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IRS PRIVATE LETTER RULINGS ON "COMBINATION" INSURANCE PRODUCTS

By Craig R. Springfield and Mark E. Griffin

In two recently issued private letter rulings, the Internal Revenue Service ("IRS") addressed federal tax issues pertaining to so-called "combination" insurance products. The first ruling, PLR 200903001 (Oct. 14, 2008), involved a critical illness insurance rider to a life insurance contract, and the second ruling, PLR 200919011 (Feb. 2, 2009), is the first private letter ruling to be issued regarding combinations of long-term care ("LTC") insurance with an annuity contract, which were authorized by the Pension Protection Act of 2006 ("PPA").

PLR 200903001—
Critical Illness Rider to Life Insurance Contract

In PLR 200903001, a critical illness rider (the "Rider") to a life insurance contract provided for an acceleration of the life insurance contract's death benefit upon the insured's critical illness. More specifically, the accelerated death benefit (referred to as the "Rider Benefit") was payable when the insured was diagnosed by a physician as having one of a number of qualifying covered conditions, which in turn were defined by the Rider.

The underlying life insurance contract was an individual, nonparticipating, flexible premium adjustable life insurance contract and generally was designed to comply with the requirements of section 7702 (defining "life insurance contract" for federal tax purposes) by meeting the guideline premium limitation/cash value corridor test of section 7702(a)(2), (c) and (d). The ruling notes, however, that certain of the contracts would be issued with an endorsement that would ensure their compliance with the cash value accumulation test of section 7702(a)(1) and (b). The taxpayer represented that the contract and critical illness rider were purchased with after-tax monies and that the critical illness rider was not a "qualified additional benefit" under section 7702(f)(5)(A).

Because the triggering event for benefits was the insured's critical illness, the Rider is not governed by section 101(g), which addresses certain accelerated death benefits payable upon an insured's terminal illness or chronic illness, nor is the Rider governed by section 7702B, which also can apply to certain accelerated death benefits payable upon an insured's chronic illness.

The IRS ruled that the critical illness rider was accident or health insurance and that benefits received under the rider would be excludable from the recipient's gross income under section 104(a)(3). (Section 104(a)(3) generally excludes from income amounts received through accident or health insurance for personal injuries or sickness.) The ruling also notes that a request for ruling had been withdrawn under section 7702(f).

The IRS's conclusion in this private letter ruling is consistent with its prior rulings under section 104(a)(3). *See, e.g.,* PLR 200339015 (June 17, 2003) and PLR 200339016 (June 17, 2003), both involving critical illness riders to cash value life insurance contracts, and PLR 200627014 (March 6, 2006), involving a critical illness rider to a term life insurance contract.

PLR 200919011—LTC-Annuity Rider

In PLR 200919011, a life insurance company intended to add an LTC insurance rider (the "Rider") to a deferred annuity contract. For tax years after 2009, the Rider was designed to comply with the definition of a "qualified long-term care insurance contract" under section 7702B(b). The Rider provides for monthly LTC benefit payments (not to exceed the per diem limitation of section 7702B(d)(2)) upon the insured's chronic illness. The Rider is funded through an annual charge assessed against the annuity contract's cash value. This charge is at an arms-length rate for the Rider coverage and is determined in accordance with widely accepted actuarial principles based on the insurer's good faith expectation for the claims experience it will incur.

Prior to the annuity starting date, LTC benefits are comprised of two components: i) a "Linked Component" that reduces the annuity contract's cash value on a dollar-for-dollar basis, and ii) an "Unlinked Component" that is paid from net amount at risk. If the insured is chronically ill and LTC benefits are being paid on the scheduled annuity starting date, LTC benefits continue until the contract's cash surrender value is reduced to zero. If the contract owner is not receiving LTC benefits on the scheduled annuity starting date, the Rider generally terminates unless the contract owner elects to continue LTC coverage.

If the annuity contract is annuitized on the annuity starting date, the contract owner elects to continue LTC coverage after this date, and the insured then meets the eligibility requirements for payment of LTC benefits, LTC benefits will replace the annuity payments being made from the contract. The monthly LTC benefits in this circumstance equal the sum of the annuity payments that would have been made plus the monthly Unlinked Component immediately prior to the annuity starting date, subject to certain maximums.

In the first requested ruling, the insurer had asked the IRS to rule that the LTC portion of the annuity-LTC contract met the definition of a "qualified long-term care insurance contract" under section 7702B(b). In this regard, the insurer represented that, if the LTC portion of the contract constituted an "insurance contract," all of the requirements to be a qualified long-term care insurance contract under section 7702B(b)(1) would be satisfied for tax years beginning after Dec. 31, 2009. Thus, the question before the IRS was whether the LTC "portion" of the annuity-LTC contract, as defined by section 7702B(e), constituted an "insurance contract."

