

# Long-Term Care Insurance and Tax Planning

## What Is Long-Term Care and Who Is Responsible for Its Cost?

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When people consider the subject of long-term care, they generally think about nursing homes. In fact, long-term care often has little to do with nursing homes. Much of the long-term care in this country is “custodial care” delivered in the patient’s home and not in a nursing facility. An understanding of that fact, the system for paying for long-term care, and the tax consequences can help practitioners better advise the families of the growing number of people who will need long-term care.

Improvements in health care and increases in longevity have led to an increase in the number of people who will need long-term care at some point in their lives. Thirty years ago, few people had ever heard of Alzheimer’s; today, it is a leading reason why people need long-term care services. The longer people live, the more likely they are to need care. The question is, what will the providing of that care do to their families and finances?

### **Long-Term Care Is Usually Custodial Care**

Long-term care is defined in the Code as “necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services” for a chronically ill individual (Sec. 7702B(c)(1)). A chronically ill individual is someone who needs assistance with the activities of daily living (toileting, bathing, dressing, eating, transportation from one point to another, and continence) (Sec. 7702B(c)(2)). Chronic illness also includes cognitive impairment so severe that the individual needs constant supervision.

In today’s society, if a patient needs custodial care, chances are it will be delivered in the community, not in a nursing home. While the *New England Journal of Medicine* found that 43% of those over age 65 will need nursing home care, this was the percentage that may spend some time in a facility, not those who will permanently reside in one (Kemper and Murtaugh, “Lifetime Use of Nursing Home Care,” 324 *New England Journal of Medicine*, No. 9 (1991): 595). Every study conducted finds that care is overwhelmingly provided at home. The key question, of course, is who is going

to pay for that care?

### **Who Covers the Cost?**

Medicare does not cover the cost of long-term care. Although it is the primary health care program for retirees, it pays only for skilled or rehabilitative care, not custodial care in any venue (42 USC §1395d). Medicaid, a federal and state program for financially needy individuals, will pay for custodial care, but primarily in nursing homes (42 USC §1396a; 42 CFR §§409.33(a)(1) and (d)). Medicaid funding for home care and assisted living is very limited and is based on the availability of funds.

Many veterans believe that the Veterans Administration will pay for home care, adult day care, or assisted living. As with Medicaid, funding is limited and is generally based on service-related disability (see [www.va.gov/healtheligibility/coveredservices/standardbenefits.asp](http://www.va.gov/healtheligibility/coveredservices/standardbenefits.asp)). The federal government has in effect acknowledged this by encouraging veterans to purchase long-term care insurance through the new Federal Long-Term Care Insurance program.

The result is that consumers are forced to pay privately for their care. Unfortunately, the best thought-out retirement plan rarely takes into consideration all the ramifications of living a long life. Put another way, those assets and income have been allocated to pay for retirement, not for the consequences of living a long life. Chronic illness therefore results in the need to invade principal and divert income. As a result, one of seniors' greatest fears—that of outliving their assets—may come true.

### **The Role of Long-Term Care Insurance**

The use of long-term care insurance (LTCI) thus becomes an important part of planning for the increased risk of disability that comes from living a long life. The product has two roles: helping relieve families of the burden of caring for their disabled family member and allowing the family member's retirement portfolio to serve the purpose for which it was intended—namely, retirement.

LTCI does not replace the need for family involvement in providing care but rather supplements it. It pays professionals to assist the affected person with the toughest tasks, such as toileting, bathing, and feeding. This in turn allows the family to provide longer and better care at home.

From a financial point of view, LTCI allows the patient's retirement plan to stay intact. That is particularly important given the recent steep declines in portfolio values. LTCI in effect protects the balance of the account value. It also protects income. Although the patient may qualify for Medicaid to pay for nursing home costs by spending down (i.e., transferring) assets, his or her income (pension, Social Security, IRA, and 401(k) payouts) cannot be protected that way.

### **Tax Savings for LTCI**

**Individuals:** Premiums paid for qualified LTCI are deductible as medical expenses on Schedule A, Itemized Deductions, but the deductible amount of the premiums is limited by the age of the individual at the close of the tax year (Sec. 213(d)(10)). The deductible portion of the premiums is inflation adjusted every year. For 2008, the

deductible amounts are (Rev. Proc. 2007-66):

<b>Age 40 or less</b>	<b>\$1,310</b>
<b>Age 41–50</b>	<b>\$1,580</b>
<b>Age 51–60</b>	<b>\$1,150</b>
<b>Age 61–70</b>	<b>\$3,080</b>
<b>Age 71 or older</b>	<b>\$3,850</b>

***Self-employed individuals:*** Under Sec. 7702B(b), a self-employed person may deduct 100% of premiums paid for the individual, as well as the individual's spouse and dependents, up to the maximum eligible allowed (as indicated in the above chart) without regard to the 7.5% medical expense limitation. The premiums are deductible as an above-the-line deduction on line 29 of Form 1040, U.S. Individual Income Tax Return.

