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Long-Term Care Discussion Group

LTC Insurance and Tax Reform

Randy Hardock and Craig Springfield
Davis & Harman LLP

Overview

- **2017 Tax Reform Legislation**
  - General observations on tax reform
  - LTC-related policyholder-level changes
  - LTC-related company-level changes
- **So Where Does that Leave the Current Tax Treatment of LTC Insurance?**
- **Legislative Outlook – Risks and Opportunities for LTC Insurance**
  - General considerations
  - Cafeteria plans and FSAs
  - "Within plan" LTC insurance
  - HSA incentives for LTC purchases

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2017 Tax Reform Legislation

General Observations on Tax Reform

- **Tax Reform at Light Speed**

Nov. 2 → Nov. 9 → Nov. 16 → Dec. 2 → Dec. 19 & 20 → **Dec. 22**

- **Most Provisions Effective 1/1/18**
- **Major Tax Cuts (Some Tax Increases)**
  - Overall Tax Cuts -- $1.65 Trillion over 10 Years
  - Spending Cuts -- $ 0.2 Trillion over 10 Years
  - Increase in Static Deficit -- $1.45 Trillion over 10 Years

2017 Tax Reform Legislation

General Observations on Tax Reform

- **Corporations:**
  - 21% Flat Tax Rate for Tax Years After 2017
  - AMT Repeal
- **Individuals:**
  - Across the Board Rate Reduction -- 37% top tax rate on joint return taxable income over $600,000 ($500,000 individual)
  - AMT Thresholds Increased
  - Cap. Gains/Dividends Tax Rates Unchanged
- **Estate Tax: Exemption Doubled**
- **Most Individual Changes Sunset After 2025**

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2017 Tax Reform Legislation

LTC-Related Policyholder-Level Changes

- **Itemized Deduction for Medical Expenses**
  - For 2017 and 2018, the medical expense itemized deduction is available to the extent that expenses for medical care (which includes eligible long-term care premiums for qualified long-term care insurance (QLTCI)) exceed 7.5% of adjusted gross income (AGI)
    - In recent years the AGI threshold generally was 10%, except from 2013-2016 when the AGI threshold was 7.5% for taxpayers age 65 and over.
  - After 2018, the Act sunsets the new 7.5% AGI limit. Reverts to a 10% of AGI limitation
  - The Act does not affect the current law deduction in Code § 162(l) for premiums paid by a self-employed individual for insurance which constitutes medical care.

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2017 Tax Reform Legislation

LTC-Related Policyholder-Level Changes

- **Inflation Adjustments – Adoption of Chained CPI**
  - Affects "eligible long-term care premiums" under Code § 213(d)(10) and the per diem limitation of Code § 7702B(d)
  - Medical care cost component continues, except now such component of the chained CPI applies
  - Chained CPI grows at a slower rate
- **Transition Issues**
  - Prior to tax reform, the IRS in Rev. Proc. 2017-58 announced inflation-indexed amounts for 2018
  - Tax reform change to inflation adjustment is effective for years after 2017
  - Further IRS guidance expected

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2017 Tax Reform Legislation

LTC-Related Company-Level Tax Changes

- **Company Tax Rules – The Act made numerous changes to the tax treatment of insurance companies which could be relevant to the pricing of QLTCI, including:**
  - ***Reduced corporate tax rate.*** As noted earlier, the corporate income tax brackets are replaced with a single flat tax rate of 21% starting in 2018
  - ***Life insurance reserves.***
    - For QLTCI, the deductible reserve generally will equal 92.81% of the reserve determined using the "tax reserve method otherwise applicable to the contract."
    - Reserve method continues to be 1-year preliminary term method that applied under prior law.
    - No deduction for deficiency reserves is allowed.

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LTC-Related Company-Level Tax Changes

- ***Deferred acquisition costs (DAC)***
  - Under the DAC rules of Code § 848, a percentage of the net premiums for specified insurance contracts must be capitalized and amortized
  - For QLTCI, the DAC capitalization rate increased from 7.7% to 9.2% of net premiums
    - Note: the Act amended the wrong Code provision in making this change
  - The Act increased the amortization period from 10 to 15 years
  - These changes generally apply to net premiums received after 2017

So Where Does that Leave the Current Tax Treatment of LTC Insurance?

