

# Tax code treatment of long-term care and long-term care insurance

Federal tax law provides limited benefits to people who incur expenses for long-term care services or who buy private long-term care insurance. This fact sheet describes the current tax treatment of long-term care, and briefly reviews proposals for those who need long-term care and additional tax incentives to encourage more people to purchase long-term care insurance.

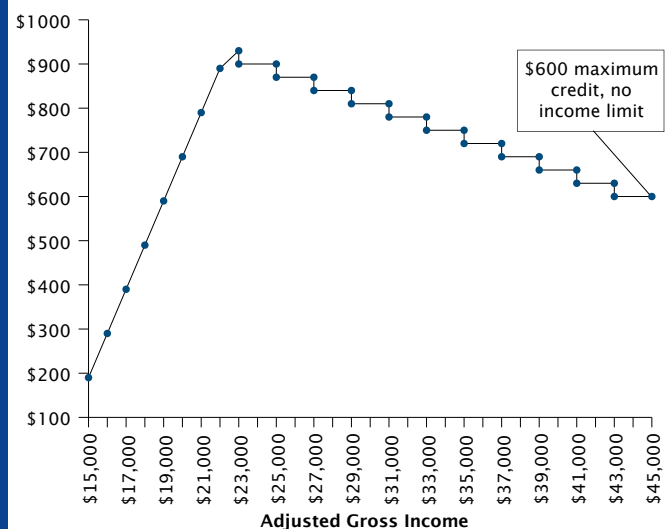
## Long-Term Care Expenses

Taxpayers who incur expenses for their own care or care of dependents may be able to deduct these expenses under the itemized medical expenses deduction. Taxpayers who pay for care of a disabled dependent so that they can work may qualify for the child and dependent care tax credit.

A deduction reduces taxable income and is more valuable to taxpayers in higher tax brackets; a one-dollar deduction reduces income tax by 10 cents for someone in the lowest bracket and by 39 cents for someone in the highest bracket.<sup>1</sup> A credit reduces the tax bill itself; a one-dollar credit can thus be equally valuable to low- and high-income taxpayers. Itemized deductions, however, like the medical expenses deduction, are of value to a taxpayer only if the sum of his or her itemized deductions is larger than the standard deduction available to people who don't itemize. Usually higher-income taxpayers are more likely to benefit from itemizing, because they have higher expenses for deductible items such as mortgage interest and state income and property taxes.

**Medical expenses deduction.** Amounts paid directly for long-term care services for the taxpayer or a dependent, and not reimbursed by any public or private insurance, may be counted toward the medical expenses deduction. (Payments to a caregiver who is a relative may not be counted.) This deduction is available only to people who itemize their deductions and only to the extent that total medical expenses exceed 7.5 percent of adjusted gross income (AGI). So, for example, a taxpayer with an AGI of \$50,000 could deduct expenses in excess of \$3,750 ( $\$50,000 \times 7.5$  percent).

Figure 1  
Maximum Credit Value for a Taxpayer with One Disabled Dependent by Income (2003)



SOURCE: Author's calculations from the Internal Revenue Code.

**Child and dependent care tax credit.** Taxpayers who pay for the care of children under 13 or dependents who are physically or mentally unable to care for themselves may qualify for a tax credit. The dependent must live with the taxpayer and the care provided must be necessary to allow the taxpayer to work or look for work. The expenses that can be counted are limited to the lesser of earned income or \$3,000 for one dependent or \$6,000 for two or more dependents. The actual credit is a fixed percentage of countable expenses, starting at 35 percent for taxpayers with AGI up to \$15,000 and phasing down to 20 percent for those with incomes greater than \$43,000.

The child and dependent care credit is "nonrefundable": it can reduce the taxpayer's tax bill to zero dollars, but cannot result in a refund. A taxpayer with one disabled dependent, wage income of \$15,000, and expenses of \$3,000 might calculate a credit of \$1,050 ( $\$3,000 \times 35$  percent). However, he or she would have a tax bill of \$190 or less against which to apply this credit and hence could save no more than \$190. A taxpayer with \$43,001 or more in income could save as much as \$600. Figure 1 shows the maximum value of the credit at different income levels for a taxpayer with one disabled dependent.

