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Technical Release: Explanation of the Federal Income Taxation of Qualified Long-Term Care Insurance Premiums and Benefits

1. Introduction

The purpose of this publication is to respond to requests for an in-depth, “book, page and verse” explanation of the income taxation of **qualified** long-term care insurance (LTCI) policy premiums and benefits in two general scenarios: (1) an individual purchases the policy with personal funds, and (2) a business pays the premiums on a policy owned by the individual. This publication answers the following questions, along with several others:

- § Does it matter whether a partnership pays the qualified LTCI premium on behalf of a partner, or the partner pays the premiums with his personal funds?
- § Do qualified LTCI premiums qualify for the self-employed health insurance deduction?
- § If a business pays the qualified LTCI premium, can it deduct the premium, and if so, is the deduction limited to the eligible premium?
- § If an employer deducts a qualified LTCI premium, what amount, if any, is included in the employee’s gross income?
- § Is it possible for an employee to exclude the employer’s premium payments from gross income and also exclude any policy benefits from gross income?
- § Are there special rules regarding a more than 2% shareholder/employee in an S Corporation?
- § What are the rules with respect to spouses and dependents?
- § What is the supporting authority for the answers to these questions?

2. LTCI Premium Deductions for Individuals

Individuals have two potential income tax deductions for LTCI premiums: self-employed health insurance and itemized medical expenses.

A. Self-employed Health Insurance Deduction.

IRC Section 162(l) permits a self-employed individual to deduct the “applicable percentage” of insurance premiums for “medical care for the taxpayer, his spouse, and dependents.” IRC Section 7702B(a)(1) states that a qualified LTCI policy is treated as an accident and health insurance contract. IRC Section 162(l)(2)(C) states that a qualified LTCI policy is a medical care insurance policy, but that in applying the applicable percentage, “only eligible long-term care premiums. . . shall be taken into account.” The applicable percentage is 100. IRC Section 162(l)(1)(B). If the policy premium is less than the eligible premium, the deduction is limited to the policy premium.

five different age-based eligible long-term care premiums that are subject to annual cost of living adjustments. Based on Rev. Proc. 2003-85, the eligible premiums for 2004 are as follows:

<u>Age</u>	<u>Amount</u>
40 or younger	\$260
41 to 50	\$490
51 to 60	\$980
61 to 70	\$2,600
71 or older	\$3,250

Example 1. Bill is 62 and self-employed. His qualified LTCI premium is \$2,800. In 2004, he can claim a self-employed health insurance deduction of \$2,600, equal to 100% of the \$2,600 eligible premium for his age bracket.

Example 2. Bill in the above example is married. His wife is 58, and also insured by a qualified LTCI policy. The premium for her policy is \$2,000. Bill can also deduct 100%, or \$980, of the eligible premium for his wife's policy as a self-employed health insurance deduction.

To recap, the self-employed health insurance deduction is available for premiums paid for (1) a qualified LTCI policy or policies that (2) insure a self-employed taxpayer, his or her spouse and dependents, but (3) only for the lesser of the actual premium or the eligible premium for each policy.

The self-employed health insurance deduction reduces a taxpayer's gross income and is factored into determining the taxpayer's adjusted gross income. IRC Section 62(a) states that adjusted gross income is gross income less specified deductions. IRC Section 162 permits deductions for trade or business expenses. As noted, the self-employed health insurance deduction is found in subsection (l). This means that a self-employed taxpayer can claim the self-employed health insurance deduction whether he or she itemizes deductions or claims a standard deduction. On the other hand, the medical care deduction under IRC Section 213, discussed below, is limited to taxpayers who itemize their deductions.

(1). Limitations.

The self-employed health insurance deduction is subject to further limitations contained in Section 162(l)(2). The deduction cannot exceed the taxpayer's earned income from the business "with respect to which the plan providing the medical care coverage is established." Note that the limitation is not based on the taxpayer's earned income from all sources, but on the taxpayer's earned income from the business that provides the coverage. Moreover, the earned income limitation under IRC Section 162(l)(2) applies not simply to the deductible component of the LTCI policy (the eligible premium), but to all potentially deductible health insurance premiums provided through the business.

