Long-Term Care (LTC) Riders

The purpose of this article is to address some of the most frequently asked questions concerning long-term care riders associated with life insurance contracts (and associated riders for chronic and critical illnesses) and the differences between these types of riders. *Because this article is meant to provide a general overview of long-term care riders, state specific law and exceptions have not been considered or addressed.* State law should always be considered before advising clients.

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1. What is a Long-Term Care rider?

A Long-Term Care (LTC) rider is a rider attached to a permanent life insurance policy that accelerates the death benefit to help pay for the costs of long-term care services for chronically ill insureds.[1] To qualify as an LTC rider, the services required by a chronically ill individual must be provided pursuant to a plan of care prescribed by a licensed health care practitioner. An individual is considered chronically ill if he/she is unable to perform at least *two* of six Activities of Daily Living (ADLs) without substantial help from another person for at least 90 days due to a loss of functional capacity.[2] An individual may also be considered to be chronically ill if he/she needs substantial supervision to protect his/her health and safety because of a severe cognitive impairment.

Generally, when LTC benefits are paid from the LTC rider, the death benefit available on the policy is reduced dollar-for-dollar and such benefit payments also reduce cash value to some degree (see question 9). Consequently, LTC benefits generally are available up to the point that the policy's death benefit has been completely exhausted, unless otherwise provided in the contract.

At the insured's death, the portion of the death benefit that has not been used to pay LTC benefits will be paid to the beneficiaries as a death benefit.

For most LTC riders, the LTC benefit payable under the rider is limited to a maximum monthly benefit — usually determined based on a percentage of the death benefit or the IRS per diem limit (depending on the type of rider — see question 2).

Example of Maximum Monthly Benefit:

An LTC rider on a $750,000 life insurance policy with a 2% maximum monthly benefit would allow for a $15,000 acceleration of death benefit per month to pay for qualified long-term care expenses.

For insurance carriers who offer an LTC rider, generally such riders can be added to an insurance contract for an additional fee. Most life insurance contracts offering an LTC rider today treat the charge for the LTC portion of the contract as a charge against cash surrender value.

LTC riders may be classified as "qualified" or "non-qualified" riders. A "qualified" rider is intended to meet the requirements of a qualified long-term care contract for the purposes of Sections 7702B(b) and 101(g) of the Internal Revenue Code (Code), thus providing income tax advantages similar to stand-alone LTC insurance policies. A rider that does not meet these requirements is a "non-qualified" rider and likely will not provide favorable tax treatment. See question 3 for more information about the taxation of benefits from a qualified LTC rider.

2. What are the primary differences between an indemnity and reimbursement LTC rider?

Most LTC riders available today fall under one of two models — indemnity or reimbursement.

An *indemnity rider* pays out LTC benefits based on the maximum monthly benefit allotted under the rider regardless of the amount of actual long-term care expenses incurred by the insured. Most carriers offering an LTC indemnity rider limit the monthly benefit to the lesser of (i) a percentage of death benefit or (ii) the IRS per diem limit.[3] For 2015, the IRS per diem limit is $330/day, which is approximately $9,900 per month. When LTC payments are made under an indemnity rider, the payments are made directly to the owner of the contract.

Alternatively, a *reimbursement rider* pays out LTC benefits based on the LTC care expenses actually incurred by the insured, limited only by the maximum monthly benefit prescribed in the contract. This style of rider allows the policy owner to receive payments in excess of the IRS per diem limit without adverse tax consequences. Under a reimbursement style rider, the LTC rider payment will be paid directly to the policy owner unless the owner elects to have the care-provider* paid directly.

To qualify for LTC payments under an indemnity rider or reimbursement rider, the policy owner must demonstrate that the insured meets the definition of "chronically ill" (i.e., cannot perform two of six ADLs or has a cognitive impairment), which is certified by a licensed physician, and must meet the elimination period specified in the contract.