Tax Treatment of QLTCI Premiums

- **Employer-paid premiums are excluded from income, including for employment tax purposes (no change in law)**
  - Cannot be provided through a cafeteria plan or FSA
  - Can be provided to group of employees, e.g., all senior executives above a certain level (but no employee elections permitted)
- **Premiums on individually-purchased contracts may be deductible:**
  - For self-employed, the deduction is above-the-line
  - Others may claim itemized medical deduction only to the extent all medical expenses exceed 7.5% of AGI (for 2017 and 2018, per tax reform)
  - But all premium deductions above subject to following age-based limits (which could change due to transition to chained CPI):

Attained Age	Limit on Deduction (2018)
40 or less	$ 420
More than 40 but not more than 50	$ 780
More than 50 but not more than 60	$1,560
More than 60 but not more than 70	$4,160
More than 70	$5,200

Tax Treatment of QLTCI Benefits

- **Benefits from Individually-Purchased QLTCI Coverage**
  - Generally tax-free as accident and health (A&H) benefits under Code § 104(a)(3)
  - Per diem limitation for QLTCI benefits which do not reimburse expenses for qualified long-term care services
    - Reported by IRS in Rev. Proc. 2017-58 as $360/day ($131,400/year) for 2018
    - Awaiting further IRS guidance to see whether the change to chained CPI affects this amount
- **Benefits from Employer-Provided QLTCI Coverage**
  - Tax free as A&H benefits under Code §§ 105(b) and 7702B(a)(2)

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QLTCI Qualification Rules: Code § 7702B

- **Coverage only of qualified long-term care services**
  - Services required by a chronically ill individual
  - Provided pursuant to a "plan of care" prescribed by a licensed health care practitioner
- **Chronic illness requirement** – A licensed health care practitioner must have certified within the prior 12 months that the insured either:
  - needs substantial assistance with at least 2 of 6 activities of daily living (as defined in the tax law), or
  - requires substantial supervision to protect the insured from threats to health and safety due to severe cognitive impairment
- **Limits on cash values** – Certain return of premium benefits permitted on the insured's death or surrender
- **Other requirements** – Guaranteed renewable, Medicare coordination, and consumer protection

Types of QLTCI Combination Products

- **Life insurance-QLTCI products**
  - Authorized by HIPAA in 1996
  - LTC portion of contract can provide LTC accelerated death benefits (ADBs) and / or non-acceleration LTC benefits
    - Insurance benefits generally treated the same as under stand-alone products
- **Annuity-QLTCI products**
  - Authorized by Pension Protection Act of 2006
  - Similar tax treatment to life-QLTCI products
  - Restrictions on Combinations involving employer or qualified retirement arrangements (Code § 7702B(e)(4))

Legislative Outlook – Risks and Opportunities for LTC Insurance

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Legislative Outlook – Risks and Opportunities for LTC Insurance

General Considerations

- Efforts to Reduce Rates by Broadening the Base
  - Medical care deduction
  - Itemized deductions more generally
  - Exclusion for employer-provided coverage
- Technical Corrections for Tax Reform
- HSA Expansion
- Other Changes?
- Timing Considerations

