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What Advisors Should Know About Hybrid Long-Term Care Policies

The 2006 Pension Protection Act offered tax benefits for plans with these features

Hybrid long-term-care (LTC) policies, which allow individuals to combine life insurance with an LTC benefit, have become more popular in recent years, especially since the enactment of the 2006 Pension Protection Act (PPA), which opened the door for these type of policies. Hybrid policies are an alternative to existing stand-alone policies, which have gone out of favor due to increased premiums and other issues. Most companies don't even offer them anymore.

Hybrid policies are particularly attractive in three situations:

1. When a client has money in a low yielding investment so it may make sense to transfer that asset into asset-based LTC products. This move can offer significant LTC and death benefits while the client doesn't suffer any meaningful lost opportunity cost;
2. For clients who may not be insurable under typical underwriting parameters; and
3. For clients who want to reallocate funds from a highly appreciated annuity into a hybrid product in which capital gains can be avoided.

Background

In the late 1990s and early 2000s, many middle income families who hadn't properly planned to pay for their LTC needs found themselves facing significant costs when a loved one needed to enter a skilled nursing facility. The solution for these families was to consult with an elder law attorney and arrange their assets so as to artificially impoverish themselves and transfer the costs for this care to the Medicaid program. Needless to say, the costs were staggering, so in February 2006, Congress enacted the 2005 Deficit Reduction and Reconciliation Act, which limited these growing expenses through numerous measures, including increasing the waiting/eligibility period for Medicaid from three to five years.

In conjunction with that major change in public policy, the federal government, in discussions with the insurance industry, provided tax incentives for hybrid plans as part of the PPA. Although the PPA was signed in 2006, the tax benefits of the hybrid features didn't become effective until 2010, and it took longer for the insurance industry to begin broadly offering these products to the general public.

What's a Hybrid LTC Policy?

A hybrid LTC policy can either be a life insurance or annuity contract with a rider that offers LTC benefits. For example, say a consumer buys a $250,000 life insurance policy with an LTC rider. When the insured individual qualifies for LTC benefits (typically when he's unable to perform two of six activities of daily living (ADL) or becomes cognitively impaired), a given percent of the death benefit, 2 percent in this example, is available each month for LTC needs. This means that up to 2 percent of the $250,000, or $5,000, is paid out monthly. An annuity-based LTC hybrid policy would also have a ratcheted up benefit for LTC purposes.

An indemnity-based policy would automatically pay out the $5,000, regardless of actual LTC expenses, while a reimbursement policy would reimburse the actual costs up to the policy limit. Today, tax-free benefits are limited to $360/day or the actual cost, whichever is greater.

Some policies have LTC benefits limited to the death benefit, with the death benefit being reduced for any

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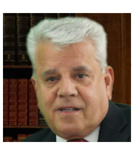

LTC benefits received. However, some companies and products offer riders that will extend cumulative benefits beyond the dollar level of the death benefits, say, two or three times as much. Additionally, inflation protection and return of premium features, among others, may be available.

Hybrid policies are certainly the product du jour, and it's easy to understand why. In the LTC insurance market, many of the main players of yesteryear are no longer in the individual LTC insurance business today. The number of companies that offer stand-alone LTC policies has dropped about 90 percent since 2002, including seven of the top 10 insurance players in the LTC market that left from 2001 to 2015.[1] On the other hand, there are more companies than ever in the market offering accelerated death benefits from life insurance policies and chronic care and LTC riders on life insurance policies and annuities.

The PPA favorably expanded on income taxation rules regarding LTC riders in annuities and life insurance policies to make hybrid policies a more tax-efficient option.

