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Hybrid Life Insurance and the Pension Protection Act of 2006

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INTRODUCTION

Hybrid long-term-care (LTC) policies are life insurance policies or annuities that are combined with long-term care insurance coverage. They have become much more popular in recent years since the enactment of the 2006 Pension Protection Act (PPA), which favorably expanded on income taxation rules and incentives regarding LTC riders in annuities and life insurance policies to make hybrid policies a more tax-efficient option. Hybrid policies are an alternative to existing stand-alone policies, which have struggled in recent years due to increased premiums and other issues. A vast majority of insurance companies that offered traditional LTC have exited the market over the last decade.

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COMBO, LINKED, AND HYBRID PRODUCTS

A hybrid LTC policy, sometimes referred to as combination/combo, linked benefit, or asset- based contracts, can be either a life insurance or annuity contract with a rider that offers LTC benefits. For example, say a consumer buys a $250,000 life insurance policy with an LTC rider. When the insured individual qualifies for LTC benefits (typically when the individual is unable to perform two of six activities of daily living (ADL) or becomes cognitively impaired), a given percentage of the death benefit, 2% for example, is available each month for LTC needs. This means that up to 2% of the $250,000, or $5,000, is paid out monthly. An annuity-based LTC hybrid policy would also have a ratcheted-up benefit for LTC purposes.

An indemnity-based policy would automatically pay out the $5,000, regardless of actual LTC expenses, while a reimbursement policy would reimburse the actual costs up to the policy limit. Today, tax-free benefits are limited to $360/day or the actual cost, whichever is greater. Some policies have LTC benefits limited to the death benefit, with the death benefit being reduced for any LTC benefits received. However, some companies and products offer riders that will extend cumulative benefits beyond the dollar level of the death benefits, up to two or three times as much. At least one carrier even has unlimited benefits. Additionally, inflation protection and return of premium features, among others, may be available.

Hybrid policies are particularly attractive in three situations:

1. When a client has money in a low-yielding investment so that it may make sense to transfer that asset into asset-based LTC products. This move can offer significant LTC and death benefits while the client doesn't suffer any meaningful lost opportunity cost;

2. For clients who may not be insurable under typical underwriting parameters;

3. For clients who want to reallocate funds from a highly appreciated annuity into a hybrid product in which taxable gain can be avoided.

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Hybrid policies are the product du jour, and it's easy to understand why. In the LTC insurance market, many of the main players of yesteryear are no longer in the individual LTC insurance business today. The number of companies that offer stand-alone LTC policies has dropped about 90% since 2002, including seven of the top 10 insurance players in the LTC market that left from 2001 to 2015.[1] On the other hand, there are more companies than ever in the market offering accelerated death benefits from life insurance policies, and chronic care and LTC riders on life insurance policies and annuities.

One major reason many consumers have been attracted to hybrid products is to avoid the ''use it or lose it'' issue often associated with stand-alone LTC policies. It would be difficult to find a homeowner who was disappointed to not have his house burn down to take advantage of the insurance he'd paid for years, but costs and consumers' concerns over paying dearly for an LTC benefit they may never receive has been a significant deterrent factor for why market penetration of LTC insurance has stagnated in the 9% to 10% range after more than 25 years.

Combo and Hybrid Products are Here to Stay

During 2017, the last year that the insurance industry had statistics, there were approximately 66,000 traditional, stand-alone long-term care policies purchased by the general public, while there were approximately 266,000 combo products purchased in the same time period.

The hybrid market has seen a shift in product design over the last several years. In 2011, 61% of policies were sold on a recurring premium basis, while 39% were single premium policies. In 2017, 89% of policies sold were recurring premium.[2] This shift suggests a growing number of buyers who may not have the financial wherewithal to invest a large lump sum but still want the dual protection these hybrid policies offer. Have these types of combination/hybrid policies become more popular? A June 11, 2018, article by Leslie Scism in the Wall Street Journal is aptly titled, *Long-Term Care Insurance Isn't Dead. It's now an Estate-Planning Tool*. The article goes on to describe the popularity of combo/hybrid plans, and how planners are suggesting the use of these new Combo plans to either pay for needed care, or for estate liquidity.

[1] NOLHGA, State of the U.S. Long-term Care Insurance Industry (March 30, 2017) .

[2] National Association of Insurance Commissioners, Long-Term Care Insurance (March 5, 2019).

