# Using LTC Riders in Estate Planning

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Long-term care (LTC) planning has been one of the hottest topics in the financial services industry and will continue to be so as the population of the United States continues to age; making this potential issue something that should be seriously addressed when doing retirement and estate planning for clients.

People with moderate wealth as well as high net worth clients may be good candidates for long-term care planning. While trust planning may not be necessary for some clients, those individuals have worked hard to accumulate assets and should not have to watch those savings dwindle away due to long term care expenses. More affluent clients who need formal trust planning should also be analyzing their potential long-term care needs. While the ultra-wealthy may be able to self-fund, they may still want to consider the risk of self-funding long-term care needs and explore other options and opportunities. Life insurance, with the addition of a indemnity LTC rider, can provide liquidity for potential estate taxes, provide additional opportunities for flexibility, and tighten up loose ends that self-funding LTC can create in the estate plan.

Estate planning includes preserving wealth as well as creating wealth. We'll start by discussing preservation of wealth for the more affluent client. Clients with high net worth will often have a need for liquidity to cover potential estate taxes. Life insurance owned by irrevocable life insurance trusts (ILIT) have long been used in estate planning to provide those funds and keep the death benefit out of the estate. However, when it comes to long-term care, many high net worth clients feel they can afford to self-fund their potential LTC needs. But is self-funding in the traditional sense the most efficient use of their assets?

## THE DOWNSIDE FOR THE WEALTHY SELF-FUNDING LTC

Let's take a look at potential effects of how self-funding LTC may not be the best solution for many affluent people. In order for the high net worth client to self-fund, they must have assets available to them that are liquid and accessible inside their estate in the event they encounter a LTC situation that needs funding. Let's assume this client sets aside $1,000,000 for this purpose. If the client actually needs LTC and spends through most or all of the $1,000,000, then the self-funding plan worked well enough. However, if the client needs none or very little of the assets set aside, there is a cost to being "lucky" enough to not need LTC, as these funds could be left subject to estate taxation. Assuming a 2022 maximum estate tax rate of 40%, up to $400,000 of the $1,000,000 could be taxed if it was never needed for LTC expenses (assuming holding on to this additional $1,000,000 puts the client's estate over the exempt amount). But there is a way to potentially avoid the financial risk of self-funding inside of the estate.

## AN ALTERNATIVE SOLUTION

Traditional long-term care insurance (LTCi) policies are intended for clients who are looking only to cover long term care needs. For clients with potential estate tax liabilities there is an alternative solution that may better fit their overall planning strategy. A life insurance policy owned by an ILIT, with the addition of a LTC rider that pays indemnity benefits, may be used to fund LTC needs while maintaining the goal of providing funds for paying estate taxes. We'll discuss that concept momentarily, but first it is important to understand the difference between an indemnity and a reimbursement plan - and why an indemnity plan can work in an irrevocable life insurance trust.

### Indemnity vs. reimbursement

Long-term care benefits are generally paid in one of two ways, through an indemnity plan or a reimbursement plan. For illustrative purposes, we will assume the plan in each example has a $5000 per month benefit.

A reimbursement plan is just what is sounds like – it reimburses the policy owner for expenses already incurred. Most reimbursement plan insurance companies also offer direct billing and reimbursement between themselves and the care provider. Either way, bills and receipts must be submitted each month to the insurance company, who then determines which

expenses qualify for reimbursement. Any expenses not covered are paid out of pocket. In our example, the reimbursement plan may provide a maximum $5,000 LTC monthly benefit, but if the qualifying expenses only add up to $3,000, then the reimbursement is only $3,000. Reimbursement plans may be problematic in an ILIT. Bills and receipts will need to be submitted by the trustee each month creating a mass of paperwork and potential expenses if the trustee is paid for their time. If the insurance company and care provider participate in direct billing, the result could create a chain of events that may be construed as a violation of IRC §2042 by providing a direct link from the ILIT to the grantor/insured and destroy the integrity of the trust. An attorney should be consulted.

Indemnity plans however, pay the full LTC benefit directly to the owner of the policy. Generally, no bills or receipts need to be submitted in order to receive monthly LTC benefits, and the actual LTC expenses of the insured are not considered when paying LTC benefits. If an insured qualifies for a $5,000 monthly benefit, $5,000 is sent to the owner of the policy each month. Thus, an indemnity plan can work within a ILIT because the LTC benefit, without regard to expenses of the insured, is sent directly to the owner of the policy, which in the case of trust ownership would be the trust/trustee. The life insurance policy is essentially funding the ILIT with cash via payment of an accelerated death benefit. *(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.)* 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. But from here flexibility exists, and various strategies may be implemented.

