What every Practitioner should Know about

Disability and Taxes

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Professional Experience. Mr. Rice has been in private practice since November 1979 as a tax professional. Prior to law school, Mr. Rice worked for the accounting firm of Coopers & Lybrand. Mr. Rice is the sole proprietor of the law firm of David Lee Rice, APLC, rated AV by Martindale & Hubbell, and was one of Los Angeles Magazine’s Los Angeles’s Super Lawyers for 2006 - 2012. Mr. Rice is also a Professor in Accounting (Course Coordinator for Taxation) with California Polytechnic University, Pomona.

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Publications & Lectures. Mr. Rice has published numerous articles which have been published in the Journal of Taxation, the Estate Planning Journal, Practicing Law Institute, California Tax Lawyer, Los Angeles Lawyer, Association of Certified Family Law Specialists, the Daily Journal and Tax Notes. Has drafted three papers for the IRS and Treasury concerning substantive changes to the Tax Code and has testified before the IRS, Department of Treasury, House Ways and Means Committee and Senate Finance Committee. Has taught on the Masters of Taxation Program at California State University at Northridge and Golden Gate University, as well as many courses at the University of West Los Angeles School of Law. He currently lectures for the LL.M. in Tax at Chapman University School of Law and will be teaching once again on the MBT program at CSUN. Mr. Rice has also lectured before the Internal Revenue Service, South Bay Bar Association, Beverly Hills Bar Association, Loyola Law School, California Society of CPAs, Orange County Society of CPAs, Estate Planning Counsels of Los Angeles, South Bay and San Fernando, Dean Whittier, Jewish Federation Council, Anti-Defamation League, Kaiser Permanente, Miller & Company, California State Bar Educational Institute, Annual California State Bar Meetings, the Los Angeles County Bar Association, COSMA, and before various Elder Care Groups sponsored with the Los Angeles County Bar Association in conjunction with the Los Angeles County Board of Supervisors.

Associations. Mr. Rice is currently the Chair of the ABA Income and Family Tax Committee. He is also a Certified Specialist of Taxation Law of the California Board of Legal Specialization. Former Chair of the State Bar Income Tax Committee, Former Chair of the Los Angeles County Bar Association Committee on Procedure and Litigation, Former Chair of the State Bar Committee on Procedure and Litigation, Commissioner and Former Chair of the Board of Legal Specialization Committee of the State Bar on Taxation, Former Chair of the Tax Section of the Beverly Hills Bar Association, former Vice Chair of the Tax Section of the Los Angeles County Bar Association, member of the South Bay Bar Association, South Bay Estate Planning Council, Board of Directors of the Fibromyalgia Treatment Center, Board of Director of the Wellness Center in Redondo Beach, CA, and Former Trustee of the Board of Trustees of the University of West Los Angeles Law School.

Introduction

In view of the income limitations of many disabled taxpayers, it is more important than ever to minimize the tax burden imposed upon them with proper planning. Even if someone else is helping to support a disabled taxpayer such as a parent or child, it is incumbent upon the tax practitioner to ensure that the parent or child is also minimizing their taxes by taking the appropriate tax deductions and credits.

This paper will focus on the plethora of tax credits and deductions available as well as various techniques and devices a tax practitioner can utilize in assisting their clients minimize their taxes and tax advantage of some of the government programs which are available. It is imperative that the tax practitioner have some knowledge of the government based programs when advising a client or at the very minimum bring in a practitioner that fully understands this area.

Exemptions for Disabled Persons – Who Is Entitled to the Award?

If a disabled person files his or her own return and is not a dependent of another taxpayer, that disabled person is entitled to a regular dependency deduction. The exemption amount for the 2012 taxable year is $3800. If the disabled taxpayer is either deemed a qualifying child or qualifying relative of another taxpayer, that taxpayer is entitled to take the exemption for the disabled taxpayer.

A taxpayer is allowed one exemption for each qualifying relative he or she claims as a dependent, either as a qualified child or a qualified relative. In order to be a qualified child, seven (7) tests must be met as follows:[[1]](#footnote-1)

1. Relationship: This includes a taxpayer’s child, adopted child, stepchild, eligible foster child brother, sister, half brother or sister, stepbrother or stepsister, or a descendant of any of those parties.
2. Age Test: The child must be under the age of 19 at the end of the year and younger than either the taxpayer or the taxpayer’s spouse (assuming a joint return was filed) or a full time student (attends school for some part of 5 months) and under the age of 24 and again younger than either the taxpayer or the taxpayer’s. However, if the child is permanently and totally disabled at any time during the year, age is not relevant.
3. Support Test: The child cannot have provided more than half of his or her support. Only the funds used by the child are considered for this test.
4. Abode: A qualifying child must live with the taxpayer more than half of the year not taking into account temporary absences such as school, vacation, medical care, etc.
5. Citizen or Residency Test: The dependent must be a U.S. citizen or a U.S. resident or a resident of Canada or Mexico for part of the calendar year in which the taxpayer’s tax year begins. [[2]](#endnote-1)
6. Joint Return: The dependent cannot have filed a joint return unless the sole purpose of filing the joint return was to get back a refund and no tax liability would have existed for either spouse on separate returns.
7. Tie Breaker Rules:
   1. The Parent wins if one of the persons is a parent and the other person is not a parent.
   2. If both persons are parents, and the child lives with one parent for a longer period of time, the parent who can show the longer period wins.
   3. If both persons are parents and have equal time, look to the parent with the highest AGI.
   4. If none of the individuals are parents, look to the highest AGI.

