Chapter 5: Tax Planning for People with Disabilities

Corrections were made to this workbook through January of 2004. No subsequent modifications were made.

Demographic statistics reflect the fact that Americans are living longer, resulting in a growing number of taxpayers who will either become or care for disabled individuals. This chapter summarizes tax provisions and decisions that affect the disabled and/or handicapped.

GROSS INCOME

Disabled individuals receive a variety of cash benefits from numerous sources. Some of these benefits are excluded from taxation, others are partially taxable, and some are fully taxable.

EXCLUDABLE BENEFITS

Common sources of excludable benefits are shown below. The statutory or judicial authority is also discussed.

Accident or Health Insurance Benefits from a Policy Paid Entirely by Taxpayer

If an individual pays the entire cost of an accident or health plan, any benefits received from the plan for personal injury or sickness are excludable. However, if the individual and his employer **each** paid **part** of the premium, an allocation is required to determine the taxable and nontaxable portion of each payment.

Example 1A. Alice is disabled by an accident. She receives $2,500 per month for life under an insurance policy for which she paid all of the premiums. Therefore, the entire $2,500 monthly benefit is excluded from her gross income.

Example 1B. Assume the same facts as **Example 1A,** except Alice's employer paid **80%** of the premiums and Alice paid the remaining 20%. In that case, only $500 per month is excludable. $2,000 per month (**80%** of $2,500) is taxable and must be included in her gross income.

Military Disability Pensions

Certain military disability pensions are not taxable.

Service-Connected Disability. Individuals may be able to exclude a pension received due to personal injury or sickness resulting from active service in the armed forces of any country.

Conditions for Exclusion. The disability payments are not included in gross income if **any** of the following conditions apply:

- The disability payments began before September 25, 1975.
- The individual was a member of the military, including reserve units, on September 24, 1975.
- The disability payments are received for a combat-related injury.

- The individual would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if he applied for it. The exclusion under this condition is equal to the amount the individual would be entitled to receive from the VA.

More information regarding VA disability benefits is discussed later in the chapter.

Damage Awards Related to Personal Injury or Sickness

Damage awards resulting from personal injuries or illness are often received by individuals who become disabled. These damage awards include payments:

1. To **compensate** the individual for his condition, and
2. To **punish** the party responsible for the situation.

The **compensatory** portion of the payment is **excluded from gross income;** however**,** the **punitive** portion is **fully taxable.**

Example 2. Bart is disabled on the job. He sues the company that manufactured the equipment that injured him. The jury awards him compensatory damages of $100,000 and punitive damages of $200,000. If the full payment is received in the current year, Bart will report $200,000 of gross income. After the verdict, however, the manufacturer's insurer, Illini Casualty Enterprises (ICE) proposes an alternative payment method (i.e., $80,000 per year over a 4-year period). If Bart opts for this alternative, the annual payments would be reported as follows:

Compensatory damage portion	$25,000	(not reported)
Punitive damage portion	50,000	(reported as gross income)
Interest portion	5,000	(reported as gross income)

Another possible route for Bart with ICE is a **structured settlement** which involves ICE purchasing an annuity policy. The annuity company would make periodic payments to Bart. A structured settlement can result in all of the income being excluded from gross income for Bart. Since structured settlements represent an area of extreme complexity, coverage of the particulars is not covered in this chapter.

Example 3. Bart was disabled in an auto accident. His attorney negotiated a settlement for $100,000 of compensatory damages and $200,000 of punitive damages. Bart must include the $200,000 in gross income when he receives it.

Fixed Benefit Accident and Health Insurance Policy

These policies are normally acquired by an individual to provide protection against a specific illness (e.g., cancer, heart attack) or injury. Since they are not designed to protect earnings, the entire amount received is tax exempt.[1]

Long-Term Care Insurance Proceeds

Payments received from a long-term care insurance policy are, in general, excludable from income. The insurance contract must only provide coverage for qualified long-term care which includes a variety of services (e.g., diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative) and/or maintenance or personal care services prescribed by a doctor for a chronically ill individual. The exclusion for the year 2003 is $220/day. For most taxpayers, all of the proceeds received from long-term care insurance contracts are fully excluded from gross income.[2]

Example 4. Willis Bruce, a chronically ill individual, is also disabled. During 2003, Bruce receives $36,000 ($3,000 per month) to cover prescribed personal care services. Since Bruce's exclusion for the year 2003 exceeds $36,000 ($220/day × 365 = $80,300), the $36,000 is excluded from income.

Medical Expense Reimbursement for Current and/or Future Expenditures

When a disabled person is reimbursed for actual and/or anticipated medical costs, the amount received is not considered an element of gross income. Instead, the taxpayer must reduce the amount of allowable medical expenses. Proper treatment of the medical expense deduction is covered below.

Care must be exercised when a payment contains an element of medical care reimbursement and some other factor (e.g., personal injury damages). Where a specific allocation has not been made, it is presumed the medical settlement is received initially. While this has no gross income implications, it can impact the amount of medical expenses included in itemized deductions.

Payments for Loss of Limbs and/or Disfigurement

These payments are excluded from gross income under IRC §105(c) which states:

Gross income does not include payments for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement of the taxpayer, his spouse or a dependent.