***Limited liability companies, partnerships, and S corporation 2% owners:*** These entity business owners are all treated as if they are partners. LTCI premiums have been classified as health insurance under Sec. 7702B(a)(3), and when the business pays the premiums, they are deductible by the business entity and are includible in the business owner's income as guaranteed payments. The business owner can deduct the payments as self-employed health insurance to the extent allowable under Sec. 162(l) (Secs. 707(c), 162, 61).

***C corporations, professional corporations, and tax-exempt organizations:*** These businesses may deduct, as a business expense, all qualified LTCI premiums paid for employees, employees' spouses, and dependents, as well as retirees and their spouses. This includes the business owner, who is considered an employee of the corporation. The employer's contributions toward the cost of the premiums are not included as imputed income to the employee (Secs. 162(1), 106).

***Contributory arrangements:*** When the employer and the employee share the cost of the LTCI premium, the company may deduct all premiums it contributes for qualified LTCI plans as a business expense. Premiums paid for the spouse and dependents of employees and retirees and their spouses are treated similarly. For federal income tax purposes, the employee's portion of the premium is treated as if paid by the individual and is deductible—subject to the age-based limits for individual taxpayers—to the extent the employee's total unreimbursed medical expenses, including qualified LTCI premiums, exceed 7.5% of the employee's adjusted gross income (Sec. 213(a)).

***Per diem contracts:*** For 2008, the tax-free receipt of benefits under a per diem policy is limited to \$270 per day. If the total of the benefits received for a period under a per diem policy exceeds this amount, the excess will be included in gross income (Sec. 7702B(d); Rev. Proc. 2007-66).

### **How Benefits Are Paid: Reimbursement Versus Indemnity**

There are two ways that benefits are paid from an LTCI contract: indemnity or reimbursement. Under an indemnity provision, the insurance provider pays the entire

daily/monthly benefit at the end of each month, no matter what the actual expenses were. This is an optional benefit/rider with some companies. The premiums for indemnity contracts are generally much higher than for a reimbursement contract, and these contracts and riders are getting harder to find.

Under a reimbursement provision, the policy will reimburse based on actual long-term care expenses incurred. The actual amount is subject to a daily/monthly benefit limit. Reimbursement can work in two ways:

1. The insured can pay the long-term care expenses and be reimbursed at the end of each month by the insurance provider.
2. The insurance provider can be billed directly by the care provider and the insured will be responsible for any expenses over the daily/monthly limit.

### **LTCI State Partnership Programs**

Some states and private insurance companies have developed long-term care insurance partnership programs to encourage the purchase of LTCI by people who otherwise might rely on Medicaid to pay for their long-term care. Under such programs, people who purchase qualifying LTCI policies can retain a specified amount of assets and still qualify for Medicaid, once they use up their insurance benefits (provided they meet all other Medicaid eligibility criteria). See the [exhibit](#) on this page for listings of the states currently participating in the partnership program and those that have partnership plans pending.

Partnership programs are designed for people with low to middle incomes; however, surveys show that most purchasers have substantial assets (Kassner, "Long-Term Care Insurance Partnership Programs," AARP Public Policy Institute, 2006). Each state can have different program features, so practitioners should be sure to check with the state in which the insured resides.

### **Deficit Reduction Act of 2005**

The Deficit Reduction Act of 2005, P.L. 109-171, further defined the partnership program by paving the way for the creation of a national partnership program. Among other changes, the act denies Medicaid nursing home coverage to people with home equity exceeding \$500,000 (states can elect up to \$750,000). It also changed the Medicaid "lookback" date to the date of the application instead of the date of transfer and the lookback time from three to five years.

One item further defined is dollar-for-dollar asset protection. Basically, if the LTCI policyholder exhausts the policy, Medicaid will exempt the value of the policy. In other words, for every dollar of protection, a dollar of assets is exempt from a Medicaid spend down.

### **Filial Responsibility Laws**

Thirty states currently have filial responsibility laws on the books (Bulcroft, Van Leynseele, and Borgatta, "Filial Responsibility Laws: Issues and State Statutes," 11 *Research on Aging*, No. 3 (1989): 374). Under a filial responsibility law, adult children can be made responsible for the financial support of indigent parents and, in some

cases, medical and nursing home costs. In most states, actual enforcement of the law has occurred only when a parent has tried to give away assets in order to “spend down” to Medicaid eligibility. However, nursing homes do not have to actually invoke the law, they just have to threaten to invoke it.

Suppose a parent dies in a nursing home. She has been there for three years and has not had the resources to pay the facility for her care. The final bill comes to \$126,000. What would most children do if they got a call from the nursing home telling them that their state has a filial responsibility law and demanding payment for the parent’s care? Most children will be glad to settle the bill for \$75,000 to avoid getting taken to court for the full amount.

## **Conclusion**

Given all the recent activity concerning state partnership programs, the Deficit Reduction Act of 2005, and filial responsibility laws, practitioners should be talking to their clients about LTCL.

