



Difficulty of Care: Operational Challenges and Considerations

*Financial Membership Services (FMS)
Member Forum Summary*

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Table of Contents

Introduction	1
What is the purpose of Difficulty of Care payments?	1
A Brief History of Difficulty of Care and Notice 2014-7	1
Summary	2
Clarifying the Ambiguity of Difficulty of Care	2
Application of Notice 2014-7 to Medicaid programs other than the 1915(c) waivers.....	2
Workers qualifying for Difficulty of Care and workers being FICA exempt	3
Qualifying for Difficulty of Care vs. being “Exempt” on a W-4	3
Potential fraud, tracking the residencies, and the role of FMS entities	3
Providing accurate information about the tax benefit and accurately reporting wages	4
Providing information to workers.....	4
Conclusion.....	5
Appendix 1: Difficulty of Care: Financial Membership Services (FMS) Member Forum Polls.....	6

Introduction

On January 3, 2014 the IRS released Notice 2014-7 which created a potential increase in take-home pay for qualifying live-in care providers by expanding Difficulty of Care payments to apply to workers receiving payments through a Medicaid Home and Community Based Service waiver.

Determining *if* a worker qualifies for Difficulty of Care is not always straightforward. Once a worker qualifies, there continues to be confusion about operationalizing, including the documentation and reporting of the payment, and how these payments are different from a tax exemption. Applied Self-Direction continues to receive many inquiries regarding the operationalization and reporting of Difficulty of Care by Financial Management Services (FMS) entities, as well as inquiries from live-in care providers who may potentially qualify and would like additional clarity about the potential tax advantage.

In April of 2023, Applied Self-Direction held a forum for FMS members to discuss Difficulty of Care. This forum provided a space for members to discuss challenges, identify possible solutions, and clarify areas of confusion.

What is the purpose of Difficulty of Care payments?

Difficulty of Care payments are considered a tax benefit for qualifying live-in care providers that ultimately increase the take-home pay of live-in care providers because these payments are excludable from federal income tax; the payments are not considered wages for federal income tax purposes. Some states also recognize Difficulty of Care, and if so, these payments may also be excluded from income for state income tax purposes. It is important to keep in mind, Difficulty of Care payments still are considered wages for purposes of Social Security and Medicare, as well as the Earned Income Tax Credit and Additional Child Tax Credit (per *Feigh v. Commissioner*, 2019).

A Brief History of Difficulty of Care and Notice 2014-7

Difficulty of Care is an income reclassification that was originally created for foster care payments and allows payments to not count as wages for federal income tax purposes only. Section 131(c) of the Internal Revenue Code defines Difficult of Care payments as *“compensation for providing the additional care of a qualified foster care individual which is: (i) required by reason of a physical, mental, or emotional handicap of such individual with respect to which the State has determined there is a need for additional compensation, and (ii) provided in the home of the foster care provide.”*¹ Some, but not all, states also recognize this reclassification for state income taxes purposes.

Prior to 2014, Difficulty of Care payments only applied to compensation for foster care. IRS Notice 2014-7 expanded the Difficulty of Care reclassification in Section 131(c) of the Internal Revenue Code to apply to self-direction workers who live full-time with their employer, have no other residences, and receive payment through a Medicaid 1915(c) or similar waiver. Since Notice 2014-7 was not created within the home and community-based services arena, it notably leaves ambiguity for other waivers to also

¹ <https://www.law.cornell.edu/uscode/text/26/131>

potentially be included that would meet the same criteria; *“a state may obtain a Medicaid waiver that allows the state to include in the state’s Medicaid program the cost of home or community-based services (other than room and board) provided to individuals who otherwise would require care in a hospital, nursing facility, or intermediate care facility (eligible individuals). Home or community-based services include personal care services, habilitation services, and other services that are “cost effective and necessary to avoid institutionalization.”*

Notice 2014-7 states the purpose of the notice was *“To achieve consistent federal tax treatment of Medicaid waiver payments among the states and individual care providers, this notice provides that as of January 3, 2014, the Service will treat qualified Medicaid waiver payments as Difficulty of Care payments under § 131(c) that are excludable under § 131, and this treatment will apply whether the care provider is related or unrelated to the eligible individual.”*² Unfortunately, the consistency the IRS was hoping to achieve by releasing Notice 2014-7, has caused additional questions in the self-direction space as various workers and administrators attempt to clarify the details, making the tax benefit for workers harder to realize.

Summary

During this FMS member forum, attendees identified ambiguities of Notice 2014-7, including the application of Notice 2014-7 for Home and Community-Based Services beyond those funded by 1915(c) waivers, the ongoing confusion surrounding workers being exempt from taxes while also qualifying for Difficulty of Care and how to differentiate the two, the roles and responsibilities of the FMS, ways to avoid potential fraud, and how to accurately report and provide information about the benefit of Difficulty of Care.

