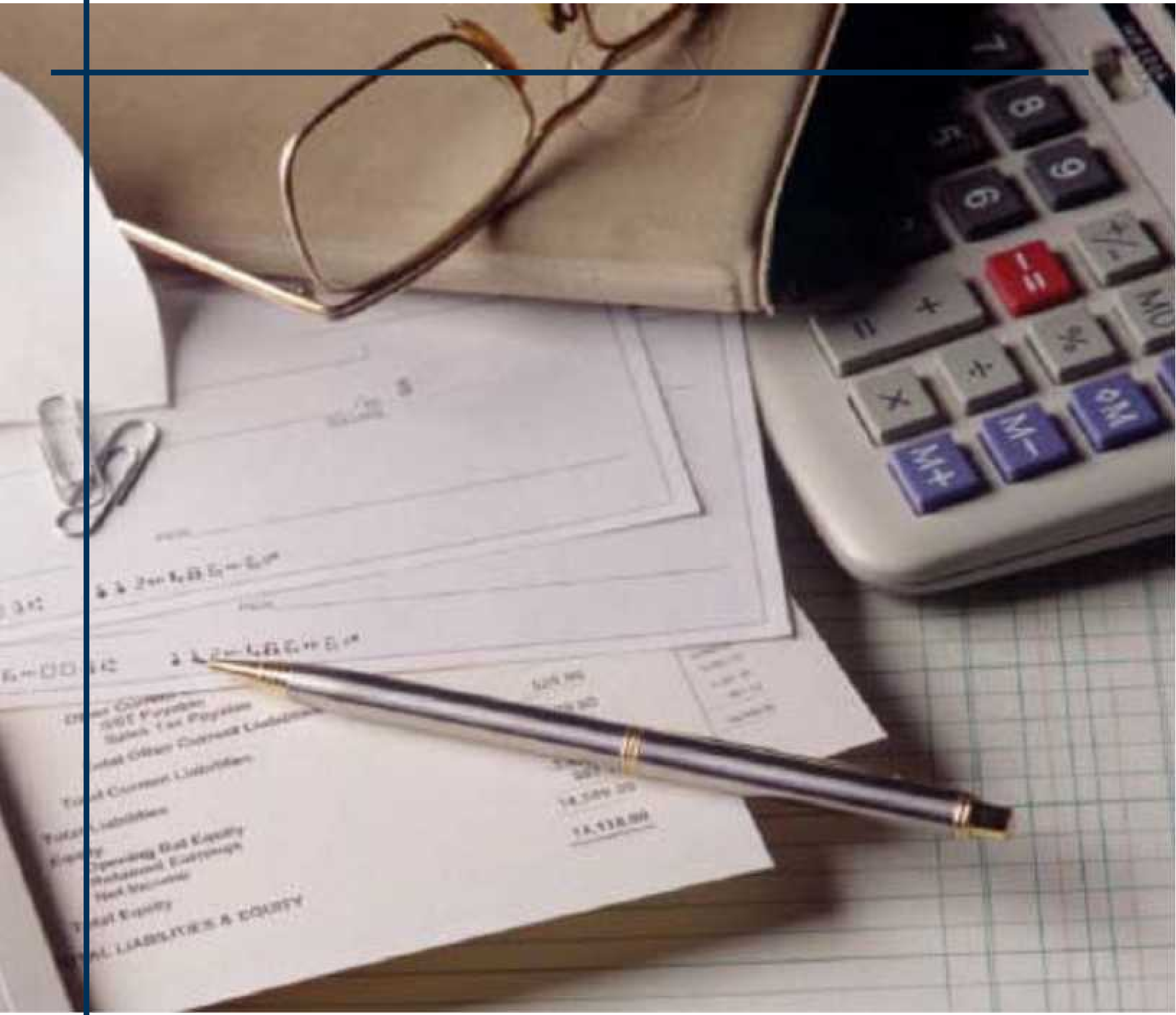
Advanced Strategies

Asset-based Long Term Care Benefits

Tax guide for individuals and businesses



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Tax Guide for Asset-Based Long Term Care Benefits

The development of asset-based Long Term Care

In 1996, with the Health Insurance Portability and Accountability Act (HIPAA), the federal government set forth the requirements for tax-qualified Long Term Care (LTC) policies. These provisions are codified in Internal Revenue Code (IRC) section 7702B. HIPAA also provided for life insurance/LTC combination contracts or what are known as hybrid or asset-based LTC policies.