When purchasing insurance, individuals should look for a long-term care insurance specialist and consider his or her training, educational credentials, and commitment to help solve long-term care needs. The key is whether the specialist emphasizes a plan or a product. If he or she focuses first on product and price rather than the plan, the client should consider getting another opinion.

## **Make the most of tax rules for premiums and benefits.**

by Daniel R. Finn

### **EXECUTIVE SUMMARY**

- **Long-term care (LTC) insurance benefits are tax-free** to the insured for either reimbursement of qualified expenses or payments up to a per-diem limit indexed for inflation—\$270 in 2008.
- **Premiums for LTC insurance are tax-deductible according to limits** that are also indexed to inflation and increase with the age of the insured. For an individual purchaser, however, premiums, along with other qualified medical expenses, are further subject to the floor of 7.5% of adjusted gross income as an itemized deduction.
- **More favorable treatment is available** to self-employed persons, who may be able to deduct as a trade or business expense premiums (up to the annual limit) of an LTC plan sponsored by their business for themselves or spouse or dependents.
- **A company that pays premiums for nonowner employees** is generally allowed still more favorable treatment: deduction without regard to the annual limits. LTC insurance is generally not allowable as part of a "cafeteria plan"; however, premiums up to the eligible amount or LTC expenses may be funded through a health savings account, medical savings account or health reimbursement arrangement.

The number of baby boomers in or near retirement is rising, and so too is the demand for long-term care (LTC) insurance. Depending on the age of the insured, such coverage can be expensive, but fortunately for them, Congress and some states have provided income tax incentives for the purchase of certain LTC insurance policies—called “qualified” LTC contracts—in IRC § 7702B. CPAs who have a command of these rules will be well-placed to provide valuable advice to clients. To that end, this article provides an overview of the income tax treatment for both premiums paid into and benefits received from qualified LTC insurance contracts for individuals (nongroup policies). As you’ll see, benefits and premiums can be excluded or deducted from income—within limits—but the crucial question of who pays can make the difference ultimately whether that’s true of any, some or all of the cost.

#### TAXATION OF BENEFITS

The federal income taxation of benefits received under an LTC policy depends on the type of contract. Under a “per-diem,” also known as indemnity-based, policy, the insurance company generally pays the same benefit regardless of the insured’s actual LTC expenses. These amounts are received income-tax-free up to the greater of (1) costs incurred for LTC services or (2) a daily limit indexed for inflation—\$270 per day in 2008. Any excess amount is taxed. (The taxable amount is further reduced by reimbursements received for LTC services, but with a per-diem policy, that reduction often will be zero). See IRC § 7702B(d) and Rev. Proc. 2007-66. Under a “reimbursement” policy, the insurer does not pay a set amount. Instead, it pays for LTC expenses incurred, up to the maximum benefit under the contract. All amounts received under a reimbursement policy are income-tax-free. See IRC §§ 7702B(a)(2) and 104(a)(3).

#### TAXATION OF PREMIUMS

The federal income tax treatment of premiums paid into a qualified LTC policy differs not by the type of contract, but by the type of taxpayer (or in some respects, the relationship between the premium payer and insured/policy owner). There are three categories: individual (good), self-employed (better) and employer-employee (best).

***Individual (Good).*** When individuals personally buy LTC insurance (no business is involved in the purchase) that covers themselves, a spouse or a dependent, they can deduct a portion of the premium. See IRC §§ 7702B(a)(4), 213(a) and 213(d)(1). Dependents generally include the taxpayer’s children and certain relatives (including parents, siblings, aunts and uncles) for whom the taxpayer provides over half the support. See IRC § 152. To determine the deductible amount, the individual must consider two limitations: the “eligible long-term care premium” amount and 7.5% of adjusted gross income (AGI).

The eligible LTC premium amount is the maximum portion of the LTC insurance premium that an individual can take into account when calculating the deduction. See IRC § 213(d)(1) and Rev. Proc. 2007-66. The eligible amount is dictated by the insured’s age (not the taxpayer’s) at the close of the taxable year and is indexed for inflation. In 2008, the amounts are:

- Age 40 or less: \$310
- 41 through 50: \$580

■51 through 60: \$1,150

■61 through 70: \$3,080

■71 or more: \$3,850

The appropriate eligible LTC premium amount is added to other unreimbursed medical expenses, and this total is deductible only to the extent that it exceeds 7.5% of AGI. See IRC § 213(a). At first blush, it seems few taxpayers will have enough unreimbursed medical expenses to claim this deduction (see [Exhibit 1](#)). But some individuals—retirees, for example— might not have much income in a given year, so 7.5% of their AGI may not be a large number. And other individuals might be paying LTC premiums not just for themselves but also for a spouse and senior generation dependents, any of whom might also have high unreimbursed medical expenses. So the aggregate LTC premiums and expenses might be high enough to exceed 7.5% of their AGI and result in a deduction.

### Exhibit 1 Deduction for Individuals

In 2008, a client purchases LTC insurance for himself and his spouse, both age 55, for a total premium of \$3,000 a year (\$1,500 for each policy). Given their ages, their eligible LTC premium amounts are \$1,150 + \$1,150 = \$2,300. The client also has \$2,600 of unreimbursed medical expenses. AGI is \$100,000.

