John Hancock INSURANCE

ADVANCED MARKETS

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Long-Term Care (LTC) Riders

The purpose of this article is to address some of the most frequently asked questions concerning long-term care riders associated with life insurance contracts. Because this article is meant to provide a general overview of long-term care riders, state specific law and exceptions have not been considered or addressed. State law should always be considered before advising clients.

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1. What is a long-term care rider?

A long-term care (LTC) rider is a rider attached to a permanent life insurance policy that accelerates the death benefit to help pay for the costs of long-term care services for chronically ill insureds.[1] To qualify as an LTC rider, the services required by a chronically ill individual must be provided pursuant to a plan of care prescribed by a licensed health care practitioner. An individual is considered chronically ill if he/she is unable to perform at least two of six Activities of Daily Living (ADLs) without substantial help from another person for at least 90 days due to a loss of functional capacity.[2] An individual may also be considered to be chronically ill if he/she needs substantial supervision to protect his/her health and safety because of a severe cognitive impairment.

EXAMPLE OF MAXIMUM MONTHLY BENEFIT:

An LTC rider on a $750,000 life insurance policy with a 2% monthly acceleration would allow for a $15,000 maximum monthly benefit amount for qualified long-term care expenses.

Generally, when LTC benefits are paid from the LTC rider, the death benefit available on the policy is reduced dollar-for-dollar and such benefit payments also reduce cash value to some degree (see question 10). Consequently, LTC benefits generally are available up to the point that the policy's death benefit has been completely exhausted, unless otherwise provided in the contract.

At the insured's death, the portion of the death benefit that has not been used to pay LTC benefits will be paid to the beneficiaries as a death benefit.

For most LTC riders, the LTC benefit payable under the rider is limited to a maximum monthly benefit — usually determined based on a percentage of the death benefit or the IRS per diem limit (depending on the type of rider — see question 3).

For insurance carriers who offer an LTC rider, generally such riders can be added to an insurance contract for an additional fee. Most life insurance contracts offering an LTC rider today treat the charge for the LTC portion of the contract as a charge against cash surrender value.

LTC riders may be classified as "qualified" or "non-qualified" riders. A "qualified" rider is intended to meet the requirements of a qualified long-term care contract for the purposes of Sections 7702B(b) of the Internal Revenue Code (Code), thus providing income tax advantages similar to stand-alone LTC insurance policies. A rider that does not meet these requirements is a "non-qualified" rider and may not provide favorable tax treatment. See question 4 for more information about the taxation of benefits from a qualified LTC rider.

2. What is a Chronic Illness rider and how does it differ from an LTC rider?

A Chronic Illness rider is another type of rider that allows for the acceleration of death benefit from an insurance contract to pay for the qualified expenses incurred by a "chronically ill" individual. Although the definition of "chronic illness" for a chronic illness rider is the same as the definition associated with LTC riders – i.e., being unable to perform at least two activities of daily living for a period of 90 days or requiring substantial supervision due to severe cognitive impairment – some chronic illness riders require a permanency condition that requires a physician to certify that the insured's chronic illness is expected to last the rest of the insured's life.[3] As such, temporary claims that would be covered under an LTC rider – e.g., mild to moderate strokes, orthopedic repairs, physical complications from cancer recovery, and other recoverable conditions – would not be covered under a chronic illness rider requiring permanency of a condition.

While the NAIC amended its model regulations on accelerated death benefit riders (i.e., chronic illness riders) in 2014 to no longer require the permanency condition, some chronic illness riders still require permanency in their contract. Consequently, it is very important that advisors familiarize themselves with the conditions for qualification of benefits for any chronic illness rider they are recommending to clients, as the requirement for permanency (or lack thereof) could be different from carrier to carrier and state to state.

PLANNING NOTE

Chronic Illness riders cannot be marketed or referred to as long-term care insurance.

Another important distinction that can arise with a chronic illness rider is the determination of benefit. Many chronic illness riders can be added to a policy with no upfront cost to the policy owner and without any additional underwriting. However, the cost of these riders is paid when the insured initiates a claim by having a portion of the death benefit forfeited or subject to a lien. In either case, the amount of death benefit available for chronic illness payment may be less than the face amount and may not be determinable prior to claim.

