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Income Tax Planning for Long-Term Care

by David M. English
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Planning for long-term involves more than the preparation of powers of attorney and counseling on possible asset transfers to qualify for Medicaid reimbursement. Steps should also be taken to make certain that the person receiving care continues to file an income tax return and does so at a minimum possible income tax cost. Practitioners should be familiar with the procedure for filing a return on behalf of an incapacitated individual. The medical expense deduction, while of little importance for most taxpayers, is critical for many elderly, particularly for those receiving long-term care. Long-term care insurance and life insurance may be tapped as a financial resource for paying the costs of long-term care without fear of adverse tax consequences. Significant tax benefits also are available to families paying for a parent's or other relative's care, including the claiming of an additional personal exemption and deduction of the relative's medical expenses.

Signing the Return

Admission to a nursing home or other facility does not relieve an individual from the obligation to file a return. But the serious mental incapacity often associated with admission to a nursing home or receipt of other long-term care means that non-filing can easily become a reality. Steps should be taken to make certain that an authorized substitute is available to sign the return.

An income tax return for an incapacitated taxpayer may be signed by:

- the spouse signing the incapacitated person's name to the return if the spouse adds that it is being signed "By _____ Husband (or Wife)" and attaches a statement to the return explaining why the other spouse cannot sign, Treas. Reg. § 1.6012-1(a)(5);
- a legally authorized representative, such as a conservator or guardian, I.R.C. § 6012(b)(2); or
- an agent under a durable power of attorney if the power authorizes the agent to handle tax matters and a copy of the power of attorney is attached to the return. Treas. Reg. § 1.6012-1(a)(5). Form 2848, the Service's power of attorney form, is inadequate unless modified. The Service's form is a nondurable power of attorney that is automatically revoked upon the principal's incapacity. *Halper v. Comm'r*, 73 T.C.Mem. 1997-58.

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Refund Claims

When representing an individual of declining capacity, the practitioner should be alert to possible errors on the return and file refund claims on returns that are still open if the amount involved justifies the added expense. I.R.C. § 6511 requires that a claim for refund normally must be filed by the later of three years after the filing of the return or two years after payment of the tax. The Supreme Court, in *United States v. Brockamp*, 519 U.S. 347 (1997), held that this period was mandatory and not suspended by the taxpayer's disability. Congress quickly reversed this result. Pursuant to I.R.C. §6511(h), enacted in 1998, the limitations period is suspended during any period that:

- the taxpayer is unable to manage financial affairs by reason of a medically determinable physical or mental impairment which could be expected to last for at least one year or result in death; and
- the taxpayer was not represented by a conservator, agent under a durable power of attorney, or other person authorized to handle financial matters.

When requesting a suspension of the limitations period on account of disability, the claimant must:

- submit a statement from a physician certifying that the taxpayer had the requisite disability; and
- certify on the claim for refund that no one was authorized to act on behalf of the taxpayer during the relevant period. Rev. Proc. 99-21, 1999-1 C.B. 960.

Supporting a Parent

Due to the growing number of elderly who will likely receive financial assistance from their children to defray the costs of care, the methods under the Code for receiving at least some help in paying these costs will be a subject of increasing interest. Similar to a taxpayer providing support for a minor child, children who support a parent may be able to claim a personal exemption for the parent and deduct the parent's unreimbursed medical expenses which the child has paid. The claiming of a dependent care credit is a possibility. Children paying for a parent's care, either with their own or their parent's funds, should also be aware of the rules on payroll withholding for home and domestic workers.

Claiming a Personal Exemption

A child may claim a personal exemption for a parent if the parent:

- has gross income of less than the personal

exemption amount (\$3,000 in 2002);

- did not file a joint return for the year; and
- qualifies as the child's dependent. I.R.C. § 151.

A parent qualifies as the child's dependent if the parent:

- received over half of his or her support from the child during the taxable year; and
- is a United States citizen, resident or national, or a resident of Canada or Mexico, for at least part of the taxable year. I.R.C. § 152; Treas. Reg. § 1.152-2(a).

Eligible support, whether provided by the parent or child, includes:

- food, shelter, clothing, medical care, and similar benefits;
- benefits provided in-kind, such as the fair rental value of in-law quarters in the child's home; and
- Social Security benefits but not Medicare, Medicaid, or private health insurance reimbursements. Treas. Reg. § 1.152-1(a)(2); Rev. Rul. 79-173, 1979-1 C.B. 86; *Archer v. Comm'r*, 73 T.C. 963 (1980).

To assure that the child pays for more than half of the parent's support needs, the child and parent should carefully coordinate expenditures and the source of funds used.

