Recalibrating Retirement Spending and Saving

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Chapter 13

Tax Issues and Life Care Annuities

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A life care annuity (LCA) is an integrated insurance product consisting of life annuity and long-term care insurance (LTCI) segments. It addresses inefficiencies in the separate private markets for its component parts—adverse selection, which increases the price of life annuities, and strict underwriting, which restricts the availability of LTCI. In this chapter, we argue that, by lowering prices and increasing availability, an LCA may be more attractive to retirees making critical choices in financing their lifetime retirement spending and insuring against the bankrupting contingency of severe disability. This attractiveness, in turn, may decrease pressures on government social insurance and welfare programs, such as Social Security and Medicaid, which are already underfinanced. This chapter first explains the present and future tax treatment of the LCA, both as an after-tax product and in a qualified retirement plan, and then turns to describe the product idea and its motivation in more detail.

Description of, and Motivation for, a Life Care Annuity

In return for the payment of one or more premium charges, an LCA product will pay a stream of fixed periodic income payments for the lifetime of the named annuitant, and, for a higher premium charge, any named co-annuitant survivor. These payments may be fixed in nominal terms, increasing, or inflation indexed. In addition, the LCA pays an extra stream ('pop-up') of fixed payments if the annuitant (and/or the co-annuitant) has severe cognitive impairment or is unable to perform without substantial human assistance at least two of the six recognized activities of daily living (ADLs), such as walking or eating. These are the same triggers used in LTCI policies that may be qualified under current tax law.

Because this pop-up segment of the LCA is intended to function as comprehensive LTCI, it is important that the level of the additional layer of payments to the disabled annuitant be sufficient to cover the extra expenses incurred for home health care or nursing home care, perhaps increasing

with the degree of disability and therefore the costs of providing care. Over time, such costs of care have risen rapidly, often in excess of the rate of general inflation, and therefore inflation-indexing or automatic increases of the level of disability payments would seem particularly advantageous for these segments. That being said, it is difficult to set a standard level of payment for the LTCI portion, given substantial geographic variation in costs of care, as well as different personal preferences and means of payment for care (e.g., private vs shared room). Even more so, the appropriate or desired level of payments in the first or life-annuity segment of the LCA will vary considerably from household to household, reflecting preferences, means, and so on.

The premium (or premiums) charged for an LCA product would depend on many factors. Obviously, the number of insured, and whether there is a survivor benefit, would be influential. Risk factors such as the age(s) of the annuitant(s) at the start of the income payments also affect the price, but other observable risk factors may be prevented from being used by law or by marketing acceptance. Most significantly, of course, the premium of the LCA will reflect the level of income and disability payments being guaranteed and whether inflation indexing is to be applied to either or both segments. The premiums charged on newly issued contracts will change over time, inversely with movements in interest rates available in the financial markets on fixed-income investments used to underpin the LCA, as well as with changes in expected trends in mortality and disability experience.

The integration of two already widely available products, life annuities and LTCI, is intended to address inefficiencies in the separate markets for those products. Research by Friedman and Warshawsky (1990) and by Mitchell et al. (1999) has shown that the costs of immediate life annuities increase by as much as 10 percent because of adverse selection by mortality risk classes in voluntary choice situations (i.e., individuals with lower life expectancies avoid life-annuity purchase). Using simulation analyses using a life-cycle framework and reasonable estimates of risk aversion, this work also showed that a large improvement in utility could be achieved by the annuitization of assets at fair actuarial value in retirement. But this improvement in welfare is, at least in part, blocked by market inefficiencies. Especially for couples, deviation from fair value (i.e., loads arising from adverse selection and marketing costs) dissuades annuity purchases (Brown and Poterba 2000).

On the LTCI side, Murtaugh, Kemper, and Spillman (1995) show that insurance company underwriting practices prevent 25–33 percent of the retirement-age population (age 65–75) from purchasing individual LTCI policies because individuals in impaired health or unhealthy lifestyles cannot purchase LTCI. Brown and Finkelstein (2004*a*), using simulation

analysis, predict a substantial willingness to pay for actuarially fair private LTCI coverage on top of Medicaid, by individuals in most income groups. So, here too, market inefficiencies compromise otherwise large welfare gains available from insurance markets. Many of these research findings about annuities and LTCI are confirmed by observations from the insurance industry, including high rejection rates on LTCI policy applications at older ages, and discussions among actuarial professionals of annuity pricing.

