Seeking Stable, Efficient Coverage for Long-Term Care with Asset-Based Products

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ABSTRACT

The purpose of this article is to familiarize professionals (including attorneys, accountants, and financial advisors who advise the elder population) with the basics of asset-based long-term care products and to highlight situations in which the use of an asset-based policy might be most beneficial to clients with long-term care concerns.

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An Incomplete Seminar

Many seminars are billed as complete discussions of long-term care (LTC), but often the option of asset-based LTC is missing from the agenda. There is the usual discussion of Medicare and what it does and does not cover, along with a discussion of Medicaid and that program's eligibility requirements for receiving benefits. Also discussed is health-based, or what is sometimes referred to as stand-alone, long-term care insurance (LTCI). What is not discussed in these otherwise quite thorough presentations is asset-based, sometimes referred to as combination or hybrid, LTC protection.

Health-based LTCI is a lot like health insurance. The insured pays monthly premiums, and when LTC expenses are incurred, the insurance starts paying. Health-based LTCI has no cash value. If the insured never requires LTC, no LTC benefits are paid, and there is no benefit for the insured's heirs. Asset-based LTC protection links LTC benefits with either life insurance or a deferred annuity. When LTC expenses are incurred, LTC benefits are paid. If LTC is not needed or if the policyholder dies, assets are transferred to the insured's heirs.

The omission of asset-based LTC protection is unfortunate yet somewhat understandable. It is not uncommon to find professionals who work for an enterprise that has been offering asset-based LTC products for years who do not fully appreciate the efficiency of these products. No wonder then that a seminar speaker, a respected attorney, or a law professor who does not work in the insurance industry, would fail to mention such products when discussing the topic of LTC planning.

But why is this so? Many of the advisors in the vast LTC arena, from attorneys, accountants, and financial professionals to elderly clients themselves, simply do not fully understand these products and how they work. This stems from two failures: First, the failure to understand the taxation of asset-based LTC products and second, the failure to understand the insurance principles upon which life insurance and annuity asset-based LTC products are based. This heretofore obscure intersection of tax law, insurance concepts, and aging presents a challenge for those who wish to present a full menu of options to elderly clients.

Most functionally literate American adults have at least a vague understanding of what insurance involves. They know it involves the spreading of risk—the concept that if a large number of people throw a small amount of money into a pot there will be a large amount of money for the small number of people who have claims. They know this involves some heavy lifting in the area of mathematics. Statistics, probability, and the field of actuarial science are involved.

Most Americans also know that taxes can affect the rate at which individuals accumulate wealth. Less paid in taxes means more to invest. Indeed, favorable tax treatment is a big factor in the decision to place funds in qualified retirement plans, IRAs, health savings accounts, and college 529 plans. Often, the typical middle-class taxpayer is aware of these tax incentives and is not hesitant to claim them. The favorable treatment of asset-based LTC products, however, remains unknown to many Americans.

A Brief History of LTCI

Health-based LTC policies first appeared over 30 years ago. The early policies were mainly "facilities" policies that provided limited coverage for people who were recovering and required nursing home care. Over the years, health-based LTCI has expanded to cover more types of care, and the premium for policies can vary greatly with the type and level of coverage provided. Health-based coverage has evolved to provide benefits with five general considerations: (1) per diem benefit (for indemnity-style policies), (2) length of coverage, (3) elimination period, (4) home care coverage (if offered in addition to assisted living facility coverage), and (5) inflation protection. Each of the five considerations forces the prospective policyholder to make choices in a cost-benefit analysis that involves a lot of guesswork. The more benefits provided by the insurer, the more the premium increases.[1]

Age also plays a major role in pricing. A review of pricing from a major carrier in 1997 revealed a fourfold increase in the cost of a policy with identical coverage from an issue age of 55 to an issue age of 75,[2] and due to the steepness of the morbidity curve this pricing difference continues in 2016.[3] Hence, it seems the "younger the better" for buying health-based LTCI. However, the younger the buyer, the longer the time until a claim is likely to be experienced. The prospective purchaser is left to wonder whether the cumulative premium payment before a claim is experienced will be more than the premium difference encountered had the purchaser waited to an older age to buy the coverage (assuming the purchaser remains insurable at a later age).[4] Purchase at younger ages also increases the need for inflation protection, but inflation protection is generally the consideration that most drastically increases price.[5]

Younger issue age also likely increases the time a health-based policy will be subject to rate increases before potential payment of benefits begins. Indeed, rate instability has been a major drawback in the health-based LTC marketplace. Although LTC premiums cannot be raised on a particular individual, the premiums can be raised for an entire class of policies, such as those issued in a particular state, subject to state approval.

Companies that sell LTCI face the same task that all insurance companies face in that they set premiums, in part, based on the expected number of claims and cost of those claims. For the provider of homeowners insurance, what is the risk of home damage due to fire, weather, or theft? For the whole life insurance carrier, what is the risk the insured will die prematurely, and for term insurance, what is the risk the insured will die during the term? For some types of insurance coverage, the maximum claim payment is known. Life insurance, for example, has a stated death benefit. For other types of coverage the cost of claims on any particular policy may be harder to determine, and for these types of coverage there is generally a maximum stated benefit that will be paid.

