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Journal of Accountancy

Potential income tax benefits for families with special needs children

Disabled children can qualify for dependency exemption and other benefits regardless of age.

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June 1, 2013

As the number of children diagnosed with autism, Asperger's syndrome, and other neurological disorders continues to skyrocket, the disruption it causes in the lives of all those concerned is unmistakable—as are the costs of providing care for the special needs child. As reported by the Autism and Developmental Disabilities Monitoring (ADDM) Network in March 2012, as many as 1 out of 88 children born today has an autism spectrum disorder or ASD. And a report by the Centers for Disease Control and Prevention (CDC) has estimated that rate is as high as 1 in 50. Other disabilities are also becoming more prevalent, according to the CDC. Between 1997–1999 and 2006–2008, there was an 18.2% increase in blindness/sight impairment among children age 3 to 17, a 9.1% increase in seizures, and a 24.7% increase in “other developmental delay” (which excludes autism, attention deficit hyperactivity disorder, and learning disabilities).

Further complicating the situation, parents with special needs children are often unaware of possible tax benefits that are available and forgo hundreds, if not thousands, of dollars in potential tax deductions and credits. Michael A. O'Connor, an attorney who has written extensively on this topic, believes that 15% to 30% of families with a disabled child have one or more unclaimed tax benefits. Among these potential tax benefits are deductions or credits for the dependency exemption, medical expenses, special instruction, capital expenditures for medically required home improvements, impairment-related work expenditures, and the earned income tax credit.

THE DEPENDENCY EXEMPTION

A taxpayer may claim a dependency exemption (\$3,900 for 2013), for a “qualifying child” or a “qualifying relative.” With passage of the Working Families Tax Relief Act of 2004, P.L. 108-311 (effective 2005), the definition of a “qualifying child” and “qualifying relative” in Sec. 152(a) was amended to provide a uniform definition for purposes of the dependency exemption and for the child tax, dependent care, and earned income tax credits.

Under the definition, to be a qualifying child, in addition to meeting the relationship test (taxpayer's child, stepchild, eligible foster child, adopted child, or descendant (e.g., grandchild), or taxpayer's brother, sister, stepbrother, stepsister, or their descendant (e.g., niece, nephew)), an individual (Sec. 152(c)) must meet any one of the following three requirements (the so-called age test). Either the individual must be under the age of 19 at year end; the individual must be a student under the age of 24 at the end of the year (to be a student the individual must be enrolled as a full-time student during some part of five calendar months during the year); or the individual must be totally and permanently disabled at any time during the year (Sec. 152(c)(3)(B)). Furthermore, while Sec. 152(c)(3) was amended for tax years beginning in 2009 to require that the qualifying child be younger than the individual claiming the dependency exemption, this rule does not apply to a child who is permanently and totally disabled. Age is not relevant in determining the dependency exemption of an individual who is permanently and totally disabled.

An individual is permanently and totally disabled if he or she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not less than 12 months (Sec. 22(e)(3)). A physician must certify in writing that the individual is permanently and totally disabled.

When considering whether an individual is a taxpayer's qualifying child, it is important to remember that grandparents, uncles, aunts, brothers, and sisters can satisfy the relationship test and, therefore, may be allowed to claim the dependency exemption for an individual who is permanently and totally disabled, regardless of the child's age.

SPECIAL SCHOOL INSTRUCTION

In general, to the extent they exceed the 10%-of-adjusted-gross-income (AGI) floor in 2013 (7.5% of AGI for 2012), a taxpayer can deduct qualifying medical expenses, including those of his or her spouse and dependent children. In most cases, costs related to providing a child's education are not considered medical care and, therefore, are not deductible as a medical expense. However, according to Regs. Sec. 1.213-1(e)(1)(v), the unreimbursed cost of attending a "special school" for a neurologically or physically handicapped individual is deductible as a medical expense if the principal reason for sending the individual to the school is to alleviate the handicap through the school's resources.

The expenses of a special school that are deductible as medical expenses include amounts paid for lodging, meals, transportation, and the cost of ordinary education that is incidental to the special services the school provides. Also, any costs incurred for the supervision, care, treatment, and training of a physically and/or neurologically handicapped individual are deductible if the institution provides the services. Alternatively, taxpayers participating in tax-advantaged plans through work for funding medical expenses, such as flexible spending accounts (FSAs) or health savings accounts (HSAs), can set aside limited amounts of money to finance medical care expenses on a pretax basis, thereby avoiding the 10%-of-AGI limitation. The definition of medical care expenses for this purpose is the same as it is for the medical expense deduction. Amounts that can be set aside pretax under an HSA in 2013 are \$3,250 for employees with single coverage and \$6,450 for employees with family coverage. The maximum pretax contribution to a health FSA for all taxpayers is \$2,500 beginning in 2013.

