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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, 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 as well as high net worth clients may be good candidates for long-term care planning. While trust planning may not be necessary for some clients, those individuals 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 LTC rider, can provide liquidity for potential estate taxes as well as provide additional opportunities and flexibility for the estate plan.

Estate Planning and Long Term Care

Estate planning includes preserving wealth as well as creating wealth. We'll start by discussing preservation of wealth for the more affluent client. Clients with high net worth will often have a need for liquidity to cover potential estate taxes. Life insurance owned by irrevocable life insurance trusts (ILIT) have long been used in estate planning to provide those funds and keep the death benefit out of the estate. However, when it comes to long-term care, many high net worth clients 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?

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 high net worth client to self insure, they must have assets available to them 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 none of, or very little of the assets set aside, there is a cost to being "lucky" enough to not need LTC as these funds could be left subject to estate taxation. Assuming

[1] CMM, U.S. Department of Health and Human Services, http://www.medicare.gov December 2015

a 2016 maximum 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 way to potentially avoid this pitfall.

An Alternative Solution

Traditional LTCi 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 a LTC rider that pays indemnity benefits, may be used to fund LTC needs while maintaining the goal of providing funds for estate tax expenses. We'll discuss that concept momentarily, but first it is important to understand the difference between and indemnity and reimbursement plans and why an indemnity plan can work in an irrevocable life insurance trust.

Indemnity vs. reimbursement

Long term care benefits are generally paid in one of two ways; through 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 LTC benefit directly to the care facility or agency providing care – or - reimburses the contract owner for expenses already incurred. Bills and receipts must be submitted each month to the insurance company. Then, the insurance company determines which expenses qualify for reimbursement. In our example, the reimbursement plan may provide a maximum $5,000 LTC monthly benefit, but only the exact amount of total LTC bills – up to the $5,000 benefit – is reimbursed. It is generally believed that a reimbursement plan may not work in an ILIT because bills for the LTC expenses of the insured are submitted to the insurance company by the trustee of the ILIT (which owns the policy), but the insurance company reimburses the trustee of the ILIT for the actual LTC expenses of the insured. This chain of events may be construed as a violation of Section 2042 by providing a direct link from the ILIT to the grantor/insured and destroy the integrity of the trust.

Indemnity plans however, pay the full LTC benefit directly to the owner of the contract. No bills or receipts need to be submitted nor are considered. If an insured qualifies for a $5,000 monthly benefit, $5,000 is sent to the owner of the plan each month. Thus, an indemnity plan can work within a ILIT because the LTC benefit, without regard to expenses of the insured, is sent directly to the owner of the policy, which in the case of trust ownership would be the trust/trustee. The life insurance policy is essentially funding the ILIT 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.

How the Concept Works

A ULIT (Ultimate Life Insurance Trust) is used, which is a type of ILIT for the purposes of getting long-term care rider benefits from the trust. The ILIT is made "defective" for the purpose of being able to access funds from the trust using arms length fully collateralized loan provisions. The loan must be legitimate - secured by property pledged by the Grantor/Insured, with 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. Collateral can be pledged all at once, or can be pledged along the way as long as there is always adequate collateral pledged to cover the full amount of the current loan balance.

The interest rate charged should be at least equal to the guaranteed interest rate charged on the life insurance policy (although in this concept there will be no loan taken against the policy itself). Because

a larger interest debt allows for more funds to be paid from the estate to the trust, using an appropriate interest rate on the high side may work best.

Ideally, the loan interest is allowed to accrue, but the loan interest should be paid back prior to the death of the Grantor/Insured if possible, as this will 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 taxable estate has been further reduced by the interest it has incurred and paid on the loan transaction created with the ILIT.

The Process of taking the Collateralized Loans

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

- File a claim for the LTC benefit
- After the 90 day elimination period (during which the claim is verified), monthly LTC benefit checks will be sent to the trustee as policy owner
- The grantor, upon pledging property as collateral, borrows money from the ILIT
- Those funds can be used to pay LTC bills or used for a variety of other purposes
- Interest is not repaid immediately, but allowed to accrue to purposely increase the debt
- Ideally, interest is repaid just prior to death – thus remaining tax free to the ILIT
- At the grantors death, the loan principal is repaid from estate assets. The amount of the accrued interest, as well as the loan principal has been removed 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 (ULIT). 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. 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 ILIT 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 will be paid to the ILIT, providing funds to offset estate or other tax burdens. (*Due to state requirements in New York and the Virgin Islands, the policy structure must be slightly different. Policies issued in these dominions require the death benefit and the LTC rider amount to be equal at policy issue. Therefore, with cases written in these locations, two policies should be considered. Using this case as an example, one policy will be written for $1 million with the addition of the LTC rider for $1 million, and a 2nd policy will be written for $2 million dollars with no LTC rider.*)

When the insured is in need of LTC services, the trustee will file a claim, and after the 90 day elimination period (during which the claim is verified), the trustee, as owner of the policy, will start receiving the full tax-free monthly LTC benefits. No bills or receipts will need to be submitted for consideration, since full qualifying benefits are paid with an indemnity policy. At that point, the collateralized arms length loan provisions maybe enacted. The trustee may loan money to the insured to help defray LTC costs. We will make the assumption the grantor is borrowing $10,000 a month from the ILIT 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 ILIT for the principal amount of $1 million. We will assume for this example all interest was repaid just prior to the death of the grantor.

The result is that the taxable estate is further reduced by the total amount of the loan principal repaid to the trust as well as the interest repaid prior to death. The ILIT 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. Already added to trust assets was 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 the LTC benefit to the ILIT trustee ($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 – (which is repaid just prior to death)
- 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
- Interests debt was repaid just prior to death equaling $352,000
- Estate repays principal debt of $1,000,000
- Estate has now repaid the total debt of $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 2016 tax rates of 40% **- $540,800**
- **Trust also now has $3,352,000**

Final Result

- *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 potential a tax savings of **$540,800***
- *PLUS – the trust has an additional **$352,000** (less income tax if repaid after death).*

The final result may be more assets in the trust – with fewer assets left in the estate to be taxed.

LTC Riders on Survivorship policies

It is now possible to purchase a survivorship policy with LTC rider coverage on one or both insureds. The concept of using arm's length collateralized loans is virtually identical as laid out above. However, there are some additional details that should be considered by the client's attorney when planning to use this concept with a survivorship life insurance policy. These considerations include:

- Neither insured can be a trustee of the ULIT/ILIT
- The loan provisions should state that the loan principal is not due for repayment until after the death of the second insured. It is important that no principal repayment will be required upon the first death. This is to assure that if desired, dollars generated by the death benefit can be used to repay the loan principle.
- Keep in mind all interest should be repaid prior to the second death to keep it from being taxed as income to the trust.

Other Flexible Solutions Provided by a Trust owned Life/LTC Policy

An indemnity 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, the insured 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 as previously stated. Assuming the terms of the trust allowed, the cash assets generated by the acceleration of death benefit could be used 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 wanting to create or preserve an estate

While moderately affluent clients may have no need for trust planning, such clients may find using the combination of life insurance with a LTC Rider a good solution for their financial strategy. 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 purposes, 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 the policy benefits will ultimately be paid to someone no matter what direction life takes.

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, traditional long term care 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.

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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 purchase should be based on the life insurance 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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