A reimbursement rider requires the policy owner to provide the insurance carrier with bills associated with the insured's LTC care and services received; depending on the carrier, an indemnity rider may not require bills to be provided to receive payment.

John Hancock currently offers a reimbursement-style LTC rider, which includes an extension of benefit provision, guaranteeing additional LTC benefits will be paid in specific circumstances.[4]

3. How are amounts received for LTC expenses from a qualified LTC rider treated for income-tax purposes?

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) allows for certain federal income tax advantages for long-term care insurance contracts that are designated as "qualified," as defined in Code Section 7702B.

Per Section 7702B(a), amounts received from a qualified long-term care insurance contract are treated as amounts received for personal injuries and sickness and are treated as reimbursements for expenses actually incurred for medical care (as defined by Sec 213(d)). Code Section 104(a)(3)

EXAMPLE: John owns a life insurance policy with an LTC rider.

Indemnity rider: John's policy has a $750,000 death benefit with a maximum monthly benefit for LTC purposes of the lesser of 2% of the death benefit or the IRS per diem limit. In January 2015, John has $12,000 worth of LTC expenses. John will receive $10,230 ($330 x 31 days) for these expenses from the indemnity rider. The next month, John only has $8,000 worth of LTC expenses, but receives $9,240 ($330 x 28 days) from the indemnity rider.

Reimbursement rider: John's policy has a $750,000 death benefit with a maximum monthly benefit for LTC purposes of 2% of the death benefit — i.e., $15,000/month. In January 2015, John has $12,000 worth of LTC expenses and will receive $12,000 to reimburse him for those expenses. The next month when John has only $8,000 worth of LTC expenses, John will receive $8,000 from the reimbursement rider.

In either case, the $750,000 death benefit will be reduced by the amount of LTC benefit received.

This is a hypothetical example for illustrative purposes only.

* Not all care providers may qualify for direct payments. See contract for details.

generally provides that amounts received for personal injuries or sickness are not includible in gross income.

For LTC riders provided as part of a life insurance or annuity contract, Section 7702B(e) specifically provides that such riders shall be treated as separate long-term care contracts for the purposes of Section 7702B. Accordingly, "qualified" LTC rider accelerated death benefits generally should receive the same tax treatment as stand-alone qualified long-term care contracts.[5] However, see question 10 for commentary on taxation of third-party ownership of contracts with LTC riders.

Most LTC riders offered today are intended to be "qualified" long-term care contracts under Code Section 7702B(b) and meet the acceleration of death benefit for chronic illness provisions of Section 101(g). This is true of the LTC rider offered by John Hancock.

The tax treatment of the amounts received for LTC expenses paid from a qualified LTC rider generally is the same whether the contract reimburses actual long-term care expenses (a reimbursement contract) or pays a per diem amount toward long-term care (an indemnity contract). However, if an indemnity contract pays a per diem benefit that exceeds the IRS per diem limit ($330/day in 2015), the excess is taxable income to the extent it exceeds actual long-term care expenses incurred. If multiple indemnity-style contracts are owned on a single insured, the payments received from these contracts are combined for the purposes of determining whether amounts received exceed the greater of total LTC expenses incurred by the insured or the per diem limit.[6]

An example of the possible taxation of multiple-owned indemnity-style contracts can be found below. Distributions received from a life insurance policy with an LTC rider, other than those payments associated with long-term care benefits, are taxed according to the rules governing the underlying life insurance contract.