Lastly, in terms of taxation, Section 101(g) of the Code generally provides that death benefit accelerated on behalf of a chronically ill individual will be received income-tax free – similar to an LTC rider. However, in the case of a third-party owner, there may be instances where such acceleration is not received income tax free. Section 101(g)(5) provides that amounts received by a business will not be exempt from income taxes when the insured is a director, officer or employee (see question 14). Additionally, amounts accelerated may be subject to income taxes if the "payee" (i.e. the policy owner) has not incurred the costs for expenses for which the acceleration of the death benefit is related – i.e., the payee is not actually paying expenses on behalf of the insured.[4]

3. What are the primary differences between an indemnity and a reimbursement LTC rider?

Most LTC riders available today fall under one of two models: reimbursement or indemnity.

A *reimbursement rider* pays out LTC benefits based on the eligible LTC care expenses actually incurred by the insured, limited only by the maximum monthly benefit prescribed in the contract. This style of rider allows the policy owner to receive payments in excess of the IRS per diem limit without adverse tax consequences. Under a reimbursement style rider, the LTC rider payment will be paid directly to the policy owner unless the owner elects to have the care-provider[5] paid directly.

An *indemnity rider* pays out LTC benefits based on the maximum monthly benefit allotted under the rider regardless of the amount of actual long-term care expenses incurred by the insured. Most carriers offering an LTC indemnity rider limit the monthly benefit to the lesser of (i) a percentage of death benefit or (ii) the IRS per diem dollar limit.[6] For 2017, the IRS per diem limit was $360/day. Due to tax reform, the 2018 per diem amount has not be finalized, but is expected to be anywhere from $250/day to $360/day.

To qualify for LTC payments under a reimbursement rider or an indemnity rider, the policy owner must demonstrate that the insured meets the definition of "chronically ill" (i.e., cannot perform two of six ADLs or has a cognitive impairment), which is certified by a licensed physician, and must meet the elimination period specified in the contract.

A reimbursement rider requires the policy owner to provide the insurance carrier with bills associated with the insured's LTC care and services received; depending on the carrier, an indemnity rider may not require bills to be provided to receive payment.

John Hancock currently offers a reimbursement-style LTC rider, which includes an extension of benefit provision, guaranteeing additional LTC benefits will be paid in specific circumstances.[7]

EXAMPLE: JOHN OWNS A LIFE INSURANCE POLICY WITH AN LTC RIDER

Reimbursement rider: John's policy has a $750,000 death benefit with a maximum monthly benefit for LTC purposes of 2% of the death benefit — i.e., $15,000/month. In January 2017, John has $12,000 worth of LTC expenses and will receive $12,000 to reimburse him for those expenses. The next month when John has only $8,000 worth of LTC expenses, John will receive $8,000 from the reimbursement rider.

Indemnity rider: John's policy has a $750,000 death benefit with a maximum monthly benefit for LTC purposes of the lesser of 2% of the death benefit or the IRS per diem limit. In January 2017, John has $12,000 worth of LTC expenses. John will receive $11,160 ($360 x 31 days) for these expenses from the indemnity rider. The next month, John only has $8,000 worth of LTC expenses, but receives $10,080 ($360 x 28 days) from the indemnity rider.

In either case, the $750,000 death benefit will be reduced by the amount of LTC benefit received.

This is a hypothetical example for illustrative purposes only.

4. How are amounts received for LTC expenses from a qualified LTC rider treated for income-tax purposes?

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) allows for certain federal income tax advantages for long-term care insurance contracts that are designated as "qualified," as defined in Code Section 7702B.

Per Section 7702B(a), amounts received from a qualified long-term care insurance contract are treated as amounts received for personal injuries and sickness and are treated as reimbursements for expenses actually incurred for medical care (as defined by Section 213(d)). **Code Section 104(a)(3) generally provides that amounts received for personal injuries or sickness are not includible in gross income.**

For LTC riders provided as part of a life insurance or annuity contract, Section 7702B(e) specifically provides that such riders shall be treated as separate long-term care contracts for the purposes of Section 7702B. Accordingly, "qualified" LTC rider accelerated death benefits generally should receive the same tax treatment as stand-alone qualified long-term care insurance contracts.[8]

Most LTC riders offered today are intended to be "qualified" long-term care insurance contracts under Code Section 7702B(b). This is true of the LTC rider offered by John Hancock.

