# What You Need to Know About Long-Term Care Insurance

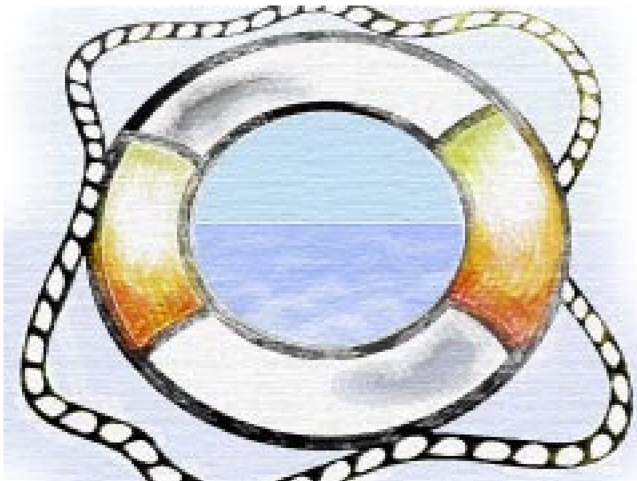
*By Paula Hogan*

**Custodial care is not a topic that any of us deals with easily.**

First of all, no one likes to think about incapacity. It's hard enough when the health of your parents begins to fail, but the idea of planning for one's own incapacity is, for most people, literally unspeakable.

Secondly, our intuitive sense about the nature of aging and the available modes of care is outdated. Most people equate custodial care with nursing home care and think they have only a small chance of needing nursing home care. But the nature of aging is changing as longevity increases; the amount of time we spend in adulthood has more than doubled in the last century. It is now typical to need some part-time, in-home assistance in early old age, with sporadic periods of full-time care in an assisted-living facility interspersed. Then, farther into old age, there may be a need for full-time care in an assisted-living facility, and toward the end of life some full-time care in a nursing home.

However, the frightening prospect that many face today is that custodial care is expensive and can easily drain financial resources. Because of this, the decision to buy long-term care insurance has become an important financial planning issue.



## Long-Term Coverage

Most people do not realize that long-term care insurance offers good value. In contrast to the old nursing home policies that many of us still have in mind, long-term care insurance has evolved into a product that supports people staying at home as long as it makes sense for the insured, or living in a facility when full-time care becomes appropriate.

In addition to nursing-home fees, excellent long-term care policies pay for homemaker and companion services, modest home renovations to facilitate handicapped living, adult day care, and assistance—in the insured's home or in a facility—with bathing, dressing, eating, continence, toileting, and transferring.

A useful way to think about long-term care insurance is that in exchange for an annual premium, you get access to a large pot of money that you can use to pay for care, either in your home or in a facility, and with no tax liability on the benefit payments. Usually, there is a waiver of premium once care begins and a spousal discount for couples. Also, some portion of the annual premium may be tax-deductible.

Buying coverage earlier rather than later not only captures a relatively lower premium, it also protects against the possibility of becoming uninsurable. You can buy inflation protection by purchasing an inflation rider that will make the benefits grow, for example, at 5% compounded each year. Premiums are not scheduled to increase from year to year.

However, there are strong inflationary pressures in this

industry, and insurers do have the ability to raise rates by class of insureds if they gain approval from the regulators. Thus, insured persons should anticipate the possibility of a price increase during their lifetimes. However, policies are guaranteed renewable—once you are insured, the company cannot change the benefits.

## The Costs

Premiums increase with age and also vary by health status but interestingly not by gender. Premiums are also expensive—as expected, given the high and growing cost of custodial care.

- For example, a single 69-year-old in excellent health would currently pay about $6,000 to $6,500 a year for a typical policy from one of the top carriers. (A typical policy is assumed here to offer $5,000 per month of benefits, a six-year benefit duration period, 5% per year compounding of benefits, and a 90-day elimination period [the number of days for covered services before the policy pays] for facility care and a zero-day elimination period for home health care.)
- For this same coverage, a healthy 48-year-old would pay about $2,500 per year; and
- For the same coverage, a healthy 75-year-old would pay $10,000 to $12,000 per year.

It's true for all of us: The language of long-term care insurance policies is confusing. The policies use the language of traditional insurance products for a non-traditional, new service.

