

Long-Term Care Insurance Products and Addressing the 'Use It or Lose It' Concern

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Key Points

- Tax policy in the past has provided incentives for the purchase of long-term care insurance (LTCI), but those incentives have come with some product design restrictions.
- One restriction on tax-qualified LTCI products is that, other than a return-of-premium feature, they are not allowed to have any kind of cash value feature. This creates a "use it or lose it" concern for some consumers.
- Various life and annuity combination products have emerged that address the "use it or lose it" issue by providing value to consumers even if the LTC benefits are not needed.
- Tax law changes that allow cash values on qualified LTCI could address "use it or lose it" concerns for some consumers and provide additional premium flexibility.

Introduction

Existing public programs do not provide financing for long-term care (LTC) needs unless someone meets the asset and income requirements of state Medicaid programs. To fill that void, private long-term care insurance (LTCI) has been offered to provide financing for the LTC needs especially of importance given the growing elderly population. This coverage has taken many forms. Currently the stand-alone LTCI market has been contracting while the combination products market has been expanding. This issue brief provides a brief history of these products and explores how a cash value LTCI design might provide additional consumer options.

An Evolving Marketplace and Regulatory Environment

Early versions of LTCI policies issued in the mid- to late-1980s primarily provided nursing facility coverage with limited coverage for home and community-based care. After more than two decades of rapid growth through the early 2000s, the LTCI industry underwent significant contraction in both the number of participating insurers and sales. Carriers that left the market cited mounting losses from adverse experience relative to pricing assumptions. LTCI agents cited that consumers' reasons for not buying a policy included cost, difficulty of choosing a policy, lack of confidence in insurers to pay stated benefits, and uncertainty about future product changes or premium increases. As traditional LTCI sales declined and stagnated, sales of combination or hybrid products grew, as noted in the chart below.



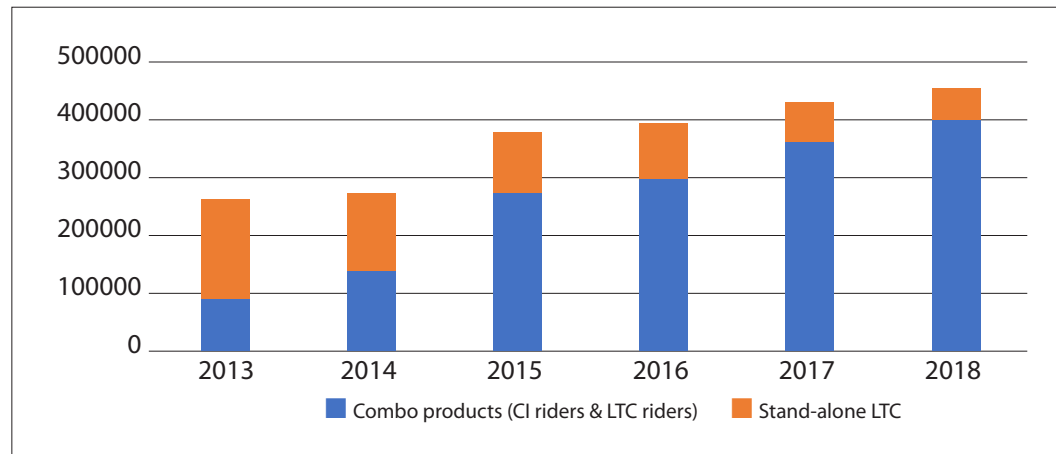
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Individual Combo Products—New Sales Lives Includes Both Chronic Illness Riders and LTC Riders



Source: LIMRA U.S. individual life combination products—annual review. Combo products include zero premium discounted death benefit features.

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) states that qualified LTCI will be subject to favorable tax treatment under the Federal Income Tax Code, similar to accident and health insurance products. Benefits paid by a tax-qualified (TQ) policy will not be counted as taxable income to the policyholder under most circumstances, and premiums paid can be counted as a non-reimbursed medical expense for those itemizing their deductions for tax purposes. Almost all policies sold today are TQ policies, although non-TQ policies continue to be available.

The Pension Protection Act of 2006 (PPA) clarified the tax treatment of cash value distributions under life insurance policies or annuity contracts to pay for LTC. With the 2010 enactment of the new LTC tax provisions, benefits paid under LTC riders attached to either life insurance or annuity products will not be counted as taxable income to the policyholder under most circumstances.

This issue brief was developed by the following members of the Long-Term Care Reform Subcommittee:

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Current LTC Financing Alternatives

There are multiple ways to address LTC financing needs, including savings, insurance, life settlements, and reverse mortgages (for more information, see the Academy's October 2015 brief, "[*Long-Term Care Insurance: Product Design Flexibility*](#).") Several insurance and annuity product alternatives that can provide financing for LTC services are summarized below:

Traditional or stand-alone LTC insurance generally provides comprehensive coverage for nursing facilities, assisted living facilities, and home and community care. Most products sold today reimburse actual expenses, although many indemnity policies and some disability-type¹ policies remain in force. As discussed above, stand-alone LTCI receives favorable tax treatment under Section 7702(b) of the Internal Revenue Code. This product is generally considered to provide the greatest LTC benefits per dollar of premium, but in the absence of a return-of-premium feature, if no LTC benefits are needed the policy only provides peace of mind.

