Northwestern Mutual

The Taxation of Accelerated Care Benefits

Accelerated Care Benefits – The Basics

The Accelerated Care Benefit ("ACB") is a provision available on some Northwestern Mutual life insurance contracts.[1] ACB permits death benefit proceeds under a life insurance policy to be advanced during the insured's lifetime to reimburse the policyowner for qualifying long term care expenses actually incurred.

ACB is a provision of a life insurance policy and is not considered a "qualified long term care insurance contract" for tax purposes.[2] It is, instead, designed to be an acceleration of death benefit that qualifies for income tax-free treatment.

To receive income tax-free reimbursements under Section 101(g) of the Code, three features are required:

1. Reimbursements. ACB payments are reimbursements for qualifying long term care expenses incurred and not otherwise reimbursed.[3]
2. Qualified long term care expenses. Qualified long term care expenses means necessary treatment or personal services which (i) are required by a chronically ill individual, and (ii) are provided pursuant to a plan of care prescribed by a licensed health care practitioner.[4]
3. Chronically Ill. Generally, "chronically ill" means a licensed health care practitioner determines that the insured (i) needs substantial assistance to perform two of six activities of daily living (eating, toileting, transferring, bathing, dressing, and continence),[5] or (ii) requires substantial supervision to protect the insured from threats to his health or safety due to a severe cognitive impairment.[6] A permanent chronic illness is not required.

Premium Payments

ACB premiums are not deductible because ACB is a life insurance feature, and not a qualified long term care insurance contact. While qualified long term care insurance contract premiums may be deductible in certain instances,[7] life insurance premiums are not deductible.[8]

Taxation of Benefits

Benefits paid to a chronically ill individual for qualified long term care services are generally income tax free.[9] However, if an insured receives benefits from the ACB and, during the same year, benefits are paid from other

[1] ACB may not be available on all policies or in all states.
[2] A qualified long term care insurance contract must meet certain requirements, such as it only provides insurance for long term care services, and it does not provide for cash surrender value. IRC § 7702B(b).
[3] IRC § 101(g)(3)(A)(i).
[4] IRC §§ 101(g)(4)(C), 7702B(c)(1).
[5] IRC § 7702B(c)(2)(B).
[6] IRC § 7702B(c)(2).
[7] IRC § 213(d).
[8] IRC § 264(a).
[9] IRC § 101(g)(1)(B).

contracts due to the insured's chronic illness, a portion of the benefits may be taxable. The Code requires that all benefits received in the same year as chronic illness and benefits and from qualified long term care insurance policies be added together.

The total amount that can be excluded from income is the greater of:

1) the costs of qualified long term care services provided to the insured; or

2) the "per diem" limitation ($370 per day in 2019).

Any excess amounts are taxable as ordinary income.[10]

If a business owns a policy that permits acceleration of benefits for a chronically ill insured, the benefits are taxable income, regardless of the amount.[11] Note that Northwestern Mutual requires that the insured be the owner of any policy with ACB.

Section 1035 Exchanges

Life insurance contracts can be exchanged tax-free for other life insurance contracts, nonqualified annuities, or qualified long term care insurance contracts.[12] This is commonly referred to as a Section 1035 exchange, after the Code section authorizing the exchange.

- A life insurance contract without ACB can be exchanged for a life insurance contract with ACB.
- Because ACB is not a qualified long term care insurance contract, the charge for the ACB rider cannot be paid with Section 1035 exchange proceeds, while the life insurance portion of the premium can be paid by the 1035 proceeds.
- To remain tax-free in such an exchange, the ACB rider portion of the premium must be paid from other sources, such as cash, policy loan, or partial surrender of a life insurance contract's cash value.
- Nonqualified annuities can be exchanged tax-free into qualified long term care insurance contracts, but not into a life insurance policy, regardless of whether the policy has ACB.[13]

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[10] *See* Instructions for IRS Form 8853.

[11] IRC § 101(g)(5). This subsection imposes income taxation when the business has an insurable interest in the insured by reason of the insured being a director, officer, or employee, or being financially interested in the business. Other subsections may impose income taxation if a business owns a policy where the insured does not meet these criteria. IRC §§ 101(a)(2), 101(j).

[12] IRC § 1035(a)(1).

[13] IRC § 1035(a)(3).