The deduction calculation is:

unreimbursed medical expenses + eligible LTC premiums – 7.5% of AGI,  
or \$2,600 + \$2,300 – \$7,500 = no deductible amount.

***Self-Employed (Better).*** Self-employed taxpayers generally can deduct as a trade or business expense the LTC premiums paid for themselves, their spouses or dependents pursuant to an employer-sponsored plan. See IRC § 162(l). Unlike the deduction for individuals, the deduction for self-employed taxpayers is not subject to the 7.5% of AGI limitation but is generally limited only by the eligible LTC premium amount. Well, there are other minor limits: The deduction is available only to the extent that the taxpayer has earned income from the business providing the coverage (W-2 wages or guaranteed payments), and is not available if the taxpayer is eligible for LTC coverage under a subsidized health plan maintained by his spouse's employer or by his employer, if he works for one in addition to running his own business. The mechanics of these rules mimic those for accident and health insurance for self-employed taxpayers, a feature that, among other things, suggests that it's wise to put the plan in writing. See Notice 2008-1 and Revenue Ruling 91-26; also IRC §§ 162(l)(2), 401(c), 707(c), 1372(a), 1402(a), and 7702B(a)(3).

So who is a self-employed taxpayer? Sole proprietors, partners of partnerships, members of limited liability companies taxed as partnerships, and S corporation shareholders who own more than 2% of the corporation are all self-employed taxpayers— but only if they provide personal services to the business. Also, due to ownership attribution rules under IRC §§ 1372(b) and 318(a), certain family members of S corporation owners also might be treated as self-employed owners, even if they are merely employees. This is generally undesirable, as treatment for self-employed taxpayers is less favorable than that for employees, as shown in [exhibits 2](#) and [3](#).

## Exhibit 2 Deduction for Self-Employed Taxpayers

A client is self-employed, and neither the client's employer nor her spouse's employer provides LTC coverage under a subsidized plan. The client buys LTC policies for herself and her spouse, both age 55, for a total premium of \$3,000 (\$1,500 for each policy).

The client's earned income from the business providing the coverage is \$45,000, and the 2008 eligible LTC premiums (based on each spouse's age) is the same as in the previous example:  $\$1,150 + \$1,150 = \$2,300$ . The full \$2,300 is deductible.

**Employer-Employee (Best).** The best federal income tax treatment occurs when employers provide LTC coverage to employees (or their spouses and dependents) under an employer-sponsored plan. An employer can deduct LTC premiums it pays on an employee's behalf as long as they are ordinary, necessary and reasonable business expenses; they are not limited to the eligible LTC premium amount (for premiums paid by the employee under an employersponsored plan, see discussion of cafeteria plans below). Moreover, the premiums are not included in the employee's income, and the employee can receive the ultimate LTC benefits entirely tax-free. See IRC §§ 106(a), 162(a) and 7702B(a)(3), also Treas. Reg. § 1.106-1. Clearly, this is an extremely attractive employee benefit (see [Exhibit 3](#)).

## Exhibit 3 Deduction for Employer-Paid Premiums

In 2008, an employer pays premiums for LTC policies (not limited-pay contracts) covering an employee and his spouse, both age 55, for a total premium of \$3,000 (\$1,500 for each policy). Given the age of the client and the spouse, their eligible LTC premium amounts are  $\$1,150 + \$1,150$ , or a total of \$2,300. Because of the employment status, however, their ages are irrelevant and the eligible LTC premium amount is not a limit on deductibility. The employer's deduction is the total \$3,000 premium paid, none of which is included in the employee's income.

Unlike self-employed owners of S corporations or partnerships, owners of C corporations are allowed to be treated as employees for this purpose and, therefore, potentially can enjoy the same generous tax treatment. But the fact that C corporation owners can also be employees does not mean they are assured employee treatment with respect to the LTC premiums paid by the business; the corporation's payments must be made pursuant to a plan to benefit the individual because of employment status rather than ownership status. There is no clear-cut formula to follow to prove LTC coverage is based on employment status, so it's often best to describe plan eligibility in a manner that could cover a nonowner employee in addition to shareholders. In fact, it's safer still to cover at least one nonowner employee. See *Leidy v. Commissioner*, TC Memo 1975-340, *aff'd*, 39 AFTR2d 77-877 (4th Cir. 1976); *Larkin v. Commissioner*, 48 TC 629 (1967), *aff'd*, 21 AFTR2d 1307 (1st Cir. 1968).

Another caveat arises with "limited-pay" contracts, which provide coverage for the rest of the insured's life after the payment of only, say, 10 annual premiums. IRC §§ 419

and 419A impose rather strict limits on the amount an employer can deduct when prefunding welfare benefits (which include LTC). Although it's not entirely clear that these Code sections apply to limited-pay LTC contracts, there's a good chance they do (certain *nonguaranteed* contracts aren't covered by sections 419 and 419A, but all qualified LTC contracts are *guaranteed* renewable), so any employer should be prepared to either live within the limits or explain to the IRS why these Code sections don't apply.