For health-based LTCI the determination of expected claims and the cost of those claims is extraordinarily difficult. What is the risk that the insured will require LTC services? If there is a claim, when will the claim occur? How long will the insured be on claim? What will be the cost of the claim? As the nation ages, the number of those potentially requiring LTC services is constantly increasing. It has been estimated that 70 percent of people now age 65 will need LTC services at some point before their deaths.[6] The cost of LTC services has essentially skyrocketed over the past decade. The average cost of care in an LTC facility is estimated to be $75,000 per year,[7] and a recent study placed the median annual cost of care for a private room in a nursing home nationally at $91,250.[8]

An additional question is, how many policyholders will retain their coverage for the duration of their lives? (That is, how many policies will lapse before a claim arises?) Even with the premium increases that have occurred with many health-based policies, policyholders tend to endure the increase and retain the policy for fear of losing all they have invested in premiums. Also, keeping existing coverage may be the best economic choice when comparing premiums on an existing policy to premiums on a newly issued health-based policy. Indeed, the National Association of Insurance Commissioners (NAIC) model LTCI regulation provides that a carrier seeking to raise rates must state that renewal premium rate schedules are not greater than new business premium rate schedules.[9] For these reasons, policy retention with health-based LTCI has been much higher than the issuing carriers anticipated. Policy retention is yet another factor that has forced carriers, which use lapse-supported pricing assumptions, to raise rates.

A hard-to-determine claims experience and a hard-to-determine claims cost equal a very difficult insurance product to price accurately and as history now shows, an easy product to underprice. Add to these difficulties the current sluggish economy and low interest rates—rates on the various types of fixed investments insurance companies purchase to back their promises to policyholders—and you have an economically incendiary mix leading to an explosion of premium rates for health-based LTC policies. In some cases, premiums have tripled from the time of policy issue, which may make the policy premium higher than what the policyholder is able to pay, let alone what the policyholder ever expected to pay.[10]

Companies that increase premium rates on LTC policies do so, in essence, to forestall insolvency. In the past 5 years, the chaos in the LTC marketplace has led half of the top 20 carriers to leave the LTC market entirely,[11] and one major carrier recently reported an $844 million loss that was driven by $531 million in pretax costs to increase its LTC reserves.[12] Carriers leaving the marketplace and ever-increasing premiums have led consumers to wonder if health-based LTCI remains a viable choice for protecting against LTC risk. However, if health-based LTCI is not the answer, where can the individual or couple with concerns about LTC turn?

The Partnership Concept

In the late 1980s, the LTC Partnership Program was initiated as a demonstration project with funding received from the Robert Wood Johnson Foundation. The Partnership Program was designed to attract consumers who might not otherwise purchase LTC insurance. California, Connecticut, Indiana, and New York were the original four participating states.

The idea behind the partnerships is that people who purchase specially designated LTCI policies will be eligible for Medicaid after they exhaust their LTCI benefits. The policyholder who exhausts all of his or her LTCI benefits is allowed to retain assets equal to those benefits and still qualify for Medicaid (assuming the state's other requirements, such as income level and being medically in need of LTC, are met).[13]

However, citing concerns about the appropriateness of using Medicaid for this purpose, Congress enacted legislation in 1993 that placed restrictions on the further development of partnership plans, which essentially kept additional states from participating in the program. This situation changed in 2005 with passage of the Deficit Reduction Act. With this law, Congress authorized all state governments to create LTC partnerships similar to those in the original four states, provided that certain consumer protections are met.[14]

Partnership policies have specific requirements based on model provisions established by the NAIC, the most notable of which is the requirement that the policies have inflation protection.[15] As noted earlier, this is a provision that adds to the cost of coverage. An additional drawback is that any assets in excess of insurance benefits paid must be spent down before the individual is eligible for Medicaid.

For example, if an individual purchases $100,000 in partnership LTCI benefits, that individual may retain $100,000 and qualify for Medicaid. However, non-Medicaid-exempt assets above that amount must be depleted before he or she is eligible. Hence, if this individual goes on claim, uses all of the partnership LTC benefits, and still requires LTC, the family business, vacation home, investments, and other assets in excess of $100,000 that the individual may wish to preserve are not protected. The result is that use of partnership policies is attractive only to the lower economic tier of individuals with LTC concerns. The retired middle-income (or above) couple will often have retirement plans, a home, investments, and perhaps a family business they wish to pass on to their children. Thus, for those who wish to accomplish some intergenerational wealth transfer, partnership policies have little utility.

Two states, Indiana and New York, offer programs called "total asset protection" in addition to "dollar-for-dollar" programs. Under these programs, if a sufficient dollar amount of benefits has been paid, all of the insured's assets will be disregarded during the Medicaid eligibility process. In Indiana, the policy must have a provision under which the daily benefit increases by at least 5 percent per year, compounded at least annually, and the applicant must have exhausted maximum benefits of at least $336,927 in 2016. This latter number increases by 5 percent annually as well.[16]

Although the total-asset-protection programs appear to be more powerful than dollar-for-dollar programs because of the potential for unlimited asset protection from Medicaid, some of the drawbacks of the dollar-for-dollar programs persist. First, the required benefit levels are high and, thus, expensive. Second, if the insured moves to a nontotal-asset-protection state, the benefit will likely convert to a dollar-for-dollar benefit. Third, the "use-it-or-lose-it" nature of the coverage gives pause to many who would consider purchasing such policies. This last drawback will be analyzed in more detail as this article progresses, but it is fair to say that this combination of factors has prevented large-scale use of partnership policies. Indeed, one commentary noted that sales of partnership policies have been "disappointingly small."[17] A response to these issues has been to combine LTC benefits with either a life insurance policy or a deferred annuity policy.

The Combination of Life Insurance with LTC Benefits

The chaos in the health-based LTC marketplace, and the limited utility of partnership policies, may lead middle-income retirees to throw up their hands in frustration and decide to simply take their chances on not needing assistance in old age. Understanding this frustration, Congress has passed two laws that incentivize taxpayers to purchase LTC coverage but in a manner different from traditional stand-alone, health-based LTCI. In 1996, with the Health Insurance Portability and Accountability Act (HIPAA), the federal government set forth the requirements for tax-qualified LTC policies. Until that time, the tax status of benefits paid under LTC policies was uncertain. HIPAA provides that, if the policy meets certain triggering events for payment of benefits, then the benefits paid will be received free of income tax. These provisions are codified in Internal Revenue Code (IRC) Section 7702B.[18] HIPAA also provides for the first type of "combination contract" or what is known as a hybrid or asset-based LTC policy.

