John Hancock

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2006 Tax Guide

Long Term Care Insurance

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Introduction

This brochure presents an overview of the rules and regulations concerning the deductibility of tax-qualified long term care insurance (LTCI). It addresses the tax deductibility or exclusion of premiums paid, and the exclusion of benefits from adjusted gross income.

To assist you in the understanding of how tax-qualified LTCI premiums are treated, we have included examples that illustrate the following situations:

- Individual Purchase
- Self-Employed
- Partnership, Subchapter S Corporations, Limited Liability Companies (LLC)
- Subchapter C Corporations
- Employer-Pay Contributory Arrangements

This is an interpretation of the Federal Guidelines by John Hancock's Corporate Law Department. Clients should consult with their legal tax advisor regarding tax issues.

I. Individual Purchase

Tax-qualified LTCI premiums are considered a medical expense. For an individual who itemizes income tax deductions, medical expenses are deductible to the extent that they exceed 7.5% of the individual's adjusted gross income (AGI). The amount of the LTCI premium treated as a medical expense is limited to the Eligible Premium Deduction, as defined by Internal Revenue Code[1] 213(d), based on the age of the insured individual. That portion of the LTCI premium that exceeds the Eligible Premium Deduction is not deductible as a medical expense. Table 1 illustrates the allowable deductions:

TABLE 1

Age of Insured Before the Close of the Year	2006 Eligible Premium Deduction
Ages 40 or Less	$280
Ages 41 to 50	$530
Ages 51 to 60	$1,060
Ages 61 to 70	$2,830
Ages Over 70	$3,530

Example

Basic Information	
Age of Individual	55
Adjusted Gross Income (AGI)	$55,000
Medical Expenses (Excluding LTCI Premiums)	$4,000
Annual Premium for Tax-Qualified LTCI Policy	$2,000
Calculating the Deduction	
Eligible Premium Deduction (Table 1)	$1,060
Total Medical Expenses	$5,060 *($4,000 Medical Expenses + $1,060 of Eligible LTCI Premiums)*
7.5% of AGI	$4,125
Medical Expenses that Exceed 7.5% of AGI	$935 *($5,060 - $4,125)*
Total Deduction	$935
AGI Less Deduction	$54,065 *($55,000 - $935)*

If an individual purchases tax-qualified LTCI on behalf of a parent who is not a dependent, he or she is not entitled to a medical expense deduction. A dependent is generally someone for whom at least 50% of financial support is provided by the taxpayer.

Generally, benefits received under a tax-qualified LTCI policy purchased by an individual will be excluded from AGI, and therefore, are non-taxable.

1. Internal Revenue Code will be listed as "IRC," followed by the section numbers.

II. Self-Employed

A self-employed individual can deduct 100% of his or her out-of-pocket long term care insurance premiums, up to the age-based Eligible Premium amounts listed in Table 1. [IRC 162(l)]. However, a self-employed individual may not deduct LTCI premiums during any calendar month in which he/she or his/her spouse is eligible to participate in an employer-sponsored health plan. The portion of LTCI premiums that exceeds the Eligible Premium amount is not deductible as a medical expense. The deductible amount includes eligible premiums paid for spouses and dependents. [IRC 162(l)]. It is not necessary to meet a 7.5% AGI threshold in order to take a deduction.

Example

Basic Information	
Age of Self-Employed Individual	55
Gross Income	$60,000
Annual Premium for Tax-Qualified LTCI Policy	$2,000
Calculating the Deduction	
Eligible Premium Deduction (Table 1)	$1,060
Gross Income Less Deduction	$58,940 *($60,000 - $1,060)*

Generally, benefits received from a tax-qualified LTCI policy that was purchased by an individual will be excluded from adjusted gross income, and therefore, are non-taxable.

III. Partnership/Limited Liability Company (LLC)/Subchapter S Corporation

Partners in a partnership, members of an LLC that is taxed as a partnership, and shareholders/employees of Subchapter S Corporations who own more than 2% of the Corporation,[2] are taxed as self-employed individuals. The partnership, LLC, or Subchapter S Corporation pays the premium. The partner, member, or shareholder/employee includes the LTCI premium in his or her adjusted gross income, but may deduct up to 100% of the age-based Eligible Premium amount, as listed in Table 1.[3] It is not necessary to meet a 7.5% AGI threshold in order to take a deduction.

Example

Basic Information	
Age of Partner	55
Gross Income	$60,000
Annual Premium for Tax-Qualified LTCI Policy	$2,000
Calculating the Deduction	
Eligible Premium Deduction (Table 1)	$1,060
Gross Income Less Deduction	$58,940 *($60,000 - $1,060)*

Generally, benefits received from a tax-qualified LTCI policy that was purchased by an individual will be excluded from adjusted gross income, and therefore, are non-taxable.

IV. Subchapter C Corporation

Employer

When a business purchases a John Hancock tax-qualified LTCI policy on behalf of any of its employees, or their spouses and dependents, the corporation is entitled to take a 100% deduction as a business expense on the total premiums paid.[4] The deduction is not limited to the age-based Eligible Premium amounts listed in Table 1. [IRC 162(l)].

The purchase of a tax-qualified LTCI policy is not subject to any nondiscrimination rules, thus allowing an employer to be selective in the classification of employees it elects to cover (e.g., a select group of officers).

