A deposit-based approach to long-term care insurance planning

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[Headnote]

A deposit-based, long-term care insurance policy may enhance and protect your clients' estate plans. In this article, the authors will introduce deposit-based long-term care insurance policies. The article will explore the arguments in favor of incorporating long-term care insurance policies into clients' estate plans, and will then explain why a deposit-based approach should appeal to most clients, including those who previously were reluctant to purchase long-term care insurance due to the costs involved.

With increasing frequency over the past several years, insurance planners have been advising other trusts and estates practitioners to incorporate long-term care insurance ("LTCI") into their repertoire of estate planning techniques.l With the August, 1996 passage of the Kennedy-Kassebaum health bill (see the sidebar: The Kennedy-Kassebaum Bill), we should expect to hear even more about this subject.2 Basically, adding LTCI to an estate plan protects the plan (by protecting the assets designed to fund the plan) and adds comfort and peace of mind to the clients, who know their needs will be met if they become ill and they need not impoverish themselves to do so. However, many practitioners have not advised clients to purchase LTCI, while many others have been unsuccessful in convincing clients to purchase LTCI, even when the situations appeared ripe. In this article, the authors introduce depositbased LTCI as a different approach which may benefit your clients.3 Familiarity with deposit-based LTCI policies may help advisors to demonstrate to clients the value LTCI brings to an overall estate plan, and may also make the costs of LTCI more palatable to clients.

For those of us who have been frustrated when advising clients to buy traditional LTCI,4 we have consistently heard from our clients either (i) LTCI is too expensive or (ii) the clients will never need LTCI, because they won't enter a nursing home. With traditional policies if the clients never require care, they "lose" or "waste" all of the premiums. Even in light of the ever-burgeoning statistical evidence that they will in fact need some form of long-term care ("LTC"), many clients feel the risks of paying for such policies outweigh the rewards.5 However, as will be discussed in more detail below, with deposit-based LTCI policies, clients who never require care will receive their money back - with interest. Thus, depositbased LTCI policies are fundamentally different from traditional policies, and the authors believe deposit-based LTCI policies are more palatable for the majority of clients.

Furthermore, deposit-based LTCI will help advisors address LTCI with wealthy clients. Many clients (and many advisors as well) feel LTCI is only appropriate for people who cannot afford to pay for care. The authors suggest even wealthy clients should consider LTCI in the same manner and for the same reasons they consider life insurance, homeowners's insurance or auto insurance. After all, most very wealthy clients don't really need these types of insurance either, but they buy them nevertheless to insure against statistical risks. Thus, even wealthy clients can protect their assets from real and significant risks by purchasing deposit-based LTCI policies.

What Is Long-Term Care?

As USED IN THIS ARTICLE, LTC encompasses nursing home care, intermediate care and home health care. Currently, there are LTCI policies specifically designed to only cover home health care, policies designed to only cover nursing home care and policies which insure for both types of care (usually referred to as "comprehensive" policies). In addition, some LTCI policies have recognized the propriety of intermediate care and pay for stays in assisted living facilities with less intense care (as compared to a nursing home). Thus, for our clients, a variety of sicknesses or debilitating diseases may trigger a need for LTC which may come in a variety of services. The type of policy purchased and the clients' particular circumstances will determine entitlement to benefits.

In many cases, the costs associated with home care are roughly equal to (or in many instances are much greater than) nursing home care;6 therefore, in this article, the authors will not distinguish between nursing home only and home health care only policies. In addition, many clients who start with home care develop health situations which ultimately require nursing home stays. Thus, the authors suggest that insuring for only home health care or for only nursing home care is insuring for only half of a reasonably knowable risk. Therefore, when discussing LTC and LTCI policies, we assume clients will purchase comprehensive coverage, and, if available, intermediate level, assisted care as well.

Why LTCI Is An Important Component In Estate Planning?

