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# Funding A Tax- Advantaged Long Term Care Insurance Plan

This is part three of the series on designing affordable LTCI plans using new visualization tools. Part One, *Visualizing a Long Term Care Insurance Plan*, appeared in the August, 2017, issue, and Part Two, *Carving Out a Long Term Care Insurance Plan*, appeared in the September, 2017, issue.

In part one of the series we discussed LTCI 2.0—A reboot of LTCI plans designed to protect against the escalating cost of long term care. In part two, we discussed one of the biggest opportunities in LTCI where business owners can often deduct the premiums paid for long term care as a business expense, yet still receive tax-free benefits.

In this conclusion to the three part series, we will bring these concepts into a visual

framework that will allow us to analyze the tradeoffs of various funding alternatives to cover long term care expenses. We will also explore the 1035 exchange, a tax-advantaged way to fund LTCI.

Long term care is a risk that we all know needs to be funded. In the absence of LTCI coverage, the burden of long term care can shift to family and friends. For high net worth individuals, setting aside sufficient assets dedicated to pay future long term care expenses is one possible strategy. Unfortunately, self-insuring of future long term care expenses has its limits: Assets currently grow slowly in today's low interest rate environment, especially if there are taxes to be paid on the accumulating funds.

**Table 1: Long Term Care Funding Alternatives**

Source	Self-Insuring	LTCI + Return of Premium	Stand-alone LTCI
Summary	<ul style="list-style-type: none"> <li>Put aside assets for long term care expenses</li> </ul>	LTCI benefits if needed, ROP if not used for LTCI	Fully leverage premium to cover long term care risk
Pros	<ul style="list-style-type: none"> <li>Full flexibility of funds</li> <li>No waiting period</li> </ul>	<ul style="list-style-type: none"> <li>Less expensive than self-insuring</li> <li>Benefits whether you live, die, or quit</li> </ul>	<ul style="list-style-type: none"> <li>Most affordable and efficient risk transfer</li> <li>Wide range of benefit and payment options</li> </ul>
Cons	<ul style="list-style-type: none"> <li>Most expensive way to fund the tail risk</li> <li>Low investment returns today</li> <li>Potential taxation on accumulation</li> </ul>	<ul style="list-style-type: none"> <li>More expensive than stand-alone LTCI</li> <li>Extra death benefit the client may not need</li> </ul>	<ul style="list-style-type: none"> <li>No residual value if long term care is not used</li> <li>Rate increase possible unless premium paid up front</li> </ul>

LTCI plans can be an enhancement to self-insuring. Life/long term care combo products allow acceleration of the death benefit for long term care expenses. The most flexible of these products even provide for extension of LTCI benefits once the death benefit is exhausted. The extended coverage can provide up to three to eight times the premium. The client receives a tax-free death benefit if LTCI benefits are not used. In addition, the policy can be surrendered for a cash payment, typically equal to 80 percent of the premiums paid. These plans are often referred to as “asset-based LTCI.” Although less frequently utilized, there are annuities that can provide an extension of LTCI coverage, but typically only up to three times the premium.

Return of premium riders (ROP) upon death can be added to stand-alone LTCI plans. Functionally, these operate similarly to asset-based LTCI solutions. The ROP provides for all premiums to be paid back to the insured’s beneficiary as a death benefit if not used for long term care expenses. In addition, a cash surrender option can be added that allows the insured to surrender the policy and receive back 80 percent of premiums paid. These plans remove the fear of “use it or lose it” by providing benefits regardless of whether the client uses long term care, dies, or needs access to the funds. LTCI with ROP has the flexibility to allow richer inflation protection, a full range of premium payment options, and lifetime

benefits to provide full long term care risk transfer.

Stand-alone plans today are more robust than legacy LTCI. Rate increases are less likely because of conservative pricing. Paying premiums up front can mitigate the fear of rate increases. Although ROP does not preclude a rate increase, any extra costs would be returned to the beneficiary as an additional death benefit if not used for LTCI benefits.

Table 1 analyzes the tradeoffs of long term care funding alternatives:

Plans need to be more price stable and still provide value at a reasonable cost to be mainstream solutions. We can assess the value of LTCI coverage using new visualization tools. Let us compare the value of the asset-based plan from Part 1 to the stand-alone plan from Part 2 for the age 50 couple that required long term care services at age 80. We will assume the couple has about \$50,000 sitting in a bank account that they have set aside for future long term care expenses.

