Prudential's Long Term Care Insurance Tax Guide

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The Taxability of Long Term Care Insurance

The following information provides an overview of the impact of the Health Insurance Portability and Accountability Act of 1996 (HIPAA) on the taxability of qualified Long Term Care (LTC) contracts. HTPAA provided a tax incentive for individuals to take financial responsibility for their long term care needs. This information is based on The Prudential Insurance Company of America's interpretation of current IRS rules. It is provided for informational purposes only and should not be construed as tax advice. Please consult your own tax advisor for advice regarding your particular circumstances.

• Premium contributions may be made by both the employee and the employer. There are no limits on the amount an employer may contribute as premiums for its employee's LTC contract. These premium contributions are treated as medical expenses and will be tax deductible to the employer.

• Premiums paid by the employer on behalf of an employee will be excluded from the employee's gross income.

• Benefit amounts paid to an employee under a qualified LTC contract are generally excluded from their gross income.

• Premium contributions made by an employee may be deductible for individuals if itemized medical expenses exceed *7.5%* of their annual income, subject to the following limits:

Attained Age of the Individual Before the close of Taxable Year	**Maximum Tax Deductible Premiums (2000)**
40 **or** below	$ 220
41 through 50	**$** 410
51 through 60	$ 820
61 through 70	$2,200
71 and above	$2,750

(Note: These amounts are subject to change each year)

• LTC insurance is not permitted under Section 125 Cafeteria Plan or a Flexible Spending Arrangement. The amount of premium contributions may be included in an employee's gross income

• Premium contributions are tax deductible by a self-employed individual, subject to the limits on deductions for health insurance by the self-employed.

• Long term care is an acceptable expenditure for the new medical savings accounts that are available to self-employed and small businesses with fewer than 50 lives.

Contributory arrangement

Example 1

An employer pays a portion of the premium and the employee pays the remainder for a qualified LTC contract.

Annual premium $2,400
63 year old individual
Unreimbursed medical expenses of $6,000 (excluding LTC premium)
Adjusted Gross Income is $60,000
Employer Contributes $700
Employee Contributes $1,700

How are employer premium contributions treated?

The employer receives the same treatment for the portion of LTC premium contributions it pays as it would if it paid the entire amount. Therefore, the employer gets a full deduction for the premium paid on behalf of its employee (regardless of the age-based limit shown in the introduction).

In the case of Sub-S corporations and Limited Liability Companies (LLCs), the employer may deduct the full premium it pays for employees, including owner/employees (2% shareholders for Sub-S corp. and 10% members for LLCs), for their services. The portion of the premium contributions paid by the employer for owner/employees is included in their income.

What are the tax consequences to the employee?

Employees

The $700 employer premium contribution for the LTC policy is excluded from the employee's income. The $1,700 employee premium may be added to medical expenses for a total of $7,700 ($6,000 + $1,700). He may then be entitled to a deduction for unreimbursed medical expenses of $3,200 ($7,700 - *7.5%* x 60,000). Please see Example 3 for possible limits on the employee's deduction of long term care insurance premium.

Self-employed

Those individuals who are self-employed (including partners, 10% LLC members and 2% shareholders of a Sub-S corporation) would have AGI increased to $60,700 for the employer-provided LTC coverage of $700. The potential deduction available is limited to $2,200 for an employee age 6 1-70. Please see the Introduction and Example 3.

For 2000, a self-employed individual could take 60% of $2,200 ($1,320) as a deduction for self-employed accident and health insurance, reducing AGI to $59,380. A deduction may then be taken to the extent the remaining unreimbursed medical expense of $6,880 ($6,000 + $2,200 - $1,320) exceeds *$4,454 (7.5%* x *$59,380).* Therefore, an additional deduction of $2,426 ($6,880 - *$4,454)* would be permitted.

How are benefits taxed?

Benefits received are generally excluded from income as long as the insured is chronically ill (as defined by the Internal Revenue Code) and the benefits are used for qualified long term care services (e.g. nursing home, home care, personal care and maintenance services).

NOTE: Benefits received on a per diem basis may be taxed different/v and are discussed in another section.

Corporation (C-corporation or entity with a 501 trust providing coverage to its employees)

Example 2

Annual premium contribution of $2,400
63 year old individual
Unreimbursed medical expenses of $6,000
Adjusted Gross Income (AGI) is $60,000

How are employer premium contributions treated?

A corporate employer (as defined above) may deduct all premium contributions paid for long term care insurance coverage for its employees (including spouses and dependents) as a general business expense, since it is considered accident and health coverage. The deduction applies to the total amount of premium contributions made, even in excess of the age based limits.

