Understanding LTC Tax Advantages and Tax Reporting of LTC Combo and Hybrid Products

Nationwide®

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NFM-23225AO (08/23)

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Important things you should know

When evaluating the purchase of a variable annuity, your clients should be aware that variable annuities are long-term investment vehicles designed for retirement purposes and will fluctuate in value; annuities have limitations; and investing involves market risk, including possible loss of principal.

This information assumes that the life insurance is not a modified endowment contract, or MEC. As long as the contract meets the non-MEC definitions of IRC Section 7702A, most distributions are taxed on a first-in/first-out basis. Surrender charges may apply to partial surrenders. Loans and partial surrenders from a MEC will generally be taxable, and if taken prior to age 59 ½, may be subject to a 10% tax penalty. Loans and partial surrenders will reduce the cash value and the death benefits payable to your beneficiaries, and withdrawals above the available free amount will incur surrender charges. If your contract were to lapse with a loan outstanding, the loan amount in excess of basis will be treated as a distribution and all or a portion will be subject to income tax.

The underlying investment options to a variable annuity or life insurance product are not publicly traded mutual funds and are not available directly for purchase by the general public. They are only available through variable annuity/variable life insurance policies issued by life insurance companies.

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Important things you should know

As your clients' personal situations change (i.e., marriage, birth of a child or job promotion), so will their life insurance needs. Care should be taken to ensure these strategies and products are suitable for long-term life insurance needs. You should weigh your clients' objectives, time horizon and risk tolerance as well as any associated costs before investing. Also, be aware that market volatility can lead to the possibility of the need for additional premium in the policy. Variable life insurance has fees and charges associated with it that include costs of insurance that vary with such characteristics of the insured as gender, health and age, underlying fund charges and expenses, and additional charges for riders that customize a policy to fit your clients' individual needs.

Not all Nationwide products and services are suitable for all clients or situations. There may be products, issued by other companies, which better suit your clients' goals. Be sure to consider your clients' objectives, their need for cash flow and liquidity, and overall risk tolerance when using any strategy.

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Agenda

- Rules all LTC benefits have in common
- Structure of combo policies for LTC premiums to be tax deductible
- Age-based limits for individual tax payors and HSA eligibility
- Tax advantages for business owners and employees
- Joint Life policies – how tax advantages work
- Section 334 of Secure 2.0
- Clarifying Section 1035 exchange rules
- IRS Form 1099-R - who receives it and what it reports
- IRS 1099-LTC
- IRS Tax Form 8853
  - ➢ Who needs to file it?
  - ➢ How easy is it to complete
- Summary of main points

Tax Rules Common to All LTC Benefits

- IRS Guidelines for tax free LTC benefits apply to all types of policies

LTC benefits may be received **tax free,** cumulative of all policies paid on insured to the <u>greater of</u>:

- The HIPAA per diem in the year of claim, OR
- Actual qualifying LTC expenses incurred

- Benefits paid in excess of this formula will be taxed as ordinary income
- Policy <u>owner</u> is responsible for paying any tax

Examples of IRS guidelines for tax-free LTC benefits

LTC expenses that are less than the HIPAA per diem

- HIPAA per diem is $12,600 a month
- Actual LTC expenses are $8,000 a month
- LTC benefits paid are $10,000

In this case all $10,000 is tax free because the LTC benefits received are less than the HIPAA per diem

  - No expenses need to be justified

LTC expenses are more than the HIPAA per diem

- HIPAA per diem is $12,600 a month
- Actual LTC expenses are $14,000 a month
- LTC benefits received are $15,000 a month

In this case $14,000 is tax free because when justified by actual LTC expenses

Only $1,000 is taxable as ordinary income, because that is the amount that exceeds IRS guidelines

Nationwide does not give tax or legal advice. Please consult your tax advisor

Tax Rules Common to All LTC Benefits – cont.

