

Tax Issues for Personal Service Contracts

This will explain some of the common tax issues that arise with respect to Personal Service Contracts, both for the recipient, as well as the payor. As a result of the enactment of the “Nursing Home Bankruptcy Act” (also known as the Deficit Reduction Act of 2005), personal service contracts will become an even more popular method to assist elderly clients in their daily care, as well as a planning technique to qualify elderly clients for Medicaid. However, if you intend to spend down your assets through compensating relatives for care taking services, then the contract must be in writing.

Is a Caregiver an Employee or an Independent Contractor?

Generally, if you hire someone to perform household work, including caregiver services, that person is deemed to be an employee. The relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which the work is done. In essence, an employee is subject to the will and control of the employer, not only as to what shall be done, but as to how it should be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the serves are performed, it is sufficient if he has the right to do so.

The right to discharge is also an important factor indicating that the person possessing the right is the employer. Other factors include how the person is paid, the furnishing of tools and of a place to work, and whether there is real risk as a result whether the worker will realize a profit or suffer a loss.

Indeed, the IRS asserts in Publication 926 that cleaning people, health aides, private nurses, caregivers, and similar domestic workers are employees. Based on the factors set forth above, the IRS is probably correct as to the classification of these types of workers, with the exception of perhaps private nurses and those hired from agencies where the agency is paid for the worker’s services.

With respect to private nurses, if the worker is licensed by the State and only checks on the patient sporadically or even once a day just to render medical assistance, then that individual may be deemed an independent contractor. On the other hand, if that private nurse is rendering care on an ongoing basis, daily and for many hours a day, than that individual is more likely to be deemed an employee.

If the workers, including private nurses, are hired through an agency and the agency is paid for the services, then the agency will be deemed an employer. However, if all the agency receives is a commission, then the person receiving services may be deemed an employer. However, if the agency establishes the scope of the work, when the caregiver will be paid, and the caregiver rate, then the agency can be deemed the employer. This should be discussed with the agency ahead of time to assure that you are not the one responsible for taxes.

Withholding Requirements

If you hire a caregiver in 2006 and pay wages of \$1,500 or more to that individual, you may need to withhold and pay Social Security and Medicaid taxes, as well as pay federal unemployment tax (FUTA) and certain state

employment taxes. You may also need to withhold Federal Income Tax if both you and the caregiver agree to do so. If you agree, then you should give the caregiver a Form W-4 Employee's Withholding Allowance Certificate to fill out. If you do not agree, then there is no obligation on your part to do so, but you should notify the caregiver in writing of such non-agreement.

For 2006, the Social Security taxes amount to 15.3% of the wages. You are responsible for paying one-half (1/2) of the tax and the employee is responsible for the other one-half (1/2), providing you withhold the caregiver's portion. If you do not withhold, you are responsible for paying the full amount of the tax; however, the taxes you pay to cover the caregiver's portion must be included in the caregiver's wages for income tax purposes. The caregiver's share of Social Security and Medicare taxes are not counted as Social Security, Medicare, or as FUTA wages. In addition, you will also be responsible for paying a FUTA equal to 0.8 percent of the first \$7,000 of wages for each employee. Finally, each state will differ as to its taxes.

For purposes of Medicare, Social Security taxes, and FUTA, you should not count any wages paid to your spouse, a child under the age of 12, or a parent. If the caregiver is under the age of 18 and his principal occupation is providing household services, then he or she isn't required to pay deductions. Consequently, this deduction is only available to taxpayers who itemize their deductions as opposed to taking the standard deduction, which in 2005 was \$5,000 for singles, \$7,300 for head of household, and \$10,000 for married couples. An additional \$1,250 is allowed to any taxpayer who is at least 65 by December 31st. However, fully one-half of all taxpayers over 65 don't have a tax liability, making this deduction to be of illusory benefit.

Assuming that you do indeed have a tax liability and itemizes as opposed to taking the standard deduction, there is still another limitation on the medical deduction. Medical expenses are only allowed to the extent that they exceed 7.5% of adjusted gross income (AGI). Accordingly, if your client has AGI of \$40,000, then the client can only deduct those medical expenses that exceed \$3,000. Finally, the taxpayer can only deduct those medical expenses that are not covered by insurance, including Medicare.

From the tax perspective of a payor, payments made to a caregiver will most likely result in no tax benefit at all. Payments to family members are not deductible, unless made to a family member who is a "licensed professional" for which such services are performed. Even if the payments were deductible, the payor would have to be a taxpayer with an income tax liability and who itemizes his or her deductions and then would still be subject to the 7.5 percent deduction from AGI, as well as not be entitled to reimbursement by insurance, including Medicare. As a result, unless the payments to the caregiver are sufficient in nature and not made to a family member (unless he or she is a licensed professional), then in all likelihood the payments will not result in a deduction for tax purposes.

Tax Consequences to Caregivers

Individuals are taxed on the compensation they receive for services, whether that compensation is received in the form of cash, cash equivalents, property, or options to acquire property. As a result, the recipient of the income will be subject to the following tax consequences:

- Federal and State income taxes
- Social Security tax of 12.4% on the first \$90,000 of earnings
- Medicaid tax of 2.9% on all earnings
- Local taxes such as in the city of New York
- The city may charge a business license tax since in essence the caregiver is conducting a business in the location where the services are performed.