There is no requirement that LTC be provided by the employer on a non-discriminatory basis. The premium contributions are deductible whether the coverage is provided under a group policy or under individual policies.

Are premium contributions excluded from the employee's income?

Premium contributions made on behalf of the employee are generally excluded from their income. The income exclusion applies to the full amount of an employer's premium contribution, even if the cost exceeds the age-based limit on deductibility for individuals. This is provided in Internal Revenue Code Section 106.

How are benefits taxed?

The benefits received under employer provided qualified LTC insurance are generally excluded from income as long as the insured is chronically ill (as defined by the Internal Revenue Code) and the benefits are used to pay for qualified long term care services (e.g. nursing home, home care, personal care and maintenance services).

NOTE: Benefits received on a per diem basis may he taxed differently and are discussed in another section.

Individual who purchased a qualified Long Term Care contract

Example 3

Annual premium contribution of $2 400

63 year old individual

Unreimbursed medical expenses of $6,000 (excluding LTC premium)

Adjusted gross income (AGI) is $60,000

How are the premium contributions treated?

Subject to the limits below, as well as other limits on itemized deductions, the unreimbursed medical expenses and LTC premium may be deductible to the extent they exceed *7.5%* of AGI.

Attained Age of the Individual Before the close of Taxable Year	**Maximum Tax Deductible Premiums (2000)**
40 or below	**$** 220
41 through 50	**$** 410
51 through 60	**$** 820
61 through 70	$2,200
71 and above	$2 *750*

(Note: These amounts are subject to change each year)

First, determine the maximum LTC premium deduction for the individual's age bracket ($2,200). That amount plus the $6,000 of unreimbursed medical expenses ($8,200 in total) is deductible to the extent that the total exceeds *7.5%* of AGI (or $4,500*).* In this case $3,700 is the itemized medical deduction ($6,000 + $2,200 - $4,500*).*

How are benefits taxed?

Benefits received are generally excluded from income as long as the insured is chronically ill (as defined by the Internal Revenue Code) and the benefits are used for qualified long term care services (e.g. nursing home, home care, personal care and maintenance services).

NOTE: Benefits received on a per diem basis may be taxed differently and are discussed in another section.

Limited Liability Company

Example 4

A Limited Liability Company (LLC) is treated as a partnership for the purpose of these rules. Therefore, a LLC may deduct LTC premium contributions on behalf of both its owners and its employees. Ten percent shareholders or members of an LLC are those who are subject to the same 60% limit on health insurance deductions as partners and those who are self-employed.

A Partnership purchases a qualified Long Term Care contract for non-partner employees & partners who perform services

Example 5

Annual premium contribution of $2,400
63 year old individual
Unreimbursed medical expenses of $6 000 (excluding LTC premium)
Adjusted Gross Income (AGI) of $60,000

How are premium contributions treated?

A partnership may deduct any premium contributions for LTC insurance for its employees (and their spouses and dependents) using the same rules outlined for corporations.

If a partnership contributes to LTC coverage (or other accident and health coverage) for its partners (including spouses and dependents) for services rendered by the partners, which payments are not based on the income to the partner, the premium contributions are deductible to the partnership in the same manner as they would be for employees.

The amount of premium contributions attributable to each partner is included in that partner's income and reported by the partnership on each partner's K- 1.

The partnership may deduct the full $2,400 paid on behalf of a partner and $2,400 should be included in the insured partner's income. The partner may count $2,200 as eligible for the 60% deduction available to the self-employed (see Example 1). In addition, the partner may take the deduction for the other 40% of the $2,200 (or $880) as unreimbursed medical expenses in excess of 7.5% of AGI.

Therefore, the partner may take a deduction of $1,320 (60% of $2,200) and count the remaining $880 (40% of $2,200) as unreimbursed medical expense. The unreimbursed medical expenses of $6,880 ($6,000 + $880) may be deducted to the extent they exceed 7.5% of AGI.

The amount of premium contributions are included in the partner's total income, so AGI would be $61,080 ($60,000 + $2,400 - $1,320). The deduction would then be $2,299 ($6,880- [$61,080 x 7.5%l). The total deduction is $3,619 ($1,320 + $2,299).

How are benefits taxed?

Benefits received are generally excluded from income as long as the insured is chronically ill (as defined by the Internal Revenue Code) and the benefits are used for qualified long term care services (e.g. nursing home, home care, personal care and maintenance services).

NOTE: Benefits received on a per diem basis may he taxed different/v and are discussed in another section.

