

SOA Health Spring Meeting 2007

Session 31: Update – Recent Tax Guidance for Health Insurers

Taxation of LTC Combination Products

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Combination LTC Plans

- Hybrid life/LTC coverages beginning a period of expansion
 - Shrinking number of insurers selling stand-alone LTC
 - Increased rates for new LTC sales
 - Companies willing to develop reduced risk plans
 - Significant product development activity in the works

- Interesting new annuity/LTC combinations appearing, with more in development due to new tax law changes

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Life/LTC Product Basics

- Various base plans including single premium universal life, flexible premium UL, WL, and VUL
- Accelerated Death Benefit LTC rider (ADB)
 - Pays out a specified portion of DB per month with a proportionate reduction to CV's
 - Charge structure typically YRT per thousand of NAR
- First generation
 - ADB only
 - Low cost
 - Self Insurance
 - Protect the producer

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Market Positioning

- First generation
 - ADB only
 - Low cost
 - Self Insurance
- Second generation
 - Adds EOB
 - Asset re-positioning: Return assets, a multiple of assets (DB), or a multiple of DB (EOB)
- Distribution channels
 - Life producers, banks, annuity producers, financial planners

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Life/LTC Product Variations

- LTC benefit structure
 - Expense incurred with caps
 - Fixed indemnity, daily or monthly if formal care is required
 - Disability model that doesn't require care
- Nonforfeiture Benefits
- Return of Premium Options
- Residual death benefits
- Guaranteed minimum death benefits
- No lapse guarantees

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Life/LTC Product Variations

- Waiver
 - Trigger
 - LTC charges only or all charges
- LTC lifetime maximums
 - Linked to life specified amount
 - Linked to life DB after corridor
 - Unlinking of LTC maximums from life specified amount
- Option B
 - Life only, with option A LTC
 - LTC benefit set at life benefit, policy switches to Option A at claim time
 - LTC Option B

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Regulatory/Tax Requirements

- ADB not subject to a series of LTC requirements
 - Suitability and Shopper's guide
 - Loss ratio
 - Inflation Option

- ADB may be treated as DB for taxes

- Common view is that EOB benefits subject to all LTC regulatory requirements
 - Favored tax treatment if meeting TQ requirements

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Company Taxation and 7702

- CVAT tests

- GPT tests

- Non-QAB's

- DAC taxes

- Premium taxes

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Life/LTC Reserves

- Stat
- Tax
- GAAP

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Future Considerations

- Tax issues
 - Not QAB's
 - Charges deemed to be distributions, but under Pension Protection Act (HR4), not taxable but rather reduce basis @ 1/1/2010 for tax qualified LTC
- Market evolution

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PPA Impact on Life/LTC Combination Plans

	Current Law	Under PPA
Benefits	LTC benefits are tax-free if they qualify under 7702B or 101(g)	Same
Tax Treatment of charges	The LTC rider charges are treated as distributions. MEC contracts treated as gain first.	The LTC rider charges still distributions, but not taxable, however they reduce basis in the life contract
1035 Exchanges	Tax treatment of transaction unclear	Allowed

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Annuity/LTC Product Variations

- Deferred annuities
 - Design one: Withdrawal of AV without SC during first 2 or 3 years of LTC, with extension of benefits after that
 - Design two: Independent payment of benefits into AV
 - Charge structures generally specified basis points on AV
- Immediate annuities
 - Enhanced pay-outs when LTC trigger met

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Consumer and Company Benefits

- Deferred annuity, first design:
 - Waiver of SC modest cost to company
 - Extension of coverage addresses full LTC need, with a long elimination period
 - Package still less risky than stand-alone LTC
 - Cost of LTC benefits still less expensive than stand-alone coverage
 - Pricing synergies between annuity and LTC

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Consumer and Company Benefits

- Deferred annuity, second design:
 - No “self insurance” as in first design, but cost of LTC benefits can be kept down through extended waiting period such as the first six or seven policy years
 - The biggest benefit to waiting period is to reduce anti-selection with limited underwriting