HIPAA stated that life insurance and LTC benefits could be combined in one policy. If the provisions for payment of LTC benefits comply with the law, those benefits will be received income tax free.[19] Additionally, if the policy pays no LTC benefits and the policy pays its life insurance death benefit on the insured's death, then that benefit will also be received free from income tax.[20] The typical configuration of a life insurance asset-based contract involves what is basically a prepayment of a permanent life insurance policy's death benefit for qualified LTC claims. For example, a policy may provide that the maximum monthly LTC benefit is 2 percent of the policy's death benefit. Hence, if the policy had a $250,000 death benefit, the maximum monthly LTC benefit would be $5,000 per month for 50 months. Each payment of LTC benefits would correspondingly reduce the policy death benefit. If the full payment of $5,000 were to be paid for 50 months, the policy death benefit would likewise be exhausted.

The advent of asset-based life insurance LTC contracts eliminates a number of concerns that are present with health-based LTC policies. First, the "use-it-or-lose-it" nature of stand-alone health-based policies is not present with asset-based contracts. This has been perhaps the largest hurdle in convincing prospects to buy LTC coverage in the first place—the idea that, if they never go on claim, the cumulative premium payments were for nothing. With asset-based life insurance LTC policies, if there are no LTC claims the insured's beneficiaries receive the policy death benefit, and receive it income tax free.

A second benefit of asset-based contracts is pricing stability. Nearly a century-and-a-half ago an initial version of life insurance appeared in the United States in the form of assessment associations.[21] Ever since that time, the U.S. population and its mortality have been the subject of enormous study. What started as mutual assurance and fraternal assistance has evolved into an industry that constantly studies claims experience, expenses, and investment and that constantly adjusts price accordingly. It is fair to say that the mortality of the U.S. population has been one of the most studied of any in history, and it is fair to say that the actuarial profession has the mortality risk of the general population pretty well figured out.

This is in contrast with the risks associated with LTC, which is a relative newcomer to the insurance arena and for which the pricing has proven difficult to judge. This is due to the competitive environment among carriers and the fact that policy retention has been much higher than anticipated. Life insurance LTC asset-based products provide the opportunity to pair the uncertainty of LTC with the comparatively stable assumptions used in life insurance. The risk of prepaying a definable claim, as is done with asset-based life insurance LTC policies, is easier than determining the risk of having any claim at all. And the maximum exposure is known and reserved for in the asset-based setting because, after all, everyone is mortal. This combination in general protects asset-based life insurance LTC products from the pricing volatility experienced in the health-based market.

A third benefit of asset-based LTC policies is that they permit the individual who is willing to partially self-insure his or her LTC risk the ability to do so and to do so in a manner that is generally more tax efficient than with any other method of investment. Setting aside funds in an asset-based life insurance LTC policy can free up other funds to use as the insured desires in his or her retirement and estate planning. The cash reserve in a permanent life insurance policy is not taxed as it grows, LTC benefits are received income tax free, and death benefits are received income tax free. If the individual were to set aside a personal savings fund for LTC claims, that individual would have a shortfall if claims were incurred before the fund had a chance to grow, and if claims occurred years into the future, the gain on the investments in the savings fund would be subject to income tax, either as ordinary income or capital gain, depending on the type of investment. In this manner, asset-based contracts are similar in tax benefits to Roth IRAs but without the contribution restrictions and distribution requirements present with those incentivized accounts.

The Combination of Deferred Annuities with LTC Benefits

The second of the two laws passed by Congress that beneficially affects the LTC marketplace is the Pension Protection Act of 2006 (PPA). The PPA extended the preferential treatment of life insurance LTC combination contracts to deferred annuity LTC combination contracts.[22] Some of these contracts provide a higher account value for LTC withdrawals than for withdrawals made for non-LTC purposes (an LTC account with a higher credited interest rate simultaneous with a non-LTC account at a lower credited interest rate), and some contracts provide additional LTC benefits beyond account value. Similar to life insurance combination contracts, the payment of LTC claims from an LTC account-style contract results in a corresponding reduction to the LTC account value. For example, the policy may provide that the LTC account value at the time of claim will be paid in 36 equal monthly installments. Hence, if the policy LTC account value at the time of claim is $180,000, the policy could pay up to $5,000 per month for 36 months.

By way of definition, an annuity is a contract that provides that, in return for receiving one or more premiums from the policyholder, the insurance company agrees to pay a regular income for a specified time period, the life of the annuitant (the person whose life on which the annuity payments are based), or a combination. During the time period before the payments begin the contract is known as a "deferred annuity." After regular payments begin, the contract is said to be "annuitized." Annuitized payouts and all other guarantees are subject to the claims-paying ability of the issuing insurance company. There is no legally mandated age when annuitized payouts must begin on a nonqualified deferred annuity. Indeed, the majority of deferred annuity policyholders die without ever annuitizing the contract.

Annuity LTC asset-based contracts are both similar to and different from life insurance asset-based contracts in regard to how distributions are taxed. As with the cash reserve in permanent life insurance, the cash value in a deferred annuity is not taxed as that value grows. With a traditional (non-LTC) deferred annuity, withdrawals are taxed as ordinary income to the extent there is gain in the contract, and gain is deemed to be distributed first.[23] However, as with life insurance LTC contracts, the payments made from an asset-based annuity for qualified LTC expenses are income tax free. Amounts remaining in the contract at the annuitant's death are ordinary income to the annuitant's beneficiaries to the extent there is taxable gain remaining in the contract.