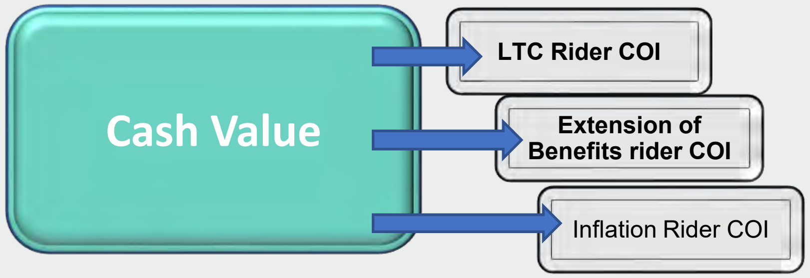
- What if there are multiple policies with multiple owners on a single insured?
  - The insured will get first rights to any tax-free benefits
  - Any remaining tax-free benefit and any taxable amounts will be split pro-rata by the other policy owners
    - If the insured does not own any policies, the policy owners will split pro-rata the tax-free amounts and any tax due

- What if LTC benefits come from a rider on life insurance policy that is a MEC? (modified endowment contract)
  - LTC benefits are still tax-free based on IRS guidelines
    - Policy could be in form of a rider on life insurance or linked benefit policy
    - LTC benefits are an acceleration of the death benefit – not a withdrawal or loan

Policy structure is key to tax deductible LTC premiums

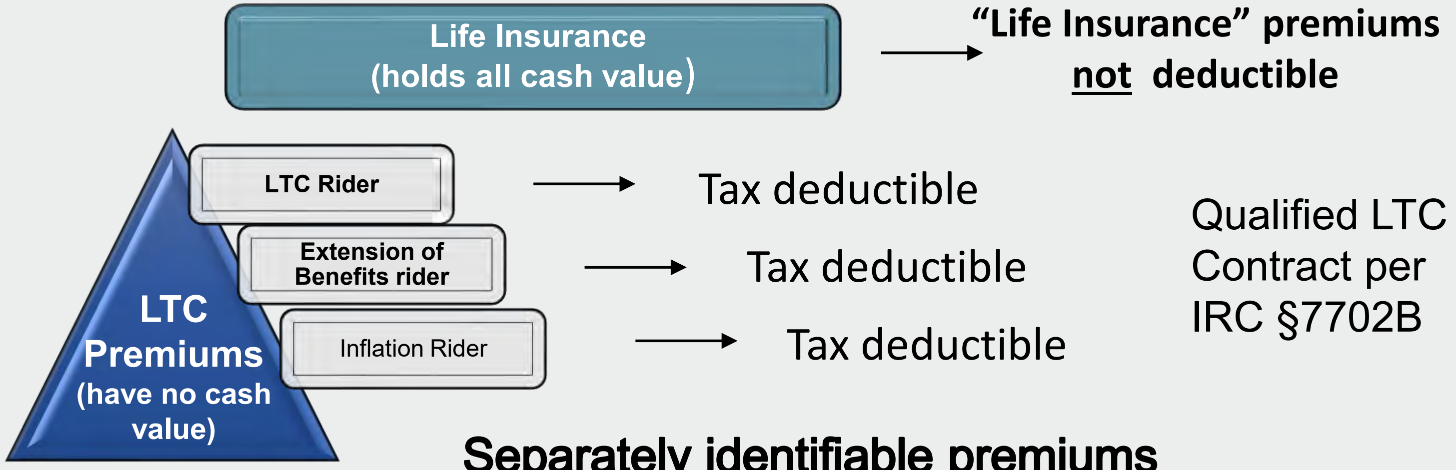
- LTC premiums must be separate and identifiable
  - Cost of insurance for LTC rider charges is **not** a premium
- Traditional stand alone LTC policies have separate identifiable LTC premiums
- Some linked benefit LTC policies have separate identifiable LTC premiums
- Rare for LTC riders on life insurance to be structured with separate identifiable LTC premium premiums (usually only found on whole life policies)
- LTC riders on annuities do not have separate identifiable LTC premiums

NOT deductible



Cost of Insurance is not a premium

Deductible



Separately identifiable premiums

Hierarchy of Tax Advantages by Situation

The value of tax advantages varies by business entity and individual opportunities

Most valuable	More valuable	Valuable	Valuable
Business purchases for C-Corp owner/EE - or- Any business entity purchases for an employee	**Pass Through Entities – Self-employment health insurance deduction**	**Individual tax deduction**	**Use HSA distributions to pay LTC premiums**
LTC Premium 100% tax deductible as a business expense	LTC Premium tax deductible up to age-based limits taken “above the line”	LTC Premium tax deductible up to age-based limits - subject to 7½% floor	May pay LTC Premium – up to age-based limits with HSA distributions

