Public Policy & Alternative Finance Solutions

Tax and Regulatory Considerations for Select LTC Innovative Financing Approaches

Tuesday March 20, 2018
2:00 – 3:15 pm

ILTCI

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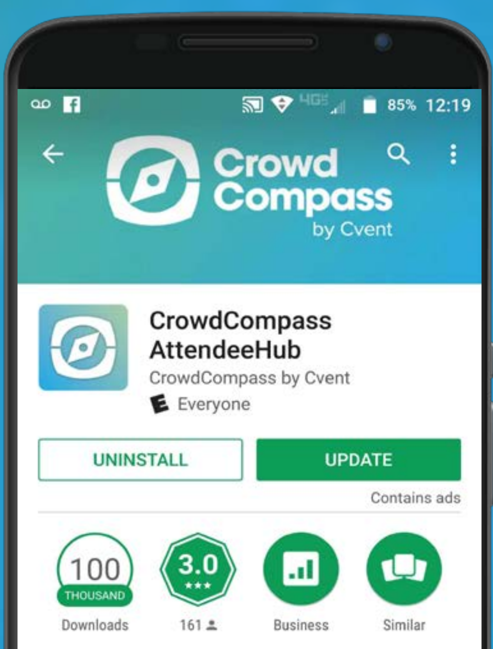

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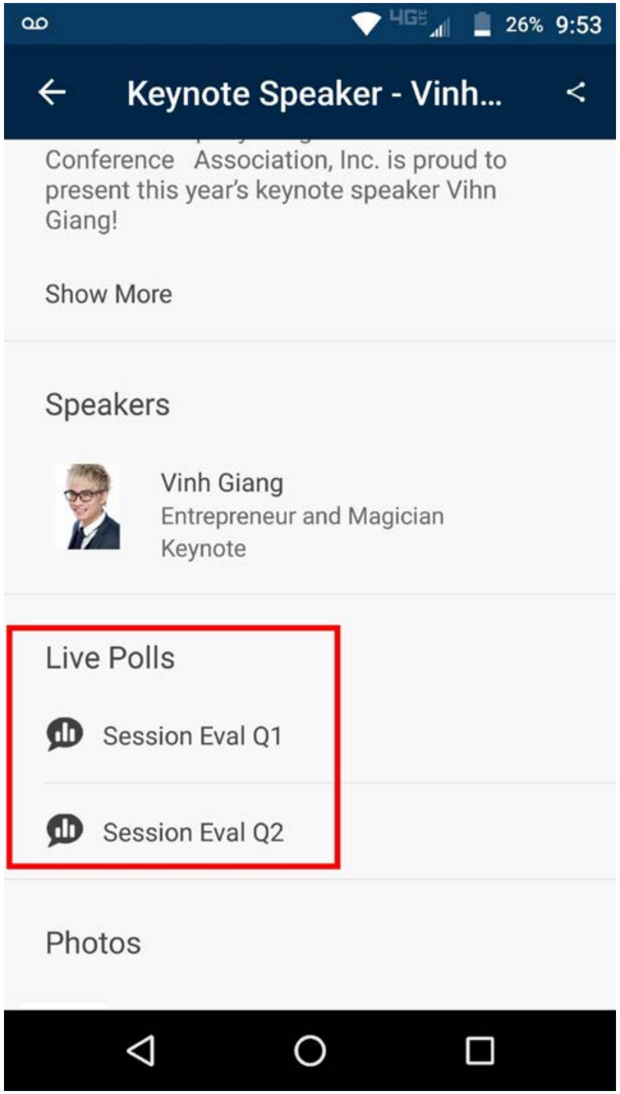

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Speakers

- Susan Coronel, AHIP
- John O’Leary, O’Leary Marketing Associates
- Craig Springfield, Davis & Harman LLP
- Brian Ulery, LTCG

Overview of Current Tax Treatment Qualified Long-Term Care Insurance (QLTCI)

