By Philip T. Davis

The New Investment Alternative

Using long-term care insurance to conserve assets, reduce estate taxes and transfer wealth

Long-term care (LTC) insurance can be an attractive investment alternative for high-net-worth individuals for two reasons: (1) It has a multi-million dollar upside if extended health care is needed, and (2) there's little or no cost if care isn't needed. In addition, many experts believe it can be used to reduce estate taxes and transfer wealth on a tax-advantaged basis.

Tax planners and investment managers should give serious thought to using LTC insurance—either on an individual policy basis or as part of a life insurance contract—to preserve their clients' wealth and to minimize taxes. Additionally and perhaps most importantly, estate-planning attorneys should advise their clients on these tax-advantaged options.

The Risks

The need for long-term health care is caused by serious injuries and strokes and from illnesses such as cancer, Parkinson's and Alzheimer's disease (AD). In many of these cases, the conditions are incurable and require the ongoing need for caregivers and therapists.

Yet, many people don't realize that 20 percent of all Americans reaching age 65 will need extended health care for five or more years.[1] (See "Who Will Need Long-term Health Care?" p. 22.) This means that for a husband and wife, there's a 40 percent chance that one of them will need care for this period of time. In addition, continuing advances in medical science mean longer and longer life expectancies. Also, diseases and injuries that used to be fatal will instead now cause disabilities.

Finally, no discussion of risk would be complete without recognizing the increasing impact of AD on care costs. For example, the Alzheimer's Organization estimates that 21 percent of all women reaching age 65—and 14 percent of all men—will succumb to AD at some time during their lifetimes.[2] Further, studies indicate that people age 65 and older with AD survive an average of four to eight years after a diagnosis of the disease, and some will live as long as 20 years after diagnosis.[3]

The Costs

In many cases, the costs of health care will be minor, but when it's needed for extended periods of time, costs can run into the millions of dollars:

- The current annual cost of 24/7 home care—the type that might be needed for an AD patient—is $175,000.[4]
- The current annual cost of a private nursing home room can run over $160,000 a year.[5]
- Since 2004, long-term health care costs have grown at the rate of 4.7 percent to 47 percent, depending on the type of care.[6]

Therefore, eight years of care—due to a severe injury or a disease such as AD—starting in 2011 with an annual cost of $175,000 could be $1.612 million at a 4 percent inflation rate. Further, assuming the same 4 percent inflation rate, 20 years from now the costs might be $3.397 million.

However, these are just the direct costs—there are three additional indirect costs that can be significant:

1. **The investment surcharge:** Every asset dollar used to pay care costs is a dollar lost on an investment return.

Philip T. Davis is the president and founder of Corporate Compensation Plans, Inc. in Danbury, Conn.

Who Will Need Long-term Health Care?

The number of people who will require these services after age 65 is higher than you might expect

Out of every 100 individuals living beyond age 65				
30	**18**	**12**	**20**	**20**
will never need care	will need care for less than 1 year	will need care from 1 to 2 years	will need care from 2 to 5 years	will need care for more than 5 years
NO PROBLEM	MINOR PROBLEM		BIGGER PROBLEM	MAJOR PROBLEM

— The Department of Health and Human Services

Over time, this investment loss can be significant and can equal the cost of care itself.

2. **The potential tax surcharge:** If assets in qualified or nonqualified retirement plans have to be sold off to pay care costs, they'll be subject to income taxes in the highest bracket. For example, to pay $175,000 in care costs would require a liquidation of $291,000 in individual retirement account assets assuming a 40 percent federal and state marginal income tax rate. Further, if investment profits were used to pay care costs, they would be subject to the current 15 percent capital gains tax.

3. **The liquidation surcharge:** Many high-net-worth individuals have the bulk of their assets in illiquid investments such as real estate or stock in closely held corporations; the forced sale of such assets often involves significant losses.

