Long-Term Care Discussion Group

LTC Insurance and Tax Reform

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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
2017 Tax Reform Legislation
2017 Tax Reform Legislation

General Observations on Tax Reform

- **Tax Reform at Light Speed**

- **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**
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.
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
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.
2017 Tax Reform Legislation

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):

<table>
<thead>
<tr>
<th>Attained Age</th>
<th>Limit on Deduction (2018)</th>
</tr>
</thead>
<tbody>
<tr>
<td>40 or less</td>
<td>$420</td>
</tr>
<tr>
<td>More than 40 but not more than 50</td>
<td>$780</td>
</tr>
<tr>
<td>More than 50 but not more than 60</td>
<td>$1,560</td>
</tr>
<tr>
<td>More than 60 but not more than 70</td>
<td>$4,160</td>
</tr>
<tr>
<td>More than 70</td>
<td>$5,200</td>
</tr>
</tbody>
</table>
**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)
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
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
Legislative Outlook – Risks and Opportunities for LTC Insurance – FSAs and Cafeteria Plans?

**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?

LTCI may be financed out of HRAs that are not FSAs.

Eliminating FSA restriction without eliminating Cafeteria Plan restriction would only allow LTCI to be financed out of FSAs that are not in Cafeteria plans.
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
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
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
### Within Plan Proposal – Illustrative Example

<table>
<thead>
<tr>
<th>Age/Year</th>
<th>Transaction</th>
<th>Current Law</th>
<th>Within Plan</th>
</tr>
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</table>
| 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** |
## Within Plan Proposal – Illustrative Example (continued)

<table>
<thead>
<tr>
<th>Age/Year</th>
<th>Transaction</th>
<th>Current Law</th>
<th>Within Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>85-87</td>
<td>$35,000/year in QLTCI benefits received for three years by taxpayer/insured ($105,000 total)</td>
<td>$35,000/year in QLTCI benefits (excludable from income)</td>
<td>$35,000/year QLTCI benefits treated as taxable Plan distributions</td>
</tr>
<tr>
<td></td>
<td>Assumptions: •$35,000/year in qualified LTC expenses •No other medical expenses •Other income is $45,000 •Income tax calculation is simplified</td>
<td>Total Tax: <strong>$0</strong></td>
<td>(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: <strong>$1,600/year</strong></td>
</tr>
</tbody>
</table>

**Total Taxes**

| Total Taxes | $17,500 | $4,800 |

*Income tax calculation (Years 85, 86, 87): 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: **$5,400**. Assumes medical costs compensated by taxable insurance benefits are deductible under Code § 213, subject to AGI limitation.*
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
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?
 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?