If the disabled individual does not come within the classification of a “qualified child” he or she still may be able to be deemed a dependent under the “qualified relative” test. The test is somewhat broader in terms of the Relationship Test, but can be more difficult to meet because of the Gross Income test. There are 4 tests that must be met in order for a person to be a qualifying relative of another taxpayer:[[3]](#footnote-2)

1. Not a qualifying child test. A child cannot be a qualifying relative if the child is the taxpayer’s qualifying child or the qualifying child of any other taxpayer.
2. Member of Household or Relationship Test. The qualifying relative must either live with the taxpayer all year as a member of the household or be related to the taxpayer as a child (including stepchild and foster child) or a descendant of any of them, brother or sister (including half brothers, half sisters, stepbrothers and stepsisters), a parent or grandparent (but not a foster parent), stepfather or stepmother, niece or nephew, uncle or aunt, or son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law. Note that any of the foregoing relationships do not end by death or divorce and that unrelated taxpayers can qualify if they live with the taxpayer providing the relationship doesn’t violate state law. Cousins do not qualify!
3. Gross Income Test: Gross Income is all income in the form of money, property, and services that is not exempt from tax. It must be less than $3800 for 2012. However, the gross income of an individual who is permanently and totally disabled at any time during the year does not include the income for services the individual performs at a sheltered workshop.[[4]](#footnote-3) The availability of medical care at the workshop must be the main reason for the individual’s presence there. In addition, the income must come solely from activities at the workshop that are incident to this medical care.
4. Support Test: Same as qualifying child. The qualifying relative’s gross income for the year must be less than $3,800 for 2012. Lastly, the taxpayer generally must provide more than half of the qualifying relative’s total support during the calendar year.

Multiple Support Agreement. Sometimes, however, no one provides more than one half of the support of a qualifying relative. Instead, two or more persons, each of whom would be able to take the exemption but for the support test, together provide more than half of the qualifying relative’s support. In this instance, all taxpayers who provide more than 10% of the qualifying relative’s support can agree that only one of them can claim an exemption for that qualifying relative. Each of the others must sign a statement agreeing not to claim the exemption for that year. The person who claims the exemption must keep the signed statements for his or her records. A multiple support declaration identifying each of the others who agreed not to claim the exemption must be attached to the return of the taxpayer claiming the exemption.[[5]](#footnote-4)

Additional Standard Deduction Amounts

A taxpayer who is 65 or over or blind qualifies for an additional standard deduction of $1450 if he or she is single or head of household. If he or she has a different filing status the amount is limited to $1150. If the taxpayer is over 65 and blind he or she gets two additional standard deductions. On the other hand, a taxpayer may not claim an additional standard deduction for a dependent.[[6]](#footnote-5)

Gross Income Exclusions

Disabled taxpayers are entitled to certain breaks on various types of income. In addition, pulling money out of retirement accounts is usually not subject to any penalties if it is distributed to a taxpayer who is totally disabled.

Disability Insurance. In general, disability income from an insurance policy is taxable to the recipient if it was paid for by the employer, which is the case in most group policies covered under ERISA. If the employee reimburses the employer or the employee pays the premiums, the benefits are not taxable. The key is who actually makes the contribution. Accordingly, if the employer pays part and you pay the balance of the premiums with after tax dollars, then 50% of the benefits will be taxed.

Government Disability Insurance. The income from Social Security Disability Income (“SSDI”) is generally not taxable if that is the only source of income. If there are other sources of income, the taxable portion is computed in the same method to determine what amount of the social security received is taxable. The formula is somewhat complex depending on filing status, other sources of income and base amounts. After a taxpayer has been on SSDI for 18 months, the taxpayer will be entitled to Medicare benefits.

Worker’s Compensation Insurance. Proceeds received from worker’s compensation insurance for disability is generally nontaxable. If, however, a taxpayer returns to work and still receives income, such income will be taxable unless it reduces the SSDI benefit, in which case the reduction amount will not be taxable.

Veterans benefits. With the exception of rehabilitative services, benefits received from the VA are nontaxable.

Military Benefits. The pay may or may not be taxed based upon a number of factors, and is slightly complex. In order for the pay to be nontaxable it must first meet one of the following conditions:

1. The disabled person was entitled to receive retired pay computed on the basis of percentage disability prior to or on 9/24/1975;
2. On or after 9/24/1975 the disabled person was a member of the armed services under written commitment to become a member; or
3. The member receives disability retired pay because of a combat-related injury.

Assuming the disabled veteran qualifies under one of the above exemptions, then the tax exemption is granted is based on further criteria. If the military retired pay is based on the percentage or degree of disability or is paid under disability retirement laws in effect prior to 10/1/1949, the entire amount is exempt from tax. Where the gross military pay is based on years of service (2.5 percent for each year), the amount payable solely on percentage of disability is tax exempt. For all other disabled veterans (those who became members of the armed services after 9/24/1975, and the injury is not combat related nor is the Veteran eligible to receive Veterans disability benefits), the income is taxable.

Accelerated Death Benefits. In the event an individual is either terminally ill or chronically ill, the proceeds from the surrender of a policy may be partially or totally tax exempt. In the case of someone who is terminally ill[[7]](#footnote-6) the proceeds are tax free. For a person who is chronically ill,[[8]](#footnote-7) as long as the proceeds are used for long-term care, that person is exempt from tax.

Dependent Care Deductions

A tax credit, the Dependent Care Credit (“DCC”),[[9]](#footnote-8) is available to taxpayers who have to pay for a caretaker of a spouse or dependent so that that taxpayer can work. The credit taken will be based on a percentage of the taxpayer’s income and the amount of money paid to the caretaker in order for the taxpayer to be gainfully employed. Essentially, the credit is calculated as a percentage of the amount of work related dependent care expenses the taxpayer paid to a caretaker so that that taxpayer could be gainfully employed. As an example, assume that the taxpayer’s child had special needs and continued to live with his Mother, even though he was 30 years of age. If Mother hired a caregiver whoseFor example, a taxpayer who lives with her mother who is physically incapable of caring for herself that hires a nurse whose sole duty consists of providing the care of the mother in the home while the taxpayer is at work in order to be gainfully employed may receive a credit, with certain limitations, for the amounts spent for the nursing services. The same could hold true of a dependent disabled child.