Employee[5]

The entire LTCI premium amount paid by the business is excluded from the employee's adjusted gross income, even if the premium exceeds the Eligible Premium amount listed in Table 1.[6] This exclusion applies to shareholders/employees in a Subchapter C Corporation and to shareholders/employees who own 2% or less of the corporation in a Subchapter S Corporation.

Example

Basic Information	
Premium Paid by Subchapter C Corporation	$20,000 *($2,000 premium x 10 individuals)*
Calculating the Deduction	
Total Deduction	$20,000
Calculating the Exclusion	
Amount Excluded from Each Employee's Taxable Income	$2,000

Generally, premiums paid by the employer and benefits received under an employer-purchased tax-qualified LTCI policy will be excluded from the employee's adjusted gross income and therefore, are non-taxable. [IRC 7702B, 104(a)(3)].

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2 IRC Section 1372 states that a more than 2% shareholder/employee is generally treated as a partner in a partnership, rather than as an employee, when it comes to fringe benefits. The deduction hinges on the more than 2% shareholder/employee being treated as a partner and self-employed by participating in a plan in which the employer pays the policy's premiums. [IRC162(1); Rev. Rul. 91–26].

3 [IRC 162(l)].

4 [IRC 162(a)].

5 For LTCI coverage provided by a closely-held C Corporation, the IRS can challenge tax benefits claimed under an employer-provided plan that covers only shareholders/employees, if they find that the plan is not for employees.

6 [IRC 106, 7702B, 104(a)(3)].

V. Employer-Pay Contributory Arrangement on Behalf of an Employee

If an employer pays all or a portion of the tax-qualified LTCI premiums on behalf of an employee, the amount paid is deductible by the employer as a business expense.[7] The deductions are not limited by the age-based limits on Eligible Premium listed in Table 1.[8] [IRC 162(a)]. The entire employer contribution would also be excluded from the employee's adjusted gross income.

If the employer only pays a portion of the premium, the employee is able to apply the balance that he or she pays towards his or her medical expenses, up to the Eligible Premium amount, and would then be entitled to a deduction for medical expenses that exceed 7.5% of AGI.

Example: Employee Deduction

Basic Information	
Age of Individual	55
Adjusted Gross Income (AGI)	$55,000
Medical Expenses (Excluding LTCI Premiums)	$6,000
Annual Premium for Tax-Qualified LTCI Policy	$2,000
Employer Contribution	$500
Premium Paid by Employee	$1,500
Calculating the Deduction	
Eligible Premium Deduction (Table 1)	$1,060
Total Medical Expenses	$7,060 *($6,000 medical expenses + $1,060 of eligible LTCI premiums)*
7.5% of AGI	$4,125
Medical Expenses that Exceed 7.5% of AGI	$2,935 *($7,060 - $4,125)*
Total Deduction	$2,935
AGI Less Deduction	$52,065 *($55,000 - $2,935)*

Example: Employer Deduction

Basic Information	
Premium Paid by Employer	$500
Calculating the Deduction	
Total Deduction as a Business Expense	$500

Generally, benefits received under a tax-qualified LTCI policy that was purchased by an individual will be excluded from adjusted gross income, and therefore, are non-taxable. Premiums paid by the employer are also excluded from adjusted gross income.

VI. Gift Tax Exclusion

In addition to the annual Gift Tax exclusion of $12,000 per donee, a donor has the ability to pay for the medical expenses of the donee.[9] If those medical expenses are tax-qualified long term care insurance premiums, the exclusion is subject to the age-based limits for Eligible Premium listed in Table 1. An individual (donor) can purchase LTCI policies for family members (donees) and still maintain the annual Gift Tax exclusion and choose either John Hancock's Ten-Pay or Accelerated Payment Option. If the donor pays more than the eligible premium that applies to the donee, that amount will impact the annual $12,000 Gift Tax exclusion. If the donor pays less than the eligible premium, it will not impact the $12,000 Gift Tax exclusion.

Example

Basic Information	
Annual Gift Tax Exclusion	$12,000
Age of LTCI Policy Recipient (Donee)	55
Annual Premium for Tax-Qualified LTCI Policy (Paid by Donor)	$1,500
Calculating the Exclusion	
Eligible Premium Deduction (Table 1)	$1,060
Premium Amount that Would Impact the Annual Gift Tax Exclusion	$440 *($1,500 - $1,060)*
Amount that Donor Could Still Give Donee Under the Annual Gift Tax Exclusion	$11,560 *($12,000 - $440)*

VII. Return of Premium

The refund is included in the beneficiary's gross income and is taxable, to the extent it was either excluded from the owner's income or deducted by the owner. It must be included in income the year it is received.

VIII. Health Savings Accounts (HSAs)

Tax-qualified LTCI premiums can be reimbursed through an HSA, tax-free, up to the Eligible Premium amounts listed in Table 1, even if the HSA is offered through an employer-provided cafeteria plan.

IX. Cafeteria Plans

Tax-qualified LTCI policies cannot be purchased with pre-tax dollars under an employer-provided cafeteria plan. However, LTCI premiums may be paid through an HSA that is offered under an employer-provided cafeteria plan.

X. Flexible Spending Accounts (FSAs)

Tax-qualified LTCI premiums cannot be reimbursed under an FSA.

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7 [IRC 162 (a)].

8 [IRC 162 (l)].

9 [IRC Sec. 2503(e)].

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