

## Having Your Cake and Eating It, Too – Twice!

Robert S. Balter

When medical expenses are paid by a donor on behalf of the donee, who is entitled to take the income tax deduction? I have been asked this question any number of times,<sup>1</sup> and, until recently there has been no answer. This article sets forth the applicable law and provides the Tax Court's recent answer, as well as analysis of the implications.

Section 213 of the Internal Revenue Code<sup>2</sup> provides a deduction for the unreimbursed medical expenses of the taxpayer or a dependent.<sup>3</sup> Medical expenses are defined in Section 213(d) as .... expenses incurred by the taxpayer for medical care treatment.

When a person pays an expense for another, an indirect gift takes place.<sup>4</sup> IRC Section 2503(e) excludes from taxable gifts those gifts made directly to providers of medical care or for tuition, and the Treasury goes on to exclude such transfers from even reportable gifts.<sup>5</sup>

By definitional cross reference,<sup>6</sup> gifts that qualify as medical care for purposes of the gift tax exclusion also qualify for the income tax deduction. There is no express provision in the Internal Revenue Code or Regulations allocating the income tax deduction between the donor and the donee.

A taxpayer is only allowed an income tax deduction to the extent that the aggregate of expenses for medical care exceeds 7.5% of the taxpayer's adjusted gross income.<sup>7</sup> As a general matter, it seems likely that a donor will have greater adjusted gross income than will a donee, and also likely that a deduction by the donor for a dependent's medical expense will be lost by reason of the 7.5% hurdle.

On the other hand, the donee never had the money with which the payment was made and the Internal Revenue Service has challenged income tax deductions taken by a donee as not paid by the taxpayer. It was such a deduction that was challenged by the Service in *Judith F. Lang*.<sup>8</sup>

Judge Goeke succinctly summed up the pertinent facts as follows:

"Petitioner's mother, Frances Field (Mrs. Field), paid \$24,559 directly to medical providers on account of petitioner's medical expenses and paid \$5,508 directly to the city government on account of petitioner's real estate tax. Petitioner was not a minor, and Mrs. Field was not legally obligated to pay petitioner's expenses."<sup>9</sup>

The petitioner timely filed her return and claimed deductions consisting in part of the amounts paid by her mother. Treasury argued "that because the money was paid directly from Mrs. Field to petitioner's creditors, petitioner may not claim the deductions."<sup>10</sup>

Judge Goeke's holding is set forth in two brief sentences:

"Applying substance over form, we treat petitioner as having received from her mother a gift of \$24,559 with which petitioner paid her own medical expenses. Petitioner should be credited with having made the payments for purposes of the income tax deduction in question."<sup>11</sup>

This seems to be the correct analysis. §2503(e) seems to give the taxpayers a choice regarding who may take the deduction in many cases. If the donee is a dependent of the donor, the donor can take the deduction under the authority of IRC §213(a) taken together with IRC §152. In those same cases, the donee also seems able to take the deduction (so long as the donor does not) if the donor is not obligated to make the payment as part of a support obligation.<sup>12</sup> If the donee is not a dependent of the donor, only the donee seems authorized to take the deduction under the authority of the *Lang* case and by reverse implication from IRC §213(a)'s dependency requirement.

Thus, whether to take the donee as a dependent becomes the pivot point on which deductibility of the §2503(e) medical expenses depends. In many cases, wealthy families will find this an especially small price to pay given the phase-out of those deductions under IRC §151.<sup>13</sup> The result will be less tax paid by the unit consisting of donor and donee.

Nor does this seem to be an abusive result. There is no public policy favoring the non-deductibility due to percentage thresholds. That "deductions are a matter of legislative grace" does not evince a policy in favor of expanding percentage

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thresholds. Rather, the legislative judgment seems to be that medical expenses generally (as defined) are the sort of expense that should be taken into account in determining adjusted gross income.<sup>14</sup>

And that brings us to the question whether Lang might apply beyond its own facts: Who is entitled to the credits for tuition payments<sup>15</sup> made by IRC §2503(e) gifts? Here, however, there is no real doubt, since United States Treasury Department Regulations § 1.25A-5(b)(1) provides that the donee is entitled to the credit.

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#### Footnotes

1 Principally by Jane Amodei, Guggenheim Private Family Office in King of Prussia, PA.

2 Referred to herein as "IRC" or "Code."

3 The term "dependent" is defined in Internal Revenue Code ("IRC") Section 152, but for these purposes is "determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof," that is without regard to whether a dependent is another's dependent, whether a dependent is married or whether a dependent has more income than the amount of the personal exemption.

4 See generally United States Treasury Department Regulations ("Regs") §25.2511-1(c)(1) and §25.2511-1(h)(2) and -1(h)(3).

5 See Regs. §25.2503-6(a); and see Form 709 Instructions at page 2.

6 See IRC Section 2503(e)(2)(B) cross referencing IRC Section 213(d).

7 IRC §213(a).

8 Judith F. Lang, T. C. Memo 2010-286 (12-30-2010, Tax Court Docket No. 27276-08) (concerning Tax Year 2006).

9 *Id.*, slip opinion at page 2.

10 -*Id.*, slip opinion at page 3.

11 *Id.*, slip opinion at pages 4-5.

12 Compare Lang slip opinion at page 2 ("Petitioner was not a minor, and Mrs. Field was not legally obligated to pay petitioner's expenses," indicating that a different result might obtain).

13 Note that this phase-out does not apply in 2011 or 2012 due to Section 101 of the TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION AND JOB CREATION ACT OF 2010, effective December 17, 2010.

14 IRC §213(a).

15 Referred to as the Hope and Lifetime Learning credits, these are provided respectively by IRC §§ 25A(a)(1), 25A(i)(1), 25A(a)(2) & 25A(c)(1).