## Long-Term Care Insurance

A private long-term care insurance policy provides payment toward the cost of long-term care services, such as nursing home care or home care; typically the plan will pay up to a fixed amount for each day of care. A policy is treated as "tax-qualified" if it meets several key criteria. First, it must provide benefits only when the policyholder needs help with two or more activities of daily living (such as eating, bathing, or dressing) or needs supervision as a result of a cognitive impairment. Second, the insurer must offer inflation protection, under which the daily benefit

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amount rises over time, and nonforfeiture benefits, which preserve some coverage for purchasers who stop paying premiums. Finally, the insurer must comply with specified consumer protection standards developed by the National Association of Insurance Commissioners. Most policies sold today are tax-qualified.<sup>2</sup>

Qualified private long-term care insurance policies receive favorable tax treatment in a number of respects:

- Long-term care insurance premiums paid by individuals may be counted toward the medical expense deduction; the allowable amount is subject to limits based on the age of the taxpayer.<sup>3</sup> Again, this deduction is available only to people who itemize their deductions and only to the extent that medical expenses (including long-term care insurance premiums and any other deductible medical or long-term care expenses) exceed 7.5 percent of AGI.
- Long-term care insurance premiums paid by a self-employed person are fully deductible whether or not he or she itemizes and without regard to the 7.5 percent threshold.
- Long-term care insurance premiums paid by an employer, or long-term care benefits furnished directly by an employer, are deductible for the employer and are not taxable income for the employee. However, long-term care insurance premiums paid through a cafeteria plan or a flexible spending account (FSA) are not tax-exempt.<sup>4</sup>
- Interest earned on reserves held by the insurer is not taxable to the insurer or the policyholder.
- Benefits paid by the policy, up to specified limits, are not taxable income.

Other forms of insurance or retirement savings receive one or more of the tax preferences accorded to long-term care insurance (see Figure 2). But long-term care insurance is unique in being tax-favored when money is put into the plan, while accumulated money is earning interest, and when money is taken out.

## Policy Options for Broader Tax Assistance

President Bush's budget proposal for fiscal year 2004 includes an additional personal exemption for a spouse or parent who has long-term care needs and who lives with the taxpayer. (Each personal exemption reduces taxable income by \$3,050 in 2003.) Unlike the dependent care credit, this would help caregivers who are not in the workforce and/or provide care directly instead of paying for it. However, exemptions—like deductions—are generally more valuable to people

Figure 2

### Tax Treatment of Long-Term Care Insurance and Other Savings or Insurance Plans

	Long-term care ins.	Individual life insurance	Regular IRA	Roth IRA	401(k)	Fixed annuity
Premium or contribution deductible	•		•		•	
Employer contribution not treated as income	•				•	
Earnings on savings/reserves not taxed	•	•	•	•	•	•
Payout or benefits not taxed	•	•		•		

SOURCE: Internal Revenue Code.

in higher tax brackets.<sup>5</sup> An alternative proposed by the Clinton administration would have provided a caregiver tax credit.

There have been numerous proposals to make the deduction for private long-term care insurance premiums available to more taxpayers. In 2002, the House passed legislation that would have provided a deduction of premiums for taxpayers, regardless of whether or not they itemized and without regard to the 7.5 percent threshold. A similar measure is in President Bush's budget proposal. Supporters of these proposals argue that promoting the purchase of long-term care insurance would protect consumers against possible catastrophic losses and ultimately save the federal and state governments money by reducing future Medicaid outlays for long-term care. Opponents contend that much of any new tax incentives might go to people who would have bought long-term care insurance anyway, and that long-term care insurance will remain a "niche" product, attractive chiefly to relatively wealthier people at or near retirement age.

## Notes

<sup>1</sup> A deduction can also reduce income subject to state income tax in states that follow federal rules.

<sup>2</sup> S. Lewis, J. Wilkin, and M. Merlis, *Regulation of Private Long-Term Care Insurance: Implementation Experience and Key Issues* (Washington, DC: The Henry J. Kaiser Family Foundation 2003).

<sup>3</sup> A growing number of states also offer some form of state income tax deduction or credit for long-term care insurance premiums.

<sup>4</sup> Under a cafeteria plan, an employee may choose to apply employer-contributed funds to different benefits (for example, health insurance, dental insurance, assistance with child care, or term life insurance). Under an FSA arrangement, an employee can pay for health insurance premiums or other medical expenses using pre-tax dollars.

<sup>5</sup> Exemptions are phased out for single taxpayers with AGI greater than \$139,500 or couples with income greater than \$209,250.



## About the Project

The *Georgetown University Long-Term Care Financing Project* pursues analysis designed to stimulate public policy discussion about current long-term care financing and ways to improve it. The project is supported by a grant from the Robert Wood Johnson Foundation. Mark Merlis wrote this *Fact Sheet*.