Profit-Sharing Distributions

When an individual's disability results in distribution of both the vested and nonvested portion of a profit-sharing plan, the entire distribution may be exempt. One court case, *James A. Wood*, addressed this issue and generated the following response: "The *Wood* case could mean that payments from any plan, profit-sharing or otherwise, which provides for payments on disability, will be exempt, if they would have been exempt if paid from an accident and health plan."[3] Mr. Wood's situation involved a qualified profit-sharing plan that was designed to share profits, provide security, and make distributions to an individual incurring permanent total disability.

State or Local Government Payments

Disabled individuals may receive benefits from state or local governments for specific (e.g., fuel costs, rent payments) or general use. These supplemental or one-time benefits are not included in gross income.[4]

Supplemental Security Income (SSI)

Disabled individuals are eligible to receive tax-free Supplemental Security Income (SSI) payments if certain stringent qualifications are met. SSI benefits may be restricted, revoked, or recovered, but they are never taxable. Social security disability benefits, as opposed to SSI payments, are treated the same for income tax purposes as social security retirement benefits.

VA Disability Benefits

Disability pensions received from the VA are not included in gross income. If military disability benefits are paid to a retired military person, the retiree is allowed to exclude from income the amount of disability benefits equal to the VA benefits he was entitled to receive.

> **Example 5.** Regis and Rhonda are disabled retired military personnel. Regis receives $8,400 per year from the VA as a disability pension which is excludable. Rhonda's army disability benefits are $18,000 per year. If Rhonda had applied for and received VA benefits, they would have been $8,400 annually. Thus, Rhonda must include $9,600 per year in her gross income ($18,000 – $8,400 = $9,600). The balance of $8,400 is excludable.

Workers' Compensation

Personal injuries or sicknesses that trigger benefits from a state or local government workers' compensation fund are excluded from taxation.[5] Workers' compensation may be received in a lump sum or a series of payments.

> **Note.** See the *Norris* 9th Circuit Court of Appeals case in the Rulings and Cases chapter for an interesting factual situation concerning workers' compensation benefits.

Other

Several other potential sources of gross income are granted exemptions. For instance, a taxpayer can exclude up to $5,000 per year for dependent care assistance provided under an employer's qualified dependent care assistance plan. This is most likely to be used by an individual caring for a person with a disability who is not capable of self-care.

IRC §79(b)(1) allows a disabled individual to have more than $50,000 of group term life insurance coverage without any tax implications. To qualify for this exemption, the disabled employee must be retired.

Benefits from a "no-fault" insurance policy that are related to the loss of earning power are not included in gross income. Rev. Rul. 73-155 declares that the exemption occurs since the amounts received are deemed to be "accident or health insurance for personal injuries or sickness."

Also, based on IRC §104(a)(5), an exemption is allowed to any person who, while an employee of the U.S. government after 1976, was disabled as a direct result of an act of violence outside of the United States. The Secretary of State must determine that a terrorist attack occurred while the individual must prove that he was engaged in official duties when injured.

TAXABLE OR PARTIALLY TAXABLE BENEFITS

Some disability payments are partially or fully included in gross income. Often the individual receiving the payment must calculate the amount to be included based on the type of payments involved.

Partial Taxability

As indicated in **Example 1B,** accident or health insurance benefits attributable to employer contributions are taxable to the recipient.

Example 6. As a result of a cost-of-living adjustment, Alice's monthly disability benefit is increased from $2,500 to $2,700. Since Alice paid 20% of the premiums while she was employed, her new monthly exclusion amount is $540. The remaining monthly amount of $2,160 is taxable.

When annuity contract payments are received due to a disability, the taxable portion depends on the investment in the contract and the expected return per IRC §72.

A ratio (investment in the contract ÷ expected return) is used to determine how much of the annuity payments are excluded. Under IRC §72(b)(2), the exclusion applies until the investment in the contract is recovered.

Example 7. Eunice is disabled before reaching her normal retirement age. She invested $12,000 in her annuity contract which has an expected return of $200,000. Eunice's exclusion ratio is **6%** ($12,000 ÷ $200,000).

If Eunice receives $8,000 of annuity payments in 2003, $480 (6%) is excludable and the remaining $7,520 is taxable.

Note. If and when the excluded portion accumulates to $12,000, subsequent annuity payments are fully taxable.

Provisions in a life insurance or endowment contract may permit a recently disabled individual to receive certain benefits while coverage continues. Often, this privilege is used as a marketing strategy by insurance companies. In such situations, proceeds that exceed the cost of the policy must be included in gross income.

Full Taxability

If accident or health insurance plans are fully funded by an employer, all payments in excess of the disabled individual's out-of-pocket medical costs are fully taxable. This tax treatment also applies to wage continuation payments that occur before insurance benefits begin. For example, normal and usual wages are to continue for 90 days before the insurance policy becomes operative. Thus, if the employer or a policy fully paid by the employer is the source of the accident or health insurance benefits, the recipient must recognize income under the general rule stated in IRC §105(a).

A medical reimbursement that applies to medical expenses deducted in a prior taxable year is fully taxable.[6] The same treatment also applies to the punitive portion of damages.[7]

Example 8. In 2002, Florence Falcon was involved in an incident that caused her to miss six months of work. The incident occurred due to a faulty relay in machinery manufactured by Atlanta Alliance (AA) which was used in the engineering operation of Peach Enterprises (PE). Florence received severe burns on her hands. Payments received by Florence during 2003 included:

- $16,000 from PE to cover wages lost while recuperating.
- $32,000 from Hawk Insurance Corp. to reimburse Florence for medical expenses deducted on last year's tax return.
- $52,000 from AA which represented a punitive damage payment.
- All of the $100,000 received in the current year must be included in Falcon's gross income.