The tax treatment of the amounts received for LTC expenses paid from a qualified LTC rider generally is the same whether the contract reimburses actual long-term care expenses (a reimbursement contract) or pays a per diem amount toward long-term care (an indemnity contract). However, if an indemnity contract pays a per diem benefit that exceeds the IRS per diem limit, the excess is taxable income to the extent it exceeds actual long-term care expenses incurred. If multiple indemnity-style contracts are owned on a single insured, the payments received from these contracts are combined for the purposes of determining whether amounts received exceed the greater of total LTC expenses incurred by the insured or the per diem limit.[9]

An example of the possible taxation of multiple-owned indemnity-style contracts can be found below. Distributions received from a life insurance policy with an LTC rider, other than those payments associated with long-term care benefits, are taxed according to the rules governing the underlying life insurance contract.

EXAMPLE OF MULTIPLE INDEMNITY CONTRACTS OWNED ON SAME INSURED

(adapted from instructions to IRS Form 8853)

Mrs. Smith was chronically ill in 2017 and received six monthly payments (the "LTC period") on a per diem basis from a qualified LTC insurance contract. She received $5,000 per month ($30,000 total) from the LTC contract and incurred $45,000 worth of costs for qualified LTC services. Mrs. Smith's son, Sam, and daughter, Deborah, each also own a qualified LTC insurance contract on Mrs. Smith. Neither Sam nor Deborah incurred any costs for qualified LTC insurance services for Mrs. Smith in 2017. For the same six-month LTC period as Mrs. Smith, Sam received per diem payments of $4,000 per month ($24,000 total) and Deborah received per diem payments of $3,000 per month ($18,000 total). [Note, see question 11 for discussion of third-party ownership of LTC riders].

Per Code Section 7702B(d)(3) aggregation rules, the total per diem limit for this six month period — $65,160 ($360/day for 181 days) — must be allocated among Mrs. Smith, Sam, and Deborah as follows:

Allocation to Mrs. Smith: Because Mrs. Smith is the insured, the per diem limitation is allocated first to her to the extent of the per diem payments she received during the LTC period (i.e., $30,000). The remaining per diem limitation of $35,160 is allocated between Sam and Deborah.

Allocation ratio to Sam: 57% of the remaining limitation (i.e, $20,041) is allocated to Sam because the $24,000 he received during the LTC period is 57% of the $42,000 received by both Sam and Deborah during the second LTC period. That means that Sam will have to report $3,959 worth of income from the LTC payments he received.

Allocation ratio to Deborah: 43% of the remaining limitation (i.e, $15,119) is allocated to Deborah because the $18,000 she received during the LTC period is 43% of the $42,000 received by both Sam and Deborah during the LTC period. That means that Deborah will have to report $2,881 worth of income from LTC payments she received.

	AMOUNT RECEIVED FROM LTC INSURANCE FOR LTC PERIOD	TAXABLE AMOUNT
Mrs. Smith	$30,000	$0
Sam	$24,000	$3,959
Deborah	$18,000	$2,881

This is a hypothetical example for illustrative purposes only.

5. Is the tax treatment for qualified LTC benefits received different for a life policy classified as a modified endowment contract (MEC)?

No. Even if the policy is classified as a MEC, the intent is for the long-term care benefit payments to continue to be excludable from income taxes and there is nothing in the tax code or the regulations that provides for a different tax result for qualified LTC amounts received from a MEC.

6. Are premium payments associated with an LTC rider tax deductible?

Although "eligible long-term care premiums" for a qualified long-term care stand-alone insurance contract may be deductible by an individual to the extent such amount does not exceed the limitation set in Code Section 213(d)(10) (and for taxpayers that itemize deductions subject to the limitation under Section 213(a)), Code Section 7702B(e) prohibits a deduction for LTC premium payments when such payments are made as a charge against the cash surrender value of a life insurance contract. Because most (but not all) life policies apply a charge against cash surrender value to pay for the rider charges associated with a qualified long-term care rider, a deduction is typically not available.