Attendees discussed and attempted to clarify these perplexities, and agreed that educating, without providing tax advice, is the best way to support workers. Over three-quarters of attendees said there is a need for additional publicly available information for workers, tax preparers, and other stakeholders. Nearly three-quarters of attendees reported it is an extremely or fairly important worker benefit.

Clarifying the Ambiguity of Difficulty of Care

Application of Notice 2014-7 to Medicaid programs other than the 1915(c) waivers

Difficulty of Care could potentially apply to a funding source other than a 1915(c) waiver if a state (or an individual) receives a private letter ruling (PLR) from the IRS. However, it does not apply to non-waiver programs, including both Veteran Directed Care (VDC) and Older Americans Act (OAA) funded programs. Although an individual worker or state may apply for a Private Letter Ruling (PLR) from the IRS, which formalizes the applicability to be used for other waivers, this creates a cumbersome and financially burdensome additional step to realize the full benefit, particularly due to the large number of waivers in each state and nationwide that have similar long-term goals, each requiring their own PLR. Additionally, live-in providers are not often aware of the waiver funding their payment.

² https://www.irs.gov/irb/2014-04_IRB

Workers qualifying for Difficulty of Care and workers being FICA (Social Security and Medicare) exempt

Many self-direction workers are family members of their employer. Certain family relationships allow both the employer and the employee to qualify for exemptions from Social Security and Medicare taxes, also known as FICA.

Qualifying for FICA exemptions and Difficulty of Care have separate qualifying criteria, so some workers may be only FICA exempt, and others might be only Difficulty of Care eligible, while a third group could qualify for both Difficulty of Care and FICA exemptions.

FICA exemptions are not optional for individuals (and they are written into the tax code), while the IRS has confirmed that Difficulty of Care payments can be treated as wages by FMS entities and claimed by employees on their personal taxes, since it is really a benefit for individuals.

Social security benefits later in life are not impacted by the reclassification of Difficulty of Care, but if a worker is FICA exempt, social security benefits would be impacted.

How does this impact an IRS Form W-2? If an employee received Difficulty of Care payments and was also FICA exempt, a W-2 could have all zeros. There is no requirement to issue Form W-2 in this case, but may be operationally easier to do so and could be helpful for the employee to have additional details populated in Box 14.

If the employee received a Difficulty of Care payment, and was not FICA exempt, Box 1 should be 0, but the SS & Medicare wages and withholdings should be listed in boxes 3, 4, 5 and 6.

Qualifying for Difficulty of Care vs. being “Exempt” on a W-4

Filing as “Exempt” from federal and state taxes is different than qualifying for Difficulty of Care. An individual who receives Difficulty of Care payments would by default not owe any federal taxes on the payment itself.

The IRS has suggested obtaining a signed certification from an employee would be a best practice for proof of qualifying for Difficulty of Care. A sample can be found in the [IRS Q&A, in the answer to Q15](#).

Additionally, is a best practice for FMS entities to still obtain a W-4 for individuals who might qualify for Difficulty of Care in case their living situation changes and taxes need to be withheld.

Potential fraud, tracking the residencies, and the role of FMS entities

There continues to be concerns about the liability for potential fraud, especially when mailing addresses between the employer and employee are not the same.

The IRS Office of Chief Counsel informed ASD that recognizing and declaring Difficulty of Care/Notice 2014-7 payments were ultimately the employee’s responsibility, not the employer's or FMS’ responsibility. Their reasoning is that only the employee could be sure whether their living situation met

the eligibility criteria, and therefore this responsibility could not logically be placed on the employer or agent.

If a worker qualifies for Difficulty of Care and would like to reclassify the payment, the worker could provide a signed affidavit. The IRS has suggested obtaining a sample certification from an employee as a best practice. One can be found in the [answer to Q15](#).

Providing accurate information about the tax benefit and accurately reporting wages

Attendees stressed the importance of not providing tax advice, and only providing information to workers about the potential benefit, which they noted generally happens during the onboarding process. Over 80% of attendees said there is need for additional publically available information and documentation from the IRS that could be shared with workers, tax preparers and other stakeholders.

The IRS Office of Chief Counsel confirmed in 2015 that it is permissible for FMS entities to treat Difficulty of Care payments as wages and issue a Form W-2 at year-end, and the employee can then reclassify those payments on their individual tax return. However, any benefit payments associated with the work would not be considered a Difficulty of Care payment and should be reported separately from payments for work, which are considered Difficulty of Care payments. For example, if a worker who received Difficulty of Care payments also received PTO, the PTO would be considered taxable wages but the Difficulty of Care payment would not be considered taxable for federal income tax. So, the W-2 would need to distinguish between the Difficulty of Care payment and the PTO payment for the worker to account for the Difficulty of Care payment on their individual tax return.

