

## IN PRACTICE

## TAXATION

## Tax Benefits for Parents of Children with Special Needs

By Cynthia Sharp

Families raising a special needs child are often unaware of significant tax benefits that would allow them to retain a larger share of their hard-earned income. This article serves as an introduction to the federal income tax deductions and credits that may be available to these taxpayers.

As a preliminary note, the financial benefit derived from a *deduction* depends upon the individual's marginal tax rate, which will range between 10 and 35 percent. A tax *credit*, on the other hand, is significantly more beneficial since the credit is a dollar-for-dollar reduction in tax liability.

### Medical Expenses

The medical expense deduction is designed to mitigate the economic effect of the high cost of medical care. Those who itemize their deductions may be entitled to deduct eligible medical expenses if the expenses exceed 7.5 percent of adjusted gross income (AGI). 26 U.S.C. Sec. 213 (a). The taxpayer is well advised to maintain thorough records so

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as to document the deductions with receipts, prescriptions and appraisals.

Naturally, the special needs families and the general population expend funds on similar types of medical services, such as routine physical exams, hospital stays and medication. However, the following categories of medical expenditures are largely unique to the special needs population: transportation, modifications to the home, education and attending conferences and seminars.

### Transportation

Transportation costs primarily for and essential to medical care (such as the actual fare for a taxi, bus, train or ambulance) can be deducted. A taxpayer who uses her own vehicle for medical transportation has the option of deducting the actual out-of-pocket expenses (such as gas and oil) or may choose to deduct the standard mileage rate, which is 16.5 cents per mile for 2010. Under either method, tolls and parking fees are deductible. IRS Publication 502 (2010), Medical and Dental Expenses.

### Home Modifications

The general rule is that home improvements are treated as capital expen-

ditures. However, those who revamp a home to accommodate a family member's disability are entitled to a deduction so long as the main purpose of any modification or special equipment is medically based. Reg. Sec. 1.213-1(e)(iii). The amount of deduction allowable for the cost of a permanent improvement that increases the value of property is determined by reducing the cost of the improvement by the increase in value. This formula has been applied in determining the allowable deduction for installation of a swimming pool where a physician prescribed swimming as treatment for a medical condition. Rev. Rul. 83-33, 1983-1 CB 70. Operating and maintenance costs such as water, electricity, cleaning and chemicals for such improvements may also be deductible. Reg. Sec. 1-213-1(e)(iii).

The IRS has recognized that certain medically necessary modifications to a home do not add value to a property and has thus ruled that the cost of those items is fully deductible. This category includes installation of entrance and exit ramps, widening doorways or hallways, modifying stairways as well as adding handrails or grab bars. Rev. Rul. 87-106, 1987-2 CB67.

### Education as a Medical Expense

No deduction is permitted for the cost of traditional education. However, a deduction is permitted for the cost of attending a "special school" for a mentally or physically handicapped person, so long as a physician has recommended the school based upon the diagnosis of a

disorder. The principal reason for attendance must be to manage or correct the child's handicap. Reg. Sec. 1.213-1 (c) (1)(v).

A taxpayer with two dyslexic children in a special program offered at an "ordinary" school received a favorable ruling from the IRS regarding the deductibility of education expenses. PLR 200521003. The IRS found the curriculum in question to be designed to enable a child to deal with medical handicaps and to move on to study at a regular school, recognized as the "essence of special education." It was further determined that the children were attending the school primarily to receive medical care in the form of special education and that the children's dyslexia constituted a medical disability that the special education was designed to alleviate.

The Service also ruled favorably where the taxpayer provided expert evidence in the form of a neuropsychological report that the student needed a support program and counseling if she were to successfully attend college in the future. The staff at the particular school had designed a self-contained program to enable the special needs student to compensate for and overcome the numerous diagnosed medical disorders. PLR 200729019.

The taxpayer referenced in PLR 8616069 was not so fortunate. The IRS found that the principal reason the taxpayer's child was attending the school in question was a concern over his reading ability. Concluding that the taxpayer had sent the child to the particular school for "academic" therapy rather than for medical treatment, the deduction was denied.

#### **Attending Medical Conferences and Seminars**

Registration fees for medical conferences and seminars are deductible so long as the topic relates to the dependent's specific medical condition and the primary purpose of the trip is to attend the conference. Rev. Rul. 2000-24, 2000-19

IRB. Although travel expenses incurred in connection with attending the event are deductible, no deduction is available for the cost of meals or lodging. It is prudent to obtain a written recommendation from the child's physician that the material presented will be beneficial from a medical point of view.

#### **Other Pertinent Tax Issues**

Tax benefits are also available for expenditures not related to medical treatment. While the scope of this article prohibits analysis of each of the pertinent tax provisions, the most significant are discussed below.

#### **Credit for Special Needs Adoption Expenses**

Families who adopt a child with special needs are eligible to claim a federal tax credit if the tests set forth in the Internal Revenue Code are satisfied. 26 U.S.C. Sec. 23. In 2010, the amount of the credit is fixed at \$13,170 per child, regardless of the actual expenses incurred for the adoption. To claim the credit, Form 8839 must be filed along with Form 1040.

The amount of the credit that may be used in a given year is limited to the taxpayer's federal income tax liability. Beginning with the year 2010, the amount that the credit exceeds the tax liability is refundable. Under prior law, excess credits could only be carried forward for five years.

#### **Qualified Dependent Care Assistance**

The general rule is that payment for babysitting or daycare of a child so that a person can maintain employment does not constitute a deductible business expense. 26 U.S.C. Sec. 162(a). A dependent care credit may be available for expenses related to the care of a dependent of any age residing with the taxpayer who is physically or mentally incapable of taking care of herself. 26 U.S.C. Sec. 21. Even a payment to a relative will qualify so long as the relative is not a dependent of the taxpayer. While a credit

may be claimed for regular child care services, after-school programs and summer camps, the tax benefit is not available for the cost of overnight summer camp.

#### **Taxable Income**

Most special needs children will not have a source of income until they turn age 18 and may then qualify for Supplemental Security Income (SSI). SSI benefits are not included in gross income and are therefore not taxable.

In some circumstances, a child became disabled as the result of being a victim of a tortfeasor and subsequently receives compensation for damages suffered. Settlements and judgments relating to personal injury or sickness are not taxable. However, any settlement or judgment characterized as punitive damages is subject to federal income taxation. 26 U.S.C. Sec. 104(a). As an aside, a special needs trust should be considered where a disabled person collecting "needs based" benefits (such as SSI or Medicaid) becomes entitled to a tort recovery or any other funds that would result in disqualification.

#### **Amending Returns**

If a parent failed to take advantage of available tax benefits in prior years, all is not lost. A claim for a refund for a tax overpayment can be filed on Form 1040X, which in essence corrects the original filing. The claim must be filed within three years from the original deadline of the tax return.

Another crucial point is that where an insurance company or school district reimburses the taxpayer for an expense that was deducted on a prior return, she is required to declare the reimbursement as taxable income in the year received.

Individuals are well advised to seek out the services of a qualified professional to guide them through the complex maze of the tax system. Otherwise, they may inadvertently deprive themselves of important benefits to which they are entitled. ■