To qualify the taxpayer for the DCC, the disabled taxpayer must either be a dependent or spouse of the taxpayer who is mentally or physically incapable of caring for himself or herself and have the same place of abode as the taxpayer for more than one half of the taxable year.[[10]](#footnote-9) In addition to having a qualifying dependent, the taxpayer must meet several conditions in order to receive the DCC.

The taxpayer and his or her spouse must have earned income from wages, salaries, tips or other taxable employee compensation, or net earnings from self-employment.[[11]](#footnote-10) The taxpayer’s spouse is exempt from the earned income requirement if he or she is either a full-time student or is physically or mentally incapable of self-care.[[12]](#footnote-11) The taxpayer must maintain a home for the qualifying dependent or elder.[[13]](#footnote-12) The payment for care cannot be paid to someone the taxpayer can claim as his dependent on his return or to his child who is under age 19.[[14]](#footnote-13) If married, the couple must file a joint tax return. Additionally, to claim the DCC, the taxpayer must file Form 2441.

The DCC is allowed only with respect to “employment related expenses.” Employment related expenses must be incurred to enable the taxpayer to be gainfully employed.[[15]](#footnote-14) Employment related expenses include expenses for household services and expenses for the care of the dependent disabled taxpayer. If expenses for the dependent disabled taxpayer are for services outside the taxpayer’s household, the taxpayer is given credit only where the dependent disabled taxpayer regularly spends at least eight hours a day in the taxpayer’s household. Employment related expenses incurred for services provided outside the taxpayer’s household by a dependent care center will be taken into account as a potential credit only if such center complies with all applicable laws and the regulations of a State or unit of local government and the dependent care center provides full-time or part-time care for more than six individuals (other than residents of the facility) on a regular basis during the taxpayer’s taxable year and receives a fee, payment, or grant for providing services for any such individuals.

There is a limitation on the amount of employment related expenses that can be taken into account. The amount of employment related expenses incurred during any taxable year shall not exceed Three Thousand Dollars ($3,000) if there is one qualifying disabled taxpayer or Six Thousand Dollars ($6,000) if there are two or more qualifying disabled taxpayer with respect to the taxpayer for such taxable year.[[16]](#footnote-15)

Expenses for household services include expenses that are paid for the performance in and about the taxpayer’s home of ordinary and usual services necessary to the maintenance of the household.[[17]](#footnote-16) In order to receive a credit for the household services, the services must be attributable to the qualifying disabled taxpayer. For example, amounts paid for the services of a domestic maid or cook are considered to be expenses paid for household services if part of those services is provided to the qualifying individual.

Expenses for the care of a qualifying disabled taxpayer must be incurred “to assure the individual’s well-being and protection.”[[18]](#footnote-17) Generally, amounts paid to provide food, clothing or education are not expenses paid for the care of a qualifying individual. Additionally, expenses incurred for transportation of a qualifying disabled taxpayer between the taxpayer’s home and a place outside the taxpayer’s home where services for the care of the qualifying individual are provided are not incurred for the care of a qualifying individual.[[19]](#footnote-18) In providing care, the taxpayer need not use the least expensive alternative available to the taxpayer. A reasonable allocation must be made if an expense can be allocated to both an employment related expense and other personal purposes. No allocation is required for de minimis allocation where the other purpose was insignificant or minimal. Additionally, no allocation is required where an employment related expense includes expenses for other benefits which are incident to and inseparably a part of the care. As such, the full amount of the expense is considered to be incurred for care.[[20]](#footnote-19) For example, the full amount paid to a dependent care center is considered as care for the dependent elder even though the dependent care center also furnishes food.

Credit for the elderly or disabled

A credit is given for those individuals who are 65 or older; or are retired on permanent and total disability[[21]](#footnote-20) and have taxable disability income. The tax, if figured on Schedule R, and the AGI must be less than the following amounts:

Single: $17,500

MFJ: $20,000 with one spouse eligible and $25,000 with

two spouses eligible.

MFS: $12,500

HOH: $17,500

Qualifying Widow: $17,500

Impairment-Related Work expenses

Impairment-related work expenses are deductible on form 2106 and are those expenses that are ordinary and necessary expenses incurred by a disable person to be able to work. For example a blind taxpayer’s use of a reader would be such an expense. Such expenses are deductible as itemized deductions but are not subject to the 2% of the AGI floor.[[22]](#footnote-21)

Medical Expenses

An important area of deduction for disabled taxpayers deals with medical expenses. A medical expenditure is incurred for the “diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.”[[23]](#footnote-22) Beginning in 2013, only those expenses in excess of 10% of AGI are deductible. In addition, as is explained more fully below, “Long-Term Care” expenses can also be deducted as medical expenses and it is important not to overlook these types of expenditures.

Capital expenditures may constitute medical expenses and are deductible in the year incurred to the extent that such expenditures do not increase the value of the property. For example, if a disabled person is told to install an elevator so he doesn’t have to climb stairs and the cost of the elevator is $15,000 and the house’s value is increased by $5,000, then $10,000 would be deductible.[[24]](#footnote-23)

Tuition expenses of a dependent at a special school may be deductible as a medical expense. The cost of medical care can include the expenses of a special school for the mentally or physically handicapped individual. However, the deduction is only allowed if the principal reason for sending the dependent to school is the school’s special resources for alleviating infirmities. If this is the case, not only is tuition deductible, but so is the food and lodging.[[25]](#footnote-24)

The full cost of certain home-related capital expenditures to enable the physically handicapped individual to live independently and productively also constitutes a medical expense. Examples of qualifying costs include expanding doorways for wheelchairs, installing support bars, adjusting electrical outlets, etc.[[26]](#footnote-25) However, just as with other home improvements, the deductible amount is subject to the 10% of AGI and, to the extent the improvement does not increase, the value of the home.