Presented by Craig Springfield

Overview – Tax Treatment of QLTCI Benefits and Premiums

- **Treatment of insurance benefits.** QLTCI benefits generally are tax-free as accident and health (A&H") benefits under Code § 104(a)(3) if qualification requirements are met
  – Per diem limitation for contracts not reimbursing expenses – generally $360/day ($131,400/year) for 2018
- **Premium deduction.** "Eligible long-term care premiums" deductible for taxpayers itemizing deductions, subject to adjusted gross income limitation (7.5% of AGI for 2017-18)
- **Employer-provided coverage.** Employer-paid premiums are excludable from income and insurance benefits generally are excludable, subject to the per diem limitation
  – Cannot utilize in cafeteria plans or flexible spending arrangements

Overview – QLTCI Qualification Rules: Code § 7702B

- **Coverage only of qualified long-term care services**
  - Services required by a chronically ill individual
  - Provided pursuant to a “plan of care” prescribed by a licensed health care practitioner
- **Chronic illness requirement** – A licensed health care practitioner must have certified within the prior 12 months that the insured either:
  - needs substantial assistance with at least 2 of 6 activities of daily living (as defined in the tax law), or
  - requires substantial supervision to protect the insured from threats to health and safety due to severe cognitive impairment
- **Limits on cash values** – Certain return of premium benefits permitted on the insured’s death or surrender
- **Other requirements** – Guaranteed renewable, Medicare coordination, and consumer protections

Overview - Types of QLTCI Combination Products and Retirement Plan Restrictions

- **Life insurance-QLTCI products**
  - Authorized by HIPAA in 1996
  - LTC portion of contract can provide LTC accelerated death benefits (ADBs) and / or non-acceleration LTC benefits
    - Insurance benefits generally treated the same as under stand-alone products
- **Annuity-QLTCI products**
  - Authorized by Pension Protection Act of 2006
  - Similar tax treatment to life-QLTCI products
  - Restrictions on Combinations involving employer or qualified retirement arrangements (Code § 7702B(e)(4))
- **Other retirement plan barriers** – Treas. Reg. § 1.402(a)-1(e), required minimum distribution rules, incidental benefit rules

Within Plan Legislative (or Tax Regulatory) Proposal

Presented by Susan Coronel

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Description

- Removes barriers that prevent retirement plans from investing directly in QLTCI.
- Individuals will be able to allocate a portion of their retirement plan assets towards the purchase of QLTCI, which would be treated like any other investment of the retirement plan.

How Would Premiums Be Treated?

- The QLTCI policy is treated as an asset of the Qualified Account.
- The monies from the Qualified Account used to pay QLTCI premiums are not taxable distributions; rather, this is simply the movement of funds within the Qualified Account from one investment to another.

Within Plan Proposal

How Would Benefits be Treated?

- When the insured becomes chronically ill, the QLTCI policy pays benefits to the Qualified Account; those benefits are then withdrawn by the Account owner.

- These distributions would be taxable like any other Qualified Account distribution.

Within Plan Proposal – Illustrative Example

Age/Year	Transaction	Current Law	Within Plan
55 - 59½ (4½ years)	Current Law: $2,631.58/year withdrawn to generate $2,000 after-tax to pay for QLTCI (outside of Plan) Within Plan Approach: $2,000/year of Qualified Account applied to QLTCI as Plan asset	$631.58/year income tax + $263.16/year penalty **Total Tax: $4,026.33** (reflects 24% tax rate)	No income tax consequence from QLTCI premium payments **Total Tax Years: $0**
59½ - 64 (5½ years)	Current Law: $2,777.78/year withdrawn to generate $2,000 after-tax to pay for QLTCI (outside of Plan) Within Plan Approach: $2,000/year of Qualified Account applied to purchase QLTCI as Plan asset	$631.58/ year income tax **Total Tax: $3,473.69** (reflects 24% tax rate)	No income tax consequence from QLTCI premium payments **Total Tax Years $0**
65-84 (20 years)	Current Law: $2,500.00/year withdrawn to generate $2,000 after-tax to pay for QLTCI (outside of Plan) Within Plan Approach: $2,000/year of Qualified Account applied to purchase QLTCI as Plan asset	$500/year income tax **Total Tax Years: $10,000** (reflects 20% tax rate)	No income tax consequence from QLTCI premium payments **Total Tax Years $0**

Within Plan Proposal – Illustrative Example (continued)