Example 3. Bill in Example 1 is a sole proprietor. In 2004, his business pays \$3,000 for a major medical insurance policy plus \$2,800 for Bill's LTCI policy. Bill can deduct 100% of the major medical premium (there is no eligible premium limit) and 100% of the eligible premium for the LTCI policy, for a total deduction of \$5,600 (\$3,000 + \$2,600), provided his earned income from the sole proprietorship is at least \$5,600.

A second limitation in IRC Section 162(l)(2) applies when the taxpayer is eligible to participate in a subsidized LTCI plan of another employer.

Example 4. Bill's wife is employed by XYZ, Inc. XYZ, Inc. has adopted an employee benefit plan that pays the LTCI premiums for selected employees and their spouses. Bill's wife is eligible to participate in XYZ's plan. If Bill is also eligible to participate, his eligibility eliminates any self-employed health insurance deduction. If, however, participation in XYZ's plan does not include spouses, Bill could deduct 100% of the eligible premium for his LTCI policy.

(2). Who Is Self-employed?

With the exception of a more than a 2% S corporation shareholder/employee, a person is self-employed if he or she is treated as an employee under IRC Section 401(c)(1). IRC Section 162(l)(1)(A).

IRC Section 401(c) permits self-employed individuals to be treated as employees in order to participate in qualified retirement plans. It defines a self-employed individual as one who has net earnings from self-employment. The category of self-employed individuals includes sole proprietors, general partners in a partnership (but generally not limited partners), and members of a limited liability company (LLC) taxed as a partnership who perform services for the LLC. Treas. Prop. Reg. Section 1.1402(a)-2. A more than 2% shareholder/employee in an S corporation is also treated as self-employed for this benefit.

(3). More than 2% S Corporation shareholder/employees.

IRC Section 162(l)(5) states that a more than 2% S corporation shareholder/employee will be treated as self-employed for purposes of the self-employed health insurance deduction. A shareholder/employee in an S corporation is not self-employed under Section 401(c), and is generally treated as an employee of the corporation under the Code. Notwithstanding, IRC Section 1372 states that with respect to employee fringe benefits, an S corporation is treated as a partnership, and a more than 2% shareholder/employee is treated as a partner in that partnership. Although a more than 2% shareholder/employee is not treated as an employee under IRC Section 1372, but is also not self employed, he or she is treated as self-employed under IRC Section 162(l)(5) for purposes of the self-employed health insurance premium deduction.

(4). Plan is necessary.

As noted, IRC Section 162(l)(2) requires that there be a "plan providing the medical coverage." If, for example, a partner in a partnership simply pays the LTCI premium out of his or her pocket, the self-employed health insurance deduction may be denied. IRC Section 162(l), however, refers only to the term "plan" without any mention as to how detailed the plan must be. This suggests that the plan may be fairly simple, such as a partnership resolution to pay LTCI premiums to the insurer on behalf of the partners, and possibly their spouses and dependents. The resolution, however, should contain enough detail so as to minimize disputes regarding the rights and obligation of the partnership and the partners. An S corporation or an LLC taxed as a partnership could take a similar approach for more than 2% shareholder/employees and service members, respectively. In the case of a sole proprietorship the "plan," perhaps, may be even less detailed since it affects only one business owner. A memo for record may be sufficient. Moreover, prudence suggests that the premiums be paid from the business's checkbook.

The above describes plans limited to self-employed individuals. If the business wishes to pay LTCI premiums on behalf of employees, it could establish a second plan for them, or combine self-employed individuals and employees in one plan. Employee benefit plans are generally subject to ERISA, and, as such, are apt to be more detailed than a plan limited to self-employed individuals.