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Annuity/LTC Reserves

- Stat
- Tax
- GAAP

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Regulatory/Tax Requirements

- Ancillary riders not uncommon on annuities, some that look much like limited forms of LTC
 - Some are not to be filed as health insurance
 - May arguably avoid marketing, licensing, and design requirements of LTC
 - May not have optimal tax positioning
- Pension Protection Act
 - Favored tax treatment if rider meets TQ requirements
 - Charges not taxable, but reduce basis

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Company Taxation

■ DAC taxes

- Currently 1.75%
- Change as a result of HR4, beginning after 12/31/2009
- Treated as LTC, with DAC tax rates of 7.7%

■ Premium taxes

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PPA Impact on Annuity/LTC Combination Plans

	Current Law	Under PPA
Benefits	Not clearly defined. Most companies take the position that the LTC payments are taxable	Favorable tax treatment of benefits if riders designed as TQ, on non-qualified annuities only Portions (or all?) of AV currently taxable may be paid out tax-free
Tax Treatment of charges	Not clearly defined	The LTC rider charges are distributions but not taxable, however they reduce basis. No 213(b) deduction of premium allowed.
1035 Exchanges	Tax treatment of transaction unclear	Allowed
DAC taxes	1.75%, but consider IRC 848(e)(3)	7.70%

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**Society of Actuaries
2007 Spring Health Meeting**

**LTC / Annuity
Combination Products
and Other Health-Related Tax
Developments**

June 13, 2007

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LTC-Combinations - Prior Law

- **Qualified LTC under Code Section 7702B**
 - ◆ QLTCI benefits tax-free if qualification requirements are met
 - ◆ Qualification requirements include:
 - ☞ Must be an “insurance” contract
 - ☞ No “cash surrender value” permitted, with minor exceptions
 - ☞ Only “qualified long-term care services” can be covered

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Prior Law (cont.)

■ LTC / life insurance combinations

- ◆ Code Section 7702B(e) permits LTC riders to life insurance contracts
- ◆ Treats LTC “portion” as a separate contract
 - ☞ This allows Code Section 7702B qualification rules to apply to LTC rider without regard to life insurance contract
 - ☞ Also allows Code Section 7702 qualification rules to apply to life insurance contract without regard to LTC rider

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Prior Law (cont.)

■ LTC / life insurance combinations (cont.)

- ◆ Cash value under life insurance contract, as well as the “pure” LTC insurance benefits, can be paid as tax-free QLTC benefits under the combination product
- ◆ Guideline premium & 7-pay test treatment
- ◆ Treatment of LTC charges as distributions
- ◆ Acceleration vs. independent LTC benefits
 - ☞ Code Sections 101(a) and (g)

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Prior Law (cont.)

■ LTC / Annuity Combinations

- ◆ Not expressly sanctioned by Code under prior law
- ◆ Uncertain tax treatment due to “separate contract” issue

■ Tax-Free Exchanges

- ◆ Code Section 1035 does not address exchanges of QLTCI contracts under prior law
- ◆ Also does not address exchanges of life insurance, annuity, or endowment contracts for QLTCI contracts

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New Legislation: Overview

- Pension Protection Act of 2006
- Allows LTC / annuity combination products
- Amends some rules for LTC / life insurance combination products
- Amends rules for tax-free exchanges
- Amends “DAC tax” rules
- Imposes reporting requirements
- Delayed effective date for most of the new rules

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New Legislation: Annuity Combos

- Separate contract treatment
 - ◆ Follows prior law rules for LTC / life insurance combinations by treating LTC “portion” and annuity “portion” as separate contracts
 - ☞ “Portion” defined
 - ◆ Facilitates compliance with QLTCI rules under Code Section 7702B and annuity rules under Code Section 72
 - ◆ Does not apply to certain retirement plan or employer-related annuities

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New Legislation: Annuity Combos (cont.)