Multiple Support Agreements

A parent's dependency status is not necessarily lost because a child contributes less than half the parent's support. As long as the children as a group contribute more than half the parent's support, the children may agree among themselves as to which child will claim the personal exemption. A child contributing less than 50% is entitled to claim the exemption if:

- the child contributed at least 10%;
- the child and other persons, as a group, contributed more than half the parent's support;
- no single individual contributed more than 50%;
- the other persons who have each contributed at least 10% sign declarations renouncing a right to claim the exemption, ordinarily on Form 2120; and
- the child claiming the exemption attaches the Form 2120s to the child's return. I.R.C. § 152(c).

Deducting a Parent's Medical Expenses

For a child to deduct on the child's return the medical expenses of the parent which the child has paid, the parent must qualify as the child's dependent under the test described above. I.R.C. § 213(a). Eligibility to also claim a personal exemption for the parent is not necessary, meaning that the parent may have more than \$3,000 in gross income. Medical expenses paid by a child are deductible on the child's return if the parent qualified as the child's dependent either on the date the services were incurred or on the date payment was made. I.R.C. § 213(a); Treas. Reg. § 1.213-1(e)(3).

Before paying a parent's medical expenses in the hope of receiving a deduction, the child should make certain that the other requirements for the deduction are met. The child must have sufficient other deductions in order to itemize rather than claim a standard deduction. Also, even if the child itemizes, medical expenses are deductible only to the extent they exceed 7.5% of adjusted gross income. I.R.C. § 213(a).

FICA and FUTA Withholding for Domestic Help

Spurred on by the Nannygate controversy of 1993, Congress in 1994 liberalized the rules on FICA (Social Security and Medicare tax) withholding for domestic help. Formerly, withholding was required if an employee's cash compensation exceeded \$50 per quarter. The amendments raised the minimum floor to \$1,000 per year with increases for inflation. I.R.C. §§ 3102(a), 3121(a)(7)(B), (x). For 2002, the withholding floor is \$1,300. FUTA (unemployment tax) withholding is required if a care worker or workers were paid more than \$1,000 in compensation during any quarter of the current or preceding calendar year. I.R.C. §§ 3301, 3306(a)(3). Withholding of both FICA and FUTA may be reported on Schedule H to the Form 1040 and paid with the filing of the return.

To avoid a withholding obligation, the home care worker must not be classified as the taxpayer's "employee." Whether providers of care will be classified as employees or as independent contractors responsible for their own taxes depends on the provider's professional qualifications. Registered nurses and licensed practical nurses performing private duty services are generally classified as independent contractors; nurse's aides and other personal attendants are classified as employees. Rev. Rul. 61-196, 1961-2 C.B. 155. Withholding by a taxpayer is not required, however, for aides and personal attendants who are classified as someone else's employees, such as the agency that hired them. If the agency holds itself out as performing personal care services, does the hiring and firing, fixes the attendant's rate of compensation, and cuts the attendant's paycheck, the agency will be regarded as the employer. See Rev. Rul. 80-365, 1980-2 C.B. 300. But if the agency functions merely as a referral source, with the taxpayer and the worker negotiating rates of compensation and other terms of employment, the worker will be regarded as the employee of the taxpayer and not of the agency. Tech. Adv. Mem. 9344003 (Nov. 5, 1993); Tech. Adv. Mem. 9206002 (Jan. 7, 1992). If a domestic worker is classified as the taxpayer's employee, the taxpayer, in addition to any required FICA or FUTA withholding, must prepare a W-2 but need not withhold income tax. I.R.C. § 3401(a)(3).

Dependent Care Credit

While directed principally at parents with young children, the credit for dependent care is also available to taxpayers paying certain of the care expenses of a parent or spouse. To claim the credit, the individual receiving care must:

- be the taxpayer's spouse or dependent, I.R.C. §21(b)(1);
- be physically or mentally incapable of providing self care, I.R.C. §21(b)(1), meaning that the individual cannot care for his or her own hygiene or nutritional needs, or needs the full-time attention of another person for the individual's safety or the safety of another, Treas. Reg. §1.44A-1(b)(4); and
- reside in the taxpayer's household. Treas. Reg. §1.44A-1(d)(1). A credit for services provided by an outside facility is available only if the recipient spends at least eight hours each day in the taxpayer's home. I.R.C. §21(b)(2)(B)(ii).

Expenses qualifying for the credit must be incurred to enable the taxpayer to be gainfully employed. Expenses potentially qualifying for the credit include the costs of a personal attendant and other domestic care allocable to the dependent's needs, and the expense of an approved dependent care facility, excluding costs of transport to the facility. I.R.C. §21(b)(2); Treas. Reg. §1.44A-1(c).