Age/Year	Transaction	Current Law	Within Plan
85-87	$35,000/year in QLTCI benefits received for three years by taxpayer/insured ($105,000 total) <u>Assumptions:</u> •$35,000/year in qualified LTC expenses •No other medical expenses •Other income is $45,000 •Income tax calculation is simplified	$35,000/year in QLTCI benefits (excludable from income) **Total Tax: <u>$0</u>**	$35,000/year QLTCI benefits treated as taxable Plan distributions (1) Income tax on QLTCI benefits: $7,000/year, less (2) Tax benefit from deducting QLTC expenses: $5,400/year (3) Net tax consequence of LTC benefits and expenses: **<u>$1,600/year*</u>** **Total Net Taxes: <u>$4,800</u>** (reflects 20% tax rate)
Total Taxes		**$17,500**	**$4,800**

*<u>Income tax calculation (Years 85, 86, 87):</u> Tax on $35,000 of QLTCI benefits:$7,000. This would be offset by tax benefit of deduction of qualified LTC expenses; $35,000 – 10% of AGI of $80,000: <u>$5,400</u>. Assumes medical costs compensated by taxable insurance benefits are deductible under Code § 213, subject to AGI limitation.

LifeStage Proposal

Presented by John O'Leary

LifeStage Description

- LifeStage Protection is an insurance product that starts as term life insurance during your prime income-earning years and then changes to long term care insurance during your later years. It is designed to provide you and your family with the type of financial protection you need when you need it most.
- LifeStage will be available through your employer, or is something you can buy on your own if it's not available at your work, or if you are self-employed.
- It can replace or be added to the term life insurance protection you may currently have at work, and then, in addition, it provides the long-term care protection that many are likely to need later in life. If you buy it through your current employer, unlike most other workplace benefits, it is fully portable if you change employers.
- You choose the coverage level you want (e.g., $100,000, $200,000, or $300,000). When you reach the transition age, (i.e. age 65) your life insurance coverage will end and your long-term care coverage in the same amount, will begin. Then, as long as you continue to pay your premiums, if you need care, your expenses will be covered up to the lifetime maximum amount you selected.
- Your monthly premium will remain the same when your coverage changes from life to long term care.

LifeStage Proposal

How Would Premiums Be Treated?

- Option A- Premiums handled like term life insurance during working years (i.e. up to age 65); like LTC after age 65- deductible if medical expenses (including LTCi premiums) exceed 10% (7.5% next two years) of AGI.

- Option B- Like option A but the portion of working years premium(approximately 20%) attributable to LTC is also be deductible if medical expenses meet 10% of AGI.

- Option C- Enable inclusion of Lifestage as Cafeteria Plan element so all premiums (including LTC during working years) handled pre-tax in the same way as term life and health insurance.

How Would Benefits be Treated?

- Neither Life insurance nor Long-Term Care insurance benefits (assuming they were for qualified LTC services) are taxable; the assumption is there would be no tax implications for Lifestage benefits.

Retirement Plus Proposal

Presented by John O'Leary

Retirement Plus Proposal

Product Description

- Retirement Plus is a flexible retirement plan like a 401K/IRA but with expanded contributions and long-term care insurance built right in. This allows you to simultaneously invest for retirement and be covered for long-term care should you need it. In the event you need long-term care, the insurance component kicks in and pays for long-term care expenses.
- Enroll and make your investment selections just like you would for a typical retirement account by indicating how much money/what percentage of your income you want to put into Retirement Plus and select the level of long-term care insurance you would like (e.g. $100,000, $150,000, $200,000). Based on your selections, your Retirement Plus account will be funded automatically from either your paycheck or your bank account. The cost of the long-term care insurance will be deducted from your Retirement Plus account balance.
- Once you reach retirement age, the funds can be used for whatever you want and just like a 401K or IRA you pay taxes at the time you use the money. In the event you need long-term care, your account funds can be used to cover those expenses. If the money is spent on long-term care, you pay no taxes on it. If you spend the entire account balance, the insurance kicks in and pays your long-term care expenses up to the maximum benefit amount selected during enrollment.

Retirement Plus Proposal

How Would Premiums Be Treated?

- Option A - Premiums handled like an annuity based product - therefore not eligible for tax deductions

- Option B - Retirement Plus would be treated like any employer-sponsored retirement product - therefore premium contributions could be made on a pre-tax basis

How Would Benefits be Treated?