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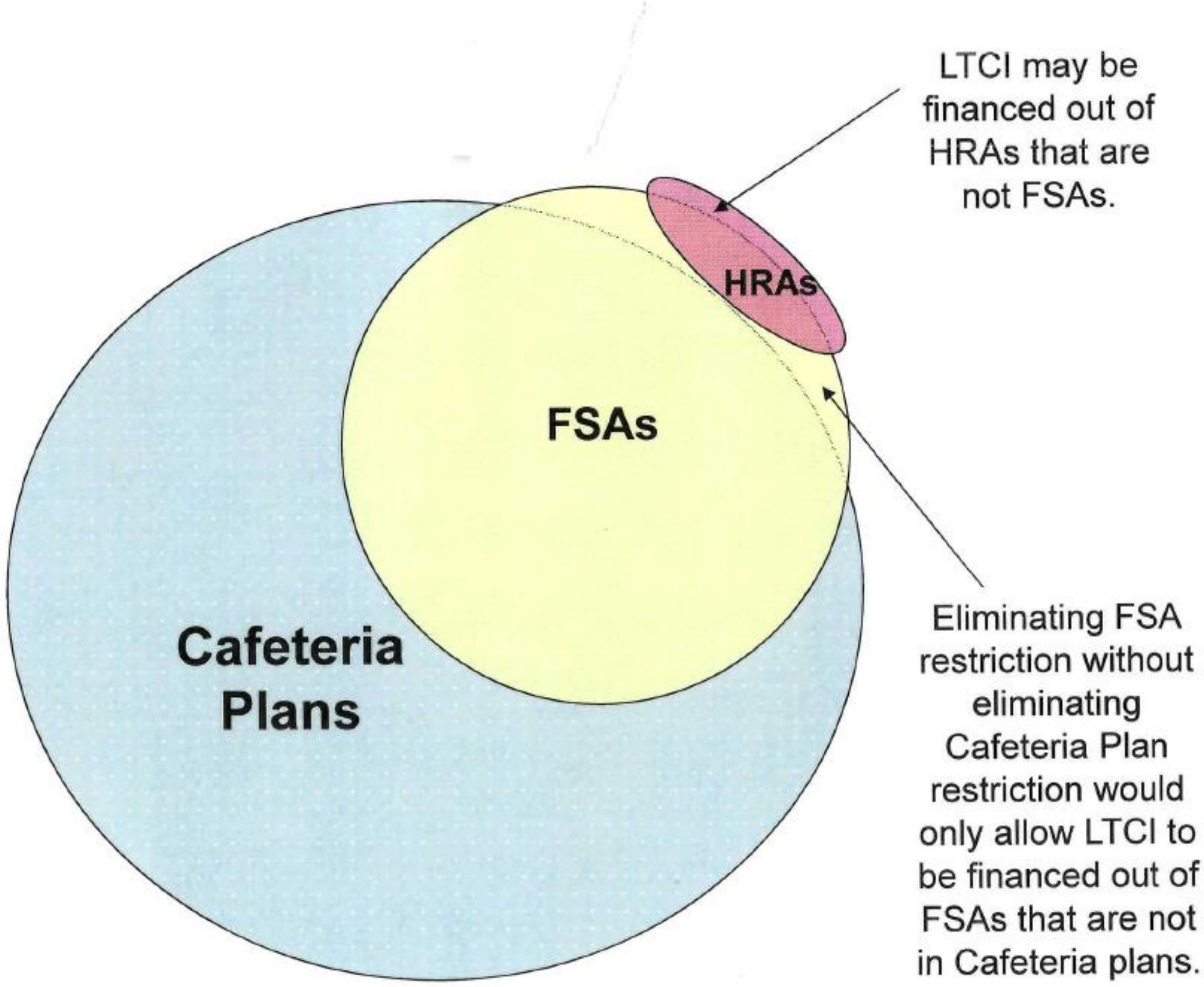
FSAs and Cafeteria Plans

- **Health Flexible Spending Arrangement (FSA)**
  - An employer-provided arrangement that may be funded by the employer and/or the employee via salary reduction (self-employed are not eligible)
  - FSA contributions and withdrawals are excluded from income (2018 maximum will be $2,650)
  - Amounts must be used only for qualified medical expenses. Qualified medical expenses are as defined under Code § 213(d), but FSAs may *not* be used to reimburse insurance premiums, including long-term care
  - Balances may not generally be carried forward (use-it-or-lose-it)
- **Cafeteria Plan (Code § 125)**
  - An employee benefit plan that allows a choice from among a variety of generally tax-favored benefits that may include health FSAs, health insurance, pre-tax health insurance premium deductions, dependent care FSAs, cash benefits, and/or retirement plan contributions
  - Tax treatment is the same as that applicable to the underlying choice

Legislative Outlook – Risks and Opportunities for LTC Insurance – FSAs and Cafeteria Plans?



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Legislative Outlook – Risks and Opportunities for LTC Insurance – FSAs and Cafeteria Plans?

FSAs and Cafeteria Plans

- **Allow QLTCI Under Cafeteria Plans and FSA?**
  - **Advantages**
    – Income and payroll tax advantage
    – Increased employer involvement in marketing
    – Allows individual choice
  - **Disadvantages and Barriers:**
    – Limited to employees with access to cafeteria plan/FSA
    – Tax-favored plan access lost when leave employment
    – Limited access reduces cost, but costs are immediate

Legislative Outlook – Risks and Opportunities for LTC Insurance – "Within Plan" QLTCI?

Within Retirement Plan Approach

Up-Front Tax Advantages

- Purchased with retirement plan assets that are already in tax-favored format (i.e.: that have already been excluded from income and employment taxes*
- * (employee elective deferrals are subject to employment tax)

Inside Build-Up

- As an investment by the retirement plan, receive inside build-up.

Taxation of Benefits or Distributions

- Taxed as retirement plan withdrawals (i.e., generally taxable)
- Taxable distributions of QLTCI benefits would be required
- Costs for LTC costs would still be deductible under § 213

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Legislative Outlook – Risks and Opportunities for LTC Insurance – "Within Plan" QLTCI?