7. Is the cost of insurance for the LTC rider considered a taxable distribution?

No. For tax years *after* December 31, 2009 (effective date of the Pension Protection Act of 2006), the LTC rider charge against the cash value of an insurance policy is not included in income, but will reduce the basis in the contract (but not below zero).[10] This rule applies whether the life insurance contract is classified as a MEC or not.

> For policies where the LTC rider cost is charged against the policy's cash value, the policy owner should expect to receive a 1099-R each year from the carrier reporting the LTC rider charge and reduction of basis in the contract as required by the Pension Protection Act.

For tax years beginning *before* January 1, 2010, LTC charges were treated as partial withdrawals. If the policy was a MEC, those withdrawals were taxable income to the extent that there was gain in the policy. A 10% penalty may also have been applicable to those withdrawals. If the policy was a MEC but there was no gain in the contract, the withdrawals reduced the owner's basis in the contract, same as with non-MEC policies.

8. Is the LTC rider rate guaranteed?

The answer depends on the carrier. For LTC riders issued by John Hancock, the LTC rider charge is based on an amount per $1,000 of the Net Amount at Risk. The rate is set at issue and is guaranteed not to increase over the life of the policy. However, if the Net Amount at Risk changes, the total amount charged for the LTC rider will change accordingly, even though the guaranteed rate per $1,000 of Net Amount at Risk does not change. The charge is part of the monthly deductions.

Many carriers do not have guaranteed rates for LTC charges.

9. If the owner of a policy with a LTC rider goes on claim, are premiums still due on the policy?

This depends on the carrier and the product. For life insurance policies with LTC riders issued by John Hancock, unless the Waiver of Monthly Deductions rider or Disability Payment of Specified Premium rider[11] is also in effect, all policy and rider charge deductions continue while on claim, and premiums may still be due. If there is sufficient cash value in the policy, future premium payments may not be required.

10. If an insured goes on claim for LTC purposes, how do the LTC payments generally affect the cash value or account value of the insurance contract?

This depends on the carrier. When an insured goes on claim and LTC payments are made, many carriers reduce the cash value in the contract dollar-for dollar. John Hancock, however, reduces the policy's cash value or policy value proportionally instead of dollar-for-dollar.

EXAMPLE SHOWING HOW THE FACE AMOUNT AND CASH VALUE MAY BE AFFECTED

Assumptions:

1. Total Face Amount (at time of claim): =$250,000
2. Policy Value (at time of claim): =$50,000
3. Maximum Monthly Benefit for LTC: =2% x $250,000 = $5,000

Assume that claims are submitted for the full reimbursable amount (e.g., $5,000). Each month, the Total Face Amount will be reduced by the benefit payment; and the Policy Value will be reduced in proportion to the amount of the payment. Because of these decreases, the Net Amount at Risk also decreases.

	MONTH 1	MONTH 2
Total Face Amount Calculation	$250,000 – $5,000 = $245,000	$245,000 – $5,000= $240,000
Policy Value Calculation	$50,000 x $\frac{\$245,000}{\$250,000}$ = $49,000	$49,000 x $\frac{\$240,000}{\$245,000}$ = $48,000
Net Amount at Risk Decrease	From $200,000 to $196,000	From $196,000 to $192,000

This is a hypothetical example for illustrative purposes only.

11. Is there a tax issue associated with third-party ownership of a life insurance contract with an LTC rider?

Code Section 7702B is silent on the question of third-party ownership; that is, the statute does not specifically prohibit or allow third party ownership.

Although there are strong arguments for the favorable tax treatment of policies with an LTC rider owned by a third-party, there is no specific guidance from the Internal Revenue Service as to the tax effects of such third-party ownership. **This is true whether the LTC rider is classified as a reimbursement rider or an indemnity rider.**

Given the current lack of guidance regarding the ramifications of third-party ownership, there is the risk that such ownership structure could cause adverse income, estate, and/or gift tax consequences. Therefore, the client should seek tax and legal counsel to review the particulars of an intended ownership arrangement in light of the income, gift, and estate tax provisions of the Internal Revenue Code. A life insurance policy with an LTC rider should only be purchased by or transferred to a person other than the insured after all parties have carefully reviewed the issues with their own tax and legal advisors.

