



Genworth®  
Financial



## 2011 TAX INFORMATION

*If you have questions,  
call the Genworth Advanced  
Marketing team at  
800 532.9116 or e-mail us at  
advanced.marketing@genworth.com*

### **TAX-QUALIFIED LONG TERM CARE INSURANCE**

Long Term Care Insurance underwritten by  
Genworth Life Insurance Company, and in New York, by  
Genworth Life Insurance Company of New York.

Administrative Offices: Richmond, Virginia.



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**Insurance and annuity products:**

- **Are not** deposits.
- **Are not** insured by the FDIC or any other federal government agency.
- **May** decrease in value.
- **Are not** guaranteed by the bank or its affiliates.

## GENERAL

Unless otherwise stated, any discussion in this guide relating to the tax treatment of tax-qualified long term care insurance (LTCI) premiums addresses only traditional LTCI, not linked benefit products such as life insurance policies and annuities that have tax-qualified LTCI riders.

### Tax-Qualified LTCI

For tax purposes, “tax-qualified” LTCI is generally treated as accident and health insurance. (IRC §7702B). Premiums paid for tax-qualified LTCI and benefit payments from such insurance for long term care expenses may be afforded certain favorable income tax treatment under the tax code and regulations.

In general, the term “tax-qualified LTCI” means any insurance if:

- the only insurance protection provided is coverage of tax-qualified long-term care services;
- such insurance does not pay or reimburse expenses incurred for services or items to the extent that such expenses are reimbursable under Medicare or would be reimbursable if there was not a deductible or coinsurance amount;
- such insurance is guaranteed renewable;
- such insurance does not provide for a cash surrender value or other money that can be paid, assigned, or pledged as collateral for a loan, or borrowed;
- all refunds of premiums, and all dividends or similar amounts under such insurance are to be applied as a reduction in future premiums or to increase future benefits; and,
- such insurance meets certain specified consumer protection requirements.

### Eligible Premiums

Only “eligible” LTCI premiums are considered a deductible medical expense (Internal Revenue Code (IRC) §213(d)). Eligible LTCI premiums are the lesser of the actual premiums paid and the age-based limit premiums shown below. Premiums exceeding that limit are not a deductible medical expense (IRC §213(d)). The age-based limits are adjusted annually for inflation.

### AGE-BASED LONG TERM CARE INSURANCE PREMIUMS

Age at End of Taxable Year	Premium Limit 2010 Amount	Premium Limit 2011 Amount
40 or less	\$330	\$340
41 through 50	\$620	\$640
51 through 60	\$1,230	\$1,270
61 through 70	\$3,290	\$3,390
71 and older	\$4,110	\$4,240

## GENERAL (CONT.)

### Return of Premiums

Although tax-qualified LTCI must generally use any refunds or dividends to reduce future premiums, there are two exceptions: Premium refunds paid on the insured's death; and premium refunds paid on surrender or cancellation.

- The Code is silent as to whether premium refunds paid on the insured's death are generally not taxable income to his or her estate or beneficiary (IRC §7702B(b)(2)(C).
- Premium refunds paid on a complete surrender or cancellation of the insurance must be included in the taxpayer's gross income to the extent that the taxpayer was allowed a deduction or exclusion for the premium payments (IRC §7702B(b)(2)(C).

This is federal law. Customers should seek advice from their tax advisor regarding any potential state tax liability associated with an LTCI premium refund where the taxpayer has received a deduction or credit under state law.

### Jointly Owned LTCI

A couple may jointly own shared benefit LTCI which insures their joint lives, with the premiums undivided. The question is how to determine which portion of the undivided premium should be attributed to each insured for deductibility purposes? While the IRS has not provided clear guidance on this issue, we see two possible options that might be used (However, customers will need to seek independent tax advice on this question):

John and Mary are ages 71 and 61 respectively. They are married, file jointly and itemize on their tax return. They jointly own and are the joint insureds with shared benefit Genworth Life Insurance Company LTCI purchased in 2008 with an undivided annual premium of \$8,000.

**Option One** Under this approach, the premium is divided equally. Since the premium would be divided equally, \$4,000 would be attributed to each spouse. Remember that the eligible premium for deductibility purposes is the lesser of actual premium paid for the insured or his/her age-based limit. John's age-based limit amount for 2011 is \$4,240, so his eligible premium for deductibility will be the \$4,000 attributed to his half of the insurance premium. Mary's age-based limit amount for 2011 is \$3,390, so her eligible premium for deductibility will be \$3,390. They would deduct \$7,390 (\$4,000 + \$3,390) as a medical expense to the extent that this expense when added to all other unreimbursed medical expenses exceed 7.5% of their combined AGI.

- This "split" approach also makes sense when considering a situation where a business wants to pay 100% of the LTCI premium for an employee, but none of the premium for that employee's spouse, and the couple owns LTCI coverage with a shared benefit and an undivided premium. Allocating half of the premium to the employee would seem a logical approach.

## GENERAL (CONT.)



**Option Two** Another possible approach is for them to treat as the eligible premium amount the lesser of the full premium paid (with no dividing of the premium) or their combined age-based limit amounts. For 2011, their combined aged-based limit amounts would be \$7,630 (\$4,240 + \$3,390), and their full actual premium paid would be \$8,000. They would deduct \$7,630 as a medical expense to the extent that this expense when added to all other unreimbursed medical expenses exceed 7.5% of their combined AGI.

### Tax treatment for same sex couples

A number of states have passed laws legalizing and/or recognizing same sex marriages. However, federal income tax law does not recognize the validity of those marriages. The federal Defense of Marriage Act, which became law in 1993, restricts the definition of marriage to a union between a man and a woman. Since the Internal Revenue Code is federal law, the term “spouse” in the Internal Revenue Code does not include a same sex spouse, even if the individuals are legally married according to the laws of their state.

As a result, if an employer pays the premiums for LTCI on an employee’s spouse, and if the employee and spouse are of the same sex, the premiums paid for the spouse’s coverage are generally not deductible to the employer or tax-free to the employee. This rule does not affect the deductibility of premiums paid for the employee’s LTCI: they will remain tax deductible to the employer and tax-free to the employee.

However, it may still be possible to obtain favorable federal income tax treatment if the same sex spouse is a dependent of the employee for federal income tax purposes. Taxpayers are allowed to claim “qualifying relatives” as dependents. The IRC defines a qualifying relative as an individual who depends on the taxpayer for at least half their support during the year, lives in the same residence as the taxpayer and is a member of the taxpayer’s household (IRC §152(d)(2)(H)). In appropriate circumstances, a same sex spouse could qualify as a dependent under this definition. If so, the employer could deduct the premiums paid for the same-sex spouse’s LTCI (and the employee would not have to include those payments in income) by treating the premiums as paid for LTCI owned by the employee’s dependent.

