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Tax Issues Complicate the Costs of Chronic Illness and Long-Term Care Insurance

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An aging U.S. population is coming to terms with the realities and costs of 21st century healthcare, making plans to deal with the possibility of chronic illness and the need for long-term care. There are, not surprisingly, tax consequences at almost every turn: Are the costs of care deductible? Are insurance premiums deductible, and by whom? Are insurance reimbursements or other benefits taxable?

As a result of increased life span due to modern medical technology, the elderly and their families have good reason to be concerned about chronic illness and the cost of long-term care. Those costs can be very high—enough to consume the estates of many chronically ill individuals. It is only prudent, then, to consider insuring against those costs. The deductibility of long-term care costs, and the taxation of long-term care insurance and life insurance available for chronic illness, are examined below.

LONG-TERM CARE SERVICES

A taxpayer generally may deduct the unreimbursed cost of certain long-term care services prescribed for a "chronically ill individual." [1] For example, the cost of services provided in a nursing home for a chronically ill individual normally would be deductible as long-term care services.

Definition

Deductible long-term care expenses for chronically ill individuals are, in large part, the same types of medical expenses as those deductible by taxpayers who are not chronically ill. Deductible long-term care services include "necessary diagnostic, preventive, therapeutic, curing, treating, mitigation, and rehabilitative services." [2] The general definition of medical care in Section 213 and the related Regulations includes essentially the same types of services. [3]

There are, however, some significant differences. First, the long-term care deduction is limited to "services," whereas other deductible medical expenses are not so limited. Second, and probably most important, long-term care services include "maintenance or personal care services," a type of service not deductible by taxpayers who are not chronically ill. [4]

The "services" limitation. Limiting the deduction for long-term care to the cost of services is not quite as restrictive as it may at first sound. The Tax Court has held in other contexts that the term "services" includes the use or transfer of medical supplies as an integral part of the performance of medical services.

In *Hospital Corporation of America,* 107 TC 116 (1996), *aff'd* 92 AFTR 2d 2003-6705, 348 F3d 136 (CA-6, 2003), *cert. den.* (*HCA*), the issue involved a hospital's method of accounting for uncollectible receivables, a method that was available only for income derived from the performance of "services." [5] The IRS contended that income attributable to medical supplies was not income from services.

The Tax Court held, however, that medical supplies furnished by the hospital were so "inseparably connected" to the performance of medical services that those services necessarily included income attributable to the supplies. The court noted that hospitals do not acquire medical supplies for sale to patients. Rather, a hospital's use of medical supplies is merely incidental to its main purpose of rendering medical services. Patients go to hospitals to receive a course of treatment (i.e., medical services), not to select and purchase medical supplies.

In *Osteopathic Medical Oncology & Hematology, P.C.,* 113 TC 376 (1999), *acq. in result,* [6] the issue was whether drugs administered by a chemotherapy clinic were "merchandise" that had to be inventoried. [7] A divided Tax Court held that the chemotherapy drugs were so integral to the performance of medical services that income earned from the drugs was medical service income, and thus not income from the sale of merchandise. The court noted that the patient could not buy the drugs without accepting the medical services. The court did not find it significant that the cost of the drugs was large in relation to the amounts charged patients or that the clinic itemized the cost of the drugs on its bills. The Tax Court also distinguished a case holding that caskets sold by a funeral home were merchandise—primarily on grounds the magnificence of the caskets was as much a factor in drawing customers as the actual services provided by the funeral home. [8]

The effect of these cases may be more expansive than at first appears. The list of medical supplies dealt with by the court in *HCA* was extensive. It included casts, crutches, canes, walkers, bandages, sutures, splints, skin staples, joint replacements, pacemakers, heart valves, orthopedic devices, drugs, intravenous solutions, blood, blood derivatives, surgical instruments, sponges, surgical drapes, surgical gowns, towels, syringes, alcohol preparations, drainage tubes, irrigating tubes, tourniquets, X-ray film, chemicals, dyes, nuclear materials, insulin, oxygen, and other gases.

Although these cases characterized medical supplies from the standpoint of the service provider, the same characterization should apply from the standpoint of the patient. *HCA* analyzed the question from the perspectives of both the service provider and the patient, and *Osteopathic Medical* agreed with that analysis. Furthermore, the issue of characterization of medical supplies from the tax perspective of the patient is uncomplicated by the medical provider's need to do a proper tax accounting for receivables and inventories. Nevertheless, because the Tax Court decided these cases in different contexts, some caution is warranted in applying them to long-term care services.

The rationale of these cases should not apply to the cost of medical supplies not associated with the performance of medical services. For example, medical supplies purchased from a medical supply retailer for the taxpayer's own use should not qualify as long-term care expenses. The same may be said of purchases from a medical services provider if the medical supplies are not an integral part of the provision of services. For example, the purchase of a wheelchair from a hospital for the taxpayer's own use may not qualify as a long-term care expense, whereas the temporary use of a hospital's wheelchair while in the hospital would likely qualify.

In any event, it is important to recognize that the cost of medical supplies will likely be deductible under the Code's overall definition of medical expenses even if the supplies do not qualify as a part of long-term care services. [9] Nevertheless, the proper identification of long-term care expenses becomes very significant in determining the tax treatment of benefits received under long-term care insurance (as discussed further, below).

Maintenance or personal care services. As noted above, probably the most significant aspect of deductible long-term care services is that they include maintenance or personal care services provided to a chronically ill individual. Maintenance or personal care services are not limited merely to assistance with the "activities of daily living" (see below) that may have qualified the individual as chronically ill. Rather, services are deductible if their primary purpose is to provide needed assistance with any of the disabilities causing the chronic illness. [10] It does not matter that workers who are not healthcare professionals perform these services. [11]

Thus, deductible services include meal preparation, household cleaning, and other similar services the chronically ill individual is unable to perform. Unfortunately, a definitive determination of qualifying "similar services" awaits Regulations. It seems doubtful, however, that work such as household repairs would qualify, except perhaps for simple repairs an able-bodied occupant normally could make. [12]

Medical and nonmedical supplies. For the reasons discussed above, maintenance or personal care services should include related medical supplies furnished as an integral part of the services. [13] The more difficult question, though, is whether a taxpayer may deduct nonmedical supplies furnished as part of such services. For example, may a taxpayer deduct the cost of household supplies (i.e., detergents, cleansers, etc.) furnished and used by a cleaning service in the house of a chronically ill individual?

By analogy to the medical supply cases discussed above, it does appear a taxpayer may make a substantial argument for deduction of the household supplies. As with medical supplies, the performance of house-cleaning services by a service provider using and consuming its own supplies seems distinguishable from the business of selling household supplies. That is, the use of cleaning supplies appears to be as incidental to the cleaning process as the use of medical supplies is to the performance of medical services. Further, as with medical supplies, the taxpayer's primary interest is in obtaining the cleaning services, not in purchasing household supplies.

Nevertheless, the existence of several distinguishing factors might undermine the argument. For example, the taxpayer might be able to purchase the supplies independently of the service provider, or might be able to choose the type of supplies used. The service provider might leave surplus supplies in the patient's house for use by the taxpayer or others. The service provider's bill may separately itemize the supplies (although the court in *Osteopathic Medical* did not consider that a very important factor).

