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Using Long Term Care Riders in Estate Planning

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Long term care (LTC) planning has been one of the hottest topics in the financial services industry lately, and will continue to be so as the population of the United States continues to age. It is estimated that people reaching age 65 will have a 70% chance of needing long term care at some point in their life[1], making this potential issue something that should be seriously addressed when doing retirement and estate planning for clients.

People with moderate wealth may be good candidates for long-term care planning. While trust planning may not be necessary for some of these clients, they have worked hard to accumulate assets and should not have to watch those savings dwindle away due to long term care expenses. More affluent clients who need formal trust planning should also be analyzing their potential long term care needs. While the ultra wealthy may be able to self insure, they may still want to consider how self insuring long term care needs could affect the financial legacy they hope to leave to their loved ones. Life insurance, with the addition of an indemnity-style LTC rider, can provide liquidity for potential estate taxes as well as provide additional flexibility and opportunities to the estate plan.

Estate Planning and Long Term Care

Estate planning includes creating and preserving wealth. First, let's discuss preserving wealth for the more affluent client. More affluent clients will often have a need to provide estate liquidity to cover potential expenses. Irrevocable trusts and life insurance have long been used in estate planning, with the life insurance policies being owned by an irrevocable life insurance trust (ILIT) to keep the death benefit out of the estate. However, when it comes to long-term care, many wealthy people feel they can afford to self insure the LTC risk. But is self insuring in the traditional sense the most efficient use of their assets?

[1] *CMM, U.S. Department of Health and Human Services, http://www.medicare.gov December 2014*

The downside for the wealthy self-insuring LTC

Let's take a look at potential effects of how self insuring LTC may not be the best solution for many affluent people. In order for the client to self insure, they must have available to them assets that are liquid and accessible inside their estate in the event they encounter a LTC situation that needs funding. Let's assume this client sets aside $1,000,000 for this purpose. If the client actually needs LTC and spends through most or all of the $1,000,000, then the "self insure" plan worked well enough. However, if the client needs very little or none of the assets set aside, these funds could be left subject to estate taxation. Assuming a 2015 estate tax rate of 40%, up to $400,000 of the $1,000,000 could be taxed if it was never needed for LTC expenses (assuming holding on to this additional $1,000,000 puts the client's estate over the exempt amount). But there is a potential way to avoid this pitfall.

An Alternative Solution

Traditional long term care policies are intended for clients who are looking only to cover long term care needs. For clients with potential estate tax liabilities there is an alternative solution that may better fit their overall planning strategy. A life insurance policy owned by an ILIT, with the addition of an indemnity-style LTC rider, may be used to fund LTC needs while maintaining the goal of providing funds for estate expenses. We'll discuss that concept momentarily, but first it is important to understand the difference between and indemnity-style and reimbursement plan and why only an indemnity-style plan can work in an irrevocable trust situation.

Indemnity vs. reimbursement

Long term care benefits are generally paid in one of two ways; an indemnity plan or a reimbursement plan. For illustrative purposes, we will assume the plan in each example has a $5000 per month benefit.

A reimbursement plan pays the benefit directly to the nursing home or agency providing care or, reimburses the contract owner for expenses already incurred, and bills or receipts must be submitted each month to the insurance company. In our example, the reimbursement plan may provide a maximum $5,000 monthly benefit, but only the exact amount of the bill – up to the $5,000 benefit – is paid. A reimbursement plan will not work in a trust because bills for the long term care of the insured are submitted to the insurance company by the trust (which owns the policy), but the insurance company reimburses for the actual LTC expenses of the insured. This chain of events provides a direct monetary benefit from the trust to the insured and destroys the integrity of the trust.

An indemnity-style plan however, pays the full benefit directly to the owner of the contract. If an insured qualifies for a $5,000 monthly benefit, $5,000 is sent to the owner of the plan each month. No bills or receipts need to be submitted nor are considered. Only an indemnity-style plan can work within a trust because the LTC benefit, without regard to expenses of the insured, is sent directly to the owner of the contract, which in the case of trust ownership would be the trust/trustee. The life insurance policy is essentially funding the trust with cash via payment of an accelerated death benefit. *(Keep in mind that as an acceleration of the death benefit, the LTC rider payout will reduce both the death benefit and cash surrender values.)* It is important to note the insured (grantor) must never have the LTC benefit directly in hand nor can they have claims against the trust for such monies. But from here, flexibility exists and various strategies may be implemented.