Remember that various states offer credits and deductions according to their state income tax laws. Those laws may not be as restrictive as the federal income tax law in their treatment of same sex spouses. In those states that have passed laws legalizing and/or recognizing same sex marriages, state credits or deductions for payment of LTCI premiums may be unaffected.

## GENERAL (CONT.)

### **HSAs**

Money saved in an HSA may be used to help pay LTCI premiums. See the discussion on page 22 of this guide for details.

### **Cafeteria Plans and FSAs**

LTCI cannot be offered as part of a cafeteria plan (IRC §125(f)). Nor can premium payments for tax-qualified LTCI premiums be reimbursed tax-free from a Flexible Spending Account (IRC §106(c)).

### **LTCI paid from an Eligible Retirement Plan for Eligible Retired Public Safety Officers**

Under the Pension Protection Act, an eligible retired public safety officer may have up to \$3,000 per year paid from his or her eligible retirement plan for tax-qualified LTCI premiums for themselves, their spouse and eligible dependents. The payment must be made directly from the plan to the insurer issuing the LTCI. It cannot be made to the individual. This feature is available only if the retirement plan offers it.

A public safety officer includes a paid or volunteer police officer, firefighter, rescue or ambulance squad member or chaplain. He or she may also be someone who performs official Federal Emergency Management Agency (FEMA) duties that are related to disasters or emergencies, and are deemed hazardous. An "eligible retired" public safety officer is one who, because of disability or attainment of normal retirement age, has separated from service.

An eligible retirement plan includes a qualified defined benefit or defined contribution plan. Governmental §457(b) plans and §403(b) plans or annuities are eligible retirement plans, but IRAs are not.

If your customer qualifies for the tax benefits under this section, he or she will not have to treat the distribution from their plan as a taxable distribution.

## GENERAL (CONT.)

### **Linked-Benefit Contracts — LTCI Coverage Provided as Part of a Life Insurance or Annuity Contract**

In addition to LTCI offered as stand-alone coverage, LTCI may also be provided by a separate rider on or as part of a life insurance or annuity contract (IRC §7702B(e)) - also commonly referred to as “linked benefit” contracts. These riders may be either tax-qualified or non-tax-qualified (see explanation of “tax-qualified LTCI” on page 2). Note: LTCI on all Genworth linked benefit products is tax-qualified.

Premiums paid to fund linked benefit contracts are treated as premiums to fund the base contract (either a life insurance policy or annuity contract) and are not tax deductible. Monthly LTCI rider charges are also not tax deductible. These rider charges reduce cost basis in the underlying policy/contract, but not below zero.

If the LTCI rider is tax-qualified, then benefits paid for qualified long term care expenses are not includible in income. Distributions from a linked benefit contract, other than as qualified long term care benefits, are taxed according the rules governing the underlying life insurance policy or annuity contract.

### **Limited Pay Premiums**

LTCI may also offer the option of paying premiums for a limited time or until a certain date, after which the coverage is paid up. It is not certain that the entire amount paid is deductible in the year paid. One approach may be to amortize any deductibility to which the premium payor may be entitled over the insured’s life expectancy. Customers must consult with their tax advisors.

### **Federal Income Tax Treatment of Benefits Paid**

Benefits paid under tax-qualified LTCI are treated as reimbursements for medical care, and are excluded from the taxpayer’s income. There is no limit on this exclusion for insurance that reimburses for actual long term care expenses incurred (Genworth Life LTCI works this way). Some companies offer insurance that pays a per diem amount for long term care expenses. Benefits paid on a “per diem” basis, that do not exceed the per diem limit, are federal income tax free. For 2011, this limit is \$300.

## GENERAL (CONT.)

### Gift Tax Issues

Federal gift tax law lets you pay the eligible LTCI premiums for another person without having to treat the premium as a taxable gift.

The eligible LTCI premium is the lesser of the age-based premium (see table on page 2) and the actual premiums paid. Under federal gift tax law, the eligible premium is considered a medical care expense (IRC §213(d)(1)(D)). Anyone may pay anyone else's medical care expenses without the payment being treated as a gift (Reg. §25.2503-6), as long as they pay the money directly to the service provider or institution that provided the care. In the case of LTCI premiums, paying the eligible premiums directly to the insurance company qualifies those premiums for this special gift tax treatment.

Remember that individuals may pay LTCI premiums for their spouses and eligible dependents without those premiums being treated as a gift. In general, taxpayers who itemize their deductions may also deduct those premiums on their federal income tax returns to the extent that all the eligible premiums they paid, plus all other unreimbursed medical expenses, exceed 7.5% of adjusted gross income.

If an individual pays LTCI premiums for anyone else, directly to the insurer, only the eligible premium will be exempted from gift tax treatment. The balance of the premium will be treated as a gift (though no gift tax will be owing if the total gifts the donor makes to that individual during the year do not exceed the annual exclusion, \$13,000 in 2011). There will be no deductibility for federal income tax purposes, though the taxpayer may be able to obtain some relief on their state income taxes, depending on the state.

### State Income Tax Deductions and Credits

Many states offer an income tax deduction or credit for LTCI premiums paid. See the appendix to this guide for a list of which states offer a deduction or credit. It is important that customers speak with a tax advisor to determine if they may take a state deduction or credit.

# INDIVIDUAL TAXPAYER

Purchased by an individual on an after-tax basis



*Assumption:* Mary has tax-qualified Genworth Life Insurance Company LTCI with a \$3,500 annual premium. She is 61 years old. In 2011, she had \$2,400 in medical expenses not covered by insurance. Her adjusted gross income (AGI) is \$50,000.

## Deduction for LTCI Premium

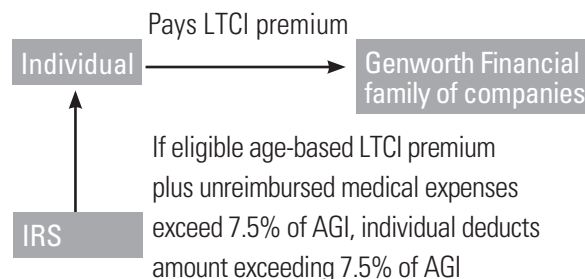
Although LTCI premiums for an individual taxpayer, his or her spouse and eligible dependents are deductible medical expenses (IRC §213(d)), Mary may deduct them (assuming she itemizes deductions) only up to the eligible premium limits (page 2), and then only to the extent that those premiums and all other medical expenses not paid by insurance or otherwise reimbursed to Mary exceed 7.5% of AGI (IRC §213(a)).