Section 3 below (LTCI Premiums Paid By Business) notes that an employer can establish an accident and health plan for its employees, extend participation to the spouses and dependents of the employees, deduct the premiums in full, and the premiums will be excluded from the employee's gross income. Suppose both spouses work in the same business, one spouse is an employee and the other spouse is a self-employed sole proprietor, partner or member of an LLC (but not a more than 2% shareholder/employee of an S corporation who is treated as self-employed, as explained in the Caveat below). Taxes may be saved if the plan covers employees and their spouses, and the self-employed spouse participates as a spouse of the employee spouse. In other words, rather than establishing a plan for the self-employed spouse and his or her spouse, the plan is limited to employees and their spouses, thereby allowing the self-employed spouse to be treated as the spouse of an employee rather than as self-employed.

Example 5. Bill's wife in the above examples is now an employee in her husband's business. As noted in Examples 1 and 2, the premiums for Bill's and his wife's qualified LTCI policies are \$2,800 and \$2,000, respectively, for a total premium of \$4,800. The combined eligible premiums are \$3,580 (\$2,600 and \$980). If the plan is based on Bill's status as self-employed with his wife participating as Bill's spouse and not as an employee, the couple's deduction in 2004 will be limited to \$3,580 of eligible premiums, with the \$1,220 premium balance non-deductible. If Bill participates as self-employed and his wife participates as an employee, there is still no deduction for the \$200 difference between the premium for Bill's policy and the eligible premium.

The self-employed health insurance deduction is a deduction in arriving at adjusted gross income, but its tax impact is the same as a gross income exclusion of the same amount. Instead of basing participation on Bill as self-employed, if he participates as the spouse of an employee, Bill and his wife can exclude the entire \$4,800 in premiums from their gross income.

Note: Bill's wife must be a bona fide employee in order to be treated as an employee. Moreover, Rev. Rul. 71-588 suggests that she may also have to be a fulltime employee to allow Bill to participate as her spouse.

Caveat: This tax planning technique is not available if an employee's spouse is a more than 2% shareholder/employee in an S corporation. The reason is that IRC Section 1372(b) contains a stock attribution rule that treats the spouse of a more than 2% shareholder as also owning the shares owned by the more than 2% shareholder spouse. Consequently, both spouses will be treated as a more than 2% shareholder even if all of the shares are directly owned by only one spouse.

B. Itemized Medical Expense Deduction.

IRC Section 213(a) permits individual taxpayers who itemize their deductions to deduct their, their spouse's and their dependents' "medical care" expenses that in total exceed 7 ½% of adjusted gross income. IRC Section 213(d)(1)(D) states that the term "medical care" includes "amounts paid . . . for any qualified long-term care insurance contract," but limits the deduction to "only eligible long-term care premiums."

In the case of individuals who are not entitled to any self-employed health insurance deduction under IRC Section 162(l), the entire eligible premium constitutes a medical care expense under IRC Section 213(a).

As noted, deductions under Section 213(a) are limited to individuals who itemize their deductions. In calculating the deduction, the eligible LTCI premium is added to other deductible medical expenses, but only the amount of the total medical expenses that exceed 7 ½% of adjusted gross income is actually deductible. This threshold often results in many individuals who itemize deductions not being unable to deduct any medical

eligible LTCI premium qualifies as a deductible medical expense. There is no the premium in excess of the eligible premium.

Since only incurred medical expenses are deductible, if the actual premium is less than the eligible premium, the deductible amount is capped at the amount of the actual premium. But if the actual premium exceeds the eligible premium, the excess is not deductible.

3. LTCI Premiums Paid By Business.

A. Employee Accident Or Health Plan.

An employer can deduct reasonable business expenses, including fringe benefits it pays for its employees. IRC Section 162(a). An employer can pay and deduct the LTCI premiums on policies that insure an employee, including the LTCI premiums on policies that insure the employee's spouse and dependents, and the premiums will be excluded from the employee's gross income, provided the employer pays the premiums under an accident or health plan and the policies are owned by the insureds and not by the employer.

