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IRS Rules on Long-Term Care Coverage Provided Through an Annuity Contract

On May 8, 2009, the Internal Revenue Service published its first ruling ([PLR 200919011](#)) considering a long-term care (LTC) rider to an annuity contract. Internal Revenue Code § 7702B provides certain advantageous tax treatment (for both policyholders and insurers) to LTC coverage issued after 1996 as a separate policy of insurance or as part of a life insurance contract. That section was amended by the Pension Protection Act of 2006 (PPA), extending that tax treatment to LTC coverage that is a part of or attached by rider to an annuity contract, starting in 2010.

The private letter ruling (PLR) addresses many of the federal income tax issues associated with adding an LTC rider to an annuity contract. In particular, the PLR reaches a favorable conclusion on the question of whether any portion of an annuity contract's cash value can be used to fund LTC benefits paid under an LTC rider issued with such annuity contract.

The PLR specifically concludes that, under the facts and representations of the ruling:

- The LTC rider will constitute a qualified LTC insurance contract within the meaning of § 7702B(b)(1) even though some portion of the LTC benefits can be paid out of the base annuity contract's cash value;
- All LTC benefits paid under the LTC rider—including those that reduce the base annuity contract's cash value during the accumulation phase and those that replace the otherwise payable annuity payments after the annuity starting date—will be excludable from the annuity contract holder's gross income under § 104(a)(3) to the extent such benefits do not exceed the applicable per diem limitation set forth in § 7702B; and
- The payment of the LTC benefits under the LTC rider will reduce the owner's "investment in the contract" (but not below zero) with respect to the base annuity contract for purposes of §72.

In reaching its first conclusion, the PLR suggests that the amount of the LTC benefit cannot be funded *entirely* out of the cash value of the base annuity contract. In this regard, the PLR notes that § 7702B(b)(1) defines a qualified LTC insurance contract as an "insurance contract" that meets the other requirements specified in that section. In obtaining the PLR, the taxpayer specifically represented that the LTC rider would meet those other requirements; the IRS, with this representation in hand, focused on whether the LTC rider constituted an "insurance contract." After noting that neither the Code nor the regulations defines "insurance" or "insurance contract," the PLR states that the meaning of such terms is derived from federal case law such as *Helvering v. LeGierse*, 312 U.S. 531 (1941) (concluding that both "risk shifting" and "risk distribution" must exist for an arrangement to constitute insurance) and the captive insurance cases. In applying this case law to the product design presented—which in particular provided that every LTC benefit payment would include an "Unlinked Component" paid by the insurer out of its own funds (i.e., out of the insurer's general account) without reducing the base annuity contract's cash value—the PLR concluded there is a shifting of economic risk of loss (the risk of incurring LTC expenses) from the annuity contract owner to the issuing insurance company.

- The PLR does not set forth the amount of the LTC benefit that must be paid out of the insurance company's general account, in relation to the amount that can be paid out of the annuity contract's cash value, for the LTC rider to constitute insurance.

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- As to the need for risk distribution, the PLR relied on the insurance company's representations that it will (1) issue the LTC rider to a large number of individuals; (2) assess actuarially appropriate charges for the LTC rider; and (3) pool those charges to help pay claims under all LTC riders it issues.

With respect to its second conclusion, namely, that all LTC benefits will be excludable from the contract holder's gross income under § 104(a)(3) (subject to the applicable per diem limitation), the IRS looked to the legislative history of the PPA for the proposition that if an LTC rider constitutes a qualified LTC insurance contract, amounts received under the rider are treated in the same manner as LTC insurance benefits, "whether or not the payment of such amounts causes a reduction in the annuity contract's cash value."

Finally, in its third conclusion, the PLR is not entirely clear on its face whether investment in the contract for the base annuity is reduced (i) only to the extent of LTC benefit payments made from the annuity's cash value, or (ii) for the full LTC benefit payment even if a portion of that payment is made from the insurer's own funds. The better answer would be that only the former reduces investment in the contract—if for no other reason than the statutory rule in § 7702B(e) treats the LTC rider as a separate contract for all purposes of the Code—and we understand that was what the Service intended.

Insurance companies considering the use of LTC riders with annuity contracts starting in 2010 should give consideration to the product design, actuarial, disclosure and other implications of this PLR.



If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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