On the other hand, if the payments made were deemed gifts, then there would be no tax consequences at all. However, if Medicaid planning is the goal, then gifting is probably no longer a reasonable alternative in light of the new law (Deficit Reduction Act) effective February 8, 2006. Under the new law, the penalty period states not from the date of the gift as under the old law, but at the time the person is in a nursing home and first qualifies for Medicaid. Consequently, the old gifting techniques, such as staggered gifting or half-a-loaf approach will no longer be viable as a method for qualifying for Medicaid.

Certainly if there is enough time to do some Medicaid planning, the use of a caregiver agreement will indeed cause you to spend down all of your assets. But with the potentially high tax rates to the caregiver, one has to determine whether the government will end up with the proceeds anyway. In other words, a calculation should be made on the savings on income taxes to you (if any), as well as the tax consequences to the caregiver (assuming that the caregiver is a family member) to determine whether a caregiver contract will be worth it in the end. Recall that if your longevity is questionable, income taxes may cause your caregiver to end up with less, as an inheritance under \$2,000,000 is not subject to any tax at all.

For example, assume that you have an estate of \$250,000 and a personal care contract is put in place on January 1, 2007, to pay your daughter, who is an accountant, the sum of \$50,000. Assume further that you die on January 1, 2008. Because the \$50,000 is paid to a family member, it is not deductible to you for income tax purposes. It is, however, taxable income to your daughter. If your daughter is married and they are in a high tax bracket, there will be FICA and Medicare taxes of 15.6%, federal income taxes of 34%, FUTA taxes (less than 1%), and state income taxes which will vary by jurisdiction.

In this case, using the personal care contract for spending down saved nothing with respect to Medicaid and any Medicare or Social Security tax.

The caregiver does not have to include in income the value of food and lodging, as well as reimbursement for parking in the amount of \$205 per month. Additionally, a caregiver can be reimbursed tax-free for a transit pass for a bus or train in the amount of \$105 per month.

You are required to file a W-2 for any caregiver whose Social Security and Medicare wages were \$1,500 or more for the 2006 calendar year, otherwise a 1099 should be file if the wages paid exceeded \$600 per the calendar year. However, if both you and the caregiver agreed to withhold income tax, then a W-2 would be required even if \$1,500 in wages were not paid.

If there is no income tax withholding, you can either pay the payroll taxes on a quarterly basis or all at once on April 15th of the year subsequent to the time the wages were paid. Each state will vary in their payment requirements, but will generally be on a quarterly basis. You are required to report the wages on Schedule H with your federal income tax return. If no return is due, then Schedule H can be filed separately.

If there is income tax withholding and the withholding for all federal payroll taxes is under \$50,000 per year, you will have to make deposits of all the taxes on a monthly basis for federal taxes and will have to check the state withholding requirements, which will most likely be on a monthly basis.

What are the tax consequences to you with respect to the payment for a Caregiver Contract? Assuming that you file your own tax return and do not qualify as a dependent of another, you may be entitled to deduct some of the payment as a medical expense under the Internal Revenue Code (IRC) Section 213. However, you must show that the expenditure qualifies as a medical expense. In the case of payments for caregivers, this should not present much of a problem as payments for "qualified long-term care services" are within the definition of medical expenses, as are various capital improvements to the family home to accommodate you. If the payment is "capital" in nature, the costs for the improvement would be added to the basis of the asset to the extent that the fair market value of the property has not been increased as a result of the capital improvement.

Long term care services are defined as those services which are "necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services." However, this assumes that the services are provided to a chronically ill individual. The term chronically ill means any individual who has been certified by a licensed health care practitioner as:

- (1) Being unable to perform (without substantial assistance from another individual) as least two activities of daily living for a period of at least 90 days due to a loss of functional capacity
- . . . or

(2) Requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.

It should be fairly easy for you to come within the ambit of the statute. First, the payor must not be able to perform at least two activities of daily living, which would include dressing, bathing, cooking, eating, normal bathroom functions, or even just getting up from a chair. Secondly, this must be documented by a licensed health care practitioner such as a doctor, nurse, or social worker and this must be done on an annual basis. Assuming the above requirements are met, then the expenditures for such services should be deductible as a medical expense under IRC Section 213.

However, there is an important exception in the IRC which disallows any payments to family members or other relatives for caregiver services as a medical deduction. A relative is defined as any spouse, lineal descendant, brother or sister (includes half-brother or half-sister), and various entities, including corporations, trusts, or partnerships in which any of the above individuals own more than a 50% interest. In essence, if you pay your child or brother to take care of you, then you are not entitled to a medical expense deduction. The only exception is where the family caregiver is a "licensed professional with respect to such service" in which case a deduction will be allowed.

Even assuming that the payment is deductible under the above tests, there are two additional limitations. First, the deduction is commonly referred to be tax practitioners as a "below the line deduction" which means it is deductible from Adjusted Gross Income (AGI) or is classified as an itemized \$50,000 payment to the daughter, resulting in at least \$25,000 in taxes, which would not have been paid if no caretaker contract had been entered into, as the inheritance would have been tax free.