- Any distributions for retirement savings accounts are taxable. However, if the payments are used to pay for qualified long-term services, those payments are tax deductible - theoretically offsetting some or all of the tax liability
- Long-Term Care insurance benefits (assuming they are for used qualified LTC services) are not taxable. Since the long-term care insurance built-into the Retirement Plus account would not come into play as a distribution, but would be accessed after the account balance was depleted, the assumption is there would be no tax implications for Retirement Plus insurance benefits

Tax and Medicaid Impact: Modeling Results

Presented by
Brian Ulery, FSA, MAAA
Principal Consulting Actuary, LTCG

The Two Concepts Presented

- **LifeStage Protection**
  - Life insurance coverage to age 65
  - Long term care coverage after that

- **Retirement Plus**
  - Qualified retirement plan with long term care coverage

Why Model Tax and Medicaid Impact

- Fundamentally similar products are available today
  - LifeStage Protection: Term life products exist today with optional LTC coverage
  - Retirement Plus: Non-qualified annuity with LTC coverage
- The Think Tank was charged with thinking outside the boundaries of current product design and legal/regulatory constraints
  - Encouraging tax incentives to increase consumer interest in and willingness to purchase private LTC coverage.
- The existence of private LTC insurance protection has the potential to reduce government spending through Medicaid
  - Tax incentives would conversely reduce government revenue
  - Modeled the net impact

Potential Impacts to Tax Revenue

- Three scenarios modeled
  - Current (Less Favorable): Premiums / contributions not eligible for deduction.
  - Favorable: Portion of LifeStage Protection premiums eligible for deduction. Contributions to Retirement Plus made on a pre-tax basis.
  - Preferred: Entire LifeStage Protection premiums eligible for deduction. Retirement Plus similar to Favorable scenario, but distributions for LTC needs would not be taxed.
  - In all scenarios the two concepts were modeled assuming new or additional premiums or contributions
    - Not a reallocation from other products/investments

What Factors Affect the Modeled Impact on Tax Revenue

- Premium / contribution levels
- Premium pattern
- Deductible portion of premium / contributions
- Federal cap on long term care insurance premium deduction
  - For LifeStage Protection
- Likelihood of claiming medical expense deductions on tax returns
  - Average of 8%, varying by age
  - For LifeStage Protection
- Expected benefits received tax-free
  - For Retirement Plus
- Marginal tax rates
  - Average of 25%, varying by age

Lost Tax Revenue Under Several Scenarios (millions)

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	LifeStage Protection			Retirement Plus		
	Less Favorable Tax Treatment	Favorable Tax Treatment	Preferred Tax Treatment	Less Favorable Tax Treatment	Favorable Tax Treatment	Preferred Tax Treatment
Years 1-10	0.0	6.1	12.3	0.0	34.9	40.2
Years 11-20	0.0	12.6	18.0	0.0	31.9	43.2
Years 21-30	0.0	19.7	21.0	0.0	10.6	31.7
50 Year PV	0.0	33.2	42.2	0.0	53.3	99.6
% Change	0.0%	11.4%	14.5%	0.0%	13.9%	26.0%

Note: All values are based on results of expected sales of each product over the course of a 2-year pilot program. The percentage change is the lost tax revenue as a percent of expected Medicaid spending in the absence of either private insurance product.

What are the Potential Medicaid Savings

- Long term care insurance coverage provides an additional layer of protection to the consumer before qualifying for Medicaid services

- Each dollar of LTC coverage is potentially one dollar less that the government would spend through Medicaid

What Factors Affect the Modeled Impact on Medicaid Expenditures

- Persistency
- Likelihood of needing long term care support and services
- Expected cost of long term care needs
- Amount of private insurance coverage purchased
- Amount of assets available to pay for long term care needs
  - Current available assets
  - Assumed investment yield
  - Assumed additional contributions
  - Assumed portion of assets willing to be spent for LTSS
  - Assumed years of draw-down during retirement

Potential Reduction in Medicaid Expenditures (millions)

	LifeStage Protection	Retirement Plus
Years 1-10	0.0	-22.5
Years 11-20	-2.0	-18.0
Years 21-30	-33.7	-32.0
50 Year PV	-143.6	-161.0
% Change	-49.3%	-42.0%