Potential Investment Alternative

LTC insurance policies can be purchased with a guarantee that, at the death of the insured, 100 percent of the premiums paid by the insured will be refunded to his beneficiaries—less any benefits received. This means that the maximum cost of the insurance, if extended care is never needed, becomes the opportunity cost of money—the earnings the premiums could have generated had they been invested.

For example, a 55-year-old individual buys an LTC policy with a $182,500 annual benefit increasing at 5 percent per year, a 10-year benefit period, a return of premium guarantee and a $14,000 annual premium.[7] If he needed care for eight years starting at age 75, he could be paid as much as $4,403,747 in benefits. If the insured dies at age 75 without ever having received benefits, his beneficiaries would receive a $280,000 premium refund (that is, 20 years worth of the $14,000 annual premium).

In this case, assuming the individual placed a 3.6 percent after tax value on his fixed dollar investments, the opportunity cost (that is, the 20-year cost in today's dollars) at death would be $134,409—and the 3.6 percent present value cost (that is, the value today if the insured died after one year) would be $66,257. (See "Cost of LTC Insurance if Premium Refunded at Death," p. 23.)

However, in many cases, individuals (as we'll see in the next section) can receive substantial state and federal tax subsidies. For example, New York state taxpayers can receive a direct 20 percent tax credit on their premium payments. This means that the $14,000 premium expense in the above example would be reduced to $11,200, and the 20-year cost at death—if benefits had never been received—would become just $51,527 and the 3.6 percent present value cost only $25,400. (See "The Benefits of a New York State Tax Credit," p. 23.)

In other words, viewed as an investment, the policy has the capacity to pay multi-million dollar benefits while its cost is limited to the opportunity cost of the premium.

Tax Subsidies

There are three types of tax subsidies that can be used to reduce the cost of LTC insurance:

1. **State.** Many states provide tax credits and deductions. By far, the most significant is the 20 percent New York state tax credit on the premium payment that's available to individuals, employers and trusts.

2. **Federal.** A federal tax deduction is available to sole proprietors, partners in partnerships and 2 percent plus shareholders in Subchapter S corporations as well as to their spouses and dependents. The deduction is age-related, "above the line" and therefore not subject to phase outs and the alternative minimum tax. It's indexed to the cost of medical care. The 2011 deductions are set forth in Revenue Procedure 2010-40. (See "Eligible Premium Table," p. 24.)

Cost of LTC Insurance if Premium Refunded at Death

Assuming an individual placed a 3.6 percent after-tax value on his investments, he could have earned $414,409 if he had invested his $14,000 premium instead of paying it. After the refund, the opportunity cost at death is $134,409

Loss of $14,000 invested at 3.6% after tax for 20 years	($414,409)
Premium refund (20 x $14,000)	280,000
Cost of insurance for 20 years	(134,409)
Present value* cost at 3.6%	(66,257)

* The present value of $1 in 20 years at 3.6% is 0.49295. This amount multiplied by $134,409 = $66,257

—Philip T. Davis

The Benefits of a New York State Tax Credit

The 20 percent subsidy can reduce the $14,000 premium to $11,200

Loss of $11,200 invested at 3.6% after tax for 20 years	($331,527)
Premium refund (20 x $14,000)	280,000
Cost of insurance for 20 years	(51,527)
Present value* cost at 3.6%	(25,400)

* The present value of $1 in 20 years at 3.6% is 0.49295. This amount multiplied by $51,527 = $25,400

— Philip T. Davis

For example, if a 61-year-old sole proprietor buys an LTC insurance policy with a $5,000 annual premium, he can deduct $3,390 of the premium.

3. **Employment-related.** Employers can deduct 100 percent of the premium they pay for LTC insurance as part of a plan they create for their employees or classes of their employees. Equally important is that the premium isn't taxed as income to the employees since the program is considered to be an Accident and Health plan. The deduction is also available for the employees' spouses and dependents. In addition, the employer can pay the premium directly to the insurance company or reimburse the employees for it under Revenue Ruling 61-146, 1961-2 C.B. 25.