Nevertheless, enhancing the attractiveness of life-annuity and LTCI coverage is an important public policy issue. Employer's provision of retirement income support for workers has moved, for many, to the defined contribution (DC) plan form, where a life-annuity distribution is not required and indeed is not often even offered. Accordingly, the retiree must now search in the voluntary individual annuity market if he or she would like to purchase a life annuity at retirement. Even for workers covered by defined benefit (DB) pension plans, mandatory annuitization has become less common, and therefore the scope of adverse selection may have increased. Moreover, nearly all proposals for Social Security reform envision lower growth in scheduled retirement benefits, that is, life-annuity payments. Hence, the potential scope for the voluntary life-annuity market and the resulting need to improve its efficiency may be expected to get larger still.

In 2005, the US Congress tightened eligibility for the long-term care benefits of Medicaid because it was concerned with apparent abuses of the spend-down eligibility requirements as well as by the runaway program costs. Indeed, research by Brown and Finkelstein (2004*b*) demonstrates the substantial crowd-out effect of Medicaid on the desire for private LTCI coverage, even without considering possible efforts to 'game' the system. Hence, as Medicaid eligibility tightens, private LTCI coverage will become increasingly important for the lower ranges of the income and wealth distribution, and general concern about market inefficiencies will increase. Moreover, the conventionally proposed solutions by the insurance industry given the obvious problems of tight underwriting—sales of individual LTCI policies at young ages or employer provision of the benefit, where underwriting is a less significant factor—have not found wide favor in the marketplace. In addition, there is a natural focal point for the LCA in household life-cycle planning, namely, when that household is approaching or has just begun retirement and is considering the rest of its financial future in a serious way.

The idea of the LCA as a product that results in a more efficient market and better insurance product is an application of the economic insights of Rothschild and Stiglitz (1976). Specifically, it is a practical attempt to produce a self-sustaining pooling equilibrium that is superior to the separating equilibria currently in existence where insurance coverage is restricted

and/or highly priced. The LCA works so as to blend the low-mortality risks of annuity buyers who would like cheaper life annuities with the high-disability (and -mortality) risks of those desiring, but currently denied access to, LTCI coverage, combining these population pools of risk classes. To the extent that there is a positive correlation between impaired health and mortality probability, an integrated insurance product that combines the life annuity and LTCI can draw disparate risk groups together in such a way that there is less adverse selection and less need for strict underwriting.

In their prior work, Murtaugh, Spillman, and Wershawsky (2001) proposed three hypotheses about the LCA:

1. The life expectancy of voluntary purchasers of an integrated product will be less than that of voluntary purchasers of life annuities;
2. With minimal medical underwriting, less severe than current underwriting for LTCI, the cost of the integrated product will be less than the sum of the cost of the two products sold separately (here minimal underwriting means that only those who would go immediately into claim status for LTCI benefits, e.g., nursing home residents would be rejected for the LCA or, alternatively, face coverage delays of, say, two to three years); and
3. The subpopulation eligible for, and likely to be attracted to, the integrated product will be larger than that eligible for, and attracted to, the two products issued separately.

The authors' empirical analysis suggested that only about 2 percent of the age 65+ population would be rejected by the lower underwriting standards, as opposed to 23 percent rejected by current underwriting criteria. The mean expected remaining life of the purchasers of the LCA at age 65 is 18 years, compared to 19.5 for current annuity purchasers. Hence, Murtaugh, Spillman, and Wershawsky (2001) provided support for their first and third hypotheses. They also calculated the premium at age 65 for a unisex individual for the simplest integrated product described above, and the authors reported that it would cost about 4 percent less than the two products sold separately. Finally, they also gave evidence for the assertion that a self-sustaining pooling equilibrium is likely. In particular, they showed that those who are rejected by current LTCI underwriting, but who would be eligible for the LCA, are made better off in simple value terms. That is, the ratio of actuarially fair premiums for the relevant risk groups (major illness, stroke, poor lifestyle) relative to those for the expanded purchase pool is above one for the LTCI coverage. The pooling property of this positive effect on value should be enhanced when the expected utility ('insurance') value of LTCI coverage is considered, to say nothing of the insurance value of having a life annuity.[1]

