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Asset Protection Planning with Long-Term Care Insurance

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The cost of long-term care is continuing to skyrocket. According to the 2017 Genworth Cost of Long-Term Care survey, the national median cost of care in a private room in a skilled nursing facility is over $9,000, with the average statewide median cost of such care increasing to a range of over $11,000 in New Jersey. Paying privately for care, either at home or elsewhere, can quickly exhaust a couple's resources, leaving the healthier spouse with limited funds to remain in the community. In addition, many clients want to remain at home as long as possible, and to control the care and services they receive. Fortunately, planning with a partnership long-term care insurance can be a viable solution for clients with even modest resources, so long as the client is insurable and there is time to plan ahead.

The Long-Term Care insurance partnership is a federally funded, state operated program authorized by the Deficit Reduction Act of 2005. Purchasing a long-term care insurance policy through the partnership entitles a policyholder to protect their assets, dollar for dollar, with an asset disregard or spend down disregard computed based on the value of the partnership coverage purchased. The disregard operates by allowing a state participating in the partnership program to disregard one dollar of assets which would be otherwise countable for Medicaid for every dollar in long-term care insurance benefits paid under the partnership long term care insurance policy. In other words, the partnership long-term care insurance benefit allows the policyholder receiving benefits under the policy to retain additional assets above the Medicaid countable resource threshold which would otherwise apply in the policy holder's state. Most states, with the exception of California, will reciprocate by honoring asset disregards with respect to partnership policies purchased in another state.

Benefits are typically payable under a long-term care insurance policy when the insured has satisfied a waiting period as defined in the policy contract and sustains a "triggering event," meaning that the insured requires assistance with at least two activities of daily living (walking, dressing, bathing, toileting, transitioning and feeding) or is cognitively impaired and requires supervision and cuing pursuant to a plan of care. Provided that benefits are paid pursuant to a plan of care, the benefits are generally not treated as taxable income but rather, like accident proceeds, a compensation for a loss.

In general, benefits paid as reimbursement on account of the long term care insurance policy other than dividends and refunds, will not generally constitute taxable income for the recipient for federal and state income tax purposes. However, in 2018, the excess of a per diem benefit (where a set daily rate is payable regardless of the cost of medical services used) over the daily cap of $360 is includible in computing federal taxable income. IRS Rev. Proc. 2017-58. Most states imposing an income tax generally follow the federal rules regarding the deductibility of payments of long-term care insurance premiums, although a few states have tax incentives (i.e., deductions and credits) to encourage the purchase of long-term care insurance.

Some long-term care insurance policies, particularly older policies, pay benefits on a per diem basis without regard to the cost of the actual long-term care services utilized and paid for.

The following are some examples showing how the use of long-term care insurance policies can preserve assets for your clients.

Example 1. Your delightful and divorced client, Dave Dolittle, is a single father, and an all around great guy, beloved by his family. However, as Dave's ex-wife would say, Dave is not exactly a "saver." Dave's dutiful adult children realize that someday, their father may need long-term care. For Father's Day, the children purchase a partnership policy for Dave and chip in together to pay the premiums for the intervening years, until the day comes when Dave needs the policy benefits. Thanks to his childrens' foresight, Dave is now able to pay privately for his care at home, using the policy benefit. Because the children have purchased a partnership policy for Dave and Dave resides in a participating state, he is entitled to a Medicaid asset disregard which would authorize Medicaid benefits for him. Assuming that Dave had $25,000 in his name when he began receiving benefits under the policy, and he eventually receives $25,000 in policy benefits, Dave could preserve the sum of $25,000 from Medicaid spend down, still qualify for Medicaid benefits to pay for his care, and that amount would also be exempted from Medicaid estate recovery after Dave's death.

Example 2. Your clients, Watson and Wendy Whatif, are in their mid-sixties and their health is good. Wendy's mother was recently diagnosed with Parkinson's Disease and she is now is worried that she and her husband may need long-term care. Wendy's goal is to protect their life savings of $415,600 in liquid assets to fund an inheritance for their children. Watson believes that a happy wife means a happy life. The couple has a modest household income and their two children, William and Warren, are amenable to helping their parents with the cost of long-term care insurance premiums. William and Warren are able to locate and pay for a four year term partnership policy for their parents, with an annual premium of $7,484 and a $6,000 monthly benefit amount, but if they had purchased the policy ten years earlier, the yearly premium would only be $4,440. Assuming that Wendy ultimately requires long-term care and a total of $288,000 in benefits are paid for Wendy's care under the partnership policy, the couple could save an additional sum of $288,000 of their liquid assets in addition to the maximum community spouse reserve allowance of $125,600 which Watson, the healthier spouse, may retain, plus Wendy's $2,000 disregard, allowing them to save their entitled $415,600 and receive Medicaid benefits for Wendy.

Example 3. Assume the facts as stated in Example 2, except that Watson is age 71 and Wendy is age 62. Also assume that Watson and Wendy, instead of their children, purchase a qualified long-term care insurance (as defined at IRC 7702B(b) and (6)) in 2018 using funds in their own names to pay the premiums. (A qualified long-term care insurance policy under IRC 7702B is an insurance contract which provides only coverage of qualified long-term care expenses and is guaranteed renewable, does not provide for cash surrender value that can be pledged, assigned or borrowed, refunds and dividends on which can only be used to reduce future premiums and which does not reimburse services covered under Medicare). If Watson and Wendy itemize their income taxes for the 2018 taxable year, Watson may deduct up to $5,200 and Wendy may deduct up to $4,160 of the policy premiums on their 2018 IRS 1040, provided that in addition to their long term care insurance premiums, they have already substantiated additional reasonable and necessary medical expenses totaling 7.5% of their adjusted gross income for the 2018 taxable year.

