IRS ISSUES GUIDANCE AND SEEKS COMMENTS ON LTC INSURANCE PRODUCT ISSUES

By Craig R. Springfield and Bryan W. Keene*

On Aug. 11, 2011, the Internal Revenue Service (IRS) released Notice 2011-68,[1] regarding the tax treatment of stand-alone and "combination" long-term care (LTC) insurance products. The Notice provides interim guidance on certain issues and requests public comment on others.

BACKGROUND

The Pension Protection Act of 2006 (PPA) amended the Internal Revenue Code (Code) to clarify and improve the tax treatment of LTC insurance products.[2] The amendments fall into two general categories—combination products and exchanges. A combination product is a life insurance or annuity contract that includes an LTC insurance feature.[3] The PPA amendments facilitate annuity-LTC combination products by generally extending to them the Code's rules for life insurance-LTC combination products.[4] The PPA amendments also address the tax treatment of charges against the cash value of the annuity or life insurance portion of a combination product to fund coverage under the qualified LTC insurance (QLTCI) portion, essentially treating them as non-taxable distributions from the annuity or life portion that reduce the owner's "investment in the contract" under section 72.[5] The PPA also amended section 1035 to allow tax-free exchanges of annuity and life insurance contracts for QLTCI contracts.

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INTERIM GUIDANCE ON INVESTMENT IN THE CONTRACT

The Notice provides interim guidance under section 72 on how to determine the "investment in the contract" for the annuity portion of an annuity-LTC combination product. It states that all premiums paid for such a product are generally included in the investment in the contract for the annuity if (i) the premiums are credited to the contract's cash value (rather than directly to the LTC portion), and (ii) coverage under the LTC portion is funded through charges against the annuity's cash value. In this respect, the Notice appears to merely clarify that if QLTCI rider premiums are paid directly into the rider with after-tax monies, rather than through a charging mechanism under the annuity, then such premiums have no effect (positive or negative) on the investment in the contract for the annuity. Seemingly the same rule also would apply in the case of life-LTC combination products.

In that regard, the Notice observes that, other than the PPA amendments regarding how LTC insurance charges affect investment in the contract (summarized above), the PPA did not amend the definition of investment in the contract under section 72. Consistently with this observation, the Notice also states that a waiver of premiums under an annuity-LTC combination product, such as upon disability or chronic illness, "should be accounted for in the same manner as a waiver of premiums under other contracts for which 'investment in the contract' is determined under § 72(c)(1) or 72(e)(6)."[6]

INTERIM GUIDANCE ON EXCHANGES

The Notice also provides interim guidance on the treatment under section 1035 of exchanges of an annuity or life insurance contract for a QLTCI contract. First, it clarifies that a partial exchange of an existing deferred annuity for a QLTCI contract can qualify for tax-free treatment under section 1035. This conclusion is consistent with earlier guidance and a court decision in which an exchange of a portion (but not all) of a deferred annuity for another deferred annuity was treated as tax-free under section 1035.[7]

Second, the Notice states that the "adjusted basis" of a QLTCI contract received in a tax-free exchange generally carries over from the life insurance, endowment, annuity or QLTCI contract being exchanged. In this regard, the Notice observes that although the Code prohibits a QLTCI contract from providing a cash value, it does permit a refund of premiums upon complete surrender or cancellation of the contract, and provides generally that such a refund is includible in gross income to the extent that any deduction or exclusion was allowable with respect to the premiums.[8] Thus, the

Notice's statements regarding the adjusted basis of a QLTCI contract purchased in a tax-free exchange may mean that any cancellation or surrender proceeds received under the contract are taxable to the extent the exchange involved the movement of tax-deferred inside buildup from an annuity, life insurance, endowment contract or QLTCI contract to the QLTCI contract received in the exchange.

REQUEST FOR PUBLIC COMMENT

The Notice requests public comment on several questions "to assist in the development of further guidance" on combination products. Comments were due by Nov. 9, 2011. The topics on which the Notice seeks comments are:

(1) Issues that arise when an annuity-LTC combination product is annuitized, including the effect on the owner's rights, how the LTC insurance charges should be treated after the annuity starting date, and how the exclusion ratio should be calculated under section 72(b).