Meals in the home. The cost of meal preparation for a chronically ill individual in his or her home is clearly deductible as long-term care services. [14] A taxpayer also may argue that food ingredients provided and used by the preparer should be deductible as an integral part of the preparation services. That is, the preparer's selection and use of ingredients seems incidental to the preparation process and distinguishable from the mere sale of the ingredients. It seems the individual would be primarily interested in obtaining the preparation services, rather than the raw food ingredients. Arguably, the individual's actual ingestion of the food ingredients should be no more significant to the issue than was the injection of chemotherapy drugs in *Osteopathic Medical.*

By contrast, the IRS might assert that a chronically ill individual is as interested in the quality of the food ingredients as in their preparation. In fact, the taxpayer or the service provider could have purchased the ingredients and left them in the house for use over an extended period. In that event, the ingredients would be available to the taxpayer, and it would be much more difficult to argue that they were an integral part of the preparation service. In addition, if the service provider provides both the ingredients and the preparation (e.g., delivered meals), the Service simply might argue that the provider is not providing a service but rather is selling a product.

While a taxpayer generally may deduct medical supplies as medical expenses whether or not the tax law treats them as a part of long-term care services, as noted above, [15] a taxpayer may deduct nonmedical supplies and in-home meals *only* if the tax law treats them as long-term care services.

Meals and lodging for in-home caregivers. The Regulations, cases, and rulings long have allowed a medical deduction for a portion of the costs of meals and lodging provided to an in-home medical caregiver. Specifically, the taxpayer may deduct the amount of eligible costs proportionately allocable to medical care provided by the caregiver. [16] Although the relevant supporting authority pre-dates enactment of the medical deduction for long-term care services, now eligible meals and lodging allocable to such services also should be deductible as a medical care expense. [17]

Chronically Ill Individuals

A chronically ill individual is someone certified within the preceding 12-month period (by a physician, registered nurse, or licensed social worker) as suffering from certain mental or physical impairments. [18] For physical impairments, the professional must certify that the individual is unable to perform two "activities of daily living" for 90 days without "substantial assistance." [19] At the time of the certification, the required 90-day period may be an already elapsed period, a future period, or a continuous combination of past and future periods. [20]

Activities of daily living include eating, toileting, transferring, bathing, dressing, and continence. [21] Substantial assistance with such activities includes either hands-on physical assistance or "standby assistance." Standby assistance is assistance provided by someone within arm's reach who can prevent injury during performance of the activity (e.g., by physically catching a falling individual or dislodging food from a choking individual's throat). [22]

Alternatively, the licensed professional may certify that the individual requires "substantial supervision" to protect against threats to health and safety due to the individual's "severe cognitive impairment." [23] Severe cognitive impairment means loss of intellectual capacity due to Alzheimer's disease or similar types of irreversible dementia, as determined from clinical evidence and standard tests measuring impairments of memory, orientation, and reasoning. [24] Substantial supervision includes continual physical or verbal supervision necessary to protect the health and safety of the individual. [25]

Section 7702B(c)(2)(A)(ii) invites Treasury to issue Regulations providing a third test of chronic illness—with a level of disability similar to that of the activities-of-daily-living test. No such Regulations have yet been issued.

It is not entirely clear to what extent certification by a licensed professional may be retroactive. Section 7702B(c)(2) simply defines a chronically ill individual as someone "who has been certified," provided the certification occurred "within the preceding 12-

month period." Nevertheless, the retroactivity of the 90-day test involving activities of daily living does imply a degree of retroactivity for chronic illness status. [26] In addition, it seems highly unlikely that Congress intended to punish a taxpayer for not obtaining a timely certification during a period of incapacity and stress. It also seems likely Congress inserted the 12-month look-back requirement merely to terminate chronic illness status prospectively—contingent on a subsequent retroactive recertification.

Long-Term Care Provided by Related Parties

A taxpayer may not deduct the cost of long-term care services provided directly or indirectly to an individual by the individual's spouse or relative unless the spouse or relative is licensed to provide the service (e.g., is a registered nurse). [27] "Relative" includes a parent (or parent-in-law), a child (or the child's spouse), a grandchild, a brother (or brother-in-law), a sister (or sister-in-law), and a nephew or niece. [28] Also included are stepfathers, stepmothers, stepbrothers, and stepsisters.

The denial of deductions for long-term care services also applies to services provided by certain related corporations or partnerships. [29] Nevertheless, insurance reimbursements of the cost of long-term care services provided by related individuals or entities are not taxable. [30]

Care in Assisted Living or Dementia Facilities

Assisted living facilities generally provide living accommodations and long-term care for taxpayers who need assistance with the normal activities of daily living but who do not need full-time skilled nursing care. Alzheimer's and dementia facilities generally provide living accommodations and supervision for taxpayers who suffer from mental impairments so severe that it is unsafe to leave them alone.

Deduction of fees as medical expenses. Taxpayers normally may take medical expense deductions for all payments for care in assisted living or dementia facilities (subject to overall limitations on medical deductions). More specifically, a taxpayer may deduct the usual types of medical expenses, even if included in the facility's overall fees. [31] In addition, the taxpayer normally may deduct the cost of meals and lodging included in the fee. The Regulations provide that the cost of meals and lodging paid to an institution is deductible as medical expense if the following requirements are satisfied:

> (1) The institution is regularly engaged in providing medical care or services (including qualified long-term care). [32]
> (2) One of the principal reasons for the individual's presence in the institution is the availability of medical care (including supervisory care for an individual who is unsafe when left alone due to severe cognitive impairment). [33]
> (3) The institution furnishes meals and lodging as a necessary incident to the medical care. [34]

Assisted living and dementia facilities, and their residents, normally will satisfy these conditions. [35] Thus, in most instances, fees paid to such a facility will constitute fully deductible payments for meals, lodging, and medical expenses.

Classification of fees as cost of long-term care services. Nearly all the deductible fees paid to assisted living or dementia facilities also are likely to qualify as payments for long-term care services. Certainly, the portion of the fees paid for medical services, maintenance and personal care services, and related medical supplies should qualify. It is

the fees paid for meals and lodging that are a bit problematic. The obvious question is whether meals and lodging qualify as "services" for this purpose.

It does appear likely, however, that meals and lodging will qualify as long-term care services if (as discussed above) they otherwise would qualify as deductible medical expenses. Meals and lodging are almost as "inseparably connected" to a facility's performance of medical services as were the medical supplies in *HCA* and *Osteopathic Medical,* discussed above. In *HCA,* the Tax Court stated that patients go to a hospital or clinic *primarily* to receive medical treatment, not to obtain medical supplies. Similarly, the Regulations provide that meals and lodging provided by a facility are deductible if, as is usually the case, *a principal reason* for the patient's presence in the facility is to receive medical care. [36] The medical services (including long-term care services) are the attraction—not the meals, the lodging, or the medical supplies.

The Tax Court in *HCA* also stated that deductible medical supplies furnished in the performance of medical services are "necessary" and "incidental" to the services. Similarly, the Regulations require that deductible meals and lodging provided in a facility be a "necessary incident" of medical care received in the facility. [37] In both instances, the patient must accept the incidental meals, lodging, or medical supplies in order to obtain the desired medical services. For this purpose, meals, lodging, or medical supplies may be incidental even if they are a substantial component of the cost of the services rendered. In *Osteopathic Medical,* the Tax Court held that chemotherapy drugs were an integral part of medical services despite their very high cost.

Nevertheless, the IRS could make some arguments to the contrary. The Service could contend that *HCA* found that patients go to a hospital *primarily* for medical services (and not for medical supplies), whereas the Regulations allow the deduction of meals and lodging if medical services are merely *one of* the principal reasons the patient is there. Thus, meals and lodging might not be quite as incidental as medical supplies. That is, the quality of meals and lodging may be one of the other principal reasons the patient chose the facility. For example, in *Wilkinson-Beane, Inc.,* 25 AFTR 2d 70-418, 420 F2d 352 (CA-1, 1970), *aff'g* TC Memo 1969-79, PH TCM ¶69079 , the court held that caskets provided by a funeral home were not an integral part of the funeral services provided, primarily because the quality of the caskets "played a central role" in attracting customers.