The PPA creation of asset-based LTC annuities also provides assistance with two concerns that might otherwise preclude an individual from purchasing an LTC product: insurability and tax efficiency.

Insurability

A potential drawback for an individual seeking to purchase health-based LTC coverage or asset-based life insurance LTC protection is that both products are medically underwritten. The potential insured must in general provide answers to medical questions; go through a medical exam; and perhaps submit to blood, urine, and cognitive screening tests to determine the level of risk the carrier is accepting if it chooses to issue a policy. This can be problematic for the less-healthy applicant. An individual with a chronic health condition that substantially increases the likelihood of needing extended LTC in the future may be denied health-based LTC coverage. A condition that substantially increases the likelihood of premature death may prevent the issuance of life insurance on that individual.

Deferred annuities are not medically underwritten in the manner that life insurance or health-based LTC insurance is underwritten. With asset-based LTC annuity products the carrier is primarily concerned that the applicant is simply not already on claim—i.e., that the applicant is still able to perform activities of daily living (ADLs), which are bathing, eating, dressing, toileting, transferring, and continence—and that the applicant does not currently have cancer, Alzheimer's disease, or AIDS. If the applicant can perform ADLs and does not have any of the listed conditions, the applicant will likely qualify for product issue without medical examination. Thus, a less-healthy individual who may be denied health-based coverage or life insurance can still purchase a product that will assist with payment of LTC claims. Such an individual may desire to purchase an asset-based annuity LTC product, as opposed to some other investment, because of the aforementioned tax efficiency of the product. If, because of poor heath, an individual is unable to obtain medically underwritten LTC coverage, the most-efficient method of funding for this risk may well be via an annuity LTC asset-based policy.

Tax Efficiency

Consider an individual, aged 62, who is unable to purchase medically underwritten LTC coverage due to an adverse health condition (e.g., controlled diabetes or early-stage cancer that appears to have been successfully treated), and who has $100,000 he or she would like to allocate to an investment that could assist with payment of potential LTC expenses. If he or she purchases an annuity LTC asset-based policy, paying the $100,000 as premium, and if the account grows at 4 percent annually, the annuity value 18 years later at the annuitant's age 80 would be slightly more than $200,000. If this annuitant experiences the need for LTC at age 80, and if during the remainder of the annuitant's life the entire annuity value is paid out for LTC claims, none of the more than $100,000 gain in the contract would be taxed.

Contrast this to an investment in securities where gain upon liquidation of the account would be subject to capital gain taxes, or investment in savings accounts or CDs where gain is subject to tax at ordinary income tax rates. Not only do securities and CDs incur taxation, but this reporting of income increases provisional income for purposes of taxation of Social Security benefits—thus potentially further increasing the overall tax bite encountered by the taxpayer. Also, the recently enacted 3.8 percent net investment income tax may apply to a high-income taxpayer with reportable income from these investments. Hence, for the individual who is seeking to invest to cover LTC exposure, the provisions of the PPA provide the incentive to do such investing efficiently through the use of an annuity LTC asset-based policy. This efficiency, of course, applies to the healthy as well as the less-healthy. In particular, individuals with substantial cash value in deferred annuities or life insurance who no longer desire life insurance protection may exchange existing policies to annuity LTC asset-based policies tax free under IRC Sec. 1035, which is discussed in the next section.

Note that distributions for LTC expenses from an annuity LTC asset-based policy are deemed to first come from policy basis. Thus, using the prior example, if the annuitant experiences $100,000 of LTC claims and then dies with $100,000 remaining in the policy, the annuitant's beneficiaries would pay ordinary income tax as they receive the gain left in the policy at the annuitant's death. However, this is no different from if the funds were invested in a traditional annuity or qualified retirement plan. And remember that the annuitant received tax-free LTC withdrawals during life.

IRC Sec. 1035 Exchanges to Asset-Based Policies

Many couples at or nearing retirement age have deferred annuities and permanent life insurance. Often such couples consider repositioning these products without understanding the benefits of exchanging such policies for asset-based LTC policies. A benefit with life insurance and annuity policies is that IRC Sec. 1035 permits exchanges from one policy to another policy better suited to meet the needs of the insured. Current regulations also permit partial exchanges of deferred annuity policies with basis being allocated pro rata between policies.[24]

Table 1 shows what types of contracts can be exchanged under IRC Sec. 1035.

In a gain situation, a proper IRC Sec. 1035 exchange enables the policyholder to postpone the recognition of that gain. The policyholder's cost basis in the new policy becomes the transferred basis plus any future premiums paid.

Example:

Surrender value:	$400,000	transferred to new policy
Cost basis:	$200,000	transferred to new policy
Potential gain:	$200,000	tax deferred

Consider an individual, aged 70, who holds a traditional deferred annuity with a current account value of $400,000 and a basis of $200,000. If withdrawals are made from this annuity for expenses, LTC expenses included, the $200,000 gain in the annuity will be taxed first at ordinary income rates. If the annuity is exchanged under IRC Sec. 1035 for an annuity LTC policy, taxation of the gain will be deferred, and if withdrawals are made for LTC expenses, the distributions will be income tax free.

If this individual wished to allocate half of the $400,000 account value to LTC coverage, he or she could partially exchange half of the contract for an annuity LTC policy. The result after the partial exchange would be two policies: one traditional policy with an account value of $200,000 and a basis of $100,000, and one annuity LTC policy with an account value of $200,000 and a basis of $100,000.