Possible Venues for the Life Care Annuity

Next, we explore two main forms of the LCA: an individual after-tax fixed annuity product, and a before-tax qualified retirement plan/individual retirement annuity. Home equity extraction through reverse LCA mortgages should also be considered eventually, as well as variable and gift annuities and other existing vehicles for distributing resources in retirement. The LCA might be a good distribution choice for personal retirement accounts in a reformed Social Security system.

LCAs as After-Tax Annuity Products

An LCA could be thought of as an individual immediate fixed annuity product; if purchased with after-tax income, this would be the most direct and straightforward application of their findings. As we explain below in more detail, the LCA could be offered as an immediate life annuity, with LTCI structured either as a single- or level-premium rider or as a contingent annuity. On the other hand, the market for immediate annuities is quite small at present. The after-tax deferred fixed annuity product which represents a much larger market could also be used as a venue for the LCA. In practice, the life-annuity distribution option under deferred annuity contracts is seldom used at present. Nonetheless, marketed deferred annuities contain the valuable right for the insured to get a life annuity at the better of the terms specified in the policy contract or as an immediate annuity available in the marketplace, and this right may be used increasingly in the future.[2] Moreover, inclusion of a deferred annuity product in the broad LCA concept framework could also result in the desirable outcome that LTCI coverage is provided even before any life-annuity distributions are made.

Of late, a few insurance companies have tentatively introduced product offerings that contain certain elements of the proposed product as either deferred or immediate annuities with LTCI riders. Reportedly, the relevant state insurance departments were mostly satisfied with the products, but federal tax issues with the combination product led to difficulties and ultimately caused these companies to stop issuance. Nevertheless, as is detailed below, an after-tax LCA will be more tax favored, beginning in 2010, owing to the passage of the PPA of 2006 (P.L. 109-280).

LCAs in Connection with Qualified Retirement Plans

An LCA could take various forms in a qualified retirement plan. One option would define it as the normal accruing benefit of a DB pension plan, with the LTCI segment denominated as some proportion of the final

benefit. Thus for an average-wage full-career employee, the plan could be designed such that the level of disability-contingent benefits accrued would be sufficient to cover nearly all expected LTC needs. Another option would have the LCA added as an alternative choice to the DB pension plan's distribution options, just like various joint-and-survivor payout options are currently available at cost. In particular, if the plan sponsor would like to respond positively to a demand from participants for lump-sum distributions or already has a lump-sum distribution choice, but is concerned about the impact of adverse mortality selection on the cost of its annuity offering, providing the LCA could be an effective and responsible response. Moreover, provision through a retirement plan may be a more popular way for employers to offer LTCI coverage to workers than through group LTCI plans.

Similarly, if the sponsor of a DC plan offered a life-annuity distribution option, the LCA could be added to the menu of payout choices. Life-annuity options are currently somewhat rare in the DC context, but a few employers are offering their workers a service of rolling over DC account balances to pre-negotiated individual retirement annuities from one or a few insurance companies. Others offer their workers the option of rolling over DC account balances to the DB plans that, of course, pays out benefits as life annuities. And, indeed, insurers are increasingly viewing retirement plans, especially 401(k) plans, as fertile ground for new annuity products. More broadly, it is important to consider individual retirement accounts (IRAs) as a home for the LCA, which would open a very large market. Yet as is explained below, various regulations may pose significant hurdles to the LCA in qualified retirement plans, and its tax treatment under current law is unknown or unclear, and perhaps adverse.

Table 13-1 shows total assets in various types of retirement plans and annuities to give a sense of the relative magnitudes where the LCA could reside. It would be even more relevant here to report accrued DB plan liabilities rather than assets, but these are not readily available on a consistent basis for state and local government plans. For private DB plans, currently, assets are just about equal or slightly exceed accrued liabilities, according to estimates based on financial accounting information; for government plans, there are reports that liabilities are significantly higher than assets, especially if these pension liabilities were to be marked to the market.

