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Deducting Medical Expenses

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Introduction

Understanding the tax rules can save you money. This is especially true for caregivers who pay medical expenses for other family members. This memorandum explains the rules regarding medical expense deductions. If, after reading it, you have additional questions, you should speak with your tax advisor.[2]

Section 213 of the Internal Revenue Code (the "IRC") permits the deduction of medical expenses paid by a taxpayer for himself and his spouse. Further, medical expenses paid for other family members are deductible if that family member meets the dependency tests in Section 152. The first two sections of this memorandum explore what we call "The Basic Rule" and the dependency rule to determine whose medical expenses may be deducted. In the last section, we look specifically at which medical expenses may be deducted and limitations on the amount of the deduction.

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[2] The issues discussed in this memorandum are addressed in IRS Publication 502, *Medical and Dental Expenses* (2008).

Deducting your medical expenses: The Basic Rule

Section 213 of the IRC permits the deduction from income taxes of medical expenses paid by a taxpayer during a tax year, which are not compensated by insurance or otherwise, for the taxpayer, his spouse, or a dependent, to the extent that medical expenses exceed 7.5 percent of adjusted gross income.

In discussing the rules in this memorandum, we will use two basic scenarios to explain the deduction rules. The first, involving a couple named Robert and Helen, applies to deductions you take for medical expenses paid for yourself and your spouse ("The Basic Rule"). The second involves Helen's son, Bill, who is paying Helen's medical expenses.

If you are allowed to take a medical expense deduction, you would claim it on Schedule A of Form 1040. You cannot claim a medical expense when filing Form 1040A or Form 1040EZ. Although the Elder Law Practice does not prepare tax returns, if you need assistance, Winter & Scoggins offers tax preparation services.

Breaking the Rule Down

We can break the Basic Rule down into its individual components so it is more easily understood.

First, only those medical expenses that exceed 7.5% of your adjusted gross income are deductible. This element of the rules is simply multiplication. If your adjusted gross income[3] is $100,000, then only those medical expenses exceeding $7,500 are deductible. If your income is $25,000, then only those expenses exceeding $1,875 are deductible.

> *Example: Robert and Helen have adjustable gross income of $40,000. Therefore, they can only deduct those medical expenses exceeding $3,000 (7.5% of $40,000). If they have only $2,500 in medical expenses, then the expenses are not deductible.*

[3] Adjusted gross income is defined as gross income minus adjustments to income. In 2008, it was the figure appearing on line 37 if you filed Form 1040. See also IRC, § 62,

Although medical expenses must exceed the 7.5% threshold, as shown below, medical expenses paid on behalf of certain other relatives are added together with the taxpayer's medical expenses in determining whether the deduction is available. This is what we discuss in the next section (Deducting someone else's medical expenses).

> *Example: In addition to the income and expenses in the preceding example, Robert and Helen paid $3,500 for nursing home care for Robert's mother. Assuming Robert's mother is a qualifying relative (see below), Robert and Helen can add those expenses together with their own medical expenses, bringing the total medical expenses to $6,000. Since 7.5% of their AGI is $3,000, they take a $3,000 income tax deduction.*

Second, the deduction applies only to "income taxes" and only offsets income earned during the year when the medical expense is paid. Therefore, if you do not generate income, you cannot take advantage of the deduction; even if you have income, the deduction may be underutilized if you have too much deferred income. Many seniors have income that is subject to deferred taxation (e.g., IRAs). Sometimes it is advisable to trigger tax recognition to take advantage of current tax deductions.

> *Example: Generally, Robert and Helen do not pay income taxes because they do not earn sufficient income to do so. They live off of their Social Security income and tax their required minimum distributions from Individual Retirement Accounts. However, this year Helen had $10,000 in medical expenses that were not covered by Medicare or other insurance. They withdrew funds from their IRA to pay Helen's bills. Normally, when funds are withdrawn from an IRA, they are taxed as income. Because Robert and Helen incurred uncovered medical expenses, the expenses above 7.5% of their adjusted gross income offset this additional income, keeping their tax bill low.*

> *Example: Robert and Helen had medical expenses in 2007, but did not earn enough income in 2007 to take advantage of the deduction. In 2008, they generated income by withdrawing $10,000 from their IRA to buy a new car. When they prepared their tax return, they started looking for deductions and wondered whether they could deduct the 2007 medical expenses. The answer is "no" because the medical expenses were incurred during a different tax year.*

The deduction is taken during the year when medical expenses are paid, not the year a procedure occurred. If a question arises concerning whether a payment was made during a particular tax year, expenses paid by check are deemed paid when the check is mailed or delivered. If you pay expenses online, then the payment date is the date reported on your bank statement.