Now consider an individual, aged 70, who holds a permanent life insurance policy with a death benefit of $250,000, cash surrender value of $150,000, and a basis of $100,000. If this individual surrendered the policy he or she would have $50,000 of reportable gain as ordinary income. The individual could take basis-reducing, nontaxable withdrawals from the policy or loans, but if the policy later lapses or is surrendered, the policy gain will be reportable at that time. If this policy is exchanged under IRC Sec. 1035 for a life insurance LTC policy, the risk of taxation on lapse due to withdrawals for LTC expenses disappears. If this individual can no longer pass medical underwriting, the existing life insurance policy could be exchanged under IRC Sec. 1035 to an annuity LTC policy, and distributions would then enjoy the tax-favorable treatment that product enjoys for payment of LTC expenses.

Note that all of these examples do not take into account any potential product surrender

TABLE 1
Tax-free policy exchanges permitted under IRC Sec. 1035

Type of Policy → to	Life Insurance	Endowment	Annuity	Long-Term Care*
Life Insurance	Yes	Yes	Yes	Yes
Endowment	No	Yes**	Yes	Yes
Annuity	No	No	Yes	Yes
Long-Term Care*	No	No	No	Yes

*Contract must be a "qualified" long-term care contract under IRC Sec. 7702B.
**Provided payments begin no later than under the old contract.

penalties that may apply. An inquiry regarding such penalties should always be made to the current carrier, and such penalties should be taken into account when considering any of these strategies.

Continuation of Benefits with Asset-Based LTC Policies

A final consideration in the analysis of asset-based LTC contracts is the ability to purchase continuation of benefit (COB) coverage with these policies. COB coverage takes effect after the LTC benefit balance on the base policy has been exhausted through qualifying LTC benefit payments. COB coverage will continue benefits for a predetermined period of time, and at least one carrier offers lifetime coverage. There is additional premium for this extended coverage, and it is medically underwritten. The premium may be contributed as cash or as part of an IRC Sec. 1035 exchange. COB coverage can provide the purchaser with the peace of mind that he or she will not outlive the coverage.

From the earlier example where a life insurance LTC policy was prepaying 2 percent of the death benefit each month over a period of 50 months: This insured may have concerns that coverage will be exhausted if he or she lives longer than 4 years and 2 months while on LTC claim. COB coverage, if purchased, will begin in month 51 when the base coverage runs out.

While it may seem that COB coverage is subject to the same chaos that affects health-based LTC, the reality is far less harsh. The average length of stay for current nursing home residents is slightly less than 2½ years, and the percentage of people who enter a nursing home and stay there more than 5 years is only 10 percent.[25] And while it is true some LTC claimants may live a long time on claim (an otherwise healthy individual with early-onset Alzheimer's, for example), most do not. The extended LTC claim is an outlying claim in the actuarial analysis. An analogy can be made with auto insurance. Most drivers know that a larger deductible means a materially lower premium and understand that this is the result of the insurance carrier paying less of the claim. For example, if the deductible (the amount the insured is responsible for paying) is $100 per claim, the insurance carrier is paying claims at dollar $101. If the deductible were instead $1,000, the carrier would pay $900 less than with a $100 deductible because the first $1,000 is the insured's money.

With asset-based LTC policies using COB coverage, the base policy is similar to a large deductible. The base policy is essentially the insured's money; the COB only comes into play on the extended claim. This results in a lower premium than what is seen in the health-based market for extended coverage. With some carriers COB coverage is noncancellable, and premiums are guaranteed not to increase. The Appendix to this article shows illustrative premium estimates and presents a sample comparison between asset-based and health-based coverage.

In essence, asset-based LTC policies with COB coverage combine the stable pricing and tax efficiency of the base policies with the concept of a large deductible to provide up to lifetime coverage for claims in the most-efficient and risk-minimizing manner currently available. This is, additionally, accomplished without the "use-it-or-lose-it" quandary present with health-based LTC coverage.

Two Areas of Confusion

IRC Sec. 7702B versus IRC Sec. 101(g)

In addition to providing for asset-based LTC products in IRC Sec. 7702B, HIPAA also added Section 101(g) to the IRC. This section provides for terminal illness and chronic care riders on life insurance policies. A "terminally ill individual" is a person who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months after the date of certification. A "chronically ill individual" is defined as any person (1) unable to perform, without substantial assistance, at least two ADLs for at least 90 days; (2) having a similar level of disability, as designated by regulations; or (3) requiring substantial supervision to protect the person from threats to health and safety because of severe cognitive impairment. Policy payments made for terminal illness or for chronic illness are treated as an acceleration of the policy death benefit and are received income tax free.

Hence, it may seem such riders provide the same coverage as asset-based life insurance LTC policies do because the policy death benefit may be accelerated income tax free for qualifying expenses. However, that is where the similarities end. The agent selling life insurance with IRC Sec. 101(g) riders only needs a license to sell life insurance. The selling of asset-based LTC policies requires the agent to also meet the state's licensing requirements for LTC insurance. In addition, most states have LTC training and continuing education requirements. Furthermore, consumers purchasing asset-based products are afforded the protections outlined within IRC Sec. 7702B, including limits on postclaim underwriting, suitability standards, and education (e.g., many states require that the Shopper's Guide to Long Term Care Insurance be provided to all prospective applicants prior to presentation of an application for coverage).

