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## Understanding Income Tax Exemptions (AKA Difficulty of Care Payment Exclusions)

### What is income tax?

- Income tax encompasses all those federal, state, and local taxes levied by government entities on personal income. If you're an employee, your employer withholds income tax payments from your paychecks. Employees use IRS form W-4 to indicate how the employer should withhold federal taxes from their pay. Maryland employees use form MW507 to indicate how the employer should withhold state taxes from their pay.

### Employees exempt from income tax:

- Exempt employees are those who share a legal full-time residence (as indicated on their state identification) with the employer/participant to whom they provide services under a state Medicaid Home and Community-Based Services Waiver program, such as [The Maryland DDA Self-Directed Services](#) program. Payment for services provided to the employer, by those who share the individual's home address, are classified as "difficulty of care" payments instead of regular wages. Unlike wages, difficulty of care payments are excludible from federal gross income; therefore, they are not subject to federal income tax.
- An employee and an employer need not be family members in order for the employee to qualify for difficulty of care payments.
- Please note that income taxes are NOT employment taxes. If an employee is exempt from income taxes, that does not equate to being exempt from employment tax. Difficulty of care payments are subject to FICA, FUTA, and SUTA unless the employee is already employment tax exempt due to a qualifying familial relationship to the employer. (Please see 'Understanding Fringe and Employment Tax Exemptions'.)
- For exempt employees filing their returns electronically, both TurboTax and TaxAct have confirmed that their software can accommodate difficulty of care payments.
- Family members who provide paid care to another family member may not include difficulty of care payments in their income for the Earned Income Tax Credit. By definition, difficulty of care payments are excluded from federal income.

### How exemptions impact participants:

- Employers/Participants are not impacted by an employee's income tax exemption. The budget is not changed in any way.



## The Arc Central Chesapeake Region Fiscal Management Services

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### FMS Requirements:

- The [Special Tax Exemptions](#) new hire form (page 3) provides employees a means to declare their status as an individual care provider sharing a legal residence with the care recipient.
- Exempt employees MUST notify the FMS in the event of an address change impacting their exemption status and submit an updated Special Tax Exemptions form.
- Exempt employees MUST complete a W-4 and an MW507 upon hire regardless of their exemption status. The FMS must have withholding information on file in case an employee's exemption status changes.

### Resources

- The [IRS Notice 2014-7](#) is a resource that provides more information regarding applicable income tax exemptions.
- Another helpful resource is this [IRS Notice 2014-7 Q&A](#) document.

### A final word:

- Federal and state taxation rules change frequently. Employees may elect to consult with a tax advisor to assess the impact of these rules on their taxes.
- If employees discover that their tax situation has changed during the year, they may submit a revised W-4 and/or MW507 for withholding adjustments on future pay. The most current versions of these documents can be located on our [FMS web page](#).

**PLEASE NOTE:** The Arc CCR does not provide tax, legal, or accounting advice. This material has been prepared for informational purposes only and it is not intended to provide, nor should it be relied on for tax, legal, or accounting advice.