Additionally, IRS Counsel stated previously that it is optional for FMS entities to include Difficulty of Care payments in Box 14, which can help provide proof of income (for loans or EITC) if other tax exemptions exist.

IRS Form 1040 has been updated to include a box for Difficulty of Care payments not reported on the W-2. Attendees noted that although the 1040 was amended, the instructions for reporting (or not) of Difficulty of Care payments had not been updated so leaves room for ambiguity and interpretation by tax preparers who may not be familiar with Difficulty of Care.

Providing information to workers

FMS members provide a varying degree of information about Difficulty of Care to workers which may include one or more of the following:

- No information is shared
- Obtain a certification letter from the worker stating they qualify and take Difficulty of Care into account on an ongoing basis
- Do not report any DOC payment to the employee in Box 1
- Report DOC payment in Box 14 of the W-2
- Ensure PTO and other benefits are distinguishable from DOC payments
- Provide a notice informing workers of a potential tax benefit if they meet the qualifying criteria

- Provide a more detailed document in addition to a W-2 that can be shared with a tax preparer, providing an overview of the W-2, including the amount of the Difficulty of Care payment, and resources for more information which may include:
 - [IRS Taxpayer Advocate Site](#)
 - [IRS 2014-7 Q&A](#)

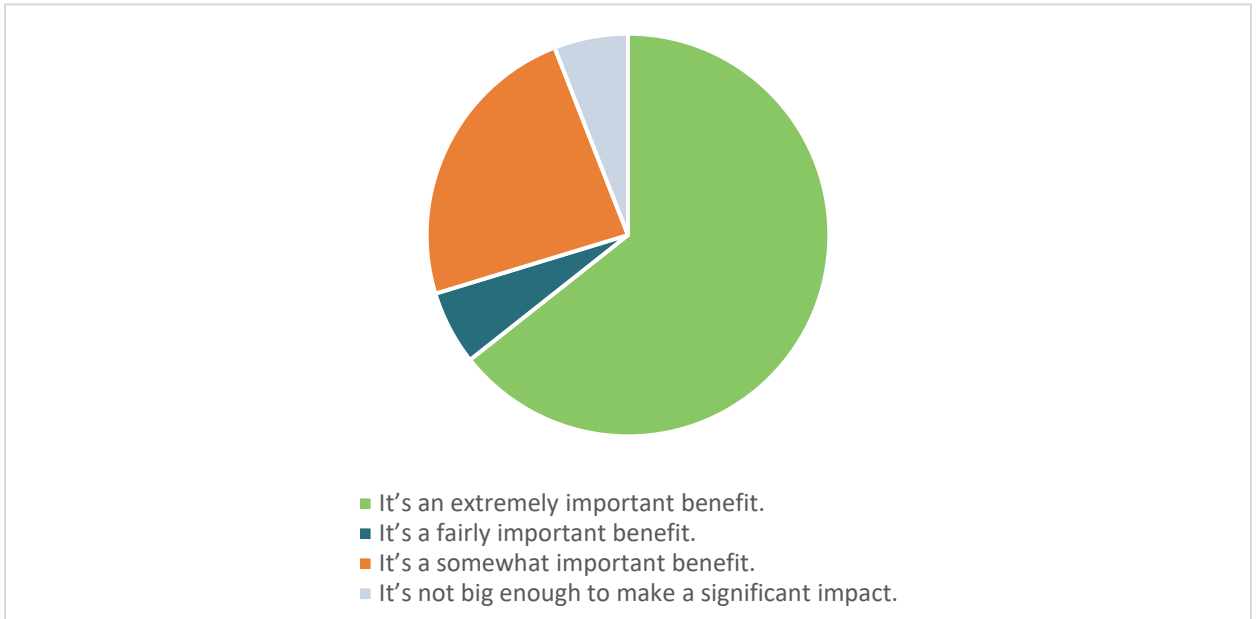
Conclusion

Although Notice 2014-7 expanded Difficulty of Care payments to self-direction workers in 2014, much ambiguity remains about the application of Difficulty of Care to self-direction workers, including the application beyond 1915(c) waivers, Difficulty of Care vs tax-exemptions, the role of the FMS in providing information about the benefit and how to accurately report payments. Since the IRS considers Difficulty of Care to be an employee benefit, FMS entities rightfully have a variety of approaches for Difficulty of Care, ranging from not sharing any information/leaving it entirely to the employee, to accounting for it on an ongoing basis and reporting it on the W-2 along with providing additional handouts of information. Forum attendees expressed a strong need for additional documentation and information from the IRS that could be shared with workers, tax preparers, and other stakeholders. Attendees also agreed that educating, without providing tax advice, is the most practical way to support workers.

