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Income Tax Planning for Long-Term Care

Dealing with taxes is one of the details that can fall through the cracks during the trying times of sorting out long-term care for an elder. As this article demonstrates, there are many advantages to be gained from keeping up with this aspect of daily affairs. However, the regulations are many and complex and require study and forethought.

By David M. English

Planning for long-term care 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 a tax return and does so at a minimum possible income tax liability. 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. Significant tax benefits are also available to families paying for a parent or other relative's care, including the claiming of an additional personal exemption and deduction of the relative's medical expenses. Individuals not wishing to throw the burden of care on their families or the state may consider purchasing long-term care insurance, the premium payments for which may be deductible. Individuals who are either terminally or chronically ill may also be able to sell or cash in their life insurance policies without concern about adverse income tax consequences.

Signing the Return

Admission to a nursing home does not relieve an individual of the obligation to file a tax return. But the serious mental incapacity often associated with admission to a nursing home or receipt of other long-term care means that nonfiling can easily become a reality. Steps should be taken to make certain that an authorized substitute is available to sign the return. The return may be signed by the person's legal representative, such as a guardian or agent under a durable power of attorney. For a signature of an agent to be effective, the power of attorney must grant the agent authority to handle tax matters and a copy of the power must be attached to the return. Form 2848, the Internal Revenue Service's (IRS) power of attorney form, is inadequate unless modified. The IRS form is a non-
durable power automatically revoked upon the principal's incapacitation. For a married couple, the IRS will also accept a signature by the competent spouse. When signing the incapacitated person's name to the joint return, the spouse must add to the signature that it is being signed "By Husband (or Wife)" and attach a statement to the return explaining why the other spouse cannot sign.

Refund Claims
When representing an individual of declining capacity, the practitioner should be alert to possible errors on the individual's income tax returns and file a refund claim if the amount involved justifies the added expense. Claims for refund must normally be filed within 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, decided in 1997, held that this limitations period was mandatory and could not be suspended on account of the taxpayer's disability. Congress, later in 1997, reversed this result. The running of the limitations period on refund claims is suspended during any period that:

1. The taxpayer is unable to manage financial affairs by reason of a medically determinable physical or mental impairment which can be expected to last for at least one year or result in death; and
2. The taxpayer, during such period of disability, is not represented by a guardian, agent under a durable power of attorney, or other person authorized to handle financial matters.

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 Internal Revenue Code (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 that the child has paid. 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:

1. Has gross income of less than the personal exemption amount ($2,750 in 1999);
2. Did not file a joint return for the year; and
3. Qualifies as the child's dependent.

To qualify as the child's dependent, the parent must

1. Receive over half of his or her support from the child during the taxable year; and
2. Be a U.S. citizen, resident or national, or a resident of Canada or Mexico, for at least part of the taxable year.

Eligible support, whether provided by the parent or child, includes food, shelter, clothing, medical care, and similar benefits. Support may include benefits provided in-kind, such as the fair rental value of in-law quarters in the child's home. Funds expended on support need not be derived from gross income but may include the expenditure of Social Security benefits, although Medicare and Medicaid reimbursements are excluded. Furthermore, funds received by the parent only count in the support equation to the extent actually expended on support. To ensure that the child pays for more than half of the parent's support, the parent and child 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 provide over half the parent's support, the children may agree among themselves as to which child will claim the personal exemption. Under such a multiple support agreement, the child claiming the exemption must have contributed at least 10 percent of the support, and the others who have also contributed at least 10 percent must sign written declarations renouncing their right to the exemption. The written declarations are ordinarily made on Form 2120. The Form 2120s are then attached to the return of the person claiming the exemption.
Deducting a Parent’s Medical Expenses

A parent’s dependency status also determines whether a child may deduct unreimbursed medical expenses of the parent that the child has paid. To deduct a parent’s medical expenses, the child need not meet the additional requirements necessary to claim a personal exemption. 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.14

Before paying a parent’s medical expenses in anticipation 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 paid by the child are deductible only to the extent they exceed 7.5 percent of the child’s adjusted gross income.15

FICA and FUTA Withholding

Spurred on by the “Nannygate” controversy of 1993, Congress in 1994 liberalized the rules on FICA (Social Security and Medicare tax) payroll 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.16 For 1999, the withholding floor is $1,100. The employer is also liable for FUTA (unemployment tax) withholding if the employer has paid more than $1,000 in compensation to a domestic worker or workers during any quarter of the current or preceding year.17 Compliance with the law has also been made easier. Withholding of both FICA and FUTA on the wages of domestic care workers 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.18 Withholding by a taxpayer is not required, howev-
dent under the test described above. To qualify for
the deduction the charges must have been one of
the following:

- Incurred to provide necessary diagnostic, pre-
  ventive, therapeutic, curing, treating, mitigat-
  ing, rehabilitative, or maintenance or person-
  al care services

- Provided pursuant to a plan of care prescribed
  by a licensed health care practitioner (physi-
  cian, registered nurse, or licensed social work-
  er)

A “chronically ill individual” is an individual
who has either a functional or severe cognitive
impairment. To qualify under the functional
impairment test, the licensed health care practi-
tioner must certify that the individual needs substantial
assistance to perform two or more of six specified
activities of daily living (eating, toileting, transfer-
ing, bathing, dressing, and continence). Temporary
need for care does not qualify. The need
for assistance must exist for at least 90 days. To
qualify under the cognitive impairment test—a test
directed primarily at those with Alzheimer’s—the
licensed health care practitioner must certify that
the individual has a severe cognitive impairment
that requires substantial supervision to protect the
individual’s health or safety. Whichever category
fits the individual, the individual’s condition must
be recertified annually.