Tax Advantages for Individuals

- Federal tax deduction (under IRC §7702B and IRC§213)
  - Must meet 7 ½ % floor of Adjusted Gross Income (AGI) in out-of-pocket medical expenses. For example:
    - AGI equals $100,000
    - $7,500 must be paid out of pocket before any deduction applies
    - LTC premiums can help to get to the required floor
  - Deduction limited to IRS age-based deduction limits
- HSA distribution
  - No 7 ½ % floor to meet
  - No itemization required
  - Distribution limited to IRS age-based distribution limits
- Individual tax-payer can <u>only choose one</u>

Age-based Limits for Individuals

- Individuals are subject to age-based limits
  - The IRS limits the amount of the tax deduction or HSA distribution an individual qualifies for
- Qualifying amount is the lesser of:
  - cumulative LTC premiums paid
  - or the amount based on age at end of tax year premium was paid

	2018	2019	2020	2021	2022	2023
40 or under	$ 420	$ 420	$ 430	$ 450	$ 450	$ 480
41-50	$ 780	$ 790	$ 810	$ 850	$ 850	$ 890
51-60	$1,560	$1,580	$1,630	$1,690	$1,690	$1,790
61-70	$4,160	$4,220	$4,350	$4,520	$4,510*	$4,770
71+	$5,200	$5,270	$5,430	$5,640	$5,640	$5,960

Pass-through entities

LTC coverage for self-employed business owners

- Self-employed individuals may deduct qualified LTC premiums
  - Above the line deduction (not subject to the 7 ½ % floor or itemizing deductions)
  - May include spouse and dependents
    - Cannot deduct LTC premiums in any month in which either spouse is eligible for subsidized LTC benefits from another employer
  - Deduction is subject to age-based limits

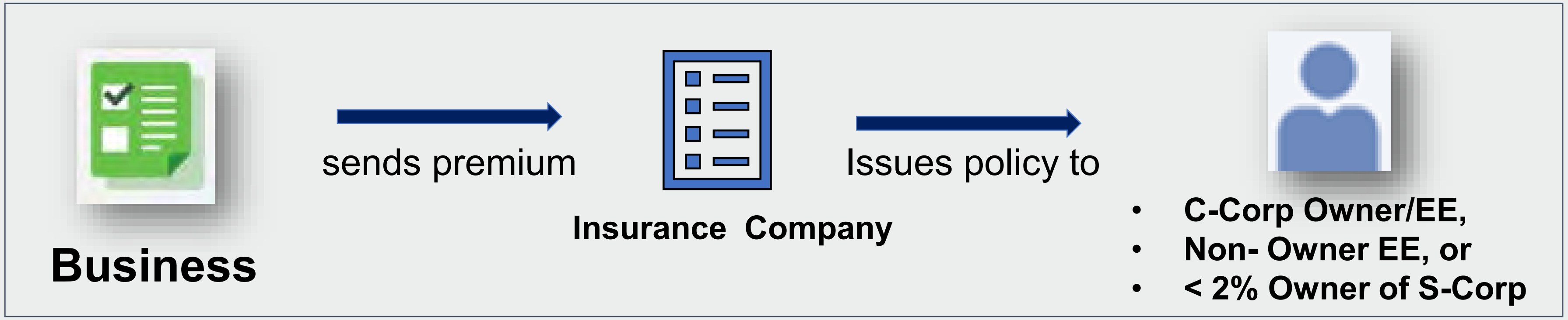
	2018	2019	2020	2021	2022	2023
40 or under	$ 420	$ 420	$ 430	$ 450	$ 450	$ 480
41-50	$ 780	$ 790	$ 810	$ 850	$ 850	$ 890
51-60	$1,560	$1,580	$1,630	$1,690	$1,690	$1,790
61-70	$4,160	$4,220	$4,350	$4,520	$4,510*	$4,770
71+	$5,200	$5,270	$5,430	$5,640	$5,640	$5,960

- Each entity has slight variations in how premiums are paid and labeled for:**
  - more than 2% owner of an S-Corporation
  - Partnership or LLC (paying taxes as a partnership)
  - Sole Proprietor

* Note the $10 reduction from 2021 numbers
** Please consult a tax advisor for details on how each business entity reports and deducts LTC premiums

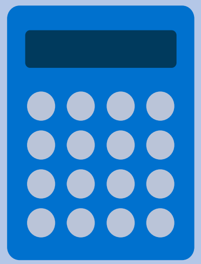
Linked benefit policy (properly structured) for Employee LTC benefits