For example, if you buy a $5,000 per month, six-year policy it could—and almost certainly will—last longer than six years. What these terms mean is that you may draw up to $5,000 per month for care as long as the pot of money lasts. If you are in full-time care, the policy will run out in six years. But if, as is more likely, you draw funds more slowly than $5,000 per month (for example, part-time care at home), then coverage may last for many years.

Thus, what this policy actually provides is access to a "bucket" of money equal to $360,000 (or $5,000 per month × 12 months a year × six years) that you can use with no income tax liability to pay for custodial care expenses at the rate that makes sense for you, but not faster than the inflation-adjusted $5,000 per month benefit level.

Note that the 5% per year inflation protection means that both the monthly maximum benefit payment *and* the remaining "bucket" of money at your disposal grows at 5% per year compounded.

## Amount of Coverage

How much coverage to purchase is a judgment call, but most people only insure a portion of potential expense. As you decide how much coverage to purchase, remember that most, if not all, of your income will still be available to pay for care.

Also, what you now pay in income taxes will likely be at least partially available if you need care. That's because custodial care expenses are tax-deductible medical expenses to the extent that they exceed 7.5% of adjusted gross income. In full-time care, the result is that funds formerly used for income taxes are in effect often redirected to long-term care costs.

And finally, if you move into an assisted-living or nursing home facility, the proceeds from the sale of your former home will also be available to pay for care.

## The Tax Angle

There are some potential income tax–advantaged ways to purchase long-term care insurance.

**Table 1. 2004 Caps for Deducting LTC Premiums**

| Attained Age at Year-End: | IRS Eligible Premium Deduction: |
|---|---|
| 40 or younger | $260 |
| Ages 41–50 | $490 |
| Ages 51–60 | $980 |
| Ages 61–70 | $2,600 |
| 71 and older | $3,250 |

The smallest tax advantage, which is admittedly available to only a small portion of taxpayers, is that premiums can be deducted as a medical expense on Schedule A of the federal tax return to the extent that the premiums exceed 7.5% of adjusted gross income and after being capped by the IRS maximums. These IRS maximum figures are adjusted annually and are also used to determine how much of a person's long-term care insurance premiums can be paid with funds withdrawn from a Health Savings Account. The IRS maximums for the 2004 tax year are listed in Table 1. Long-term care insurance premiums may also be deductible in full or in part on your state income tax return.

Further means of deducting premiums are available for workers, depending on the type of firm where you work. Check with your tax advisor for detailed information, but be aware, for example, that sole proprietors can take the IRS maximum premium deduction referenced above as an above-the-line deduction for themselves and their spouses on the front of the IRS 1040 tax form, as can partners whose partnership pays for long-term care insurance coverage, as long as there is "a written plan providing for the medical coverage."

Sole proprietors and partners can get full deductibility of premiums if they offer coverage as an employee benefit to their staff and also have their spouses work in the business. C Corporations can deduct premiums paid in full as ordinary and necessary business expenses, since employer-provided long-term care insurance qualifies as an accident and health plan within the meaning of the tax code. Coverage can also be offered on a discriminatory basis, i.e. with eligibility determined by employee class. Thus, a professional

**Table 2. Distinguishing Features of a Good Long-Term Care Contract**

| Contract Feature | Excellent Contract | Less Than Satisfactory Contract |
|---|---|---|
| *How easy is it to satisfy the elimination (the number of days for covered services before the policy pays) period?* | Insured must satisfy the elimination period only once while the policy is in force. There is no requirement for consecutive days of care and no limited period in which it must be satisfied. Plus, a day of home care will equal 7 days of care for purposes of calculating the elimination period. | The insured may be required to satisfy the elimination period multiple times because days of care count toward the elimination period only if they are sequential or occur within a specified time period. |
| *How is "need for care" defined?* | "Hands-on assistance or standby help or reminding." | "Actual hands-on physical assistance" from someone who is "continuously present." |
| *Who sets the care plan?* | The insured may choose who develops the care plan. | The insurance company requires the use of its own care manager. |
| *What conditions are excluded from coverage?* | A few clearly defined conditions, such as "alcoholism, drug addition, or chemical dependency, except for an addiction to [prescribed medicine]." | Ambiguous language such as "conditions primarily due to mental disorder, including depression and anxiety, or to substance abuse or dependency." This language leaves open the question of whether the insurance company will pay for care subsequent to the broken hip from a fall after an evening cocktail. |
| *How are benefit levels specified?* | As a certain dollar amount per month. | As a certain dollar amount per day. (If the benefit level is $150/day, and you use $300 on one day and $100 the next day, the benefit for these two days will be $300 versus the $400 of actual expenses.) |
| *When is the premium waived?* | Whenever there is a day of care that is covered or that counts toward the elimination period. | Waiver only for in-patient care or if a specified number of days of care occur within a set period. |