The dependent care credit is of limited financial value. For those paying \$2,400 or more of creditable expenses, the maximum credit is \$720 but falls to \$480 for those having adjusted gross incomes over \$28,000. In 2003, the maximum credit will increase to \$1,050 for those paying \$3,000 or more of care expenses (\$700 for those having adjusted gross incomes over \$43,000). Despite the increase, many taxpayers may still find it more beneficial to take the care expenses as a medical expense deduction, assuming the expenses otherwise qualify. Taxpayers are not entitled to take advantage of both provisions, but are denied a medical expense deduction to the extent care costs are applied to the credit. I.R.C. §213(e).

Medical Expense Deduction for Long-Term Care

The tax treatment of payments for long-term care was long uncertain. Charges for professional services, such as care by registered nurses and licensed practical nurses, have always been deductible as medical expenses. Treas. Reg. §1.213-1(e)(1)(ii). The uncertainty arose with respect to items more custodial in nature, including the services of a personal attendant in a private residence and the substantial monthly charges for care at a long-term care facility. In an effort to reduce the uncertainty, the Health Insurance Portability and Accountability Act of 1996, commonly known as the Kennedy-Kassebaum bill, enacted detailed provisions

on the deductibility of long-term care expenses.

Under Kennedy-Kassebaum, the costs of providing long-term care are deductible as medical expenses under I.R.C. § 213 if the person receiving care is a "chronically ill individual" and the expenditures are for "qualified long-term care services" as defined in I.R.C. § 7702B. Qualified expenses are deductible whether provided in a facility or private residence. Like other medical expenses, eligibility to claim the deduction is beneficial only if the taxpayer itemizes and total medical expenses paid exceed 7.5% of adjusted gross income.

To claim a deduction for paying the expenses of long-term care:

- the expense must be incurred to provide necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, rehabilitative, or maintenance or personal care services, I.R.C. § 770B(c)(1);
- the services must be provided pursuant to a plan of care prescribed by a licensed health care practitioner (physician, registered nurse, or licensed social worker), I.R.C. §7702B(c)(1)(B), (c)(4); and
- the taxpayer must be a "chronically ill individual" as certified by a licensed health care practitioner, requiring either:
 - a severe cognitive impairment necessitating substantial supervision to protect health and safety; or
 - a functional inability without substantial assistance to perform for at least 90 days at least two of six activities of daily living (eating, toileting, transferring, bathing, dressing, and continence). I.R.C. §7702B(c)(2).

Care at Private Residence

While perhaps directed primarily at institutional care, the deduction for long-term care expenses is also available for services provided in a private residence. But obtaining a deduction for such care, particularly care provided by a personal attendant, requires particular diligence. Attendants are often hired based on informal advice with little in the way of written documentation of need. Extensive record keeping is now essential. Person's receiving care in their homes must be certified as "chronically ill" and the services provided pursuant to a formal plan of care. In addition, written records of the attendant's services should be kept, on a time basis if possible. Attendants are often called upon to perform a variety of functions. In sorting out which functions qualify as deductible "maintenance or personal care services" as opposed to nondeductible "maid services," unsubstantiated estimates will be construed against the taxpayer. See, e.g., *Estate of Marantz v. Comm'r*, 39 T.C.Mem. 1979-463 (40 % deductible); *Estate of Dodge v. Comm'r*, 20 T.C.Mem. 1961-346 (50 % deductible). But assuming the taxpayer is able to qualify, the taxpayer may deduct:

- the attendant's wages including required withholding, Rev. Rul. 57-489, 1957-2 C.B. 207;
- the costs of the attendant's in-home meals, Treas. Reg. §1.213-1(e)(1)(ii);
- if an overnight stay by the attendant is required, the added costs of this lodging, including, if necessary, the expense of renting a larger apartment. Rev. Rul. 76-106, 1976-1 C. B. 71.

Long-Term Care Insurance

Kennedy-Kassebaum contains detailed provisions on the tax treatment of long-term care insurance and benefits. Prior to Kennedy-Kassebaum, the tax treatment of long-term care insurance premiums and benefits was uncertain for the same reason that deductions for direct payment for long-term care services was questioned—the difficulty of sorting out which insurance benefits were for medical and nursing costs as opposed to other items. Pursuant to Kennedy-Kassebaum, premiums for qualified long-term care insurance are fully deductible as medical expenses and insurance reimbursements from such policies are fully excludable from gross income, similar to other health insurance.

Premium payments for long-term care insurance purchased by an individual are deductible as medical expenses under I.R.C. § 213(d) and benefit payments from such policies are excludable from gross income if:

- the policy is tax-qualified (covers qualified long-term care services of chronically ill individual plus other requirements—check specimen policy for required certification by insurer);
- the annual premium does not exceed caps based on the insured's age, ranging from \$240 per year (in 2002) for an individual age 40 or less, to \$2,990 for an individual age 71 or older (partial deduction available if cap exceeded); and
- the benefits paid will not exceed the actual costs of care or a daily indemnity of \$210 (in 2002). I.R.C. §§213(d), 7702B(a)(4), (b).