Statistics Regarding Need For the vast majority of people, the true risk of needing long-term care services, either in the home or in a facility, do not begin until after retirement.7 The most commonly cited statistic is that 43 percent of our nations current 32 million 65 year olds will access long-term care services.8 In "The Case For Nursing Home Insurance, " Douglas Stanton citing the Federal Agency for Health Policy stated that "half of all women and one-third of all men turning age 65 will spend time in a nursing home."9 Moreover, as our clients age, their risk of needing LTC increases dramatically. "Sixty percent of people over age 75 need some form of long-term care, and nearly one-half of those stay in nursing homes for about three years."10

Costs. The cost of LTC has often been cited at $ 100 per day or $36,500 per year.ll Geography will play a major factor. Rural area costs are in the $80 to $100 per day range; however, costs in major metropolitan areas may exceed $200 per day. Moreover, "roundthe-clock" in-home nursing care is often more expensive than $200 per day. An average length of stay is two and one-half years.12 Thus the average costs for individuals receiving LTC are approximately $100,000. ($36,500.00 per year for 2.5 years). However, in many cases these average costs are deceptively low and actual costs may easily exceed $200,000.

Comparative Statistics. For comparison purposes, the risk of needing LTC (25 percent to 60 percent depending upon age) is much greater than the risk of losing a house by fire (.1 percent). Not only is the risk many times greater, but the harm in many cases is nearly identical. Many clients' homes are worth $100,000 to $200,000. Thus, many of our clients insure for the .1 percent chance of loss of a $100,000 to $200,000 home, but not for the 25 percent to 60 percent chance of incurring LTC costs of $100,000 to $200,000. Similarly, although most clients pay for automobile collision coverage, the risk of collecting on collision coverage as a result of a major automobile accident (the risk of a major accident in which a car is demolished under collision coverage) is cited as 1 in 240 (.42 percent). Not only is the risk much lower, but obviously, the average costs of a car demolition are much less significant than the average costs of LTC. Finally, only 1 in 5 people (20 percent) ever spend $30,000 on a hospital stay, but most clients have hospital insurance.13 These comparative statistics overwhelmingly demonstrate why clients should insure for future LTC costs; statistically, it is a wise decision.

Role of LTCI in Estate Planning. Given the statistical evidence of costs and needs for LTC described above, LTCI may play a vital role in a client's estate planning. After all, even the best estate planning may be thwarted if the client's assets are used to pay for LTC. Moreover, many estate planners recommend aggressive gifting, and some clients are hesitant to gift assets without a source available to pay LTC costs. Thus, LTCI may play an important role in protecting (ensuring) and implementing a carefully crafted estate plan.

A Problem Of Perception

EVEN WITH THE OVERWHELMING statistics cited above, and the significant costs involved, less than 3 percent of the senior market have actually purchased LTCI policies. For this fact, many explanations have been offered: poor contracts, hope that the federal government will step in, the availability and accessibility of Medicaid, and finally, and in this authors' opinions most importantly, the perceived high costs of premiums and the fear that such premiums will be wasted.

For most of our clients, it only requires a few minutes of explanation to clear up their misconceptions regarding the availability of Medicaid (which is very seldom a viable or desirable option) or the likelihood of a new federal program being created (which is virtually unimaginable, at the present time). Thus, in most cases, to convince our clients of the propriety of purchasing LTCI policies, the only significant hurdle to address is the perception that such policies are too expensive or wasteful.

The perception regarding the expensiveness of these policies and the resulting fear of wasting one's assets was founded upon the traditional LTCI policies. Traditional LTCI policies work like homeowner's insurance. You pay an annual premium and only receive benefits if there is a catastrophe. They define their protection based upon a dollar amount per day for a certain number of years. The benefit amounts range from $50 to $300 per day with benefit periods form one year to lifetime or unlimited benefits.14 A typical premium quotation to a 65 year old may be $2,500 per year for $125 per day of benefit for five years with inflation protection.15 To cover a healthy couple the premium could exceed $5,000 per year. If the clients do not need LTC during the year, they do not receive benefits. Many clients perceive this as too much money to spend to protect their assets. Moreover, the clients argue, if they never become ill, this money has been wasted. In the face of these costs, many clients choose to forgo the coverage and self-insure. For this situation, a deposit-based solution may be very attractive.

What Is Deposit-Based LTCI?

DEPOSIT-BASED LTCI PLANS come in two varieties: annuity based programs and life insurance policies with accelerated death benefit riders. With both approaches, the client places a lump sum deposit into the program, enjoys tax deferred growth on the funds and is provided with long-term care benefits in the event of an illness.