EXAMPLE OF MULTIPLE INDEMNITY CONTRACTS OWNED ON SAME INSURED (ADAPTED FROM INSTRUCTIONS TO IRS FORM 8853)

Mrs. Smith was chronically ill in 2014 and received six monthly payments (the "LTC period') on a per diem basis from a qualified LTC insurance contract. She received $5,000 per month ($30,000 total) from the LTC contract and incurred $45,000 worth of costs for qualified LTC services. Mrs. Smith's son, Sam, and daughter, Deborah, each also own a qualified LTC insurance contract on Mrs. Smith. Neither Sam nor Deborah incurred any costs for qualified LTC services for Mrs. Smith in 2014. For the same six-month LTC period as Mrs. Smith, Sam received per diem payments of $4,000 per month ($24,000 total) and Deborah received per diem payments of $3,000 per month ($18,000 total). [Note, see question 10 for discussion of third-party ownership of LTC riders].

Per Code Section 7702B(d)(3) aggregation rules, the total per diem limit for this six month period — $58,880 ($320/day for 181 days) — must be allocated among Mrs. Smith, Sam, and Deborah as follows:

Allocation to Mrs. Smith: Because Mrs. Smith is the insured, the per diem limitation is allocated first to her to the extent of the per diem payments she received during the LTC period (i.e., $30,000). The remaining per diem limitation of $28,880 is allocated between Sam and Deborah.

Allocation ratio to Sam: 57% of the remaining limitation (i.e, $16,462) is allocated to Sam because the $24,000 he received during the LTC period is 57% of the $42,000 received by both Sam and Deborah during the second LTC period. That means that Sam will have to report $7,538 worth of income from the LTC payments he received because it is over the remaining limitation ($16,462).

Allocation ratio to Deborah: 43% of the remaining limitation (i.e, $12,418) is allocated to Deborah because the $18,000 she received during the LTC period is 43% of the $42,000 received by both Sam and Deborah during the LTC period. That means that Deborah will have to report $5,582 worth of income from LTC payments she received because it is over the remaining limitation ($12,418).

	Amount received from LTC insurance for LTC period	Taxable Amount
Mrs. Smith	$30,000	$0
Sam	$24,000	$7,538
Deborah	$18,000	$5,582

This is a hypothetical example for illustrative purposes only.

4. Is the tax treatment for qualified LTC benefits received different for a life policy classified as a modified endowment contract?

No. Even if the policy is classified as a MEC, the intent is for the long-term care benefit payments to continue to be excludable from income taxes and there is nothing in the tax code or the regulations that provides for a different tax result for qualified LTC amounts received from a MEC.

5. Are premium payments associated with an LTC rider tax deductible?

No. Although "eligible long-term care premiums" for a qualified long-term care stand-alone contract may be deductible by an individual to the extent such amount does not exceed the limitation set in Code Section 213(d)(10) (and for taxpayers that itemize deductions subject to the limitation under Section 213(a)), Code Section 7702B(e) prohibits a deduction for LTC premium payments when such payments are made as a charge against the cash surrender value of a life insurance contract.

6. Is the cost of insurance for the LTC rider considered a taxable distribution?

No. For tax years *after* December 31, 2009 (effective date of the Pension Protection Act of 2006), the LTC rider charge against the cash value of an insurance policy is not included in income, but will reduce the basis in the contract (but not below zero).[7] This rule applies whether the life insurance contract is classified as a modified endowment contract (MEC) or not.

For tax years beginning *before* January 1, 2010, LTC charges were treated as partial withdrawals. If the policy was a MEC, those withdrawals were taxable income to the extent that there was gain in the policy. A 10% penalty may also have been applicable to those withdrawals. If the policy was a MEC but there was no gain in the contract, the withdrawals reduced the owner's basis in the contract, same as with non-MEC policies.

For policies where the LTC rider cost is charged against the policy's cash value, the policy owner should expect to receive a 1099-R each year from the carrier reporting the LTC rider charge and reduction of basis in the contract as required by the Pension Protection Act.

7. Is the LTC rider rate guaranteed?

The answer depends on the carrier. For LTC riders issued by John Hancock, the LTC rider charge is based on an amount per $1,000 of the Net Amount at Risk. The rate is set at issue and is guaranteed not to increase over the life of the policy. However, if the Net Amount at Risk changes, the total amount charged for the LTC rider will change accordingly, even though the guaranteed rate per $1,000 of Net Amount at Risk does not change. The charge is part of the monthly deductions.