C-Corp owner/EE, Non-owner/EEs & Less than 2% owner/EE of an S-Corporation



- **Life insurance premiums** are treated as a compensation bonus
  - 100% tax deductible to business as a business expense (paid compensation)
  - 100% taxable to employee as compensation received
- **LTC premium** treated as payments for an accident & health plan
  - LTC premiums 100% tax deductible to business (no age-based limits)
  - LTC premiums are totally excluded from employee's income (no taxation)
  - LTC benefits paid tax free per IRS guidelines
- May include spouse and dependents
- Employer may not have any ownership or beneficial rights
- Owner must be bona-fide employee – no deduction for silent partners/investor

LTC insurance may not be offered as part of a cafeteria plan under IRC §125(f),



Joint Life LTC Linked Benefit Policies

More affordable with shared LTC benefit pool

- Helps take the guesswork out of how much LTC coverage to purchase
- Often less expensive than two individual policies

To qualify for tax advantages

- Policy must have separately identifiable LTC premiums
  - not a deduction from cash value
- LTC premium amounts must be assigned for each individual

Joint LTC Policies - Tax Advantages for Individuals

Tax Deduction[1]

- If the couple files a joint tax return, then the 7 ½% floor can be met with combined household medical expenses (including the children)
- If a married couple files separate tax returns, each must meet their own 7 ½% floor
  - The payor can include any expenses they paid for a spouse or dependent (no double dipping)
  - If funds come out of a joint account, it is assumed each paid half (or proven ratio)
  - HOWEVER - In community property states any medical expenses paid out of community funds are divided equally. Generally, each person should include half the expenses. [1]
    - If medical expenses are paid out of the separate funds of one individual, only the individual who paid the medical expenses can include them.[1]
- LTC age-based limits will apply separately to each individual based on their age
- If the couple is <u>not married</u>, each must meet their own 7 ½% floor
  - The payor can include any LTC expenses they paid for a dependent
- If the policy is a joint life linked benefit LTC policy, then the life insurance portion of the policy is not deductible – only the LTC premiums are, up to age-based limits

[1] More information on Medical Deductions can be found on IRS Publication 502 or by consulting a tax advisor

Joint LTC Policies - Tax Advantages for Individuals

HSAs (Health Savings Accounts)[1]

- Each individual can get reimbursed up to age-based limits from their own respective HSA accounts - OR
- Both individual's separate LTC premiums are eligible for reimbursement from one spouse's HSA
  - This applies whether they file jointly or separately.
- Unmarried couples must use their own individual HSA unless one partner is a dependent.

[1] More information of HSA Accounts can be found on IRS Publication 969

Joint LTC Policies - Tax Advantages for Businesses

- LTC premiums must be separate and identifiable for each person

- Executive carve-outs and C-Corp owners
  - Spouses may be included
  - A family or spousal plan should ideally be set up
  - Life insurance premium will be treated as income – deductible to the employer as wages paid and taxable to the employee as wages received
  - Both LTC premiums will be deductible by the employer as accident and health premiums
    - but will not be taxable to the employee
  - LTC benefits will also be tax free

- Pass-through entities
  - Spouses and dependents can be included
  - Deducted as self-employment health insurance
  - Age-based limits apply to the owner and spouse
    - Each will use their individual age to determine their portion of the deduction

Please consult your tax advisor for more information

What about the new LTC provisions in SECURE 2.0?

- Sec. 334 of SECURE 2.0 allows using qualified funds to pay for LTC coverage – without pre-59 ½ penalty…..
- However,
  - It does **not** apply to IRA accounts
  - Limits distributions to a maximum of $2500 a year (with an annual adjustment) – and distribution
  - Only allows distribution to pay for qualifying LTC premiums/costs
    - Cannot be used to pay for life insurance portion of hybrid/combo policies
  - Only waives pre-age 59 ½ penalty - full distribution is still taxable as ordinary income
  - The PLAN does not have to allow for these distributions. It is optional, and up to the PLAN administrator whether or not to offer
  - Not available until after Dec. 29, 2025