The trust is made "defective" for the purpose of being able to access funds from the trust using arms length fully collateralized loan provisions. The loan is secured by property pledged by the Grantor/Insured. The loan must be legitimate with collateral pledged, interest charged, and an agreement to fully pay back the debt. Collateral can be anything that covers the debt; a house, artwork, coin collections, etc., as long as the asset has a legitimate fair market value. The interest rate charged should be at least equal to the interest charged on the life insurance policy (although in this concept there will be no loan taken against the policy itself). In most cases, the loan interest is allowed to accrue. Ideally, the loan interest should be paid back prior to the death of the Grantor/Insured to avoid income taxation on the interest paid to the trust. Some plans call for the repayment of interest on a periodic basis to hedge against the risk of all interest being taxable at death, though this will impact the overall accrual of debt.. In either case, the estate has been further reduced by the interest it has incurred on the loan transaction created with the Trust.

The Process of taking the Collateralized Loans

When using a ULIT type ILIT for the purposes of getting long-term care rider benefits from the trust you may do the following:

- File a claim for the LTC benefit
- After 90 day elimination period, a monthly check will be sent to the trust as contract owner
- The grantor then borrows money from the trust by pledging property as collateral
- These funds can be used to pay LTC bills or used for a variety of other purposes
- Interest is not repaid, but allowed to accrue to purposely increase the debt
- At the grantors death, the repaid loan and accrued interest is deducted from the estate assets for taxation purposes leaving a smaller tax liability.
- Any interest repaid after death is income taxable to the trust

Doing the math

Let's look at an example of a client with a potential $3,000,000 estate tax liability. A life insurance policy with a $3 million death benefit could be purchased and owned by an ILIT. A $1 million LTC rider could be added to the policy. This will allow $1 million of the $3 million to be available for the LTC needs while the insured is alive. (*Due to state requirements in New York, and the Virgin Islands, the policy structure must be slightly different. Policies issued in these areas require the death benefit and the rider amount to be equal at policy issue. Therefore, with cases written in these states, two policies will be issued. One policy will be written for $2 million dollars with no LTC rider, and a 2nd policy* *will be written for $1 million with the addition of the LTC rider for $1 million.*) As long as the life insurance policy's LTC rider pays by indemnity and LTC costs for the insured are paid as outlined above, this type of arrangement can work. The advantage is that fewer assets need to remain inside the estate to pay LTC costs. Should long term care be needed, the trust has provisions that allow funds to be accessed in a way that does not destroy the estate planning purpose of the trust. If no LTC is needed, a $3 million death benefit would be paid to the trust, available to offset estate or other tax burdens.

When the insured is in need of LTC services, the trust will file a claim, and after the 90 day elimination period, the trust, as owner of the contract, will start receiving the full tax-free monthly benefits. No bills or receipts will need to be submitted. At that point, the collateralized arms length loans provisions maybe enacted. The trust may loan money to the insured to help defray LTC costs. We will make the assumption that the HIPAA rate has reached $10,000 per month and that 7% interest is charged on the loan. If the insured dies 8 years and 4 months after going on claim(just as the LTC benefits are exhausted) the estate has a debt to the trust of the loan amount of $1 million plus any accrued loan interest. The result is that the estate is further reduced by the total amount of the loan and accrued loan interest that is due to the trust. The trust will receive the remaining death benefit of $2 million from the insurance company as well as the loan principal of $1 million repaid by the grantor's estate. This will result in the death benefit plus repaid loan principal equaling $3 million dollars, the original death benefit amount planned for. Also added to trust assets will be the accrued loan interest of approximately $352,000 repaid by the grantor's estate. If repaid prior to death, the entire amount of interest will be income tax free to the trust due to the grantor trust status. Any amount of loan interest repaid after death will be income taxable to the trust as grantor trust status no longer exists.