Many other carriers do not have guaranteed rates for LTC charges.

8. If the owner of a policy with LTC rider goes on claim, are premiums still due on the policy?

This depends on the carrier and the product. For life insurance policies with LTC riders issued by John Hancock, unless the Waiver of Monthly Deductions rider or Disability Payment of Specified Premium rider[8] is also in effect, all policy and rider charge deductions continue while on claim, and premiums may still be due. If there is sufficient cash value in the policy, future premium payments may not be required.

THE FOLLOWING EXAMPLE SHOWS HOW THE FACE AMOUNT AND CASH VALUE ARE EFFECTED IN A HYPOTHETICAL JOHN HANCOCK POLICY.

Assumptions:

1. Total Face Amount (at time of claim): =$250,000
2. Policy Value (at time of claim): =$50,000
3. Maximum Monthly Benefit for LTC: =2% x $250,000 = $5,000

Assume that claims are submitted for the full reimbursable amount (e.g., $5,000). Each month, the Total Face Amount will be reduced by the benefit payment; and the Policy Value will be reduced in proportion to the amount of the payment. Because of these decreases, the Net Amount of Risk also decreases.

	Month 1	Month 2
Total Face Amount Calculation	$250,000 – $5,000 = $245,000	$245,000 – $5,000= $240,000
Policy Value Calculation	$50,000 x $245,000 / $250,000 = $49,000	$49,000 x $240,000 / $245,000 = $48,000
Net Amount at Risk Decrease	From $200,000 to $196,000	From $196,000 to $192,000

This is a hypothetical example for illustrative purposes only.

9. If an insured goes on claim for LTC purposes, how do the LTC payments generally affect the cash value or account value of the insurance contract?

This depends on the carrier. When an insured goes on claim and LTC payments are made, many carriers reduce the cash value in the contract dollar-for dollar. John Hancock, however, reduces the policy's cash value or policy value proportionally instead of dollar-for-dollar — see the example on this page 4.

10. Is there a tax issue associated with third-party ownership of a life contract with an LTC rider?

Code Section 7702B is silent on the question of third-party ownership; that is, the statute does not specifically prohibit or allow third party ownership.

Although there are strong arguments for the favorable tax treatment of policies with the long-term care rider when they are owned by a third party, there is no specific guidance from the Internal Revenue Service as to the tax effects of such third-party ownership. **This is true whether the LTC rider is classified as a reimbursement rider or an indemnity rider.** Given the current lack of guidance regarding the ramifications of third-party ownership, there is the risk that such ownership structure could cause adverse income, estate, and/or gift tax consequences.[9] Therefore, the client should seek tax and legal counsel to review the particulars of an intended ownership arrangement in light of the income, gift, and estate tax provisions of the Internal Revenue Code. A life insurance policy with a long-term care rider should only be purchased by or transferred to a person other than the insured after all parties have carefully reviewed the issues with their own tax and legal advisors.

11. Does John Hancock allow for third-party ownership of an LTC rider?

Yes. John Hancock will issue life insurance policies with an LTC rider for most ownership scenarios, although some restrictions do apply. For example, third-party ownership is not allowed inside a qualified plan and in some business-owned policies (see question 12); it is also prohibited in New York, where a person or an entity other than the insured is not allowed to own such a policy.

Please note that in states where a person or an entity other than the insured owns the policy, we require the *Third-Party Ownership Disclosure — Long-Term Care Riders* (NB5193). This Disclosure outlines the uncertain tax consequences of having a person or entity other than the insured own the policy and it encourages clients to seek the advice of legal counsel, and needs to be signed by the insured and the owner.

12. Can a life policy with an LTC rider be owned in a trust? Does it matter whether the rider is an indemnity rider or reimbursement rider?