Nevertheless, meals and lodging in an assisted living or dementia facility generally will be deductible under the overall definition of medical expenses even if they fail to qualify as long-term care services. It is in determining the tax treatment of benefits from long-term care insurance (as discussed later in this article) that the identification of the cost of long-term care services becomes much more significant.

Overall Limitations on Medical Expense Deductions

The tax law imposes overall limitations on the deduction of medical expenses, including long-term care expenses. Specifically, a taxpayer may deduct aggregate medical expenses for regular tax purposes only to the extent they exceed 7.5% of AGI, and may deduct such expenses for alternative minimum tax (AMT) purposes only to the extent they exceed 10% of AGI. [38] Thus, general tax planning techniques applicable to aggregate medical deductions (e.g., planning the timing of income and expenses and AMT planning) also may reduce the taxes of a chronically ill taxpayer.

QUALIFIED LONG-TERM CARE INSURANCE

Premiums paid for qualified long-term care insurance (QLC insurance) may be deductible as a medical expense, and benefits paid by the insurer may be nontaxable. Because of a history of consumer abuse, however, QLC insurance contracts must satisfy rigorous requirements set forth in the tax law and elsewhere.

Those requirements include mandatory contract provisions relating to renewal, nonforfeitability, cash value, loans, dividends, premium returns, and integration with Medicare. The contracts also must satisfy certain requirements of the Long-Term Care Insurance Model Act and related regulations drafted by the National Association of Insurance Commissioners (NAIC). In addition, the tax law imposes heavy penalties on issuers for prohibited conduct relating to disclosure, marketing, and reporting. [39]

A QLC insurance contract generally must limit its insurance protection to the cost of long-term care services provided to a chronically ill individual. For this purpose, the tax law generally defines long-term care services in the same way as for deduction purposes. [40] A QLC contract, however, may limit the list of qualifying "activities of daily living" to only five of the six that the Code designates for deduction purposes. [41] In addition, the contract may provide periodic payments for a chronically ill individual even though the payments do not reimburse specific long-term care costs. [42]

The tax law generally treats long-term care insurance contracts issued before 1997 as QLC insurance contracts whether or not the contracts satisfy current requirements. Any such grandfathered contract, however, must have satisfied state law requirements when issued and must not have been modified since 1996 (except as allowed by the Regulations). The tax law also grandfathers group contracts issued before 1997 whether or not the coverage of individual participants begins before or after 1996, provided the insurer has not modified the contract or a participant's certificate since 1996 (other than as permitted by Regulations). [43]

If a taxpayer is participating as an employee (or former employee) in a long-term care plan of a state, the tax law may treat the state plan the same as a QLC insurance contract—if the state plan has provisions substantially similar to QLC insurance contracts. In addition to the taxpayer, the plan may cover the taxpayer's spouse and the couple's relatives. [44]

Deduction for QLC Insurance Premiums

Premiums paid for QLC insurance generally are deductible as medical expenses. They are not deductible, however, to the extent they exceed an annual dollar limitation (in addition to the usual overall limitations on medical expense deductions). [45] The amount of the annual dollar limitation depends on the age of the insured at the end of the tax year of the premium payment, with the limitation generally increasing with each additional ten years of age. The dollar limitation also increases with the rate of inflation and thus changes from year to year. [46] For 2007, the dollar limitations for various ages, as set forth in Rev. Proc. 2006-53, 2006-48 IRB 996, are:

Age at the end of the tax year	Limitation
40 or less	$ 290
More than 40 but not more than 50	550
More than 50 but not more than 60	1,110
More than 60 but not more than 70	2,950
More than 70	3,680

If a taxpayer receives a refund on complete surrender or cancellation of a contract, the refund is taxable to the extent of the premiums previously deducted. [47]

Premiums paid by a self-employed individual. As with other medical expenses, a self-employed individual may deduct QLC premiums as business expenses (rather than itemized deductions), subject to the limitations in the above schedule. In addition, other overall limitations and restrictions applicable to the medical expense deductions of self-employed individuals generally apply to the deduction of QLC premiums. [48]

One such overall restriction provides that medical expenses of a self-employed individual are not deductible as business expenses for any month the individual is eligible to participate in a subsidized health plan of an employer of the individual or his or her spouse. The tax law applies this restriction separately for QLC insurance. That is, the restriction does not apply to QLC premiums if no employer of the taxpayer or spouse offers subsidized QLC insurance or services, whether or not an employer offers other types of health insurance. [49]

QLC insurance provided under employer plans. Premiums paid by an employer under a QLC insurance plan are generally not taxable to employees, even if paid under a health reimbursement arrangement (HRA) other than a flexible spending arrangement (FSA). [50] Similarly, purchases of QLC insurance by Archer MSAs or health savings accounts (HSAs) are nontaxable. [51] On the other hand, the cost of the insurance is includable in employee gross income if provided under a cafeteria plan or an FSA. [52]

A QLC insurance plan is unaffected by discrimination in favor of key employees. [53] Furthermore, an employer need not offer terminated employees participation in the plan (under the COBRA rules) if substantially all coverage under the plan is for long-term care services. [54]

Taxation of QLC Insurance Benefits

QLC insurance benefits that reimburse specific long-term care expenses are generally nontaxable under the usual rules applicable to reimbursement of medical expenses. [55] In addition, though, QLC insurance payments (other than dividends or premium refunds) may be nontaxable even though they do not reimburse specific long-term care expenses. [56] The Code refers to such nonreimbursement payments as "periodic payments" presumably because they are usually periodic, though they need not be. [57] An overall limitation (explained in more detail below) applies in determining the nontaxable amount of periodic payments. [58]

QLC Insurance as Part of Life or Annuity Contracts

The tax law treats as a separate contract any QLC insurance that is part of, or a rider on, a life insurance contract. [59] Thus, QLC insurance benefits under a life insurance contract

are taxable in the same way as benefits received under a separately acquired QLC insurance contract—whether or not benefit payments reduce cash value or death benefits. [60]

For tax years beginning after 2009, the Pension Protection Act of 2006 extends this same separate treatment to QLC insurance that is part of, or a rider on, an annuity contract (issued after 1996). This separate treatment will apply only to personally purchased annuity contracts, however, not to annuity contracts acquired in connection with employment. [61]

Also for tax years beginning after 2009, application of the cash value of a life insurance or annuity contract issued after 1996 to the cost of QLC insurance included in the contract generally will *not* be taxable. Instead, application of the cash value will reduce the taxpayer's investment in the life insurance or annuity contract. [62] The taxpayer will not be able to take a medical expense deduction for QLC costs covered by the reduction in cash value, however, if the contract is a life insurance contract or a personally purchased annuity contract. [63]

Tax-Free Exchanges Involving QLC Insurance Contracts

After 2009, a taxpayer may make a tax-free exchange of a life insurance, endowment, annuity, or QLC contract for a separate or different QLC contract. In addition, the tax law will allow the tax-free exchange of (1) a life insurance contract for an annuity, life insurance, or QLC contract or (2) an annuity or endowment contract for an annuity or QLC contract—even though the annuity or life insurance contracts (but not the endowment contract) include QLC insurance. [64]