Presuming these limits are relevant, an employer can deduct the cost for the current year's coverage, and this would allow LTC premiums to be deducted under a typical pay-as-you-go contract. But with an insured plan, additional deductions for funding welfare benefits for future years is limited to those amounts needed to create a reserve for post-retirement benefits, and only to the extent this reserve is funded on a level basis over the employee's remaining working years. So if an employee has 20 more years to work before retirement, the employer's premium payments under a 10-year limited-pay LTC contract could easily be too large to be fully deductible (although, in this situation, payments under a 20-year limited-pay contract might very well be deductible). Furthermore, claiming a deduction under this post-retirement reserve category introduces nondiscrimination rules and can reduce the contribution limits to qualified retirement plans, so using limited-pay contracts can quickly become complicated.

Problems also can arise with "return of premium" contracts that offer a refund of unused premiums if the policy is canceled. Not only might the refund be taxed—see IRC § 7702B(b)(2)(C)—it might also constitute deferred compensation under IRC § 409A, which, if violated, carries a 20% penalty.

#### CAFETERIA PLANS, ALPHABET SOUP, ERISA AND STATE LAW

As if all that weren't enough, there are even more rules CPAs should know when advising clients on LTC insurance. First, LTC insurance cannot be offered as part of a cafeteria plan. See IRC § 125(f). As for the "alphabet soup" of medical savings and reimbursement accounts, they basically break down this way: HSAs (health savings accounts), MSAs (medical savings accounts) and HRAs (health reimbursement arrangements) can be used to pay both LTC expenses and LTC insurance premiums (up to the eligible premium amount). FSAs (flexible spending arrangements), however, can be used to pay only for LTC services, not LTC insurance premiums. Also, ERISA rules governing welfare plans generally require that plans be written and that they contain "fiduciary" and "claims procedure" provisions, and potentially "reporting and disclosure" provisions.

In addition, many states provide their own tax breaks—deductions or credits—so to give their clients the complete picture, CPAs should also become familiar with the specific state laws wherever they practice. Many LTC insurance carriers can provide state-by-state descriptions.

#### A KEY TO SECURITY

Whether your clients are individuals, self-employed taxpayers or employees, they increasingly will be using LTC insurance as a key risk management tool in their retirement portfolios. Therefore, providing and implementing effective tax planning and management with respect to LTC will have an important impact on your clients' long-term financial security. ♦

## Taking Emotion Out of the Decision

by Theodore J. Sarenski

Much has been written in financial planning periodicals regarding the pros and cons of long-term care insurance, perhaps because it is still in its infancy compared to other insurance products. While most individuals don't question the need for homeowner's, automobile or life insurance, many are still reluctant to purchase long-term care insurance. Why? Possibly because what the insurance is intended for and how it is presented evoke fervent emotions.

Many people find it difficult to contemplate a loss of independence and their own mortality. They might assume that Medicare or Medicaid will pick up the tab but haven't reckoned on Medicare's limits on length of stay in a skilled nursing home and restrictions on intermediate care and in-home services, or on Medicaid's eligibility requirements of low income and few assets.

It may benefit the potential purchaser of long-term care insurance to take the emotion out of the decision by thinking of it as an asset protection policy. Each of us chooses which risks we are willing to accept and which we wish to pay an insurance company to take on for us. It is always a personal decision. The owner of a long-term care policy is deferring the risk of a future in-home or skilled nursing facility cost to an insurance company rather than accepting that risk personally.

At today's level of health care costs, assets accumulated over a lifetime can disappear in a few years should the individual need skilled nursing care. According to the latest annual survey by the Metlife Mature Market Institute, the average private-pay cost of nursing home care in 2007 was \$213 per day, or \$77,745 per year, for a private room and \$189 a day, or nearly \$69,000 per year, for a shared room. Some places, such as San Francisco or Hartford, Conn., reported costs of more than double the national average. Moreover, costs have been increasing faster than the rate of inflation and could further accelerate if the number of beds doesn't keep pace with an aging population. Between 1995 and 2025, the number of elderly people will double in 21 states, according to the U.S. Census Bureau.

Healthier lifestyles and advanced medical care are allowing many people to live longer but with a greater chance that they will need assistance in their later years that family or friends are not equipped to provide physically, emotionally or competently.

Consider that a \$5,000 annual premium for a good individual long-term care policy is 1% of \$500,000, or 0.5% of \$1 million, or 0.25% of \$2 million, etc. Isn't it worth one-quarter of 1% per year to ensure that an individual's estate tax exclusion, currently \$2 million, is protected and can be distributed upon death in any manner that individual has planned? Isn't it worth the peace of mind to know that a lifetime of work and saving will be preserved to benefit future generations?