Long-Term Care Expenses: What Constitutes

Long-Term Care Expenses and Are They Deductible?

An important issue affecting many disabled Americans in planning for the costs of long-term care is the tax treatment of long-term care expenses; namely, what constitutes a long-term care expense and whether such expense is deductible. While the IRC currently allows for a medical expense deduction under Section 213,[[27]](#footnote-26) there is significant confusion regarding whether the costs of long-term care delivered in a facility setting qualify for this deduction. This confusion is primarily attributable to the fact that the Treasury Regulations pertaining to IRC Section 213’s medical expense deduction narrow and limit the scope of “medical care” as defined by the Code. As a result, the law is unclear on whether elderly or disabled taxpayers, many of whom are unable to afford the cost of their care, can deduct the full cost of a long-term care facility under the medical expense deduction.

IRC Section 213 provides taxpayers with a deduction for “medical care of the taxpayer, his spouse, or a dependent . . . .”[[28]](#footnote-27) Subsection (d) defines “medical care” as amounts paid for “the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body . . . for [medically related] transportation . . . [or] for qualified long-term care services . . . .”[[29]](#footnote-28) IRC Section 213’s medical expense deduction only applies to the extent that such expenses exceed 7.5 percent of the individual’s adjusted gross income.[[30]](#footnote-29)

The term “qualified long-term care services” is defined as “necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services . . . .”[[31]](#footnote-30) For these long-term care services to qualify for the medical expense deduction under IRC Section 213, the care provided must be prescribed by a licensed health care practitioner, and the individual receiving the services must be “chronically ill.”[[32]](#footnote-31) Again, an individual is “chronically ill” when he or she has been certified by a licensed health care practitioner as being “unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for a period of at least 90 days due to a loss of functional capacity . . . [or] requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.”[[33]](#footnote-32) It should be easy for many elderly or disabled individuals to come within the ambit of the statute and thus be deemed “chronically ill,” since the activities of daily living referred to in IRC Section 7702B include “eating, toileting, transferring, bathing, dressing, and continence.”[[34]](#footnote-33) Finally, IRC Section 7702B defines “maintenance or personal care services” as “any care the primary purpose of which is the provision of needed assistance with any of the disabilities as a result of which the individual is a chronically ill individual . . . .”[[35]](#footnote-34)

Thus, disabled individuals who receive long-term care services should be able to deduct the costs of such services as a medical care expense pursuant to IRC Sections 213 and 7702B.

As previously set forth, “medical care,” defined in IRC Sections 213 and 7702B, includes qualified long-term care services, which in turn includes, “maintenance or personal care services.”[[36]](#footnote-35) Treasury Regulation Section 1.213-1(e)(1), however, severely narrows the statutory definition of “medical care” by omitting from its definition “qualified long-term care” (and thereby eliminating “maintenance or personal care services”).[[37]](#footnote-36) In so doing, the regulation materially alters IRC Sections 213 and 7702B, and eliminates an important and otherwise allowable medical expense deduction.

Regulation Section 1.213-1(e)(1) provides that the cost of meals and lodging paid to an institution is deductible as a medical expense (1) if the institution is regularly engaged in providing medical care or services, (2) if one of the principal reasons for the individual’s presence in the institution is the availability of medical care, and (3) if the institution furnishes meals and lodging as a necessary incident to the medical care.[[38]](#footnote-37)

Specifically, Treasury Regulation Section 1.213-1(e)(1)(v)(a) states the following:

Where an individual is in an institution because his condition is such that the availability of medical care (as defined in subdivisions (i) and (ii) of this subparagraph) in such institution is a principal reason for his presence there, and meals and lodging are furnished as a necessary incident to such care, the entire cost of medical care and meals and lodging at the institution, which are furnished while the individual requires continual medical care, shall constitute an expense for medical care.[[39]](#footnote-38)

Subparagraph (b) however, asserts that where an individual is in an institution, and the person’s condition is such that the availability of medical care in the institution is not a “principal reason for his presence there, only that part of the cost of care in the institution as is attributable to medical care (as defined in subdivisions (i) and (ii) of this subparagraph) shall be considered as a cost of medical care.”[[40]](#footnote-39) Thus, for example, “meals and lodging at the institution in such a case are not considered a cost of medical care.”[[41]](#footnote-40) As discussed below, this may be an overbroad interpretation, as it is inconsistent with the Code.

Subparagraphs (i) and (ii) of subsection (e)(1) define medical care as including “diagnosis, cure, mitigation, treatment, or prevention of disease.”[[42]](#footnote-41) The regulation’s definition of “medical care” does not include any mention of qualified long-term care services, maintenance, or personal care services.

The language in the regulation is clearly inconsistent with the plain language of IRC Sections 213 and 7702B. As previously discussed, IRC Section 213 includes “qualified long-term care services”[[43]](#footnote-42) within the definition of “medical care,” which in turn includes “maintenance or personal care services.”[[44]](#footnote-43) “[M]aintenance or personal care services” include “any care the primary purpose of which is the provision of needed assistance with any of the disabilities as a result of which the individual is a chronically ill individual . . . .”[[45]](#footnote-44) By excluding these services from the regulatory definition of medical care, Regulation Section 1.213-1(e)(1) improperly narrows the Code’s definition of “medical care,” thereby precluding the possibility of a chronically ill individual deducting the cost of a retirement home or assisted living facility.