DEDUCTIONS TOWARD AGI

Individuals with disabilities are not treated any differently for tax purposes when it comes to deductions toward AGI. One of the deductions that may be worth looking into is the deduction allowed for payments to a Medical Savings Account (MSA). Employees of small businesses and self-employed individuals are allowed to make tax-deductible deductions into Archer MSAs and withdraw the money tax-free when necessary to handle the costs of medical care that is routine and preventive. If the money in the Archer MSA is not spent by the end of the year, the taxpayer is given a choice of having the funds remain in the account or rolling the funds into an IRA. In either case, the activity is tax free.

No other deductions toward AGI are specifically affected by an individual's disabled condition.

Note. It could be argued that the moving expense provision should be altered to include transfers directly related to an individual's disability (e.g., move into a warmer climate by a wheelchair user) but to date no activity has been reported.

DEDUCTIONS FROM AGI

Dependency exemptions and itemized deductions can be identified for the disabled individual and for those who support and/or care for the individual.

DEPENDENCY EXEMPTION

There are several tests (e.g., income, relationship to taxpayer) which must be met before an individual qualifies as a dependent on a tax return. In the case of a handicapped or disabled person, the support test may be the most difficult to meet if the person with a disability is receiving a scholarship or is institutionalized.

In general, scholarship amounts do not enter into support calculations. However, this provision applies only if the scholarship has been awarded to a full-time student who is a step-, adopted, or biological child of the taxpayer.

Example 9. Beth Boyd, a disabled teenager, receives an $8,000 scholarship to attend Hoosier College. Larry Boyd, Beth's father, provides for all of Beth's other needs and spends $7,000. Beth qualifies as a dependent of Larry Boyd.

Example 10. Assume the same information as **Example 9,** except Larry Boyd is Beth's grandfather. No dependency exemption is allowed to Larry Boyd.

Live-in help (e.g., housekeeper, maid, attendant) is common in a household that includes a disabled individual. Claiming the person providing the assistance and who is a member of the household as a dependent is not allowed, regardless of the value of the board and lodging. For employment tax provisions for household employees, see Chapter 9 Employment Taxes.

ITEMIZED DEDUCTIONS

Several categories of itemized deductions (e.g., taxes, interest) are not directly influenced by an individual's disability or handicap. However, impairment-related work expenses are included as an Other Miscellaneous Deduction on Schedule A.

IMPAIRMENT-RELATED WORK EXPENSES (BUSINESS OR MEDICAL)

If a disabled individual must pay for assistance while traveling, the deductibility as a work expense depends on whether the expense is solely business related. If the assistance is needed for both business and personal reasons, the expense is treated as a medical expense unless it can be demonstrated that the assistance is only required when the disabled person is traveling. Rev. Rul. 75-317 addresses the work expense versus medical expense distinction. The following three examples were included in the ruling.

Example 11. Karen is disabled. When she travels for her employer, she arranges for a typist/research clerk to be available at the out-of-town location. Since Karen requires this assistance only in business travel status, the cost is treated as an impairment-related work expense.

Example 12. Lamont, a disabled individual, hires a typist/research clerk who also handles his personal care while traveling. When Lamont is not in a travel status, he has similar needs. Since Lamont's away-from-home expenditures involve both business and personal needs, the expense is treated as a medical expense.

Example 13. Marika is a disabled individual who requires personal care assistance only when she travels for business. Since the assistance is only needed when she travels for business reasons, the expense qualifies as impairment-related work expense.

Impairment-related work expenses are deducted on line 27, Schedule A as Other Miscellaneous Deductions and are not subject to the 2% AGI reduction. These expenses are based on criteria described in Rev. Rul. 75-316 which include:

- Satisfactory performance of the individual's work requires the expense,
- Services being paid for are only incidentally related to the individual's personal activities, and
- Specific mention of the expense is not included in the Code or its nonjudicial interpretations.

Special transportation needs of a disabled individual do not generally qualify as impairment-related work expense. For example, an individual who used taxicabs since this is the only mode of secure transportation available is not allowed a deduction.[8] However, a medical expense deduction is reported if a disabled individual incurs costs for special transportation in traveling to and from a place of employment. In this instance, medical costs include the amount that exceeds the normal commuting expenses.

MEDICAL EXPENSES

Tax law regarding health care expenses for the disabled is summarized in the following sections.

Property Expenditures

The following table shows the medical expense deductions allowed for various equipment that disabled individuals may purchase. The listing is not comprehensive but illustrates expenditures which provide assistance or service over a long period of time and are treated as current medical expenses.