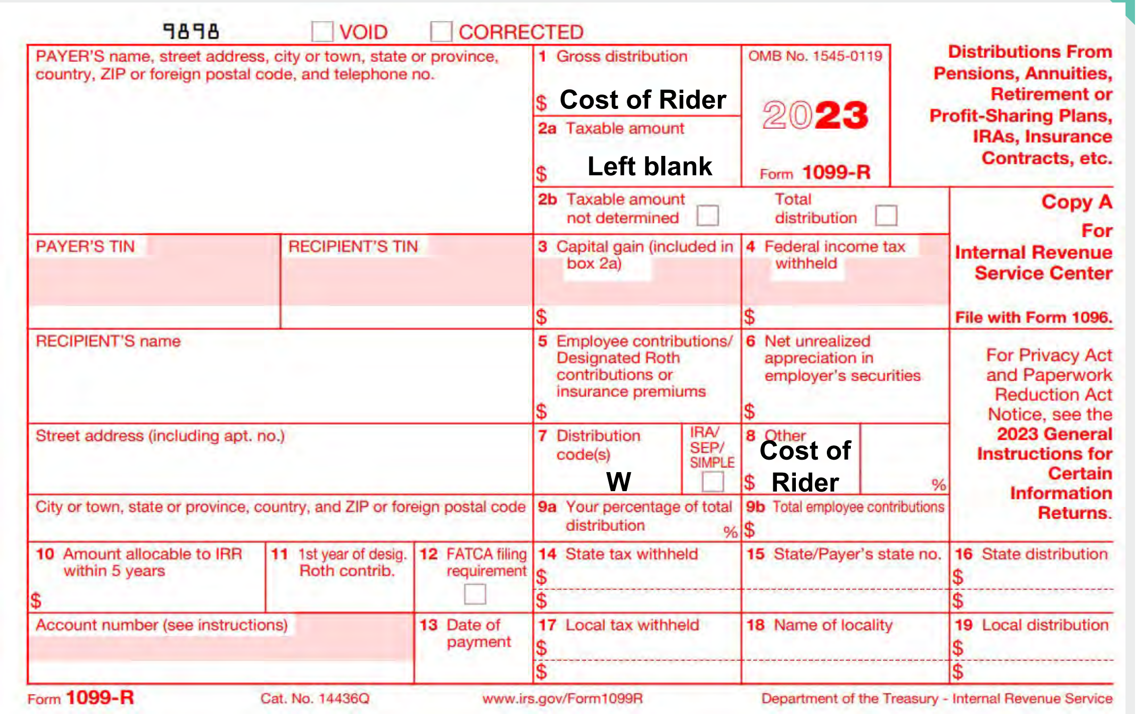
Clarifying 1035 Exchanges with LTC

- Linked benefit LTC policies and LTC Riders follow the §1035 exchange rules of the base product (meaning the base of life insurance or annuity)
- It is a **misinterpretation** of the PPA 2006 that an annuity can be 1035 exchanged into a life insurance based linked benefit policy
- Insured and owner on life insurance policy must follow "like to like" rules
  - Exception: When one insured on a survivorship policy has died, the surviving insured may §1035 exchange the policy to an individual policy (note: this may not be cost effective depending on exchange)

	To life insurance with or without an LTC rider	To life insurance based linked-benefit LTC	To an endowment contract	To annuity, with or without LTC coverage	To a traditional LTCi policy
From life insurance with or without an LTC rider	Yes	Yes	Yes	Yes	Yes
From life insurance-based linked-benefit LTC	Yes	Yes	Yes	Yes	Yes
From an endowment contract	**No**	**No**	Yes	Yes	Yes
From annuity, with or without LTC coverage	**No**	**No**	**No**	Yes	Yes

