

California Department of Insurance

Eight-Hour Mandatory Long-Term Care Course

Attachment II

Tax Treatment of Long-Term Care Insurance and Expenses

Introduction

The information provided in this treatise gives a broad description of the tax issues related to long-term care (LTC) and LTC insurance. Since most insurance agents are not tax advisors, they should be very cautious and understand their limitations in advising insureds about their specific tax situation. Agents should advise their clients to consult with a tax advisor for the final analysis of the tax impact of LTC insurance and expenses.

By including LTC insurance in Health Insurance Portability and Accountability Act of 1996 (HIPAA), Congress attempted to fulfill a number of different public policy objectives, including the following:

1. Classifying LTC costs as a medical expense, thus, providing taxpayers with some economic relief.
2. Categorizing LTC insurance as accident and health insurance thereby providing clarity as to the tax treatment of premiums and benefits.
3. Providing the general public an incentive to purchase private LTC insurance.

HIPAA Definitions and Requirements that Apply to Long-Term Care Expenses and Insurance

The Internal Revenue Code (IRC) allows deductions for medical and dental expenses under certain circumstances (IRC section 213d). Prior to the passage of HIPAA, LTC expenses were generally not deductible.

1. Qualified Long-Term Care Services/Chronically Ill Individual

The IRS defines “qualified long-term care services” as: Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, rehabilitative services and maintenance or personal care services required by a chronically ill individual pursuant to a plan of care prescribed by a licensed health care practitioner.

This is a wide-ranging universe of potential services. To control when the cost of LTC services could receive favorable tax treatment, Congress established a threshold for initiating benefits by tying services to a state of disability defined as a chronically ill individual. A chronically ill individual must be certified by a licensed health care practitioner (LHCP), within the previous 12 months, as meeting one of the following tests:

- The individual is unable, for at least 90 days, to perform at least two activities of daily living (ADLs) without substantial assistance from another individual, due to loss of

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functional capacity. ADLs are eating, toileting, transferring, bathing, dressing, and continence (see Internal Revenue Service (IRS) Notice 97-31, issued May 6, 1997, or California Insurance Code (Cal. Ins. Code) sections 10232.8(e)(1 through 6) for the definitions of the ADLs).

- The individual requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

Federal and state laws require the certification of the insured's status as a chronically ill individual to be renewed annually in order to receive favorable tax treatment.

2. Licensed Health Care Practitioner

A licensed health care practitioner (LHCP) is defined as a doctor of medicine or osteopathy, a registered nurse, or a licensed social worker (Cal. Ins. Code section 10232.8(d); 26 United States Code (USC) section 7702B(c)(4); 42 USC section 1395x (r)(1)). The United States Secretary of the Treasury may also designate other categories that would qualify as LHCPs. Cal. Ins. Code section 10232.8(c) also specifies the role of the LHCP in the certification, assessment, and plan of care of the insured for the purposes of the claims process. The LHCP must be independent of the insurance company and "shall not be compensated in any manner that is linked to the outcome of the certification."

3. 90-Day Certification for Activities of Daily Living

Congress intended to limit LTC costs to those associated with chronic illness. A clinical definition of chronic illness is one that is expected to last 90 days or more. Some expenses for acute or short-term illnesses were already deductible as a medical expense. If policy makers had ignored the distinction between acute and chronic, it could have had the unintended consequence of allowing taxpayers to deduct expenses associated with short-term disabilities due to the broad definition of qualified LTC service(s).

Therefore, a taxpayer who wishes to deduct qualified LTC expenses using the ADL definition must have a LHCP certify that the insured is likely to need substantial assistance for at least 90 days. The requirement concerns the likelihood of needing care, not the actual receipt of care. There is no requirement that the person actually receives the full 90 days of care. The insured must be re-certified by a LHCP at least annually. The 90-day certification period does not prevent the payment of LTC insurance benefits. Once the 90-day certification has been established, benefits can be paid after a waiting or elimination period, if any, has been met. The certification period can be determined retroactively in the event a claim is delayed. A claim can be delayed for many reasons, requiring the retroactive determination of the 90-day certification period.

4. Substantial Assistance

For the purposes of the ADLs, the IRS allows substantial assistance to mean both hands-on assistance and standby assistance.

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- Hands-On Assistance: the physical assistance of another person without which the individual would be unable to perform the ADL.
- Stand-By Assistance: the presence of another person within arm's reach of the individual that is necessary to prevent, by physical intervention, injury to the individual while the individual is performing the ADL.

5. Severe Cognitive Impairment and Substantial Supervision

The IRS defines a severe cognitive impairment as “a loss or deterioration in intellectual capacity that is similar to Alzheimer’s disease and like forms of irreversible dementia and is measured by clinical evidence and standardized tests that reliably measure impairment in short-term and long-term memory, orientation to people, places or time, and deductive or abstract reasoning.” Note that the 90-day certification by a LHCP is not a requirement for qualification under the cognitive impairment trigger. Similar to the ADL qualification, however, the insured must be re-certified every 12 months to ensure they still qualify for benefits.

HIPAA requires LTC insurance policies comply with its guidelines to be considered “qualified” LTC insurance. As such, qualified LTC insurance policies are generally regulated as accident and health. Policies that do not meet these requirements are considered to be non-qualified LTC insurance policies.

6. Benefits

Congress created a generalized structure to which qualified LTC products must adhere. For purposes of HIPAA, a qualified LTC insurance policy must pay benefits using no less than five of the following ADLs: eating, toileting, transferring, bathing, dressing, and continence.

Qualified LTC insurance policies may not use “medical necessity” as a benefit trigger and must coordinate benefit payment with Medicare.