Treatment of Equipment for the Disabled

Equipment, Machinery, Possessions, and Other Property	Deduction Information	Specific Provisions and Other Comments
Autoette	Cost plus maintenance and operating expenses.	Must be purchased to alleviate illness or other physical conditions.
Air conditioner	Cost plus maintenance and operating expenses.	Must not become permanent part of the structure. Installed primarily to alleviate illness or other physical condition.
Braille books and magazines	Cost exceeding the cost of regularly printed editions.	None.
Crutches	Cost.	None.
Capital expenditures that accommodate a residence for a physically disabled individual (e.g., ramps, railings, support bars, structure adjustments)	Cost of the equipment and the labor involved.	None.
Capital improvements (e.g., elevators, ramps, swimming pools)	Cost of the improvement(s) is reduced by the change in the improved property's FMV. Maintenance and operating expenses.	The taxpayer must have a property interest in real property.
Car or other vehicle	Difference between the cost of specially designed vehicle and a regular vehicle.	Equipment enables the disabled person to enter, operate, and/or use the vehicle.
Devices to aid the disabled (e.g., artificial limbs, braces, eyeglasses, educational aids, hearing aids, prosthetics)	Cost plus maintenance and operating expenses.	Devices assist the individual in the activities of daily living.
Guide dog	Cost and maintenance.	Medical expense treatment is mandated.
Hospital bed	Cost plus maintenance and operating expenses.	Special mattress required is also deductible.
Manual and motorized wheelchairs	Cost plus maintenance, repairs, and operating expenses.	None.
Reclining chair	Cost plus maintenance and operating expenses.	Must be acquired to alleviate or prevent a specific condition.
Shoes	Cost in excess of the amount paid for a regular pair of shoes.	Lifts and special heels are deductible.
Special stockings	Cost.	None.
Telephone equipment	Cost plus maintenance and operating expenses.	Purpose of the equipment is to assist the disabled individual to use the telephone.
Vehicle equipment (e.g., hand controls, lift, keyless entry system)	Cost plus maintenance and operating expenses.	Equipment enables the disabled individual to enter, operate, and/or use the vehicle.
Water fluoridation and/or purification attachment	Cost to acquire (or rent) and install.	A doctor's prescription is required.

Service Expenditures

The issue of service expenditures incurred for work-related reasons was previously covered.

Generally, services provided by an attendant or nurse are deductible as medical expenses. If the person providing the service is not licensed, it is the nature of the service that determines its deductibility. Thus, expenses of a guide who accompanies a blind child to school is deductible as medical expenses.[9] Included as medical expense are the wages, social security taxes, unemployment taxes, and medical insurance of the service provider. If household and other nonmedical duties are performed, an allocation is required between medical expense and nondeductible personal expense.

Nursing home expenses of a disabled individual are generally deductible as a medical expense. If the disabled person is principally there for medical care, all of the cost is a medical expense.

Tuition paid for a disabled individual to attend a "special school" is a medical expense. Meals and lodging costs are deductible. The regulations address the issue of what is or what is not a special school. Facts and circumstances determine whether the school's resources which alleviate the mental or physical condition of the individual are the primary reason for attending the school. Thus, therapeutic benefits generated by the educational experience don't guarantee medical expense treatment. The school's philosophy, practices, and/or programs must address the disability of the person attending the school to ensure a qualified medical expense.

Other costs that may be deductible as medical expenses include fees paid to a psychiatric social worker, telephone expenses related to medical attention and/or advice, and disbursements which provide a data bank that stores the complete medical history of an individual.

Travel and Transportation Costs

All taxpayers are allowed to deduct travel and transportation costs directly involved in health care activities. This section concentrates on the unique circumstances that are often confronted by a person with a disability.

Local transportation which is not related to medical activities is usually not allowed as a medical expense. However, the courts allow this cost to be included in medical expenses if it is an integral part of a prescribed occupational therapy program,[10] or had a positive psychotherapeutic outcome.[11]

Health and convalescence trips considered to be medically necessary are also deductible. The trip must be primarily medical in nature, involve an individual whose ailment or condition is unique, and have medical acknowledgment that the destination will alleviate or cure the ailment or condition. Examples of health and convalescence trips that are allowed include travel to Florida for heat and sunlight treatment of catarrhal deafness[12] and an Arizona excursion prescribed to alleviate a chronic respiratory ailment.[13]

Transportation costs of a relative can be deductible in some instances. When the disabled individual is a minor, immobilized by illness, and/or unable to care for his needs, the travel costs of a spouse, parent, or other relative are allowed as medical expenses.

Other transportation situations which are allowed include the transportation costs of a deaf individual returning to her home in California from a college for the deaf located in Washington, D.C.[14] and the cost of trips considered to be medically necessary where a permanent change of location is the ultimate result.[15]

Food and Lodging

The costs of meals and lodging while en route to a location where medical care is administered are deductible. Once the individual and, if applicable, a necessary traveling companion arrive, only lodging expenses are allowed up to $50 per night, per person. These provisions tend to have more meaning to the individual with a disability because of unique medical needs and/or the necessity of being accompanied while traveling

A special diet prescribed by a physician establishes the **possibility** of a medical deduction. The amount of medical expense allowed is based on a comparison of the costs of the prescribed diet and the individual's normal diet. Again, the disabled person tends to encounter this situation frequently since his condition may require specific nutritional or other intake (e.g., purified water prescribed to alleviate digestive and/or urinary difficulties).

Other Disbursements

Medical disbursements are disallowed or deferred in some instances. An advance payment of a medical cost cannot be deducted until the medical services are received unless there is a contract that requires current year payment. In one instance, a lump-sum disbursement that ensured lifetime care for a person who was physically and mentally handicapped was allowed as a current deduction since an advance payment policy was adhered to by the institution providing the guarantee.[16]

Using borrowed money or a credit card to pay for medical expenses is not a bar to a current deduction. Medical expenses are deductible at the time of payment by cash, or, time of charge to a credit card.