One of the major reasons consumers have been attracted to hybrid products is because they do away with the "use it or lose it" mentality typically associated with stand-alone LTC policies. Costs and consumers' concerns over paying dearly for a benefit that they may never receive has been a main factor for why market penetration of LTC insurance has stagnated in the 9 percent to 10 percent range after more than 25 years in existence. This hybrid market has seen a shift in product design over the last several years. In 2011, 61 percent of policies were sold on a recurring premium basis, while 39 percent were single premium policies. In 2017, 89 percent of policies sold were recurring premium.[2] This shift suggests a growing number of buyers who may not have the financial wherewithal to invest a large lump sum but still want the dual protection these hybrid policies offer. Have these types of combination/hybrid policies become more popular? A June 11, 2018 article by Leslie Scism in the *Wall Street Journal* is aptly titled, "Long-Term Care Insurance Isn't Dead. It's Now an Estate-Planning Tool." The article goes on to describe the popularity of the combo/hybrid plans.

It should be noted, however, that the PPA only pertains to non-qualified assets, not retirement assets for most people. The exception is that certain public safety officers can use a limited amount of their pension funds to pay for LTC on a pre-tax basis under specific parameters.

LTC vs. Chronic Illness

Some life insurance policies have a chronic illness rider instead of an LTC rider. One difference between the two is in the triggering of benefits. Generally, to trigger a chronic illness rider, not only does the insured have to meet two of six ADLs or a cognitive impairment definition, but also a decreasing number of the carriers still mandate that the impairment must be assumed to be permanent. Keep in mind that various states have their own rules governing riders, features and benefits contained in a life insurance policy. An LTC trigger doesn't need to be permanent. Chronic illness benefits are generally an advancement of death benefit, while LTC riders may offer an LTC benefit in excess of the death benefit. LTC riders generally offer a return of premium feature, while chronic illness riders don't, and inflation protection features are generally not available on chronic illness riders.

Some states that have products with a chronic illness rider don't charge a premium for benefits up front; however, when the rider is accessed at claims time, there's a calculation performed that determines LTC benefits. One form of such a rider is considered the discounted death benefit model. Depending on the age of the qualifying insured and the severity of the impairment, the insurance company will determine the value of the claim on the back end and make an offer to the policy owner. If the individual is old and very sick, this chronic illness benefit may be modestly discounted. However, if the individual is relatively young and has an impairment that isn't life threatening in the near term, the discount may be significant.

Another type of rider is the lien method. With this model, there's a formula-based payout that's subject to a lien at stated interest rates. It's critical to manage the policy appropriately as the lien and associated

interests may otherwise threaten the viability of the policy.

It's important to understand that, as opposed to dollar-for-dollar acceleration methods that generally incur an upfront charge for the rider and allow the insured to know in advance the amount of available benefits, with some types of chronic illness riders, the policy owner won't know the precise monthly benefit available for LTC needs or the amount of the death benefit he'll ultimately receive because the calculations for the benefit aren't performed until the insured individual qualifies for the claim. These are perfectly legitimate products but shouldn't be confused with LTC riders that offer LTC benefits equal to the full death benefit, or multiples of it, that consumers understand from the outset.

In the end, as with everything else, review all of the options. After debating the pros and cons of each, an individual or couple can make an educated decision regarding the right option.

The PPA

The PPA favorably expanded on income taxation rules regarding LTC riders in annuities and life insurance policies to make hybrid policies a more tax-efficient option.

PPA Section 844(a) includes special rules for "combination contracts" that provide LTC insurance. This section allows for any charge against the cash value of an annuity or life insurance contract that's part of a rider on the contract to reduce the basis (but not below zero) of the contract by the cost of the charge and that any charge shouldn't be included in gross income.

Section 844(b) allows annuity and life insurance contracts to include qualified LTC riders in addition to expanding the tax-free exchange of life insurance annuities for LTC contracts. It also allows for the exchange from a qualified LTC contract to another qualified LTC contract.

Before the PPA, the last in, first out nature of taxation for annuities meant that accessing value to pay for LTC benefits or LTC premiums was a taxable transaction. Also, in a modified endowment contract (MEC) or a non-MEC contract with no remaining basis, the cost of the LTC rider was considered a distribution and taxed as ordinary income. The PPA changes this. Withdrawals from even a non-qualified annuity are tax free if used to pay for LTC while an annuity must be "upgraded" to a qualified annuity for withdrawals to pay for tax-free LTC benefits.