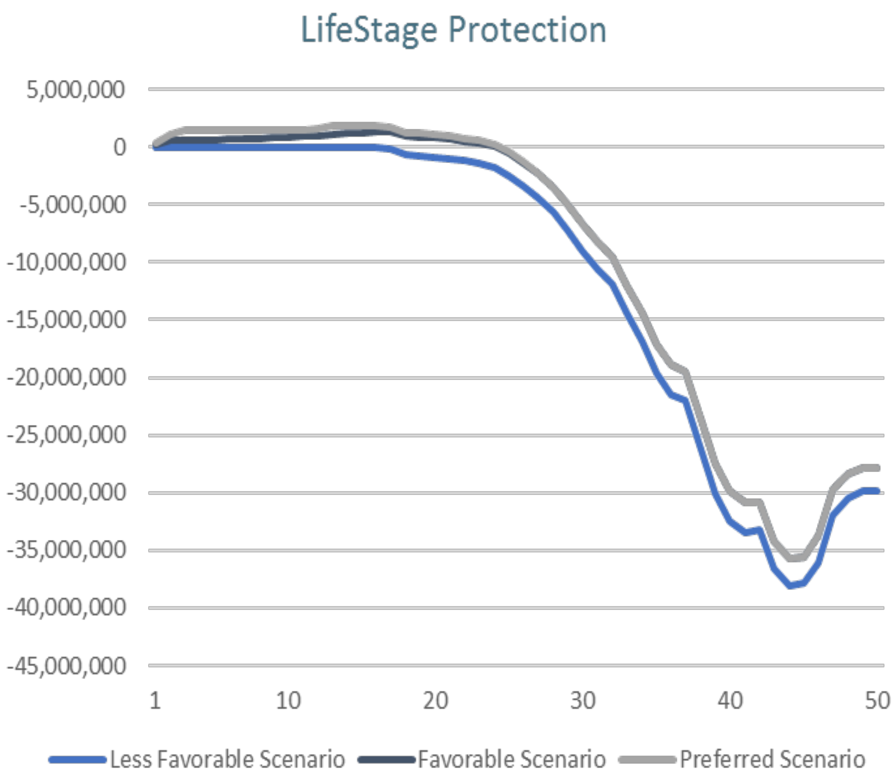
Note: All values are based on results of expected sales of each product over the course of a 2-year pilot program. The percentage change is the reduction in Medicaid spending as a percent of expected Medicaid spending in the absence of either private insurance product.

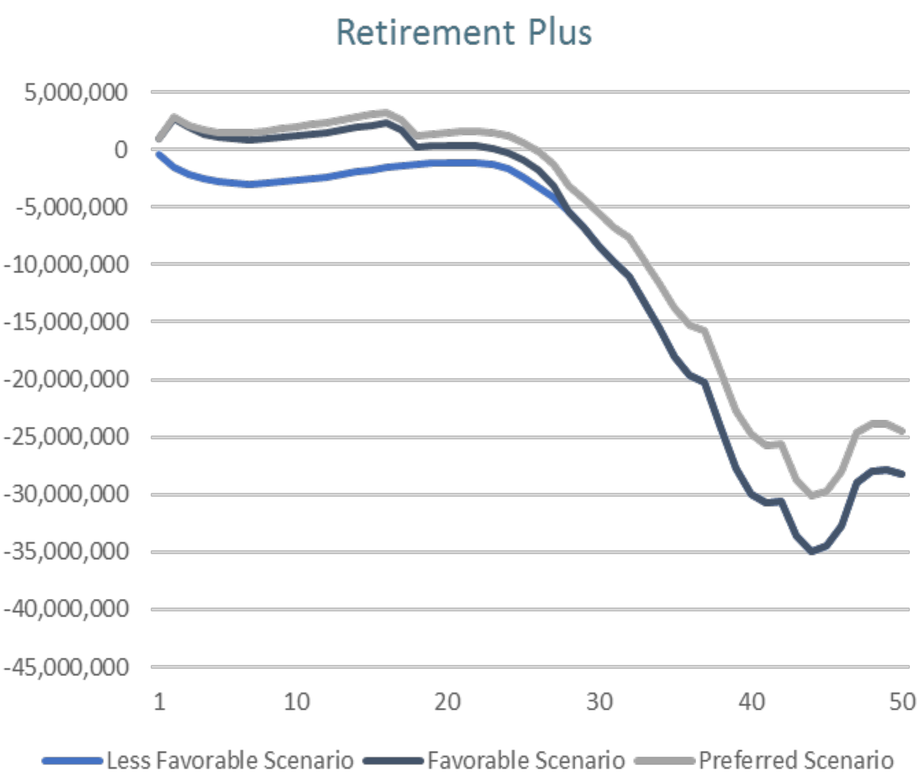
Net Impact of Medicaid Expenditure Savings and Lost Tax Revenue (millions)