There is nothing in the law that precludes a trust from owning a life insurance policy with an LTC rider. However, because of the many different types of trusts (revocable, irrevocable, grantor, etc.) and various tax considerations associated with each of these different trust structures, a life insurance policy with a long-term care rider should only be purchased by or transferred to a trust after all parties have carefully reviewed the planning and tax issues associated with this type of ownership structure with their own tax and legal advisors. Also see question 10 regarding taxation concerns associated with third-party ownership of contracts with an LTC rider.

Either an indemnity-style rider or reimbursement-style rider may be owned by a trust. However, depending on the type of trust being used, the relationship of the insured to the trust, and the estate planning and tax objectives of the parties involved, it may not always be appropriate to have LTC payments made to anyone other than the owner of the contract — i.e., the Trustee.

As discussed earlier, reimbursement-style riders generally allow the owner of the contract to receive LTC payments directly or choose to have payments made directly to the care-provider for ease of administration. When a reimbursement-style rider is used on a trust-owned policy, tax and legal counsel should be consulted before having LTC amounts paid to anyone other than the trustee.

Trusts should be drafted by an attorney familiar with such matters in order to take income and estate laws (including the generation-skipping tax) into account. Failure to do so could result in adverse tax treatment.

13. Can a life policy with an LTC rider be owned by a business on a key employee, owner or employee?

Yes; however, as noted in question 10, the tax implications of third-party ownership of a policy with an LTC rider are not entirely clear.

With business-related policies in particular, Code Section 101(g) also calls into question the potential taxation of benefits received by the business from an LTC rider. Code Section 101(g)(5), which relates to payments received for chronic illness as an acceleration of death benefit, provides that accelerated death benefit amounts received by a business will not be exempt for income tax purposes when the business "has an insurable interest with respect to the

life of the insured by reason of the insured being a director, officer, or employee" of the business or by reason of the insured being "financially interested" in the trade or business carried on by the business. Most LTC riders offered today qualify under both 101(g) and 7702B of the Code.
While there is no comparable taxation language associated with business-related policies in 7702B (or Section 104, which addresses taxation of payments received from accident and health plans), there is no authority that addresses the intersection of 101(g) and 7702B. Accordingly, a client should seek tax and legal counsel to review the particulars of an intended ownership arrangement in light of the income, gift, and estate tax provisions of the Code.

John Hancock underwriters will consider requests for business-owned policies with an LTC rider on a case-by-case basis. Generally, business ownership of policies with an LTC rider is only permitted by John Hancock when the employer is contractually obligated to pay for or reimburse the employee for LTC costs incurred by the employee.

14. Can a taxpayer exchange a life insurance contract for a life insurance contract with a long-term care rider tax-free under Code Section 1035?

Yes, after December 31, 2009, Section 1035 permits a tax-free exchange of a life insurance contract for a life insurance contract with a long-term care rider.

15. What is a Chronic Illness rider and how does it differ from an LTC rider?

A Chronic Illness rider (also commonly referred to as an Accelerated Death Benefit for Chronic Illness rider) is a rider that allows for the acceleration of death benefit from an insurance contract to pay for long-term care expenses incurred by a "chronically ill" insured. Chronic Illness riders are also governed by IRC Section 101(g), but are not subject to the long-term care insurance rules under Section 7702B or state regulations pertaining to long-term care insurance, and cannot be marketed as long-term care insurance or as providing long-term care benefits.

Although the definition of "chronic illness" under 101(g) refers to the same definition provided in Section 7702B — i.e., being unable to perform at least two activities of daily living for a period of 90 days or requiring substantial supervision due to severe cognitive impairment — NAIC regulations pertaining to Chronic Illness riders generally require that a physician certify that the insured's chronic illness "is likely to last the rest of [the insured's] life.'[10] In other words, the condition usually must be non-recoverable.