Nevertheless, the exchange will be tax free only if both the old and new contracts (other than a QLC contract) are dependent in part on the life expectancy of the insured or annuitant. [65] In addition, a person insured under the old contract must continue to be an insured or annuitant under the new contract. Further, the obligees under an annuity contract given in a tax-free exchange must continue to be the obligees under any new annuity contract received in the exchange. [66]

If the exchanging taxpayer receives cash or other property in addition to the new contract, gain on the old contract is taxable to the extent of the value of the other property or cash received. [67] Gain on the exchange of an annuity contract also may be subject to the 10% penalty tax on early distributions if none of the exceptions to that penalty applies. [68] The taxpayer may not deduct any loss on the exchange. [69]

LIFE INSURANCE PAID FOR INSURED'S ILLNESS

The exclusion from gross income of life insurance proceeds is generally limited to proceeds paid on the death of the insured. [70] Nevertheless, pre-death payments by the insurer under a life insurance policy [71] may be nontaxable if the insured is chronically or terminally ill. [72] Similarly, if the taxpayer assigns the policy to a "viatical settlement provider" (VSP), pre-death payments by the provider for a chronically or terminally ill insured may be nontaxable. [73]

Under either arrangement, payments for a chronically ill insured (but not a terminally ill insured) must be for long-term care services (including periodic payments that do not reimburse specific expenses). [74] Such an arrangement for a chronically ill insured also must satisfy certain other requirements of the Code, NAIC, or state law, including

provisions relating to disclosure, marketing, renewal, nonforfeitability, and integration with Medicare. [75]

For this purpose, a VSP is an individual or entity licensed by a state to acquire interests in life insurance contracts insuring chronically ill or terminally ill individuals, or both. If a state does not license VSPs, the provider may qualify by satisfying certain provisions of the Viatical Settlements Model Act and related NAIC regulations. [76]

Life insurance payments received for a terminal illness. Pre-death benefit payments are entirely nontaxable if received under a qualifying insurance policy on the life of a *terminally ill* individual, or under a qualifying assignment of the policy to a VSP. The payments are nontaxable without regard to long-term care costs. For this purpose, a terminally ill individual is someone certified by a physician as reasonably expected to die within 24 months due to illness or physical condition. [77]

Life insurance payments received for a chronic illness. For a *chronically ill* individual, benefit payments reimbursing specific long-term care costs are nontaxable if received under a qualifying life insurance policy or under a qualifying assignment of the policy to a VSP. [78] In addition, periodic payments under either arrangement are nontaxable except to the extent the nontaxable amount of the payments is subject to an overall limitation (discussed below). [79] The tax law defines a chronically ill individual for this purpose in the same way as for the long-term care deduction, except that the term does not include a terminally ill individual.

Business-related life insurance payments. A taxpayer may not receive life insurance benefits tax-free before the death of the insured if the taxpayer's insurable interest is due to (1) the insured's status as a director, officer, or employee of the taxpayer, or (2) the insured's financial interest in the taxpayer's business. [80]

LIMITATION ON NONTAXABLE BENEFITS

An overall limitation generally applies to the nontaxable portion of periodic payments under QLC and life insurance contracts. Specifically, the limitation applies to periodic payments attributable to (1) QLC insurance contracts insuring a chronically ill (*including* a terminally ill) individual and (2) life insurance contracts insuring a chronically ill (*excluding* a terminally ill) individual. [81]

These periodic payments are includable in gross income (regardless of taxpayer investment or basis) to the extent the total of the payments exceed a per-diem amount. The per-diem amount is (1) the *greater of* (a) the insured's long-term care costs or (b) an "alternative dollar amount," *less* (2) total reimbursements for long-term care costs. [82]

The "alternative dollar amount" for a period equals (1) a daily dollar amount multiplied by (2) the number of days in the period. The daily dollar amount increases with the rate of inflation and thus changes from year to year. [83] For 2007, the daily dollar amount is $260. [84]

Long-term care costs for this purpose are generally determined in the same way as for deduction purposes. [85] Long-term care costs for limitation purposes, however, also should include the cost of any nonprescription drugs received as an integral part of medical services (even though the cost of nonprescription drugs is generally not deductible). [86]

Computation Periods and Methods

The Code does not specify the period or periods to use in computing the limitation on nontaxable periodic payments. It refers simply to "any period" used for that purpose.[87] Tax return instructions, however, indicate the IRS has rejected methods using a single period consisting of that portion of a tax year for which a taxpayer actually received periodic payments. Instead, the instructions[88] direct taxpayers to compute the taxable amount by choosing between two somewhat different methods:

(1) The "equal payment rate" method.
(2) The "contract period" method.

The equal payment rate method. The equal payment rate method combines consecutive periods for which insurers and VSPs make periodic payments at the same rate (e.g., pay the same amount each month).[89]

Example 1: A chronically ill taxpayer is the insured under a QLC insurance contract. The taxpayer is not entitled to payments under any other QLC insurance contracts or life insurance arrangements. The insurer made periodic payments to the taxpayer of $7,500 per month for the last nine months of 2006 (i.e., made periodic payments totaling $67,500 for that period). During that same period the taxpayer's actual long-term care costs were $46,000, of which various other insurers specifically reimbursed $16,000.

Under the equal payment rate method, the alternative dollar amount is $68,750 (the daily amount of $250 multiplied by the 275 days in the nine-month payment period). The per-diem amount is $52,750—an amount equal to (1) the greater of (a) the $46,000 of long-term care costs or (b) the alternative dollar amount of $68,750, less (2) the $16,000 reimbursement of long-term care costs. Thus, $14,750 of the periodic payments is taxable (i.e., total periodic payments of $67,500 less the per-diem limitation of $52,750).

If the taxpayer in Example 1 were *terminally ill,* the result would be the same even if the taxpayer were also entitled to long-term care payments from a VSP. As previously noted, payments received under a qualifying life insurance policy insuring a terminally ill individual, or under a qualifying assignment of the policy to a VSP, are entirely nontaxable.[90] Such payments do not enter into the computation of the overall limitation on nontaxable amounts.[91]

If, however, an insurer or VSP makes life insurance payments for a *chronically ill* individual, the payments are subject to the overall limitation.[92] Furthermore, if a taxpayer's insurers or VSPs make payments at different rates for different periods, the taxpayer must compute the taxable amount separately for each such period.[93]

Example 2: A taxpayer is chronically ill (but not terminally ill) and is insured under a QLC insurance contract. The taxpayer also is entitled to long-term care payments from a VSP, but is not entitled to long-term care payments under any other contracts or arrangements.

The insurer made periodic payments to the taxpayer of $2,500 per month for April through December of 2006, and the VSP made payments of $4,900 per month for July through December. Thus, the taxpayer received total periodic payments of $2,500 per month (or a total of $7,500) for the three-month period April through June, and $7,400 per month (or a total of $44,400) for the six-month period July through December.

The insured incurred long-term care costs of $15,000 for April, $4,000 per month for May through November, and $20,000 for December. Various insurers reimbursed the taxpayer $11,000 for long-term care costs incurred for April and $12,000 of such costs for December.

Computation for the three-month period. Under the equal payment rate method, the alternative dollar amount for the three-month period is $22,750 (the daily amount of $250 multiplied by the 91 days in the three-month period). The per-diem limitation, then, is $12,000 for the three-month period. Specifically, it is (1) the greater of (a) the $23,000 cost of long-term care for April through June or (b) the alternative dollar amount of $22,750, *less* (2) the $11,000 reimbursement of long-term care costs for April. Thus, none of the periodic payments for the three-month period is taxable (i.e., total periodic payments of $7,500 are less than the per-diem limitation of $12,000).