Annuity based plans will return the remaining principal and any earnings to the named beneficiary, which at that time would be taxable as income. While there are several bundled products coming to the market, typically the annuity based approach is nothing more than a stand alone annuity allowing for systematic distributions to pay off a traditional LTCI policy. Tying these products together is more marketing strategy than product innovation. As discussed below, the authors generally recommend the life insurance LTCI program.

The most popular life insurancebased approach is a single premium modified endowment universal life policy with a long-term care acceleration rider. Death benefit acceleration riders have proliferated in recent years, therefore it is important to distinguish a true long-term care death benefit acceleration rider from other less liberal riders. Many life policies will offer the insured the right to receive a portion or all of the death benefit prior to death based on a terminal illness. Other riders will expand this to include a qualifying nursing home stay, typically limited to skilled-care only. A true LTC acceleration rider will allow death benefits to be used to pay for skilled, intermediate or custodial LTC as well as LTC in the home, or in the newest products LTC in an assisted living facility. High quality riders also will use industry standard language to trigger benefits, making benefits available for both a functional loss (as measured by a need for assistance with activities of daily living), or a cognitive incapacity as seen with Alzheimer's disease. In addition, many of the life insurance based plans will provide an enhanced death benefit if long-term care services are not needed.

The best way to illustrate this concept is by an example. There are several life insurance, deposit-based products on the market.16 A typical policy for a 65-year-old, female non-smoker might be:

Single Premium Deposit: $50,000 Initial Death Benefit: $110,000 Convalescent Care Benefit Value: $220,000

Daily Benefit: Nursing Home &

Home Health Care $150/day Adult Day Care $75/day

In the event of a LTC need, the death benefit is reduced first. When that has been exhausted then the convalescent care benefits are accessed. On the other hand, if LTC is never needed, then the death benefit (which will increase over time, if LTC benefits are not accessed) is payed to the named beneficiary.

What makes a deposit-based LTCI policy most attractive is the combination of (i) a guaranteed return either to pay for the clients' LTC needs or to the clients' beneficiaries if LTC benefits are not used (the money deposited is never "wasted") with (ii) guaranteed access to the deposit. During the life of the insured, the initial deposit is guaranteed to be fully refundable at any time, until such is exhausted in paying for LTC. If the client does not need LTC, he or she may withdraw the deposited funds plus all interest accrued thereon at any time. In ad

The KennedyKassebaum Bill

Effective January 1, 1997 the tax status of long-term care insurance has been clarified and the premiums will be tax deductible (in a manner consistent with major medical coverage) subject to the provisions set forth below:

Premiums for "qualified" long-term care polices (see explanation herein) can be deducted as a medical expense for taxpayers who itemize and whose total medical expenses exceed 7.5 percent of adjusted gross income. However, the portion of the long-term care insurance premium which is deductible is limited depending upon the age of the taxpayer as follows:

40 and Younger $200 41-50 $375 51-60 $750 61-70 $2,000 70 and older $2,500

Benefits from qualified long-term care polices will be received income taxfree.

Non-Reimbursed long-term care expenses will be deductible as medical expenses (subject to the same limitations, e.g., 7 percent of adjusted gross income.

Employer paid premiums are deductible as a business expense and not includible as income to the employee; however, LTCI premiums will not be includible as a pre-tax deduction in Sec. 125 cafeteria plans. dition, there is a minimal accumulation of cash value (typically subject to a 20-year decreasing surrender charge). The cash value accumulation rate is declared annually and has a minimum guarantee (four percent, for example). As the cash value grows there is a corresponding increase to both the death benefit and the convalescent care benefit. Therefore, for a client who receives LTC benefits after 10 years, the maximum convalescent care benefits may be greater than the $220,000 shown in the example. Moreover, for a client who never accesses the LTC coverage, his or her nominated beneficiaries will receive a death benefit in excess of the initial amount shown in the example.