In 2011, Mary may deduct only \$3,390 of her \$3,500 LTCI premiums. \$3,390 is the lesser of her age-based limit and the actual premium she paid. To that amount she adds \$2,400 in medical expenses not covered by insurance for a total of \$5,790 in medical expenses.

Mary may deduct those medical expenses that exceed 7.5% of AGI. Her AGI is \$50,000. 7.5% of \$50,000 is \$3,750. She may therefore deduct \$2,040 from her taxable income (\$5,790 – \$3,750), assuming that she itemizes deductions.

Note that if Mary had not bought LTCI, she would not have had any deductible medical expenses because her other medical expenses totaled only \$2,400, less than 7.5% of AGI.

## INDIVIDUAL PAYING PREMIUMS FOR HIS OR HER OWN LTCI



## Alternate Minimum Tax

The discussion in this guide and examples do not consider the effect of the Alternate Minimum Tax imposed on certain taxpayers by IRC §55. You should encourage customers who expect to owe this tax to consult with a qualified tax advisor before they take itemized deductions.

## Paying for LTCI Through a Tax-Free Exchange

IRC §1035 permits owners of non-qualified annuities and life insurance to exchange all or a portion of their contracts for certain related types of contracts without being taxed on any unrealized gain at the time of transfer. As a result of the Pension Protection Act of 2006, starting in 2010, a non-qualified deferred annuity, immediate annuity or life insurance policy can be exchanged tax-free for stand-alone (traditional) tax-qualified LTCI if 1035 exchange requirements are met. Any non-qualified annuity may be used, subject to limitations set by the transferring company.

Any gains transferred as part of the 1035 exchange to pay LTCI premiums would be tax free. The exchange may be either full or partial. If partial, gain and basis are transferred pro-rata. By exchanging an annuity to pay for LTCI premiums, the owner may avoid taxes on the gain portion of the amounts exchanged, which would otherwise be taxable if withdrawn from the annuity.

## SELF-EMPLOYED TAXPAYER

Self-employed person pays LTCI premiums for self and/or employees

*Assumption:* Mary is a sole proprietor and has tax-qualified Genworth Life Insurance Company LTCI with a \$3,500 annual premium. She is 61 years old. In 2011, she had \$2,400 in medical expenses not covered by insurance. Her adjusted gross income (AGI) is \$50,000.

### Deduction for LTCI Premium

A self-employed person (with a reportable net profit) may deduct eligible premiums for accident and health insurance, including LTCI premiums that they pay for themselves, their spouse and other eligible dependents. They need not consider the 7.5% of AGI threshold for deductibility of medical expenses (IRC §162(l)). Though often referred to as a deduction, this item is really an adjustment to income. It reduces a self-employed person's gross income, but does not reduce their net earnings subject to self-employment tax (IRC §162(l)(4)). Furthermore, to the extent that a self-employed person uses this adjustment to reduce income, the adjustment cannot be used to determine the amount the self-employed person may take as a medical expense deduction (IRC §162(l)(3)).

This adjustment is taken on line 29 of the 1040 return.

Mary's LTCI premium is \$3,500, but her age-based premium is \$3,390. She may deduct \$3,390, her eligible premium, in 2011. Since she is self-employed, she may take this deduction without regard to whether this amount exceeds 7.5% of her AGI. The remaining \$110 of her LTCI premium is not considered a medical expense, and is not deductible.

Because she deducted \$3,390 of her LTCI premium from her income, her AGI is reduced by \$3,390 to \$46,610. Although she had \$2,400 in other medical expenses not covered by insurance, she may not deduct them because \$2,400 does not exceed 7.5% of her new AGI.

In this example, Mary is self-employed for the entire year. The "Self-Employed Health Insurance Deduction Worksheet" in IRS Publication 535 says that Mary may not deduct LTCI premiums for any month she could participate in a LTCI plan subsidized by her employer or her spouse's employer. (Even though she is "self-employed", she could still be an employee of another business). Note that eligibility to participate is what makes Mary lose this deduction; it is not important whether she actually participates.

## SELF-EMPLOYED TAXPAYER (CONT.)

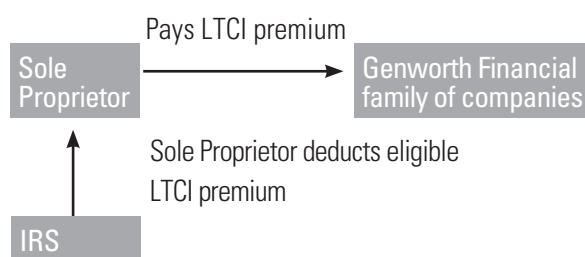
The tax treatment discussed here results in greater deductibility for Mary than she would have had as an individual. Had Mary added the \$3,390 eligible LTCL premium to the \$2,400 she had in medical expenses not covered by insurance (\$5,790 in total), her deduction would be only \$2,040 (\$5,790 - \$3,750 [7.5% x \$50,000]), \$1,350 less than the deduction she may take as a self-employed person.

The 162(l) deduction is available even if the taxpayer owns the LTCL in his or her name rather than in the name of the business (ILM 200524001 dated 5/17/2005 as to medical insurance costs).

### Self-Employed Person Pays Premiums for LTCL on Employee-Spouse

Many self-employed persons employ their spouse in their business. If the spouse is legitimately employed, the self-employed person may pay the premiums for tax-qualified LTCL on the employee/spouse; and deduct the premiums without regard to the age-based limits on page 2 (IRC §162). Nor does the employee/spouse include those premiums in income (IRC §106(a)). Note, however, that this strategy will not work with S corporations (see page 16).

### SOLE PROPRIETOR PAYING PREMIUMS FOR HIS OR HER OWN LTCL



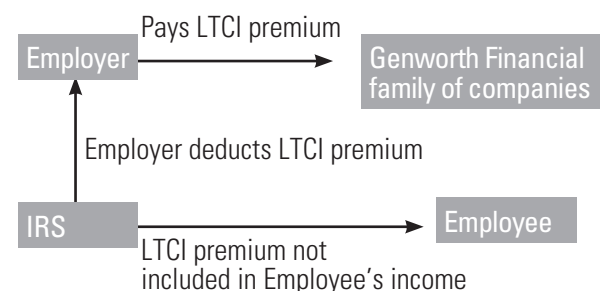
### Federal Income Tax Treatment of Premiums Paid by an Employer for Employee-owned LTCL

Employees are not taxed on premiums paid by their employer for LTCL on the employee, the employee's spouse, and the employee's eligible dependents (as defined by IRC §152), even if the premiums exceed the age-based limits discussed on page 2 of this guide (IRC §106(a)). Generally, the employer may deduct such premiums from income (IRC §162), even premiums in excess of the age-based limits. An eligible dependent is someone who depends on the taxpayer for at least half their annual support (IRC §152). Generally, if the taxpayer can claim the person as a dependent on their 1040 return, they are an eligible dependent.

