Annuity – LTC Combination Contracts

Providing for health care is a key part of retirement planning. For most Americans age 65 and over, the federal government's Medicare program, and its various components, provides most of the resources to take care of a typical retiree's health care needs.

One health care need that is only minimally covered by Medicare is that of long-term care (LTC). LTC is the term used to describe a variety of maintenance or "custodial" services required by individuals who are chronically disabled, ill, or infirm. Depending on individual needs, LTC may include nursing home care, assisted living, home health care, or adult day care.

Not everyone will need LTC in retirement. For those that do, LTC is expensive. In 2019, for example, the national median cost for a resident in an assisted living facility was $48,612 per year; the national median cost for a semi-private nursing home room was $90,155 per year.[1] The problem, then, is how to plan for an expensive need that may, or may not, occur.

One answer has been that of a stand-alone, long-term care insurance policy. Should the need arise, a LTC policy can furnish some or all of the resources needed to pay for care. LTC insurance can be expensive, however, and most policies allow for the possibility of future rate increases. Plus, if an individual uses few (or none) of a policy's benefits, there is a sense that the money was not well spent.

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One alternative to a stand-alone LTC insurance policy is a "combination" policy that links an annuity, typically a single-premium, deferred annuity, with a tax-qualified,[2] long-term care benefit. If LTC services are later needed, the accumulated value inside the annuity is withdrawn first to pay LTC expenses. If on-going LTC expenses exhaust the funds inside the annuity, additional, tax-qualified LTC coverage may be provided by the insurance company through a LTC "rider" to the base annuity. If LTC services are not needed, the annuity value can be used to either provide additional income, or, at the owner's death, can pass to named beneficiaries.

[1] Source: The Genworth 2019 Cost of Care Summary, page 3.

[2] The discussion here concerns federal income tax law. State or local income tax law may differ.

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- **The long-term care "rider":** A long-term care "rider" to the annuity adds an insurer-provided layer of LTC benefits to those derived from the cash contributed by the annuity owner. The LTC rider could be paid for by periodic withdrawals from the annuity value. Such withdrawals are tax-free as a reduction in the annuity basis. The additional LTC benefit provided by the insurance company is often measured as a multiple (2x or 3x) of the single premium deposited by the annuity owner.

- **Taxability of LTC benefit:** Annuity-LTC contracts are generally structured to meet the requirements of the Internal Revenue Code (IRC) so that the LTC benefits received (both cash values withdrawn from the annuity and the benefits provided by the insurance company), are received income-tax free.

- **Paying for the contract:** In most cases, the annuity is purchased with a large, single-premium payment, for example a premium of $10,000 - $300,000. A few contracts allow for periodic payments into the annuity. As an alternative, if an individual has an existing cash-value life insurance policy or annuity contract, IRC Sec 1035 allows for the tax-free exchange of the existing policy or contract for a new life insurance policy or annuity contract with LTC benefits.

- **Benefit "triggers":** Tax-free LTC distributions generally require that an individual be "chronically ill." An individual is chronically ill when he or she is either (1) expected to be unable to perform for 90 days two of six activities of daily living (eating, toileting, transferring, bathing, dressing, and maintaining continence), or (2) suffers from a cognitive impairment such as Alzheimer's, dementia, or Parkinson's disease.[1]

- **Deferral period:** Most contracts specify that the LTC benefits cannot be paid from the contract for a specified number of years, known as the "deferral period." Typical deferral periods might range from two to six years.

- **Elimination period:** Once an individual is determined to qualify for LTC benefits (considered to be chronically ill), and assuming that the deferral period has expired, long-term care payments can begin after a waiting, or "elimination" period, which can range from 60-100 days.

[1] See IRC. Sec. 7702B(c)(2).

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- **LTC Benefit period:** The annuity owner will select the period of time over which LTC benefits are to be paid, at the time the contract is purchased. Depending on the contract, the benefit period could extend from one to up to nine years. There may be separate benefit periods for benefits paid from the annuity value and the insurer-provided LTC benefits.

- **Monthly LTC benefit amount:** The monthly LTC benefit amount is generally a function of the total dollar amount of benefits available and the period of time selected by the annuity owner. The table below shows hypothetical, sample monthly payment amounts for various scenarios:

Single Premium Paid	Benefit Period	Leverage Factor	Maximum LTC Benefit	Monthly Maximum
$25,000	2 years (24 months)	2x	$50,000	$2,083
$25,000	2 years (24 months)	3x	$75,000	$3,125
$50,000	3 Years (36 months)	2x	$100,000	$2,777
$50,000	3 Years (36 months)	3x	$150,000	$4,166
$100,000	4 Years (48 months)	2x	$200,000	$4,166
$100,000	4 Years (48 months)	3x	$300,000	$6,250

- **Indemnity vs. actual expenses:** Some contracts pay benefits on an *indemnity* or *cash* basis, meaning that once payments begin, the monthly payment is the same regardless of the dollar amount of LTC expenses incurred. Contracts that pay benefits on an *expense* basis pay the lesser of the monthly benefit or the actual expenses incurred. If LTC expenses are less than the normal monthly payment, any unused balance is held over for future use, potentially extending the benefit period.

- **Underwriting:** Generally, annuity-LTC combination contracts, because they are frequently funded with a large, single premium, use a streamlined, simplified underwriting process, involving a telephone interview and a physician's statement.

Other Factors to Consider

There are a number of other factors to keep in mind when considering an annuity-LTC combination contract:

- **Not considered state "partnership" LTC policies:** Annuity-LTC combination contracts generally do not qualify as state "partnership" LTC policies. An insured individual with a partnership LTC policy can keep a much larger dollar amount of assets, while still qualifying for Medicaid, once the partnership LTC policy benefits are exhausted. Normally, an individual must be nearly destitute before Medicaid will pay for long-term care.

- **Effect of inflation:** Over time, the cost of LTC, like many other things that we buy, will increase. Since it may be many years in the future before long-term care is needed, consider a combination contract that offers a cost-of-living (COLI) rider. Without such a rider, there is a risk that the contract's LTC benefits will not keep pace with increases in the cost of long-term care.

- **Most funded with a large, single premium:** Most annuity-LTC combination policies are funded with a large, single premium payment. An individual may not have the resources to make such a large payment.

- **Is this the right tool?** An annuity-LTC combination contract may not be the right tool if, for example, the insured already has adequate retirement income. If there is a potential need for additional life insurance, a life insurance-LTC combination policy may be a better fit. For some individuals, a stand-alone LTC policy is more appropriate.

Seek Professional Guidance

One key part of a well-prepared retirement plan is looking ahead to the possible need for long-term care. The advice and guidance of trained financial and insurance professionals, in sorting out the various options for meeting this need, is strongly recommended.