Treasury Regulation Section 1.162-10(a) permits an employer to deduct the expenses of a "sickness, accident, hospitalization, medical expense, . . . welfare or similar benefit plan" under IRC Section 162. IRC Section 106(a) states that the "gross income of an employee does not include employer-provided coverage under an accident or health plan." IRC Section 7702B(a)(3) provides that "any plan of an employer providing coverage under a qualified long-term care insurance contract shall be treated as an accident and health plan with respect to such coverage." Consequently, if the employer pays the LTCI premiums pursuant to an employee accident or health plan, the employer will be able to deduct the premiums, and the employee will be able to exclude the premiums from his or her gross income. Moreover, the plan may include the employee's spouse and dependents. Rev. Rul. 71-588.

(1). Deduction and Exclusion Not Limited To Eligible Premium.

Is the employer's deduction limited to the eligible premium, or may it deduct the full premium? Is the employee's gross income exclusion limited to the eligible premium, or does the exclusion apply to the full premium? The IRS has not specifically addressed these questions, but Estate & Business Planning believes that neither the deduction nor the exclusion is limited to the eligible premium. Stated differently, the employer is entitled to deduct the full premium, and the employee is entitled to exclude the full premium from his or her gross income.

The provisions of IRC Section 162(l) clearly show that Congress understood that an LTCI policy's premium and the eligible premium could be different. When Congress amended IRC Section 162(l) to address qualified LTCI premiums, it also amended IRC Section 106 by adding subsection (c) to state that an employee's gross income included "employer-provided coverage for qualified long-term care services . . . provided through a flexible spending or similar arrangement." It left unchanged the general rule that "[e]xcept as otherwise provided in this section, gross income of an employee does not include employer-provided coverage under an accident or health plan." While Congress limited the deduction for self-employed health insurance and itemized deductions to eligible premiums, it did nothing to so limit the employer's deduction or the employee's gross income exclusion under an accident or health plan with two exceptions. The first, as noted, applies to a payment "provided through a flexible spending or similar arrangement." The second is that IRC Section 125(f) prohibits any long-term care insurance in a cafeteria plan. Congress understood that it was not limiting the deduction or the exclusion to the eligible premium, and neither a court nor the IRS is apt to suggest otherwise.

Added support can be found in the report by the Congressional Joint Committee on Taxation on the Health Insurance Portability and Accountability Act of 1996. This is the Act that added IRC Section 7702B and the other qualified long-term care provisions to the Internal Revenue Code. The report states:

...ding coverage under a long-term care insurance contract generally is treated as an accident and health plan. Employer-provided coverage under a long-term care insurance contract is not, however, excludable by an employee if provided through a cafeteria plan; similarly expenses for long-term care services cannot be reimbursed under an FSA. Thus, employer contributions (other than through a cafeteria plan) for long-term care insurance for the employee, his or her spouse, and his or her dependents (as defined for tax purposes) are excludable from income and wages for employment tax purposes. Employer contributions for long-term care insurance are deductible by the employer. Amounts received from long-term care insurance purchased by the employer are excludable from income in accordance with the rules relating to excludability of proceeds of accident or health insurance (and subject to the cap on per diem contracts).”

There is no mention of eligible premiums in the report. In addition, the remarks concerning per diem policies are not applicable to John Hancock; John Hancock issues only reimbursement policies.

(2). Participation May Be Limited To Key Employees.

Participation in a LTCI employee accident or health plan may be discriminatory. Although the Internal Revenue Code contains nondiscriminatory rules for specific employee benefit plans, such as qualified retirement plans and cafeteria plans, the Code does not contain a nondiscriminatory rule for all employee benefit plans or for employee benefit plans generally. This means that discrimination is permitted unless specifically prohibited, and there is no prohibition in the Code for an LTCI employee accident or health plan. Case law is supportive. For example, in Oleander Company Inc. v. U.S., 82-1 USTC para. 9395 (E.D.N.C. 1983), participation in the company’s accident and health plan was limited to the president and majority shareholder. In Wigutow v. Commissioner, TC Memo 1983-620 (1983), an employee and sole shareholder was the only participant. The Tax Court cited Wigutow in Weeldreyer v. Commissioner, T.C. Memo 2003-324 and in three companion cases to support the proposition that participation may be limited to employees who are shareholders when participation is based on duties as an employee. Consequently, participation in an LTCI accident or health plan may be limited to one or more key employees.