In fact, the term "long-term care" may not be used in marketing IRC Sec. 101(g) policies. With some IRC Sec. 101(g) riders, the physician must certify that the chronic illness is likely to last the rest of the insured's life—in other words, the condition must be nonrecoverable—whereas IRC Sec. 7702B policies provide benefits for both temporary and permanent claims. Also, some life insurance carriers place a cap on the percentage of the death benefit available for acceleration depending on the age and status of the insured at the time of the claim. A recent commentary described this dilemma as follows:

> Some companies "include" a chronic illness rider feature as part of the policy, with no underwriting and at no additional charge. But keep in mind, no charge does not equate to free. Instead of charging for the rider, the death benefit is discounted when the rider benefits are actually needed. Because of this, benefits cannot be determined until a claim is filed. The discounting of benefits is based on several variables, including age, sex of the insured, premium class as well as current interest rates and policy cash value at time of claim. The younger you are when filing a claim, the more the death benefit is discounted. While some may argue this method spares people never needing qualifying chronic care services from paying rider charges, those needing benefits may not understand at the time of claim why the total policy benefit paid is not the amount of the policy at issue.[26]

Thus, the insured who purchases an IRC Sec. 101(g) policy may not know what level of benefit will be available at the time of a claim. However, IRC Sec. 7702B policies typically pay 100 percent of the policy death benefit for LTC claims, which means the LTC benefit is known at the time of policy issue.

A final difference between IRC Sec. 101(g) policies and IRC Sec. 7702B policies is that COB is not possible with IRC Sec. 101(g) coverage. The COB coverage discussed earlier is only available with IRC Sec. 7702B policies. Hence, the guaranteed assurance of benefits for an individual's lifetime at a guaranteed premium is only available with asset-based LTC products. Chronic illness riders under IRC Sec. 101(g) can be very helpful additions to life insurance policies, and they can provide a valuable benefit in the chronic care setting. However, for the individual who is truly seeking to cover risk for LTC, especially if lifetime coverage is desired, an asset-based LTC policy is the most comprehensive option.

Are LTC Insurance Premiums Actually Deductible?

The analysis in this article has, thus far, centered on the tax treatment of distributions from asset-based LTC policies and has not addressed the issue of whether premiums paid for LTC protection are deductible. HIPAA amended IRC Sec. 213(d), which provides for the allowance of a deduction for medical care expenses, to include LTC premiums in the definition of "medical care." Thus, it seems this is an enticement that would encourage would-be purchasers to become actual buyers of LTC insurance. However, this is an example of something provided for in law but often denied in practice.

Note that, where asset-based LTC products are concerned, the medical expense deduction would only apply to premiums for COB coverage or a separate rider charge for the LTC portion of the policy. The premium on the base life insurance or annuity policy is not deductible because life insurance and annuity premiums are not deductions on a personal income tax return.

The first hurdle to claiming any level of deduction is that medical care is an itemized deduction. Thus, the deduction is not available to a majority of taxpayers because two-thirds of taxpayers claim the standard deduction and do not itemize on their returns.[27] A second limitation is that the deduction for medical care is limited by a 10 percent adjusted gross income (AGI) floor.[28] A third limitation is that the LTC premium deduction is limited to an age-related table that sets a cap on the deduction.[29] Any premiums in excess of the limits in the table provide no tax deduction benefit whatsoever, and although the table limits are adjusted annually for inflation, they set a cap nonetheless. Table 2 sets forth the deduction limits for 2016.

Consider a single taxpayer, aged 60, with an AGI of $60,000. If the taxpayer purchases LTCI, the maximum deduction is $1,460. If this individual pays $1,071 for health insurance coverage as his or her contribution for employer-provided health insurance,[30] the calculation for determining the amount of itemized deduction would be as follows:

LTCI premium	$1,460 (limit)
Heath insurance premium	$1,071
Total medical expenses	$2,531
10% of AGI	$6,000

What this demonstrates is that the taxpayer would have to incur out-of-pocket nonpremium medical expenses of at least $3,469 (the difference between $6,000 and $2,531) before any of the LTC premium would be deductible.

Note also that, if an employee's health insurance contribution is paid via an employer's cafeteria plan on a pretax basis, then the employee's contribution may not be an itemized deduction on the employee's personal tax return. Even if this taxpayer were self-employed and purchased a "platinum" plan under the Patient Protection and Affordable Care Act (PPACA) paid entirely by the taxpayer without subsidy, the example would look as follows:

LTCI premium	$1,460 (limit)
Platinum premium	$5,292[31]
Total medical expenses	$6,752
10 percent of AGI	$(6,000)
Potential deduction	$752

In a 25 percent tax bracket this taxpayer's after-tax benefit would be just $188. Hence, even for those who are paying increasing amounts for health coverage due to the PPACA, the value of the deduction may be minimal. Congress seems to be saying, "We will provide a deduction for LTC premiums, but only in limited amount and only then if other medical expenses are extraordinarily high." Since the LTC deduction is in many cases illusory or paltry, it stands to reason that most LTCI decisions should generally be made independently of whether premiums are deductible. The exception would be one niche business scenario where a potential deduction is a driving force in the sale.[32]

TABLE 2
2016 Age-Related LTC Premium Deduction Limits

Age of Insured	Annual Premium Deduction Limit
Under 41	$390
41-50	$730
51-60	$1,460
61-70	$3,900
Over 70	$4,870

Conclusion

There are currently 14 carriers that market some form of either asset-based life insurance LTC benefits, asset-based annuity LTC benefits, or both,[33] and several more carriers are planning to enter the market. While specifics of the various policies may differ, the general methodology for most of them is based on the concepts discussed in this article.

Attorneys, accountants, and financial advisors who work with the elderly often encounter clients who are concerned and confused about LTC. A complete exploration of assets and a thorough knowledge of the options available is required if the advisor is to provide competent advice. The purpose of this article has been to familiarize the professional who advises the elder population with the basics of asset-based long-term care protection.