Within Retirement Plan Approach

- **Advantages:**
  - Attractive to investor – no immediate tax cost with QLTCI purchase
  - Makes QLTCI a part of the retirement discussion – as it should be
  - Not all new savings – accesses $13+ trillion of retirement savings
    - Perhaps only realistic way to reach baby boom generation
  - Relatively more attractive to employers
    - New employee benefit to employees who want it at virtually no cost to employer (just adding another investment option to retirement plan)
  - More modest budgetary cost
    - Bulk of new QLTCI will be purchased with already tax-favored funds
- **Disadvantages and Barriers:**
  - Complexity (see below)
  - Still revenue loss to government, but less compared to coverage gains
  - Unisex rates required in employer plan

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Within Plan Proposal – Illustrative Example

Age/Year	Transaction	Current Law	Within Plan
55 - 59½ (4½ years)	Current Law: $2,631.58/year withdrawn to generate $2,000 after-tax to pay for QLTCI (outside of Plan) Within Plan Approach: $2,000/year of Qualified Account applied to QLTCI as Plan asset	$631.58/year income tax + $263.16/year penalty **Total Tax: $4,026.33** (reflects 24% tax rate)	No income tax consequence from QLTCI premium payments **Total Tax Years: $0**
59½ - 64 (5½ years)	Current Law: $2,777.78/year withdrawn to generate $2,000 after-tax to pay for QLTCI (outside of Plan) Within Plan Approach: $2,000/year of Qualified Account applied to purchase QLTCI as Plan asset	$631.58/ year income tax **Total Tax: $3,473.69** (reflects 24% tax rate)	No income tax consequence from QLTCI premium payments **Total Tax Years $0**
65-84 (20 years)	Current Law: $2,500.00/year withdrawn to generate $2,000 after-tax to pay for QLTCI (outside of Plan) Within Plan Approach: $2,000/year of Qualified Account applied to purchase QLTCI as Plan asset	$500/year income tax **Total Tax Years: $10,000** (reflects 20% tax rate)	No income tax consequence from QLTCI premium payments **Total Tax Years $0**

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Within Plan Proposal – Illustrative Example (continued)

Age/Year	Transaction	Current Law	Within Plan
85-87	$35,000/year in QLTCI benefits received for three years by taxpayer/insured ($105,000 total) <u>Assumptions:</u> •$35,000/year in qualified LTC expenses •No other medical expenses •Other income is $45,000 •Income tax calculation is simplified	$35,000/year in QLTCI benefits (excludable from income) **Total Tax: <u>$0</u>**	$35,000/year QLTCI benefits treated as taxable Plan distributions (1) Income tax on QLTCI benefits: $7,000/year, less (2) Tax benefit from deducting QLTC expenses: $5,400/year (3) Net tax consequence of LTC benefits and expenses: **<u>$1,600/year*</u>** **Total Net Taxes: <u>$4,800</u>** (reflects 20% tax rate)
Total Taxes		**$17,500**	**$4,800**

*<u>Income tax calculation (Years 85, 86, 87):</u> Tax on $35,000 of QLTCI benefits:$7,000. This would be offset by tax benefit of deduction of qualified LTC expenses; $35,000 – 10% of AGI of $80,000: <u>$5,400</u>. Assumes medical costs compensated by taxable insurance benefits are deductible under Code § 213, subject to AGI limitation.

Legislative Outlook – Risks and Opportunities for LTC Insurance – “Within Plan” QLTCI?

Within Retirement Plan Approach

- **Barriers (further considerations)**
  - **Regulatory (Treas. Reg. § 1.402(a)-1(e))**
    - Adverse tax treatment of retirement plan investments in A&H insurance, including QLTCI
    - Did Treasury need to go there, and could its current position be reversed?
    - Existing regulatory authorization of products that meet retirement-related needs
      - disability coverage
      - qualifying longevity annuity contracts (QLACs)
      - QLTCI serves a similar distinct purpose

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Legislative Outlook – Risks and Opportunities for LTC Insurance – “Within Plan” QLTCI?

Within Retirement Plan Approach

- **Barriers (further considerations)**
  - **Legislative**
    - Weighing tax advantages (and access to qualified market) versus revenue cost
    - Technical considerations
      - Treatment of premiums and QLTCI benefits
      - Required minimum distribution rules
      - Incidental benefit rules
      - Interaction with medical deduction rules
      - Eligible plans; eligible individuals; QLTCI features; other?
  - **Other Barriers?**

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Enhancement of Health Savings Accounts

Proposal for Additional Contributions to HSAs

- Allow additional contributions to an HSA in a taxable year above and beyond those otherwise allowed if the individual has QLTCI coverage during such year
- Limit additional contribution to the premiums the individual pays during the taxable year for QLTCI, to the extent such amount does not exceed the eligible long-term care premium limitation of section 213(d)(10)
- Special rules for post-age 65, since HSA contributions normally cannot be made after such time?

- Questions?

- Next Steps?

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