The employer's deduction is allowed for amounts paid for personal services rendered by the employee to the employer, and when the total amount paid to the employee, including LTCL premiums, does not represent unreasonable compensation (IRC §162(l) and Rev. Rul. 58-90, 1958-1 C.B. 88).

If the employer is directly or indirectly a beneficiary under the coverage, the employer's deduction will be denied (Rev. Rul. 58-90, 1958-1 C.B. 88).

### EMPLOYER PAYING PREMIUMS FOR EMPLOYEE



*This chart applies to all employer/employee relationships, and to S corporations and their 2% or less stockholder/employees.*

## SELF-EMPLOYED TAXPAYER (CONT.)

### Offering LTCI Only to Highly Compensated Employees

Our opinion is that employers may continue to provide LTCI underwritten by the Genworth Financial companies only to highly compensated employees without violating the 2010 Patient Protection and Affordable Care Act (PPACA). Note: Other carriers may offer LTCI bundled with medical insurance that would fall under the non-discrimination rules.

The law: Employers have long been subject to rules under Internal Revenue Code (IRC) §105(h) prohibiting discrimination in favor of highly compensated employees with respect to self-insured health plans. Additional rules prohibiting discrimination on the basis of salary were adopted with respect to insured health plans in section 1001 of the recently enacted PPACA, adding a new section 2716 to the Public Health Services Act (PHSA). An employer violating the new rules, with respect to “plan years” beginning on or after September 23, 2010, could be subject to an excise tax of \$100 per day, per insured employee.

Since a tax-qualified LTCI is treated as accident and health insurance under IRC §7702B(a)(1), the concern has been raised regarding whether it is still viable for employers to provide LTCI only for, typically, the business owners, their spouses and a select group of highly paid employees.

The resolution of this important question appears to turn on an exception buried in another part of the PHSA, as amended by the PPACA.

As codified in the United States Code (USC)

at 42 USC §300gg-21(d)(1), the exception states that the requirements of the portion of the PHSA that include new §2716 do not apply to any health insurance coverage providing “excepted benefits” under §300gg-91(c)(2) if the benefits “(A) are provided under a separate policy, certificate, or contract of insurance; or (B) are otherwise not an integral part of the plan.” Excepted benefits under 42 USC §300gg-91(c)(2), “Benefits not subject to requirements if offered separately,” include “(B) Benefits for long-term care, nursing home care, home health care, community-based care, or any combination thereof.”

Thus, group and individual LTCI appear to be generally exempt from the new non-discrimination rules adopted in the PPACA. A lingering question, however, is what is meant in §300gg-21(d)(1)(B) by “are otherwise not an integral part of the plan.” Although there is no official guidance, we believe that this provision is addressing LTCI bundled with medical insurance that would be subject to the non-discrimination rules and other existing provisions of the PHSA.

Given the sanction for non-compliance, any employer maintaining medical insurance, with or without LTCI, is strongly advised to review existing and proposed plans with legal counsel familiar with the new non-discrimination rules.

## PARTNERSHIP

Partnership employer pays premium for (a) non-partner employees, and (b) partners who perform services, and in both cases such coverage is provided in connection with the performance of such services.

*Assumption:* ABC is a partnership. It pays the \$3,500 annual premium for a tax-qualified Genworth Life Insurance Company LTCI Mary owns. Mary is 61 years old. In 2011, she had \$2,400 in medical expenses not covered by insurance. Her adjusted gross income (AGI) is \$50,000, not counting the \$3,500 LTCI premiums ABC pays.

### Tax Treatment of Employer

Generally, a partnership may deduct all premiums it pays for accident and health insurance (including premiums paid for tax-qualified LTCI) for its employees, their spouses and eligible dependents (IRC §§152 and 162).

If Mary is an employee (and not a partner), the partnership may pay and deduct the entire LTCI premiums for coverage on Mary, her spouse, and eligible dependents (IRC §152) – even premiums in excess of the age-based limits on page 2 (IRC §162).

If Mary is a partner (or the spouse or eligible dependent of a partner (IRC §152)), ABC may pay the entire LTCI premiums for Mary, her spouse, and eligible dependents – even premiums in excess of the age-based limits on page 2 (IRC §162).

See discussion on page 11 regarding the offering of LTCI only to highly compensated employees.

As long as the LTCI premiums are paid without regard to partnership income they will be considered “guaranteed”<sup>◇</sup> payments under IRC §707(c). As such, they will be deductible to the partnership

under IRC §162 (subject to IRC §263), and includable in the partners’ incomes under IRC §61 (Rev. Rul. 91-26, 1991-1, C.B. 184).

In our example, the premiums are paid without regard to partnership income (they are “guaranteed”<sup>◇</sup>). As a result, ABC may deduct the full \$3,500 premium it pays for Mary’s LTCI regardless of whether Mary is an employee or a partner. If Mary is a partner, ABC reports the premium it pays for Mary’s coverage (and for coverage on Mary’s spouse and eligible dependents) as income to Mary.

### Non-Deductible Premium Payments

Instead of treating premiums as guaranteed payments, the terms of a partnership agreement may account for LTCI premiums paid for a partner as a reduction in distributions to that partner. If so, the premiums would not be deductible by the partnership, nor would payment of those premiums affect distributive shares of partnership income and deductions.

<sup>◇</sup>The term, “guaranteed” in this context carries a restricted meaning under the IRC. It means that the payment of the LTCI premium to the partners does not come from the partners’ draws (or from the net income left at the end of the year used to make those draws). The partners are “guaranteed” their LTCI premiums only in the limited sense that the partnership treats the LTCI premium payments to them as expenses that must be paid regardless of whether the partnership makes money in a given year or not.

## PARTNERSHIP (CONT.)

### Tax Treatment of Partner/Employee

The IRS treats partners as self-employed persons. As a result, LTCI premiums the partnership pays for each partner (including premiums paid for coverage on a partner's spouse and eligible dependents (IRC §152)) are included in the partner's individual income, and reported on each partner's Schedule K-1.

See the discussion on page 9 about the deduction for self-employed persons that Mary, as a partner, may take for ABC's payment of her LTCI premiums.

