

Government Loosens Rules for Long-Term Care Planning

Included in the Pension Protection Act of 2006 (PPA) were amendments to the tax laws affecting long-term care (LTC) insurance that became effective on Jan. 1, 2010. These changes might encourage more families to acquire protection for a long-term care need by making it more tax-favorable.

Most prominently, individuals can take advantage of new tax-free exchange rules under IRC Section 1035. A policy holder may now exchange on a tax-free basis a long-term care policy, life insurance policy, endowment contract, or deferred-annuity contract for a traditional long-term care policy or qualified annuity or life insurance policy with LTC riders (linked-benefit products). Under this provision, benefits paid for long-term care services within a linked-benefit product are now treated in the same manner as benefits received from a traditional LTC policy.

This means that for 2010, up to \$290 per day in benefits are guaranteed to be tax-free. The PPA also states that LTC rider charges against the account value of a linked-benefit contract are not considered a taxable distribution, although they do reduce the cost basis (but not below zero). The net result of this provision is that one can now better leverage those assets conditionally earmarked for long-term care.

For those with sufficient assets, planning for the consequences of long-term care involves self-insuring, transferring risk through a third-party product, or combining the two.

For the purposes of this article, we will assume that a client has enough assets to comfortably self-insure the typical long-term care need without upsetting any retirement or estate plans for the family. The question we will examine is whether incorporating a third-party product, such as traditional LTC or a linked-benefit product, would be more practical than fully self-insuring. Of course, the answer is affected by an individual's risk tolerance and lifestyle, which are constantly subject to change based on factors such as one's age, the economy, and life events that we cannot always predict.

LTC vs. Linked-Benefit Product vs. Self-Insuring

How could a married, 66-year-old male utilize \$100,000 of investable assets to plan for long-term care? Let's consider three scenarios, after providing more details about the client's situation.

Mr. Jones lives in Lincoln, NE. We can assume that he is insurable but not in perfect health. We will assume that his net return on investment (after taxes and inflation) will be 4 percent per year. To determine his current and future cost of care, we referenced the Genworth 2009 "Cost of Care Survey," published in April 2009. According to the survey, the median daily rate of a private nursing home room in Lincoln is \$206. Nursing home care is generally the most expensive form of long-term care, so we are planning for the worst-case scenario.

If needed, both the linked-benefit and LTC products include coverage to help pay for services received in one's

own home. Based on the Genworth Cost of Care survey data from 2005-2009, the five-year compound annual rate increase in Lincoln is 4 percent, so we will use this to calculate future costs. By the way, according to the survey, most other areas of the country have experienced annual rate increases for nursing care higher than 4 percent, and at-home services costs are rising faster than nursing home services.

We will examine four life scenarios, each of which assumes that Mr. Jones passes away at age 84. In the first scenario, he needed no long-term care; in the second, he needed a year of care; in the third, two years; and in the fourth, three years. Also, we assume that his Medicare and supplement will cover the first 90 days of nursing care and that the length of care needed in each scenario will begin after that.

Now, a little background about linked-benefit insurance. This product is a universal life insurance policy that allows the policyholder to accelerate death benefits to pay for long-term care expenses while living (without tax consequences). The policy will reimburse expenses up to \$6,000/month for a six-year period. This policy does not include any provisions to increase the monthly allowance for long-term care expenses. At any time along the line, if Mr. Jones decides to quit the plan, he will receive his original premium back. The death benefit ranges from a high of approximately \$200,000 to a minimum of \$143,000. Even if all benefits are paid as long-term care expenses, the policy guarantees a residual death benefit of \$14,000.

For comparison, the long-term care insurance policy premium for Mr. Jones is \$5,000/year at age 66. It covers up to \$6,000/month for a 4-year period and also includes an automatic 5-percent compound inflation protection.

With that information, we can compare three investment decisions: 1) investing the \$100,000; 2) acquiring a linked-benefit product at a cost of \$100,000; and 3) investing the \$100,000 while taking out \$5,000 per year to pay premiums for a traditional LTC policy. These scenarios are compared in the table below.

