Tax-free planning opportunity for long-term care expenses

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The aging demographics of the United States coupled with the Pension and Recovery Act of 2006 (PPA) and the Deficit Reduction Act of 2007 (DRA) have provided an excellent planning opportunity to create tax efficient vehicles to solve a client's long-term care planning needs. Beginning on Jan. 1, 2010, a tax-free planning option will become available for individuals who desire to provide for long-term medical care by using an existing annuity or life insurance contract purchased after 1996. While not a new concept (it dates back to 1997), the 2010 tax-free planning opportunity may be beneficial to an individual with a larger than needed life insurance policy death benefit, unaffordable monthly or annual premiums, an underperforming or matured deferred annuity contract or the desire to incorporate long-term medical care into his or her estate plan.

Under the PPA's provisions, annuity funds may be withdrawn completely tax-free on a FIFO (first-in, first-out) basis for long-term care benefits (amending Section 72(e) of the Internal Revenue Code). The PPA also includes a "1035 exchange" option that allows for the tax-free and penalty-free basis withdrawal of the entire annuity value for qualified long-term care expenses. However, no income tax deduction will be allowed for any payment made from the cash surrender value of a life insurance contract or the cash value of an annuity contract for coverage under a qualified long-term care insurance contract (Section 213(a) of the Code).

This benefit is further enhanced by the modification of the Medicaid "look back" period from 32 months to 60 months for transferred assets and the authority for all states to adopt "partnership long-term care insurance plans" under the DRA. The qualified partnership plans allow an insured to "exclude an amount of assets equal to the value of the benefits purchased in a long-term care partnership policy from Medicaid qualification."

Implications

The benefits of converting an existing annuity or life insurance contract include 1) no surrender charge will apply to account withdrawals for qualifying long-term care expenses; 2) withdrawals for qualifying long-term care expenses will be categorized as a tax-free reduction of basis; 3) a spouse can be added to a policy for long-term care purposes; 4) 10 percent free withdrawal provision for non-long-term contract withdrawals; 5) ability to purchase an optional lifetime long-term care provision with guaranteed premiums; and 6) the annuity's cash will remain available if the long-term care portion of the policy is never used. However, the conversion will also result in 1) the commencement of a new surrender charge period for the contract; 2) medical underwriting (at a time when the individual's health may be declining); 3) health care benefits that are limited in scope and to a specified number of years; and 4) the cost of the long-term care rider reducing the annuity's tax-deferred income stream. In addition, the typical policy will contain a two-year waiting period from the time the annuity is purchased before benefits can be activated and a 90-day "elimination period" once a claim is filed.

Conclusion

A hybrid policy of this nature should not be used as a substitute for comprehensive long-term care insurance. It is recommended that these policies be used only when an individual can't afford or is uninterested in comprehensive long-term care insurance.

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