> *Example: Robert had surgery in December, 2007. Later, he discovered that $5000 was not covered by Medicare or insurance. Robert paid the expense in January, 2008. If a deduction is allowed, it would be taken on Robert's return for the 2008 tax year.*

Third, the medical expenses being deducted cannot be covered by insurance or otherwise (E.g., Medicare or Medicaid). Really, this means that the taxpayer taking the deduction must be the person paying the medical expenses. If the expenses are paid by a health insurance policy, a long-term care insurance policy, Medicare, Medicaid or by someone else (e.g., someone who injured you), then they are not deductible.

> *Example: Robert and Helen have Medicare and supplemental policies. When Robert had heart surgery, to his surprise, Medicare and his supplemental policy paid all of his hospital and physician bills. Because they were paid by Medicare and insurance, Robert cannot deduct those medical expenses.*

Fourth, only expenses relating to "medical care" can be deducted. Believe it or not, the IRS has defined the phrase "medical care." We discuss what the IRS means by "medical care" in the last section of this memorandum.

Fifth, the medical expenses being deducted must have been incurred for the taxpayer, his or her spouse or for a dependent. Deducting your own medical expenses seems to be self-explanatory. To deduct a spouse's expenses, there must be a valid marriage under State law. You should keep in mind that Georgia did away with common law marriage in 1997, so there must be an actual marriage ceremony. Also, the couple cannot be living apart under a separate maintenance agreement. We will cover the meaning of dependency in the next section.

> *Example: After 40 years of marital bliss, Robert and Helen started arguing in 2007 and Helen moved out. Although the couple did not want to divorce, Helen went to court and got an order requiring Robert to pay $500 per month for separate support. In 2008, Helen had $7,500 in uncovered medical expenses. Even though Robert paid those expenses, he cannot deduct them because the tax rules do not treat Robert and Helen as a married couple while there is an order for separate maintenance in place.*[4]

Applying the Basic Rule

Robert has $1,200 per month in income from Social Security, plus another $700 per month from a pension. His wife, Helen, has $1,000 per month of income from Social Security. Their combined annual marital income (AGI) is $34,800. For purposes of this example, we will ignore any other deductions they may have, as well as any special tax treatment they may get for being over 65.[5]

This year, Helen had two root canals, followed by two crowns. The total cost of her dental care was $4,000. Medicare did not pay for Helen's dental work and it was not otherwise covered. When the couple calculated 7.5% of their adjusted gross income, they found that they were able to deduct $1,390.

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[4] IRC, § 213(d)(8); IRC, § 6013(d).
[5] *See* IRS Publication 554, *Tax Guide for Seniors* (2008); and IRS Publication 524, *Tax Credit for the Elderly or Disabled* (2008).

Deducting someone else's medical expenses: Who is a Dependent

In this section we discuss the circumstances that must exist before you can deduct medical expenses paid for someone else. Section 152 of the IRC defines the term "dependent," which links back into "The Basic Rule" described above. If an individual is your dependent, and if you pay his or her medical expenses, then you can add those expenses together with your own when calculating the cumulative amount of your medical expense deduction.

Determining whether an individual meets the IRS's definition of "dependent" is the starting point in determining whether you can deduct someone else's medical expenses. For example, if you pay your mother's medical expenses, then you can deduct them if, and only if, she is your dependent.

Section 152 identifies two types of dependents. They are the "qualifying child" and the "qualifying relative." To deduct someone's medical expenses, he or she must be the taxpayer's dependent either at the time medical services were provided, or when they were paid. The rules relating to children and relatives require further explanation so we will address them one at a time.

Who is a qualifying child?: Grandchildren and Special Needs Children

In general, a qualifying child is someone who is under the age of 19 and who resides with the taxpayer for at least one-half of the year. As a general rule, medical expenses you pay for your minor children are deductible if they live with you.[6] For our purposes, however, we primarily explore deductions for: (1) grandparents caring for grandchildren; and (2) special needs children **over** the age of 19.

In general, there is a four (4) element test that must be satisfied before a taxpayer can deduct a child's medical expenses. The child must:

1. Be related to the taxpayer;
2. Live in the same residence with the taxpayer for at least one-half of the tax year;
3. Meet the age requirements established under the tax code; and
4. Not provide more than one-half of his or her own support.