- Tax-free benefits
 - ◆ Amounts received under the contract as provided by the QLTCI rider are treated as QLTCI benefits
 - ◆ This treatment applies whether or not the payment causes a reduction in the annuity contract’s cash value
 - ☞ Deferred annuities
 - ☞ Immediate annuities
 - ◆ Same rule applies to LTC / life insurance combinations (as under prior law)

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New Legislation: Annuity Combos (cont.)

- Treatment of charges
 - ◆ Generally treated as distributions
 - ◆ BUT not includible in income
 - ☞ This rule applies even if a distribution from the contract otherwise would be taxable under Code Section 72
 - ◆ AND reduce after-tax basis or “investment in the contract” (but not below zero)
 - ◆ Not deductible (generally same as prior law)

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New Legislation: Life Combos

- Separate contract for purposes of “title”
- Treatment of charges
- Treatment of benefits
- Coordination with Code Section 7702
 - ◆ Repeals rule providing for increase in guideline premium limitation
 - ◆ No longer necessary due to treatment of charges as reducing “premiums paid”
 - ◆ QAB treatment rejected

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New Legislation: Tax-Free Exchanges

- Amends Code Section 1035 to allow tax-free exchanges of QLTCI contract for another QLTCI contract
- Also allows tax-free exchange of life, annuity, or endowment contract for QLTCI contract
- Clarifies that combination products can be exchanged for other combination products or stand-alone contracts

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New Legislation: DAC Tax Rules

- Code Section 848 requires capitalization of “specified policy acquisition costs”
 - ◆ Annuities = 1.75%
 - ◆ Group life insurance = 2.05%
 - ◆ Other insurance contracts = 7.7%
- New rules treat LTC combination products as “other” insurance contracts
- Thus, annuity portion of LTC / annuity product will be subject to 7.7% rate rather 1.75% rate
 - ◆ *See*, however, Code Section 848(e)(3).

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New Legislation: Reporting Rules

- Issuers required to annually report:
 - ◆ the amount of the aggregate charges against the contract to fund QLTCI coverage;
 - ◆ the amount of the reduction in the investment in the contract resulting from the imposition of such charges; and
 - ◆ the name, address, and TIN of each contract owner
- Payee statements also required

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New Legislation: Effective Date

- New rules apply to contracts issued after 1996, BUT, only with respect to taxable years beginning after 2009
 - ◆ Treatment of products issued prior to 2010?
- Tax-free exchange rules apply only to exchanges occurring after 2009
 - ◆ Treatment of exchanges prior to 2010?

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New Legislation: Effective Date (cont.)

- New DAC tax rules apply to specified policy acquisition expenses determined for taxable years beginning after 2009
 - ◆ Re-application of DAC tax in 2010?
- Reporting rules apply to charges made after 2009
- Clarification that separate contract treatment applies for entire Code applies retroactively to 1996

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Further thoughts on LTC-annuity design issues

- Design considerations for LTC annuities after effective date of legislation.
 - ◆ “Insurance” contract issue
 - ◆ Meeting the rules applicable to annuity contracts, including with respect to annuitization.
 - ◆ Application of consumer protection requirements, such as inflation protection and in-kind non-forfeiture benefits.
- Design considerations before the effective date – what can be done?

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HSA Improvements

- **Contribution Limits**
 - ◆ Increased annual statutory contribution limits
 - ◆ Increased opportunity for full year contributions
- **Consolidation Rights**
 - ◆ HRAs and FSAs
 - ◆ Rollovers from IRAs

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Other Health Tax Developments

- **Defined contribution health**
- **Prefunding of health liabilities**
- **FASB rules and employer-provided health coverage**
- **President's health tax proposal**
 - ◆ Generally makes all employer-provided health taxable to the employee
 - ◆ Provides standard deduction for purchase of minimum qualifying catastrophic coverage

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Questions?