Where medical expenses are paid from a settlement received in advance and in anticipation of the health care costs, none of the medical expenses can be listed among the itemized deductions. Once the settlement amount is used, any subsequent medical expenses qualify for possible deduction.

A recent case examined nontraditional medical care and determined that expenses incurred for such treatment were acceptable for inclusion in medical expenses. The costs incurred for a "naturopathic doctor" were allowed by the U.S. Tax Court.[17]

In Rev. Rul. 2000-24, the IRS ruled that amounts paid by a parent to attend and travel to a medical conference relating to the chronic condition of a dependent child are deductible as medical expenses since the costs are primarily for and essential to the medical care of the dependent child. Thus, the transportation costs, registration fee, and meals and lodging en route to the conference are medical expenses. However, the cost of meals and lodging incurred while attending the conference cannot be included in medical expenses since neither the taxpayer parent or the dependent child is receiving medical care at that time.

CREDITS

Several tax credits are available to disabled individuals or those who care for them. These tax credits are structured to provide maximum assistance in situations involving the disabled.

CREDIT FOR THE ELDERLY OR THE DISABLED

The credit on Schedule R for the elderly or the disabled is seldom utilized. Since 1983 there have been no inflation adjustments to the base amount and the AGI phaseout thresholds. Therefore, the number of taxpayers who are currently eligible to claim the credit is negligible. Usual situations which can result in the credit are:

- The current year is the initial year of a disability and
- The disabled taxpayer's income includes a significant portion that is excludable (e.g., municipal bond interest).

Example 14. Leo is 56 years old in 2003 and becomes permanently and totally disabled in November 2002 due to a work-related injury. He receives a $30,000 workers' compensation award in 2002. In addition, he received $6,000 of taxable disability benefits that were reported on Form 1099-R. Due to a processing problem, Leo's social security disability benefits do not commence until January 2004. Leo's 2003 AGI and taxable income consists of:

Note. See Chapter 8 Elder Taxation for general qualifications for the credit for the elderly or the disabled.

Interest income	$ 3,000
Gain on sale of stock	3,000
Taxable Disability income	6,000
2003 AGI	$12,000
Less: Exemption	(3,050)
Less: Standard Deduction (single)	(4,750)
2003 Taxable Income	$ 4,200
2003 Tax (from Tax Table)	420

Due to these unusual circumstances, Leo is entitled to $413 credit for the disabled on his 2003 Schedule R.

For Example 14

Schedule R (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Credit for the Elderly or the Disabled

▶ Attach to Form 1040. ▶ See Instructions for Schedule R (Form 1040).

OMB No. 1545-0074
2003
Attachment Sequence No. 16

Name(s) shown on Form 1040: Leo
Your social security number: 777 77 7777

You may be able to take this credit and reduce your tax if by the end of 2003*:

- You were age 65 or older **or**
- You were under age 65, you retired on **permanent and total** disability, and you received taxable disability income.

**If you were born on January 1, 1939, you are considered to be age 65 at the end of 2003.*

But you must also meet other tests. See page R-1.

TIP In most cases, the IRS can figure the credit for you. See page R-1.

Part I **Check the Box for Your Filing Status and Age**

If your filing status is:	And by the end of 2003:	Check only one box:
Single, Head of household, or Qualifying widow(er)	1 You were 65 or older 1	☐
	2 You were under 65 and you retired on permanent and total disability 2	☑
Married filing jointly	3 Both spouses were 65 or older 3	☐
	4 Both spouses were under 65, but only one spouse retired on permanent and total disability 4	☐
	5 Both spouses were under 65, and both retired on permanent and total disability 5	☐
	6 One spouse was 65 or older, and the other spouse was under 65 and retired on permanent and total disability 6	☐
	7 One spouse was 65 or older, and the other spouse was under 65 and **not** retired on permanent and total disability 7	☐
Married filing separately	8 You were 65 or older and you lived apart from your spouse for all of 2003 8	☐
	9 You were under 65, you retired on permanent and total disability, and you lived apart from your spouse for all of 2003 9	☐

Did you check box 1, 3, 7, or 8?
- **Yes** ▶ Skip Part II and complete Part III on back.
- **No** ▶ Complete Parts II and III.

Part II **Statement of Permanent and Total Disability** (Complete **only** if you checked box 2, 4, 5, 6, or 9 above.)

If: 1 You filed a physician's statement for this disability for 1983 or an earlier year, or you filed or got a statement for tax years after 1983 and your physician signed line B on the statement, **and**

2 Due to your continued disabled condition, you were unable to engage in any substantial gainful activity in 2003, check this box . . . . ▶ ☐

- If you checked this box, you do not have to get another statement for 2003.
- If you **did not** check this box, have your physician complete the statement on page R-4. You **must** keep the statement for your records.