HIPAA stated that life insurance and LTC benefits could be combined in one policy. If the provisions for payment of LTC benefits complies with the law, those benefits will be received income tax free. Additionally, if the policy pays no LTC benefits and the policy pays its life insurance death benefit on the insured's death, then that benefit will also be received free from income tax under IRC section 101(a). The typical configuration of a life insurance asset-based contract involves what is basically a prepayment of a permanent life insurance policy's death benefit for qualified LTC claims.

For example, a policy may provide that the maximum monthly LTC benefit is two percent of the policy's death benefit. Hence, if the policy had a $250,000 death benefit, the maximum monthly LTC benefit would be $5,000 per month for 50 months. Each payment of LTC benefits would correspondingly reduce the policy death benefit. If the full payment of $5,000 were to be paid for 50 months, the policy death benefit would likewise be exhausted.

An additional consideration in the analysis of asset-based LTC contracts is the ability to purchase Continuation of Benefit (COB) coverage with these policies. COB coverage takes effect after the LTC benefit balance on the base policy has been exhausted through qualifying LTC benefit payments. COB coverage will continue benefits for a predetermined period of time, and lifetime coverage is also available. There is additional premium for this extended coverage and it is medically underwritten. Premiums are generally noncancelable and may be paid on a single premium, a 10-pay or an annual basis. COB coverage can provide the purchaser with the peace-of-mind that they will not outlive the coverage.

From the above example in which a life insurance LTC policy was prepaying two percent of the death benefit each month over a period of fifty months: this insured may have concerns that coverage will be exhausted if he or she lives longer than four years and two months while on LTC claim. COB coverage will begin in month fifty-one when the base coverage runs out.

The tax deduction for individually purchased policies

HIPAA amended IRC section 213(d), which provides for the allowance of a deduction for medical care expenses, to include LTC premiums in the definition of "medical care". Note that, when asset-based LTC products are concerned, the medical expense deduction would only apply to premiums for COB coverage, or a separate rider charge for the LTC portion of the policy. The premium on the base life insurance policy is not deductible because life insurance premiums are not deductions on a personal income tax return.

The first hurdle to claiming any level of deduction is that medical care is an "itemized" deduction and is not available to individual taxpayers who claim the standard deduction. A second limitation is that the deduction for medical care is limited by a ten percent Adjusted Gross Income (AGI) floor. A third limitation is that the LTC premium deduction is limited to an age-related table that sets a cap on the deduction. The table limits are adjusted annually for inflation, and the following table sets forth the deduction limits for 2016:

Age of insured	Annual Premium Deduction Limit
Under 41	$390
41 – 50	$730
51 – 60	$1,460
61 – 70	$3,900
Over 70	$4,870

Consider a single taxpayer, age 60, with an AGI of $60,000 and without any medical expenses other than LTC and health insurance premiums. If the taxpayer purchases LTC insurance the maximum deduction is $1,460. If this individual pays $1,071 for health insurance coverage as his or her contribution for employer provided health insurance, the calculation for determining the amount of itemized deduction would be as follows:

LTC insurance premium	$1,460 (limit)
Heath Insurance premium	$1,071*
Total medical expenses	$2,531
10% of AGI	$6,000

*2015 Average annual worker premium, Kaiser Foundation, *Employer Health Benefits 2015 Summary.*