Breaking down the rule

First, how does the IRS define the term "child?" The tax definition of the term "child" is more expansive than one might think. It includes the taxpayer's natural and adopted children. It *also* includes:

- Stepchildren;
- Foster children;
- Grandchildren;
- Brothers, stepbrothers and their descendents; and

[6] Special rules apply when a divorced couple shares custody. We omit them here because our focus is on elders.

- Sisters, stepsisters and their descendents.

> *Example: Helen's daughter is unable to care for her child, so Sally, her granddaughter, lives with Helen. Sally needs braces for her teeth. Assuming the other elements of the "qualifying child" test are met, Helen applies "The Basic Rule" described above and deducts the cost of Sally's braces exceeding 7.5% of AGI because Sally is Helen's dependent.*

Second, the "child" must live in the same residence with you for at least one-half of the tax year.

Third, the "child" must meet the age requirements established in the tax code. Normally, a child is only a dependent for tax purposes until he or she attains the age of 19. The IRS allows a taxpayer to continue treating a child as a dependent until age 24 if the child is a full time student. More importantly for our purposes, the child can be any age if he or she is permanently and totally disabled.

When disability is an issue, generally the Social Security definition of "disabled" applies. This means that the child cannot engage in any substantial gainful activity because of a physical or mental condition. A doctor must determine that the condition causing disability is expected to last for at least 12 months, or that it will result in death. If the child has been awarded Supplemental Security Income or Social Security Disability income, then the child is disabled.

Fourth, the "child" cannot provide more than one-half of his or her own support.

> *Example: Rachel's brother, Mark, is disabled. He receives Supplemental Security Income of $429 per month (reduced from $674 per month because Rachel provides in-kind support). On an annual basis, Rachel spends more than $429 per month supporting Mark so she pays more than one-half of Mark's support expenses. If Rachel pays Mark's medical expenses, then she can deduct them to the extent cumulative medical expenses total medical expenses exceed 7.5% of Rachel's adjusted gross income.*

Applying the Rule

Rachel brother, Mark, has severe autism and lives with her. Mark is 26 years old. The Social Security Administration found that Mark is disabled, awarding him Supplemental Security Income. Mark requires constant supervision, which Rachel found will cost about $17 per hour.

Rachel and her husband have adjusted gross income of $80,000. They have determined that they need about 30 hours per week of assistance caring for Mark. At $17 per hour, this means an annual expense of $26,520.

1.	Child/Relationship	Mark meets this test (brother).
2.	Same household	Mark meets this test.
3.	Age	Although Mark is 26, he meets the this

		test due to his disability.
4.	Support	Although Mark receives SSI income, Rachel provides more than one-half of his support.

Assuming Mark's care qualifies as a medical expense (see below), the cost of care is combined with Rachel's other medical expenses. When those expenses are combined, the amount in excess of $6,000 (7.5% of Rachel's adjusted gross income) is deductible.

Who is a qualifying relative?: Parents and Other family members

A "qualifying relative" is someone who is closely related, who is not a qualifying child, and whom the taxpayer supported during the tax year. No age limit applies when determining whether someone is a qualifying relative.

As with the previous section, there are four (4) elements to consider when determining whether someone is a qualifying relative. To meet the test, the relative must:

1. Be closely related as defined in the tax code;
2. Have gross income below the dependency exemption amount for that tax year;
3. Be supported by the taxpayer; and
4. Not be a qualifying child.

Breaking down the Rule

First, the relationship must be sufficiently close. The tax code specifies that the relationship is sufficiently close if the relative is:

- A child or grandchild;
- A brother, sister, stepbrother or stepsister;
- A father or mother, or ancestor of either;
- A stepfather or stepmother;
- A son or daughter of a brother or sister;
- A brother or sister of the taxpayer's father or mother;
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or
- An individual (other than a spouse) who, for the applicable tax year, resides with the taxpayer and is a member of the taxpayer's household.[7]

Generally, this rule is broad enough to cover most family members other than cousins. Persons who do not meet the relationship test must live with you for the *entire* tax year.

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[7] The "resides with" requirement usually requires that the taxpayer and the individual reside in the same principal residence for the entire year. However, there are exceptions. The regulation provide that "a nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which the dependent is absent for less than six months in the taxable year of the taxpayer, shall be considered temporary absence due to special circumstances. The fact that the dependent dies during the year shall not deprive the taxpayer of the deduction if the dependent lived in the household for the entire part of the year preceding his death." 26 C.F.R. § 1.152-1(b).

Second, the relative cannot have income in excess of the dependency exemption amount. In 2008, the dependency exemption amount was $3,500. Tax-exempt income, such as certain Social Security benefits, is not included in calculating an individual's gross income for purposes of this element of the test.[8] It would be considered in the next element when determining whether the taxpayer provides more than one-half of the individual's support.