## HOW THE CONCEPT WORKS

An Ultimate Life Insurance Trust (ULIT) is used, which is a type of ILIT used for the purpose of getting LTC rider benefits from the trust. The ILIT is made "defective" for the purpose of being able to access funds from the trust by using arm's length fully collateralized loan provisions. The loan must be legitimate - secured by property pledged by the Grantor/Insured, with interest charged, and an agreement to fully pay back the debt. Collateral can be anything that covers the debt; a house, artwork, coin collections, etc., as long as the asset has a legitimate fair market value. Collateral can be pledged all at once, or can be pledged along the way as long as there is always adequate collateral pledged to cover the full amount of the current loan balance.

The interest rate charged should be at least equal to the guaranteed interest rate charged on the life insurance policy (although in this concept there will be no loan taken against the policy itself). Because a larger interest debt allows for more funds to be paid from the estate to the trust, using an appropriate interest rate on the high side may work best.

Ideally, the loan interest is allowed to accrue, but the loan interest should be paid back prior to the death of the Grantor/Insured if possible, as this will avoid income taxation on the interest paid to the trust. The plan can be set up if desired for the repayment of interest on a periodic basis to hedge against the risk of all interest being taxable at death, though this will impact the overall accrual of debt. In either case, the taxable estate will be further reduced with the repayment of interest from the estate on the loan transaction created with the ILIT.

**The process of taking the collateralized loans**

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

- File a claim for the LTC benefit
- After the policy's elimination period (during which the claim is verified), monthly LTC benefit checks will be sent to the trustee as policy owner
- The grantor, upon pledging property as collateral, borrows money from the ILIT
- Those funds can be used to pay LTC bills or used for a variety of other purposes
- Interest is not repaid immediately, but allowed to accrue to purposely increase the debt
- Ideally, interest is repaid from estate assets just prior to death – thus remaining tax free to the ILIT
- At the grantor's death, the loan principal is repaid from estate assets. The amount of the accrued interest, as well as the loan principal, has been removed from the estate assets for taxation purposes - leaving a smaller tax liability.
- Keep in mind that any interest repaid after death will be treated as taxable income to the trust

## DOING THE MATH

Let's look at an example of a client with a potential $3,000,000 estate tax liability. A life insurance policy with a $3 million death benefit could be purchased and owned by an ILIT (ULIT). A $1 million LTC rider could be added to the policy. This will allow for $1 million of the $3 million death benefit to be available for LTC needs while the insured is alive. (As outlined previously, LTC riders paying indemnity benefits may make more sense with this strategy and that is what we will illustrate here.) The advantage is that fewer assets need to remain inside the estate allocated to pay LTC costs, thus helping to eliminate the risk of unused funds being estate taxed if little or no LTC is needed. Should long term care be needed, the ILIT has provisions that allow funds to be accessed in a way that does not destroy the estate planning purposes of the trust. If no LTC is needed, a $3 million death benefit will be paid to the ILIT, providing funds to offset estate or other tax burdens. (Due to New York state requirements, the structure of this concept must be slightly different for NY cases. Policies issued in NY require the death benefit and the LTC rider amount to be equal at policy issue. Therefore, two policies should be considered. Using this case as an example, one policy will be written for $1 million with the addition of the LTC rider for $1 million, and a 2nd policy will be written for $2 million with no LTC rider.)

When the insured needs LTC services, the trustee will file a claim, and after the policy's elimination period (during which the claim is verified), the trustee, as owner of the policy, will start receiving the full tax-free monthly LTC benefits. Once LTC benefits begin, no bills or receipts will need to be submitted for consideration, since the insurance company pays the full benefit amount with an indemnity policy. At that point, the collateralized arm's length loan provisions maybe enacted. The trustee may loan money to the insured to help defray LTC costs. We will assume that the grantor is borrowing $10,000 a month from the ILIT and that 7% interest is charged on the loan. If the insured dies 8 years and 4 months after going on claim (just as the LTC benefits are exhausted), the estate has a debt to the ILIT for the principal amount of $1 million. We will assume for this example all interest (in this case totaling $352,000) was repaid just prior to the death of the grantor.

The result is that the taxable estate is further reduced by the total amount of the loan principal repaid to the trust, as well as the interest repaid prior to death. The ILIT will receive the remaining death benefit of $2 million from the insurance company as well as the loan principal of $1 million repaid by the grantor's estate. This will result in the death benefit plus repaid loan principal equaling $3 million, the original death benefit amount planned for. Already added to trust assets was the accrued loan interest of approximately $352,000 repaid by the grantor's estate. If repaid prior to death, the entire amount of interest will be income tax free to the trust due to the grantor trust status. (Any amount of loan interest repaid after death will be income taxable to the trust as grantor trust status no longer exists).