A self-employed person may not deduct LTCI premiums for any month that she or her spouse is eligible to participate in an employer subsidized health plan. See the discussion on page 9. In this example, Mary is self-employed for the entire year.

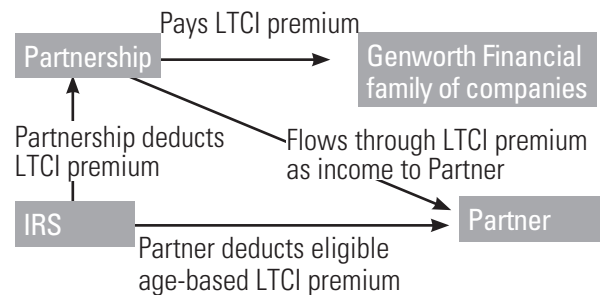
After ABC pays each partner's LTCI premiums, (and assuming they deduct them as guaranteed payments), the partners' incomes decline by the total amount of premium paid. Since Mary is a partner, her income also declines in proportion to her share of ABC's net income. However, ABC then attributes to her the premium it paid for her LTCI, causing her income to rise by \$3,500.

Since Mary is taxed as a self-employed person, this increase in income is partly offset by the \$3,390 she may deduct (her eligible premium). If the partnership pays the same LTCI premiums for each partner, and if all the partners own equal shares in the partnership, Mary may effectively deduct all but \$110 of her LTCI premium.

If Mary is an employee, she need not include in income the premiums ABC pays for her LTCI, or the premiums ABC pays for LTCI coverage on her spouse or eligible dependents (IRC §152).

See the discussion on page 11 regarding the tax treatment of LTCI premiums paid for an employee.

### PARTNERSHIP PAYS PREMIUMS FOR PARTNER



## LIMITED LIABILITY COMPANY (LLC)

LLC pays premium for employees and members.

*Assumption:* ABC is an LLC. It pays the \$3,500 annual premium for tax-qualified Genworth Life Insurance Company LTCI for Mary. Mary is 61 years old. In 2011, she had \$2,400 in medical expenses not covered by insurance. Her adjusted gross income (AGI) is \$50,000, not counting the \$3,500 LTCI premiums ABC pays.



### Tax Treatment of Employer

If the limited liability company (LLC) has elected partnership tax treatment, it is treated as a partnership for purposes of these rules. Owners of LLCs are called members. See the rules regarding partnerships on pages 12 and 13.

If Mary is an employee (and not a member) the LLC may pay and deduct the entire LTCI premiums for coverage on Mary, her spouse, and eligible dependents (IRC §152) — even premiums in excess of the age-based limits discussed on page 2 (IRC §162).

See discussion on page 11 regarding the offering of LTCI only to highly compensated employees.

If Mary is a member (or the spouse or eligible dependent of a member (IRC §152), ABC may deduct the entire LTCI premiums paid for Mary, her spouse, and eligible dependents — even premiums in excess of the age-based limits on page 2 (IRC §162)).

For LLCs that have elected partnership tax treatment, as long as the LTCI premiums are paid without regard to LLC income they will be considered “guaranteed”<sup>◇</sup> payments under IRC §707(c). As such, they will be deductible to the LLC under IRC §162 (subject to IRC §263), and includable in the members’ incomes under IRC §61 (Rev. Rul. 91-26, 1991-1, C.B. 184).

<sup>◇</sup> See page 12 for an explanation of the term, “guaranteed” in this context.

## LIMITED LIABILITY COMPANY (CONT.)

In our example, the premiums are paid without regard to LLC income (they are “guaranteed”<sup>◇</sup>). As a result, ABC may deduct the entire \$3,500 premium it pays for Mary’s LTCI regardless of whether Mary is an employee or a member. If Mary is a member, ABC reports the premium it pays for Mary’s LTCI (and for LTCI coverage on Mary’s spouse and eligible dependents) as income to Mary.

### Tax Treatment of Owner/Employee

If the LLC has elected partnership tax treatment, the IRS treats LLC members as self-employed persons. As a result, LTCI premiums the LLC pays for each member (including premiums paid for a member’s spouse and eligible dependents) are included in the member’s individual income, and reported on each member’s Schedule K-1.

See the discussion on page 9 for self-employed persons about the deductibility of income attributed to Mary as an LLC member from ABC’s payment of her LTCI premiums.

A self-employed person may not deduct LTCI premiums for any month when she or her spouse is eligible to participate in an employer subsidized health plan. See the discussion on page 9. In this example, Mary is self-employed for the entire year.

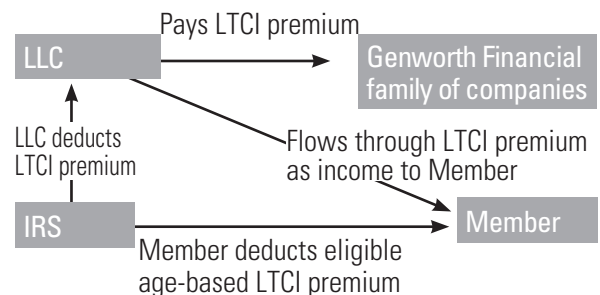
After ABC pays each member’s LTCI premiums, the members’ incomes decline by the total amount of premium paid. Since Mary is a member, her income also declines in proportion to her share of ABC’s net income. However, ABC then attributes to her the premium it paid for her LTCI, causing her income to rise by \$3,500.

Since Mary is taxed as a self-employed person, this increase in income is partly offset by the \$3,390 she may deduct (her eligible premium). If the LLC pays the same LTCI premiums for each member in the LLC, and if all the members own equal shares in the LLC, Mary may effectively deduct all but \$110 of her LTCI premium.

If Mary is an employee, she need not include in income the premiums ABC pays for her LTCI, or the premiums ABC pays for LTCI coverage on her spouse or eligible dependents.

See the discussion on page 11 regarding the tax treatment of LTCI premiums paid for an employee.

### LLC PAYS PREMIUMS FOR MEMBER



<sup>◇</sup> See page 12 for an explanation of the term, “guaranteed” in this context.

## S CORPORATIONS

S corporation pays premium for employees and shareholders.

*Assumption:* ABC Corp is an S corporation. It pays the \$3,500 annual premium for tax-qualified Genworth Life Insurance Company LTCI coverage on Mary. Mary is 61 years old. In 2011, she had \$2,400 in medical expenses not covered by insurance. Her adjusted gross income (AGI) is \$50,000, not counting the \$3,500 LTCI premiums ABC pays.