Third, the relative must be supported by the taxpayer. This means that the taxpayer claiming the deduction must have contributed more than fifty-percent (50%) toward the cost of supporting the dependent.

In determining the amount of support provided, all income that the relative contributed toward his or her own expenses is counted, regardless of whether it is included in the relative's adjusted gross income. Thus, even though Social Security income is not included in adjusted gross income, it would be included in determining whether the taxpayer provided more than half of the relative's support.[9]

If non-cash support is provided, then the amount you spent is the fair market value. Thus, if you provided housing, then the value is the fair rental value of the housing. Expenses not directly related to a family member are divided among the members of the household (e.g., the grocery bill is divided by the number of persons living together).

IRS Publication 17 (2008) indicates that if an individual does not use funds for his or her support, then those funds are not counted. The following example is provided: Your mother received $2,400 in Social Security income, plus $300 in interest. She spent $2,400 on lodging and recreation and saved $300. Because she only spent $2,400 on her support, if you spent more than $2,400 for her support, then you met this element of the test.

Fourth, the relative cannot be a qualifying child. In essence, this element of the test prevents an individual from qualifying under both dependency tests. This rule also prevents use of the deduction if the individual is not your qualifying child, but is someone else's qualifying child.

Applying the Rule

Bill is single. He lives with his mother, Helen, in Dalton. Bill works 50 hours per week. Although Helen receives a small Social Security check, Bill pays more than one-half of Helen's living expenses because he provides housing, pays the utilities and buys the groceries.

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[8] IRS Publication 915, *Social Security and Equivalent Railroad Retirement Benefits* (2008), indicates that, generally, Social Security benefits are tax exempt unless other income is earned. SSI benefits are not taxable. See also IRC, § 86.
[9] 26 C.F.R. § 1.152-1(a)(2)(ii).

Helen suffered multiple strokes over the last 10 years, which debilitated her. Recently, she was diagnosed with a malignant melanoma on her foot, resulting in a partial amputation. Helen spent a month in rehabilitation, learning to walk with the help of a prosthetic device and then returned home. Bill remodeled part of the house to accommodate Helen's disability, spending about $2,000.

Bill has also spoken with Helen's doctor about getting nursing care in the home. When he checked prices, he discovered that in-home assistance would cost about $17 per hour. Assuming Helen needs assistance while Bill is at work, even 40 hours of assistance per week would cost $35,360 per year.

Bill's concern is whether he can deduct the cost of caring for Helen. His adjusted gross income is $100,000. Therefore, he can only deduct medical expenses the exceed 7.5% of his AGI, or $7,500. Assuming Helen is Bill's dependent, and assuming he spends $35,360 per year for nursing services, then Bill may be able to deduct up to $27,860, assuming Helen's expenses are classified as medical expenses. Bill can also deduct the cost of remodeling if those expenses are primarily to meet Helen's medical needs as described below.

In determining whether Helen is a dependent, the situation is analyzed as follows:

1.	Relationship	Helen meets this element (mother).
2.	Income	Helen's income, other than Social Security, is less than $3,500.
3.	Support	Bill is paying for more than one-half of Helen's expenses.[10]
4.	Not a qualifying child	Helen meets this element.

What expenses are deductible?

In the first two sections of this memorandum we examined which individual's medical expenses are deductible. In this final section we will look at which expenses are deemed to be deductible medical expenses and the amount that can be deducted.

Traditional medical expenses

Only expenses for "medical care" are deductible. Most medical and dental procedures will be covered if they are medically necessary. These include hospitalizations, lab tests, physician services and the like. According to the IRS, "medical care" means the following:

> Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the costs for treatments affecting any part or function of the body. They include the costs of equipment, supplies, and diagnostic devices needed for these purposes. They also include dental expenses.

[10] A worksheet for calculating "support" appears at page 33 of IRS Publication 17.

> Medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness. They do not include expenses that are merely beneficial to general health, such as vitamins or vacation.
>
> Medical expenses include the premiums you pay for insurance that covers medical care, and the amounts you pay for transportation to get medical care. Medical expenses also include amounts paid for qualified long-term care services and limited amounts paid for any qualified long-term care insurance contract.[11]

Medicines and drugs

There are additional rules limiting what the IRS means by "medical care." One we cover here relates to medicines. A deduction is permitted for medicines and drugs only when the medicine or drug is prescribed, or is insulin.[12] In other words, over the counter medications are not deductible.

Travel: Can I get medical care in Hawaii and deduct the Trip?