`	LifeStage Protection			Retirement Plus		
	Less Favorable Tax Treatment	Favorable Tax Treatment	Preferred Tax Treatment	Less Favorable Tax Treatment	Favorable Tax Treatment	Preferred Tax Treatment
Years 1-10	0.0	6.1	12.3	-22.5	12.4	17.7
Years 11-20	-2.0	10.6	16.0	-18.0	13.8	25.2
Years 21-30	-33.7	-14.0	-12.7	-32.0	-21.5	-0.4
50 Year PV	-143.6	-110.5	-101.4	-161.0	-107.7	-61.4
% Change	-49.3%	-37.9%	-34.8%	-42.0%	-28.1%	-16.0%

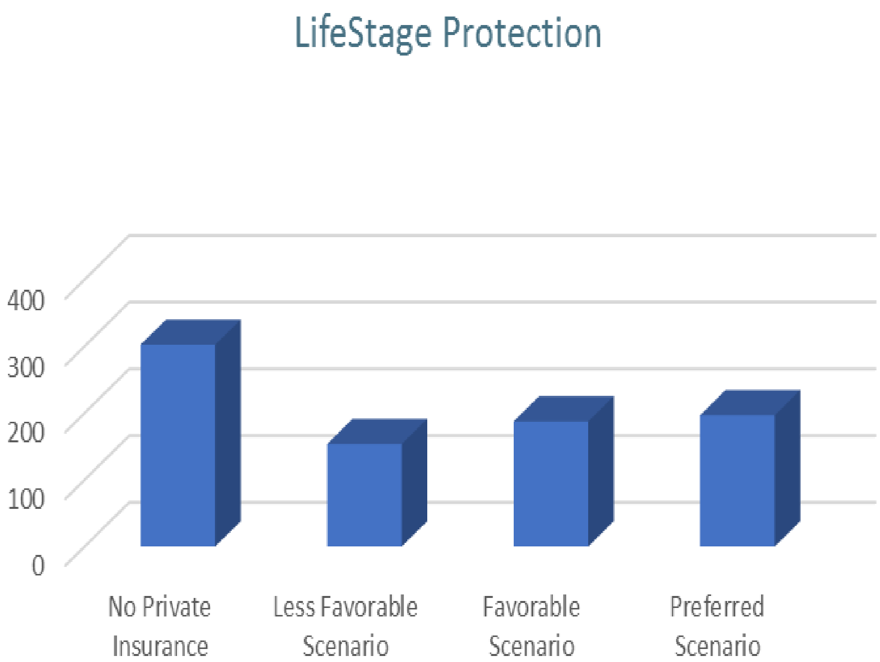
Note: All values are based on results of expected sales of each product over the course of a 2-year pilot program. The percentage change is the net impact of reduced Medicaid spending and lost tax revenue as a percent of expected Medicaid spending in the absence of either private insurance product.