service firm structured as a C Corporation might choose to pay premiums for the senior professional staff in full; for other staff members, they may offer just the ability to pay premiums via aftertax payroll deductions—but with an attractive group discount offered by the insurance company. Employers can also offer their staff the ability to purchase coverage for dependents, such as parents, in addition to spouses.

One appealing aspect of long-term care insurance coverage as an employee benefit is that it can be structured so that each insured person is covered by an individual contract that is portable beyond employment, and for which there is a group discount (which is often available when several individual contracts are purchased together). Group discounts are particularly appealing because they remain in place even after the insured leaves the group, for instance by retiring. Also, in the current marketplace, individual coverage tends to be more comprehensive than group coverage with little cost difference if the insured is relatively young and healthy, or is applying with a partner and so is eligible for a partner discount. Thus, in the current environment the most cost-efficient way to purchase coverage is with a partner, under an individual contract, purchased with pretax dollars through a group eligible for a group discount. Partners can be spouses, non-spouses in a long-term committed relationship, two siblings living together, or a parent and child living together. The key is that you live with someone who could and would help to take care of you.

Note that it is increasingly common to choose to pay premiums on an accelerated "quick-pay" basis—for example, by paying higher premiums through age 65 or for a specified 10-year period. The advantage of such

quick-pay modes of premium payment is to make full use of tax advantages during one's peak earning years, to complete a major fixed payment before retirement and, perhaps most importantly, to avoid premium increases that might occur beyond the specified payment period. "Quick-pay" premium levels are substantially higher than the pay-as-you-go premiums that are due until the insured dies or needs custodial care, and so are only suitable in particular instances.

Unfortunately, there are no gift tax planning strategies that are relevant for purchasers of long-term care insurance. Gifts of long-term care insurance premiums beyond the amounts eligible to be taken as itemized deductions are subject to the annual gift exclusion amount, currently set at $11,000 per person per year.

## When Should It Be Bought?

When to purchase long-term care insurance is an important decision, with several trends pointing to the wisdom of purchasing earlier rather than later—for instance, in one's 40s and 50s instead of at the more traditional purchase ages of 50s to 70s.

Purchasing earlier rather than later not only captures a relatively lower premium, it also protects against the possibility of becoming uninsurable. Potential tax advantages support paying premiums when earnings are high, which is usually before retirement age. Furthermore, long-term care insurance can be an important complement to disability insurance, which at best offers partial replacement of family income but not replacement income *plus* reimbursement for custodial care expenses for the breadwinner.

Financial professionals increasingly point to lowered expectations for investment returns, and advise that it is very appropriate to take an insurance approach to funding potential custodial care expenses.

Finally, some industry commentators offer the opinion that current long-term care contracts may look relatively appealing in retrospect if, as seems reasonably possible, future contracts omit such potentially attractive features as a lifetime benefit duration or have more managed care language inserted in them in order to keep costs down for the insurance companies. (Managed care language can include restricting benefit payments to a "reasonable and customary level" as defined by the insurance company or requiring that the plan of care be specified by the insurance company instead of by a neutral outside professional.)

## Who Should Buy It?

Who should buy long-term care insurance? There are a variety of good candidates, including:

- ***Parents trying to protect themselves and conserve funds for heirs:*** People who can afford to pay for some but not a lot of custodial care with private funds, but who are worried about outliving their money, or are concerned that their children's inheritance will be diminished by custodial care costs. If they cannot pay premiums out of regular income, these people pay premiums with cash from the portfolio, not regular income. They view long-term care insurance as portfolio insurance.
- ***Couples with one spouse in poor health:*** Couples where one spouse is unwell and who want to free up personal funds for the spouse with medical problems but still preserve financial security for the healthy spouse.
- ***Executives seeking peak earnings protection:*** Executives entering their peak earning years who have adequate disability insurance but not so much disability insurance or wealth that they could pay for their own care in a nursing home and still maintain the family's standard of living. (Of the people receiving long-term care services now, 40% are under the age of 65.)
- ***Wealthy people:*** Wealthy people who can afford to pay long-term care expenses with private funds, but who do not want to do so. Precisely because they are wealthy, they are also able to choose to pay long-term care insurance premiums and get the "pop-up" portfolio that long-term care insurance provides to pay care expenses with pretax dollars.
- ***Children caring for parents:*** Adult children buying long-term care insurance for their parents as a cost-effective way to uphold family values.
- ***Spouses in second marriages:*** Spouses in second marriages who require in the prenuptial agreement that they each maintain long-term care insurance in order to preserve individual assets for children from a prior marriage.
- ***People worried about managed care:*** And finally, people who look at the long-term care industry and anticipate that managed care trends might shift from acute to custodial health care purchase coverage in order to maintain choice.

## What to Look For

What should you look for in a long-term care insurance policy?

### Insurance Company Rating

First of all, it may be many years before the long-term insurance company is asked to provide benefits. Consequently, purchasing coverage from a strong insurance company is important. An evaluation of company strength should include the financial strength of the insurance company—a high rating by A.M. Best, as well as presence in the market. Companies with a large and growing book of business, everything else equal, have more financial resiliency, and more ability to negotiate substantial group discounts for their insureds from care providers.

### Benefits and Restrictions

To estimate the amount of coverage you might need, investigate the cost

in your area, or the area you intend to retire to, or where your children might live, since a common pattern is for older people to get care near family.

Make sure you understand the conditions that must be met to qualify for coverage. Typically, a policy will require a cognitive or physical impairment to qualify for benefits. And you should know who decides whether or not you qualify.

Also, make sure you understand how the benefits are specified. A long-term care insurance policy can either pay the full daily benefit regardless of the actual charges for long-term care services, or it can pay the actual long-term care charge up to the maximum benefit purchased allowed by the policy. Reimbursement policies generally have a different benefit amount for nursing home care and home care.

In addition, make sure you understand the "elimination" or waiting period. The usual range is zero days to one year. However, some contracts require that these days be satisfied sequentially or within a specified time period.

And of course you need to understand any restrictions or conditions that are excluded from coverage and who is responsible for determining the plan of care.

### Inflation Protection

The usual inflation factor is 5% per year. Some policies figure this as simple interest, and others figure it as compound interest. Compound interest offers substantially more protection and so costs substantially more than simple interest.

The inflation protector increases the benefit from the first day of the policy, not from the first day that benefits are received. Unless you are highly sensitive to cost and also far into old age and so not too worried about the impact of long-term inflation, aim to purchase the 5% per year compounded inflation protection.

Also, a growing development is for companies to offer a pay-as-you-go method of inflation protection, where you buy incremental units of insurance throughout your coverage period at rates current at that time. This can be a more expensive means of purchasing coverage, but might make sense for someone, for instance, who is buying early before income increases and with the perhaps heroic assumption that rising income will cover rising premiums. However, read the fine print carefully. For example, if you can only purchase additional units through age 65, you have no means of inflation-protection for the potentially long period from age 65 onward.

In general, remember that the key benefits of long-term care insurance are inflation protection and the ability to share risk across a large number of insured. If you skimp on inflation protection, you are potentially missing a substantial part of the value of the long-term care policy.

## Finding & Comparing Policies

Typically when purchasing coverage, you work with an agent to get quotes and comparisons for the coverage you need from several companies. Be sure to work with an insurance agent who is specialized in the long-term care field and who represents several different companies. A good agent will help tailor a contract to your particular circumstances and also steer you toward the company whose contract offers the best financial value for you given your health and financial circumstances.

For your own protection, skip the marketing brochures and focus on reading the actual contract—the only document that matters.

Everything else being equal in the current marketplace, expect individual contracts rather than group coverage to offer the best value.

When comparing one or more policies, ask for a "specimen" or "sample" contract and take the time to review several specific provisions.

Contracts differ from each other in important ways. Table 2 shows some distinguishing features of excellent contracts in the current marketplace.

## Summary

Long-term care insurance, while still an evolving field, has become part of the standard insurance coverage that each individual must consider to prudently manage personal finances. ➤

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