### Tax Treatment of Employer

An S corporation is treated similar to a partnership for purposes of these rules (see the rules regarding partnerships on pages 12 and 13). The S corporation may deduct LTCI premiums paid both on behalf of its owners (shareholders who individually own more than 2% of the stock) and its employees (including shareholders who individually own 2% or less of the stock). To be deductible, premiums must be paid in consideration for services rendered. The deductions by the corporation are not limited to the age-based limits on page 2.

See discussion on page 11 regarding the offering of LTCI only to highly compensated employees.

In our example, ABC may deduct the full \$3,500 premium it pays for Mary's LTCI regardless of whether Mary is an employee, or a greater than 2% shareholder.

### Tax Treatment of Owner/Employee

The IRS treats greater than 2% S corporation shareholders as self-employed persons (IRC §1372). As a result, LTCI premiums the S corporation pays for each greater than 2% shareholder (including premiums paid for the shareholder's spouse and eligible dependents) are included in the shareholder's income under IRC §61, and reported on their Form W-2 as wages.

However, while Rev. Rul. 91-26 requires the greater than 2% S corporation shareholder to include in income (as wages) amounts paid by an S corporation for accident and health insurance covering them, such payments are not wages for Social Security, Medicare and FUTA tax purposes (IRS Publication 15-B; Announcement 92-16, 1992-5 I.R.B. 53).

Greater than 2% S corporation shareholders may deduct eligible premiums for accident and health insurance, including LTCI premiums that the S corporation pays for themselves, their spouses, and eligible dependents. The premiums must be paid under a plan "established by the S corporation." A plan is considered "established" if the premiums are either directly paid by the S corporation, or paid by the owner and reimbursed by the S corporation. (IRC Notice 2008-1) For the 2010 tax reporting year, an owner takes the deduction on line 29 of his or her personal income tax return. The 7.5% of AGI threshold for deductibility of medical expenses (IRC §162(l)) does not apply.

## S CORPORATIONS (CONT.)

A self-employed person may not deduct LTCI premiums for any month when she or her spouse is eligible to participate in an employer subsidized health plan. See the discussion on page 9. In this example, Mary is self-employed for the entire year.

After ABC pays each greater than 2% shareholder's LTCI premiums, their incomes decline by the total amount of premium paid. If Mary is a greater than 2% shareholder, her income declines in proportion to her share of ABC's net income. However, ABC has reported on her W-2 the premium it paid for her LTCI, causing her income to rise by \$3,500.

Since Mary is taxed as a self-employed person, this increase in income is partly offset by the \$3,390 she may deduct (her eligible premium). If the S corporation pays the same LTCI premiums for each greater than 2% shareholder in the S corporation, and if all the greater than 2% shareholders own equal shares in the S corporation, Mary has effectively been able to deduct all but \$110 of her LTCI premium.

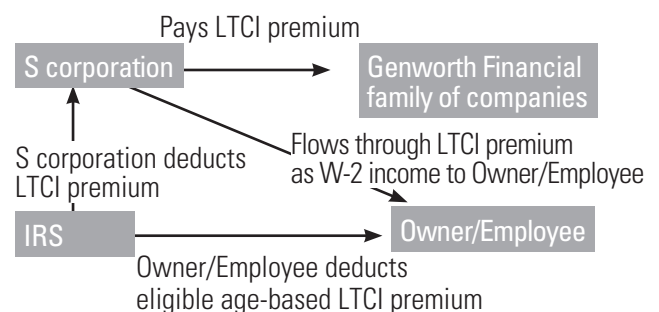
If Mary is an employee (including an employee who is also a 2% or less shareholder), she need not include in income the premiums ABC pays for her LTCI, or the premiums ABC pays for LTCI owned by her spouse or eligible dependents.

See the discussion on page 11 regarding the tax treatment of LTCI premiums paid for an employee.

One strategy that many self-employed persons use to deduct premiums paid for an employee/spouse's tax-qualified LTCI—employ their spouse in the business—will not work with an S Corporation. The attribution rules under IRC §318 cause ownership of an individual's S Corporation stock to be attributed to their spouse, children, grandchildren, and parents.

As a result, the spouse and family members employed by the S corporation will be treated as if they were self-employed, not as if they were employees, even if in fact they do not personally own any S corporation stock. They will have to include the LTCI premiums the S corporation pays for them in income, and will be able to deduct the eligible premium (lesser of paid premiums and the age-based premiums) as if they were self-employed.

### S CORPORATION PAYS PREMIUMS FOR OWNER/EMPLOYEE



## C CORPORATIONS

C Corporation employer pays premium on employees' LTCI. LTCI premiums paid for by a charity for its employees receive similar tax treatment to those provided by a C corporation.

*Assumption:* ABC Corp is a C corporation. It pays the \$3,500 annual premium for tax-qualified Genworth Life Insurance Company LTCI coverage on Mary. Mary is 61 years old, and is an employee of ABC. In 2011, she had \$2,400 in medical expenses not covered by insurance. Her adjusted gross income (AGI) is \$50,000, not counting the \$3,500 LTCI premiums ABC pays.

### Tax Treatment of Employer

Generally, a C corporation may deduct all premiums it pays for accident and health insurance (including premiums paid for tax-qualified LTCI) for its employees, their spouses and eligible dependents (IRC §152) – even premiums in excess of the eligible premium limits on page 2 (IRC §162).

See discussion on page 11 regarding the offering of LTCI only to highly compensated employees.

It may not deduct LTCI premiums paid for stockholders who are not employees, or for employees who are not actively participating in the corporation's business, unless that stockholder or inactive employee is also a spouse or eligible dependent of an active employee.

### Selectivity — C Corporation Paying LTCI for Owners

A C corporation may establish a plan to provide LTCI benefits only to a select group of employees. The adoption of a corporate

resolution establishes the plan and provides a clear definition of the eligible employees. However, ownership may not be the basis of eligibility. Rather, classifications reasonably based on seniority, job title or other criteria related to employment status should be used. It may be possible for the class to include only owner/employees provided the classification used is not also a threshold qualification of ownership.

The C corporation must make the decision on who to include and exclude, and how to justify the decision, in consultation with its legal and financial advisors. However, if a plan discriminates in favor of C corporation owner/employees as a class of participants defined solely by ownership status, the IRS may treat the premium payments as dividends to the extent of profits, and then income thereafter.

A C corporation may deduct the LTCI premiums whether the coverage is provided under group LTCI or under individual LTCI. In our example, ABC Corp may deduct the full \$3,500 premium it pays for Mary's LTCI regardless of whether Mary is a non-owner employee or an owner/employee (even an owner/employee who owns all of the shares of ABC Corp).

