KTS VALUATION ISSUES™

KLARIS, THOMSON & SCHROEDER, INC. 2010-4

Featured Article

Social Security Do-Over

Prepared by: Marc J. Soss, Esquire

A little known Social Security option may soon be eliminated by the Social Security Administration (SSA). The option is known as the Social Security "do-over" or "reset" option. The concept of a "do-over" has evolved from the time we were children and did not like a result, to a "mulligan" on a golf course, and to government benefits when we do not like the end result. The Social Security "do-over" option allows a recipient receiving social security benefits to pay back all previously received benefits (with no interest and penalties) in order to refile for benefits at a later age and receive larger monthly check for life. Any individual, over age 62, receiving benefits can select the "do-over" option by filing Form SSA-521 ("Request for Withdrawal of Application").

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Social Security Eligibility:

Social Security benefits are available to any individual beginning at age 62 with at least 40 credits. An individual can begin receiving benefits at age 62. Individuals who elect this option will receive 70-80% of the benefits they would have received at "full retirement age." Alternatively, an individual can delay their receipt of benefits and increase their benefits by as much as 8% for every year they delay the start of benefits (up until age 70).

"Do-Over" Considerations:

While the "do-over" option may result in higher future monthly Social Security benefits, the payback option requires the recipient to pay back all previously received benefits and the consent of all individuals who received benefits based on the recipient's original decision. This includes benefits received by (i) the recipient, (ii) the recipient's spouse, and (iii) the recipient's children or any other individual who received benefits based on the recipient's original application.

In addition to the requirement for the repayment of all Social Security benefits received, amounts withheld from benefit checks must also be repaid. This includes Medicare Part B and Part D premiums, voluntary federal income tax withholding,

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A Second Look at the Jensen Case

Written by: Ron A. Stramberg, ASA
Managing Director of the Washington D.C. Office

In rendering their opinion on the appropriate discount for long-term capital gains tax liability in the Jensen case, the Tax Court stated that the Estate's interest in Wa-Klo, Inc. ("Wa-Klo"), which held one special-purpose real estate property, was not comparable to the closed-end funds analyzed by Klaris, Thomson & Schroeder, Inc. ("KTS") in order to estimate an appropriate discount for capital gains tax liability. While the closed-end funds held marketable securities and not a special-purpose real estate property, given the limited information available in the marketplace, it is reasonable to consider closed-end funds in order to discern the impact of capital gains tax liability on investors' behavior.

In concluding on a discount for long-term capital gains tax liability in the Jensen case, the Tax Court did their own analysis and used a "present-value approach" to determine the estate's discount for the built-in long-term capital gains tax. In their application of the present-value approach, the Court calculated future values for the land and related improvements owned by the corporation. In estimating the future values of the land and related improvements owned by the corporation, in order to estimate a future tax liability on the long-term capital gains, the Court used appreciation rates of 5 percent and 7.725 percent over a 17-year estimated remaining useful life for the land and related improvements. The Court selected the 5 percent and 7.725 percent appreciation rates based on information included in the real estate appraisal report and appraisal report of the taxpayer's expert, respectively. Meanwhile, the Court selected a 17-year remaining useful life for the land and related improvements based on information included in the real estate appraisal report. In our opinion, it is not reasonable to expect real estate to appreciate at such high rates over an extended period of time, such as 17 years, and we are well aware in today's marketplace, that in fact, there are periods of time in which real estate does not appreciate at all, and in fact, goes down in value. As such, there is much risk in projecting such high rates of appreciation over an extended period of time, and yet, the discount rates used by the Court of 5 percent and 7.725 percent, approximate risk-free interest rates, as of the valuation date, and in our opinion, do not factor in the significant risks of achieving those high appreciation rates over the extended time period of 17 years. Had the Court factored in the significant risk of achieving those appreciation rates, much higher discount rates would have been used, which would have lowered the future values of the land and related improvements, and as such, the future tax liability on long-term capital gains.

> **"…given the limited information available in the marketplace, it is reasonable to consider closed-end funds in order to discern the impact of capital gains tax liability on investors' behavior."**

In addition, the Court chose to ignore the potential actions that may have been taken by the Corporation to defer or avoid the capital gains tax liability, by means of a section 1031 exchange or through conversion to an "S" corporation. In our opinion, the Court should have given some probability to these actions, even if just a small likelihood, such as 20 percent, as opposed to giving them no consideration, whatsoever.

A more basic question is why speculate what the future capital gains tax liability

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will be based on an estimated future value of the special purpose real estate property owned by Wa-Klo, when the capital gains tax liability can be calculated, with certainty and not speculation, as of the valuation date, utilizing the appraised value of the property, as of that date.

The only real issue is how much would the willing seller reduce his price for sale because of the capital gains tax and how much of a discount would a willing buyer require to purchase the special purpose real estate property owned by Wa-Klo. It is reasonable to assume that the answer lies somewhere in the middle of 0 percent for no discount consideration to 100% for dollar for dollar consideration.

The willing seller wanting no discount to maximize his or her economic return and the willing buyer wanting 100 percent, or a dollar for dollar discount to maximize his or her economic return. The only empirical data available on buyer considerations of built-in capital gains tax is the closed-end funds. Although the assets held are marketable securities and not real estate, the market or buyers seem indifferent to levels of built-in capital gains below the 50 percent level based on the discounts relative to the level of capital gains tax. ❐

Social Security Do-Over

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garnishments (including child support or alimony obligations), and IRS levies (to collect unpaid federal income taxes).

Tax Implications:

A recipient who previously paid federal income taxes on Social Security benefits received will not be required to amend previously filed income tax returns upon selection of the “do-over” option. The recipient may claim an "other miscellaneous itemized deduction" on Schedule A for the year(s) the benefits were refunded or submit a tax credit claim for benefits received in previous years.

Medicare:

A recipient enrolled in Medicare Parts A and B, when making the do-over election could, but is not required to, terminate their Medicare coverage. Unless the recipient is employed with health benefits they will be penalized when they re-enroll in Medicare Part B during a future Medicare Part B “open season.” The recipient will be subject to a ten percent (10%) premium increase for every year they delay their Part B enrollment.

Financial Considerations:

Actuarial research reflects that a recipient must live at least 12 to 16 years, after the higher monthly payments begin, to break even with the Social Security repayment option. A recipient with a terminal illness or short life expectancy will not benefit from the “do-over” option.

It is important to recognize that when a recipient’s benefits cease so does his or her automatic Medicare premium deductions. The recipient will become responsible to pay the Part B premiums until their Social Security benefits resume.

Proposed New Rules:

The SSA proposed new rules are designed to modify the “do-over” option. Under the proposed rules, Social Security recipients would only be allowed to withdraw their benefits application once during their lifetime and only within 12 months of them beginning to receive benefits. If the “do-over” option is elected, the recipient must pay back the benefits received, and then restart their benefits at a later date. However, once the 12 month deadline has passed, they would no longer be eligible to repay benefits in order to receive a higher benefit at a later age. ❐

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– Elizabeth Edwards

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