Thus, it may be argued, there is essentially no risk for this type of policy. In our example, a client with a $50,000 short-term certificate of deposit ("C.D.") earning approximately 4 percent to 5 percent simply purchases an insurance policy paying approximately 3 percent to 4 percent. As with the C.D., the client may withdraw and use the funds at any time. The client's return on the insurance is only slightly less (typically no more than a few points less). Of course, the C.D. only provides $50,000 of LTC (if the client becomes sick) and $50,000 to beneficiaries on death (if not used to pay for LTC). On the other hand, by switching to a deposit-based LTCI policy, the client has the same liquidity of funds, a similar rate of return, $220,000 of LTC benefits (if the client becomes sick), and at least $110,000 of death benefit to named beneficiaries (if not used to pay for LTC). 17

Finally, in order to fully explain the income tax consequences, each year after the first policy year the LTCI policy will issue a form 1099 to the owner of the contract for the internal cost of the longterm coverage. It is deemed that this money has been "distributed" to the owner from the cash value of the contract and then is used by the client to pay the annual premium. Since the policy is a modified endowment contract this "distribution" would normally be a taxable event to the owner. However, under the new Kennedy-Kassebaum bill, this "distribution" should be deductible, for clients who qualify. (See sidebar: What Is A Qualified Long-Term Care Policy?)

Where Does The DepositBased LTCI Solution Fit?

MANY CLIENTS WILL KEEP a certain portion of their portfolio in liquid, low-yield assets. These may be certificates of deposit, money market accounts or life insurance cash values. Some clients refer to such as "emergency funds." These emergency funds are the assets most typically used in the event of LTC needs. The deposit-based LTCI plan is an excellent alternative to the other financial vehicles often used for such "emergency funds." Many seniors feel that the most significant threat to their assets is the loss of principal. This is a guiding force in their financial decisions. However, as noted in the section, Why LTCI is an important component ., the need for LTC may in fact be the most significant threat to their assets. If these emergency funds would be invaded to pay for LTC costs then the depositbased LTCI approach will work well for such clients. By moving the emergency funds to a depositbased LTCI vehicle, the clients will (i) continue to have principal safety, (ii) have immediate access to the funds, (iii) earn a modest return, (iv) create a death benefit and (v) most importantly, in the event of a LTC need, multiply the value of these emergency funds by 200 percent to 400 percent (depending on their age).

These same clients are reluctant to use their emergency funds to buy traditional LTCI policies because of the costs and the fear of wasting the premiums. However, as described above, the costs of a deposit-based LTCI policy are minimal and the money placed in the deposit-based LTCI policy is never wasted. If the client needs LTC, then as described above, the policy will pay manyfold LTC benefits; in the event the client dies without ever accessing the policy for LTC benefits, there is a substantial death benefit (typically equal to 1.5 to 2.5 times the initial deposit). This creates a situation where the clients will be assured a multifold return.

Planning For Wealthy Clients

MANY ADVISORS SAY wealthy clients who can afford to pay for LTC out of income do not need LTCI policies. To those advisors, we ask: why not? If the average risk of LTC today is approximately $40,000 per year for 2.5 years, then the present risk is about $100,000. For wealthy clients, we can assume they will choose facilities with above average costs (or they may pay for private care in the home - which often costs $100,000/year or more). Thus for wealthy clients, we will assume costs equal to 200 percent average or $200,000. Moreover, for many clients the actual need for LTC is still 10 or more years away. Assuming LTC costs increase at approximately 7.0 percent per year then the risk will double in approximately 10 years. Thus, for a wealthy client likely to need LTC in 10 years, the actual risk is $400,000 or more.ls If the client does not need LTC for 15 years (or if LTC costs rise at a faster pace) then this risk may increase further to approximately $600,000, or more. Why should wealthy clients risk such substantial expenditures when they could purchase relatively inexpensive insurance today? After all, as described in the section, Why LTCI is an important component. . ., the risks of needing LTC are much greater than other risks for which clients purchase insurance - e.g. homeowner's insurance, automobile collision coverage and hospital stay insurance. The reasons for buying insurance are straightforward, and once the risks and LTC costs are properly explained, the authors believe many wealthy clients would choose to purchase deposit-based LTCI policies. The primary reason wealthy clients would not purchase such is the misconception that the funds will be wasted. However, as discussed herein, funds placed in deposit-based LTCI policies never go to waste.