The couple asks their financial advisor how to most efficiently use the \$50,000 to cover the risk of extended long term care expenses:

Option 1: They could self-insure. If we assume a tax-deferred five percent compounded return for 30 years and a 20 percent tax rate at the end of that period, the \$50,000 will have accumulated to \$182,878 after-tax.

Option 2: They could purchase an LTCI plan with ROP that provides a combined 15 years of LTCI protection (five years for each insured and an additional five year shared care pool) if they both become chronically ill. This plan provides up to \$891,596 of LTCI benefits. One hundred percent ROP (\$50,000) is paid to the beneficiary as a second-to-die death benefit if no care is needed. Eighty percent cash (\$40,000) can be returned if they choose to surrender the policy.

Option 3: They could purchase a stand-alone LTCI plan that provides the same 15 years of LTCI protection, but a higher daily benefit amount for the same premium. This plan covers up to \$1,486,010 of LTCI benefits, but nothing back if long term care is not used. The plan is guaranteed never to have a rate increase since it is all paid up front in one single premium.

We can visually see the tradeoffs in Chart 2. (on page 38) LTCI with ROP provides about five times the protection of self-insuring and stand-alone LTCI provides about eight times the protection of self-insuring.

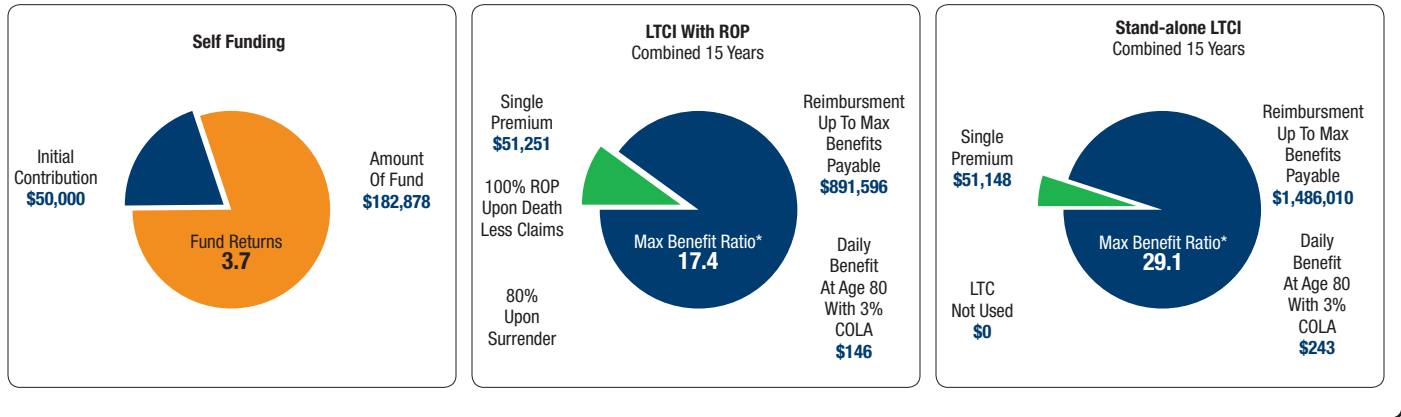
Consumers have many choices for valuable LTCI solutions. The earlier advisors and clients plan for long term care needs, the more likely clients will qualify through underwriting. Unfortunately, it is easy to find reasons to delay planning (unless, of course, their advisors or employers utilize LTCI business deductibility).