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**What the 90% of older clients who don't have this coverage need to know.**

# Long-Term-Care Insurance

BY NEIL ALEXANDER

**A**ccountants would never advise clients to go without car insurance. Yet rarely do CPAs recommend their clients purchase long-term-care insurance when, in fact, the probability of needing LTC insurance is much greater than the likelihood of being in a car accident.

The American Council of Life Insurers says less than 10% of the nation's elderly own an LTC policy. Benefits are tax-free and there's no imputed income to employees whose companies provide this insurance as a benefit. It's a good deal for many clients—even better than buying car insurance. Here's what CPAs need to know to advise clients on their LTC insurance needs.

## COMMON MISCONCEPTIONS

Many clients have a number of misconceptions about LTC insurance that makes them resist buying this important coverage:

***Existing insurance will pay for LTC.*** Wrong. Health insurance pays only for restorative care, not chronic care such as that required for a long-term illness. Medicare pays only for the first 100 days in an LTC facility. Medicaid does cover long-term-care needs. However, it's intended to cover those people with incomes at or near the poverty level—not most CPAs' typical clients.

***Personal wealth will pay for all LTC needs.*** Maybe. CPAs need to assess whether the client has sufficient personal wealth to self-insure against LTC needs. The calculation revolves around having enough principal and income to fund such care. Few families have the wealth necessary to provide extended care. For the rest, LTC insurance is essential.

***LTC insurance is too expensive.*** Not when compared with costs of actual care. The cost for LTC coverage is only a fraction of it. "This works out to about 50 cents a day for a 40-year-old and \$1 a day for a 50-year-old," says Susanne Howarth, CPA, of TBG Financial West in Los Angeles. Further, the elderly are not the only people who need to plan for long-term care. "People between 18 and 64 receive about 40% of all long-term care," says Howarth, "The younger a client purchases LTC insurance, the lower the premiums." (But the more he or she will pay over a lifetime.)

***Clients will be forced to live in a nursing home.*** Wrong. Nowadays, most long-term-care policies allow the beneficiaries to receive care at home.

## TYPES OF LTC INSURANCE

The difference between plans revolves around the treatment of premium inflation and benefit compensation. Depending on a client's circumstances, there are five common types CPAs can recommend:

***Expense reimbursement plans.*** Similar to most health insurance plans, the patient pays LTC costs and then presents the invoices to the insurance company for reimbursement. CPAs might recommend this plan to clients who don't have pressing cash flow issues and don't mind doing the paperwork to apply for reimbursement.

***Indemnity-based benefit plans.*** Here, the plan fixes the monthly benefit in advance. It requires no invoices for payment. Rather, the physician issues a statement declaring the need for long-term care. Clients who value reduced paperwork, faster payments and a guaranteed cash flow favor this plan.

***Continuous premium payment options.*** Policy owners pay the monthly premiums forever. The policy is not cancelable except in the event of nonpayment of premiums. However, the insurance company can increase premiums on an entire class of policies. The advantage of this plan is that the premiums are usually the lowest available.

***Limited payment plans.*** Policy owners pay premiums for a set time period—usually until age 65. After the last premium payment, neither the company nor the insured can cancel the policy. “Limited payment plans are more expensive—sometimes twice as much as continuous pay policies. However, their guaranteed fixed payment and no-cancel features make them attractive to some clients,” says Howarth.

***Hybrid products.*** Some life insurance policies include LTC riders. However, the benefit level is usually less than that of a standalone policy.

## **PREFERENTIAL TAX TREATMENT**

The Health Insurance Portability and Accountability Act (HIPAA) provided full deductibility of LTC insurance premiums that C corporations pay as part of an employee benefit plan. This is particularly advantageous for companies with highly compensated employees since there are no discrimination tests to meet, as with other types of benefits such as pension plans. Additionally, neither company premium payments nor care benefits are treated as income to employees.

Self-employed clients can deduct a percentage of the eligible LTC premiums based on their age and income. The percentage works on a sliding scale in 10-year increments beginning at age 40. The eligible annual premiums begin low—\$450 for ages 41 to 50—then steadily rise to a high of \$2,990 for age 71 and older. The tax-deductible percentage is generous. For 2002, it's 70%, increasing to 100% in 2003.

For most company plans, the employee's family members can purchase the same insurance at the same rate provided to the company as a group. Individuals buying LTC insurance can deduct the premiums as an itemized medical expense on schedule A; these benefits are also tax-free.

## **PITFALLS TO AVOID**

CPAs should advise clients to scrutinize historical premium increases of prospective LTC insurance carriers. Generally, those with LTC as part of their main line of business have a better track record. Determine the company's financial stability— younger clients will have to count on its surviving for decades before they collect any benefits.

CPAs should also pay close attention to provisions for benefit inflation. Most plans vary according to price, benefits and age of the insured. Compound inflation protection—where the inflation allowance compounds annually—is best. Additionally, clients should be able to increase coverage based on their age at the time of original purchase. Without this provision, additional insurance can become prohibitively expensive.

## WHAT'S NEXT?

According to a recent study by the Health Insurance Corporation of America, the average age of people buying LTC insurance has fallen to 58 from 61 in the last few years. Younger and younger clients will now be asking CPAs for policy evaluations.