Moreover, adding an LTCI policy to the estate plan of a wealthy client may help to secure the client's comfort with lifetime transfers. We often advise our wealthy clients to embark on aggressive lifetime giving programs and/or to give up control of their assets through irrevocable trusts, family limited partnership or other vehicles. Some clients would be willing to do such, but fear that loss of control or loss of their wealth (through actual gifts) could place them at risk if an LTC need should arise. Depositing a fraction of their wealth in a deposit-based LTCI policy could alleviate this fear, comfort the client and ultimately permit the aggressive planning to be implemented.l9

Tax Planning

THE INCOME TAX CONSEQUENCES of LTCI contracts, including depositbased LTCI are discussed in the sidebar (Comparison Of A $50, 000 Certificate. . .). For certain clients, the premiums now will be deductible. Obviously, some clients also are concerned about estate tax planning. Particularly for wealthy clients, adding an additional death benefit to their taxable estate may be undesirable. Unfortunately, clients cannot simply assign the death benefit to an irrevocable insurance trust and retain the LTC benefits. The retention of LTC benefits would undoubtedly be deemed a retained incident of ownership causing the entire death benefit to be taxable in the client's estate.20 The client may, however, transfer the funds to purchase a deposit-based LTCI policy to children or to a trust for the benefit of children. In that case, the LTC benefits (if accessed) would be paid to the children or to the trust for the children's benefit. As long as there is no pre-arrangement, the children could then pay for the client's LTC directly. LTC costs will now be treated in the same manner as major medical expenses, payments by the children should not constitute taxable gifts - they should qualify for gift tax exemption under Sec. 2503 of the IRC. Alternatively, the beneficiaries (children or trust) could accumulate the LTC benefits as a means of wealth replacement while the client uses his or her funds to pay the LTC costs (thereby further reducing the clients taxable estate, without additional transfer taxes). If LTC benefits are not accessed, then the death benefit should pass to the children (or the trust for their benefit) estate tax-free. Unfortunately, there are no present rulings or cases to guide estate planners in this practice. Moreover, unless the gift is in trust, the children could withdraw the LTCI policy deposit and frustrate the client's plan. Thus in many cases, prudent planners will advise clients that it may be best to own the LTCI policy outright, even if doing such increases their taxable estates. On the other hand, if clients trust their children, or desire to fund the deposit-based LTCI policy premium in an irrevocable trust, then they may remove the LTC benefits and/or the death benefits from their estates.

Conclusion

IN THIS ERA of rising medical costs, many clients should consider purchasing LTCI insurance. The most frequent objections are the perceptions that the costs are too high, the risks are too low or the premiums will be wasted. As addressed herein, the authors believe these misconceptions may be easily remedied. With a deposit-based LTCI policy, the money which would otherwise be used to pay for LTC (the emergency funds) is deposited in an insurance product that pays multifold benefits. If the client wants the return of his or her deposit, the client may have it with interest in 48 hours. If the client needs LTC, the policy will pay for care many times in excess of the care the client could have paid for had he or she not deposited the emergency funds in the depositbased LTCI policy. Finally, if the client dies without accessing (or exhausting) the LTC component, then his or her designated beneficiaries will receive a death benefit which is typically 1.5 to 2.5 times greater than the funds deposited. Hopefully this introduction will help your clients to understand how their estate plans could be improved by adding deposit-based LTCI policies.

Comparison Of A $50,000 Certificate Of Deposit ("C.D."), A Whole Life Insurance Policy, And A Deposit-Based LTCI Policy For A 65 Year Old On January 1, 1997

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End Notes

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1. See for example Grate, Richard T. and Wetzel, Peter B., "Long-Term Care Insurance Provides Parental Protection," Trusts & Estates (January 1997); Lee, Stephanie, "Blanket Your Client's Retirement Worries," Trusts & Estates (August 1996); Clapp, Alfred C., "Long-Term Care Insurance: Planner's Stay on the Cutting-Edge," Trusts & Estates (April 1996); and Stanton, Douglas R. "The Case for Nursing Home Insurance" Trusts & Estates (July 1994).
2. See for example See for example Grate, Richard T. and Wetzel, Peter B., "LongTerm Care Insurance Provides Parental Protection," Trusts & Estates (January 1997) and Fleming, Cory E. "Gifts to Children to Obtain Medicaid Are Now a Crime," Lawyers Weekly U.S.A. (September 23, 1996).
3. The authors use the term "deposit-based LTCI" throughout the article to refer to a single premium modified endowment universal life policy with a long-term care acceleration rider.
4. As used in this article, "Traditional LTCI" refers to LTCI policies for which clients pay an annual premium in exchange for a defined benefit, usually a dollar amount per day after certain triggering events have occurred. The authors recognize that some traditional LTCI policies have nonforfeiture benefits and/or return of premium riders available; however, these provide only partial returns of the paid-in premiums and they dramatically increase the costs of premiums - 30 percent to 50 percent. For example, if the tradition