Computation for the six-month period. The alternative dollar amount for the six-month period is $46,000 (an amount equal to the daily amount of $250 multiplied by the 184 days in the six-month period). The per-diem limitation, then, is $34,000 for the six-month period. It is (1) the greater of (a) the $40,000 cost of long-term care for June through December or (b) the alternative dollar amount of $46,000, *less* (2) the $12,000 reimbursement of long-term care costs for December. Thus, $10,400 of the periodic payments for the six-month period is taxable (i.e., total periodic payments of $44,400 less the per-diem limitation of $34,000).

The contract period method. Under the contract period method, the taxpayer computes the taxable portion of periodic payments separately for each period (day, month, quarter, etc.) the insurer or VSP uses to compute benefits. [94]

Example 3: The facts are the same as in Example 2 above, except that the taxpayer uses the contract period method rather than the equal payment rate method. Because the insurer and VSP both determined contract benefits on a monthly basis, the taxpayer must make the computation separately for each month. [95] Exhibit 1 shows the computation and compares the result with the taxable amount determined in Example 2 under the equal payment rate method. On these facts, none of the periodic payments would be taxable under the contract period method, whereas $10,400 of the payments would have been taxable under the equal payment rate method.

Exhibit 1. More Favorable Result Under the Contract Period Method

	Contract period method				
	Apr	May	Jun	Jul	Aug
Long-term care costs	15,000	4,000	4,000	4,000	4,000
Alternative dollar amount	7,500	7,750	7,500	7,750	7,750
Larger of the two	15,000	7,750	7,500	7,750	7,750
Less reimbursements	(11,000)	--	--	--	--
Per-diem amount	4,000	7,750	7,500	7,750	7,750
Periodic payments	2,500	2,500	2,500	7,400	7,400
Less per diem amount	(4,000)	(7,750)	(7,500)	(7,750)	(7,750)
Taxable amount	--	--	--	--	--

	Contract period method (concl'd)			
	Sep	Oct	Nov	Dec
Long-term care costs	4,000	4,000	4,000	20,000
Alternative dollar amount	7,500	7,750	7,500	7,750
Larger of the two	7,500	7,750	7,500	20,000
Less reimbursements	--	--	--	(12,000)
Per-diem amount	7,500	7,750	7,500	8,000
Periodic payments	7,400	7,400	7,400	7,400
Less per diem amount	(7,500)	(7,750)	(7,500)	(8,000)
Taxable amount	--	--	--	--

	Equal payment rate method	
	Apr-Jun	Jul-Dec
Long-term care costs	23,000	40,000
Alternative dollar amount	22,750	46,000
Larger of the two	23,000	46,000
Less reimbursements	(11,000)	(12,000)
Per-diem amount	12,000	34,000
Periodic payments	7,500	44,400
Less per diem amount	(12,000)	(34,000)
Taxable amount	--	10,400

Under other circumstances, however, the contract period method may yield less favorable results.

Example 4: The facts are the same as in Example 3 (and Exhibit 1) except for the following. For July, long-term care costs were $14,000 with a $10,000 reimbursement. For December, long-term care costs were $25,000 without reimbursement. Exhibit 2 shows that none of the periodic payments is taxable under the equal payment rate method, whereas $3,400 would be taxable under the contract period method.

Exhibit 2. More Favorable Result Under the Equal Payment Rate Method

	Contract period method				
	Apr	May	Jun	Jul	Aug
Long-term care costs	15,000	4,000	4,000	14,000	4,000
Alternative dollar amount	7,500	7,750	7,500	7,750	7,750
Larger of the two	15,000	7,750	7,500	14,000	7,750
Less reimbursements	(11,000)	--	--	(10,000)	--
Per-diem amount	4,000	7,750	7,500	4,000	7,750
Periodic payments	2,500	2,500	2,500	7,400	7,400
Less per diem amount	(4,000)	(7,750)	(7,500)	(4,000)	(7,750)
Taxable amount	--	--	--	3,400	--

	Contract period method (concl'd)			
	Sep	Oct	Nov	Dec
Long-term care costs	4,000	4,000	4,000	25,000
Alternative dollar amount	7,500	7,750	7,500	7,750
Larger of the two	7,500	7,750	7,500	25,000
Less reimbursements	--	--	--	--
Per-diem amount	7,500	7,750	7,500	25,000
Periodic payments	7,400	7,400	7,400	7,400
Less per diem amount	(7,500)	(7,750)	(7,500)	(25,000)
Taxable amount	--	--	--	--

	Equal payment rate method	
	Apr-Jun	Jul-Dec
Long-term care costs	23,000	55,000
Alternative dollar amount	22,750	46,000
Larger of the two	23,000	55,000
Less reimbursements	(11,000)	(10,000)
Per-diem amount	12,000	45,000
Periodic payments	7,500	44,400
Less per diem amount	(12,000)	(45,000)
Taxable amount	--	--

Undue Sensitivity of the Designated Methods

Unfortunately, the taxable portion of periodic payments under the two designated methods is disproportionately sensitive to minor changes in the amounts of the payments. For example, assume the amount of the periodic payments in Exhibit 2 increases a mere $100 (to $7,500) for each of the months October through December. Under the equal payment rate method, the June through December period is broken into two new periods, (1) July through September and (2) October through December. Exhibit 3 shows the disproportionate effect of this minor change on the taxable amount of the periodic payments.

Exhibit 3. Significant Tax Increase Due to Minor Change in Periodic Payments

	Contract period method				
	Apr	May	Jun	Jul	Aug
Long-term care costs	15,000	4,000	4,000	14,000	4,000
Alternative dollar amount	7,500	7,750	7,500	7,750	7,750
Larger of the two	15,000	7,750	7,500	14,000	7,750
Less reimbursements	(11,000)	--	--	10,000)	--
Per-diem amount	4,000	7,750	7,500	4,000	7,750
Periodic payments	2,500	2,500	2,500	7,400	7,400
Less per diem amount	(4,000)	(7,750)	(7,500)	(4,000)	(7,750)
Taxable amount	--	--	--	3,400	--

	Contract period method (concl'd)			
	Sep	Oct	Nov	Dec
Long-term care costs	4,000	4,000	4,000	25,000
Alternative dollar amount	7,500	7,750	7,500	7,750
Larger of the two	7,500	7,750	7,500	25,000
Less reimbursements	--	--	--	--
Per-diem amount	7,500	7,750	7,500	25,000
Periodic payments	7,400	7,500	7,500	7,500
Less per diem amount	(7,500)	(7,750)	(7,500)	(25,000)
Taxable amount	--	--	--	--

	Equal payment rate method		
	Apr-Jun	Jul-Sep	Oct-Dec
Long-term care costs	23,000	22,000	33,000
Alternative dollar amount	22,750	23,000	23,000
Larger of the two	23,000	23,000	33,000
Less reimbursements	(11,000)	(10,000)	--
Per-diem amount	12,000	13,000	33,000
Periodic payments	7,500	22,200	22,500
Less per diem amount	(12,000)	(13,000)	(33,000)
Taxable amount	--	9,200	--

Because of a mere $100 per month increase in the periodic payment, the taxable amount under the equal payment rate method increased from zero in Exhibit 2 to $9,200 in Exhibit 3. Thus, the lowest taxable amount under the two methods increased from zero in Exhibit 2 to $3,400 in Exhibit 3.