You can deduct necessary travel costs and lodging costs associated with medical care, but the IRS will not let you disguise a vacation as a medical trip. Section 213 specifically provides that travel expenses are deductible only where "there is no significant element of personal pleasure, recreation, or vacation in the travel away from home."

> *Example: Robert was working in his garage when a fire started and he suffered serious burns. He was flown to a burn center in Texas. The cost of his transportation is deductible. If, after his discharge, he has to fly to Texas for additional outpatient treatment, then his travel and lodging will be deductible as long as those trips are for medical care.*

Home Improvements

Capital improvements are deductible if the primary purpose is for medical care. The improvement must not be related to permanent improvement or betterment of the property; if the improvement increases the property value, then the expense is allowed only to the extent that its cost exceeds the increase in property value. For example, if (1) an elder's heart condition requires installation of an elevator in a home, (2) the cost of the elevator is $10,000, and (3) the property value increases by $5,000 after installation, then the allowed medical expense deduction is $5,000. Nonetheless, while the medical condition exists, the entire cost of maintenance and operation is deductible.

When are Long-Term Care expenses deductible?

Not all long-term care costs are deductible. This is because long-term care is not always deemed to be medical treatment. Instead, long-term care provides assistance with activities of daily living (e.g., bathing, grooming, etc.). Long-term care is deductible only when "qualified long-term care services" are provided to a "chronically ill individual."

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[11] IRS Publication 502 (2008), p.2. See also IRC, § 213(d)(1).
[12] IRC, § 213(b).

Qualified long-term care services are necessary diagnostic, preventative, therapeutic, curing, treating, mitigating, or rehabilitative. They also include services required for maintenance and personal care. Generally, they must be:

- Required by a chronically ill individual; and
- Be provided pursuant to a plan of care prescribed by a licensed health care practitioner.

A chronically ill individual is someone who has been certified by a licensed health care practitioner as:

- Being unable to perform (without substantial assistance) 2 or more activities of daily[13] living for 90 days or more due to a loss in functional capacity;
- Having a level of disability causing the individual to need assistance with activities of daily living; or
- Requiring substantial supervision to protect the individual from threats to health and safety due to cognitive impairment.

Example: Helen cannot get around well enough to cook her own meals and clean her home. Although Helen needs help and could not live independently without it, she cannot deduct the amount paid for help because the help is deemed to be household help rather than a medical expense. (An exception applies for certain maintenance and personal care services provided for qualified long-term care).

Example: Helen felt isolated after her husband, Robert, died. She decided to move into an assisted living facility. She moved, primarily because she had friends there and not because of a physician's recommendation. Her expenses are probably not deductible. On the other hand, if Helen had moved into assisted living pursuant to a doctor's advice because her arthritis and Osteoporosis made it unsafe for her to live alone, then her expenses may be deductible.

Deducting Long-Term Care Insurance Premiums

Premiums for long-term care insurance can be deducted only when the insurance contract meets the definition of a "qualified long-term care insurance contract." The policy meets the definition if:

1. The only coverage is for qualified long-term care services;
2. The Policy does not reimburse expenses paid by Medicare;
3. The contract is guaranteed renewable;
4. The contract does not provide for a cash surrender value;
5. All premium refunds must be applied as a reduction in future benefits or to increase future benefits; and
6. If certain consumer protection provisions appear in the contract.

[13] Activities of daily living include eating, toileting, transferring, bathing, dressing and continence.

Generally, an insurance carrier must tell you whether the insurance contract is a qualified long-term care insurance contract. If you are also planning to protect assets from potential Medicaid spend-down, then you should keep in mind that an individual qualified long-term care insurance contract purchased on or after January 1, 2007, increases the exemption amount, protecting a greater level of assets.

The deduction for long-term care insurance premiums is age weighted. In 2008, the following are the maximum deductions for long-term care insurance premiums:

1.	Aged 40 or under	$290
2.	Age 41 to 50	$550
3.	Age 51 to 60	$1,110
4.	Age 61 to 70	$2,950
5.	Age 71 or over	$3,680

Conclusion

When you pay someone else's medical expenses, knowing the tax rules may save you money. You should also keep in mind that planning opportunities exist for restructuring estates to take advantage of these rules. You should keep in mind, however, that planning to accelerate public benefits eligibility (e.g., Medicaid or Veterans benefits) forces us to examine a host of other rules. Unless you understand the applicable rules, public benefits planning should only be undertaken with the assistance of a qualified professional.

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The Elder Law Practice assists elders and special needs individuals in Georgia and Tennessee with a wide range of legal issues, including eligibility for Medicaid.