Roth Conversions- The Prepaid Medical Expense Strategy

Take-Away: Individuals who are considering a move to an assisted living environment might also consider making a Roth IRA conversion at the same time to avoid paying any income taxes on the Roth conversion.

Background: There is a lot of discussion these days about making a Roth IRA conversion before the income tax rates and brackets of the 2017 Tax Act *sunset.* Incurring an income tax now with a Roth IRA conversion, while income tax rates are lower and income tax brackets are broad, makes sense, but can be a 'tough sell' to the IRA owner. It's the reality that a Roth conversion accelerates income taxes owed on pre-tax dollars that causes some individuals to think twice before they launch into a Roth conversion strategy. Which may explain, in part, why partial Roth conversions done over a period of several years makes some sense to those who do not want to accelerate all that pre-tax income with a Roth IRA conversion into a higher marginal federal income tax bracket.

With that background, I recently ran across an intriguing Roth IRA conversion strategy in Ed Slott's IRA Advisor (August, 2024) admittedly for a narrow group of individuals, that may make sense in their living situation. The strategy centers on those folks who are considering an investment in a continuing care retirement community (CCRC) to address their long-term care needs. It exploits their prepaid medical expense.

Prepaid Medical Expenses: Prepaid medical expenses can be deducted by the payor. This tax deduction was approved by the Tax Court in *Baker v. Commissioner of the Internal Revenue, 122 Tax Court 8 (2004.)* The taxpayer, Baker, used data provided by his retirement community and determined that about 40% of the fees paid by him were deductible by he and his wife, since they were attributable to their medical care. Accordingly, the Bakers deducted that percentage of their costs on two annual income tax returns. The IRS allowed deductions of only 20%. Enters the Tax Court. That Court approved the use of the percentage allocation method based on the number of community residents and a weighted average of their monthly medical service fees. The *Baker* decision allows individuals to have their one-time entrance fees charged by a CCRC to be classified as prepaid medical expenses, subject to the current 7.5% of adjusted gross income (AGI) threshold.

Continuing Care Retirement Community Investment: CCRC 's are becoming an attractive option for older adults who want both their independence and immediate access to healthcare services. Many of these CCRC facilities offer continuum care, shifting from independent living arrangements to assisted

living, and ultimately to custodial care as a resident ages and encounters increasing health challenges. The hurdle with entering a CCRC is the high entrance or 'purchase' fee, often hundreds of thousands of dollars, depending on the services provided and the CCRC's location. This initial fee usually secures the resident's place in the facility, and it may also contribute to future healthcare costs, which is where the strategy can be used to exploit the resident's prepaid medical expense deduction.

Up-Front Income Tax Deduction: Often a large portion of the initial fee paid by the resident to the CCRC facility may be income tax deductible, as well as a portion of the CCRC's monthly charges. Accordingly, some of the upfront charges paid by the resident to the CCRC facility will be the cost of prepaid medical expenses, even if the resident lives independently in the CCRC and he/she needs little or no medical care. In the Slott article, it was suggested that for some CCRC's upwards of 55% of the initial entrance fee was deductible in 2023 as prepaid medical expenses, and 35% of the monthly fee charged by the CCRC facility was also deductible by the resident as a 'medical expense.'

Prepaid Medical Expense Calculation: Sometimes a CCRC will compare its overall medical outlays to its overall revenue from residents and report the ratio as the deductible portion of the fees paid by the residents. This portion of fees paid is the same for new residents living independently as well as residents who currently need substantial medical care and attention. This deductible expense could be as high as 30% of the fees the resident pays to the facility. The CCRC facility will provide a letter annually to its residents with the deductible percentage for the entrance fee and for the monthly service fees, usually calculated by an independent actuary.

Example: In 2024, Fred and Ethel move into a ritzy CCRC that provides them with comprehensive lifetime services. Fred and Ethel pay a whopping CCRC entrance fee of $600,000 under the CCRC's non-equity plan. The CCRC facility provides to Fred and Ethel a letter that tells them that 45% of their entrance fee, or $270,000, is tax deductible by them as an itemized prepaid medical expense deduction on their 2024 federal income tax return.

Assume that Fred and Ethel have $100,000 of adjusted gross income in 2024. Any qualified medical expenses over $7,500 in 2024 will be deductible by Fred and Ethel, or $262,000 will be deductible on their federal income tax return. While Fred and Ethel can thus deduct $262,000 in prepaid medical expenses in 2024, they will end with negative taxable income, since their income for 2024 is $100,000.

Unfortunately, the Tax Code does not permit Fred and Ethel to carry over their negative taxable income to future tax years. Consequently, since Fred and Ethel will not have sufficient taxable income

in 2024 when they bought their CCRC lifelong senior living facility arrangement, which results in a waste of a significant amount of their available income tax prepaid medical expense deduction.

The CCRC strategy intentionally creates taxable income through a Roth IRA conversion to 'soak-up' the prepaid medical expense associated with entering the senior living facility that might otherwise be lost.

Back to the example: Fred and Ethel could convert $160,000 of their traditional IRAs to Roth IRAs, and they would still owe no federal income tax on their Roth IRA conversions in 2024. [$100,000 'other' source income + $160,000 Roth IRA conversion income = $260,000 taxable income, offset by the $262,000 prepaid medical expense deduction associated with the entrance fee that they paid to the CCRC facility= no federal income tax paid in the year of the Roth IRA conversion.]

In addition, Fed and Ethel may also be able to deduct a percentage of their monthly fees paid to the CCRC facility as a prepaid medical expense.

A Note of Caution: By increasing their taxable income for 2024 with their $160,000 Roth IRA conversion, Fred and Ethel also increase their adjusted gross income (AGI) which might lead to higher Medicare premiums for them in the years to come.

The Slott article provided yet another example of how to exploit the prepaid medical expense deduction with a Roth IRA conversion.

Example: Alma needs to move into a memory care unit of an assisted living facility after her husband's death. The cost of the facility is $12,000 a month ($144,000 for the year.) Alma's other medical expenses, e.g., Medicare Part B and D premiums as well as her Medicare Supplemental premiums exceed $5,000 a year. These additional medical expenses, when added to Alma's long-term care facility medical expenses are $149,000 for the year. [IRC 213.] Alma's adjusted gross income (AGI) for the year is $100,000. Therefore, Alma's deductible medical expense for the year on her Form 1040, Schedule A, is $141,500 [$149,000 less $7,500 non-deductible floor = $141,500.] Thus, without additional planning, Alma would have no federal income taxes due. To avoid wasting Alma's full medical expense deduction, Alma could increase her adjusted gross income for the year by annually converting a portion of her traditional IRA to a Roth IRA, or simply withdraw a portion of her traditional IRA to 'zero out' her

income. In each case, by increasing her taxable income for the year with a Roth IRA conversion, Alma can consume the medical expense income tax deduction.

Conclusion: Obviously, this Roth conversion planning strategy is not for everyone. Yet for those seniors who are contemplating a move to a long-term care facility, and thus they may enter a CCRC contract, the availability of a substantial prepaid medical expense deduction might prompt them to engage in a Roth IRA conversion at the same time when it may be possible to make that Roth IRA conversion without paying an additional income tax. The same motivation may even occur when there is no up-front prepaid medical expense deduction associated with a CCRC contract, if the individual enters assisted living with large annual cash outlays for their care, all of which are deductible medical expenses, hence the need for taxable income to offset that available income tax deduction.

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