It should be noted, however, that the PPA only pertains to non-qualified plan assets, not retirement plan assets in general. The exception is that certain public safety officers can use a limited amount of their pension funds to pay for LTC on a pre-tax basis under specific parameters. At times there seems to be confusion regarding this as even the tax code uses the term ''qualified'' when referring to products that are compliant with the PPA. Using the word ''compliant'' often helps avoid unnecessary confusion.

WHAT WAS THE PURPOSE OF THE PPA?

PPA §844(b) allows annuity and life insurance contracts to include compliant LTC riders in addition to expanding the tax-free exchange of life insurance and annuities for LTC contracts. It also allows for the exchange from a compliant LTC contract to another compliant LTC contract.

Before the PPA, the last in, first out nature of taxation for annuities meant that accessing value from an annuity in a gain position to pay for LTC benefits or LTC premiums was a taxable transaction. Gain may be accessed from a compliant annuity for qualified long-term care expenses tax free when following stated rules and regulations. Doing so provides additional tax benefits and incentives for clients to consider this strategy. Also, in a modified endowment contract (MEC) or a non-MEC contract with no remaining basis, the cost of the LTC rider was considered a distribution and taxed as ordinary income. The PPA changed this and allows for partial tax code §1035 exchanges from annuities to stand alone LTC contracts. This is helpful because there isn't really such a thing as a single-pay stand-alone LTC contract.

The PPA offers an incentive for individuals to obtain private LTC coverage, which can reduce the burden on the government for paying for these costs down the road. The PPA's changes to the tax code §1035 rules still mandate company-to-company transfers of like –to- like exchanges, unlike with individual retirement account rollovers, or the advantages will be irrevocably lost, and all other §1035 rules regarding ''like-to-like'' transactions remain. The expansion of the §1035 rules allow for possible elimination of taxation on the gain from exchanging certain insurance policies for another, not just deferral of taxation, and this can be a significant benefit to taxpayers.

For example, if an annuity with significant gain is rolled into a new compliant annuity (annuities still can't be exchanged into life insurance contracts although life insurance contracts may be exchanged into annuity contracts), hypothetically, the entire value of the annuity could be used to pay for LTC costs, and the taxes on gain will forever be avoided. If there's a

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remaining value to the beneficiaries, it will be taxed as an ordinary annuity.

If an individual or couple concerned about LTC expenses have a life insurance policy in a gain position, assuming continued insurability, the policy could be §1035 exchanged into a life insurance policy with an LTC rider or, in certain situations where insurability is an issue, into an annuity with an LTC rider. If there seems to be a disproportionate focus on tax-free withdrawals from annuities, it is because with non-MEC life insurance policies, basis comes out first anyway.

DRAWBACKS TO A HYBRID

Hybrid policies also have some unfavorable tax ramifications. Many states offer a tax credit that is deducted dollar for dollar from the overall premium. For example, New York offers a 20% state tax credit for traditional stand–alone plans that is not available for the combo plans—meaning that a $5,000 premium less the 20% tax credit becomes a $4,000 net premium. Because the charges for the LTC portion of a contract lower the basis, the ultimate annuity or life insurance basis value will be lower and subject to taxation on more gain than would otherwise be the case, including lowering the exclusion ratio when annuitizing.

Furthermore, hybrid policies aren't compatible with state partnership programs, and tax code §213 tax deductions for medical expenses are no longer allowable for the cost of an LTC rider if the rider charge is deducted from the cash value of the contract. In addition, §213 allowable expenses would be deductible under the rules only for the amount that exceeds LTC payments.

Why Did the Hybrid/Combo Plan Arise?

Many middle-income families that didn't properly plan how to pay for their LTC needs found themselves facing significant costs when a loved one needed to enter a skilled nursing facility. The popular solution for many of these families was to consult with an elder law attorney and arrange their assets so as to artificially impoverish themselves, thereby qualifying for Medicaid (after a waiting period they were able to transfer the costs for this care to the Medicaid program). The costs were staggering, so Congress enacted the Deficit Reduction Act of 2005 (Pub. L. No. 109-171), which limited these growing expenses through numerous measures, including increasing the waiting/eligibility period for Medicaid from three to five years.

In conjunction with that major change in public policy, the federal government, in discussions with the insurance industry, provided tax incentives for hybrid plans as part of the PPA. Although the PPA was signed in 2006, the tax benefits of the hybrid features didn't become effective until 2010, and it took longer for the insurance industry to begin broadly offering these products to the general public.