Under the first scenario (Mr. Jones passes away at age 84 without needing any care), self-insuring is the best strategy. But what if he needs a year of care? When Mr. Jones is 84, the expected cost of care in Lincoln, NE will be \$417.32/day, or about \$152,000/year. After paying for his one year of care, Mr. Jones would have netted about \$50,000 if he had self-insured (see table). The linked-benefit product paid \$72,000 in benefits, so Mr. Jones still had

out-of-pocket costs of \$80,000. The death benefit paid his estate \$71,000 (\$143,000, less \$72,000 in paid benefits). His net out-of-pocket was \$8,500. The LTC policy paid \$152,000 in benefits (inflation protection had increased his \$6,000/month benefit to more than \$14,000/month), and he had no out-of-pocket cost for care. And the remainder of his \$100,000 that was invested (with \$5,000 taken out for his LTC premiums each year) netted \$74,000. The LTC policy came out ahead.

The table shows that as the length of Mr. Jones' long-term care increases, the LTC benefit stays the same because its benefits are inflation-adjusted. In fact, the benefits would have been steady for even a fourth year of care because his policy covered four years. But his out-of-pocket costs rise if he uses the linked-benefit or self-insuring strategies. Although advisors might think that more than a year of long-term care seems unlikely, according to the "2004 National Nursing Home Survey, Residents, Table 13" (the survey can be found at www.cdc.gov), 30.3 percent of

U.S. nursing home residents had a length of time since admission of one year to less than three years.

Economic volatility over the last two years has demonstrated that things can change quickly. Experiencing sharp declines in portfolio values and real estate in such a short time brought many people back to the table to reexamine their investment strategies. Advisors have found many clients revising their risk tolerances. Those who may have been confident that they would self-insure for long-term care may have realized that they are not as able, nor as willing. Now may be a good time to revisit those plans. NA

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| Scenario | No Need for Care | | | LTC Need 1 Year | | |
|---------------------------|------------------|------------|---------------|-----------------|------------|---------------|
| | Death age 84 | | | Linked Benefit | LTCI | Self Insuring |
| | Linked Benefit | LTCI | Self Insuring | | | |
| Cost of Product | \$100,000 | \$5,000/yr | \$0 | \$100,000 | \$5,000/yr | \$0 |
| Cost of Care at age 84 | \$0 | \$0 | \$0 | \$152,000 | \$152,000 | \$152,000 |
| LTCI Benefit | \$0 | \$0 | \$0 | \$72,000 | \$152,000 | \$0 |
| Out of Pocket Costs | \$0 | \$0 | \$0 | \$80,000 | \$0 | \$152,000 |
| Death Benefit | \$143,500 | \$0 | \$0 | \$71,500 | \$0 | \$0 |
| Value of Investment at 84 | \$0 | \$74,000 | \$202,500 | \$0 | \$74,000 | \$202,500 |
| Amount left at 84 | \$143,500 | \$74,000 | \$202,500 | (\$8,500) | \$74,000 | \$50,000 |

| Scenario | LTC Need 2 Years | | | LTC Need 3 Years | | |
|---------------------------|------------------|------------|---------------|------------------|------------|---------------|
| | Linked Benefit | LTCI | Self Insuring | Linked Benefit | LTCI | Self Insuring |
| Cost of Product | \$100,000 | \$5,000/yr | \$0 | \$100,000 | \$5,000/yr | \$0 |
| Cost of Care at age 84 | \$304,000 | \$304,000 | \$304,000 | \$456,000 | \$456,000 | \$456,000 |
| LTCI Benefit | \$144,000 | \$304,000 | \$0 | \$216,000 | \$456,000 | \$0 |
| Out of Pocket Costs | \$160,000 | \$0 | \$304,000 | \$240,000 | \$0 | \$456,000 |
| Death Benefit | \$14,000 | \$0 | \$0 | \$14,000 | \$0 | \$0 |
| Value of Investment at 84 | \$0 | \$74,000 | \$202,500 | \$0 | \$74,000 | \$202,500 |
| Amount left at 84 | (\$146,000) | \$74,000 | (\$101,500) | (\$226,000) | \$74,000 | (\$253,500) |