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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Date:
February 02, 2009

Legend

Taxpayer =

State A =
Number B =
Parent Company =
Date C =
Year D =

Dear :

This letter responds to the August 5, 2008, letter submitted by your authorized representatives, requesting rulings regarding the federal income tax treatment under §§ 72, 104, and 7702B of the Internal Revenue Code of a long-term care insurance rider that Taxpayer plans to offer with certain annuity contracts.

FACTS

Taxpayer makes the following representations:

Taxpayer is a stock life insurance company organized and operated under the laws of the State of A. Taxpayer is licensed to engage in the life insurance business in Number B jurisdictions. Taxpayer is wholly owned by Parent Company. Parent Company files a consolidated federal income tax return on behalf of itself, Taxpayer, and certain other affiliates.

On Date C, Taxpayer began issuing fixed deferred annuity contracts (“Contracts”). Beginning in Year D, Taxpayer intends to offer a long-term care insurance rider (“Rider”) to Contract owners.

For tax years beginning after 2009, the Rider is intended to constitute a Qualified Long-Term Care Insurance contract within the meaning of § 7702B(b)(1). The Rider provides for monthly long-term care insurance benefits (“LTC Benefits”) if the insured becomes a chronically ill individual and meets other requirements specified in the Rider.

Under the Rider, the monthly LTC Benefit payments cannot exceed the per diem limitations of § 7702B(d)(2). If the insured does not receive qualified long-term care services during every day of a given month, the monthly LTC Benefit payment will be prorated to derive the actual monthly LTC Benefit for the month.

The charge for the Rider will be deducted from the Contract’s cash value on an annual basis. The charge will be an arms-length rate for the coverage provided under the Rider and will be determined in accordance with widely accepted actuarial principles based on Taxpayer’s good-faith expectation of the claims experience it will incur with respect to such coverage.

Prior to the Contract’s annuity starting date, if the insured meets the eligibility requirements, the Contract owner may elect to receive LTC Benefits under the Rider. Each LTC Benefit payment will be comprised of two components: (1) a reduction to the Contract’s cash value on a dollar-for-dollar basis (the “Linked Component”); and (2) an amount funded by Taxpayer which will have no effect on the Contract’s cash value (the “Unlinked Component”).

If the insured is chronically ill and the Contract owner is receiving LTC benefits under the Rider on the Contract’s annuity starting date, the LTC benefits will continue to be paid until the Contract’s cash value is reduced to zero. If the Contract owner is not receiving LTC benefits under the Rider on the Contract’s annuity starting date, the Rider generally will terminate unless the Contract owner elects to continue coverage.

If the Contract owner elects to continue coverage after the Contract’s annuity starting date, and the insured later meets the eligibility requirements for LTC Benefits, those LTC Benefits will replace the annuity payments being made from the Contract. In such case, the monthly LTC Benefit payment will equal the sum of the annuity payments that were being made under the Contract, plus the monthly Unlinked Component of the LTC Benefit determined immediately before the Contract’s annuity starting date. The LTC Benefits will continue as periodic payments in this amount until the insured recovers or the Unlinked Component is reduced to a level specified in the Rider. Once the Unlinked Component is fully reduced, the Rider will terminate, and the annuity payments may

continue under the Contract over the remaining payment term of the selected annuity income option.

REQUESTED RULINGS

Taxpayer requests the following rulings with respect to tax years beginning after 2009:

(1) The Rider will constitute a qualified long-term care insurance contract within the meaning of § 7702B(b)(1);
(2) To the extent that they do not exceed the per diem limitation of § 7702B(d), all LTC Benefits paid under the Rider will be excludable from the recipient's gross income under § 104(a)(3); and
(3) The payment of LTC Benefits under the Rider will not reduce the "investment in the contract" of the Contract for purposes of § 72.