Appendix 1: Difficulty of Care: Financial Membership Services (FMS) Member Forum Polls

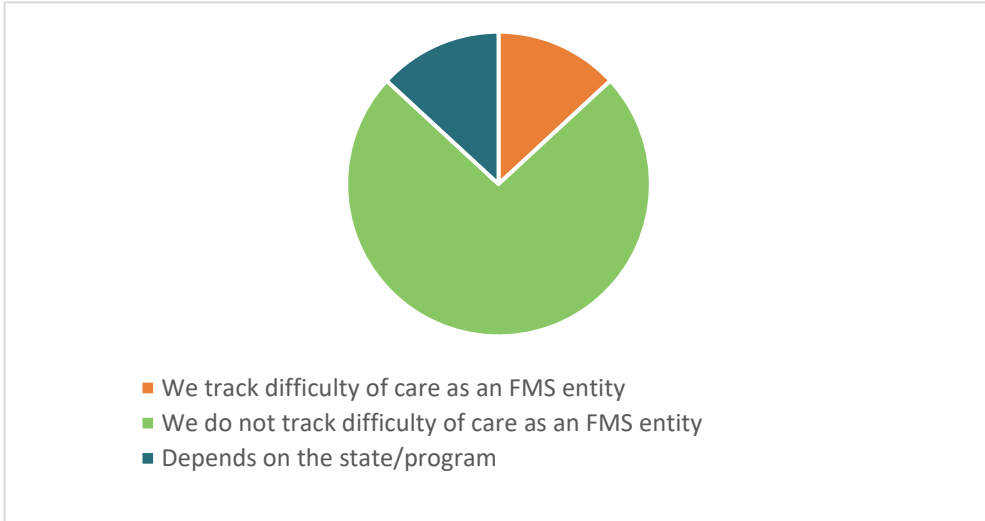
ADD Number of Attendees

1. The Difficulty of Care tax benefit aims to make caregiving more financially sustainable for family members and other live-in workers. In your opinion, how big is the impact of the Difficulty of Care benefit for workers financially?



	Percentage
It's an extremely important benefit.	65%
It's a fairly important benefit.	6%
It's a somewhat important benefit.	24%
It's not big enough to make a significant impact.	6%

2. Do you track Difficulty of Care payments as an FMS entity, or do you treat payments as wages and allow the employee to claim Difficulty of Care on their tax return?

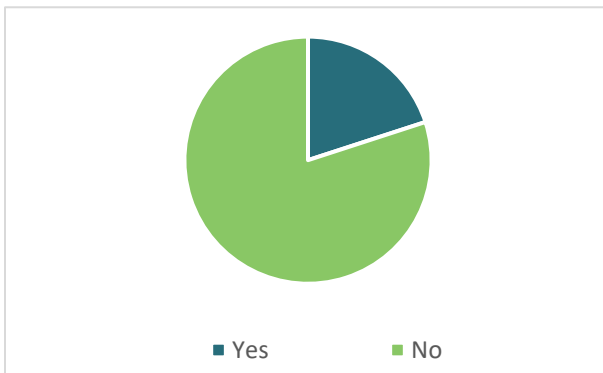


	Percentage
We track Difficulty of Care as an FMS entity	13%
We do not track Difficulty of Care as an FMS entity	73%
Depends on the state/program	13%

3. If you track Difficulty of Care payments as an FMS entity, are you contractually required to do so by your payer?

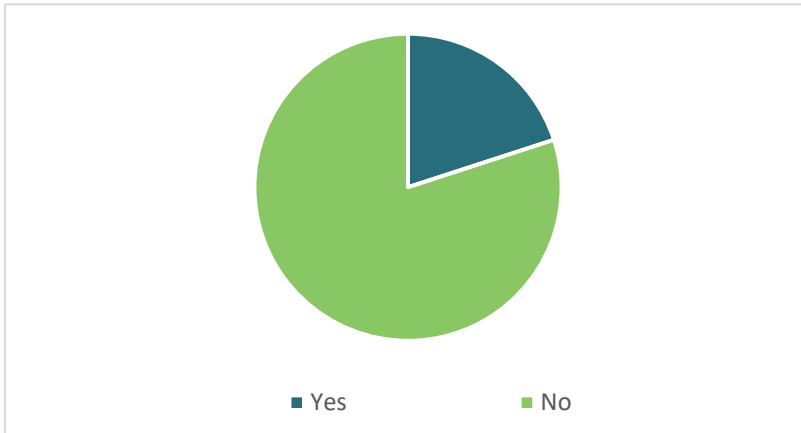
	Percentage
Yes	0%
No	100%

4. Do you include Difficulty of Care payments in Box 14 of the W-2?



	Percentage
Yes	20%
No	80%
Depends on the state	0

5. Is there enough information about Difficulty of Care publicly available for workers, tax preparers, and other stakeholders? If not, what resources might be most helpful to create?



	Percentage
Yes, there is enough information publicly available.	19%
No, more information is needed.	81%