A special school is distinguishable from a regular school by the substantive content of its curriculum, and its status is not determined by the institution as a whole but by the nature of the services received by the individual for whom a medical care deduction is sought. The IRS considers the medical facilities and therapeutic orientation of a school as critical factors in determining whether a school qualifies for a medical care deduction.

Through case law, regulations, and rulings (see, e.g., Regs. Sec. 1.213-1(e)(1)(v)(a); Letter Ruling 200729019; *Sims*, T.C. Memo. 1979-499; and Rev. Rul. 70-285), the IRS has recognized several types of schools that qualify as “special schools” for purposes of the medical expense deduction. These include schools that:

- Teach Braille to the blind and lip reading to the deaf;
- Train the intellectually disabled;
- Give personal daily attention to the student to improve the student’s low attention span;
- Provide an environment in which intellectually or physically handicapped students can adjust to a normal competitive classroom situation; or
- Design a special curriculum to accommodate the needs of handicapped children with IQ scores ranging from 50 to 75.

A regular school with special curricula can also be classified as a special school for those individuals benefiting from a special curriculum. For example, in Rev. Rul. 70-285, a child attended a regular school that had a special curriculum for intellectually disabled children. Since the school’s special education curriculum was a severable aspect of the school’s activities, the IRS ruled that the special curriculum qualified the school as a special school with respect to the child.

In Rev. Rul. 78-340, the IRS concluded that a taxpayer whose child had severe learning disabilities caused by a neurological disorder (e.g., an ASD) could deduct as a medical expense amounts paid for tuition and related fees for the child’s education at a special school that has a program designed to “mainstream” these children so they can ultimately return to a regular school. The ruling further held that amounts paid for private tutoring by a specially trained teacher qualified to deal with severe learning disabilities are also deductible. However, the ruling stated that for the costs to be deductible, a physician must recommend both the special school and the tutoring.

In Letter Ruling 200521003, the IRS expanded the definition of special schooling to include tuition for programs enabling children with dyslexia to deal with their condition. The IRS determined that the children were attending the school for the principal purpose of obtaining medical care in the form of special education required for the years in which the children were diagnosed as having a medical condition (including dyslexia) that impaired their ability to learn. As a result, the IRS ruled in favor of a medical expense deduction for the tuition paid to the school.

More recently, in Letter Ruling 200729019, the IRS ruled that a school that provides nonacademic training and support services designed to help an individual be successful in another academic or vocational school may be deemed a “special school.” The school included a student population with IQs ranging from low

average to gifted and with various learning disorders and ASDs. It designed a self-contained program for the child (who had severe developmental disorders due to a medical condition) as prescribed by her neuropsychological report to enable her to compensate and overcome her diagnosed medical condition and help her succeed in transitioning to college.

Costs of additional services provided by schools that do not otherwise qualify as special schools can also be considered deductible medical expenses if the additional services provide therapeutic value. However, while a separate payment is not required, the amount paid must be in excess of the normal tuition charged for regular students, with the premium incurred over and above normal tuition representing the qualifying medical expense. An allocation may be permitted even if the school does not distinguish between normal educational tuition and medical care in its billing (*Fischer*, 50 T.C. 164 (1968)).

The medical care determination does not depend on the title of the person rendering the service, the nature of the institution, or whether it is considered medical care to other individuals. Instead, the final determination depends on whether the care qualifies as medical care under Sec. 213. Examples of deductible medical expenses include the additional cost incurred for special programs assisting psychologically, physically, or neurologically impaired students; note takers for deaf students; or psychotherapy services to assist students in adjusting to a normal school setting (see Rev. Rul. 69-607; *Fischer*, 50 T.C. 164 (1968); and *Fay*, 76 T.C. 408 (1981)).

CAPITAL EXPENDITURES

As a general rule, 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 residence while also providing medical care (e.g., a central air conditioning system for an individual suffering from a chronic respiratory illness), and (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, and adding railings).