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11359K **Schedule R (Form 1040) 2003**

For Example 14

Schedule R (Form 1040) 2003 Page **2**

Part III **Figure Your Credit**

10	**If you checked (in Part I):** **Enter:** Box 1, 2, 4, or 7 . . . $5,000; Box 3, 5, or 6 . . . $7,500; Box 8 or 9 . . . $3,750	10: 5,000
	Did you check box 2, 4, 5, 6, or 9 in Part I? **Yes** → You **must** complete line 11. **No** → Enter the amount from line 10 on line 12 and go to line 13.	
11	**If you checked (in Part I):** • Box 6, add $5,000 to the taxable disability income of the spouse who was under age 65. Enter the total. • Box 2, 4, or 9, enter your taxable disability income. • Box 5, add your taxable disability income to your spouse's taxable disability income. Enter the total.	11: 6,000
	TIP For more details on what to include on line 11, see page R-3.	
12	If you completed line 11, enter the **smaller** of line 10 or line 11; **all others,** enter the amount from line 10	12: 5,000
13	Enter the following pensions, annuities, or disability income that you (and your spouse if filing a joint return) received in 2003.	
a	Nontaxable part of social security benefits and Nontaxable part of railroad retirement benefits treated as social security (see page R-3).	13a: 0
b	Nontaxable veterans' pensions and Any other pension, annuity, or disability benefit that is excluded from income under any other provision of law (see page R-3).	13b:
c	Add lines 13a and 13b. (Even though these income items are not taxable, they **must** be included here to figure your credit.) If you did not receive any of the types of nontaxable income listed on line 13a or 13b, enter -0- on line 13c	13c: 0
14	Enter the amount from Form 1040, line 35	14: 12,000
15	**If you checked (in Part I):** **Enter:** Box 1 or 2 . . . $7,500; Box 3, 4, 5, 6, or 7 . . . $10,000; Box 8 or 9 . . . $5,000	15: 7,500
16	Subtract line 15 from line 14. If zero or less, enter -0-	16: 4,500
17	Enter one-half of line 16	17: 2,250
18	Add lines 13c and 17	18: 2,250
19	Subtract line 18 from line 12. If zero or less, **stop;** you **cannot** take the credit. Otherwise, go to line 20	19: 2,750
20	Multiply line 19 by 15% (.15)	20: 413
21	Enter the amount from Form 1040, line 43	21: 420
22	Add the amounts from Form 1040, lines 44 and 45, and enter the total	22:
23	Subtract line 22 from line 21	23: 420
24	**Credit for the elderly or the disabled.** Enter the **smaller** of line 20 or line 23 here and on Form 1040, line 46	24: 413

Schedule R (Form 1040) 2003

Example 15. Assume the same facts as **Example 14,** except Leo receives $7,000 of social security benefits in 2003.

Question A. Is Leo entitled to any disabled credit on his 2003 Schedule R?

Answer A. No. Although the $7,000 of social security disability benefits is not taxable, it must be entered on line 13a of Leo's 2003 Schedule R. Since the $7,000 amount exceeds the $5,000 base amount on line 12 of Schedule R, Leo is entitled to no disabled credit.

CREDIT FOR CHILD AND DEPENDENT CARE EXPENSES (FORM 2441)

A working taxpayer whose household includes a dependent or spouse who is disabled or handicapped may be eligible for this credit. Work-related expenses and the taxpayer's AGI are the key elements for computing this nonrefundable credit on Form 2441.

Qualifying Person Test

The child and dependent care expenses must be for the care of one or more qualifying persons:

- A dependent who is under age 13 when the care is provided and for whom the taxpayer can claim an exemption
- A spouse who is physically or mentally not able to care for himself or herself
- A dependent who is physically or mentally not able to care for himself or herself and for whom the taxpayer can claim an exemption (or could claim an exemption except the person had $3,050 or more of gross income)

Work-Related Expense Test

The child and dependent care expenses must be work related to qualify for the credit. Expenses are considered work related only if **both** of the following are true:

- They allow the taxpayer (and a spouse if married) to work or look for work.
- They are for qualifying person's care.

The term "work" includes employment, self-employment, and partnership activities. Work can be either full-time or part-time.

Recently increased statutory limitations are placed on the amount of expenses that can be used. These are $3,000 per year when one disabled individual is involved and $6,000 per year for two or more persons. Earned income also limits the qualifying expenses. When a spouse with a disability is involved, the presumed earned income for that individual is $250 or $500 per month, depending on the number of individuals who receive care.

Definition of Physically or Mentally Not Able to Care for Oneself

Persons who cannot dress, clean, or feed themselves because of physical or mental problems are considered not able to care for themselves. Also, persons who must have constant attention to prevent them from injuring themselves or others meet the definition.

Important Changes for 2003

The following changes will be made to the child and dependent care credit on the 2003 Form 2441:

1. The credit can be as much as 35% (increased from 30% in 2002) of qualified care expenses.
2. The maximum adjusted gross income amount that qualifies for the highest percentage (35% in 2003) will increase to $15,000.
3. The dollar limit on the amount of qualifying expenses will increase to $3,000 for one qualifying individual and $6,000 for two or more qualifying individuals.

Unlike attendant care expenses (see Medical Expenses), an allocation between household service and personal care is not mandated for Form 2441 purposes. The taxpayer must decide whether to use dependent care expenses as impairment-related work expenses (discussed previously) or on Form 2441. However, the same expenses **cannot** be used to claim **both** a credit on Form 2441 and a deduction. Relatives, even if they live with the taxpayer, may be employed for purposes of calculating the credit if they are not dependents of the taxpayer(s).

