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White paper

A more practical way for the high-net worth to fund long-term care

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Long-term care is part of estate planning

When it comes to long-term care (LTC), many affluent people feel they can afford to “self-insure” for potential LTC expenses. However, it is impossible to self-insure; because insurance is defined as immediate leveraging of dollars, and one cannot immediately leverage their own money. A person could self-fund, but is self-funding the most efficient use of assets? Two of the potential challenges with self-funding are: 1) you can’t predict timing or returns, and 2) for the high net worth, a primary goal of estate planning is preserving wealth - and not only can LTC expenses can put a large dent in an estate when not properly planned for, poor planning can result in excessive estate taxation.

The downside of self-funding LTC for the high-net worth

Self-funding LTC in a typical fashion may not be the best solution for the high-net worth individual or couple whose estate could be subject to estate taxes. In order for this client to self-fund, they would want to have assets available that are liquid and accessible inside their estate in the event they encounter a need for LTC. Let’s assume this client sets aside $1,000,000 for this purpose. If the client were to need LTC and spend through most or all of the $1,000,000, then the self-funding plan worked well enough. However, if the client needs little or none of the funding they set aside for LTC expenses - and assuming a 2020 estate tax rate of 40% - estate taxation of the $1,000,000 could result in a tax bill of up to $400,000. But there is a cost-effective way to avoid this potential pitfall by purchasing a linked benefit LTC policy that pays indemnity benefits and is owned by an Irrevocable Life Insurance Trust (ILIT).

What is linked benefit LTC coverage

Simply put, an asset is re-positioned or income is directed on an annual basis to be leveraged for LTC coverage on a policy linked to life insurance. The primary purpose of the policy is insuring LTC, and that is where the full leverage of coverage will be positioned; but there is also a death benefit on the policy, which assures the premium amount is protected from loss should the policy be little or never used (assuming no withdrawals or loans). Linked benefit LTC policies can generally be paid for with a single premium, short pay schedules of up to 10 years, and with some companies there is the option to pay to attained age 65 and pay to attained age 100. Some companies also allow the policy premiums to be paid on a monthly basis, purchasing the same benefit pool as an annual payment mode.

Why indemnity?

An indemnity LTC benefit can work within an Irrevocable Life Insurance Trust (ILIT) because the LTC benefit is sent directly to the owner of the policy, which in the case of trust ownership would be the trust/trustee. The policy is essentially funding the trust with cash via payment of an acceleration of the death benefit and then from the extension of LTC benefits. There is no

reimbursement of actual LTC expenses on behalf of the insured. It is important to note the insured (grantor) must never have the LTC benefit directly in hand nor can they have claims against the trust for such monies.

Using the ILIT to help efficiently fund long-term care needs

An Ultimate Life Insurance Trust (ULIT) may be appropriate for clients who don't want to lose total control of trust assets, fearing they may need funds in the future. A ULIT is a type of Irrevocable Life Insurance Trust (ILIT) that may allow the Grantor/Insured or Grantor/Insured's spouse access to trust assets.

The trust is written with provisions to allow for arms-length fully collateralized loans. The loan is secured by property pledged by the Grantor/Insured. The loan must be legitimate with collateral pledged, interest charged, and an agreement to fully pay back the debt. Collateral can be anything that covers the debt; equity in a house, artwork, coin collections, etc. – as long as the item pledged can be given a fair market value and that value covers the loan amount. The interest rate charged should be at least equal to the interest that would be charged on a loan from the life insurance policy. And though in this concept there will be no loan taken again the policy itself, this is good fiduciary practice. Keep in mind, the higher the interest is, the better this concept works, but it still must remain reasonable. In most cases, the loan interest is allowed to accrue. Ideally, the loan interest should be paid back prior to the death of the Grantor/Insured to avoid taxation as income to the trust. Some plans of this type will set up interest to be repaid on a periodic basis to hedge against the risk of all interest being taxable at death, though this will impact the compounding of the debt (which in this case is an advantage as you will shortly see). Principal can be paid back after death with no tax liability.

The process of taking the collateralized loans

When using a ULIT type ILIT for the purposes of getting long-term care rider benefits from the trust, you may do the following:

- File a claim for the LTC benefit
- After the elimination period, a monthly check will be sent to the trust
- As policy owner, the grantor then borrows money from the trust upon pledging property as collateral
- These funds can be used to pay LTC bills
- Interest is allowed to accrue to purposely increase the debt – but ideally is paid back just prior to death to avoid income taxation to the trust
- At the grantor's death, the loan principal and any interest still unpaid is repaid to the trust; and that same amount is then deducted from the calculation of estate assets subject to estate taxation, leaving a smaller estate tax liability.

Doing the math — The numbers

Our hypothetical example will assume our client is a 55-year-old female, non-smoker, and qualified for a couple rate. She will gift $197,150 to her ULIT by using part of her lifetime exemption. The trust will purchase, own, and be the beneficiary of a linked-benefit LTC policy paying indemnity benefits that provides a six-year benefit pool of $1,080,000 in total LTC benefits. There is a guaranteed death benefit of $360,000 if LTC is never needed and a guaranteed minimum death benefit of $72,000 if LTC is needed. The monthly LTC benefit amount paid to the trust will be $15,000 per month. The trust will include loan provisions needed for this concept using an 8% interest rate.