A plan may cover one or more employees, and there may be different plans for different employees or classes of employees.



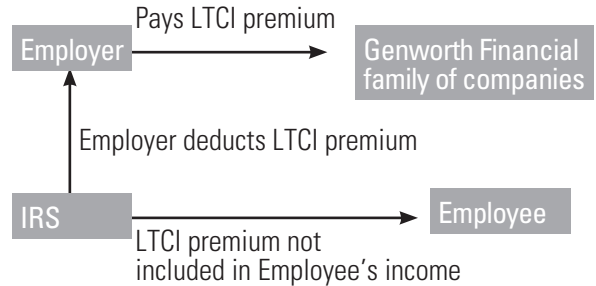
## C CORPORATIONS (CONT.)

### Tax Treatment of Owner or Non-owner Employee

Mary would have no taxable income from the employer-paid LTCI premiums nor would any benefits she receives under the tax-qualified LTCI be taxable income to her. This applies whether Mary is a non-owner employee or an owner/employee, even an owner/employee who owns all the shares of the employer (IRC §106(a)).

Mary may not treat the \$3,500 premium or any part of it as a medical expense. As a result, she has only \$2,400 in medical expenses for 2011. Since these expenses do not exceed 7.5% of her AGI ( $\$50,000 \times 7.5\% = \$3,750$ ), she may not deduct them from income (IRC §213(a)).

### EMPLOYER PAYING PREMIUMS FOR EMPLOYEE



## CONTRIBUTORY ARRANGEMENTS

Employer pays part of the premium, employee pays the rest.

*Assumption:* ABC is an employer. It pays \$1,000 towards the \$3,500 annual premium for tax-qualified Genworth Life Insurance Company LTCI coverage on Mary. Mary is 61 years old. In 2011, she had \$2,400 in medical expenses not covered by insurance. Her adjusted gross income (AGI) is \$50,000, not counting the \$1,000 LTCI premiums ABC pays.

### Tax Treatment of Employer

The employer receives the same federal income tax treatment on the portion of LTCI premium it pays that it does on the entire premium in the employer-pay-all situation (IRC §162). Thus, all employers (self-employed persons, C corporations, partnerships, LLCs and S corporations) may deduct tax-qualified LTCI premiums paid for coverage on their *employees* (in the case of an S corporation, this would include employees who are also 2% or less shareholders), and their employees' spouses and eligible dependents (IRC §152) without regard to the age-based limits (page 2).

In addition, partnerships, LLCs and S corporations may deduct LTCI premiums paid for coverage on, respectively, those entities' partners, members, and greater than 2% shareholders, and their spouses and eligible dependents. The entity then reports the premium as income to the owner.

In our example, ABC may deduct the \$1,000 it pays towards Mary's LTCI premium (and any part of the LTCI premium it pays for Mary's spouse and eligible dependents) regardless of whether Mary is an employee or an owner. Except in the case of a

C corporation, if Mary is an owner, ABC reports the premium it pays for her coverage (and for coverage on her spouse and eligible dependents) as income to Mary.

### Tax Treatment of Owner/Employee

Except in the case of a C corporation, if Mary is an owner (including a greater than 2% S corporation shareholder), she is treated as a self-employed person under these rules. She pays the remaining \$2,500 premium herself. She may deduct \$3,390, that amount representing the lesser of the age-based limit—\$3,390—and the sum of (1) the premium added to her income and (2) the premium she pays herself (\$1,000 plus \$2,500). The remaining \$110 is not considered a medical expense and is not deductible. See the eligible premium limits (page 2), and the discussion for self-employed persons (page 9).

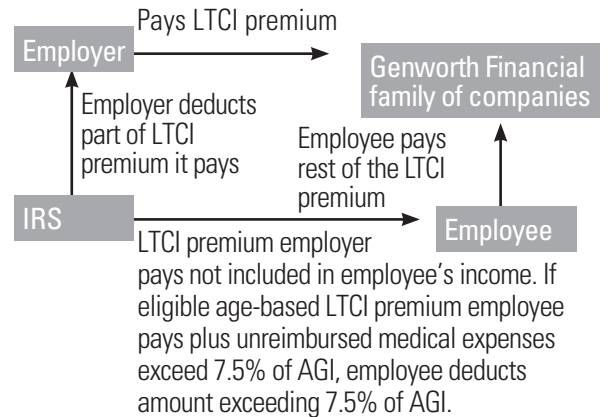


## CONTRIBUTORY ARRANGEMENTS (CONT.)

If Mary is an employee, she does not have to include in taxable income the \$1,000 ABC pays (nor any money it pays for coverage on her spouse and eligible dependents). The remaining \$2,500 in LTCI premiums that Mary pays is less than the eligible premium limit of \$3,390 (page 2). For deductibility purposes, therefore, she may add the entire \$2,500 LTCI premium expense she pays to her \$2,400 in medical expenses not covered by insurance for a total of \$4,900 in medical expenses.

7.5% of Mary's \$50,000 AGI is \$3,750. She may deduct from income that part of her qualified medical expenses that exceeds 7.5% of AGI, or \$1,150 ( $\$4,900 - \$3,750 = \$1,150$ ), assuming that she itemizes deductions.

### EMPLOYER PAYING PREMIUMS FOR CONTRIBUTORY ARRANGEMENTS



## PAYING LTCI PREMIUMS THROUGH A HEALTH SAVINGS ACCOUNT (HSA)



*Assumption:* Mary is single, and a non-owner employee of ABC. She is 61 years old. Her adjusted gross income (AGI) is \$50,000. She is covered by ABC's high deductible health care plan and otherwise qualifies to open an HSA.

The Medicare Act of 2003 allows individuals to create Health Savings Accounts (HSA). Contributions to an HSA are made on a pre-tax basis, while withdrawals for qualified medical expenses are made tax-free. Any growth inside an HSA is tax-free if withdrawals are made for qualified medical expenses, or tax-deferred if withdrawals are made for other purposes.

Tax-qualified LTCI premiums are a qualified medical expense. (IRS Notice 2004-50, Q and A 41). As a result, an individual may withdraw money tax-free from their HSA to pay tax-qualified LTCI premiums. Tax-qualified LTCI premiums are the eligible premiums (lesser of the actual premiums paid and the eligible "aged-based" premiums. See page 2). Therefore, only eligible LTCI premiums may be withdrawn tax-free from an HSA.

### Some of the Criteria for Owning an HSA Are:

The individual must be covered by a high deductible health plan (IRC §223(c)(1)(A)(ii)).