What this demonstrates is that the taxpayer would have to incur out-of-pocket medical expenses (in addition to LTC premium) of at least $3,469 before any of the medical expenses would be deductible. Note also that, if an employee's health insurance contribution is paid via an employer's cafeteria plan on a pre-tax basis, then the employee's contribution may not be an itemized deduction on the employee's personal tax return. Even if this taxpayer were self-employed and purchased a "platinum" plan under the Patient Protection and Affordable Care Act, a.k.a. "Obamacare", paid entirely by the taxpayer without subsidy, the example would look as follows:

LTC insurance premium	$1,460 (limit)
Platinum premium	$5,292**
Total medical expenses	$6,752
10 percent of AGI	$6,000
Potential deduction	$752

**National Conference of State Legislatures, *Health Insurance: Premiums and Increases*, January 2015, (chart for Single Coverage by Metal Tier and State, 2014-2015 US average).

In a 25 percent tax bracket this taxpayer's after-tax benefit would be just $188. Hence, even for those who are paying increasing amounts for health coverage due to Obamacare, the value of the deduction may be minimal.

The tax treatment of policies purchased in the employment setting

Although a tax benefit based on premium in the individual purchase setting may be illusory or paltry, the same cannot universally be said for the purchase of LTC coverage in the employment setting. Depending on the type of employer and the nature of the relationship between the employer and employee, there may be substantial tax benefit through the provision of LTC coverage as an employment benefit.

The following discussion assumes that benefits paid from LTC coverage in all cases are "qualified" under IRC section 7702B, i.e., that reimbursement payments and per diem payments up to the daily limit are not reportable in income. Once again, this covers only COB or separate rider charges for LTC coverage. The tax treatment of the base life insurance policy is different.

<u>Sole proprietors</u>

A sole proprietor can deduct his or her Long Term Care Insurance (LTCI) premiums up to the age-related cap mentioned above. This is done as an adjustment to gross income on line 29 of IRS Form 1040 (Self-employed health insurance deduction). The portion of the premium in excess of the cap is not deductible as a medical expense. The percentage of AGI threshold for deductibility on an itemized individual return does not apply.

Employees (including spouses) of sole proprietors

LTCI premiums paid by the employer are deductible by the employer, and the deduction is not limited by the age-related cap. In other words, the LTCI premium may be treated as a business expense for medical insurance premiums. Employees are not taxed on premiums paid by their employer for LTCI on the employee, the employee's spouse, and the employee's eligible dependents.

Base life insurance policy premiums

The base premiums for policies insuring the sole proprietor are not deductible by the sole proprietor. The base policy premiums on policies insuring employees, if the employee owns the policy, are deductible by the sole proprietor as compensation to the employee. The base policy premiums are reportable in income by the employee as compensation received. Per IRC section 264(a)(1), the sole proprietor may not have any interest in the policy in order to claim the deduction.

Partnerships, Limited Liability Companies (LLCs) taxed as partnerships and S corporations

LTCI premiums paid by the employer are deductible by the employer, and the deduction is not limited by the age-related cap. In other words, the LTCI premium may be treated as a business expense for medical insurance premiums.

If premium is for LTCI on a partner, this assumes the premiums are "guaranteed" payments under IRC section 707(c) where the LTCI premium payment is not deducted from the partner's draw from partnership profits. If the draw is reduced (a reduction in distributions to that partner), or the payment of LTCI premium is dependent on partnership profit, then the LTCI premium is not deductible.

For an S corporation to claim a deduction for LTCI coverage the premiums must be paid under a plan established by the S corporation. A plan is considered "established" if the premiums are either directly paid by the S corporation or paid by the owner and reimbursed by the S corporation (IRS Notice 2008-1).

Partners, LLC members and S corporation greater than 2% shareholder employees

The LTCI premium payment is treated as income from self-employment reported on Schedule K-1 for partners and LLC members, and on Form W-2 for greater than 2% shareholder employees. The owner employee can deduct his or her LTCI premiums up to the age-related cap. This is done as an adjustment to gross income on line 29 of IRS Form 1040 (Self-employed health insurance deduction). The portion of the premium in excess of the cap is not deductible as a medical expense. The percentage of AGI threshold for deductibility on an itemized individual return does not apply.