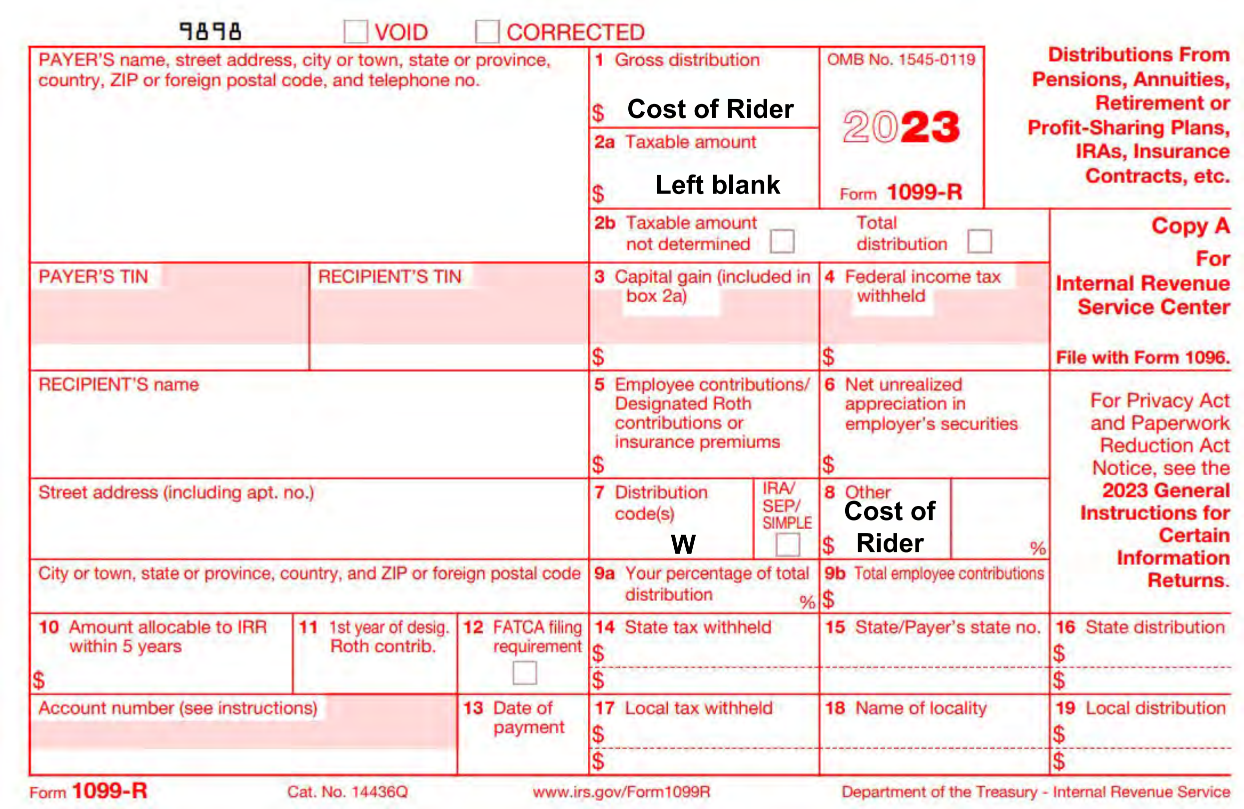
IRS Form 1099-R
Who receives this form and who doesn't

- Form is sent to the policy owner
- Policies subject to 1099-R reporting are:
  - LTC riders on life insurance when the riders are <u>paid for from cash value</u>
  - Linked Benefit (hybrid) policies on life insurance when the riders <u>are paid for from cash value</u>
  - LTC riders on annuities
- Policies not subject to1099-R reporting of LTC costs
  - Traditional LTC policies
  - Linked Benefit (Hybrid) policies that pay for LTC policy components with <u>separate identifiable premium</u>
  - LTC riders on life insurance that pay for LTC policy components <u>with separate identifiable premium</u>
    - Rare, and usually on whole life
- 1099-R's can be sent on the same policy for other reasons not related to LTC and could reflect a taxable event.
  - Box 7 would not state "W"
  - Box 2 would reflect a taxable amount.
  - Please consult a tax advisor



IRS Form 1099-R
What is reported and why

- Mandatory reporting required for insurance companies as of Jan.1, 2010 for life or annuity contracts with LTC riders that take charges from cash value
- Reports cost of insurance (not premium) that was paid for the LTC riders from cash value
  - Reflects a non-taxable distribution
  - The distribution is treated as a return of premium, which reduces the cost basis in the policy.
  - This creates "phantom gain" by reducing cost basis
  - Only affects policy if surrendered or taking distributions
- Box 1 – reports annual cost of LTC riders
- Box 2 – is left blank because these charges are non-taxable
- Box 7 – Distribution code "W" indicates there is no need to report these amounts on the tax return
- Box 8 – Shows same amount at Box 1


9898 VOID CORRECTED

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

1 Gross distribution $ Cost of Rider

2a Taxable amount $ Left blank

OMB No. 1545-0119

2023

Form 1099-R

Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

2b Taxable amount not determined

Total distribution

Copy A For Internal Revenue Service Center

File with Form 1096.

PAYER'S TIN

RECIPIENT'S TIN

3 Capital gain (included in box 2a) $

4 Federal income tax withheld $

RECIPIENT'S name

5 Employee contributions/ Designated Roth contributions or insurance premiums $

6 Net unrealized appreciation in employer's securities $

For Privacy Act and Paperwork Reduction Act Notice, see the 2023 General Instructions for Certain Information Returns.

Street address (including apt. no.)