In a nation with an aging population and a volatile economy, and where end-of-life care and the cost of that care is an ever-increasing concern, understanding the role that asset-based LTC products can play in planning for the elderly will help professional advisors bring a full menu of options to their clients. ■

This material is provided for overview or general informational purposes only. These concepts were derived under current tax laws. Changes in the tax law may affect the information provided. This is not to be considered, or intended to be, legal or tax advice. For answers to specific questions and before making any decisions, please consult a qualified attorney or tax advisor.

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(1) Richard L. Kaplan, "Retirement Planning's Greatest Gap: Funding Long-Term Care," *Lewis & Clark Law Review* 11, No. 407 (2007): 430–433 (analyzing the five components in LTC policies).

(2) *Ibid,* 434, and Nancy Ann Jeffrey, "Your Needs, Plus Your Budget, Equals What to Pay on Long-Term Care Policy," *Wall Street Journal,* March 21, 1997, C1.

(3) LTC Insurance Calculator, *Genworth Financial,* 2013; accessed at: https://www.genworth.com/long-term-care-insurance/source/make-a-plan/ltc-insurance-cost.html. (This site provides online estimated pricing by state. For example, for a male in Indiana, seeking $200 per diem LTC coverage for 4 years, the annual estimated premium cost at age 55 is $2,380.50, at age 65 is $3,587.77, and at age 75 is $11,178 per quotes generated on 3/22/2016.)

(4) "What's the Best Age to Buy Long-Term Care Insurance," *American Association for Long-Term Care Insurance,* 2016; accessed at: www.aaltci.org/long-term-care-insurance/learning-center/best-age-to-buy-long-term-care-insurance.php (discussing the fact that the percentage of applicants qualifying for coverage decreases with age, and the number of applicants who qualify for discounts decreases with age).

(5) Kaplan (2007): 435, endnote 1. National Association of Insurance Commissioners, *Shoppers Guide to: Long-Term Care Insurance,* 25, 2013. http://www.naic.org/documents/prod_serv_consumer_ltc_lp.pdf]

(6) *Ibid,* 5.

(7) "Costs of Care," *U.S. Department of Health and Human Services,* 2010; accessed at: www.longtermcare.gov/costs-how-to-pay/costs-of-care/ (based on the average cost in the United States in 2010 for a semiprivate room in a nursing home).

(8) Genworth Financial, *Genworth 2015 Cost of Care Survey* (2015): 17.

(9) National Association of Insurance Commissioners, Long-Term Care Insurance Model Regulation, Section 20.1 B(4) (2014).

(10) Kaplan (2007): 440, endnote 1.

(11) Chris Coudret, "Why It's Time to Embrace Asset-Based Long-Term Care Products," *Life Health Pro,* November 5, 2013; accessed at: http://www.lifehealthpro.com/2013/11/05/why-its-time-to-embrace-asset-based-long-term-care.

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(14) Joanie Rothstein, "Long-Term Care Partnership Expansion: A

New Opportunity for States," Robert Wood Johnson Foundation *Issue Brief* (2007): 1–8.
(15) National Association of Insurance Commissioners (2013): 12, endnote 5.
(16) Indiana Code 12-15-39.6-10, and Indiana State Bar Foundation, *Indiana Laws of Aging* (2015): 55. Also, "Indiana Long-Term Care Partnership Program;" accessed at: www.in.gov/iltcp/.
(17) Kaplan (2007): 448, endnote 1 [citing Nelda McCall et al., "The Partnership for Long-Term Care: Who Are the Partnership Policy Purchasers?" *Medical Care Research and Review* 54, No. 4 (1997): 472, 487].
(18) *Health Insurance Portability and Accountability Act,* Public Law 104-191, Sec. 321(a) (1996). Added IRC Sec. 7702B, which governs the requirements for tax-qualified LTC contracts. IRC Sec. 7702B(c) provides that benefits must be triggered if two activities of daily living (ADLs) are unable to be performed. ADLs are: eating, toileting, transferring, bathing, dressing, and continence. An additional trigger is defined as a condition "requiring supervision to protect such individual from threats to health and safety due to severe cognitive impairment."
(19) IRC Sec. 7702B(e).
(20) IRC Sec. 101(a)(1).
(21) Edward E. Graves, *McGill's Life Insurance* (The American College Press 1994): 20.
(22) IRC Sec. 7702B(e), as amended by PL 109-280, Sec. 844(c).
(23) IRC Sec. 72(e)(2).
(24) Rev. Proc. 2011-38, 2011-30 IRB 66.
(25) Christine Benz, "40 Must-Know Statistics about Long-Term Care," *MorningStar.com,* August 9, 2012; accessed at: http://news.morningstar.com/articlenet/article.aspx?id=564139.
(26) Shawn Britt, "All Riders Are Not Created Equal," *Life Health Pro,* November 1, 2012; accessed at: http://www.lifehealthpro.com/2012/11/01/all-riders-are-not-created-equal.
(27) Benjamin Harris and Daniel Baneman, "Who Itemizes Deductions?" *Tax Policy Center Tax Notes,* January 17, 2011: 345. Eric Toder and Carol Rosenberg, "The Share of Taxpayers Who Itemize Deductions is Growing," *Tax Policy Center Tax Notes,* (2007): 659.
(28) *Patient Protection and Affordable Care Act of 2010,* Public Law 111-148. Raised the threshold for the itemized medical expense deduction from 7.5 percent of AGI to 10 percent of AGI beginning with the 2013 tax year. This increase does not apply to individuals aged 65 and older until the 2017 tax year. See, IRC Sec. 213(f).
(29) IRC Sec. 213(d)(10).
(30) The Kaiser Family Foundation and Health Research and Educational Trust, "Employer Health Benefits—2014 Summary of Findings," (2014). Noted the average annual worker premium contribution in 2014.
(31) "Health Insurance: Premiums and Increases," *National Conference of State Legislatures,* January 2015; accessed at: http://www.ncsl.org/research/health/health-insurance-premiums.aspx (chart "Premiums and Premium Increases, Single Coverage, by Metal Tier and State, 2014–2015").
(32) IRC Secs. 105(b), 213(d), 7702B(a)(1), and 7702B(a)(3). C Corporations that pay LTC premiums through a valid IRC Sec. 105 medical reimbursement plan for employee coverage may deduct the premiums and are not limited by the age-related-cap maximum deduction, nor are they limited by the 10 percent AGI floor. Such coverage is also not taxable to the employee. Hence, C corporation owner-employees where the corporation has retained earnings may find asset-based LTC policies with comprehensive COB coverage attractive. The COB coverage is deductible to the corporation without limit, and benefits are not taxable to the owner-employees. This assumes owner-employee compensation is reasonable under IRC Sec. 162.
(33) The following carriers market integrated permanent life insurance/LTC policies: The State Life Insurance Company, Lincoln National Life Insurance Company, Pacific Life Insurance Company, Massachusetts Mutual Life Insurance Company, New York Life Insurance Company, and Nationwide Life Insurance Company. The following carriers market permanent life insurance policies with optional qualified LTC insurance riders: The Guardian Life Insurance Company of America, Metropolitan Life Insurance Company, Transamerica Life Insurance Company, Minnesota Life Insurance Company, John Hancock Life Insurance Company, Nationwide Life Insurance Company, and AXA Equitable Life Insurance Company. The following carriers market deferred annuity/LTC policies: The State Life Insurance Company, Forethought Life Insurance Company, Lincoln National Life Insurance Company, and Guaranty Income Life Insurance Company. This list based on data available March 25, 2016.

