New Year, New Per Diem: The Method Behind the IRS's Chronic Illness Per Diem Allowance

At the time of this writing, year-over-year consumer price inflation through November 2021 stands at 6.8% compared with year-end 2020 prices, the kind of increase not seen since 1982.*

For those who remember, the late 1970s and early 1980s were years of double-digit price inflation, which led to double-digit federal fund rates and, consequently, double-digit consumer lending rates and bond yields. While high bond yields were a not-so-bad part of the story, they came at the cost of a steep drop in the dollar's purchasing power. Between 1974 and 1982, the U.S. cost of living nearly doubled.

It remains to be seen if such conditions will return. But today, after so long a period of low inflation and low interest rates, higher inflation naturally leads to uncertainty and questions: How will it affect GDP growth? Will the Federal Reserve increase the federal funds rate, driving market lending rates and bond yields higher?

Apart from these, another question emerges among life and health insurance professionals who are following along: In an inflationary environment like the current one, how can a government index linked to the cost of living go ***down***? Specifically, how and why did the Internal Revenue Service announce in November that the per diem limitation for qualified long-term care and accelerated benefit life insurance contracts is $390 for 2022, down from $400 in 2021?

To understand this, it helps to start with how the federal government tracks consumer prices. In general, price reporting is based on the Consumer Price Index for All Urban Consumers (CPI-U), compiled and maintained by the U.S. Department of Labor. Though CPI-U is composed of dozens of individual categories of consumer spending, all of them roll up under eight main indices: Food and Beverages, Housing, Apparel, Transportation, Medical Care, Recreation, Education and Communication, and All Other Goods and Services. These items, less certain sub-categories relating to food and energy, make up what is called core inflation – the number used by economists to gauge durable changes to the cost of living. Core inflation currently stands at 4.9%. However, raw inflation – including food and energy - is up 6.8% year-to-date for 2021.

Recognizing that overall inflation is not a fair measure in determining an allowable exemption for medical care, Congress mandated in 1996 the limit would change in step with the Medical Care component of CPI-U and ignore the other seven indices. Even at that time, it was clear that consumer costs for medical care would increase more rapidly than overall spending. This has been borne out: consider that the baseline per diem allowance was $175 in 1996, compared with $400 in 2021. That's an average annual increase of 3.7%, compared with average core inflation of 2.31% from 1996 to today.** The difference may not seem great, but its cumulative effect is: Americans' overall household expenses have increased 77% in the last 25 years, but the cost of medical care has gone up 129%.

The IRS offered no commentary when it announced the lower 2022 per diem limit, but it's clear from public data that health care costs did decrease between 2020 and 2021. The raw Medical Care index was 199.993 for August 2020 vs. 199.911 for August 2021. (Per the statute, August-to-August is the measuring timeframe.) It wasn't a large decrease, and very likely temporary. Because the dollar value of the per diem limitation is rounded to the nearest $10, higher or lower, a difference of a few basis points in the raw index value is enough to send it one way or the other. That is evidently what occurred this year, opposite to its usual direction.

What's unclear is why after relentless increase over 24 years (including 2009, the lone year between 1996 and 2021 overall inflation fell), the Medical Care component of the CPI took a pause in 2021. The obvious suspect is the effect of the COVID-19 pandemic. It may be that consumers postponed routine medical care out of precaution or substituted free services such as COVID-19 vaccination for part of their normal healthcare expenditure or, most tragically, that a diminished population of vulnerable consumers reduced overall demand.

The decrease could also be a result of the switch to chained CPI (C-CPI-U) for increases to certain tax allowances, implemented by the 2017 Tax Cuts and Jobs Act. While CPI-U reports the nominal prices of goods and services, C-CPI-U is based on consumers' tendency to shift buying patterns to compensate for higher nominal prices, achieving their purchasing goals at effectively lower cost. Commentators reported after passage of the Tax Cuts and Jobs Act that the rate of increase to inflation-linked tax provisions would slow as a result of the switch to C-CPU-U, even resulting in occasional decreases. The 2022 drop in the LTC/chronic illness per diem limitation may be an example of this effect.

Future commentators may shed more light on the causes behind the 2022 change. Until then, we hope you find this information helpful. For questions regarding changes in tax law or any advanced concept or strategy, please contact Prudential's Advanced Planning team at 800-800-2738, option 4.

* Aratani, L. (Dec 10, 2021). *US inflation rate rose to 6.8% in 2021, its highest since 1982*, The Guardian, accessed via https://www.theguardian.com/business/2021/dec/10/us-inflation-rate-rise-2021-highest-increase-since-1982; Leonhardt, M. (Dec 10, 2021). *Inflation is up 6.8% over the past year, the largest rate increase since 1982. Here's what that means*, Fortune, accessed via https://fortune.com/2021/12/10/inflation-largest-increase-since-1980s/

** Webster, I. (Dec 27, 2021). *$1 in 1996 → 2022 | Inflation Calculator*, Official Inflation Data, Alioth Finance, accessed via https://www.in2013dollars.com/us/inflation/1996?amount=1

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