For example, where chronically ill individuals enter either an assisted living facility or a retirement home, pursuant to a plan of care prescribed by a licensed health care practitioner, for the “primary purpose” of receiving assistance with the disabilities that render them chronically ill (i.e., maintenance or personal care services), the entire cost of the facility should be deductible. This is because the Code includes such services within the definition of medical care, and thus the individual’s primary purpose of entering the facility is the availability of medical care. Where the regulations omit “qualified long-term care services” and “maintenance or personal care services” from the definition of medical care, the taxpayer loses the benefit of these valuable deductions.

Skilled nursing facilities provide constant medical treatment to their residents. Individuals do not typically enter a skilled nursing facility unless their health has deteriorated to a point where they require 24-hour medical attention. The staff of a skilled nursing home includes physicians, registered nurses, and other health care professionals who are qualified to provide medical care and treatment to the disabled resident. A skilled nursing facility is much like a hospital.[[46]](#footnote-45)

The entire cost of a skilled nursing home should be deductible as a medical expense under IRC Section 213 (subject to the 7.5 percent limitation). As discussed in Regulation Section 1.213-1(e)(1)(v), where the availability of medical care in a facility is the principal reason for an individual’s presence there, the entire cost, including meals and lodging, will be deductible.[[47]](#footnote-46) As is the case with a hospital, nearly every individual who resides in a skilled nursing home is there for the purpose of obtaining “medical care,” as defined by the Code and the Regulations.[[48]](#footnote-47)

While IRC Section 213’s medical expense deduction arguably includes the entire cost of skilled nursing homes, many taxpayers do not currently avail themselves of this significant benefit. This is, simply, because the applicability of the medical expense deduction to skilled nursing homes is not clearly laid out in the applicable regulations. The Department of Treasury and IRS should amend Regulation Section 1.213-1(e)(1) to expressly include all services and costs of a skilled nursing home in IRC Section 213’s medical care expense deduction.[[49]](#footnote-48)

An assisted living facility (often referred to as a board and care facility) does not typically provide its residents with “medical care” as defined by Treasury Regulation Section 1.213-1(e)(1) (i.e., “diagnosis, cure, mitigation, treatment, or prevention of disease”).[[50]](#footnote-49) These services are commonly outsourced to independent contractors. However, these facilities do provide residents with “qualified long-term care services” and “maintenance or personal care services.”[[51]](#footnote-50) That is, assisted living facilities provide residents with care, “the primary purpose of which is the provision of needed assistance with any of the disabilities as a result of which the individual is . . . chronically ill. . . .”[[52]](#footnote-51)

Since the latter type of care is considered “medical care” under IRC Sections 213 and 7702B, all costs and expenses that can be shown to be “medical care” in an assisted living facility, where the chronically ill taxpayer’s principal reason for entering the facility is the availability of such care, should be deductible. This result is entirely consistent with the plain language of the Code.[[53]](#footnote-52) Because Treasury Regulation Section 1.213-1(e)(1)(i) & (ii) does not include “qualified long-term care services” in its definition of “medical care,” taxpayers, and tax preparers alike, should not deduct the entire cost of assisted living facilities, but only that portion arguably which is medically related.

A retirement home includes an apartment or residential facility which primarily caters to retired individuals.[[54]](#footnote-53) A retirement home will often provide meals and cleaning services for the resident, however the residents of a retirement home are most often self-sufficient and are not confined to the facility.[[55]](#footnote-54) In addition to the provision of meals and cleaning services, retirement homes provide various individual and group activities for their residents, which may include exercise classes, mental conditioning classes, bingo, music performances, lectures, arts and crafts, religious prayer, movies, and regular transportation for shopping or other excursions, to name a few.

Similar to assisted living facilities, medical services (as defined in Treasury Regulation Section 1.213-1) are rarely provided by a retirement home; rather any such medical services required by the residents are provided by independent contractors or by the residents’ own physician. As a result of the outsourced medical treatment, retirement homes are a desirable option for many chronically ill individuals, since these homes are less akin to the hospital environment. Clearly, a retirement home resident will be able to deduct the medical services provided by the independent contractor under IRC Section 213.[[56]](#footnote-55)

However, retirement homes provide assistance with an individual’s disabilities, based on the needs of the resident.[[57]](#footnote-56) For example, where a chronically ill individual is unable to bathe him or herself, and has trouble with transferring, the retirement home staff will provide assistance with these activities of daily living. Where this is the case, again that portion attributable to medical care should be deductible for these individuals, since the care provided is “medical care” under IRC Sections 213 and 7702B; so long as the individual’s principal reason for entering the facility is the availability of such care.[[58]](#footnote-57) In a retirement home and assisted living home setting, the excess costs for food and other amenities for long term care should be deductible.[[59]](#footnote-58)

Further, “qualified long-term care services” includes not only “maintenance or personal care services,” but also “necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services . . . .”[[60]](#footnote-59) Where the chronically ill individual is in a retirement home, pursuant to a plan prescribed by a licensed health care practitioner, the costs apportioned to the organized activities provided by the retirement home, which serve the taxpayer’s therapeutic, rehabilitative, or other “qualified long-term care” needs, should be deductible by the taxpayer. Where the principal reason for the chronically ill taxpayer’s presence in the retirement home is to obtain the therapeutic, treating, or rehabilitative services offered by the home, in the form of organized activities, the entire cost of the facility should be deductible.[[61]](#footnote-60)

Again, to accurately reflect Congress’ intent, as evidenced by the plain language of IRC Sections 213 and 7702B, Treasury and the IRS should alter Treasury Regulation Section 1.213-1(e)(1) to include “qualified long-term care services” and “maintenance or personal care services” as a deductible medical expense. Accordingly, a chronically ill individual who enters a retirement home for the principal reason of obtaining such services should also be entitled to deduct not just the apportioned cost of those services, but also the auxiliary services including meals and lodging.