Non-owning employees

One strategy that self-employed persons use to deduct premiums paid for LTCI on a spouse is to employ the spouse in the business. This does not work in an S corporation because the family attribution rules under IRC section 318 cause ownership of an individual's S corporation stock to be attributed to his or her spouse, children, grandchildren, and parents. As a result, those affected by the family attribution rules are treated like the greater than 2% shareholder employee regarding tax treatment of LTCI premiums.

Employees (not subject to family attribution) are not taxed on premiums paid by their employer for LTCI on the employee, the employee's spouse, and the employee's eligible dependents.

Base life insurance policy premiums

The base policy premiums on policies insuring employees, if the employee owns the policy, are deductible by the business as compensation to the employee. This is Schedule K-1 self-employment income for partners and LLC members, and is Form- W-2 income for S corporation shareholder employees. In other words, the base policy premiums are reportable in income by the employee as compensation received. Per IRC section 264(a)(1), the business enterprise may not have any interest in the policy in order to claim the deduction.

<u>C Corporations</u>

LTCI premiums paid by the employer are deductible by the employer, and the deduction is not limited by the age-related cap. In other words, the LTCI premium may be treated as a business expense for medical insurance premiums.

A corporation may establish a plan under IRC section 105 to provide LTCI benefits only to a select group of employees. The plan should be in writing and approved by the corporation's legal counsel. It should define which employees are eligible using reasonable classifications related to employment status such as compensation, job title or years of service.

C Corporation employees (owners and non-owners)

The entire LTCI premium paid by the business is excluded from the employee's income. This exclusion applies to shareholder employees in C corporations and to shareholder employees who own 2% or less of an S Corporation.

Thus, to review: C corporations which pay LTCI premiums through a valid IRC section 105 plan for employee coverage may deduct the premiums and are not limited by the age-related cap. Nor are C corporations limited by the 10 percent AGI floor. Such coverage is also not taxable to the employees. Hence, C corporation shareholder employees, where the corporation has retained earnings, may find asset-based LTCI policies with comprehensive COB coverage attractive. The COB premium is deductible to the corporation without limit, the COB premium is not taxable to the shareholder employee, and LTC benefit payments are tax free under IRC section 7702B. This assumes total shareholder compensation is "reasonable" under IRC section 162.

Base life insurance policy premiums

The base policy premiums on policies insuring employees, if the employee owns the policy, are deductible by the business as compensation to the employee. The base policy premiums are reportable in income by the employee as compensation received. Per IRC section 264(a)(1), the business enterprise may not have any interest in the policy in order to claim the deduction.

Other considerations

<u>PPACA and LTCI plans</u>

The Patient Protection and Affordable Cara Act (PPACA - a.k.a. Obamacare) affected an employer's ability to provide medical reimbursement under IRC section 105 as such a plan may not meet the approved PPACA requirements. However, there is an exception from PPACA for dental, vision and LTCI plans (42 USC Section 300gg-91(c)(2)).

Contributory arrangements

If an employer only pays a portion of the LTCI premium, the employee is able to treat the balance that the employee pays as a deductible medical expense. The employee must itemize, and the deduction is limited by the age-related cap. Also, the employee is entitled to the deduction only to the extent that total medical expenses exceed 10% of AGI. The employer may deduct the full amount the employer pays as an employer provided medical expense.

It is important to note that LTCI premiums an employer pays must be considered additional compensation for services provided by the employee. To the extent that an employee's salary or bonus is reduced to pay LTCI premium, that reduced amount is considered paid by the employee and would be taxable to the employee.

