Combination of Life Annuities and Long-Term Care Insurance: Tax Issues

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Overview

- Description of the life care annuity, its rationale, and potential venues
- Tax treatment of life care annuity under various arrangements
  - Current law
  - Pension Protection Act
- Numerical examples of tax treatment of life care annuity

Life care annuity: description

- A life annuity combined with long-term care insurance.
- In exchange for a single premium, LCA provides a stream of fixed income payments until death.
- The income payments are increased in the event of long-term care needs
  - Impairment in ADLs
  - Cognitive impairment.

Life care annuity: rationale

- Life annuity market and LTCI market attract opposing risk groups
  - Life annuity market attracts those with higher than average life expectancies (adverse selection).
  - LTCI market attracts those with higher than average expected exposure to the imminent need for LTC services (and who die prematurely), but underwriting prevents coverage for this population.
- By combining a life annuity with LTCI, the life annuity can be sold more cheaply and LTCI can be offered to a larger population.

Life care annuity: possible venues

- After-tax annuity product
- Distribution option in a qualified retirement plan
- Component of entitlement reform

Possible structures of LCAs

- Immediate life annuity + single-premium LTCI policy
  - One-time charge against the annuity contract is taken to finance LTCI premium
- Immediate life annuity + periodic-premium LTCI policy
  - Periodic charges against the annuity contract are taken to finance LTCI costs
- Contingent annuity
  - No explicit LTCI component

Issues in a qualified retirement plan

- Minimum distribution requirements do not contemplate increasing payouts for disability benefits (also applies to IRAs).
- Gender-neutral pricing requirements may tamper with risk pooling.
- Whether “joint-and-survivor” requirement on life annuity extends to the disability component is unclear.
- Is the disability component an incidental benefit? Is it health insurance?
- Tax treatment for premiums for LTCI component is unclear.
  - Premiums on stand-alone employer-provided LTCI are excludable.
  - Distribution from plan to pay LTCI premiums may be taxable.
  - PPA provisions for LCA (explained below) do not apply to employer plans.
  - PPA does give exclusion for LTCI premiums from employer plans to first responders.

Current tax treatment of LCA

- Question whether IRS would regard a LCA as a contingent annuity or as a life annuity with a LTCI rider
- LCA as a single contract (contingent annuity)
  - Premiums excluded over policyholder's expected remaining life
  - LTCI charges against cash value are likely ignored
  - Disability component fully includable if not viewed as LTCI benefit
  - Qualified long-term care expenses may be deductible as itemized medical expense (subject to 7.5% AGI floor)
- LCA as separate contracts
  - Possible allocation of premiums between annuity and LTCI portions
  - LTCI charges against cash value treated as taxable distributions – possibly increasing taxable Social Security benefits
  - LTCI contract may not be qualified – if so, premiums are not deductible
  - Disability component viewed as LTCI benefit – if so, benefits are generally excludable

Pension Protection Act

- Provisions applicable after 2009
- LCA components treated as separate contracts, but questions regarding premium allocations remain
- LTCI charges against the contract’s cash value are excludable distributions
- Investment in the contract is reduced by the amount of the excluded LTCI charges, but not below zero

Examples

- Two individuals
  - Both age 65 with $1,200 in annual additional unreimbursed medical expenses
  - Both purchase LCA that pays out $1,000/month without disability, additional $140/day with disability.
  - Moderate income individual has $7,000 in other taxable income and $12,000 in Social Security benefits
  - High income individual has $75,000 in other taxable income
- Three LCA structures
  - Single-premium LTCI rider
  - Level-premium LTCI rider
  - Contingent annuity
- Three situations
  - Before implementation of PPA (current law)
  - After implementation of PPA
  - Above-the-line deductibility of LTCI premiums

Metric of comparison

- Expected present discounted value of taxable income over remaining lifetime
- Compared to individual under similar circumstances separately purchasing a life annuity that pays out $1,000/month and a single-premium LTCI policy under current law
- No adjustment made for cost saving of LCA relative to separate contracts

Results

Net Effect on Taxable Income of Purchasing LCA Under Different Arrangements

Moderate Income	Level Premium LTCI Policy	Single Premium LTCI Policy	Contingent Annuity
Before 2010	$22,568	$31,139	($17,657)
After 2009	($3,267)	($3,806)	($3,806)
w/ ATL Deduction	($23,590)	$28,189	($17,657)

High Income	Level Premium LTCI Policy	Single Premium LTCI Policy	Contingent Annuity
Before 2010	$15,878	$15,878	($23,787)
After 2009	($8,571)	($8,286)	($8,286)
w/ ATL Deduction	($25,137)	$12,928	($23,787)

Conclusions

- If treated as a contingent annuity under current law, a LCA would offer significant tax advantages relative to other LCA structures.
- The PPA greatly enhances the tax advantages of purchasing a LCA with a LTCI rider by eliminating tax on charges for LTCI premiums.
- Above-the-line deductibility of LTCI premiums would convey further tax benefits under a level-premium structure.
- Several unresolved issues remain with regards to the requirements and tax treatment of a LCA in a qualified retirement plan.