Taxation of Qualified Long-Term Care Insurance and Life Insurance Contracts

Qualified long-term care (“QLC”) insurance policies provide elderly and disabled individuals with reasonable means of affording long-term care.[[62]](#footnote-61) A QLC contract may exist on its own, or as part of a life or annuity contract. The IRC provides for favorable tax benefits arising from QLC insurance contracts. Specifically, the premiums paid for a QLC insurance policy are generally deductible, and the benefits received under such a policy may be nontaxable.

The deductibility of QLC premium payments follows the same guidelines as deductible medical expenses under IRC Section 213, and are subject to the same limitations (both of which are discussed above). QLC premium payments however, are subject to an additional limitation: they are not deductible to the extent they exceed an annual limitation, which is defined by IRC Section 213(d)(10).[[63]](#footnote-62)

Benefits received under a QLC insurance contract also receive favorable tax treatment, as they may be excludible from gross income under IRC Section 7702B – governing the rules applicable to reimbursement of medical expenses. This exclusion from income applies regardless of whether the insurance contract exists as a stand-alone policy, or as a rider to a life insurance or an annuity policy.

Similarly, while post-death life insurance payments are generally excludible from gross income, benefits received during one’s life, pursuant to a life insurance policy, may also be nontaxable if the insured is chronically or terminally ill.[[64]](#footnote-63) The IRC defines a “terminally ill” individual as one who “has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less. . . .”[[65]](#footnote-64) A terminally ill individual is entitled to a one-hundred percent exclusion of life insurance proceeds received during life. Additionally, premium payments are fully deductible by the terminally ill individual.

The chronically ill individual’s exclusion of life insurance proceeds is limited by the amount of benefits attributable to reimbursement of his or her long-term care costs. The life insurance benefits paid to chronically ill patients are subject to a further limitation, which also limits the excludability of QLC insurance benefits.

Limitations on Exclusion of Benefits. As noted above, benefits from QLC insurance policies and life insurance benefits (paid to chronically ill patients) may be excludible from gross income. The IRC provides for limitations on the excludability of “periodic payments” from QLC or life insurance contracts; an important factor in determining how to fund one’s long-term care.

First, the IRC distinguishes between benefits arising from two different types of contracts: QLC insurance contracts and life insurance contracts. Additionally, the limitation on the nontaxable benefits varies based upon the “status” of the individual (i.e., whether the individual is chronically ill or terminally ill). With these distinct categories in mind, the limitation applies to payments from (1) QLC insurance contracts insuring chronically ill individuals, including terminally ill patients; and (2) life insurance contracts insuring chronically ill individuals, excluding terminally ill patients.

Specifically, IRC Section 7702B(d)(1) sets forth the limitation as follows:

1. In general. If the aggregate of –

(A) the periodic payments received for any period under all qualified long-term care insurance contracts which are treated as made for qualified long-term care services for an insured, and

(B) the periodic payments received for such period which are treated under section 101(g) as paid by reason of the death of such insured, exceeds the per diem limitation for such period, such excess shall be includible in gross income without regard to section 72.

In other words, periodic payments of applicable insurance benefits are not excludible from gross income to the extent they exceed a “per diem” amount. The section defines the per diem amount as the greater of (1) a defined dollar amount ($310 per day in 2012), or (2) the long-term care costs. The greater of 1 or 2 is reduced by any reimbursements for long-term care costs. Thus, the “per diem” amount for an individual with $100,000 in long-term care costs over a one-year period and $40,000 in reimbursements will equal $73,150.[[66]](#footnote-65) Under Section 7702B(d)(1), the exclusion of qualified benefits received by the individual will be limited to this “per diem” amount.

However, Section 7702B fails to define what constitutes a long-term care “period” for purposes of determining the limitation of nontaxable benefits. Rather, two differing methods are commonly employed, each resulting in different results. These methods are the “equal payment rate” method and the “contract period” method.

Under the equal payment rate method, the long-term care period is the “period during which the insurance company uses the same payment rate to compute an individual’s benefits.”[[67]](#footnote-66) As exemplified in the instructions to IRS form 8853, where an insurance carrier computes payments at the rate of $250 per day from March 1 to May 31, and a rate of $195 per day from July 1 to December 31, the taxpayer has two long-term care “periods”. Similarly, where the insured receives benefits at a single rate for an entire year, that individual has one long-term care “period”.

Under the “contract method” however, the insured’s long-term care period is equal to the period used by the insurance carrier to calculate the benefits. For example, where the insurance carrier calculates the benefits to be $20 per day for one year, the insured has 365 long-term care “periods” under this “contract” method. As the examples below indicate, choosing one method over the other can have significantly different tax consequences.

Example 1 – Equal Payment Rate Method – Assume a chronically ill individual is insured under a life insurance policy (or a QLC contract) which pays the insured accelerated death benefits during the 2012 taxable year.[[68]](#footnote-67) Those benefits are paid on a monthly basis totaling $10,000 per month and are scheduled to extend from January 1 to December 31, 2012. During the 2012 taxable year, the insured’s actual long-term care expenses totaled $70,000, and the insured received reimbursements from other insurance policies totaling $10,000.

Applying the formula set forth in Section 7702B, the per diem amount equals $113,150 – which is the greater of (1) the “dollar amount” (i.e., $310 x 365 days in the period, which is $113,150) or (2) the actual long-term care costs ($120,000), less the amount reimbursed ($10,000). As noted above, the insured received $10,000 per month in periodic payments totaling $120,000. Since those benefits are includible to the extent they exceed the per diem amount, a total of $10,000 is taxable ($120,000 in total benefits received - $110,000 per diem amount).[[69]](#footnote-68)

Example 2 – Contract Method – Assume the same facts as Example 1, except that the insured’s actual long-term care costs of $70,000 breaks down as follows: $10,000 in January and December, $12,000 in February, and $4,222 in each other month. Additionally, the $10,000 in reimbursed expenses was paid in 12 equal installments of $833 per month. The insured still receives $9,000 per month for the entire 2012 taxable year. Under the contract method, since the benefits are calculated by the insurance carrier on a monthly basis for a term of one year, there are 12 periods, and each must be calculated individually.