Once the allowable expenses are identified and the proper limitation rules applied, the amount of AGI will determine the appropriate multiplier which ranges between 20% and 35% (i.e., the higher the AGI the lower the credit rate), as shown on Form 2441.

Example 16. Chad Sanders is married to Mary, who is disabled. They have a 12-year-old son, Brent. Chad pays $7,000 to his sister Lisa in 2003 to provide care to Mary and Brent for the entire year. Chad's **2003** wages are $35,400. The AGI on Chad and Mary's joint **2003** return is $37,600. Their completed 2003 Form 2441 follows.

Observation. For **Example 16:**

1. Chad and Mary used only $6,000 of the $7,000 of dependent care expenses to compute the credit on Form 2441. The remaining $1,000 or a portion of it may qualify as a medical expense for Mary's care, depending on the service provided by Lisa.
2. Since Mary was disabled for the entire year, she is considered to have worked and earned $500 per month in 2003. Therefore, $6,000 ($500 × 12 months) is entered on line 5, Form 2441.[18]
3. If Lisa was employed in Chad and Mary's home, they must prepare a 2003 Schedule H *(Household Employment Taxes)* and attach it to their joint 2003 Form 1040.

For Example 16

Form **2441** — Department of the Treasury, Internal Revenue Service (99)

Child and Dependent Care Expenses

▶ Attach to Form 1040.

▶ See separate instructions.

OMB No. 1545-0068 — **2003** — Attachment Sequence No. **21**

Name(s) shown on Form 1040: **Chad and Mary Sanders**

Your social security number: **111 11 1111**

Before you begin: You need to understand the following terms. See **Definitions** on page 1 of the instructions.

- **Dependent Care Benefits**
- **Qualifying Person(s)**
- **Qualified Expenses**
- **Earned Income**

Part I **Persons or Organizations Who Provided the Care—**You **must** complete this part. (If you need more space, use the bottom of page 2.)

1	(a) Care provider's name	(b) Address (number, street, apt. no., city, state, and ZIP code)	(c) Identifying number (SSN or EIN)	(d) Amount paid (see instructions)
	Lisa Sanders	143 Grant Rd. French Lick, IN 47432	444-44-4444	7,000

Did you receive **dependent care benefits?**

No ▶ Complete only Part II below.

Yes ▶ Complete Part III on the back next.

Caution. If the care was provided in your home, you may owe employment taxes. See the instructions for Form 1040, line 59.

Part II **Credit for Child and Dependent Care Expenses**

2 Information about your **qualifying person(s).** If you have more than two qualifying persons, see the instructions.

(a) Qualifying person's name — First	Last	(b) Qualifying person's social security number	(c) Qualified expenses you incurred and paid in 2003 for the person listed in column (a)
Mary	Sanders	222 22 2222	3,500
Brent	Sanders	333 33 3333	3,500

3	Add the amounts in column (c) of line 2. **Do not** enter more than $3,000 for one qualifying person or $6,000 for two or more persons. If you completed Part III, enter the amount from line 26	3	6,000
4	Enter your **earned income**	4	35,400
5	If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions); **all others,** enter the amount from line 4	5	6,000
6	Enter the **smallest** of line 3, 4, or 5	6	6,000
7	Enter the amount from Form 1040, line 35 — 7: 37,600		
8	Enter on line 8 the decimal amount shown below that applies to the amount on line 7	8	× .23

If line 7 is:

Over — But not over	Decimal amount is	Over — But not over	Decimal amount is
$0—15,000	.35	$29,000—31,000	.27
15,000—17,000	.34	31,000—33,000	.26
17,000—19,000	.33	33,000—35,000	.25
19,000—21,000	.32	35,000—37,000	.24
21,000—23,000	.31	37,000—39,000	.23
23,000—25,000	.30	39,000—41,000	.22
25,000—27,000	.29	41,000—43,000	.21
27,000—29,000	.28	43,000—No limit	.20

9	Multiply line 6 by the decimal amount on line 8. If you paid 2002 expenses in 2003, see the instructions	9	1,380
10	Enter the amount from Form 1040, line 43, minus any amount on Form 1040, line 44	10	2,375
11	**Credit for child and dependent care expenses.** Enter the **smaller** of line 9 or line 10 here and on Form 1040, line 45	11	1,380

For Paperwork Reduction Act Notice, see page 3 of the instructions. Cat. No. 11862M Form **2441** (2003)

MISCELLANEOUS INFORMATION

A potpourri of other possibilities pertaining to the disabled person exists. This section covers procedural matters.

WITHHOLDING AND FICA PAYMENTS

Benefits paid by an employer or a private sector third party are subject to withholding and FICA taxes in some instances. Understanding these provisions can be beneficial since it may eliminate unnecessary deductions and provide more working resources to the disabled person.

If the employer or the employer's agent is providing taxable benefits, withholding and social security taxes are deducted. However, IRC §3121(a)(4) provides an exception pertaining to FICA taxes on "any payment on account of sickness or accident disability, or medical or hospitalization expenses in connection with sickness or accident disability, made by an employer to, or on behalf of, an employee after the expiration of six calendar months following the last calendar month in which the employee worked for such employer."

> **Example 17.** Sam is disabled as a result of an injury sustained in April while working for Wrigley Country Enterprises (WCE). Beginning May 1, WCE pays taxable disability payments of $2,000 per month to Sam. Withholding taxes must be deducted from each monthly payment. FICA taxes will reduce the May through October benefits. The November, December, and all future payments will not be subject to FICA.