APPENDIX
Illustrative Premium Hypothetical Examples for Asset-Based Life Insurance LTC Protection

TABLE 3
Illustrative Premium Estimate, Male Aged 65

Annual premium for male, aged 65, preferred underwriting class, $250,000 death benefit, $5,000 maximum LTC benefit per month for 50 months with base policy

	Base Policy Premiums	
One Pay $158,900	10 Pay $18,947	Full Pay $12,035
	Continuation of Benefits Premium—50 months	
One Pay $8,210	10 Pay $950	Full Pay $535
	Continuation of Benefits Premium—Lifetime	
One Pay $11,302	10 Pay $1,310	Full Pay $745
	Continuation of Benefits Premium—Lifetime 5 Percent Inflation	
One Pay $42,446	10 Pay $4,937	Full Pay $2,772

TABLE 4
Illustrative Premium Estimate, Female Aged 65

Annual premium for female, aged 65, preferred underwriting class, $250,000 death benefit, $5,000 maximum LTC benefit per month for 50 months with base policy

	Base Policy Premiums	
One Pay $141,828	10 Pay $16,493	Full Pay $9,600
	Continuation of Benefits Premium—50 months	
One Pay $8,210	10 Pay $950	Full Pay $535

APPENDIX (cont'd)

TABLE 4 (cont'd)
Illustrative Premium Estimate, Female Aged 65

Continuation of Benefits Premium—Lifetime		
One Pay $11,302	10 Pay $1,310	Full Pay $745
Continuation of Benefits Premium—Lifetime 5 Percent Inflation		
One Pay $42,446	10 Pay $4,937	Full Pay $2,772

TABLE 5
Illustrative Premium Estimate, Joint Husband and Wife Aged 65

Annual premium for joint (male and female), aged 65, both preferred underwriting class, $250,000 death benefit, $5,000 maximum LTC benefit per month for each insured with base policy. Policy pays death benefit on death of survivor insured. If both insureds claim maximum LTC benefits simultaneously the $10,000 monthly payments would last 25 months.

Base Policy Premiums		
One Pay $128,000	10 Pay $15,583	Full Pay $8,415
Continuation of Benefits Premium—50 months		
One Pay $15,276	10 Pay $1,745	Full Pay $899
Continuation of Benefits Premium—Lifetime		
One Pay $21,845	10 Pay $2,508	Full Pay $1,305
Continuation of Benefits Premium—Lifetime 5 Percent Inflation		
One Pay $87,424	10 Pay $10,006	Full Pay $5,153

APPENDIX (cont'd)

TABLE 6
Sample Comparison between Asset-Based and Health-Based LTC Coverage

Hypothetical example of asset-based life insurance LTC benefits compared to health-based LTC coverage for an individual, single life, policy

Sample insured: Female, aged 55, nonsmoker	*Asset-based life insurance LTC benefits:* values reflect COB rider, preferred underwriting class, guaranteed values, no inflation rider	*Health-based LTC coverage:* values reflect select underwriting class, no inflation rider
Benefits		
Initial monthly LTC benefit	$5,000	$5,000
LTC benefit period	50 months (base policy and COB)	48 months
Elimination period	30 days home health care 60 days all other care	30 days (all types of care)
Waiver of premium	Yes	Yes
Guaranteed premiums	Yes	No
Guaranteed cash surrender value (if not used for LTC)	End of year 10: $22,222 End of year 20: $50,629	End of year 10: $0 End of year 20: $0
Death benefit (if not used for LTC)	$125,000 (4% of death benefit per month for LTC)	$0
Costs		
Net cost of ownership if surrendered after 10 years	$14,098	$25,670 (assuming no premium increases)
Total annual premium	$3,632	$2,567 (assuming no premium increases)

All examples are for illustrative purposes only. These are not offers of coverage; illustrative asset-based life insurance LTC premium examples prepared March 2016. Hypothetical asset-based life insurance LTC comparison to health-based LTC coverage prepared February 2016.