As the 78 million baby boomers age, experts predict they will live longer, but not necessarily healthier. Our society no longer has extended families living together and able to provide long-term care to the sick or elderly. The burden falls to individuals to provide this care for themselves.

The AICPA cites \$50,000 annually as the national average cost for long-term care. As this cost escalates, CPAs should look for the eventual need for such care to take an increasing role in personal financial planning. ■

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## LTC Insurance for Owners and Executives

A valuable perk for key employees.

BY PAUL S. DEVORE

### EXECUTIVE SUMMARY

■ **COMPANIES INCREASINGLY OFFER LONG-TERM-CARE** insurance as a benefit to owners and key employees. Company-sponsored LTC insurance is an economical way to prefund long-term care and protect executive retirement income from the cost of nursing home care.

■ **ACCORDING TO GOVERNMENT STATISTICS**, individuals age 65 or older have a 40% chance of entering a nursing home sometime in their life. The annual cost of a nursing home stay is \$50,000—even higher in certain metropolitan areas. Specialized care can be as much as \$200,000.

■ **PREMIUMS A C CORPORATION PAYS ON LTC POLICIES** are fully deductible. Pass-through entities and sole proprietorships enjoy a full deduction for nonowners and up to 100% for owners depending on their age and the premium amount. Company-paid premiums are not taxable

income to the executive.

■ **CPAs SHOULD PAY CAREFUL ATTENTION TO** the fine print in an LTC policy. The lowest premium does not necessarily mean the lowest cost over the life of the policy if premiums increase or coverage is not adequate to meet long-term health care costs.

■ **WHEN EVALUATING LTC COVERAGE** companies should consider the variety of optional riders available. They cover things such as automatic cost-of-living increases and the availability of home health care benefits.

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**C**CPAs are generally familiar with the many nonqualified benefits available today for business owners and key corporate executives. Many companies offer programs designed to provide these individuals with financial security in the event of death, disability or retirement. But they just now are beginning to see long-term medical care insurance as a valuable benefit for a broader range of key employees. More and more, CPAs are being asked to help companies determine the viability of establishing insured long-term-care (LTC) plans and to analyze available policies.

Business owners are realizing that company-sponsored LTC insurance is an economical way to prefund long-term care and protect retirement income from the enormous cost of nursing home and related medical expenses. This article describes the nuances of LTC policies CPAs will need to understand when recommending this insurance to employers or clients.

### **THE GROWING NEED**

The issue of providing employees with long-term-care coverage comes to the forefront at a time when medical care costs are skyrocketing and people require more assistance as they live into their 80s and beyond. A 2001 report by the U.S. Department of Health and Human Services said individuals age 65 or older have a 40% chance of entering a nursing home some time in their lives. And the need for long-term care isn't limited to the elderly; fully 40% of people receiving these services are between the ages of 18 and 64.

#### **Caring for Execs**

Most companies do not currently offer a long-term-care insurance benefit to their executives.

■ Only 29% of survey respondents said they provided access to long-term-care coverage for executives.

■Of companies that provided coverage, 92% did not pay any part of the premium.

■Among the companies that offer the insurance, 60% use a group contract and the remaining 40% use individual LTC policies.

Source: Clark Consulting, North Barrington, Illinois, 2004  
*Executive Benefit Survey*, [www.clarkconsulting.com](http://www.clarkconsulting.com).

Individuals need long-term care when they no longer can perform daily activities including bathing, dressing, eating and toileting or suffer from cognitive impairment. Care can be provided in a variety of settings, including nursing homes and assisted living facilities, or through in-home patient care. Many people assume Medicare will foot the bill for long-term-care services. Not so. Medicare was designed to cover acute medical care, not chronic care or disabilities due to old age. The Insurance Association of America says the average annual cost for home care is \$20,000. Other studies put the annual cost of a nursing home stay at \$50,000 or more in certain metropolitan areas. Specialized care can cost \$200,000 or more.

## HIPAA

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) defines LTC plans as accident and health insurance. Thus they are not subject to ERISA guidelines (IRC section 7702B(a)(2)). This means companies can decide who is to participate in the plan and limit it to certain highly compensated employees and their dependents if they so desire.

Some of the important tax characteristics of an insured LTC plan are

■Premiums paid on policies are fully tax-deductible to C corporations for all employees, including stockholders (IRC section 162(a); Treasury regulations sections 1.162-10(a) and 1.106-1).

■Pass-through entities and sole proprietorships enjoy a full tax deduction for nonowners and 100% or partial deductions for owners depending upon their age and the premium amount (sections 162(a) and 162(1); regulations sections 1.162-10(a) and 1.106-1; IRC sections 213(d)(1)(D) and 213(d)(10)).

■Premiums paid by the company are not taxable income to the executive (IRC section 106(a)).

■Benefits are tax-free (up to \$240 a day in 2005) (IRC section 7702B(d)(4)).