This may not sound like a huge development, but it's quite meaningful. The PPA offers an incentive for individuals to obtain private LTC coverage, which can reduce the burden on the government for these costs down the road. (Note that some states have their own tax credits or deductions.) The new Internal Revenue Code Section 1035 rules still mandate company-to-company transfers, unlike with individual retirement account rollovers, or the advantages will be irrevocably lost, and all other Section 1035 rules regarding "like-to-like" transactions remain. The expansion of the Section 1035 rules allow for possible elimination of taxation on gain, not just deferral of taxation, and this can be a significant benefit to taxpayers.

For example, if an annuity with significant gain is rolled into a new qualified annuity (annuities still can't be exchanged into life insurance contracts though life insurance contracts may be exchanged into annuity contracts), hypothetically, the entire value of the annuity could be used to pay for LTC costs, and the taxes on gain will forever be avoided. If there's a remaining value to the beneficiaries, it will be taxed as an ordinary annuity.

The Down Side

Hybrid policies also have some unfavorable tax ramifications. Because the charges for the LTC portion of a contract lower the basis, the ultimate annuity or life insurance value will be lower and subject to taxation on more gain than would otherwise be the case, including lowering the exclusion ratio on annuitization. Most would see this as a favorable trade-off, but it should still be noted. The same occurs with the return of premium features. If a policy owner paid $100,000 into a contract and then changed his mind down the road and received the $100,000 back, he'll be subject to tax on some gain.

Furthermore, hybrid policies aren't compatible with state partnership programs, and IRC Section 213 tax deductions for medical expenses are no longer allowable for the cost of an LTC rider if the rider charge is deducted from the cash value of the contract. Also Section 213 allowable expenses would be deductible under the rules only for the amount that exceeds LTC payments.

Trust Friendly?

When a life insurance policy with an LTC or chronic illness rider is placed into an irrevocable trust, there's a question as to whether the triggering of the benefit

is considered an incidence of ownership. Some say when the benefit is an indemnity policy, there's no problem, but when the type of policy is a reimbursement policy, as is often the case with a chronic illness rider, there could be a problem with incidence of ownership. However, with the estate tax exemption at $11.4 million, it's less of an issue for most individuals, and for those high-net-worth individuals who would be affected, leaving the LTC benefits in the trust and spending estate assets could be considered a form of non-taxable gifting.

A Good Opportunity?

The PPA and the resulting hybrid policy options may open the market up to younger people who are in need of life insurance protection today but may desire LTC protection later. Furthermore, a client's LTC needs may show up at a time when he's no longer insurable or able to qualify for a new LTC policy.

We've been talking with more wealthy clients about LTC than ever before. Through our consulting practices, advisors are regularly asking us to analyze life insurance policies, often trust owned, for clients who bought them for estate tax liquidity and who don't need them anymore due to tax law changes. Others have simply changed their plans. Nonetheless, we analyze the contracts to help them determine if they're a good use of money.

Sometimes the policies are stinkers with sinking cash values and may never pay a death benefit, and other times, the cash value and premium prove to be an unduplicable use of money. Either way, policy owners and trustees need to make decisions regarding the best use of assets, and sometimes the cash value from these policies is considered "found money" and redeployed into LTC protection.

In the end, money for LTC and the care itself can come from only so many places. On a percentage basis, most of it comes from the government in the form of Medicaid, but that isn't likely to be most of your clients. Personal investments are always going to be a substantial source of the funds, and homes are a significant piece of this. After the PPA, the tax benefits of obtaining LTC insurance for these costs may move the insurance option up the list. It should certainly be a part of the discussion.

Endnotes

1. 2017 and 2019 National Association of Insurance Commissioners reports, *www.naic.org/documents/cmte_e_mlwg_related_state_of_ltc_industry.pdf.*
2. *www.naic.org/cipr_topics/topic_long_term_care.htm.*

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