Results under the designated computation methods are also highly sensitive to the *timing* of medical treatment. For example, assume that, in Exhibit 3, the insured undergoes major medical treatment in September rather than in December and, consequently, incurs $21,000 of unreimbursed long-term care costs in September rather than December. Exhibit 4 shows the substantial effect this timing shift has on the taxable amount of the periodic payments.

Exhibit 4. Significant Tax Decrease Due to Shift in Timing of Major Medical Treatment

	Contract period method				
	Apr	May	Jun	Jul	Aug
Long-term care costs	15,000	4,000	4,000	14,000	4,000
Alternative dollar amount	7,500	7,750	7,500	7,750	7,750
Larger of the two	15,000	7,750	7,500	14,000	7,750
Less reimbursements	(11,000)	--	--	10,000)	--
Per-diem amount	4,000	7,750	7,500	4,000	7,750
Periodic payments	2,500	2,500	2,500	7,400	7,400
Less per diem amount	(4,000)	(7,750)	(7,500)	(4,000)	(7,750)
Taxable amount	--	--	--	3,400	--

	Contract period method (concl'd)			
	Sep	Oct	Nov	Dec
Long-term care costs	25,000	4,000	4,000	4,000
Alternative dollar amount	7,500	7,750	7,500	7,750
Larger of the two	25,000	7,750	7,500	7,750
Less reimbursements	--	--	--	--
Per-diem amount	25,000	7,750	7,500	7,750
Periodic payments	7,400	7,500	7,500	7,500
Less per diem amount	(25,000)	(7,750)	(7,500)	(7,750)
Taxable amount	--	--	--	--

	Equal payment rate method		
	Apr-Jun	Jul-Sep	Oct-Dec
Long-term care costs	23,000	43,000	12,000
Alternative dollar amount	22,750	23,000	23,000
Larger of the two	23,000	43,000	23,000
Less reimbursements	(11,000)	(10,000)	--
Per-diem amount	12,000	33,000	23,000
Periodic payments	7,500	22,200	22,500
Less per diem amount	(12,000)	(33,000)	(23,000)
Taxable amount	--	--	--

Because of just a shift of medical treatment from December to September, the taxable amount of periodic payments under the equal payment rate method decreased from $9,200 in Exhibit 3 to zero in Exhibit 4. Thus, the zero taxable amount under the equal payment rate method provides the more favorable result.

Comparison of the two methods. As Exhibits 1-4 illustrate, it is advisable to run computations under each of the available methods. There are simply too many variables to predict which method will produce the lowest taxable amount.

Computations under the contract period method are undeniably harder to do. In fact, under that method, the taxpayer is required to compute the taxable amount on a daily basis if he or she has more than one insurer or VSP and they do not all use the same period to compute benefits.[96] Compare such daily computations for 365 days with the relatively simpler monthly computations in the exhibits—for daily computations, a computer spreadsheet is obviously a welcome tool.

The Service's designation of methods. It is peculiar that the IRS chose to make available computational methods using periods that are so very sensitive to minor variations in the amounts or the timing of expenses and benefits. As previously noted, the Code merely provides that the taxpayer make the computation for "any period."[97] Nevertheless, both of the computational methods allowed by the Service require a constant rate of payment over the computation period. It appears, then, that the IRS has gratuitously interpreted the statutory phrase "any period" as if it read "any period during which the rate of payment is unchanged."

Based on the actual statutory language, the Service could have instead mandated computation of the taxable amount for any period for which the taxpayer received benefits, without regard to varying rates of payment during the period. Such a method would in effect average the elements of the computation over a single computational period and eliminate existing computational anomalies. It also would considerably simplify the computation and eliminate much of the incentive for manipulation of payments.

The IRS still could easily adopt such a "simplified" method since it has specified the existing methods only in tax return instructions[98] and not by Regulation, Revenue Ruling, Notice, or other pronouncement. In so doing, however, the Service would in effect allow a taxpayer to apply (1) exclusion amounts in excess of periodic payments for some days against (2) periodic payments that exceed the exclusion for other days. This is a result the IRS might not like, although there does not appear to be any language in the statute that would prevent it.

Multiple recipients of periodic payments. If more than one person (e.g., the insured and several of his or her children) are receiving periodic payments as owners of contracts, the owners must first make the computation as if they were all a single person.[99] They may then allocate the computed per-diem limitation to the insured to the extent of the insured's periodic payments, and then to the other owners in proportion to their respective payments.[100]

COMPARISON WITH NONQUALIFIED INSURANCE

To put the tax benefits and detriments of QLC insurance in perspective, it will be helpful to examine the tax treatment of nonqualifying long-term care (NLC) insurance. In this connection, an NLC insurance contract paying benefits for personal injuries or sickness normally will qualify as accident or health insurance (A&H insurance).[101]

Generally, premiums paid by a taxpayer for A&H insurance are deductible as a medical expense only to the extent of the insurer's reasonable estimate of the portion allocable to future medical expense reimbursements. [102] Consequently, such premiums are not deductible to the extent allocable to periodic or other NLC insurance benefits that do not reimburse specific medical expenses (i.e., that are tantamount to ordinary disability benefits). If, however, the taxpayer's employer pays the premiums, they generally are excludable in their entirety from the taxpayer's gross income. [103]

A&H insurance benefits (including NLC insurance benefits) received for personal injuries or sickness are entirely excludable from gross income if the taxpayer paid all the insurance premiums. [104] Such benefit payments are includable, however, to the extent attributable to employer premium payments that were not includable in employee gross income—unless the benefit payments reimburse amounts otherwise deductible as medical expenses. [105] That is, periodic or other NLC insurance benefits that do not reimburse specific medical expenses (e.g., disability benefits) are includable in gross income if the employer paid all the premiums (without including the premiums in employee gross income).

Exhibit 5 compares the tax treatment of premiums and benefits for NLC insurance and QLC insurance when the taxpayer pays all the premiums (or when all premium payments by the taxpayer's employer are included in the taxpayer's gross income). If the taxpayer pays all the premiums for long-term care insurance, the more favorable tax treatment of QLC insurance is clear whenever premiums do not exceed the dollar limitation and benefits do not exceed the per-diem benefits limitation. In that event, both QLC benefits and NLC benefits are entirely nontaxable, but QLC premiums—unlike NLC premiums—are entirely deductible. Of course, if QLC premiums exceed the deductible dollar limit or QLC benefits exceed the nontaxable per-diem limitation, the tax treatment of QLC insurance becomes relatively less favorable. More broadly stated, the larger the nondeductible excess for QLC premiums or the taxable excess for QLC benefits (or both), the less favorable QLC insurance becomes relative to NLC insurance.

Exhibit 5. NLC vs. QLC Insurance: Taxpayer Pays Premiums

	NLC insurance	QLC insurance
Tax treatment of premiums	Premiums reasonably allocable by the insurer to reimbursement of medical expenses are deductible. Premiums for periodic benefit payments and other nonreimbursement or nonmedical benefits are not deductible.	Premiums are deductible to the extent they do not exceed a dollar amount based on the taxpayer's age.
Tax treatment of benefits	Benefits paid for injuries or sickness are nontaxable.	Benefits are nontaxable to the extent they do not exceed a per-diem limitation. The excess is taxable.

Exhibit 6 compares the tax treatment of premiums and benefits for NLC insurance and QLC insurance if an employer pays all the premiums, and the premium payments are not included in the gross income of the taxpayer. The more favorable tax treatment of QLC insurance is clear if an employer pays all the premiums for long-term care insurance and benefits do not exceed the per-diem limitation. In that event, both QLC premiums and NLC premiums are excludable from the taxpayer's gross income, but QLC benefits—unlike NLC benefits—are entirely nontaxable. Of course, if QLC benefits exceed the nontaxable per-diem limitation, the tax treatment of QLC insurance becomes relatively less favorable. That is, the larger the taxable excess for QLC benefits, the less favorable QLC insurance becomes relative to NLC insurance.