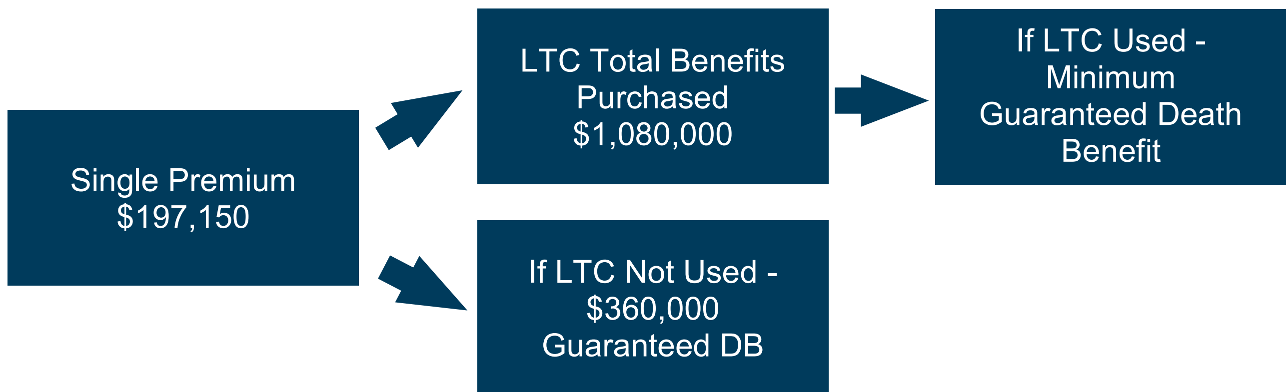
Upon going on LTC claim, the grantor borrows funds from the trust over a 6-year period equaling $1,080,000. It may be wise to borrow funds in a manner that doesn't align exactly with the payment of LTC benefits to the trust. Please consult an attorney for guidance on a lending process within the ULIT. Interest on this loan will accrue to a total of $309,582. At grantor's death, the minimum death benefit is paid to the trust equaling $72,000.

The results

The principal can be repaid after death with no tax consequences. However, if the loan interest is repaid just prior to death, the $309,582 interest payment is moved from the estate into the trust and is spared from estate taxes (and possible income taxes), saving the beneficiaries $123,833. In addition, when you add the death benefit of $72,000 to the $123,833 in tax savings, the beneficiaries net an extra $195,833. The original cost of the policy was $197,150. The policy paid out $1,080,000 in LTC benefits – borrowed from, now repaid to and residing tax free in the trust for the beneficiaries. Thus, the potential net cost of purchasing a policy paying an amount of $1,080,000 for LTC benefits and helping to protect the inheritance to the beneficiaries by the same amount is just $1,317.

If LTC is never needed, the trust will receive a $360,000 tax free death benefit. In addition, by using this concept, the client does not have to subject themselves to the risk of estate taxation that self-funding would have placed them in. In this example, this may have resulted in avoiding over $400,000 in estate taxes.

The following charts will provide a visual for the concept and the numbers.



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Results upon death after a 6-year LTC claim		
Estate	**Trust**	**Net policy cost**
Repays principal borrowed of $1,080,000	Repaid principal $1,080,000	Single premium paid $195,150
Repays loan interest just prior to death $309,582	Repaid loan interest not subject to estate tax $309,582	Minus tax savings from interest moving from estate into trust -$123,832 (40% tax rate)
The above funds are now removed from the estate	Guaranteed death benefit $72,00	Minus guaranteed death benefit - $72,000
	Total in trust **$1,461,582**	**$197,150 - $123,832 - $72,000 = $1,317** **Net policy cost** **$1,317**

Summary

While every situation is different and must be individually considered, a financial advisor may want to consider the effective use of an indemnity Linked Benefit LTC policy to enhance the amount of inheritance a client could potentially leave to loved ones. In addition, such a strategy may help the high net worth client avoid the downside of exposing a portion of assets to estate taxation by self-funding LTC.

The LTC rider is offered at an additional charge. It is possible for the LTC rider to be offered on a rated basis, which may increase the premium illustrated. Also, keep in mind that as an acceleration of the death benefit, the LTC rider payout will reduce both the death benefit and cash surrender values. Care should be taken to make sure that your clients' life insurance needs continue to be met even if the rider pays out in full. There is no guarantee that the rider will cover the entire cost for all of the insured's long-term care as these vary with the needs of each insured. Inflation protection is not available, so the policy amount purchased today may not provide adequate funds for LTC expenses in the future.

Please note that as your clients' personal situations change (i.e., marriage, birth of a child or job promotion), so will their life insurance needs. Care should be taken to ensure these strategies and products are suitable for long-term life insurance needs. You should weigh your clients' objectives, time horizon and risk tolerance as well as any associated costs before investing. Also, be aware that market volatility can lead to the possibility of the need for additional premium in the policy.

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