12. Does John Hancock allow for third-party ownership of an LTC rider?

Yes. John Hancock will issue life insurance policies with an LTC rider for most ownership scenarios, although some restrictions do apply. For example, third-party ownership is not allowed inside a qualified plan and in some business-owned policies (see question 13); it is also prohibited in New York, where a person or an entity other than the insured is not allowed to own such a policy.

Please note that in states where a person or an entity other than the insured owns the policy, we require the *Third-Party Ownership Disclosure — Long-Term Care Riders* (NB5193). This Disclosure outlines the uncertain tax consequences of having a person or entity other than the insured own the policy and it encourages clients to seek the advice of legal counsel, and needs to be signed by the insured and the owner.

13. Can a life insurance policy with an LTC rider be owned in a trust? Does it matter whether the rider is an indemnity rider or reimbursement rider?

There is nothing in the law that precludes a trust from owning a life insurance policy with an LTC rider. However, because of the many different types of trusts (revocable, irrevocable, grantor, etc.) and various tax considerations associated with each of these different trust structures, a life insurance policy with an LTC rider should only be purchased by or transferred to a trust after all parties have carefully reviewed the planning and tax issues associated with this type of ownership structure with their own tax and legal advisors. Also see question 11 regarding taxation concerns associated with third-party ownership of contracts with an LTC rider.

Either an indemnity-style rider or reimbursement-style rider may be owned by a trust. However, depending on the type of trust being used, the relationship of the insured to the trust, and the estate planning and tax objectives of the parties involved, it may not always be appropriate to have LTC payments made to anyone other than the owner of the contract — i.e., the Trustee.

As discussed earlier, reimbursement-style riders generally allow the owner of the contract to receive LTC payments directly or choose to have payments made directly to the care provider for ease of administration. When a reimbursement-style rider is used on a trust-owned policy, tax and legal counsel should be consulted before having LTC amounts paid to anyone other than the trustee.

Trusts should be drafted by an attorney familiar with such matters in order to take income and estate laws (including the generation-skipping tax) into account. Failure to do so could result in adverse tax treatment.

14. Can a life insurance policy with an LTC rider be owned by a business on a key employee, owner or employee?

Yes; however, as noted in question 11, the tax implications of third-party ownership of a policy with an LTC rider are not entirely clear.

Code Section 101(g)(5), which relates to payments received for chronic illness as an acceleration of death benefit, provides that accelerated death benefit amounts received by a business will not be exempt for income tax purposes when the business "has an insurable interest with respect to the life of the insured by reason of the insured being a director, officer, or employee" of the business or by reason of the insured being "financially interested" in the trade or business carried on by the business. Although Code section 101(g) is believed to apply to Chronic Illness Riders (see question 2) and not to LTC riders that are qualified under 7702B, there are some instances where state law may require an LTC rider to qualify under both 7702B and 101(g) of the Internal Revenue Code.

While there is no comparable taxation language associated with business-related policies in 7702B (or Section 104, which addresses taxation of payments received from accident and health plans), there is no authority that addresses the intersection of 101(g) and 7702B. Accordingly, a client should seek tax and legal counsel to review the particulars of an intended ownership arrangement in light of the income, gift, and estate tax provisions of the Code.

PLANNING NOTE

John Hancock underwriters will consider requests for business-owned policies with an LTC rider on a case-by-case basis. Generally, business ownership of policies with an LTC rider is only permitted by John Hancock when the employer is contractually obligated to pay for or reimburse the employee for LTC costs incurred by the employee.

15. Can a taxpayer exchange a life insurance contract for a life insurance contract with a long-term care rider tax-free under Code Section 1035?

Yes, after December 31, 2009, Section 1035 permits a tax-free exchange of a life insurance contract for a life insurance contract with a long-term care rider.