This permanency condition is not required of LTC riders and is a notable distinction between these two types of riders. Conditions such as mild to moderate strokes, orthopedic repairs, physical complications from cancer recovery, and other recoverable conditions would not be eligible for claim under a chronic illness rider, but may be eligible under a long-term care rider.

A life insurance policy with a Chronic Illness rider also does not require the agent to be licensed to sell long-term care coverage or have any special training, as is required with a LTC rider.

In terms of taxation, Section 101(g) of the Code provides that any amount received as accelerated death benefits for a chronically ill individual shall be treated as an amount paid by reason of the death of the insured. This means that accelerated death benefits for a chronic illness are generally treated as having the same income tax exclusion as is accorded to benefits paid at the actual death of the insured. That is, amounts are generally received tax-free.

16. What is a Critical Illness rider and how does it differ from an LTC rider?

A Critical Illness rider allows the owner of the policy to accelerate a portion of the death benefit if the insured is diagnosed with one of several critical illnesses specified in the contract. Typically, the specified illnesses are either terminal diseases or chronic illnesses that will require continuous care over an extended period. The enumerated diseases often include illnesses such as heart attacks, strokes and cancer.

Designs differ, but in general, the policy owner can accept all or a portion of the accelerated amount the insurer offers. If the owner accepts the entire offer, the benefit is paid out and the life policy terminates; if the owner takes less than the offered amount, the remainder stays in the policy, which then continues in force with a reduced face amount.

Neither Section 101(g) nor 7702B make any mention of benefits received for "critical illness," and the tax implication of these accelerated payments is less than clear. However, there is some guidance by way of Private Letter Rulings issued by the IRS indicating that accelerated death benefits from a Critical Illness rider may be received free of income tax under other code provisions.[11]

17. Are LTC benefits received from an LTC rider or Chronic Illness rider reportable to the IRS?

Yes. When benefits are received by a taxpayer from either a long-term care insurance contract (including an LTC rider) or for accelerated death benefits for chronic illness (including a Chronic Illness rider), the IRS requires the insurance company to issue a Form 1099-LTC. Form 1099-LTC reports the gross amount of long term care benefits paid, and identifies whether the benefits are paid per diem or as reimbursement for LTC expenses actually incurred.

If the LTC benefits are received as reimbursement, then no further action is required. However, if the LTC benefits are received per diem (i.e., payments were made on any periodic basis without regard to actual expenses incurred), then the taxpayer must complete Form 8853 and file it with their income tax return. Form 8853 is used to help calculate the taxable amount (if any) associated with per diem payments received by the taxpayer from these contracts.

1. See IRC §7702B(b) and (c).
2. See IRC §7702B(c)(2)(B). The six ADLs are: bathing, continence, dressing, eating, toileting, and transferring.
3. IRC §7702B(d).
4. See John Hancock LTC Rider Technical Guide.
5. See also Section 101(g), which provides favorable tax treatment for amounts received as an acceleration of death benefit for chronically ill individuals.
6. Section 7702B(d) and associated regulations; See also IRS Form 8853 and Instructions.
7. Section 72(e)(11).
8. The Waiver of Monthly Deductions rider and the Disability Payment of Specified Premium riders are not offered on all products.
9. For example, the language in IRC §101(g)(3) that "such payment is for costs incurred by the payee" suggests that third-party ownership of an LTC rider may put at risk the payment's favorable income tax treatment of an accelerated death benefit under §101(g).
10. NAIC Model Regulation 620, Accelerated Benefits Model Regulation, §2(B). Model Regulation 620 requires that "accelerated benefits" be paid out upon the occurrence of a "qualifying event." See Section 2(B) for other qualifying events other than a medical condition that is expected to last for the rest of the insured's lifetime.
11. PLRs 200339015, 200339016, 200627014, and 200903001. Private letter rulings are not binding authority for taxpayers other than the taxpayer to whom the ruling is issued.

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