Capital expenditures in the first category are deductible only to the extent that the cost exceeds the increase in the property's fair market value as a result of the capital expenditure. For example, after a physician recommends installing an elevator for an individual suffering from a chronic and disabling arthritic condition limiting the individual's mobility, an elevator costing \$20,000 is installed in the taxpayer's home. As a result of the expenditure, the home increases in value by \$5,000. Therefore, \$15,000 may be deducted as a medical expense. 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.

Under either category, costs incurred to operate or maintain the capital expenditure (such as increased utility and maintenance costs to operate the elevator) are deductible currently as medical expenses as long as the medical reason for the expenditures continues to exist.

CONFERENCES AND SEMINARS

Parents and guardians of special needs children often attend medical conferences and seminars to learn more about their child's disability. Under Rev. Rul. 2000-24, amounts paid for the registration fees and travel expenses are deductible as medical expenses if the costs are primarily for and essential to the dependent's medical care. Parents should obtain a recommendation from their child's doctor to ensure the medical deduction is not disallowed. The conference or seminar must deal specifically with the medical condition the child has, not just general health and well-being issues. Moreover, the ruling does not permit deductions for meals and/or lodging costs incurred while attending the conference.

IMPAIRMENT-RELATED WORK EXPENDITURES

As special needs individuals mature and enter the workplace, many are entitled to claim itemized deductions for their unreimbursed impairment-related work expenses under Sec. 67(d). Impairment-related work expenses refer to expenses that a handicapped individual incurs for attendant care services at the place of employment enabling the individual to maintain employment, and that qualify as trade or business expenses. Handicapped individuals for this purpose are defined as those having a physical or mental disability (including but not limited to blindness or deafness) that is a functional limitation to employment or a physical or mental impairment (including but not limited to impaired sight or hearing) that substantially limits one or more major life activities, such as performing manual tasks, walking, speaking, breathing, learning, or working.

According to the IRS instructions in Publication 502, *Medical and Dental Expenses*, an employee should include impairment-related work expenses on his or her Form 2106, *Employee Business Expenses*, or Form 2106-EZ, *Unreimbursed Employee Business Expenses*. These expenditures are then transferred to Form 1040's Schedule A, *Itemized Deductions*, as an unreimbursed business expenses *that are not subject* to the 2%-of-AGI limitation on miscellaneous itemized deductions (Publication 529, *Miscellaneous Deductions*).

EARNED INCOME TAX CREDIT

The idea behind the Sec. 32 earned income tax credit (EITC) is to encourage the economically disadvantaged to work by partially offsetting the Social Security taxes on wages. Appropriately, the EITC is not available to taxpayers who have unearned income (i.e., dividends, interest, gains on sales of securities) above a specified threshold (\$3,300 for 2013). Families with AGI in 2013 under \$51,567 who file a married joint return and have three qualifying children (with two qualifying children, AGI under \$48,378, and with one qualifying child, AGI under \$43,210) may qualify for the EITC, which is a refundable credit.

For EITC purposes, a "qualifying child" has the same definition as for the dependency exemption—an individual who has the requisite relationship with the taxpayer, who resided with the taxpayer for more than six months during the calendar year, and who is under age 19 at the end of the year, under the age 24 and a full-time student, or is permanently and totally disabled (Sec. 32(c)(3)). Thus, as noted previously, a severely disabled child is a "qualifying child" regardless of age, even into adulthood, as long as the child continues to live with his or her parent(s) or another person who meets the relationship test with respect to the child. The maximum EITC for 2013 is \$6,044 for families with three or more qualifying children; \$5,372 for families with two qualifying children; and \$3,250 for families with one qualifying child.

CONCLUSION

The number of individuals with special needs is escalating at unprecedented rates. Some experts argue that this may simply be a matter of better recognition of special needs, as changes in autism diagnostic criteria have evolved over the years. Now, autism is the sixth most commonly classified disability in the United States. Whether due to diagnostic changes or not, these increased numbers are affecting state and local government programs as they face shortfalls because of increasing demand for services, forcing parents to absorb more of their children's medical care and other related expenses.

This article provided a brief overview of some of the more common deductions and credits that may be available under current tax law. However, practitioners with clients who are parents of special needs children should be aware that specific rules apply to each benefit and the determination of whether a benefit applies is often fact-specific. For example, to claim a child's educational expenses as medical expense deductions when the child attends facilities that are primarily educational and not special schools, the particular services provided to the child must be considered. Similarly, deductions for medical conference expenses are case-specific. Even the generally available EITC has multiple requirements and limitations. In the end, it is important for practitioners to understand that substantial tax benefits are available to those caring for children with special needs and to make clients who have special needs children aware of them.