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al policy cost $5,000 for a couple then with these types of riders the premium could increase to $7,500. Plus, if the riders are activated, and the clients never received LTC, then the clients only receive a return of part of their paid-in premiums. Compare that to a deposit-based program, where the couple deposits $50,000 to $100,000 but can receive 100 percent of the money back (with interest) if the LTC benefits are not accessed. Moreover, the deposit based program may offer a death benefit equal to 1.5 to 2.5 times the deposit. The authors believe the deposit-based approach is vastly superior to (and ultimately much less expensive then) a traditional policy with partial return riders.
5. The statistical risks will be described in more detail in the section, Why L TCI is an important component. . " below.
6. See Clapp, Alfred C. "Long-Term Care Insurance: Planner's Stay on the CuttingEdge," Trusts & Estates (April 1996).
7. There is large population of younger long-term care recipients; however, it is beyond the scope of this article to address that population.

[Footnote]
8. Aging America, Trends & Projections", 1991 edition prepared by the U.S. Senate Special Committee of Aging.
9. Stanton, Douglas R., "The Case for Nursing Home Insurance," Trusts & Estates July 1994).
10. Id. citing Business Week, May 20,1991.
11. In "The Case for Nursing Home Insurance" Douglas R. Stanton cites the annual cost in the Pittsburgh, Pennsylvania area as approximately $40,000. In her Newsweek column, Jane Bryant Quinn recently cited long-term care costs in a range of $28,000 to $70,000 per year. Newsweek, "Aging: The Endgame" September 30, 1996, page 53.
12. See Marion Merril Dow Study, 1993. See also "Long-Term Care Insurance: Planner's Stay on the Cutting-Edge" citing the same 2.5 year average based on the 1995 National Nursing Home Survey prepared by the National Center for Health Statistics.
13. All of the statistics in this Section are quoted from Stanton, Douglas R., "The Case for Nursing Home Insurance," Trusts fs Estates (July 1994).
14. See end note 4 above. There are many components to what constitute a well written contract with appropriate coverages. We will not cover that ground in this Article. For a more complete discussion of traditional contracts please see Hill, Alfred H. "Standards for Selecting Long Term Health Care Insurance," Trusts & Estates, April, 1993 and Clapp, Alfred C., "Long-Term Care Insurance: Planner's Stay on the Cutting-Edge," Trusts di Estates (April 1996). Additionally, there is an excellent discussion on how to evalu

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ate any LTC policy in Grate, Richard T. and Wetzel, Peter B., aLong-Term Care Insurance Provides Powerful Protection,' Trusts di Estates January 1997).
15. The example used in this section is based on the average of several LTCI policies.
16. The example used in this section is based upon the average of several LTCI policies.
There is one problem with deposit-based LTCI contracts. Currently deposit-based programs do not offer inflation protection. Thus, for younger clients, they may need to fund a contract to pay $200 or $250 per day-due to the inflation of average health care costs expected between now and the time they will actually access LTC benefits. However, if the client does not access the LTC benefits for many years, then the internal build-up in the policy will generate increased LTC benefits. Moreover, in order to be "qualified" under the Kennedy-Kassebaum bill, these policies will offer clients the option to annually purchase increased benefits, which works out similar to inflation-protection.
18. See Clapp, Alfred C., "Long-Term Care Insurance: Planner's Stay on the CuttingEdge," Trusts Gi Estates (April 1996) and Stanton, Douglas R., "The Case for Nursing Home Insurance," Trusts & Estates (July 1994).
19. See for example Grate, Richard T. and Wetzel, Peter B., "Long-Term Care Insurance Provides Parental Protection," Trusts & Estates (January 1997).
20. See Sec. 2042 of the Internal Revenue Code of 1986, as amended (the "Code").

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Abstract (Document Summary)

A deposit-based, long-term care insurance policy may enhance and protect one's estate plans. An article introduces deposit-based long-term care insurance policies, and it explores the arguments in favor of incorporating long-term care insurance policies into clients' estate plans. It also explains why a deposit-based approach should appeal to most clients, including those who previously were reluctant to purchase long-term care insurance due to the costs involved.

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