Self-employed person who purchased a qualified Long Term Care contract with after tax dollars

Example 6

Annual premium contribution of $2,400

63 year old individual

Unreimbursed medical expenses of $6,000 (excluding LTC premium)

Adjusted gross income (AGI) is $60,000

How are the premium contributions treated?

A self-employed person may deduct a percentage of the premium contributions paid for accident and health insurance (including those premiums for spouse and dependents) without regard to the *7.5%* threshold discussed in the introduction. LTC is considered accident and health insurance; therefore, the deduction for self-employed persons applies to the premium contributions.

The percentages allowed without regard to the *7.5%* threshold are as follows:

I998	45%	2002	70%
1999-2001	60%	2003-thereafter	100%

For LTC premium contributions, the self-employed deduction is limited to the above percentage multiplied by that age-based annual premium maximum shown in the first example for individuals.

Using the above criteria, this individual may deduct $1,320 (60% of $2,200) in 2000 under Code Section 162 (1) without regard to whether medical expenses exceed the *7.5%* AG! threshold.

The balance of the LTC premium paid by the self-employed individual is potentially deductible under Code Section 213, as an itemized medical expense, as long as it and other unreimbursed medical expenses exceed *7.5%* of AGI. (Alternatively, the entire $2,200 may be applied as a deduction against the *7.5%* threshold).

Therefore, under the facts assumed, the unreimbursed medical expenses of the insured would be $6,880 ($6,000 + $2,200- $1,320) (assuming $1,320 of LTC premium was used as a deduction under the self-employed rules). Since AGI would be reduced to $58,680 ($60,000 - $1,320), an additional deduction of $2,479 may be available ($6,880 - $4,401 [$58,680 x *7.5%])* for a total deduction of $3,799 ($1,320 + $2,479).

How are benefits taxed?

Benefits received are generally excluded from income as long as the insured is chronically ill (as defined by the Internal Revenue Code) and the benefits are used for qualified long term care services (e.g. nursing home, home care, personal care and maintenance services).

NOTE: Benefits received on a per diem basis may be taxed differently and are discussed in another section.

Sub-S Corporation

Example 7

Sub-S corporation is treated as a partnership for the purpose of these rules. Therefore, a Sub-S corporation may deduct LTC premium contributions paid on behalf of its owners (defined as a shareholder who owns 2% of stock) or its employees. Two percent shareholders of Sub-S corporations are subject to the same limits on health insurance deductions as partners and the self-employed.

Fixed Periodic (or "Per Diem") Payments

Qualified Long Term Care insurance contracts which provide benefits on a "per diem" basis, that is, the provision of a predetermined specified amount of dollars on a periodic basis, regardless of how much the long-term care provider(s) charges for its services, are treated differently for tax purposes than indemnity policies. The tax free receipt of per diem benefits is limited, so that policyholders will be taxed on the amount of benefits which exceeds:

- The greater of $190 per day (for 2000) ($69,350 annually; indexed by inflation)
- The amount of qualified long term care expenses incurred by the insured

Only benefits paid under a policy specifically to reimburse actual expenses are not subject to the cap. Payments made on a cyclical or even lump-sum basis will be considered periodic payments subject to the cap. If the periodic payments exceed the cap, the benefit amounts in excess of the cap will be included in income.

Examples:

An insured receives $200 per day in benefits. In 2000, only $190 is excludable from income. However, if the employee can show that $200 of expenses were actually incurred, then the entire amount received may be excludable.

A policy pays an insured $5,000 for a 20-day period of chronic illness. The actual expenses were $3,800 or less, ($190 x 20). The insured will have $1,200 of taxable income.

Prudential Group and Individual Long Term Care Insurance is underwritten by The Prudential Insurance Company of America, 751 Broad Street, Newark, NJ 07102-3777. This coverage contains benefits, exclusions, limitations, eligibility requirements and specific terms and provisions under which the insurance coverage may be continued in force or discontinued. For costs and complete details of coverage, call Prudential's Long Term Care Customer Service Center at 1-800-732-0416 or contact your agent. If you are considering long term care insurance that is being offered to you as a member of a group or association call 1-800-732-0416. If you are not a member of a group and you would like more information, contact your Prudential Representative or call 1-888-888-ROCK (1-888-888-7625).

The Prudential Insurance Company of America is licensed in all states. All insurance policies may not be available in your state. Individual coverage is issued under Prudential's Long Term CaresSM Insurance policy numbers GRP 98176, GRP 98177 and GRP 98178; however, policy numbers may vary by state. Group coverage is under contract series 83500. The examples used in this document are hypothetical and are shown for illustration purposes only. They do not constitute a ruling by the Internal Revenue Service. This should not be construed as tax advice. Consult your financial advisor or tax consultant regarding tax advantages.