(3). Shareholder/Employees.

Shareholder/employees, as indicated in Oleander and Wigutow above, may participate in the employer’s accident or health plan, and the employer can deduct the premium and the shareholder/employee can exclude the premium from his or her gross income, if the benefit is provided to the shareholder/employee as an employee rather than as a shareholder. If all of the participants are both shareholders and employees, a question may arise as to whether the plan is for employees who happen to be shareholders or for shareholders who happen to be employees. If the IRS concludes that the plan is essentially a shareholder benefit plan, it will treat the premiums as a nondeductible dividend that is included in the recipient’s gross income. The key to favorable tax treatment is to base plan participation solely on a person’s status as an employee.

(4). Form 5500.

Form 5500 is an annual report on employee benefit plans submitted to the IRS. The category of employee benefit plans includes welfare benefit plans. An employee accident and health plan, as described above, would be classified as a welfare benefit plan. The Instructions for Form 5500, however, provide several filing exemptions, chief among which are plans with fewer than 100 participants and plans, regardless of the number of participants, if participation is limited to a select group of management or highly compensated employees.

An employee accident or health plan is clearly a fringe benefit and, as noted, a more than 2% S corporation shareholder/employee generally is not treated as an employee with respect to employee fringe benefits. Instead, he or she is treated as a partner in a partnership. A more than 2% shareholder/employee may participate in the plan the corporation establishes for its employees, or in a separate plan limited to more than 2% shareholder/employees.

A partnership may make a “guaranteed payment” to a partner. IRC Section 707(c) states that a guaranteed payment is a distribution for services rendered that is made without regard to partnership income. A partnership deducts any guaranteed payments, and the partner receiving the guaranteed payment includes it in his or her gross income. In Rev. Rul. 91-26, the IRS ruled that an S corporation’s payments of accident and health insurance premiums on behalf of a more than 2% shareholder/employee are to be treated as a guaranteed payment, deductible by the corporation and included in the more than 2% shareholder/employee’s gross income.

C. Partners.

Rev. Rul. 91-26 suggests that a partnership’s payments on behalf of partners will likely be characterized as a guaranteed payment, deductible by the partnership and included in the partner’s gross income. The payments could, however, be based on the partnership’s income, in which case the payments would not be deductible, but the partners would still include the payments in their gross incomes. In either case, the partners would be entitled to the self-employed health insurance deduction, discussed above.

D. LLC Members.

Some state laws require a limited liability company to have two or more members. When the LLC has two or more members, the LLC usually elects to be taxed as a partnership. Some states, however, permit single member LLCs. In this case, the LLC may elect to be taxed as a corporation or a sole proprietorship. The election will determine the tax treatment of the LTCI premium to both the entity and the members.

4. LTCI Policy Benefits

Qualified long-term care policy benefits are generally excluded from gross income. IRC Section 7702B(a)(2) states that with the exception of dividends and premium refunds, “amounts . . . received under a qualified long-term care insurance policy shall be treated as amounts received for personal injury and sickness and shall be treated as reimbursement for expenses actually incurred for medical care.” IRC Section 104(a)(3) excludes from gross income LTCI benefits that are attributable to, and not in excess of, deductible medical expenses. Section 104(a)(3) applies to cases in which the premiums were included in gross income or paid with after-tax dollars. If the premiums were excluded from gross income, as in the case of an employee benefit plan, IRC Section 105(b) excludes from gross income benefits that reimburse a taxpayer for the medical care expenses incurred by the taxpayer, his or her spouse or his or her dependents.

Notwithstanding IRC Sections 104(a)(3) and 105(b), benefits paid from a per diem LTCI policy could trigger gross income. IRC Section 7702B(d) states that if LTCI payments exceed the greater of \$230 for 2004 (as adjusted for inflation) or the costs incurred for qualified long-term care services, the excess is included in gross income. This exception does not apply to a reimbursement LTCI policy. As noted, John Hancock issues only reimbursement LTCI policies.

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