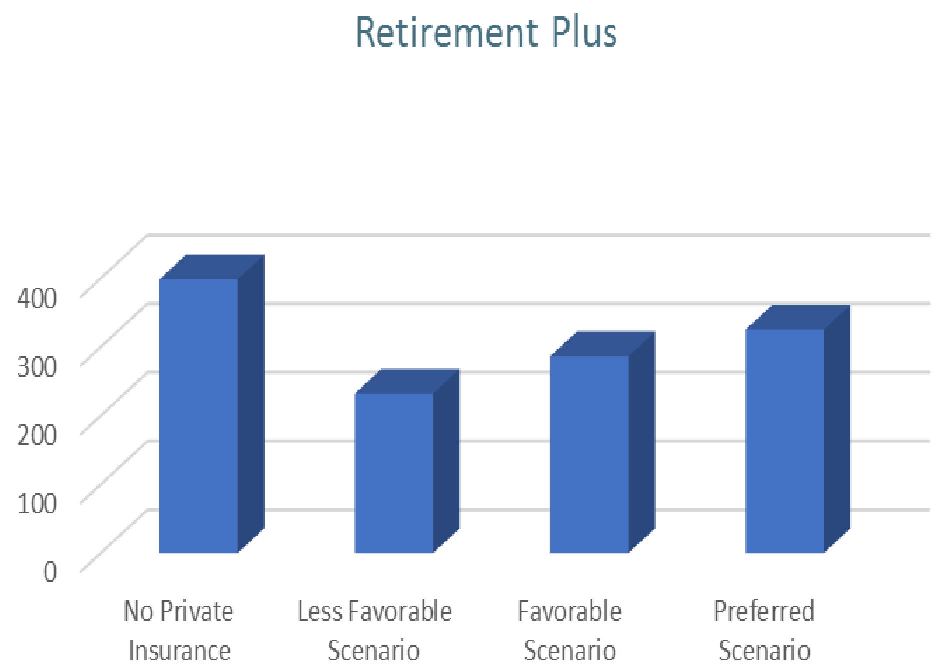
Net Impact of Medicaid Expenditure Savings and Lost Tax Revenue





Sample Pilot 50 Year PV of Medicaid Spending Net of Private Insurance Impact (millions)





Reaction to 3 Proposals

- **Barriers**
  - Regulatory (Treas. Reg. § 1.402(a)-1(e))
    - Adverse tax treatment of retirement plan investments in A&H insurance, including QLTCI
    - Did Treasury need to go there, and could its current position be reversed?
    - Existing regulatory authorization of products that meet retirement-related needs
      - Disability coverage
      - Qualifying Longevity Annuity Contracts (QLACs)
      - QLTCI serves a similar, distinct purpose

Reaction to 3 Proposals

- **Barriers (cont.)**
  - Legislative
    - Weighing tax advantages (and access to qualified market) versus revenue cost
    - Technical considerations
      - Treatment of premiums and QLTCI benefits
      - Required minimum distribution rules
      - Incidental benefit rules
      - Interaction with medical deduction rules
      - Eligible plans; eligible individuals; QLTCI features; other?
  - Other Barriers?
- **Opportunities**
- **Other Comments/Reactions**

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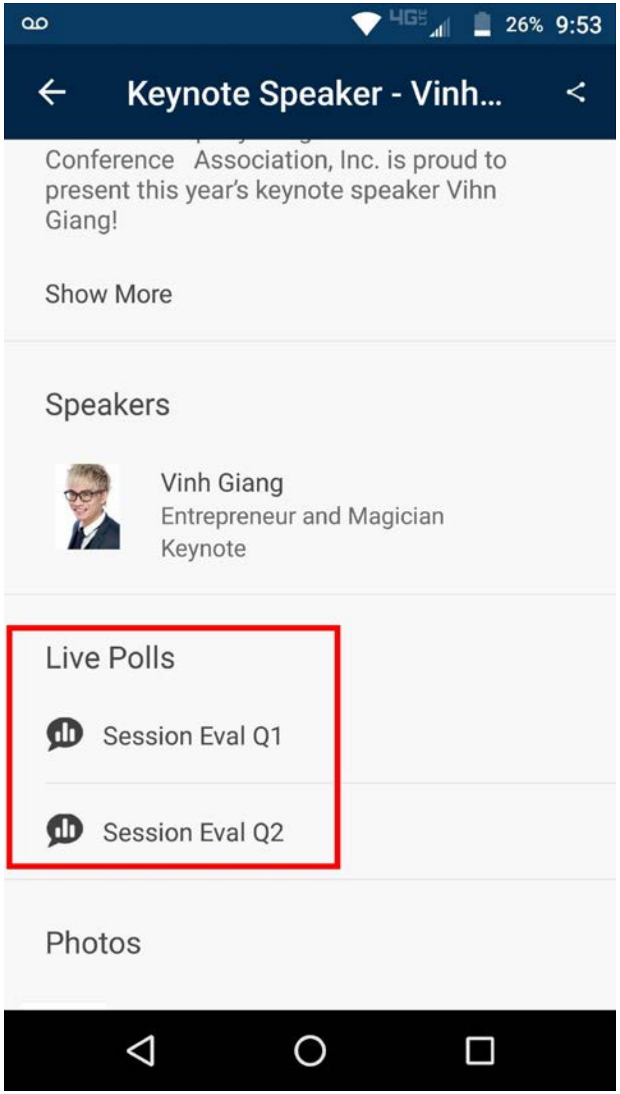