Health Savings Account (HSA)

Tax-qualified LTCI premiums can be reimbursed through an HSA, tax-free, up to the age-related cap. Tax-qualified LTCI premiums cannot be paid with pre-tax dollars under an employer provided cafeteria plan. However, LTCI premiums may be paid through an HSA that is offered under an employer provided cafeteria plan. Tax-qualified LTCI premiums cannot be reimbursed through a Flexible Spending Account (FSA), nor can LTCI premiums be paid on a pre-tax basis through a Health Reimbursement Account (HRA).

Return of premiums

Upon surrender or cancellation of an LTCI policy during the insured's lifetime, any refund shall be included in gross income to the extent that any deduction or exclusion was allowable with respect to the premium. The tax code and regulations are silent as to whether premium refunds paid on the insured's death are taxable income

With asset-based life insurance/LTC products, the payment of the life insurance policy death benefit on the death of the insured is received income tax free by the policy beneficiary.

Jointly Owned LTCI

A couple may purchase LTCI which insures their joint lives. Some policies are considered to be policies with joint insureds, and with other policies the second insured is covered via a policy rider. Any deduction available to the owner/insureds will be for each insured and will be based on that insured's age for purposes of the age-related cap.

Eligible Retired Public Safety Officers

Under the Pension Protection Act of 2006 (PPA), an eligible retired public safety officer may request a total of up to $3,000 per year paid from his or her eligible retirement plan for tax-qualified LTCI premiums for themselves, their spouse or eligible dependents. The payment must be made directly from the plan to the insurer issuing the LTCI. It cannot be made to the individual. This feature is available only in plans that specifically offer this option.

1035 Exchanges to LTCI

Many couples at or nearing retirement age have deferred annuities and permanent life insurance. Often such couples consider repositioning these investments without understanding the benefits of exchanging such policies for asset-based LTC policies. A benefit with life insurance and annuity policies is that IRC section 1035 permits exchanges from one policy to another policy better suited to meet the needs of the insured. Regulations also permit partial exchanges of deferred annuity policies with basis being allocated pro-rata between policies.

The chart that follows shows what types of contracts can be exchanged under section 1035.

Type of Policy → to	Life Insurance	Endowment	Annuity	Long Term Care*
Life Insurance	Yes	Yes	Yes	Yes
Endowment	No	Yes**	Yes	Yes
Annuity	No	No	Yes	Yes
Long Term Care*	No	No	No	Yes

* Contract must be a “qualified” long term care contract under IRC section 7702B
** Provided payments begin no later than under the old contract.

In a gain situation, a proper IRC section 1035 exchange enables the policyholder to postpone the recognition of that gain. The policyholder’s cost basis in the new policy becomes the transferred basis plus any future premiums paid.

In 2006, the PPA provided for annuity/LTC combination contracts in a manner similar to life insurance/LTC combination contracts under HIPPA.

Consider an individual age 70 who holds a traditional deferred annuity with a current account value of $400,000 and a basis of $200,000. If withdrawals are made from this annuity for expenses, LTC expenses included, the $200,000 gain in the annuity will be taxed first at ordinary income rates. If the annuity is exchanged under IRC section 1035 for an annuity LTC policy, taxation of the gain will be deferred, and if withdrawals are made for LTC expenses the distributions will be income tax free.

If this individual wished to allocate half of the $400,000 account value to LTC coverage, he or she could partially exchange half of the contract for an annuity LTC policy. The result after the partial exchange would be two policies. One traditional policy with an account value of $200,000 and a basis of $100,000; and one annuity LTC policy with an account value of $200,000 and a basis of $100,000.

Now consider an individual age 70 who holds a permanent life insurance policy with a death benefit of 250,000, cash surrender value of $150,000 and a basis of $100,000. If this individual surrendered the policy he or she would have $50,000 of reportable gain as ordinary income. The individual could take basis-reducing non-taxable withdrawals from the policy or loans, but if the policy later lapses or is surrendered, the policy gain will be reportable at that time. If this policy is exchanged under IRC section 1035 for an asset-based life insurance/LTC policy, the risk of taxation on lapse due to withdrawals for LTC expenses disappears. If this individual can no longer pass medical underwriting, the existing life insurance policy could be exchanged under IRC section 1035 to an annuity LTC policy, and distributions would then enjoy the tax favorable treatment that product enjoys for payment of LTC expenses.