Current Tax Treatment of Life Annuities and LTCI When Issued as Separate Contracts

Next, we turn to a discussion of tax treatment of different products underlying the LCA construct.

Table 13-1 Total Assets in Annuities and Pension and Retirement Plans (as of 12/31/06)

	Assets (billion $)
Private DB plans[a]	2,308.0
Private DC plans[a]	4,060.0
IRA accounts[a]	4,232.0
Annuities[a]	1,624.0
Federal government DB plans[b]	918.8
Federal government DC plans[b]	223.5
State and local government DB plans[c]	2,776.0
State and local government DC plans[c]	240.0
Total assets	16,382.3

Sources: [a] Investment Company Institute (2007); [b] Investment Company Institute (2007) and Thrift Savings Plan (2006) as of 12/31/2006; [c] Investment Company Institute (2007), Public Fund Survey (2007), and Watson Wyatt estimates.

After-tax Individual Life Annuity

Annuity payments from individual life annuities are treated partially as taxable income and partially as an untaxed return of the policyholder's cost, or 'investment in the contract.' In general, an annuity's investment in the contract is recovered in equal increments over the annuitant's expected remaining life, although the details differ for 'nonqualified' and 'qualified' annuities. Nonqualified annuities are those not paid from a qualified employer plan or other qualified savings plan, such as an individual retirement account (Brown et al. 1999). The investment in the contract as of the annuity start date is used to determine the annual annuity exclusion amount.[3] It equals the sum of premiums or other consideration paid for the contract before the annuity start date, less any refunded premiums, dividends, or other amounts that were received before that date but which were not included in gross income. Premiums paid for additional coverages (say, disability or double indemnity coverages) are excluded from investment in the contract.

Under the general rule for taxing nonqualified annuities, one must compute the contract's 'expected return,' or the total amount that annuitants can expect to receive under the contract. For life annuities, it is obtained by multiplying the annuity's initial periodic (annualized) payment by the annuitant's life expectancy in years. The latter is determined using published unisex tables from the Internal Revenue Service (IRS).[4] Published tables are also available for determining the expected return for temporary life annuities (where the number of total payments is limited), for joint-and-survivor annuities (where a periodic income is paid until the death of

one annuitant, and an equal or different amount is paid until the death of a second annuitant), and for joint life annuities (where payments are made only if both named annuitants remain alive). For cases not covered by the published tables, taxpayers must request a ruling from the IRS to determine the contract's expected return. Dividing investment in the contract by the contract's expected return yields the contract's 'exclusion percentage.' This percentage is multiplied by the first regular periodic payment, and the result is the tax-free-exclusion amount of each annuity payment. This exclusion amount remains the same for all years, even if the annual annuity payment changes.

Once investment in the contract is recovered through annual exclusion amounts, then the annuity payments are fully included in gross income. Any unrecovered investment in the contract remaining at the death of the last annuitant is allowed as a miscellaneous itemized deduction on the last return of the final decedent. This deduction is not subject to the usual floor on miscellaneous deductions (equal to 2 percent of adjusted gross income (AGI), but it is allowed only for those (deceased) taxpayers that itemize their deductions on their final return.

For variable annuities, investment in the contract is simply divided by the number of expected payments to yield the tax-free-exclusion amount for each payment.[5] If the annual tax-free amount is more than the payments received for the year, then the excess may be divided by the expected number of remaining payments, and the result added to the previously determined exclusion amount.

Contract distributions that are not periodic annuity payments (including policy loan proceeds) are generally taxed in full if received after the annuity start date. If received before the annuity start date, distributions are generally taxable, but only to the extent that the contract's cash value (determined immediately before the amount is received) exceeds investment in the contract at that time (i.e., such distributions are taxed on an 'income-first' basis). Under certain circumstances, taxable distributions not received as an annuity payment are subject to an additional 10 percent tax.