Tax Benefit Checklist for Families Caring for Special Needs Children

✓ Deducting the cost of a special school or institution

What is a special school?

A school is a special school if the ordinary education it furnishes is incidental to the special services it furnishes. Thus, the curriculum of a special school may include some ordinary education, but this must be incidental to the school's primary purpose to enable the student to compensate for or overcome a handicap, to prepare him or her for future normal education and living.

What are some examples of a special school?

Schools with programs to "mainstream" children with neurological disabilities (e.g., autism spectrum disorders) and schools that teach Braille, lip reading, or sign language.

What costs of a special school are deductible?

- Lodging;
- Meals;
- Transportation;
- Incidental educational costs provided by the institution; and
- Costs of supervision, care, treatment, and training.

When can regular schools be classified as a "special school" for an individual?

A school that has a special curriculum for the disabled individual can be classified as a special school for that individual (Rev. Rul. 70-285).

What private tutoring by a specially trained teacher is deductible?

The costs for tutoring by a teacher who is specially trained and qualified to deal with severe learning disabilities are deductible, provided the child's doctor recommended such tutoring (Rev. Rul. 78-340).

When is special education for dyslexic children deductible?

Dyslexia is a medical condition that handicaps the child's ability to learn. Therefore, if a child is diagnosed with dyslexia, the costs of special education to overcome dyslexia are deductible medical care expenses (Letter Ruling 200521003).

✓ **Deduction for medical conferences and seminars**

Both transportation and admission fees to qualifying medical conferences or seminars are deductible, but lodging and meals are not (Rev. Rul. 2000-24).

✓ **Prescribed vitamin therapy; hyperbaric oxygen therapy; chelation therapy; equestrian therapy; individualized or group art, dance, music, and play therapies; summer camps, etc.**

✓ **Medical travel and transportation**

- For 2013 tax returns: 24 cents per mile.
- For 2012 tax returns: 23 cents per mile.
- Lodging costs (but not meals) up to \$50 per day are deductible for the taxpayer and one additional person if an overnight stay is necessary.

✓ **Consider FSA health care plan if ineligible for medical expense deduction**

✓ **Impairment-related work expenses**

- Business deduction for attendant care services at place of employment (ordinary and necessary expense to help in performing job).
- Not subject to 2%-of-AGI limitation imposed on unreimbursed employee business expenses.

✓ **Qualifying child**

- Special needs individual can be any age and claimed as a dependent.
- No gross income limitation for a "qualifying child."

- Prior to 2009, a taxpayer could claim a dependency exemption for an older sibling. This option is not available for tax years beginning in 2009 and later unless the older sibling is permanently and totally disabled (Fostering Connections to Success and Increasing Adoptions Act of 2008, P.L. 110-351).

✓ Credit for special needs adoption expenses

- \$12,970 for a special needs child (\$12,650 in 2012), regardless of adoption expenses.
- Must be a U.S. citizen or resident who requires adoption assistance.
- Qualifying expenses include legal fees, court costs, and other adoption-related costs.
- The limit is per child, not per year (the credit was refundable for 2010 and 2011 only; for pre-2010 credits and post-2011 credits, the credit is nonrefundable with a carryover of five years).
- Credit phases out for taxpayers with AGI exceeding \$194,850 (\$189,710 in 2012); the credit is phased out completely at \$40,000 above the threshold.

EXECUTIVE SUMMARY

The number of disabled children has increased in recent years as has the cost of caring for them.

Practitioners should know about the tax benefits available to parents or other qualifying relatives for some of these costs, a number of which are deductible as medical expenses, above a certain floor.

The costs of modifying a house to be handicapped-accessible as well as the cost of attending a special school are examples of costs deductible as medical expenses.

Disabled children qualify for dependency exemptions and other tax benefits (e.g., child and dependent care credit, earned income tax credit) no matter how old they are as long as they live at home with their parents or other qualifying relative.

Disabled adults can deduct impairment-related work expenses for the cost of attendant care services and other expenses that permit them to work at their place of employment. These expenses are not subject to the 2%-of-AGI floor on itemized deductions.

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AICPA RESOURCES

JofA articles

[“Unrelated Child as a Qualifying Relative \(/issues/2009/nov/20091989.html\),”](#) Nov. 2009, page 68

[“Tax Matters: Qualifying Child Definition Amended \(/issues/2009/nov/qualifyingchild.html\),”](#) Nov. 2009, page 74

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