



WRMarketplace

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Long-Term Care Insurance – Individual Income Tax Basics.

MARKET TREND: As society ages and health care costs escalate, long-term care (“LTC”) insurance may play a vital role in financial planning and risk management.

SYNOPSIS: More individuals are likely to face significant LTC expenses, which can exhaust savings and place a heavy burden on family members. “Qualified” LTC insurance coverage can provide a solution for the payment of such expenses. Coverage types can vary, including “traditional” policies that solely cover LTC, or “hybrid” products that combine LTC insurance coverage with a life insurance policy or an annuity. The tax rules applicable to LTC insurance reimbursements and premiums may make LTC insurance coverage attractive for certain clients.

TAKE-AWAYS: Many clients may benefit from qualified LTC insurance coverage, such as those who do not have the means to self-insure and/or need both LTC and life insurance protection. As the tax rules regarding LTC insurance reimbursements and premium deductions may vary depending on the type of coverage (i.e., traditional or hybrid) and the applicable state tax law, advisors should become familiar with both the federal rules and the laws of their specific states to properly assist their clients.

MAJOR REFERENCES: *Internal Revenue Code (“Code”) §§213(d) and 7702B.*

The American population is living longer. With aging and longevity eventually comes the need for long-term care, the costs of which are rising rapidly. For many individuals, these costs can deplete their personal savings, potentially leaving them dependent on children or without the means to support their spouse.¹ LTC insurance coverage may provide a solution, as the tax rules applicable to LTC insurance reimbursements and premiums may make such coverage more affordable for many taxpayers.

LONG-TERM CARE INSURANCE FOR TAX PURPOSES

Qualified LTC Services. For federal tax purposes, “qualified” long-term care insurance covers only “qualified long-term care services” (“**qualified LTC services**”), which are necessary diagnostic, preventive, therapeutic, curing, treating, mitigating and rehabilitative services, and

maintenance and personal care services² that are required by a chronically ill individual and are provided pursuant to a plan of care prescribed by a licensed health care practitioner. An individual is chronically ill if, within the previous 12 months, a licensed health care practitioner has certified that the individual is either (i) unable to perform at least two activities of daily living without substantial assistance from another individual for at least 90 days (activities of daily living are eating, toileting, transferring, bathing, dressing, and continence), or (ii) the individual requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

Other Required Provisions. To qualify, a contract for LTC insurance must include the following:

- The contract must be guaranteed renewable;
- The contract cannot provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed;
- Refunds, other than refunds on the death of the insured or complete surrender or cancellation of the contract, and dividends under the contract must be used only to reduce future premiums or increase future benefits; and
- The contract must generally prohibit paying or reimbursing expenses incurred for services or items that would be reimbursed under Medicare, except where Medicare is a secondary payer or the contract makes per diem or other periodic payments without regard to actual expenses.

“Hybrid” Coverage. While qualified LTC insurance covers only qualified LTC services, this coverage can be provided through a stand-alone policy (a “traditional” contract) or as a rider on, or as part of, a life insurance or annuity contract (a “hybrid” contract).³ Essentially, these hybrid contracts offer two types of protection, with the payment of any LTC insurance benefits typically reducing the cash value or death benefit of the life insurance/annuity, depending on the design of the contract. If the insured never uses the LTC coverage, benefits may still be paid from the contract to the designated beneficiaries (e.g., as death benefits). However, as noted below, premiums for hybrid contracts may not be deductible, and clients must factor in other considerations when selecting between traditional and hybrid contracts, including premium costs, the scope of LTC coverage provided, the need for life insurance, etc.⁴

For federal income tax purposes, the portion of the hybrid contract that provides for LTC insurance is treated as a separate contract. Thus, LTC benefits are taxed under separate rules discussed below, and the annuity or life insurance benefits are taxed according to the Code sections applicable to annuity and life insurance contract death benefits.⁵

Note on 1035 Exchanges. Code §1035 permits the exchange of a life insurance contract for a qualified LTC insurance contract (or a hybrid life/LTC contract) and an annuity contract for a qualified LTC insurance contract (or hybrid annuity/LTC contract) without tax penalty. Further, under Code §72(e)(11),⁶ a charge against the cash value of a life insurance or an annuity contract as payment for LTC coverage reduces (but not below \$0) the investment in the life insurance or annuity contract (i.e., basis) and is not included in gross income. Relying on these rules, clients in need of LTC insurance who have existing life or annuity contracts with cash value could

exchange to hybrid products that fulfill both their insurance/annuity and LTC needs without tax penalties and possibly without owing additional premiums.

DEDUCTIBILITY OF PREMIUMS

Traditional Contracts. For traditional “qualified” LTC insurance contracts, the LTC insurance premiums paid by an individual are deductible as medical expenses for federal income tax purposes, subject to certain limitations. First, there is a cap on the amount that may be deducted. The cap is based on the insured’s age at the end of the tax year and is indexed annually for inflation. The following are the maximum amounts available for deduction in 2015.

Insured’s Age by the End of the Year	2015 Maximum Annual Premium Deduction Per Individual
Age 40 or under	\$370
41-50	\$700
51-60	\$1,400
61-70	\$3,720
71 and over	\$4,660

Second, the deduction is subject to the 10% (or 7.5% if the taxpayer or the taxpayer’s spouse is over age 65) threshold applicable to itemized medical deductions. The amount eligible for deduction is combined with other unreimbursed medical expenses. Only the portion of the combined total that exceeds 10% (or 7.5%, if applicable) of the taxpayer’s adjusted gross income (“AGI”) may be taken as an itemized deduction.