7 Distribution code(s) W

IRA/ SEP/ SIMPLE

8 Other $ Cost of Rider %

City or town, state or province, country, and ZIP or foreign postal code

9a Your percentage of total distribution %

9b Total employee contributions $

10 Amount allocable to IRR within 5 years $

11 1st year of desig. Roth contrib.

12 FATCA filing requirement

14 State tax withheld $ $

15 State/Payer's state no.

16 State distribution $ $

Account number (see instructions)

13 Date of payment

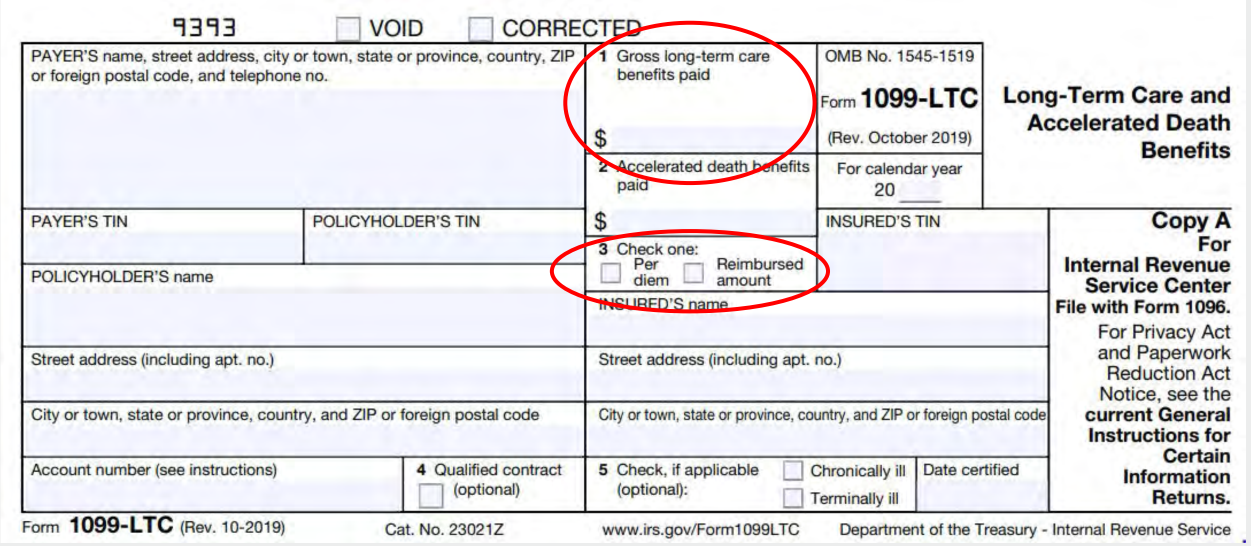
17 Local tax withheld $ $

18 Name of locality

19 Local distribution $ $

Form 1099-R Cat. No. 14436Q www.irs.gov/Form1099R Department of the Treasury - Internal Revenue Service

IRS Form 1099-LTC
What it does and does not report



9393 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

1 Gross long-term care benefits paid
$

OMB No. 1545-1519

Form **1099-LTC**

(Rev. October 2019)

For calendar year 20 ____

Long-Term Care and Accelerated Death Benefits

2 Accelerated death benefits paid
$

PAYER'S TIN

POLICYHOLDER'S TIN

3 Check one: ☐ Per diem ☐ Reimbursed amount

INSURED'S TIN

POLICYHOLDER'S name

INSURED'S name

Street address (including apt. no.)

Street address (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

City or town, state or province, country, and ZIP or foreign postal code

Account number (see instructions)

4 Qualified contract (optional) ☐

5 Check, if applicable (optional): ☐ Chronically ill ☐ Terminally ill

Date certified

Copy A For Internal Revenue Service Center

File with Form 1096.

For Privacy Act and Paperwork Reduction Act Notice, see the **current General Instructions for Certain Information Returns.**

Form **1099-LTC** (Rev. 10-2019) Cat. No. 23021Z www.irs.gov/Form1099LTC Department of the Treasury - Internal Revenue Service

- Reports amount of LTC benefits that were paid by the insurance company
  - If there are multiple policies from multiple insurance companies, each company sends a separate 1099-LTC
  - If there are multiple policy owners, each owner receives their own 1099-LTC
  - Please consult a tax advisor for proper reporting. With multiple owners, all owners must use same formula
- Reports whether a policy was paid for by:
  - per diem (indemnity), or
  - reimbursement
- Does not report whether or not any tax is due
  - Provides the information to put on IRS Tax Form 8853