Life/LTC combination or hybrid products come in three common forms:

- Life insurance with a chronic illness rider—This rider accelerates life insurance benefits, is governed by Section 101(g) of the Internal Revenue Code, and cannot be marketed as LTC insurance. When LTC benefits are paid, the life policy face amount is commonly reduced dollar-for-dollar up to 100% of the face amount of the life policy. A pro rata reduction applies to the cash value. Acceleration benefit options are typically two years, three years, or four years, or range from 1% to 5% of the face amount per month. Chronic illness riders might also provide a lump sum payment for qualified LTC events.
- Life insurance with an LTC acceleration rider—Similar to a stand-alone LTCI policy, LTC acceleration riders are governed by Section 7702(b) of the Internal Revenue Code and must comply with the National Association of Insurance Commissioners (NAIC) LTC model regulation. The LTC rider benefit structure is almost identical to the chronic illness rider above except that a lump sum payment is rarely seen under this rider.
- Life insurance with both an LTC acceleration rider and an LTC extension of benefit rider—Both riders are governed by Section 7702(b) of the Internal Revenue Code. With this type of product, long-term care benefits are first funded by the LTC acceleration rider until the specified total LTC amount (up to 100% of the face amount) is fully depleted. Then the extension of benefit rider provides additional LTC coverage beyond the acceleration rider period, typically for two to four years. Extension of benefit riders are funded by a separate premium as opposed to the policyholder's own account value.

¹ Does not require receipt of services like reimbursement and indemnity policies.

A rider could be made available on more than one life base product chassis. Currently a majority of such riders are attached to universal life policies.

Annuity/LTC combination or hybrid products are less common in the market, as there are only a handful of carriers with a filed product. Some carriers with filed products are not actively marketing their annuity combination products due to the prolonged low-interest-rate environment, which makes this type of product less attractive than some other alternatives available to consumers.

A common annuity combination design is a single-premium deferred annuity with LTC benefits, which has an LTC acceleration rider and an extension rider. The single premium is credited with interest until the account value is annuitized—i.e., converted to a lifetime payment stream. If the policyowner dies prior to annuitization, the account value is paid to the beneficiary as a death benefit. If the policyowner needs LTC services prior to annuitization, the account value covers LTC services for the first two or three years of claim. After the annuity's account value is depleted, LTC expenses can be covered by an extension rider for perhaps an additional two to four years.

Enhanced payout options are another variation in the annuity market. Under this design, LTC benefits are available within the guaranteed lifetime withdrawal benefit rider (GLWB) of a variable or fixed indexed annuity. The LTC enhanced payouts increase the lifetime payment amount if the insured meets the benefit eligibility requirements. The amount of the LTC enhancement varies in the market from 50% to 300% of the lifetime payout amount and can be effective for either a limited number of years (such as five years) or for the life of the insured.

A Proposal to Enhance Stand-Alone LTC Product Designs

Although the tax treatment of various LTC products was largely improved and clarified within HIPAA in 1996 and the Deficit Reduction Act in 2005, those laws contained very specific policy and consumer protection requirements, some of which impede the marketing of qualified LTCI policies today.

Perhaps the biggest challenge is that other than a return-of-premium feature available only upon complete surrender or cancellation of the contract, current tax laws do not allow stand-alone qualified LTCI to have any type of cash value feature. This limitation creates a “use it or lose it” aspect to the product. As one article puts it:

Many people regard long-term-care insurance as having no real value if ultimately the payouts aren't needed. That is, instead of looking at long-term-care insurance primarily as financial protection, many people think of it as an investment — and a bad one at that. They see the premiums as money that would be wasted if the policy owner ultimately doesn't need long-term care. They don't think about the catastrophic losses a policy could help them avoid.²

While combination products can address the “use it or lose it” issue, they require consumers to purchase some level of other coverage to address what they might see as primarily an LTCI need. The NAIC recommendations to federal policymakers³ have suggested that LTCI with a cash value feature could address the consumer concern about not receiving any value from their LTCI if the LTC benefits are not needed. Certainly, cash values would increase the premiums for LTCI, but they might improve consumer perceptions of the cost relative to the value. In addition, from the insurer's perspective, having some growing portion of the policy benefits that will be paid out one way or another could help insurers balance the morbidity and mortality risks in the same way that hybrid products have helped insurers to balance the overall policy risks.

Furthermore, the NAIC recommendations suggested that cash value features can allow more flexible premium options that “could increase consumer choice and flexibility by allowing prefunding for LTC needs under a variety of premium payment patterns.”⁴ The NAIC LTC Model Regulation currently allows premiums to increase with the age of the insured, but only to age 65. Allowing cash values on qualified LTCI could allow insureds additional premium flexibility while addressing “use it or lose it” concerns. Cash value features could also reduce the portion of premium needed to pay for a death benefit relative to a combination product.

Some have noted that LTCI is already a complicated product and that adding a cash value feature would further complicate LTCI for consumers. On the other hand, having a cash value component could facilitate discussions with people who otherwise might not consider the purchase of an LTCI policy. Whatever cash value designs are developed, companies need to be sure that those designs can be explained to agents and that agents will in turn be able to explain those designs to potential consumers.

Finally, from a macroeconomic level, having more LTC services covered by private funds can help relieve public programs, such as Medicaid, of additional costs in the future. Therefore, adding new features to make existing products more attractive to a broader range of consumers could result in long-term beneficial societal impacts.

² Olivia S. Mitchell and Daniel Gottlieb; “[Why People Don't Buy Long-Term-Care Insurance](#)”; *MarketWatch*; June 25, 2015.

³ NAIC; *Long-Term Care Federal Policy Options to Present to Congress*; April 2017.

⁴ *Ibid.*

Conclusion

For decades, consumers and LTC insurers have benefitted from tax incentives for the purchase of LTC insurance policies. However, those incentives have come with some product design restrictions lessening the attractiveness of the products for consumers, including a requirement that eligible policies not have cash values beyond a return-of-premium feature. Various life and annuity combination product designs have emerged that address this “use it or lose it” issue by providing consumer value if the LTC benefits are not needed. Tax law changes to allow cash values on qualified LTCI would be another way to address this issue and could also provide additional premium flexibility for consumers.

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