying further taxes on it.

Unless you either meet the IRS definition of permanently and totally disabled or qualify with allowable medical expenses, all withdrawn amounts that exceed your contributions to the plan will have to be included as income. This amount may also be subject to the penalty tax for early withdrawal.

- **Early withdrawal from employee stock ownership plans:** Unless you are age 59½ or older, or totally and permanently disabled, the withdrawal is subject to tax, plus a special 10 percent tax on the early distributions.

Selling a Home

There are times when a survivor may find it necessary or desirable to sell an existing home to obtain cash. A qualified tax professional can help you determine whether any or all of the profit from the sale of your home is taxable. It is important to understand:

- If you live in your house for two full years (24 months), there is an exclusion of income from capital gains taxes. That means that some or all of the profit you made from the sale of your house is not taxed.
- If you have lived in the house for less than two full years and sell it for health reasons, you still may be able to keep some of the profit (gain) tax-free.

To calculate how much of the gain you can likely exclude from taxable income, take the number of months you have lived in the home, divide it by 24 (months), then multiply that figure by the maximum exclusion allowed by the IRS for your situation.

Working with a Tax Preparer

If you decide to work with a tax preparer, remember that the more complex your return, the more training and experience you should look for in a tax preparer. Tax professionals, in order of professional training required, include:

- **Tax attorneys** - lawyers who specialize in tax law
- **Certified public accountants (CPA)** - college graduates who have passed a state exam and who must take continuing-education classes to keep their designation as a CPA.

- **Enrolled agents** - people who have passed a two-day IRS exam or worked for the IRS in a technical capacity for at least five years
- **Accountants** - individuals who have had formal college training
- **Commercial tax preparers** - individuals who typically received short-term training through a program such as those offered by a tax preparation business
- **Trained volunteer tax help** - people trained to provide free services to help qualified individuals with tax returns through programs such as the IRS Volunteer Income Tax Assistance (VITA) program, Tax Counseling for the Elderly (TCE) and the Armed Forces Tax Council (AFTC)

When considering whether to work with a tax professional, keep in mind that they can:

1. Look over your past tax returns to see if anything was omitted that can be corrected now, such as allowable deductions
2. Assist you in communications with the IRS relating to an IRS examination of your tax records (audit)
3. Advise you if there are better ways to do things in the future, such as helping you decide if there are better ways to change spending patterns within a family to benefit your tax situation
4. Provide some peace of mind by freeing you from worry and the burden of learning all the tax rules yourself

Some tax professionals are able to represent you to the IRS should the need arise, although there may be an extra charge for these services.

Items Needed For Tax Preparation

Keeping good tax records and documentation of all medical expenses paid is an important part of the tax process. Remember to keep your documentation for at least seven years after the tax return was filed in case you are audited.

The IRS recommends you bring the following to a tax professional when you have your tax returns prepared:

- Photo identification is required by most tax professionals
- Social Security cards for yourself, your spouse and dependents
- Birth dates for primary and secondary filers and dependents listed on your tax return
- Current year's tax package if you received one
- Wage and earning statement(s) Forms W-2, W-2G, 1099-R, from all employers
- Documentation of medical expenses including receipts and statements
- Interest and dividend statements from banks (Form 1099)
- A copy of last year's federal and state returns
- Your bank routing numbers and account numbers for direct deposit

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- Other relevant information about income and expenses including the total paid for day care and the day care provider's tax identification number
- To file taxes electronically on a married filing joint tax return, both spouses must be present to sign the required forms

If you have large out-of-pocket medical or other expenses and are unsure about how and where to deduct them, or if your tax situation is somewhat complicated, a professional tax preparer may be able to help you and minimize the amount of taxes you have to pay. On the other hand, if your tax return is simple, the instructions that accompany Form 1040, or a tax preparation program you can purchase for your home computer, may meet your needs.

Remember, you do not have to become an expert in all areas of tax law. In addition to family members and friends who have had experience preparing tax forms, there are many resources and tax professionals available to help you.

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