7. Required Consumer Protection

Qualified LTC insurance policies are required to meet specific consumer protection guidelines of the National Association of Insurance Commissioners (NAIC) Model Act and Regulations for Long-Term Care Insurance. Many of the consumer protections in the NAIC models had already been adopted in California with the passage of Senate Bill 1943, 1992, and subsequent legislation that included protections related to the following: guaranteed renewal or non-cancellation of the policy; prohibitions on exclusions and limitations; extension of benefits and conversions; replacement; unintentional lapse; post-claim underwriting; requirement to offer inflation protection and rejection by consumer; restrictions on preexisting conditions and probationary periods; disclosure; and non-forfeiture provisions.

8. IRS Reporting Mechanism

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HIPAA also establishes a reporting mechanism for benefits received under all LTC insurance policies. If a policyholder receives benefits from an LTC insurance policy, they will receive an IRS 1099 LTC form issued by the carrier.

9. Grandfathered Policies Sold Prior to 1997

LTC insurance policies issued prior to January 1, 1997, meeting “long-term care insurance requirements of the State in which the contract was ... issued” are grandfathered in for the purposes of tax qualification unless the policyholder made a “material change” to the policy.

10. Definition of “Material Change”

Tax qualified status can be lost if a material change is made to the policy. It is the insurer’s responsibility to provide notice to the policyholder that a change to a policy is a material change (Cal. Ins. Code section 10232.96). A change in the mode of premium payment and/or an increase or decrease in premiums is not a material change; neither is the acceptance of an option to reduce benefits.

New Trends: LTC Insurance, Life Insurance, Annuities, and Benefit Riders

IRC section 101(g)(1) governs the accelerated payment of death proceeds on the life of a terminally or chronically ill insured. Essentially, if the qualifying event for benefits matches the chronic illness definition established by HIPAA, the early payout of the death benefit for LTC expenses will not be taxed as income. However, the payments cannot exceed the higher of per diem limits (the dollar amount for the current year) or actual expenses incurred for qualified LTC expenses and must comply with other provisions.

The premiums (or charges) for this coverage can be deducted from the internal growth of the life insurance contract or annuity without a taxable event (income) to the annuitant. In addition, the LTC benefits payments from the life contract or annuity will be received income tax free. One of the central points is the LTC benefits must be consistent with HIPAA.

A typical product design for a single premium deferred annuity (SPDA/LTC insurance) combo product will provide an LTC benefit that is generally a multiple of the annuity account value. The payout will be delivered over a certain number of months – 24, 36, or 48. Examples will vary by insurance carrier, age, and health conditions. For example, an insured wants \$6,000 per month of benefit for 48 months ($\$6,000 \times 48 = \$288,000$). In order to get that \$288,000 benefit, the policy holder may have to place \$100,000 into the SPDA combo product. A risk charge will be taken from the accumulation of the product to provide the additional \$188,000 of coverage.

The first money out of the SPDA to pay the LTC benefit will be the insured’s initial premium to the plan. If the policyholder dies before their contribution is exhausted, a beneficiary will receive the difference. Once benefits are paid beyond the initial premium, the insurance company will continue to pay benefits until they are exhausted. The risk charge for the benefit beyond the premium will generally be between one-half to 1.25 basis points. In other words, if a typical SPDA was paying a return of 5.5 percent, the combo plan may only pay 4.5 percent.

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Since the LTC benefit under the program qualifies under IRC section 7702B, the cost of the LTC benefit will not be a taxable event to the insured. LTC benefit payments will reduce the basis of the annuity for income tax purposes. This may create a larger tax burden on heirs of the annuity owner after death.

Here are some key points for agents to think about when discussing “combo products” with consumers:

1. LTC benefit qualification must be consistent with HIPAA. In order to solicit/sell LTC insurance in California, agents need to hold a current license as: Accident & Health or Sickness Agent, or Life Agent (only if it is an LTC rider on a full life policy).
2. What sorts of LTC expenses will the life or annuity combo pay for nursing home only, assisted living, home care, or all of the above? Will the plan reimburse for incurred costs or provide some sort of indemnity (per diem) benefit based on a day-of-service incurred? What sorts of assessments and plans of care will the claims process require?
3. Underwriting criteria will lead to choices of deferral periods based on insured’s health issues. This will be a special challenge to life insurance agents selling annuities, marketers, and wholesalers not attuned to underwriting issues in the current SPDA environment.
4. 1035 exchange opportunities are likely to occur (moving cash values from life insurance and annuity contracts to those with LTC benefits).
5. Which type of life insurance product (SPDA, fixed, indexed, or variable) will be best suited to specific clients? What if they do not perform as anticipated? Will consumers who purchase a combo plan be faced with a lower level of benefits if the underlying life insurance or annuity contract pays the guaranteed rate as opposed to the current rate? Will there be “true-up” provisions which give the insured an ability to “reinforce” their LTC pay-out in the event that product investment performance does not reach expectations?

Conclusion

This complex area of law, especially the advent of “combo products” (life and annuity), raises many new questions regarding how agents discuss LTC needs and solutions with consumers. Full discussion of suitability of specific LTC products and disclosure of all terms, conditions, and protections will become even more important as will suggesting the correct and suitable solution.

Finally, all insurance agents should be keenly aware that the information provided in this treatise gives a broad description of the tax issues related to LTC insurance. Since most agents are not certified public accountants (CPAs) or tax preparers, they should be very cautious and understand their limitations in advising insureds about their specific tax situation

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and circumstances. Agents should always refer clients to the insured's tax advisor for a final analysis of the tax impact of LTC insurance and expenses.