Fortunately, there is still substantial value

### Chart 2: Age 50 Self-Insuring

Return On Investment: 5% • Tax On Gains At Age 80: 20%

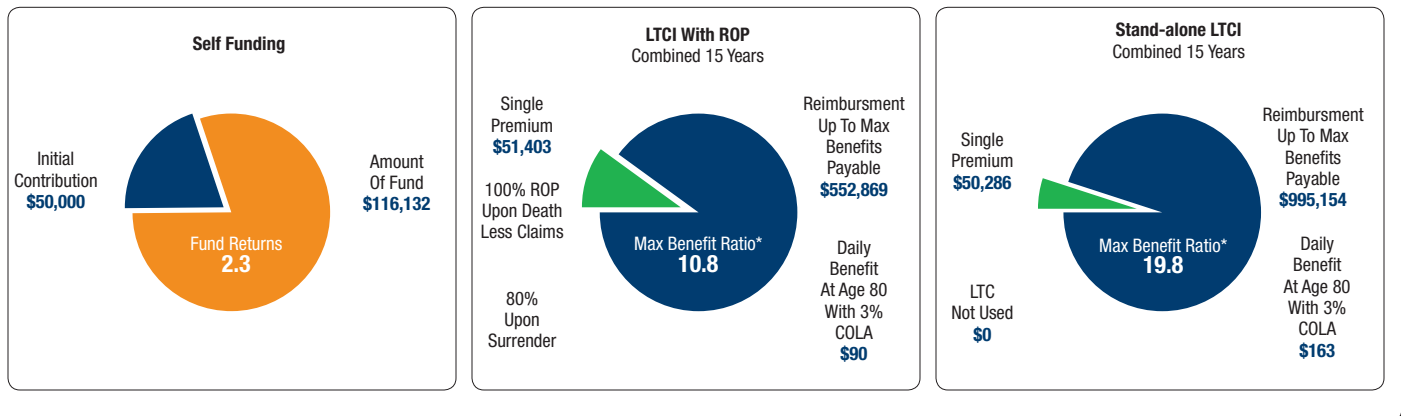
Married Couple Age 50 With Projected Benefits For Each At Age 80  
 Joint Issue Age: 50 • Projected Claim Age: 80 • Elimination Period: 90-Day



### Chart 3: Age 60 Self-Insuring

Return On Investment: 5% • Tax On Gains At Age 80: 20%

Married Couple Age 60 With Projected Benefits For Each At Age 80  
 Joint Issue Age: 60 • Projected Claim Age: 80 • Elimination Period: 90-Day



even if the clients have waited until closer to retirement. Let us analyze the same scenario, but assume the plan is implemented 10 years later, when they are each 60. We will continue to assume the couple becomes chronically ill at age 80, but now with only 20 years to fund the LTCI plan.

Compared to self-insuring, there is still

almost five times the maximum LTCI protection with ROP and almost nine times with stand-alone LTCI as shown in Chart 3.

Given the clients are nearer to retirement, they may have more assets to fund the LTCI plan. This may include cash, investments, life insurance, and annuities. While most LTCI plans are funded with cash, Congress

opened the door for new funding sources starting in 2010. The Pension Protection Act (PPA) expanded the definition of tax-free 1035 exchanges to include the use of life insurance or annuity cash values to fund stand-alone LTCI plans.

Many insurance advisors are aware of

1035 exchanges that can fund life/long term care policies from legacy life insurance. However, there is a bigger opportunity that has just begun to be utilized. Using tax-deferred annuities to fund stand-alone LTCI offers the additional benefit that gains in the annuity can now be used to fund the LTCI premium. The gains would normally incur ordinary income tax upon surrender or death. Effectively, the annuity has been exchanged into an LTCI plan that is fully paid up after applying the cash value toward a single premium.

Let us reexamine our age 60 couple who waited 10 years to purchase their LTCI coverage. They own a joint annuity that has a \$50,000 cash surrender value, which they purchased several years ago. The annuity had an original cost basis of \$25,000 and has accumulated \$25,000 of deferred gains. If their income tax rate is 35 percent, the current tax liability on the gains would be \$8,800. They can choose to use the full \$50,000 through a 1035 exchange to fund an LTCI plan without incurring the \$8,800

tax liability. After the exchange is complete, there is almost \$1 million of total benefits available under the LTCI plan should they both become chronically ill 20 years later. The value of this approach can be seen visually in Chart 4.

These are many variations on this 1035 exchange theme:

- Although LTCI with ROP can be purchased, a tax advisor needs to be consulted on the tax ramifications of the 1035 exchange after the residual ROP is paid to the designated beneficiary.
- Many types of tax-deferred policies can be used with the primary requirement being that the owner(s) and insured(s) match at the time of the policy exchange.
- Partial exchanges can be taken out of annuities, but a life insurance policy may need to be split first and not have loans outstanding.
- Although annuity or life insurance policies cannot be 1035 exchanged from a qualified vehicle (e.g. 401k or IRA),

the after-tax distributions can be used to pay the LTCI premiums.

What a time to become a long term care planning expert. Today, more than ever, clients are acutely aware of the need. LTCI plans can provide a wide variety of customizable solutions. Yet, many financial and tax advisors do not realize that stand-alone plans can deliver tremendous value, mitigate rate increases, receive return of premium, provide tax deduction for business owners, and be funded with annuities, life insurance, or even health savings accounts (HSAs). In fact, middle-market clients in many states are eligible for LTCI policies using state approved partnership programs that match the LTCI benefits received with an equal amount of asset disregard for Medicaid planning purposes. Exploring these new frontiers can provide a significant competitive advantage for insurance advisors seeking to grow their practices. 🌐