## THE NUMBERS

When insured/grantor needs LTC services

- Nationwide® pays the LTC benefit to the ILIT trustee ($10,000 per month in this example)
- Insured/grantor borrows funds from trust (per the loan provisions) to pay LTC expenses
- Accrued interest debt totals $352,000 – (which is repaid just prior to death)
- Insured/grantor dies just as LTC benefits are exhausted
- Principal debt totals $1,000,000
- Total debt to trust - **$1,352,000**

At insured/grantor's Death

- Death claim is filed – remaining death benefit of $2,000,000 is paid to trust
- Interests debt was repaid just prior to death equaling $352,000
- Estate repays the principal debt of $1,000,000
- Estate has now repaid the total debt of $1,352,000
- Estate has been drained of an additional $352,000 which is no longer subject to estate tax
- Tax savings on this amount – at 2022 rates of 40% - $140,800
- Trust also now holds $3,352,000

Final result

- The trust possesses the **$3,000,000** planned for liquidity to pay any estate tax liability
- Repaying the loan interest from the estate prior to death results in potential estate tax savings of **$140,800**
- PLUS – the trust has an additional **$352,000** (less income tax if repaid after death).

The final result may be more assets held in the trust – with fewer assets left in the estate to be taxed. In addition, even if the LTC rider is never accessed, the cost of the rider would likely be far less than the cost of estate taxes caused by self-funding long-term care inside of the estate.

## OTHER FLEXIBLE SOLUTIONS PROVIDED BY A TRUST OWNED LIFE/LTC POLICY

An indemnity LTC rider may also provide flexible solutions for clients who may later find they need to spend down additional assets left in the estate to further control estate tax liabilities. In this case, the insured would pay their long-term care expenses directly from estate assets, thus lowering the total amount subject to estate taxation at death. Upon filing a claim, LTC benefits would be paid directly to the trust as previously stated. Assuming the terms of the trust allowed, the cash assets generated by the acceleration of death benefit could be used for some of the following scenarios:

- Funds could be distributed to beneficiaries by the trustee as a type of "early inheritance"
- Funds could also be held in the trust to be distributed at a future date
- Funds could be re-invested for potential growth of trust assets

## LTC RIDERS ON SURVIVORSHIP POLICIES

It is now possible to purchase a survivorship policy with LTC rider coverage on one or both insureds. The concept of using arm's length collateralized loans is virtually identical as laid out above. However, there are some additional details that should be considered by the client's attorney when planning to use this concept with a survivorship life insurance policy. These considerations include:

- Neither insured can be a trustee of the ULIT/ILIT
- The loan provisions should state that the loan principal is not due for repayment until after the death of the second insured. It is important that no principal repayment will be required upon the first death. This is to assure that the surviving spouse is not burdened with the debt, and that the debt can be repaid upon the second death from estate proceeds as outlined previously outl.
- Keep in mind all interest should be repaid prior to the second death to keep it from being taxed as income to the trust.

## FOR CLIENTS WANTING TO CREATE OR PRESERVE AN ESTATE

While moderately affluent clients may have no need for trust planning, such clients may find using the combination of life insurance with a LTC Rider a good solution for their financial strategy. A pool of money is generated that can pay for LTC needs during the insured's lifetime through an acceleration of the death benefit, helping to protect other assets from being depleted by long term care bills. If long-term care is never needed, or the LTC benefit is only partially accessed, any remaining money not used for LTC expenses is paid to the beneficiary as a federal income-tax-free death benefit. For families without trust needs for estate tax purposes, it provides a way to help cover long term care costs while allowing for the possibility of creating a larger inheritance for beneficiaries. And the "use it or lose it" concern is eliminated, as the policy benefits will ultimately be paid to someone no matter what direction life takes.

## IN SUMMARY

Long-term care is a subject that should be addressed in insurance needs analysis planning whether a trust is involved or not. In addition, traditional long-term care policies should be discussed as a possible remedy in LTC planning. But for many clients, the purchase of a life insurance policy with the addition of a LTC rider will prove to be an appropriate solution. One of the advantages of using such a rider is that someone is going to receive the benefit, whether it is the policy owner receiving LTC benefits, or the beneficiary receiving a federal income-tax free death benefit. In addition, many of these policies can be purchased with guaranteed premiums. Whether doing an estate plan for a high net worth client, a moderately affluent client or doing basic retirement planning for middle income clients, some form of long-term care planning should be a part of the financial picture.

This material is not a recommendation to buy or sell a financial product or to adopt an investment strategy. Investors should discuss their specific situation with their financial professional.

This material is designed to provide general information about ideas and strategies. It is for discussion purposes only since the availability and effectiveness of any strategy are dependent upon your client's individual facts and circumstances. Clients should always consult with their independent attorney and/or tax advisor before implementing any financial, tax, or estate planning strategy. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws. Failure to do so could result in adverse treatment of trust proceeds.

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