<u>LTCI versus Chronic Illness Riders</u>

In addition to providing for asset-based LTC products in IRC section 7702B, HIPAA also added section 101(g) to the IRC. This section provides for terminal illness and chronic care riders on life insurance policies. A “terminally ill individual” is a person who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death within 24 months after the date of certification. A “chronically ill individual” is defined as any person (1) unable to perform, without substantial assistance, at least two activities of daily living for at least 90 days, (2) having a similar level of disability, as designated by regulations, or (3) requiring substantial supervision to protect the person from threats to health and safety because of severe cognitive impairment. Policy payments made for terminal illness or for chronic illness are treated as an acceleration of the policy death benefit and are received income tax free.

Hence, it may seem such riders provide the same coverage as asset-based life insurance LTC policies because policy death benefit may be accelerated income tax free for qualifying expenses. However, that is where the similarities end. The agent selling life insurance with section 101(g) riders only needs a license to sell life insurance. The selling of asset-based LTC policies requires the agent to also meet the state’s licensing requirements for LTC insurance. In addition, most states have LTC training and continuing education requirements. Furthermore, consumers purchasing asset-based products are afforded the protections outlined within section 7702B, including limits on post-claim underwriting, suitability standards, and education (e.g. the provision of the Buyer’s Guide to Long Term Care Insurance).

In fact, the term "long-term care" may *not* be used in marketing 101(g) policies. With some 101(g) riders, the physician must certify that the chronic illness is likely to last the rest of the insured's life – in other words, the condition must be non-recoverable. Whereas, 7702B policies provide benefits for both temporary and permanent claims. Also, some life insurance carriers place a cap on the percentage of the death benefit available for acceleration depending on the age and status of the insured at the time of the claim. A recent commentary described this dilemma as follows:

> "Some companies "include" a chronic illness rider feature as part of the policy, with no underwriting and at no additional charge. But keep in mind, no charge does not equate to free. Instead of charging for the rider, the death benefit is discounted when the rider benefits are actually needed. Because of this, benefits cannot be determined until a claim is filed. The discounting of benefits is based on several variables, including age, sex of the insured, premium class as well as current interest rates and policy cash value at time of claim. The younger you are when filing a claim, the more the death benefit is discounted. While some may argue this method spares people never needing qualifying chronic care services from paying rider charges, those needing benefits may not understand at the time of claim why the total policy benefit paid is not the amount of the policy at issue."*
>
> * Shawn Britt, *All riders are not created equal,* Life Health Pro, November 1, 2012.

Thus, the insured who purchases a 101(g) policy may not know what level of benefit will be available at the time of a claim. However, 7702B policies typically pay 100 percent of the policy death benefit for LTC claims which means the LTC benefit is known up front at the time of policy issue.

A final difference between 101(g) policies and 7702B policies is that continuation of benefits is not possible with 101(g) coverage. The COB coverage discussed earlier is only available with 7702B policies. Hence, the guaranteed assurance of benefits for an individual's lifetime at a guaranteed premium is only available with asset-based LTC products. Chronic illness riders under 101(g) can be very helpful additions to life insurance policies, and they can provide a valuable benefit in the chronic care setting. However, for the individual who is truly seeking to cover risk for LTC, especially if lifetime coverage is desired, an asset-based LTC policy is the most comprehensive option.