For January and December respectively, the per diem amount equals $9,167 (the long-term care costs -- which is greater than the “dollar amount” of $310 x 31days -- less the reimbursed expenses for that month). Because the per diem amount exceeded the benefit amount nothing is taxable.

For February, which has only 29 days in 2012, the per diem amount equals $11,167 (the “greater” of the actual expenses and the “dollar amount”, less the amount reimbursed). In February the taxpayer received only $9,000 in LTC benefits which is less than the per diem amount and thus nothing is taxed.

For each month with 30 days, (e.g., April, June, September and November), the per diem equals $8,467 ($9300 - $833). The taxpayer received $9,000 in each of those months of which $8,467 was excluded leaving $533 taxable each month for a total amount taxed as income for the 4 months of $2,132.

Finally, for each month with 31 days (March, May, July, August and October), the per diem is $8,777. The benefits received exceed this amount by $223 a month, leaving a total of $2,615 for these five months.

When added together, the amount of the benefits not excludible from gross income (i.e., the taxable amount) equals $1,115.

In both examples, the insured received exactly $120,000 in benefits, expended $70,000 in actual expenses and was reimbursed a total of $10,000 during the 2012 taxable year. The limitation on the nontaxable benefits differs however, depending on whether the taxpayer chooses the “equal payment rate” or the “contract period” method. Specifically, under the former method, the taxable income was $17,625, while under the latter method, the taxable amount was only $3,247. Using different figures, more disparate amounts may even result.[[70]](#footnote-69) Clearly, the limitations found in IRC Section 7702B must be analyzed under both methods before one can properly advise their client.