■When the policy contains a “refund of premium” feature, the insured’s beneficiary can receive all premiums paid into the policy as a tax-free benefit at the death of the insured (IRC section 7702B(b)(2)(c)). This can be especially attractive for stockholders/employees as the premiums were originally deductible, fully or partially, by the company.

## THE BENEFITS

In addition to the obvious advantage of paying for long-term care with tax-deductible

corporate dollars, group LTC insurance plans offer other benefits.

■ ***Guaranteed acceptance.*** Most plans will insure all active employees the employer wants to cover. New employees typically are covered as long as they apply within the time frame stated in the policy.

■ ***Payroll deductions.*** Insured employees can make any required premium contributions through regular deductions from their payroll or pension checks.

■ ***Technical assistance.*** Most insurers help companies explain the coverage to their employees with written materials and on-site seminars.

The right long-term-care coverage can provide significant benefits for a company's executives and their spouses.

***Example.*** International Widget, a C corporation, decided to implement an insured LTC plan to cover the owner, six highly compensated employees and their spouses. The premium for the policies, \$87,265 a year, would be fully paid after 10 years. This amount is 100% deductible to the corporation and not taxable as income to any of the insured executives or their spouses. When the insureds ultimately die, their beneficiaries will receive the total amount of premiums paid on their behalf tax-free.

Shortly after the policy is in place, the owner's wife suffers a stroke and begins to receive insurance benefits of \$280 a day to pay for care she receives at home. The first \$240 a day is tax-free, while the additional \$40 a day is taxable. (Higher limits are likely to apply in 2006 and beyond.) When the owner and his wife die, their children will receive 100% of the premiums the corporation paid into the policy as a tax-free death benefit in addition to any long-term-care benefits the couple may have received.

Given the potentially devastating costs of long-term care, having such insurance is an extremely valuable perk that can act as part of a "golden handcuffs" package to help retain key employees. Under one company's plan, should an executive leave the company prior to age 65, a vesting schedule determines the portion of the premium refund that would be paid to the employee's beneficiary at death. The balance would be paid to the company. The vesting schedule can be modified as necessary to accommodate situations such as death, disability or involuntary termination.

Long-term-care coverage isn't limited to large businesses. In another example, the sole employee of one highly profitable C corporation wants to provide LTC coverage for herself and her family. The company's CPA helped devise a plan that provided a strong program of benefits using a policy that will be fully paid in 10 years. The owner will pay \$19,822 a year. When she and her husband die, their trust will receive the \$198,220 of premiums tax-free. (As with any insurance product, insurance companies make their money on LTC coverage through investment earnings.)

## **THE FINE PRINT**

Companies typically have a great deal of flexibility when deciding on plan objectives, eligibility, types of policies to use, optional policy benefits and riders, coverage amounts and durations, guarantees and payment options. CPAs who are helping companies select the right coverage should keep in mind the lowest premium

does not necessarily mean the lowest cost. Indeed, initial low-cost policies can end up costing more if the policy does not adequately cover long-term health care costs or allows rates to rise. Here are some other policy features CPAs should understand to recommend the best coverage.

## PRACTICAL TIPS TO REMEMBER

■ Pay careful attention to policy features such as the waiting period before benefits are paid and whether home health care is covered to make sure the LTC coverage the company selects meets the needs of all covered executives.

■ Keep in mind the lowest premium does not necessarily mean the lowest cost. Low-cost policies could end up costing more if they do not adequately cover long-term health care costs or allows premium rates to rise.

■ A good optional rider to have with LTC policies is one that provides cost-of-living adjustment (COLA) increases to keep up with inflation in health care costs. The increase is often a set percentage each year, increasing either on a simple or compound basis up to a multiple of the base policy.

LTC policies are typically “guaranteed renewable.” This means that as long as premiums are paid when due, the insurer cannot refuse to keep the policy in force. It can, however, increase rates—sometimes after a brief guarantee period. The company may be forced to choose between paying the higher premium and losing the policy.

Unlike most LTC policies for the general population, executive benefit policies are customarily paid up within 10 years and sometimes even with one single premium. Besides the larger tax deduction for the shorter premium period, the policy is truly “paid” and the insurer cannot increase premiums. Thus, an extra measure of price safety exists.

Most LTC policies specify how many activities of daily living the insured must lose before triggering benefit payments and classifying the loss as needing “hands on” or “standby” assistance.

Policies are structured as “indemnity” or “reimbursement” models. In its pure form, the indemnity policy pays a specific amount of daily benefit irrespective of costs actually incurred, while the reimbursement model pays actual qualified costs or a percentage.

Elimination (waiting) periods are spelled out in the policy. These are essentially deductible features where the insurer pays no benefits for a specified period of time after the insured begins care. Typical waiting periods are 30 to 90 days; the executive must pay long-term-care costs out of pocket until the benefits kick in. The shorter the waiting period, the higher the policy premium.

Optional riders are available with LTC policies. A common one provides a cost-of-living allowance (COLA) designed to keep up with inflation in health care costs. These come in a variety of formats, often a set percentage each year, increasing on a

