Long Term Care vs. Chronic Illness

Why these designations matter to the IRS and how they can impact the cash value of your insurance policy's benefit

-Contributed by Justin Fundalinski-

Last month, we scratched the surface on pros and cons of life insurance policies that are designed as "hybrids" and have a **primary purpose** to provide long term care (LTC) benefits under a special long term care rider. Unfortunately, a lot of confusion is generated by life insurance policies that have long term care riders. Some policies are termed "life insurance", but are designed specifically to be long term care policies and have the LTC rider built right into them (hybrids). Other policies are life insurance policies with a LTC rider that is added on (à la carte style) to the standard policy. This month we are going to dig a little deeper and explore the intricacies of these "special riders" and how one long term care rider can be very different from the next – especially when the long term care benefit was added on à la carte. There are two specific differentiators that need to be discussed so you know what to look for in a new or existing policy: how the LTC rider is filed for tax purposes, and how the rider affects the policy's death benefit and cash value.

Fun IRS tax jargon:

The reality is when you buy one of these long term care riders they are an acceleration of your death benefit (and sometimes an extension of benefits beyond your death benefit). This simply means the insurance company will let you tap into your death benefit (and sometimes more) before you actually pass away if your medical condition matches certain conditions spelled out in your policy. Now you may be wondering how any money received under an accelerated death benefit will be taxed. After all, if you pass away, any life insurance death benefits received by your beneficiaries will be 100% income tax free. But an accelerated death benefit is paid directly to you while you're living! The good news is if the sponsoring insurance company files the rider under one of two IRS approved classifications known as 101(g) or 7702B you could (there are a few exceptions) receive your accelerated death benefit payments to cover certain long-term care expenses 100% income tax free!

1. **101(g)** – Technically, if the rider is filed with the IRS under section 101(g), it will not be termed as long term care rider but as chronic illness rider. However, it is often thought of as a long term care rider because "chronic illness" can have very similar eligibility criteria as defined under HIPPA long term care eligibility guidelines. The major differentiator is that keyword "*chronic*". Your condition **must be permanent** in order to receive these benefits. With a traditional long-term care insurance policy under Federal HIPPA guidelines your condition need only last at least 90 days to be defined as long term care and pay your benefits. For example, if you needed a hip replacement and as a result you needed assistance in your home for several months after your operation a 101(g) "chronic illness" rider would not pay any benefits because your condition is not permanent. However, if you suffered a condition that put you in a wheelchair for the rest of your life, your condition is now "chronic" and the rider would pay you your benefits.

Another interesting facet of a 101(g) "chronic illness" rider is how your benefits are actually paid to you. Unlike most long-term care policies that operate under a "reimbursement" model where your benefit is paid to reimburse you for actual services you received from licensed medical providers, 101(g) riders operate under an "indemnity" model where your total eligible benefit is paid directly to you in no relation to actual services received once you qualify for benefits under the provisions of your policy. (There are more facets to this payment model than we are reviewing in this article. Talk with your insurance agent and tax advisor for specifics on this 101(g) indemnity model and how benefits paid may be taxed.)

2. **7702B** – This insurance rider is as close to a true long term care insurance policy as you can get without actually purchasing a traditional long-term care policy. Any life insurance policy that directly advertises itself as having a "long term care" benefit must be filed under Section 7702B with the IRS. (A policy offering the abovementioned 101(g) chronic illness rider cannot hold itself out as offering a long-term care benefit.)

   Under a 7702B filing benefits will be paid tax free **for temporary or permanent long term care claims**. This benefit falls in line with what most people think of as long term care. Often, with various exceptions, these benefits are paid under a "reimbursement" model. That is you pay a long term care bill and submit your receipts to the insurance company. However, many companies offer a coordination of benefits program where your medical service provider can submit payments directly to the insurance company without you having to pay first and wait for reimbursement.

How your death benefit and cash value is affected:
Anytime you end up using one of the accelerated benefit riders discussed above remember that you are receiving your death benefit early, so every accelerated benefit you get reduces your death benefit. Of course there are various iterations of what your absolute minimum death benefit could be even after receiving all of your long term care benefits, but it all depends on the policy type and verbiage. So just remember, your long term care benefit eats away at your death benefit – there is no double dipping.

The other side of the coin is that some life insurance policies have cash value that builds in them above and beyond the death benefit. All I can say is read the fine print (or have us read it) on how cash value is affected when an accelerated benefit is used. We have seen long term care benefits that erode away cash values at a rate much greater than the amount of accelerated long-term care benefits actually paid out.

In conclusion, it's important that you know your policy and that you and your family know how your policy fits into your overall retirement and long term care plan. Don't be intimidated by all of this, if you have questions on this topic, please feel free to reach me at Justin@JimHelps.com.