THE DIFFERENCE BETWEEN LTC AND CHRONIC ILLNESS RIDERS

At times life insurance policies with rider definitions are referred to as §7702B policies vs. §101(g) policies. Tax code §7702B refers to life insurance with long-term care benefits and tax code §101(g) refers to policies with chronic illness riders. Section 101(g) contracts are, fundamentally, accelerated death benefit features where the benefits are treated as paid by reason of the death of the insured and can't be referred to as long term care. Section 7702B contracts include true long-term care benefits, which generally offer more comprehensive coverage.

There are meaningful differences between LTC and chronic illness riders. One difference between the two is in the way in which benefits are triggered. Generally, to trigger a chronic illness rider, not only does the insured have to meet two of six ADLs or a cognitive impairment definition, but also a (decreasing) number of the carriers still mandate that the impairment must be assumed to be permanent. Keep in mind that various states have their own rules governing riders, features, and benefits contained in a life insurance policy. An LTC trigger doesn't need to be permanent. Because chronic illness benefits are generally an advancement of a portion of the death benefit the total benefits are usually less than with LTC riders, which may offer an LTC benefit in excess of the death benefit. LTC riders generally offer a return of premium feature, while chronic illness riders don't. In addition, inflation protection features are generally not available on chronic illness riders.

Some products with a chronic illness rider don't charge a premium for benefits up front, however, when the rider is accessed at claim time, there's a calculation performed that determines benefits. One such rider is the discounted death benefit model. Depending on the age of the qualifying insured and the severity of the impairment, the insurance company will determine the value of the claim on the back end and make an offer to the policy owner. If the individual is old and very sick, this chronic illness benefit may be modestly discounted. However, if the individual is relatively young and has an impairment that isn't life threatening in the near term, the discount may be significant.

Another type of rider is the lien method.This model contains a formula-based payout that's subject to a

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lien at stated interest rates. It's critical to manage the policy appropriately as the lien and associated interests may otherwise threaten the viability of the policy.

It's important to understand that, as opposed to dollar-for-dollar acceleration methods that generally incur an upfront charge for the rider and allow the insured to know in advance the amount of available benefits, with some types of chronic illness riders, the policy owner won't know the precise monthly benefit available for LTC needs or the amount of the death benefit he or she will ultimately receive because the calculations for the benefit aren't performed until the insured individual qualifies for the claim.

It's extremely important for the advisor as well as for their clients to review all of the available options, and make a determination as to what's best based on the client's objectives. Because the great majority of people are not are familiar with many of the available options, nor with the various applicable strategies, they should obtain the advice of an independent experienced life insurance professional familiar with the topic. Then, after understanding and debating the pros and cons of each, an individual or couple can make an informed decision regarding the right course of action.

FINAL THOUGHTS

When a life insurance policy with an LTC or chronic illness rider is placed into an irrevocable trust, there's a question as to whether the triggering of the benefit is considered an incidence of ownership. Some say when the benefit is an indemnity policy, there's no problem, but when the type of policy is a reimbursement policy, as is often the case with a chronic illness rider, there could be a problem with incidence of ownership. However, with the estate tax exemption at $11.4 million, it's less of an issue for most individuals, and for those high-net-worth individuals who would be affected, leaving the LTC benefits in the trust and spending estate assets could be considered a form of non-taxable gifting.

As a hidden benefit, the PPA and the resulting hybrid policy options may open the market up to younger people who are in need of life insurance protection today but may desire LTC protection later—perhaps at a time when no longer insurable or able to qualify for a new LTC policy.

Most of the money to pay for long-term care costs continues to come from the government in the form of Medicaid, so there will likely be other incentives to try and encourage consumers to pay for their own long-term care needs. The array of products available and tax benefits made possible by the PPA have created a new and sophisticated planning tool that in the opinion of the authors, far too few clients have yet taken advantage of. There are some relatively new tax benefits, incentives, and strategies within the PPA that will allow a client to be more flexible in their short- and long-range planning, and obtain the maximum value from their annuities, life insurance, and long-term care insurance expenditures. In our opinion the PPA was a very significant and successful first step taken by the government toward encouraging the general public to pay for a larger percentage of their own long- term care expenses. They should be commended for their efforts and encouraged to continue in their efforts.

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