16. Are LTC benefits received from an LTC rider or Chronic Illness rider reportable to the IRS?

Yes. When benefits are received by a taxpayer from either a long-term care insurance contract (including an LTC rider) or for accelerated death benefits for chronic illness (including a Chronic Illness rider), the IRS requires the insurance company to issue a Form 1099-LTC. Form 1099-LTC reports the gross amount of long-term care benefits paid, and identifies whether the benefits are paid per diem or as reimbursement for LTC expenses actually incurred.

If the LTC benefits are received as reimbursement, then no further action is required. However, if the LTC benefits are received per diem (i.e., payments were made on any periodic basis without regard to actual expenses incurred), then the taxpayer must complete Form 8853 and file it with their income tax return. Form 8853 is used to help calculate the taxable amount (if any) associated with per diem payments received by the taxpayer from these contracts.

17. What is a Critical Illness rider and how does it differ from an LTC/Chronic Illness rider?

Although "critical illness" may sound like "chronic illness," a critical illness rider functions very differently than a chronic illness (or LTC) rider. A critical illness rider pays a benefit if the insured is diagnosed with a covered critical illness, such as cancer, heart attack, or stroke, rather than an ADL or a cognitive deficiency.

Some carriers offer a critical illness rider which functions as an acceleration of death benefit, meaning the policy owner can accelerate either all or a portion of the death benefit in a lump sum. If the entire portion is accelerated, the life policy terminates; if only a portion of the amount is accelerated, the policy will remain in force with a reduced death benefit.

John Hancock's Critical Illness Benefit Rider (CIBR) is unique as it is not an acceleration of the death benefit - it is *in addition to* the death benefit. John Hancock's CIBR pays a one-time, lump sum benefit up to $250,000 upon initial diagnosis of a covered critical illness. Because it is a separate benefit, the payment will not jeopardize the death benefit pool, preserving it for beneficiaries and/or a long-term care need - which is especially important at a time when insurability could very well be compromised.

Although neither Section 101(g) nor 7702B make any mention of benefits received for "critical illness," there is some guidance by way of Private Letter Rulings issued by the IRS indicating that benefits received under a Critical Illness rider should be received free of income tax under other code provisions.[12]

1. See IRC §7702B(b) and (c).
2. See IRC §7702B(c)(2)(B). The six ADLs are: bathing, continence, dressing, eating, toileting, and transferring.
3. NAIC Model Regulation 620, Accelerated Benefits Model Regulation, §2(B). Model Regulation 620 requires that "accelerated benefits" be paid out upon the occurrence of a "qualifying event." See Section 2(B) for other qualifying events other than a medical condition that is expected to last for the rest of the insured's lifetime.
4. For example, the language in IRC §101(g)(3) that "such payment is for costs incurred by the payee" suggests that third-party ownership of an LTC rider may put at risk the payment's favorable income tax treatment of an accelerated death benefit under §101(g).
5. Not all care providers may qualify for direct payments. See contract for details.
6. IRC §7702B(d).
7. See John Hancock LTC rider contract.
8. See also Section 101(g), which provides favorable tax treatment for amounts received as an acceleration of death benefit for chronically ill individuals.
9. Section 7702B(d) and associated regulations; See also IRS Form 8853 and Instructions.
10. Section 72(e)(11).
11. The Waiver of Monthly Deductions rider and the Disability Payment of Specified Premium riders are not offered on all products.
12. PLRs 200339015, 200339016, 200627014, and 200903001.Private letter rulings are not binding authority for taxpayers other than the taxpayer to whom the ruling is issued.

The Critical Illness Benefit Rider provides a one-time lump sum benefit for covered critical illnesses subject to eligibility requirements. The benefit will not be paid for critical illnesses initially diagnosed before the rider effective date or during the waiting period. See the product producer guide for additional details.

The Long-Term Care (LTC) rider is an accelerated death benefit rider and may not be considered long-term care insurance in some states. There are additional costs associated with this rider. The Maximum Monthly Benefit Amount is $50,000. When the death benefit is accelerated for long-term care expenses it is reduced dollar for dollar, and the cash value is reduced proportionately. Please go to www.jhsaleshub.com to verify state availability.

This rider has exclusions and limitations, reductions of benefits, and terms under which the rider may be continued in force or discontinued. Consult the state specific Outline of Coverage for additional details.

Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02210 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

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