This means that employee-owners of shares in Subchapter C corporations can buy LTC insurance for themselves and their spouses under these favorable tax circumstances:

- The corporation can deduct 100 percent of the premium either as a direct payment to the insurance company or as a reimbursement of the premium to the employee.
- The employee isn't taxed on the premium payments.
- The insurance payments—to the extent they reimburse actual LTC costs—are income tax-free and may be estate tax-exempt.
- When the employee dies, 100 percent of the corporate premium payments—less any benefits paid—will be refunded to the insured's personal beneficiaries (in this case, the refund may be taxable to the beneficiaries as the premiums for it were excluded from income).

Reducing Estate Taxes

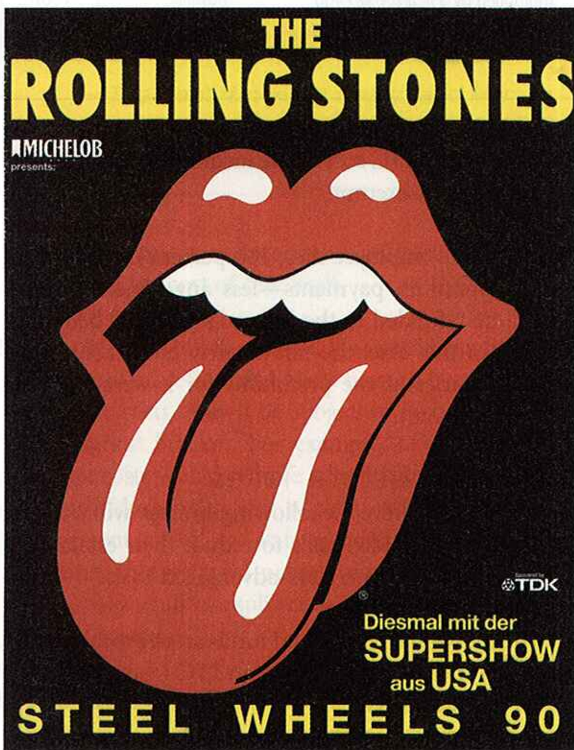
Many experts believe the following strategy will work for high-net-worth individuals to reduce their estate taxes and transfer wealth on a tax-advantaged basis.[8]

- The individual creates and funds an irrevocable trust, which then buys and owns an LTC insurance policy on the grantor's life.
- If the individual needs long-term health care, he'll plan on paying for it by liquidating assets that, in turn, will reduce the taxable estate (Note: If this strategy is used, the individual must have liquid assets to pay the care costs). At the same time, the insurance company will make payments into the irrevocable trust.
- If the individual never needs care, the sum of the premiums paid by the trust will be refunded to it when the individual dies.

Now let's look at this strategy in more detail:

- The grantor of the trust helps finance the purchase of the policy by making gifts to it and therefore, the trust must provide *Crummey* withdrawal powers. (Some tax authorities believe that, to take advantage of state tax credits or deductions, the insured can pay the premium directly to the insurance company and still qualify for the gift tax annual exclusion as long as the trust has *Crummey* provisions and the ability to meet any demand for cash).

- The insurance payments to the trust should be income tax-free as they're reimbursements for actual medical care expenses.



SPOT LIGHT

Mixed Emotions

This poster, "The Rolling Stones Steel Wheels," advertising a concert that took place in Berlin on Aug. 13, 1990, sold for $1,230 at the Christie's Popular Culture: Rock and Pop Memorabilia auction on June 14, 2011 in South Kensington, London. After splitting up in 1983, Mick Jagger and Keith Richards put their differences aside and recorded "Steel Wheels." The tour, which covered North America, Japan and Europe, was their biggest stage production to date.