While perhaps directed primarily at institution-
al care, where plans of care and assessments of
ability to perform activities of daily living have
become almost routine, at least at some facilities,
the deduction for long-term care expenses is also
available for services provided in a private resi-
dence. But obtaining a deduction for such care,
particularly care provided by personal attendants,
requires certain 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. Persons receiving
care in their homes must be certified as “chronical-
ly ill” and the services provided pursuant to a for-
mal 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 per-
form a variety of functions. In sorting out which
functions qualify as deductible “maintenance or
personal care services” as opposed to nonde-
eductible “maid services,” unsubstantiated estimates
will be construed against the taxpayer. But assum-
ing the taxpayer is otherwise able to qualify, the
taxpayer may deduct the attendant’s wages includ-
ing required withholding, the costs of in-home meals,
and, if an overnight stay is required, the added costs of this lodging, including, if necessary,
the expense of renting a larger apartment. Charges for services provided by a spouse or other
relative who is not a licensed professional are not
deductible under HIPAA.

**Long-Term care Insurance**

HIPAA contains detailed provisions on the tax
treatment of long-term care insurance and benefits.
The treatment of long-term care insurance was pre-
viously uncertain for the same reason the
deductibility of direct payment for the services that
it insures was uncertain—the difficulty of sorting
out which charges were for medical and nursing
costs as opposed to other items. The tax treatment
of long-term care insurance is now subject to pre-
cise but complex rules. Beginning in 1997, premi-
ums for qualified long-term care insurance are fully
deductible as a medical expense and the benefits
fully excludable from gross income, similar to
other health insurance. Not surprisingly, the
HIPAA provisions on long-term care insurance
largely track its provisions on the direct payment of
long-term care. Premium payments are deductible
only for insured items that would qualify as
deductible medical expenses were the insured to
pay them directly. This is accomplished by gener-
ally using the same definitions, particularly the same
definition of “chronically ill individual.” When
examining an outline of coverage or specimen pol-
icy, practitioners should look for the required certi-
fication that the policy is tax qualified.

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, such coverage is not entitled to preferential treatment under either a cafeteria plan
or flexible spending arrangement. Nor is it subject
to the COBRA continuation requirements.

Before advising a client to purchase long-term
care insurance, practitioners should be aware of
some limits. Deductible premiums may not exceed
annual caps based on the insured’s age, ranging
from $210 per year for an individual age 40 or less
charges will only benefit insureds who itemize their the actual costs of care unless payable in the form of a daily indemnity of not more than $190 per-day. Finally, the ability to deduct premium charges will only benefit insureds who itemize their deductions and whose premium charges, together with their other medical expenses, exceed 7.5 percent of adjusted gross income.

Responding at least in part to demands for greater consumer protection in the sale of long-term care insurance, HIPAA requires insurers that wish favorable tax treatment to incorporate a number of specified provisions into their policies and to follow certain sales practices. But a safe harbor is provided for pre-1997 policies that fail to comply with the National Association of Insurance Commissioners (NAIC) standards but that complied with the standards of the state whose laws governed the policy at the time of issue.

**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. While originally prompted by the AIDS crisis, viatical settlements and accelerated benefit riders are increasingly being looked to as an alternative to long-term care insurance for financing care of the elderly.

Based on a literal reading of the Code, however, the income tax treatment of such transactions was not favorable. While Code Section 101 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).

HIPAA changed the rules. Starting in 1997, Code Section 101(g) exempts accelerated death benefit proceeds from income tax, whether the proceeds are received directly from the insurance company or in the form of a viatical settlement. But insureds who are “chronically ill” are treated less favorably than insureds who are “chronically ill” but not terminally ill. The definition of “terminal illness” is liberal, requiring that a physician certify that the insured’s death can reasonably be expected to occur within 24 months. If the necessary certification is made, all proceeds paid on account of terminal illness are exempt from income tax, regardless of how applied. For insureds who are certified as chronically but not terminally ill, the exclusion is limited to the amount of qualified long-term expenses or the $190 daily limit applicable to tax-qualified long-term care insurance. The test for determining whether an individual is chronically ill is copied from the long-term care provisions.

Special consumer protection rules apply if the insured does not strike a deal with the insurer but instead sells the policy to a viatical settlement provider. Proceeds from a sale to a viatical settlement provider are excluded from gross income only if the viatical investor is licensed by the state or meets standards established by the NAIC. Special limits also apply if the policy is not owned by the insured. The exclusion from gross income 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 receiv-
ing 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 IRS, however, allows a deduction
based on the facility's past experience with the use
of these services. If the taxpayer is entering a new
facility, the estimate may be based on the experi-
ence of comparable facilities.

If the taxpayer later
leaves the facility, the taxpayer must include in
gross income the portion of any refund attributable
to charges previously deducted.

Endnotes

3. Halper v. Comm'r, 73 T.C.M. (CCH) 1897
   (1997).
19. See Rev. Rul. 56-502, 1956-2 C.B. 688, as modi-
27. See, e.g., Estate of Marantz v. Comm'r, 39 T.C.M.
   (CCH) 516 (1979) (40 percent deductible); Estate
   of Dodge v. Comm'r, 20 T.C.M. (CCH) 1811
   (1961) (50 percent deductible).
37. I.R.C. § 213(d)(10) (1998); Rev. Proc. 98-61,
38. I.R.C. § 7702B(d) (1998); Rev. Proc. 98-61, 1998-
   52 I.R.B. 18.
40. For the required policy provisions and sales prac-
   tices, see I.R.C. §§ 4980C, 7702B(g) (1998).
42. See Barbara Looney, Viatical Settlements—An
   Overview of the Use of Viatical Settlements as a