Example 4. Wendy Whatif's family is so happy with the outcome that they refer Wendy's cousin, Wynter Whiner, who is age sixty-one, and wants a partnership policy, but complains that the policy premiums are too expensive. Wynter does have a health savings account. Under IRC 223, distributions from Wynter's health savings account are tax free when used for qualified medical expenses. A special rule applies to allow Wynter to withdraw the sum of $4,160 (based on her age) in 2018 to pay for at least a portion of her long term care insurance premiums under IRC 223(d)(2)(C)(ii). IRS Rev. Proc. 2017-37. However, the benefits payable to Wynter under the policy will not be completely tax free.

Example 5. Assume the facts as stated in Example 4 except that Wynter did not purchase the premiums with funds distributed from her health savings account. Instead, Wynter's employer and Wynter herself split the cost of the premiums. The payments by Wynter's employer are deductible to the employer under IRC 106, which excludes from an employee's taxable income an employer's payments of the cost of accident and health insurance premiums. The future benefits paid to Wynter will not be taxable income to her, because she contributed to the cost of the policy premiums.

Example 6. Wynter's employer, Eddie Entrepreneur, is a self-employed sole proprietor who is aged 46. If

Eddie purchases a long-term care insurance policy for himself through his business, he remains subject to a lower age cap of $780 in 2018, but he is not subject to the 7. 5 per cent of adjusted gross income threshold applicable in 2018 and 2019, because the long-term care insurance premium deduction for a self-employed individual is an above the line deduction. Note that under the Tax Cuts and Jobs Act of 2017, the threshold will rise from 7.5 percent to 10 percent beginning on January 1, 2020.

Example 7. Assume the facts as stated in Example 7, however, Edna, the wife of Eddie Entrepreneur, also works in her husband's business as a bona fide employee and her coverage is provided as part of her compensation. If Edna's long-term care insurance premium costs $4,500 annually, Eddie may deduct the full premium on the business's income tax return, regardless of Edna's age, because Edna is an employee of the business.

Example 8. Terrence Topproducer is a long-term care insurance salesman, aged 49, with two teenagers fast-approaching college age. Ten years ago, Terrence purchased a deferred annuity (which is not an individual retirement account annuity) at a premium of $40,000. The deferred annuity now has a fair market value of $50,000, reflecting $10,000 in build-in gains. Terrence's mother was just diagnosed with Alzheimer's disease and he is terrified that he will require long-term care himself one day. Fortunately, you advise Terrence that he could transfer $4,000 from the annuity to pay his long-termcare insurance premium, and four-fifths of that amount will be deductible from Terrence's principal and one-fifth will come from the annuity's taxable gains. So now Terrence may use the $4,000 from the annuity without owing any income taxes and this strategy will reduce his income by $800 (20 percent of $4,000). This enables Terrence to contribute the sum of $800 to his children's 529 plans.

Example 9. Even though she was born after the Great Depression ended, ever since Ima Saver read Howard J. Ruff's book, How to Prosper in the Coming Bad Years (Warner Books, 1984), she has feared becoming poor. Over the years, she has deposited her life savings into an individual retirement account. With the help of therapy and her friends in the Penny Pinchers Support Group, she is able to overcome her urge to save every dime, and now wants to use the funds in her traditional individual retirement account to pay for the long term care insurance premiums. Fortunately, IMA is over age 70 ½ and is already taking her required minimum distributions. She could annuitize her individual retirement account, transforming it into an IRA annuity. This would not be taxable event to Ima. She can direct that her required minimum distributions be payable directly to the long-term care insurance company to cover the cost of her premiums.

Example 10. Harriet Healthy, age 72, is active and independent and amazingly takes no medications. Since her mother lived to age 104 and spent her last seven years in an assisted living facility, and remained of sound mind to the very end, Harriet figures she had better buy long-term care insurance, but cannot reconcile herself to the thought that would be throwing away the policy premiums if she died without receiving any benefits. She also wants to leave an inheritance to her children, Howie and Heather, who are in their fifties, but just getting by. Fortunately, Harriet owns a certificate of deposit with a balance of $60,000 that she does not need for day to day living expenses. If Harriet is not worried about Medicaid, she could use the certificate of deposit proceeds to buy a hybrid life insurance policy with a long-term care insurance rider. Under the terms of the policy contract, Harriet may withdraw the funds from the policy to pay for her long-term care needs until the funds are exhausted. Any unused benefits would be payable to Howie and Heather after Harriet's death. If Harriet purchased an extension of benefits rider, she could potentially receive a lifetime of benefits at a fraction of the cost of traditional long-term care insurance.

ABOUT JANE

Jane Fearn-Zimmer *dedicates her practice to serving clients in the areas of elder and disability law, special needs planning, asset protection, tax and estate planning and estate administration. A frequent author and lecturer, Ms. Fearn-Zimmer speaks and writes on a variety of tax, special needs planning, Medicaid planning, guardianship and estate planning topics to a broad range of groups. Jane also serves as the Editor of The Elder Law Report, Including Special Needs Planning, a national newsletter dedicated to elder law and special needs planning. She also frequently writes for her own Elder and Disability Law blog, which can be found at www.janefzimmer.com.*

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