A taxpayer also can deduct qualified LTC insurance premiums paid for his or her spouse and those paid on behalf of any “**qualifying relative**” if the taxpayer provided over half of the relative’s support for the year. Qualifying relatives include children, stepchildren and foster children (and the descendants of each), siblings, half-siblings, nieces and nephews, parents and other ancestors. The amount that may be deducted is also subject to the cap based on the insured’s age.

Example: H and W will be ages 52 and 51, respectively, at the end of 2015. Both of H’s parents are living and will be ages 73 and 75 at the end of 2015. H provides over half of the annual support for his parents each year. H also pays qualified LTC insurance premiums annually for himself in the amount of \$3,500, for W in the amount of \$3,000, and for his parents in the amounts of \$5,000 and \$5,500. The maximum amount H may use as a deduction with respect to the LTC insurance premiums is \$12,120 (\$1,400 for each of H and W and \$4,660 for each of H’s parents).

At the end of 2015, H and W have additional unreimbursed medical expenses of \$7,500 and H’s AGI is \$175,000. H’s total itemized medical expenses are \$19,620 (the maximum qualified LTC insurance premiums of \$12,120 plus other unreimbursed medical expenses of \$7,500). H may use \$2,120 as an income tax deduction (the amount of eligible medical expenses exceeding 10% of H’s AGI).

For state income tax purposes, the ability to deduct qualified LTC insurance premiums varies from state to state. Many states generally follow the federal rules to determine deductibility. Some states allow the total LTC premium to be deducted without imposing a cap, and yet other states grant a tax credit (rather than a deduction) for LTC insurance premiums.

Hybrid Contracts. Typically, premiums paid for hybrid contracts are not deductible as a medical expense for income tax purposes.⁷

TAX TREATMENT OF LTC INSURANCE REIMBURSEMENTS

Generally, payments received for LTC services from qualified LTC coverage purchased by an individual are treated as reimbursements for medical care expenses. Like accident and health insurance benefits,⁸ reimbursements generally are not subject to tax. However, if reimbursements are paid as a set dollar amount per day (or other periodic basis) without regard to actual medical expenses paid, then reimbursements not subject to tax would be limited to the larger of (i) actual costs of qualified LTC services for the period, and (ii) \$330 per day for the period (\$120,450 for 2015).⁹ If the reimbursements exceed the larger of these two amounts, the excess must be included in the individual's gross income and will be subject to income tax.

Example: X's qualified LTC insurance coverage pays him \$400 per day for his qualified LTC services, or \$146,000 for the year. X's actual cost for such qualified LTC services is \$10,000 per month (\$329 per day or \$120,000 for the year). X must include \$25,550 in his gross income for 2015 (i.e., that portion of the benefit that exceeds the \$330 per day limit (\$146,450 less \$120,450)).¹⁰

For state income tax purposes, whether reimbursements are taxed and the ability to deduct the costs of unreimbursed qualified LTC services also varies from state to state. Many states generally follow the federal rules.

TAKE-AWAYS

- Many clients may benefit from qualified LTC insurance coverage, such as those who do not have the means to self-insure and/or need both LTC and life insurance protection.
- As the tax rules regarding LTC insurance reimbursements and premium deductions may vary depending on the type of coverage (i.e., traditional or hybrid) and the applicable state tax law, advisors should become familiar with both the federal rules and the laws of their specific states to properly assist their clients.

NOTES

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¹ Generally, LTC costs are not covered by Medicare and are recovered by Medicaid only on a need-determined basis.

² "Maintenance or personal care services" is care which has as its primary purpose the providing of a chronically ill individual with needed assistance with his or her disabilities (including protection from threats to health and safety due to severe cognitive impairment).

³ Code §7702B(e).

⁴ In addition, only traditional policies that are state-approved and meet other requirements will qualify for the "Long Term Care Partnership Program," which allows individuals who purchase LTC insurance obtain some asset "disregards" for purposes of determining Medicaid eligibility.

⁵ See *WRMarketplace No. 14-31* for a general discussion of the income tax rules applicable to life insurance contracts and *WRMarketplace No. 14-49* for general rules applicable to annuity contracts.

⁶ Effective as of 2010.

⁷ The deductibility of LTC insurance premiums is dependent on many factors and should be reviewed with the client's legal and tax advisors.

⁸ See Code §104(a)(3).

⁹ The per day limit for 2015 is \$330. The per day limit is indexed annually for inflation.

¹⁰ If the cost of qualified LTC services for the period exceeds the reimbursements received under the LTC insurance plan, the excess costs may be included in the taxpayer's itemized medical deductions for the period. For example, assume X receives \$300 per day for qualified LTC services, or \$109,500 for the year. X's actual cost for such qualified long-term care services is \$10,000 per month (\$329 per day or \$120,000 for the year). X may include \$10,500 of unreimbursed LTC costs as part of his itemized medical expenses for 2015 (i.e., that portion of the costs that exceeds the \$300 per day reimbursement (\$120,000 less \$109,500)).

DISCLAIMER

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