Income Tax Deductions for Tax Qualified Long Term Care Insurance (LTCI)

<table>
<tr><th>Type of Taxpayer</th><th>Premium Deductions</th><th>Taxation of Benefits</th></tr>
<tr><td>Individual taxpayer who does not itemize</td><td>No deduction[1]</td><td rowspan="2">Reimbursement benefits for qualified LTC services are not taxed. Per Diem or Indemnity benefits are not taxed except those benefits that exceed the greater of:[4]
- Total qualified LTC services charged, or
- $340 (2016)</td></tr>
<tr><td>Individual taxpayer who itemizes deductions</td><td>Treated as medical insurance premiums.[2] Limited to the lesser of the actual premium paid or the amount per person from an age-related table that caps maximum deductible premiums. Table is adjusted annually for inflation. See below:
<table>
<tr><th>Age</th><th>2016 Max Deduction</th><th>2015 Max Deduction</th></tr>
<tr><td>Age 40 or younger</td><td>$390</td><td>$380</td></tr>
<tr><td>Age 41 – 50</td><td>$730</td><td>$710</td></tr>
<tr><td>Age 51 – 60</td><td>$1,460</td><td>$1,430</td></tr>
<tr><td>Age 61 – 70</td><td>$3,900</td><td>$3,800</td></tr>
<tr><td>Age 71 and older</td><td>$4,870</td><td>$4,750</td></tr>
</table>
Premium deduction is effective to the extent that the deductible premium above added to taxpayer paid medical premiums and deductible out-of-pocket medical expenses exceeds 10% of the taxpayers AGI (7.5% of AGI for age 65 and over through 2016, then 10% in 2017 and beyond).[3]</td></tr>
<tr><td>IRA owners</td><td>IRAs may not own LTCI, and IRA distributions may not be rolled tax-free to LTCI. Distributions, after tax, may pay LTCI premiums.</td><td rowspan="5">Return of Premium (ROP) benefit:[5]
- Available only upon total surrender or death.
- May not be borrowed or pledged.
- Not taxable at death.
- Taxable upon policy surrender to the extent premiums were deducted.</td></tr>
<tr><td>Flexible Spending Accounts (FSAs)</td><td>FSAs may not reimburse LTCI premium.[6] LTCI may not be paid through an employer provided cafeteria plan.[7]</td></tr>
<tr><td>Health Savings Accounts (HSAs)</td><td>LTCI premiums can be reimbursed through an HSA, tax-free, up to the age-related cap. HSA may be inside an employer provided cafeteria plan.[8]</td></tr>
<tr><td>Employees (Non-Owners)</td><td>Premiums paid by employees
- Deductible by the employee who itemizes as an individual taxpayer.
- May not be paid through section 125 or 401(k) accounts.[9]
Premiums paid by employer
- Deductible by employer[10]
- Not taxable to employee[11]
- Not limited to the age-related cap on deduction
- Not subject to 10% of AGI threshold</td></tr>
<tr><td>C Corporation Owner - Employee</td><td>Treated as employee[12]</td></tr>
<tr><td>Other Business Owners:
- Sole Proprietors
- S Corp greater than 2% owners
- Partners
- LLC Owners</td><td>May be treated as a business expense for medical insurance premiums.[13] Limited to the lesser of the actual premium or the amount per person from an age-related table that caps maximum deductible premiums.[14] Table is adjusted annually for inflation. See below:
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</table></td><td>This material is provided for overview or general informational purposes only. These concepts were derived under current tax laws. Changes in the tax law may affect the information provided. This is not to be considered, or intended to be legal or tax advice. For answers to specific questions and before making any decisions, please consult a qualified attorney or tax advisor.</td></tr>
</table>

[1] IRC Sec. 63(b).
[2] IRC Sec. 7702B(a)(1).
[3] IRC Sec. 213(f).
[4] IRC Secs. 7702B(a)(2), 7702B(d) and 104(a)(3).
[5] IRC Sec. 7702B(b)(2)(C).
[6] IRC Sec. 106(c).
[7] IRC Sec. 125(f)(2).
[8] IRC Sec. 106(d).
[9] IRC Sec. 125(f)(2).
[10] IRC Secs. 213(a) and (d).
[11] IRC Sec. 105(b).
[12] IRC Sec. 106(a).
[13] IRC Sec. 162(l).
[14] IRC Sec 213(d)(10)(A).

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