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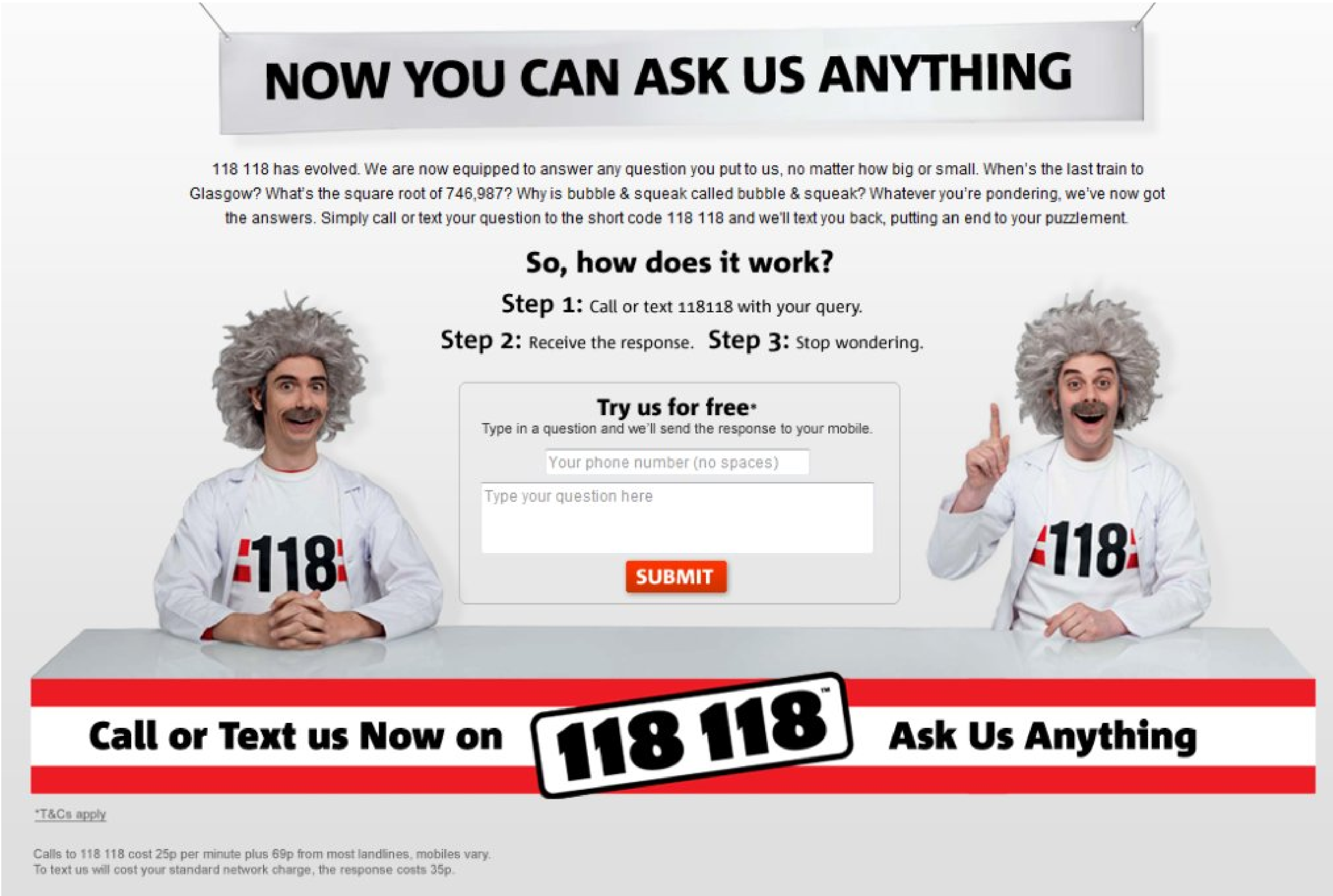
Q&A



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