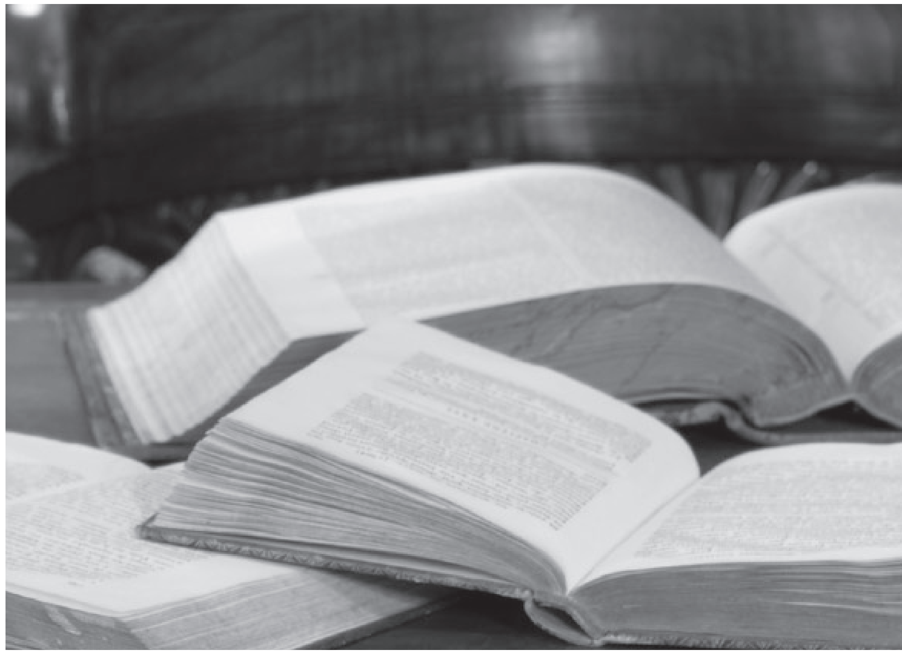
(2) Issues involving how a "risk shifting" analysis should apply in determining whether the LTC portion of a combination product is an "insurance" contract for purposes of section 7702B, including how LTC benefit payments that reduce the annuity contract's cash value should be taken into account in such an analysis and whether there are common features or contract designs that would lend themselves to published guidance on the risk shifting issue.

(3) Whether guidance is needed on partial exchanges of some or all of the payments under an immediate annuity for a QLTCI contract, including how to effect such an exchange, how such a partial exchange is treated under section 1035, and how the adjusted basis and investment in the contract are determined for the contracts involved in the partial exchange.

(4) Whether any changes are needed to existing guidance, including publications, forms, and instructions, on information reporting and record keeping with respect to QLTCI contracts and combination products.

ADDITIONAL ISSUES

Although the Notice provides interim guidance on some issues and seeks public comments on others, it is silent on a few questions that have arisen in connection with combination



products. Perhaps most conspicuously, the Notice does not address or seek input on the question of how tax-free benefits received under the QLTCI portion of an annuity-LTC combination product affect the owner's investment in the contract for the annuity portion of the product.

In that regard, in most products that combine a deferred annuity with a QLTCI feature, at least some of the benefits paid under the QLTCI portion have the effect of reducing the cash value of the deferred annuity portion.[9] In a 2009 private letter ruling,[10] the IRS concluded that LTC insurance benefit payments "will reduce the 'investment in the contract'" of the annuity, but the ruling did not elaborate on how. This conclusion in the ruling has been questioned,[11] and the life insurance industry has advocated for a different result. As a result, it is expected that the industry's response to the Notice will include comments on this issue. In that respect, the IRS has indicated informally that it is willing to consider any comments that taxpayers may wish to file in response to the Notice, even on issues that the Notice does not specifically identify.

CONCLUSION

The Notice provides interim guidance on a narrow set of issues that are relatively devoid of controversy. In that regard, IRS and Treasury representatives have indicated informally

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that the Notice was intended as a first step toward addressing questions on combination products and to seek input on other questions that may be more difficult from a technical or tax policy perspective. As a result, the most interesting guidance in this area is likely still to come.

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END NOTES

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1 2011-36 I.R.B. 205.

2 Pub. L. No. 109-280 § 844 (2006). For a detailed discussion of the PPA amendments regarding LTC insurance products, *see* Craig R. Springfield, Bryan W. Keene and Frederic J. Gelfond, *New Rules and Opportunities for Long-Term Care Insurance Combination Products*, Taxing Times, May 2007, at 20.

3 *See* section 7702B(e) (referring to LTC insurance coverage "provided by a rider on or as part of a life insurance contract or annuity contract"). Unless otherwise indicated, each reference herein to a "section" is to a section of the Internal Revenue Code of 1986, as amended.

4 *See* section 844(c) of the PPA (amending Code section 7702B(e) to refer to annuity contracts).

5 *See* section 72(e)(11). QLTCI rider charges cannot reduce the investment in the contract below zero. *Id.*

6 The Notice cites Estate of Wong Wing Non v. Commissioner, 18 T.C. 205 (1952), for the proposition that waived premiums are not treated as constructively received as disability benefits, and thus are not included as part of the premiums paid for an endowment life insurance contract. *Compare* Rev. Rul. 55-349, 1955-1 C.B. 232.

7 *See* Rev. Proc. 2011-38, 2011-30 I.R.B. 66; Rev. Rul. 2003-76, 2003-2 C.B. 355; Conway v. Comm'r, 111 T.C. 350 (1998), acq., 1992-2 C.B. xvi. For a discussion of Rev. Proc. 2011-38 and the treatment of partial exchanges of annuities more generally, see Bryan W. Keene and John T. Adney, *Partial Exchange Guidance Keeps Improving*, Taxing Times, Feb. 2012, at 1. *http://www.soa.org/news-and-publications/newsletters/taxation/tax-detail.aspx.*

8 *See* section 7702B(b)(1)(D) (prohibiting cash values under QLTCI contracts); section 7702B(b)(1)(E) and (2)(C) (regarding refunds of premiums under QLTCI contracts).

9 *See, e.g.*, PLR 201105001 (Oct. 22, 2010); PLR 200919011 (Feb. 2, 2009).

10 PLR 200919011 (Feb. 2, 2009).

11 *See, e.g.*, Craig R. Springfield and Mark E. Griffin, *IRS Private Letter Rulings on "Combination" Insurance Products,* Taxing Times, Sept. 2009, at 56.