Long-term care insurance eligible for tax-favored treatment does not quite have the status of a conventional health insurance plan. While long-term care insurance may be offered as part of an employer plan, I.R.C. §7702B(a)(3), such coverage is not entitled to preferential treatment under either a cafeteria plan or flexible spending arrangement. I.R.C. §§106(c), 125(f). Nor is it subject to the COBRA continuation requirements. 29 U.S.C. §1167(1).

Accelerated Death Benefits

During the 1980s, individuals with terminal illnesses, primarily those with AIDS, began looking to their life insurance as a source of funds for paying the catastrophic costs of long-term care and other pressing financial needs. While one way of accomplishing this

task was to cancel the policy and withdraw its cash value, this step was generally not advantageous. Given the nearness of death, the policy was often worth far more than its current cash value. Recognizing this dilemma, investors stepped in and began purchasing policies from those with terminal illnesses under what is known as a "viatical settlement." Working backwards from the expected death benefit, investors would discount the policy based on such factors as current interest rates and the probable timing of the insured's death. Insurance companies, recognizing a new market, also began offering life insurance policies with accelerated benefit riders under which a terminally ill insured could receive directly from the insurance company a discounted percentage of the expected death benefit.

Based on a literal reading of the Code, however, the income tax treatment of such transactions was not favorable. While Section 101 of the Code excludes from gross income life insurance proceeds payable by reason of the insured's death, such was not the case with lifetime benefits. If the policy was cashed in or sold during life, the insured was normally required to recognize ordinary income to the extent the proceeds exceeded the insured's basis (premiums paid less dividends and other returns).

Kennedy-Kassebaum changed the rules. Regardless of the insured's basis, proceeds paid to a living insured, whether by an insurance company or viatical settlement provider, are excludable from gross income if the payment qualifies as an accelerated death benefit under I.R.C. § 101(g). To exclude the proceeds under I.R.C. § 101(g), the insured must be either:

- "terminally ill," requiring a certification by a physician that the insured's death is reasonably expected to occur within 24 months; or
- "chronically ill," applying the same definition as applies for purposes of deducting direct payment of long-term care costs or premiums on long-term care insurance.

Accelerated death benefits paid to terminally ill insureds are fully excludable from gross income, no matter how applied, but the exclusion for insureds who are certified as chronically ill is limited to the amount of qualified long-term expenses or the \$210 daily limit. Proceeds from a sale to a "viatical settlement" provider qualify for the exclusion only if the provider is licensed by the state or meets standards established by the National Association of Insurance Commissioners. In addition, the exclusion is not available if the policy is owned by a business in which the insured is an employee, officer, or director or has a financial interest.

Retirement Communities

Retirement homes and communities often charge substantial admission fees, in addition to monthly

charges. Many of these homes and communities are designed to provide lifetime care. While the individual, upon admission, may be healthy, a nursing home wing and other services may be available if the individual later needs long-term care. Sometimes a separate charge is assessed for these services. In other cases, the services are covered by the general entrance and monthly fees, with those who are healthy in effect subsidizing those receiving care. The estimated portion of the entrance fee and monthly charges allocable to expected medical, nursing, and long-term care costs is deductible as a medical expense. The problem is in determining that portion. The Service, however, allows a deduction based on the facility's past experience with the use of these services. Rev. Rul. 67-185, 1967-1 C.B. 70; *Estate of Smith v. Comm'r*, 79 T.C. 33 (1982); acq., AOD 1984-051, 1984 WL 270642. If the taxpayer is entering a new facility, the estimate may be based on the experience of comparable facilities. Rev. Rul. 76-481, 1976-2 C.B. 82. But if the taxpayer later leaves the facility, the taxpayer must include in gross income the portion of any refund attributable to

charges previously deducted. Rev. Rul. 75-302, 1975-2 C.B. 86.

Appointing a Guardian

For individuals who fail to adequately plan for possible incapacity, a decision to seek admission to a nursing home will sometimes coincide with the filing of a petition to appoint a guardian or conservator. The facility will in some cases insist on such an appointment in order to clear up concerns about financial responsibility for charges. Despite the absence of any direct medical component, the costs of obtaining a guardianship or conservatorship are sometimes deductible as a medical expense. To qualify for a deduction, the appointment must be a precondition for admission to the facility, and the charges of the facility itself must be deductible as a medical expense. Assuming this test is met, the taxpayer, among other things, may deduct the fees of petitioner's counsel and also may deduct the fees of respondent's counsel if the appointment of counsel for respondent was required. See *Gerstacker v. Commissioner*, 414 F. 2d 448 (6th Cir. 1969); Rev. Rul. 71-281, 1971-2 C.B. 166.