- Annual deductible of at least \$1,200 for individuals, \$2,400 for a family (2011 limits, adjusted for inflation)
- Annual out-of-pocket limits not exceeding \$5,950 for an individual, \$11,900 for a family (2011 limits, adjusted for inflation)

The individual may not be covered under a non-high deductible health plan (HDHP) or a plan that duplicates benefits of their own plan (IRC §223(c)(1)(A)(ii)), such as a spouse's plan through the spouse's employer.

However, an individual may be covered under some types of insurance that do not require high deductibles (such as tax-qualified LTCI) and still own an HSA (IRC §223(c)(1)(B)(ii)).

## PAYING LTCI PREMIUMS THROUGH A HEALTH SAVINGS ACCOUNT (HSA) (CONT.)

### Deductibility for Contributions to an HSA is Denied When:

- The individual is claimed as a dependent on another's income tax return (IRC §223(b)(6)), or
- The individual becomes covered by Medicare (IRC §223(b)(7)).

### Contribution Limits

The maximum monthly contribution amount is 1/12 of the statutory annual maximum (\$3,050 for individuals and \$6,150 for families (IRC §223(a)(2), 2011 limits, amounts indexed to inflation)). These limits are decreased by aggregate contributions made to an Archer MSA (IRC §223(a)(4)).

Individuals who first become eligible on or before December 1 of a tax year are treated as though they had been eligible for that entire year. The individual, though, must continue to be eligible for a 12 month period beginning December of the enrollment year, otherwise, contributions attributed to months prior to the month of enrollment will be included in taxable income and subject to a 20% penalty tax.

Individuals between 55 and 65 may also make additional catch-up contributions. For 2011, the additional allowed catch-up contribution is \$1,000.

Mary is single and owns an HSA. In 2011, she may contribute a maximum of \$3,050 to her HSA, plus a catch-up contribution of \$1000, for a total of \$4,050. Her HSA contributions are tax-deductible, and any growth is tax-free as long as distributions are taken for qualified medical expenses.

Any other type of distribution is included in taxable income and subject to a 20% penalty tax.\* Unlike Flexible Spending Accounts, HSA account balances do not have to be entirely withdrawn by the end of the year or forfeited. Assuming the HSA started the year with a zero account balance, and Mary achieves a 3% rate of return on her monthly HSA contributions of \$337.50, she will have an account balance of about \$4,110 by year-end.

Mary also owns Genworth Life Insurance Company LTCI. Her annual premiums are \$3,500. Her eligible age-based premiums are \$3,390. ABC does not pay any part of her LTCI premiums. However, Mary's eligible premiums are a qualified medical expense for HSA purposes. As a result, Mary may withdraw up to \$3,390 tax-free from her HSA to help pay her LTCI premiums. The balance of her LTCI premium, \$110, is not a qualified medical expense, and Mary may not withdraw HSA funds to pay for it.

\* The penalty tax does not apply if the distributions are made after death, disability, or attaining age 65.

## PAYING LTCI PREMIUMS THROUGH A HEALTH SAVINGS ACCOUNT (HSA) (CONT.)



In 2011, Mary also had \$2,400 in medical expenses not covered by insurance, in addition to her LTCI premiums. Assuming that these expenses are qualified medical expenses under the HSA rules, Mary may withdraw the remaining \$720 from her HSA to help pay them. Her remaining unreimbursed medical expenses, \$1,680, do not exceed 7.5% of her AGI (even allowing for deductions for HSA contributions), and are not deductible.

### **Transfer of IRA Money to HSA**

Individuals may make a one-time tax-free transfer of money from their traditional or Roth Individual Retirement Account (IRA) to their Health Savings Account (HSA) in the amount of the maximum deductible contribution they could make to their HSA for the year of the transfer.

IRA money transferred in a direct trustee-to-trustee transfer to an HSA under IRC §408(d) will not be treated as income, nor will it be subject to the 10% federal penalty tax applicable to premature distributions from IRAs and qualified plans. The transfer must be a direct trustee-to-trustee transfer. A rollover, in which the IRA owner withdraws money from their IRA and deposits it to their HSA, will not receive the favorable tax treatment this law provides.

Transfers of amounts to an HSA from an ongoing Simplified Employee Pension (SEP IRA) or SIMPLE IRA do not qualify for the tax treatment under these Code sections.

## CHANGES TO “GRANDFATHERED/ TAX-QUALIFIED” LTCI

Final IRS Regulations are in effect for “grandfathered” LTCI, those issued before January 1, 1997. Here are the changes to grandfathered Genworth Life Insurance Company LTCI that will be considered disqualifying, and those which will not (Treas. Regs. § 1.7702B-2).

### **Changes Not Considered Disqualifying (will NOT affect tax-qualified status)**

- Reductions in Coverage  
(at lower premiums)
  - Decrease in Daily Benefit Amount
  - Increase in the Length of the Elimination Period
  - Decrease to Benefit Period or Policy Maximum Benefit Amount
  - Deletion of Inflation or Benefit Increase Rider
- Changes in Premium Mode
- Adding a Couples Discount

### **Changes Considered Disqualifying (WILL affect tax-qualified status)**

- Increase in Daily Benefit Amount
- Decrease in the Length of the Elimination Period
- Increase in Benefit Period/Policy Maximum Benefit Amount
- Addition of Currently Available Inflation or Benefit Increase Riders

## APPENDIX: STATE LTCI TAX CREDITS AND DEDUCTIONS

State	Deduction or Credit	State	Deduction or Credit
Alabama	Deduction	Missouri	Deduction
Arkansas	Deduction	Montana	Deduction and Credit
California	Deduction	Nebraska	Deduction
Colorado	Credit	New Jersey	Deduction****
District of Columbia	Deduction	New Mexico	Deduction and Credit
Hawaii	Deduction	New York	Credit***
Idaho	Deduction	North Carolina	Credit
Indiana	Deduction	North Dakota	Credit
Iowa	Deduction	Ohio	Deduction
Kansas	Deduction	Oklahoma	Deduction
Kentucky	Exclusion	Oregon	Credit
Louisiana	Credit	Utah	Deduction
Maine	Deduction and Credit**	Vermont	Deduction
Maryland	Credit***	Virginia	Deduction or Credit
Minnesota	Credit	West Virginia	Deduction
Mississippi	Credit	Wisconsin	Deduction

*Note: Not all states offer a full deduction or credit.*

*\*\* Individual deduction/employer credit.*

*\*\*\* Separate credits offered for both individual and employer paid premiums.*

*\*\*\*\* New Jersey allows a deduction for "medical expenses" which may include premiums paid for LTCI.*

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Genworth Life Insurance Company

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