THE NUMBERS

When Insured/Grantor needs LTC Services

- Nationwide pays LTC benefit to the Trust ($10,000 per month in this example)
- Insured/Grantor borrows funds from trust (per the loan provisions) to pay LTC expenses
- Insured/Grantor dies just as LTC benefits are exhausted
- Estate's Principal Debt is - $1,000,000
- Estate's Accrued Interest Debt is- $ 352,000
- Total Debt to Trust - **$1,352,000**

At Insured/Grantor's Death

- Death claim filed – remaining death benefit of **$2,000,000** is paid to trust
- Estate repays total debt - $1,352,000
- **Estate has been drained of - $1,352,000** and no longer is subject to estate tax
- **Tax savings** on this amount – at 2015 tax rates of 40% **- $540,800**
- **Trust also now has $3,352,000**

Loan interest repaid to the trust after death is income taxable to the trust

<u>Final Result</u>

- *The trust contains the **$3,000,000** planned for liquidity to pay any estate tax liability*
- *Reducing the estate to repay the loan and interest results in a tax savings of **$540,800** – PLUS*
- *Trust has an additional **$352,000** (less income tax if repaid after death).*

In other words, the final result may be fewer assets left in the estate to be taxed, with more assets in the trust.

Other Flexible Solutions Provided by a Trust owned Life/LTC Policy
An indemnity-style rider may also provide flexible solutions for clients who may later find they need to spend down additional assets left in the estate to further control estate tax liabilities. In this case, they would pay their long-term care expenses directly from estate assets, thus lowering the total amount subject to estate taxation at death. Upon filing a claim LTC benefits would be paid directly to the trust providing cash assets, if allowed for by the terms of the trust, for some of the following scenarios:

- Funds could be distributed to beneficiaries by the trustee as a type of "early inheritance"
- Funds could also be held in the trust to be distributed at a future date
- Funds could be re-invested for potential growth in the trust

For Clients without Trust Needs
Estate planning can also be about creating more of an estate. While moderately affluent clients may not have need for trust planning, there are many who could benefit from using life insurance to create additional wealth for legacy purposes. These clients may find using the combination of life insurance with a long term care rider a good solution for their financial strategy. By purchasing a life insurance policy with a long term care rider, a pool of money is generated that can pay for LTC needs during the insured's lifetime through an acceleration of the death benefit, protecting other assets from being eaten away by long term care bills. If long-term care is never needed, or the LTC benefit is only partially accessed, any remaining money not used for LTC expenses is paid to the beneficiary as a federal income-tax-free death benefit. For families without trust needs for estate tax issues, it provides a way to help cover long term care needs while allowing for the possibility of creating a larger inheritance for beneficiaries. And the "use it or lose it" concern is eliminated, as someone will ultimately be paid the benefits.

In Summary
Long term care is a subject that should be addressed in insurance needs analysis planning whether a trust is involved or not. In addition, long term care stand alone policies should be discussed as a possible solution. But for many clients, the purchase of a life insurance

policy with the addition of a LTC rider will prove to be an appropriate solution. One of the advantages of using such a rider is that someone is going to receive the benefit, whether it is the insured for LTC needs or the beneficiary being paid the benefit via a federal income-tax free death benefit. Whether doing an estate plan for an affluent client or doing basic retirement planning, some form of long-term care planning should be a part of the financial picture.

Care should be taken to make sure that your clients' life insurance needs continue to be met even if the rider pays out in full. There is no guarantee that the rider will cover the entire cost for all of the insured's long-term care as these vary with the needs of each insured.

Riders are offered at an additional cost and may not be available in all states. A life insurance or annuity purchase should be based on the life insurance or annuity contract, and not optional riders or features. The cost of an option may exceed the actual benefit paid under the option.

Please note that the use of any life insurance product should be part of an integrated estate plan and, as such, the desirability and appropriateness of any insurance purchased by the ILIT should be determined by the customer's independent tax and legal advisor. Neither Nationwide nor its representatives provide tax or legal advice. Before implementing any strategy you should carefully consider your clients' objectives and needs, including the need for liquidity before selecting any product or implementing any strategy.

Federal income tax laws are complex and subject to change. The information in this memorandum is based on current interpretations of the law and is not guaranteed. Neither Nationwide, nor its employees, its agents, brokers or registered representatives gives legal or tax advice. You should consult an attorney or competent tax professional for answers to specific tax questions as they apply to your situation.

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