1. See IRC §152 and IRS Publication 501. [↑](#footnote-ref-1)
2. [↑](#endnote-ref-1)
3. *Id.* [↑](#footnote-ref-2)
4. A “sheltered workshop” is a school that (a) provides special instruction to alleviate the disability of the individual, and (b) is operated by certain tax-exempt organizations or by a state, U.S. possession, a political subdivision of a state or possession, the United States or the District of Columbia. See also IRS Pub. 501. [↑](#footnote-ref-3)
5. IRC §152(d)(3). [↑](#footnote-ref-4)
6. IRC § 63(c)(3). [↑](#footnote-ref-5)
7. A terminally ill individual is a person whose medical doctor certifies as having an illness that is expected to result in death within 24 months. [↑](#footnote-ref-6)
8. A person is chronically ill if he or she is certified as being unable to perform without assistance certain activities of daily living. [↑](#footnote-ref-7)
9. IRC § 21. [↑](#footnote-ref-8)
10. IRC §§ 21(b)(1)(B) & (C). [↑](#footnote-ref-9)
11. IRC § 21(d)(1). [↑](#footnote-ref-10)
12. IRC § 21(d)(2). [↑](#footnote-ref-11)
13. IRC § 21(e)(1). [↑](#footnote-ref-12)
14. IRC § 21(e)(6). [↑](#footnote-ref-13)
15. IRC § 21(b)(2). [↑](#footnote-ref-14)
16. IRC § 21(c). [↑](#footnote-ref-15)
17. Treas. Reg. § 1.44A-1(c)(2). [↑](#footnote-ref-16)
18. Treas. Reg. § 1.44A-1(c)(3). [↑](#footnote-ref-17)
19. *Id.* [↑](#footnote-ref-18)
20. Treas. Reg. § 1.44A-1(c)(6). [↑](#footnote-ref-19)
21. Permanent and total disability means the individual is unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment that can be expected to result in death, or that has lasted or can be expected to last for a continuous period of at least 12 months. *See* IRC §22(c)(2). [↑](#footnote-ref-20)
22. IRC §67(b)(6). [↑](#footnote-ref-21)
23. IRC § 213(d)(a)(A) [↑](#footnote-ref-22)
24. *Riach v. Frank*, 62-1 USTC ¶9419, 9 AFTR 2d 1263, 302 F.2d 374 (CA-9 1962). [↑](#footnote-ref-23)
25. *Donald R. Pfeifer,* 37 TCM 816, T.C. Memo 1978-189. [↑](#footnote-ref-24)
26. For a complete list of these items, see Rev. Rul. 87-106, 1987-2 C.B. 67. [↑](#footnote-ref-25)
27. S*ee* IRC § 213. [↑](#footnote-ref-26)
28. IRC § 213(a). [↑](#footnote-ref-27)
29. IRC § 213(d). [↑](#footnote-ref-28)
30. IRC § 213(a). Thus, for example, an individual with $100,000 of adjusted gross income may only deduct medical expenses that exceed a $7,500 threshold. [↑](#footnote-ref-29)
31. IRC § 7702B(c)(1). [↑](#footnote-ref-30)
32. *Id.* [↑](#footnote-ref-31)
33. IRC § 7702B(c)(2)(A). [↑](#footnote-ref-32)
34. IRC § 7702B(c)(2)(B). [↑](#footnote-ref-33)
35. IRC § 7702B(c)(3). [↑](#footnote-ref-34)
36. IRC §§ 213(d) & 7702B(c)(1). [↑](#footnote-ref-35)
37. *See* Treas. Reg. § 1.213-1(e)(1)(i)&(ii). [↑](#footnote-ref-36)
38. Treas. Reg. § 1.213-1(e)(1)(v); *see also* Blankenship, *Tax Issues Complicate the Costs of Chronic Illness and Long-Term Care Insurance*, 106 J.Tax’n. 216, 221 (2007). [↑](#footnote-ref-37)
39. Treas. Reg. § 1.213-1(e)(1)(v)(a) (emphasis added). [↑](#footnote-ref-38)
40. Treas. Reg. § 1.213-1(e)(1)(v)(b) (emphasis added). [↑](#footnote-ref-39)
41. *Id.* [↑](#footnote-ref-40)
42. Treas. Reg. § 1.213-1(e)(1)(i)&(ii). [↑](#footnote-ref-41)
43. IRC § 213(d). [↑](#footnote-ref-42)
44. IRC § 7702B(c)(1). [↑](#footnote-ref-43)
45. IRC § 7702B(c)(3). [↑](#footnote-ref-44)
46. *See* United States Dept. of Health and Human Services, *Glossary of Disability, Aging, and Long-Term Care Terms*, *available at* http://aspe.hhs.gov/daltcp/diction.shtml#assisted (defining a nursing facility as “licensed by the state to offer the residents . . . skilled nursing care on a 24-hour basis,” and defining skilled nursing care as “[d]aily nursing and rehabilitative care that can be performed only by or under the supervision, skilled medical personnel”). [↑](#footnote-ref-45)
47. Treas. Reg. 1.213-1(e)(1)(v)(a). [↑](#footnote-ref-46)
48. Recent Tax Court decisions support the notion that all costs expended at a skilled nursing facility are deductible under Section 213. Specifically, *Hospital Corporation of America*, 107 T.C. 116 (1996), *aff’d* 348 F.3d 136 (6th Cir. 2003), held that medical supplies furnished by a hospital are so “inseparably connected” to the performance of medical services that those services necessarily included income attributable to the supplies. By analogy, the auxiliary services provided by a skilled nursing facility (e.g., meals and lodging), are so “inseparably connected” with the provision of medical care, that the entirety of such costs should be deductible. *See also* *Osteopathic Medical Oncology & Hematology, P.C.*, 113 T.C. 376 (1999); Blankenship, *supra* note 36, at 221. [↑](#footnote-ref-47)
49. This is entirely consistent with the IRS’ current position regarding nursing homes, where the resident’s principal reason for being in the home is to obtain medical care. Specifically, IRS Pub. 502 at 12 (2007) states the following: “You can include in medical expenses the cost of medical care in a nursing home, home for the aged, or similar institution . . . . This includes the cost of meals and lodging if a principal reason for being there is to get medical care.” The Regulations should reflect the fact that personal care services and long-term care services are included in the statutory definition of medical care. [↑](#footnote-ref-48)
50. There may be a viable argument however, that where the facility provides supervision of, or assistance with, taking medication, the facility is providing medical care as “treatment, or prevention of disease.” [↑](#footnote-ref-49)
51. *See* Dept. of Health and Human Services, *supra* note 23 (defining assisted living facility as a “‘home with services’” where “[p]ersonal care services are available on a 24-hour-a-day basis”); *see also* IRC §§ 213(d) & 7702B(c)(1). [↑](#footnote-ref-50)
52. IRC § 7702B(c)(3). [↑](#footnote-ref-51)
53. *See* IRC §§ 213(d) & 7702B(c)(1). [↑](#footnote-ref-52)
54. *See* Dept. of Health and Human Services, *supra* note 44. [↑](#footnote-ref-53)
55. *Id.* [↑](#footnote-ref-54)
56. IRC § 213; Treas. Reg. §§ 1.213-1(e)(1)(i), (ii) & (v). [↑](#footnote-ref-55)
57. *See* Dept. of Health and Human Services, *supra* note 44 (describing a retirement home (*i.e.,* a continuing care retirement community) as providing “residential services (meals, housekeeping, laundry), social and recreational services, health care services, personal care, and nursing care”). [↑](#footnote-ref-56)
58. Treas. Reg. § 1.213-1(e)(1)(v). [↑](#footnote-ref-57)
59. In a discussion with the Office of Chief Counsel there has been some discussion as to enacting regulations in this area with safe harbors. [↑](#footnote-ref-58)
60. IRC § 7702B(c)(1). [↑](#footnote-ref-59)
61. *See* Treas. Reg. 1.213-1(e)(1)(v). [↑](#footnote-ref-60)
62. As a result of consumer fraud, there are stringent requirements governing QLC insurance contracts. *See* Blankenship, *supra* note 36. These requirements are not the relevant to the present discussion. [↑](#footnote-ref-61)
63. The limitations vary based on age and are indexed for inflation. For example, in 2012, the limitation on the QLC premium deduction for an individual over the age of 70 years old is $4,370. Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (2006). [↑](#footnote-ref-62)
64. *See* IRC § 101(g); Blankenship, *supra* note 36. [↑](#footnote-ref-63)
65. IRC § 101(g)(4). [↑](#footnote-ref-64)
66. The dollar amount of $310 per day for one year is $113,150, which is greater than the long-term care costs of $100,000. Thus, $113,150 - $40,000 = $73,150 is the per diem amount. A much easier formula is that the exclusion from gross income is limited to the greater of the following amounts: (a) per diem amount which is $310 a day in 2012 or (b) the actual cost of long-term care. You take the higher of (a) or (b) and subtract any reimbursements and that is the amount that may be excluded from income. [↑](#footnote-ref-65)
67. IRS Form 8853 Instructions. [↑](#footnote-ref-66)
68. As previously noted, if the insured is terminally ill, benefits received under a *life insurance policy* are completely excluded from gross income. [↑](#footnote-ref-67)
69. Since the actual cost of LTC is greater than the per diem amount, you would use the actual costs, as opposed to the daily per diem amount, less reimbursements to determine the per diem amount. [↑](#footnote-ref-68)
70. *See* Blankenship, *supra* note 36. [↑](#footnote-ref-69)