Special Needs Planning

Often overlooked deductions for medical capital improvements and their financing.

By Thomas M. Brinker, Jr., LL.M., CPA

As the number of children diagnosed with autism and other intellectual disorders continues to skyrocket, the lives of all those concerned are impacted. In March 2020, the Centers for Disease Control and Prevention reported that as many as one in 54 children born today have an autism spectrum disorder (an increase from the CDC's 2018 report that found a one in 59 prevalence), with boys more than four times as likely to be identified with autism than girls. In addition, the CDC says that about one in six children ages 3–17 have been diagnosed with a developmental disability (such as autism, ADHD, blindness, and cerebral palsy among others), with one in four U.S. adults nationwide having a disability.

Parents caring for those with special needs are often unaware of the substantial tax benefits available to them and often forego hundreds, if not thousands, of dollars in potential tax deductions and reductions in their tax liability. Medical care expenditures alone for a child with special needs can prove astronomical. As a result, parents and their advisors need to become familiar with some unusual Internal Revenue Code provisions that may assist and/or hinder in this process.

The following focuses on the medical expense and home equity interest expense deductions pertaining to home-related capital expenditures incurred to accommodate an individual having special needs.

The medical expense deduction

Only individuals itemizing their deductions on their federal individual income tax returns can claim a medical expense deduction. Un-reimbursed medical expenses are deductible only to the extent they exceed 7.5% of a taxpayer's "adjusted gross income" or AGI. This 7.5% AGI threshold for the medical expense deduction was made permanent under the Taxpayer Certainty and Disaster Tax Relief Act of 2020.

Alternatively, parents who are eligible to participate in tax-advantaged plans through work for funding medical expenses, such as flexible spending accounts or health savings accounts, can set aside limited amounts of money to finance medical care expenses on a pre-tax basis while bypassing the AGI limitation.

Although these amounts are indexed annually for inflation, pre-tax contributions to flexible spending accounts are currently limited to $2,750 for 2021, with health savings accounts capped at $3,600 for singles and $7,200 for families with an additional $1,000 catch-up contribution (for 2021) for those over age 55.

The missed opportunity: capital expenditures as a medical expense

Under most circumstances, capital expenditures are not permitted as a medical expense deduction. However, a medical expense deduction is available when the capital expenditure is made primarily for the medical care of the taxpayer, the taxpayer's spouse, and/or the taxpayer's dependents. To secure a current medical expense deduction for a capital expenditure, the cost must be reasonable in amount and incurred out of medical necessity for primary use by the individual requiring medical care.

Qualifying capital expenditures for medical expense deductions fall into two categories:

1. Expenditures improving the taxpayer's home while also providing medical care (e.g., a central air conditioning system for an individual suffering from a chronic respiratory illness).
2. Expenditures removing structural barriers in the home of an individual with physical limitations (e.g., construction costs incurred for an entrance ramp, widening doorways and halls, customizing bathing facilities, lowering kitchen cabinets, adding railings).

Under Treas. Reg. 1.213-1 (e)(1)(iii), capital expenditures in the first category are deductible only to the extent that the cost of the improvement exceeds the increase in the property's fair market value as a result of the capital expenditure. For example, after a physician recommends daily swimming for an individual suffering from arthritis, the family installs a therapeutic swimming pool costing $30,000. As a result of the expenditure, the home increases in value by $5,000. Therefore, $25,000 may be deducted as a medical expense (plus the ongoing pool maintenance). Expenditures incurred in the second category are fully deductible under the presumption that there is no increase in the property's value as a result of removing a physical barrier.

As illustrated in the examples above, under either category, costs incurred to operate or maintain the capital expenditure (such as increased utility and maintenance costs to operate the elevator or air conditioning system) are deductible currently as medical expenses as long as the medical reason for the expenditures continues to exist.