The IRS ruled that the "insurance contract" requirement was met, citing *Helvering v. Le Gierse*, 312 U.S. 531 (1941) and related authorities. Under these authorities, the IRS observed that risk shifting and risk distribution must be present, and the arrangement must constitute insurance in the commonly accepted sense based on all the facts surrounding the case. The ruling noted that courts had identified several nonexclusive factors bearing on this, including the treatment of the arrangement under state law, premiums priced at arm's length, and the language of the operative agreements and the method of resolving claims.

From the disclosed facts of the ruling, it is unclear how large the Unlinked Component of LTC benefits was (*i.e.*, the amount paid from net amount at risk) relative to the Linked Component (*i.e.*, the amount paid from the annuity cash value or from annuity payments). Also, the ruling otherwise largely focuses only on the facts presented, which is typical for private letter rulings. Thus, even though the PPA appears to offer considerable flexibility with respect to designs for annuity-LTC products, the ruling provides little indication of how the IRS will address design alternatives, apart from it being clear that the LTC portion of a contract must constitute an "insurance contract."

In the second requested ruling, the insurer had asked the IRS to rule that LTC benefits (including both the Linked and Unlinked Components) would be excludable from gross income to the extent not in excess of the per diem limitation of section 7702B(d)(2). The IRS agreed with the insurer and ruled favorably. In describing the applicable law, the ruling stated that, under section 7702B(a)(1) and (2), LTC insurance benefits received under a qualified long-term care insurance contract are treated as amounts received for personal injuries and sickness under accident or health insurance, subject to limits with respect to per diem LTC benefits under section 7702B(d).

In addition, the ruling stated that the LTC "portion" of a contract means only the terms and benefits under an annuity contract that are in addition to the terms and benefits under the contract without regard to LTC insurance coverage. In this regard, the ruling cited the Joint Committee on Taxation's "Bluebook" explanation of the PPA, which states that –

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> … if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the life insurance contract's death benefit or cash surrender value or in the annuity contract's cash value.[1]

In the third requested ruling, the insurer had asked the IRS to rule that payment of LTC benefits did not reduce the "investment in the contract" of the annuity contract for purposes of section 72. The IRS disagreed with the insurer and ruled that "investment in the contract" was reduced by "the payment of LTC Benefits under the Rider."

The definition of "investment in the contract" in section 72(e)(6) provides that this term means, as of any date, "(A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus (B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income…." While the IRS's rationale for the third ruling is not expressly stated, it appears to be based on the view that LTC benefits that are excludable from income constitute amounts within the scope of section 72(e)(6)(B). The IRS does not address the interaction between section 72(e)(6)(B) and section 7702B(e), which treats the LTC portion of the contract as a separate contract for purposes of the entire Internal Revenue Code. Given the separate contract treatment under section 7702B(e), seemingly the LTC benefits should be treated as having been received under the qualified long-term care insurance portion of the contract (as the IRS so held in the second ruling), and correspondingly no part of the LTC benefits should be treated as having been received from the annuity "portion" of the contract. Since section 72(e)(6)(B) only accounts for amounts received "under the contract" (and not amounts received under a separate LTC insurance contract), it is not clear why the IRS concluded that "investment in the contract" is reduced by LTC benefits.

It is also pertinent that section 72(e)(11) (as amended by the PPA) excludes from income LTC rider charges that are assessed against an annuity contract's cash value, but then further provides that such charges reduce "investment in the contract" under section 72(e)(6). Implicitly, this rule recognizes that imposition of LTC rider charges results in deemed distributions from the annuity contract that then are paid into the rider. Section 72(e)(11) is entirely consistent with section 7702B(e), *i.e.*, one reflects and the other dictates separate contract treatment for the LTC portion of a contract. What is inconsistent, however, is the ruling's rejection of separate contract treatment when LTC benefits are paid. It seems very unlikely that Congress would have intended for "investment in the contract" to be reduced by the deemed distributions arising from charges for an LTC rider, but then to disregard the separate contract treatment prescribed by section 7702B(e) and further reduce "investment in the contract" when LTC benefits are paid.

Even if such a result were somehow justified, it also seems incorrect to reduce "investment in the contract" by the net amount at risk portion of LTC benefits, since the effect of this would be to create additional income on the contract that would not have existed absent the LTC coverage.

As the Jan. 1, 2010, effective date for the new annuity-LTC rules enacted as part of the PPA draws nearer, it will be interesting to watch the development of both products and IRS guidance on this subject.

END NOTES

1 Staff of the J. Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as passed by the House on July 28, 2006, and as considered by the Senate on August 3, 2006, at 195 (J. Comm. Print.).