LAW AND ANAYLSIS

Section 7702B of the Code was added by §§ 321 and 325 of the Health Insurance Portability and Accountability Act of 1996 (Pub.L. 104-191, 110 Stat. 1936, 2054 and 110 Stat. at 2063). Section 7702B establishes the tax treatment for qualified long-term care insurance contracts. Section 7702B applies to contracts issued after December 31, 1996.

The Pension Protection Act of 2006 (Pub. L. 109-280, 120 Stat. 780) ("PPA") enacted tax rules for long-term care insurance that is provided by a rider on or as part of an annuity contract. PPA provisions are effective generally for contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009.

Section 7702B(e) (as amended by PPA) provides that, except as otherwise provided in the Income Tax Regulations, in the case of any long-term care insurance coverage (whether or not qualified) provided by a rider on or as part of an annuity contract, the portion of the contract providing such coverage shall be treated as a separate contract. The term "portion" means only the terms and benefits under an annuity contract that are in addition to the terms and benefits under the contract without regard to long-term care insurance coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the annuity contract's cash value. STAFF OF J. COMM. ON TAX'N, 109TH CONG., TECHNICAL EXPLANATION OF H.R. 4, THE "PENSION PROTECTION ACT OF 2006", AS PASSED BY THE HOUSE ON JULY 28, 2006, AND CONSIDERED BY THE SENATE ON AUGUST 3, 2006, AT 195 (COMM. PRINT 2006).

Requested Ruling #1

A qualified long-term care insurance contract is defined under § 7702B(b)(1) as any insurance contract that provides only coverage of qualified long-term care services and that (1) generally does not pay or reimburse expenses reimbursable under Medicare (except as provided under § 7702B(b)(2) when the contract makes per diem or other periodic payments without regard to expenses incurred during the period to which the payments relate, or where Medicare is a secondary payor); (2) is guaranteed renewable; (3) 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; and (4) refunds (other than refunds on the death of the insured or complete surrender or cancellation of the contract) and dividends under the contract may be used only to reduce future premiums or increase future benefits.

Taxpayer represents that, assuming the Rider is an insurance contract, the Rider satisfies all requirements necessary for treatment as a qualified long-term care insurance contract under § 7702B(b)(1) for tax years beginning after December 31, 2009.

Neither the Code nor the regulations thereunder define the term "insurance" or "insurance contract." The Supreme Court of the United States has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. Le Gierse, 312 U.S. 531 (1941). The risk transferred must be a risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-291 (2d Cir. 1950), and must not be merely an investment or business risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114, as amplified by Rev. Rul. 2007-47, 2007-30 I.R.B. 127. In addition, the arrangement must constitute insurance in the commonly accepted sense. See, e.g., Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135,1153 (Fed. Cir. 1993); AMERCO, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992).

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer such that as a loss by the insured does not affect the insured because the loss is offset by a payment from the insurer. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken as premiums and set aside for the payment of such claim. By assuming numerous, relatively small, independent risks

that occur randomly over time, the insurer can smooth out losses to match more closely its receipt of premiums. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

The "commonly accepted sense" of insurance derives from all the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with that known to be insurance. Court opinions identify several nonexclusive factors bearing on this, such as the treatment of an arrangement under the applicable state law, AMERCO v. Commissioner, 96 T.C. 18, 41 (1991); the adequacy of the insurer's capitalization and utilization of premiums priced at arm's length, The Harper Group v. Commissioner, 96 T.C. 45, 60 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992); separately maintained funds to pay claims, Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728 (1991)., aff'd per curiam , 988 F.2d 1134 (Fed. Cir. 1993); and the language of the operative agreements and the method of resolving claims, Kidde Indus. Inc. v. United States, 49 Fed. Cl. 42.

The risk of incurring expenses relating to qualified long-term care services is a morbidity risk that, absent insurance coverage, will be borne solely by the person insured under the Rider. Each LTC Benefit payment provided under the Rider includes an Unlinked Component that will be paid by the Taxpayer out of its own funds and will not reduce the Contract's cash value. As a result, the Unlinked Component of each LTC Benefit payment represents risk of economic loss that is shifted to the Taxpayer by the Contract owner.