EXAMPLE 1: In 2020, Johnny was injured in an extreme sport accident. Johnny sustained a chronic disabling leg injury, which requires him to spend most of his time in a wheelchair. His physician recommends that he install an elevator in his home to alleviate the pressure on his lower body from walking up and down stairs. During the year, Johnny made the following expenditures: wheelchair: $3,500; elevator: $19,500; operational and maintenance costs incurred with the elevator: $2,800; and entrance ramp and door modifications: $7,500. According to appraisers, the home increased in value as a result of the elevator by $5,000. As a result of the appraisal, Johnny's medical expense deduction associated with his capital expenditures is $28,300 ($33,300 less the home's increase in value of $5,000). If Johnny's AGI was $75,000 in 2020, his medical expense deduction would be $22,675 after subtracting 7.5% of his AGI.

EXAMPLE 2: In 2020, Amy, a single mother with AGI of $80,000, fully supported her 20-year-old daughter living with her. Her daughter has no income for the year, and was properly claimed as Amy's dependent. During the year, Amy installed a central air conditioner at a cost of $17,500, which her physician said was required in caring for the daughter's asthma. After installation, Amy's home increased in value by $6,000. In addition, Amy incurred the following medical expenses in 2020: over-the-counter medications: $550; prescribed drugs: $350; physician expenses: $1,250; and un-reimbursed health insurance premiums: $4,250. For 2020, Amy's current medical expense deduction is $11,350 after subtracting 7.5% of her AGI ($17,350 less $6,000). If the air conditioning system increases the monthly utility bill by $125, Amy's deduction would increase by $1,500, resulting in an $12,850 medical expense deduction for the year 2020. (Note: Over-the-counter medications are not a deductible medical expense.)

Can a home equity loan provide a deduction when financing the improvement?

Families caring for those with special needs frequently borrow against their homes in financing their family medical expenses. Although interest expense incurred on a home equity loan is no longer deductible as an itemized deduction under 2017's Tax Cuts and Jobs Act (TCJA), there are notable exceptions.

In general, home equity loans represent borrowings other than the indebtedness incurred in acquiring, constructing, or substantially improving a principal residence and/or a second home. Under Sec. 163(h)(3)(F): "Special Rules for taxable years 2018 through 2025," the home mortgage interest deduction is currently limited to acquisition indebtedness of $750,000 (from prior law's $1,000,000) for homes acquired after 2017. Further, the home equity loan interest deduction has been suspended through 2025.

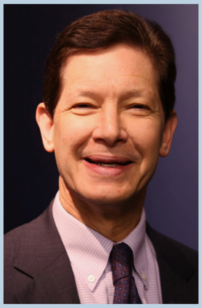
As of 2018, parents seeking an interest expense deduction for home equity indebtedness will only be permitted a deduction if the loan is to purchase, construct, or substantially improve a residence.

Therefore, a home equity loan interest deduction will only be permitted if the parents secure the loan for medical capital expenditures (i.e., substantially improving the home) made to the home in accommodating the individual with special needs (with total indebtedness limited to $750,000). However, utilizing a home equity loan to finance ongoing medical care will not result in an interest expense deduction.

EXAMPLE 3: Bill and Jane Johnson made a $200,000 down payment and borrowed $700,000 to purchase a residence worth $900,000 in 2013. Their home is currently valued at $1,150,000 with an acquisition debt remaining of $500,000. In 2020, they borrow $200,000 to provide for the ongoing medical care of their 15-year-old son with special needs and use their residence to secure this note. They may deduct interest on the $500,000 of remaining acquisition debt only… unless the $200,000 home equity loan was utilized to improve the home, such as a medical capital expenditure (e.g., installing an elevator or therapeutic swimming pool, constructing entrance ramps, widening doorways and halls, lowering kitchen cabinets, adding railings). It should be noted that both the medical capital expenditure and the home equity loan's interest are deductible as an itemized deduction if the Johnsons itemize their deductions.

Where to seek answers?

In addition to national organizations devoted to special needs planning, talk to a locally recommended Chartered Special Needs Consultant or a CPA and/or financial services provider specializing in planning for those with special needs to see how a medically related capital expenditure may reduce your tax bill.



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