Exhibit 6. NLC vs. QLC Insurance: Employer Pays Premiums

	NLC insurance	QLC insurance
Tax treatment of premiums	Premiums paid by the employer are excluded from the taxpayer's gross income.	Premiums paid by the employer are excluded from the taxpayer's gross income.
Tax treatment of benefits	Benefit payments reimbursing otherwise deductible medical expenses are nontaxable. Periodic benefit payments and other nonreimbursement or nonmedical benefits are includable in gross income.	Benefits are nontaxable to the extent they do not exceed a per-diem limitation. The excess is taxable.

RECONCILIATION OF A&H AND QLC PROVISIONS

The Code treats a QLC insurance contract as an A&H contract.[106] A taxpayer with an A&H contract generally may exclude from gross income *all* benefit payments under the contract for personal injury or sickness whether or not the payments are periodic—if the payments are not attributable to contributions by an employer.[107] Even if the benefits are attributable to employer contributions, they are excludable from gross income if they constitute reimbursement for otherwise deductible medical expenses.[108]

Consequently, if an employer pays all the premiums under an A&H contract, the employee generally must include in gross income those benefit payments not reimbursing specific medical expenses.[109] Congress finessed this problem for QLC contracts by artificially classifying periodic payments under such contracts as excludable reimbursements for medical expenses.[110] Thus, the provisions governing A&H contracts and QLC contracts are, for the most part, logically consistent.

It is true periodic payments under QLC contracts, unlike payments under other A&H contracts, are subject to the overall per-diem limitation discussed above.[111] Nevertheless, this different treatment of QLC contracts is easy to reconcile with the A&H provisions—if an employer has paid all the premiums for the insurance. In that event, Congress merely used the overall limitation to take back some of the tax benefit it conferred by artificially classifying periodic payments under QLC contracts as excludable reimbursement for medical expenses.

The different treatment is a bit more problematic if an employer does not pay the QLC premiums (i.e., if the taxpayer pays them). In that situation, the taxpayer might argue that the overall QLC limitation should not override the long-standing statutory provision excluding from gross income all payments under an A&H contract that are not attributable to employer contributions. [112] The Code nowhere expressly provides (by cross reference or otherwise) that the overall QLC limitation trumps the A&H exclusion rules when the taxpayer pays all the premiums. [113]

It is, however, unlikely such an argument would prevail. The Service believes, [114] and the evidence indicates, that Congress intended the overall limitation to apply to all QLC periodic benefit payments regardless of who paid the premiums. First, Congress imposed the overall QLC limitation in Section 7702B as part of HIPAA in 1996, legislation more recent and specific than the A&H statutory provisions. Second, in explaining the overall QLC limitation, the legislative history does not make distinctions between QLC contracts depending on whether or not an employer paid the premiums. [115]

CONCLUSION

The elderly and their families have good reason to be concerned about chronic illness and the costs of long-term care. Long-term care costs can be very large. Fortunately, though, favorable tax treatment helps alleviate some of the financial burden.

Practice Notes

- A taxpayer may generally deduct the unreimbursed cost of certain long-term care services prescribed for a chronically ill individual. Long-term care services include "maintenance or personal care services," a type of service not deductible by taxpayers who are not chronically ill.
- A taxpayer may be able to argue successfully that supplies and meal ingredients furnished by a service provider are deductible as part of long-term care services. A taxpayer also may make substantial arguments that otherwise deductible meals and lodging provided in an assisted living or dementia facility also qualify as part of long-term care services.
- Premiums paid for QLC insurance generally are deductible as medical expenses, but are deductible only to the extent they do not exceed an annual dollar limitation (in addition to the usual overall limitations on medical expense deductions). A self-employed individual generally may deduct QLC premiums as business expenses rather than itemized deductions—subject, however, to the same annual dollar limitation applicable to other taxpayers. By contrast, the cost of QLC insurance paid by an employer is generally entirely excludable from the employees' gross incomes.

[1] Sections 213(d)(1)(C) and 7702B(c)(1).

[2] Section 7702B(c)(1).

[3] Section 213(d)(1)(A); Regs. 1.213-1(e)(1)(i) and (ii).

[4] Sections 213(d) and 7702B(c)(1).

[5]

See Section 448(d)(5). See also, generally, Seago, "More Choices Than Ever Are Now Available Under the Nonaccrual Experience Method," page 207, this issue.

[6]

In acquiescing, the Service stated that in some cases it might treat chemotherapy drugs as deferred expenses that are deductible by the medical provider only in the year used. AOD 2000-05; Reg. 1.162-3. This factor, though, does not appear to affect the classification of the use of the drugs as a part of services rendered. See also Mid-Del Therapeutic Center, Inc., TC Memo 2000-130, RIA TC Memo ¶2000-130 (following the Osteopathic Medical decision on virtually identical facts). See also, generally, Devitt, "Accrual vs. Cash Accounting for Health-Care Providers: The Tax Court Fashions a New Test," 92 JTAX 79 (February 2000).

[7]

See Reg. 1.471-1.

[8]

Wilkinson-Beane, Inc., 25 AFTR 2d 70-418, 420 F2d 352 (CA-1, 1970), *aff'g* TC Memo 1969-79, PH TCM ¶69079 .

[9]

Rev. Rul. 2003-58, 2003-1 CB 959. See generally Megaard, "Recent Rulings Expand Definition of Medical Care but Tax Benefits May Remain Limited for Many," 99 JTAX 38 (July 2003).

[10]

Section 7702B(c)(3).

[11]

Estate of Marantz, TC Memo 1979-463, PH TCM ¶79463 ; Rev. Rul. 75-317, 1975-2 CB 57. But see the text accompanying notes 27-30 for restrictions on deductibility of services provided by unlicensed relatives.

[12]

Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96, 12/18/96) ("HIPAA Blue Book"), page 335 ("Treatment of Long-Term Care Insurance and Services").

[13]

See the text accompanying notes 5 through 9, *supra.*

[14]

See the HIPAA Blue Book, *supra* note 12. For more on the HIPAA changes, see generally Christopher, "New Law Provides Ways to Reduce Tax Burdens Relating to Long-Term Care Expenses," 86 JTAX 20 (January 1997).

[15]

See note 9, *supra.*

[16]

Reg. 1.213-1(e)(1)(ii); Estate of Marantz, *supra* note 11. Costs of lodging for a caregiver are not eligible for deduction unless they are out-of-pocket expenditures over and above normal household expenditures—for example, additional utility expense attributable to the caregiver or additional rent paid after moving to an apartment with an additional bedroom for the caregiver. See Rev. Rul. 76-106, 1976-1 CB 71.

[17]

In 1996, HIPAA amended Section 213(d)(1)(C) to clearly provide that "[t]he term 'medical care' means amounts paid ... for qualified long-term care services...."

[18]

Section 7702B(c)(2)(A).

[19]

Section 7702B(c)(2)(A)(i).

[20]

Notice 97-31, 1997-1 CB 417. See also H. Rep't No. 104-736, 104th Cong., 2d Sess. 16 (1996) ("HIPAA Conference Report"); HIPAA Blue Book, *supra* note 12.

[21]

Section 7702B(c)(2)(B).

[22] Notice 97-31, *supra* note 20. This Notice also allows certain long-term care insurers to continue to use their own pre-1997 standards for determining substantial assistance under post-1996 contracts.