Taxpayer represents it intends to issue the Rider to a large number of individuals. Taxpayer also represents the charge for the Rider will be an arm's-length rate for the coverage provided under the Rider and will be determined in accordance with widely accepted actuarial principles based on the Taxpayer's good-faith expectation of the claims experience it will incur with respect to such coverage. Taxpayer will pool the charges it collects under all the Riders it issues and use the resulting pool to help pay any claims that become due under any particular Rider.

Based on Taxpayer's representations and the authority cited above, we conclude that the Rider will constitute a qualified long-term care insurance contract within the meaning of § 7702B(b)(1).

Requested Ruling #2

Section 7702B(a)(1) provides that a qualified long-term care insurance contract is treated as an accident and health long-term care insurance contract. Section 7702B(a)(2) provides that amounts (other than policyholder dividends and premium dividends) received under a qualified long-term care insurance contract shall be treated

as amounts received for personal injuries and sickness and shall be treated as reimbursement for expenses actually incurred for medical care (as defined in § 213(d)).

Section 104(a)(3) provides that, except in the case of amounts attributable to (and not in excess of) deductions allowed under § 213 (relating to medical, etc. expenses) for any prior taxable year, gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer).

Under § 7702B(d), periodic payments received under qualified long-term care insurance contracts are subject to a per diem limitation. Amounts received in excess of the per diem limitation, with respect to which no actual costs were incurred for long-term care services, are fully includable in income without regard to § 72.

Taxpayer represents that the Contract and Rider are “purchased with after-tax monies” and are not attributable to contributions by an employer which were not includible in gross income or paid by the employer. Accordingly, the Rider will be treated as accident or health insurance for purposes of § 104(a)(3) of the Code.

Based on the representations and the authorities cited above, we conclude that to the extent that they do not exceed the per diem limitation of § 7702B(d), all LTC Benefits paid under the Rider will be excludable from the Contract owner’s gross income under § 104(a)(3).

Requested Ruling #3

Section 72 sets out various rules for the tax treatment of amounts received under an annuity contract. Section 72(a) provides in part that gross income includes any amount received under an annuity contract. The exclusion ratio for amounts received as an annuity determined under § 72(b) is calculated with respect to the taxpayer’s investment in the contract as defined by § 72(c)(1). Section 72(e) applies to amounts that are not received as an annuity, and provides in general that amounts not received as an annuity are included in gross income to the extent of the income on the contract. A taxpayer’s investment in the contract, as defined by § 72(e)(6), is taken into account in determining that income.

For amounts received as an annuity, § 72(c)(1) defines the term “investment in the contract” as of the annuity starting date as (A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus (B) the aggregate amount received under the contract before such date, to the extent that such amount

was excludable from gross income. For amounts not received as an annuity, § 72(e)(6) defines the term “investment in the contract” as of any date as (A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus (B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income.

The Pension Protection Act of 2006 (Pub. L. 109-280, 120 Stat. 780) added § 72(e)(11). Section 72(e)(11) provides that any charge against the cash value of an annuity contract made as payment for coverage under a qualified long-term care insurance contract that is part of or a rider on the annuity contract is not includable in income. The investment in the contract is reduced (but not below zero) by the charge.

As we concluded above, to the extent that they do not exceed the per diem limitation of § 7702B(d), all LTC Benefits paid under the Rider will be excludable from the Contract owner’s gross income under § 104(a)(3). As such, we conclude that payment of LTC Benefits under the Rider will reduce the “investment in the contract” of the Contract for purposes of § 72.

No opinion is expressed with respect to any other section of the Code or regulations thereunder that may be applicable to Taxpayer. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Sheryl B. Flum
Chief, Branch 4
(Financial Institutions & Products)