IRS Form 8853 and who needs to file it

- Quick and easy to fill out
- Can be easily done on tax preparation software
- Required if policy is indemnity (per diem)
  - Not required for reimbursement policy, if only one policy
- LTC reporting goes on page 2, Sec. C of form 8853
  - Form reports Archer MSAs and Long-Term Care Insurance
- Form is filled out by policy owner
  - Trust owned policies are reported by the trustee
- Line 18 – report cumulative 7702B LTC rider benefits
  - LTC riders on life insurance and annuities
  - Linked benefit policy riders – LTC rider, Extension of Benefit Rider and Inflation Rider
- Line 19 - reports chronic illness riders
- Line 21 always reflects the HIPAA per diem for the current tax year

Form 8853 (2022) Attachment Sequence No. 39 Page 2

Name of policyholder (as shown on return) | Social security number of policyholder

Section C. Long-Term Care (LTC) Insurance Contracts. See *Filing Requirements for Section C* in the instructions before completing this section.

If more than one Section C is attached, check here ☐

14a Name of insured **b** Social security number of insured

15 In 2022, did anyone other than you receive payments on a per diem or other periodic basis under a qualified LTC insurance contract covering the insured or receive accelerated death benefits under a life insurance policy covering the insured? ☐ **Yes** ☐ **No**

16 Was the insured a terminally ill individual? ☐ **Yes** ☐ **No**

Note: If "Yes" and the **only** payments you received in 2022 were accelerated death benefits that were paid to you because the insured was terminally ill, skip lines 17 through 25 and enter -0- on line 26.

17 Gross LTC payments received on a per diem or other periodic basis. Enter the total of the amounts from box 1 of all Forms 1099-LTC you received with respect to the insured on which the "Per diem" box in box 3 is checked **17**

Caution: Don't use lines 18 through 26 to figure the taxable amount of benefits paid under an LTC insurance contract that isn't a **qualified** LTC insurance contract. Instead, if the benefits aren't excludable from your income (for example, if the benefits aren't paid for personal injuries or sickness through accident or health insurance), report the amount not excludable as income on Schedule 1 (Form 1040), line 8e, or, for taxpayers filing Form 1040-NR, on Schedule NEC (Form 1040-NR), line 12.

18 Enter the part of the amount on line 17 that is from **qualified** LTC insurance contracts **18**

19 Accelerated death benefits received on a per diem or other periodic basis. Don't include any amounts you received because the insured was terminally ill. See instructions **19**

20 Add lines 18 and 19 **20**

Note: If you checked "Yes" on line 15 above, see ***Multiple Payees*** in the instructions before completing lines 21 through 25.

21 Multiply $390 by the number of days in the LTC period **21**

22 Costs incurred for qualified LTC services provided for the insured during the LTC period (see instructions) **22**

23 Enter the **larger** of line 21 or line 22 **23**

24 Reimbursements for qualified LTC services provided for the insured during the LTC period **24**

Caution: If you received any reimbursements from LTC contracts issued before August 1, 1996, see instructions.

25 Per diem limitation. Subtract line 24 from line 23 **25**

26 **Taxable payments.** Subtract line 25 from line 20. If zero or less, enter -0-. Also include this amount in the total on Schedule 1 (Form 1040), line 8e, or, for taxpayers filing Form 1040-NR, on Form 1040-NR, Schedule NEC, line 12. For taxpayers filing Form 1040-NR, on Schedule NEC (Form 1040-NR), line 12, enter "LTC" and the amount **26**

Form **8853** (2022)

Summarizing the Big Questions

- LTC benefits are tax free to the GREATER of the HIPAA per diem in year of claim, **or actual LTC costs incurred**
  - (it is <u>not true</u> that indemnity tax free benefits are capped at HIPAA)
- All traditional LTC policies are HSA eligible and potentially tax deductible
- Linked benefit policies must have separate identifiable premiums in order to be eligible for the tax advantages
  - LTC riders on life insurance <u>rarely</u> are structured for tax deductions
  - LTC riders on annuities are not tax deductible
- Business owners have more opportunities for getting LTC premium deductions than individual taxpayers
- 1035 exchanges must follow the base policy 1035 rules
- Tax forms do not have to be scary or time consuming!

Nationwide is here when you need us.

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Nationwide Financial Network Solutions Center:	1-877-223-0795
Brokerage General Agents Solutions Center:	1-888-767-7373