Other income not subject to FICA tax includes payments resulting from a permanent disability and benefits paid by an employer to a nonperforming employee where the employee has been receiving social security disability benefits that started in a year prior to the employer payments. Payments deemed to be exempt (e.g., worker's compensation, compensation damages) are not subject to withholding or FICA provisions.

FILING STATUS

A taxpayer who cares for and/or is responsible for a disabled person may need guidance in determining his filing status. This is especially true if the disabled individual is residing away from home (e.g., at school, in a nursing home). In cases where the time away from the taxpayer's dwelling is limited, no difficulties emerge. Let's consider what happens when the disabled dependent requires constant medical attention necessitating living full-time in a nursing home. An interpretation of the Code provides that this is viewed as a temporary absence.

> **Example 18.** Matt's disabled son, Peter, resides in the Rose Rest Home. Matt, a widower since 1990, has no other dependents and provides for the full support of Peter. Matt's filing status is head of household since Peter's residency at the Rose Rest Home is regarded as a temporary situation.

REASONABLE CAUSE

Failure to file a tax return on a timely basis can lead to civil penalties. It is the responsibility of the taxpayer to prove that this failure was the result of a reasonable cause and not willful neglect. The usual definition of reasonable cause is events or occurrences that would lead an ordinarily intelligent person to respond under like circumstances as the taxpayer. Although no legislation or litigation has specifically addressed the disabled situation, the usual definition of reasonable cause seems to apply. Such a defense might be beneficial to a disabled taxpayer for the tax year(s) when the condition occurred and/or was discovered.

TAX PLANNING

Tax choices exist for disabled individuals or those taxpayers who are responsible for them. The flexibility in how certain items are incurred or treated allows for tax planning.

CLASSIFYING EXPENDITURES

Some payments, like nursing care for a dependent child, can be classified as dependent care on Form 2441 or as medical expenses on Form 1040 Schedule A. Depending on specifics such as marginal tax rate, level of AGI, or other expenditures, the taxpayer's classification of the expenses can determine total tax liability. A taxpayer who is unable to itemize deductions or whose medical expenses are lower than the 7.5% AGI limitation should list the expense and claim the credit on Form 2441. As shown in Example 16, the Form 2441 restrictions could result in an allocation between the credit and itemized deduction treatment. The examples that follow illustrate the possibilities. In each instance:

- The taxpayer incurs $5,000 of nursing care costs since the taxpayer's spouse is disabled,
- A 25% rate is used to determine the credit, and
- The taxpayer's marginal tax bracket is 15%.

Example 19. The taxpayer's itemized deductions do not provide an AGI reduction. Listing $3,000 (the statutory limit) of the nursing care as eligible for the dependent care credit would reduce the total tax bill by $750 ($3,000 × 25%).

Example 20. Other spending for itemized deductions will allow the entire $5,000 to be deducted from AGI. This choice would lower the total tax due by $750 ($5,000 × 15%).

Example 21. Other spending will provide the taxpayer with a choice in allocating the $5,000. If $3,000 is classified as dependent care expense and the remaining $2,000 is cited as a medical expense, the savings amount to $1,050:

$3,000 × 25% =	$ 750
$2,000 × 15% =	300
	$1,050

TIMING OF MEDICAL DISBURSEMENTS

The presence of general and specific statutory limits on itemized deductions and medical expenses provides a planning opportunity. Accelerating or deferring deductible medical costs can influence not only the amount of tax but when it is paid. Deferring an expense to a later year may be a wise tax decision. The conventional wisdom of accelerating deductions provides obvious tax advantages.

Example 22. Serena sustained a disabling injury during 2003. A bill for $3,000 of medical expenses is received on December 20, 2003. Serena's AGI and other spending will enable only $2,000 of the medical spending to reduce taxable income. The applicable marginal tax brackets for the current year and next year are 15% and 33%. A decision to wait until next year might be a beneficial move for Serena. On the other hand, if some uncertainty about next year's itemized deductions is present, accelerating the spending along with some other medical costs could drop the current year tax by as much as $450 ($3,000 × 15%).

ENDNOTES

1 Rev. Rul. 58-602

2 Rev. Proc. 2002-70

3 *Federal Tax Coordinator 2d*, November, 1985, H-2314, p. 26,181

4 Rev. Rul. 71-425

5 IRC §104(a)(1)

6 IRC §105(b)

7 Treas. Reg. 1.61-14 and *O'Gilvie v. United States* (519 U.S., 79, 117 S. Ct. 452)

8 *Clark, TC Memo 1978-276*

9 Rev. Rul. 64-173, 1964-1 CB 121

10 *Misfeldt v. Kelm,* U.S. District Court of MN, 52-2 USTC ¶9495, 44 AFTR 1033 (July 3, 1952)

11 *Weinzimer, TC Memo 1958-137*

12 *Watkins, TC Memo 3/31/54*

13 *Stringham,* (1949) 12 TC 580, affd. (1950, CA6) 183 F.2d 579

14 *Est Baer, TC Memo 1967-34*

15 *Prem, TC Memo 1962-157*

16 Rev. Rul. 75-303, 1975-2 CB 87

17 *Dickie v. Commr., TC Memo 1999-138*

18 2003 Form 2441 Instructions