Eligible Premium Table

Here are the 2011 federal tax deductions for long-term care insurance

Age 40 and under	$340
Age 41 to 50	640
Age 51 to 60	1,270
Age 61 to 70	3,390
Over age 70	4,240

— Revenue Procedure 2010-40

- To make certain the proceeds of the trust won't be included in his estate, the grantor can have no ability to direct the trustee to distribute trust assets to pay for health care costs. However, the trust could be given discretion to make distributions to trust beneficiaries who would then pay the grantor's LTC costs under the medical care gift tax exclusion.

This type of tax planning can enhance an individual's estate by millions of dollars with little, or no cost to the estate if care isn't needed because:

- The premium is small in relation to the benefits it can produce and, from a cash flow standpoint, isn't an issue for affluent individuals.
- The premium is effectively discounted at death by the estate tax rate because, had it not been paid, it would have been part of the estate and taxed.

- If extended health care is never needed, the insurance company will refund to the trust the premiums it has paid.

- Tax subsidies—for example, the New York state 20 percent tax credit—may substantially reduce the net cost of the premium.

Note: Some companies have developed software that quantifies all of these concepts.

Recent Developments

There have been two recent—and significant— developments in the LTC insurance marketplace:

1. Most insurance companies that sell LTC insurance have taken severe losses on that segment of their business—or they've predicted major losses on it in the future. In response to those losses, some of the companies have left the business, while others have substantially increased the premium rates on their policyholders.

There are four ways that individuals who are considering the purchase of individual LTC insurance policies can minimize—or eliminate—the potential for rate increases:

(1) Buy a single premium policy that guarantees the insurance company can never increase the premium rate.

(2) Buy a limited payment policy such as five or 10 years because, at the end of that period, the insurance company no longer has the option to increase the premium.

(3) Buy a return of premium option that guarantees, even if premiums are increased, the cost of the policy will either be returned at death (if LTC is never needed) or with benefits (if care is needed).

(4) Buy from a company that has never increased its premiums and has very low claims to premiums ratios.

2. In response to the concern that individuals who buy LTC insurance will never receive benefits—or that their rates will be increased—a few large insurance companies now sell life insurance policies with an LTC insurance benefit either on a single premium or lifetime premium-paying basis. For example, an individual could buy a $1 million dollar life insurance policy with a $15,000 per month LTC insurance benefit. If the individual needed LTC, he could collect that amount for 66 2/3 months—the $1 million dollar face amount of the policy. If he never needed care, his beneficiaries will collect the $1 million dollars as a death benefit. And if he collected, as an example, $400,000 in LTC insurance benefits and died, his beneficiaries will be paid $600,000, the remaining balance of the policy. Equally attractive is that the premiums and benefits on these policies are guaranteed. Furthermore, there would appear to be no reason these contracts couldn't be owned by an irrevocable trust, thus performing a double-duty function—estate tax-free life insurance benefits and/or estate tax-free LTC insurance benefits.

Endnotes

1. U.S. Department of Health and Human Services, *www.longtermcare.gov/LTC/Main_Site/Understanding_Long_Term_Care/Basics/Basics.aspx*.
2. 2011 Alzheimer's Disease Facts and Figures, *www.alz.org/downloads/Facts_Figures_2011.pdf*.
3. *Ibid*.
4. 2010 MetLife Mature Market Survey of the costs of long-term health care, *www.metlife.com/assets/cao/mmi/publications/studies/2010/mmi-2010-market-survey-long-term-care-costs.pdf*.
5. *Ibid*.
6. 2010 Prudential long-term care cost study, *www.prudential.com/media/managed/LTCCostStudy.pdf*.
7. Representative premiums for a standard risk in New York state with a marital discount and an indemnity benefit.
8. For a detailed discussion on third-party ownership of long-term care insurance, *see* the 2010 *MassMutual Advanced Underwriter*, Volume 1, Issue 2, available at *www.corpcompinc.com/cc*.

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