[23] Section 7702B(c)(2)(A)(iii).

[24] See note 20, *supra.*

[25] See note 22, *supra.*

[26] See note 20, *supra.*

[27] Section 213(d)(11)(A).

[28] Sections 152(d)(2)(A) through (G).

[29] Section 213(d)(11)(B).

[30] Section 213(d)(11) (flush language).

[31] Section 213(d).

[32] Reg. 1.213-1(e)(1). This Regulation was last amended in 1979, well before the 1996 enactment of a medical deduction for qualified long-term care services; see note 17, *supra.* Thus, the fact that the Regulation does not include qualified long-term care services in its definition of medical care should not matter.

[33] *Id.*; Sections 213(d)(1)(C) and 7702B(c)(2)(A)(iii).

[34] Reg. 1.213-1(e)(1)(v)(*a*).

[35] See Counts, 42 TC 755 (1964), *acq.* (deductions allowed for medical care, meals, and lodging in a nursing home for the elderly). In fact, the IRS and the courts have occasionally strained to find the regulatory requirements satisfied for care in some surprising types of "institutions." See Kelly, 27 AFTR 2d 71-912, 440 F2d 307 (CA-7, 1971) (post-operative care provided in a hotel room in lieu of a hospital); Ungar, TC Memo 1963-159, PH TCM ¶63159 (care in a medically equipped apartment for an elderly woman recuperating from a brain hemorrhage); Rev. Rul. 69-499, 1969-2 CB 39 (care of a retarded person in the home of an unrelated family).

[36] See note 34, *supra.*

[37] *Id.*

[38] Sections 213(a) and 56(b)(1)(B).

[39] Sections 7702B(b) and (g); Reg. 1.7702B-1.

[40] Sections 7702B(b)(1)(A) and 7702B(c).

[41] Section 7702B(c)(2)(B).

[42] Section 7702B(b)(2)(A).

[43]

HIPAA section 321(f)(2); Reg. 1.7702B-2.

[44] Section 7702B(f).

[45] Sections 213(a), (d)(1)(D), and (d)(10).

[46] Section 213(d)(10).

[47] Section 7702B(b)(2)(C).

[48] Section 162(l).

[49] Section 162(l)(2)(B).

[50] Sections 106(a) and 7702B(a)(3); Notice 2002-45, 2002-2 CB 93; Rev. Rul. 2005-24, 2005-16 IRB 892; Rev. Rul. 2006-36, 2006-36 IRB 353.

[51] Sections 220(d)(2)(B)(ii)(II) and (f)(1); Sections 223(d)(2)(C)(ii) and (f)(1). See generally Baum, "Congress Makes Health Savings Accounts More Attractive to Employers, Employees," 106 JTAX 159 (March 2007), and Baum, "IRS Issues Guidance on New HSA Transfer Rules," page 246, this issue.

[52] Sections 106(c)(1) and 125(f); HIPAA Conference Report, *supra* note 20; HIPAA Blue Book, *supra* note 20.

[53] The antidiscrimination provisions of Section 105(h) apply only to self-insured employer plans, not to insured plans.

[54] Section 4980B(g)(2).

[55] Sections 7702B(a)(1) and (2); Section 105(b).

[56] Sections 7702B(a)(2) and (d)(6).

[57] Nonreimbursement payments do not include policy dividends or premium returns; see Section 7702B(a)(2).

[58] Section 7702B(d).

[59] Section 7702B(e)(1).

[60] Pension Protection Act of 2006 (P.L. 109-280, 8/17/06), section 844(f); Staff of the Joint Committee on Taxation, *Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006* (JCX-38-06).

[61] Section 7702B(e), as amended by PPA sections 844(c) and (g)(1).

[62] Section 72(e)(11), added by PPA sections 844(a) and (g)(1).

[63] Section 7702B(e)(2), as amended by PPA sections 844(c) and (g)(1).

[64] Section 1035, as amended by PPA sections 844(b) and (g)(2).

[65] Section 1035(b).

[66]

Section 1035(a)(3); Reg. 1.1035-1; Rev. Rul. 2003-76, 2003-2 CB 355.
67

Section 1031(b).
68

Sections 72(q) and (t).
69

Section 1031(c).
70

Section 101(a)(1).
71

The tax law generally treats a contract as a life insurance contract if it so qualifies under state or foreign law and if, in addition, it satisfies the somewhat complex requirements of Section 7702. See the HIPAA Blue Book, *supra* note 12, page 345 ("Treatment of Accelerated Death Benefits Under Life Insurance Contracts").
72

Section 101(g).
73

Section 101(g)(2)(A).
74

Sections 101(g)(3)(A) and (C).
75

Section 101(g)(3).
76

Section 101(g)(2)(B). If a state has enacted a VSP licensing statute, the Code does not allow a provider to qualify under the NAIC Model Act or regulations. In that situation, the VSP must obtain its license from the state, either temporarily or permanently. Rev. Rul. 2002-82, 2002-2 CB 978.
77

Sections 101(g)(2)(B) and (g)(4)(A).
78

Sections 101(g)(3)(A)(i), (g)(4)(C), and 7702B(c).
79

Section 101(g)(3)(C).
80

Section 101(g)(5).
81

Section 7702B(d)(1).
82

Sections 7702B(d)(1) and (2). Item (2) may not apply in part to certain pre-8/1/96 contracts; HIPAA section 321(f)(5) contains a grandfather clause limiting the reduction for unmodified pre-8/1/96 long-term care contracts to reimbursements under post-7/31/96 contracts.
83

Sections 7702B(d)(4) and (5).
84

Rev. Proc. 2006-53, 2006-48 IRB 996.
85

Section 7702B(c)(1).
86

Nonprescription drugs fall within the Code's definition of medical expenses even though the Code expressly denies a deduction for them; see Sections 213(b) and (d). Since the drugs do qualify as medical expenses, however, insurance reimbursements for them are nontaxable; see Sections 104(a)(3) and 105(b). Thus, nonprescription drugs may qualify as long-term care costs for QLC insurance purposes. Rev. Rul. 2003-58, *supra* note 9; Rev. Rul. 2003-102, 2003-2 CB 559.
87

Sections 7702B(d)(1) and (2).
[88]

Instructions for IRS Form 8853 (2005).
[89]

Id.
[90]

Section 7702B(d)(1).
[91]

Sections 101(g)(2)(B) and (4)(A).
[92]

Id.
[93]

See note 88, *supra.*
[94]

Id.
[95]

Id.
[96]

Id.
[97]

Section 7702B(d)(1)(A).
[98]

See note 88, *supra.*
[99]

Section 7702B(d)(3)(A).
[100]

Section 7702B(d)(3)(B).
[101]

Section 104(a)(3).
[102]

Section 213(d)(6).
[103]

Section 106(a).
[104]

Sections 104(a)(3) and 105(a).
[105]

Sections 104(a)(3), 105(a), and 105(e); Reg. 1.105-1(b).
[106]

Sections 7702B(a)(1) and (a)(3).
[107]

Section 104(a)(3).
[108]

Sections 105(b) and 7702B(a)(3).
[109]

Section 105(a).
[110]

Section 7702B(a)(2).
[111]

See note 81, *supra,* and the accompanying text.
[112]

Section 104(a)(3).
[113]

Compare Section 101(g)(3)(D), which expressly acknowledges that life insurance payments and assignments for a chronically ill individual are subject to the overall QLC limitation.
[114]

See note 88, *supra.*

115 HIPAA Conference Report, *supra* note 20; HIPAA Blue Book, *supra* note 12.