Qualified Long-term Care Insurance Policy: Premiums and Benefits

A qualified LTCI policy enjoys certain tax benefits under current US law. To be qualified, the contract must meet certain conditions. Among these is the requirement that the only insurance protection provided under the contract is coverage of qualified long-term care services.[6] An exception to this restriction exists under current law for LTCI provided as a rider or as part of a life-insurance contract and, after 2009, for LTCI provided as a rider or as part of an annuity policy. In addition, the contract cannot provide a

cash surrender value that can be borrowed, paid, assigned, or pledged as collateral for a loan. Premium refunds and policyholder dividends must be applied as a reduction in future premiums or as an increase in future benefits, except when paid as a refund on the death of the insured or upon complete surrender or cancellation of the contract. Any refund cannot exceed the aggregate premiums paid under the contract. A qualified long-term care contract must also meet certain consumer protection requirements specified in law.

A qualified LTCI policy may pay benefits on a per diem or other periodic basis without regard to the actual long-term care expenses incurred. However, such payments are subject to a per diem limitation. This limitation is set at $260 in 2007, and it is also indexed to the medical-care component of the Consumer Price Index (CPI). The aggregate of such LTCI benefits must be added to any periodic 'accelerated death' payments received (tax-free) by a chronically ill insured from life-insurance policies. Any excess of the aggregate payment over the per diem limit, calculated for the period of coverage, is treated as taxable income.

A qualified LTCI policy is treated as a health or accident insurance contract, and benefit payments are treated as amounts received for personal injuries and sickness, implying that such benefits are generally excludable from taxable income. Amounts received from qualified policies are treated as reimbursement for expenses actually incurred for medical care. Employer-provided coverage under a qualified LTCI contract is treated as an accident and health plan, so that employer-paid premiums are excludable from employee income. Nevertheless, LTCI cannot be offered as part of an employer cafeteria plan.

Qualified status also bestows tax benefits as regards premiums. Premiums paid on individual qualified policies, up to specified age-based, inflation-indexed limits, are treated as medical insurance premiums, and thus as potentially deductible medical-care expenses. The excess of medical-care expenses over 7.5 percent of an individual's AGI is deductible as a 'below-the-line' itemized deduction. Finally, premiums on qualified LTCI contracts may be paid from a health savings account (HSA) established in connection with a high-deductible health-insurance policy. Because HSA amounts are pretax amounts, such a use of HSA funds effectively allows a full exclusion of amounts used to pay qualified LTCI premiums.

Life Annuity and Long-term Care Insurance in a Qualified Retirement Plan

The life annuity is currently the required default form of distribution in qualified pension plans (i.e., DB and money purchase DC plans). There are various regulatory requirements that must be met for distributions in this

form. Moreover, if a DC plan offers a life annuity as a distribution option, these requirements must also be met when a life annuity is chosen. A few of the requirements even extend to IRAs. Interpreted strictly, some of the requirements would likely prevent, or at least impair, the offering of an LCA in a qualified retirement plan or as an individual retirement annuity, and therefore legislative and/or regulatory adjustments may be needed to facilitate LCAs within such plans.

Minimum Distribution Requirements

Minimum distribution requirements have been established under section 401(a)(9) of the Internal Revenue Code (IRC) to ensure that retirement plans and IRAs serve their intended purpose to support income security in retirement, and not as tax avoidance schemes to accumulate assets on a favorable tax basis for wealth transfer to another generation. In general, taxable distributions from the plan or IRA must start at retirement or age $70^1/_2$, whichever is later, and be no less than a specified percentage of the account balance. If the distributions are in the form of a life annuity, then, according to the regulations, all annuity payments must be nonincreasing or increase only in accordance with one of six specifically allowed exceptions. For example, payments may increase in accordance with annual increases in the CPI, or they may increase to pay higher benefits resulting from a plan amendment.

These regulations do not contemplate distributions through an LCA, and hence that form or product would likely be disallowed under a strict reading of the regulation. That being said, the LCA does not appear to fall under the concerns that originally prompted the rules—the entire corpus of the account balance or accrued benefit is paid out over the lifetimes of the participant and spouse under the LCA, with nothing held back beyond any guaranteed periods chosen otherwise allowable under the regulation. Hence, it is possible that the LCA could be included as an allowable distribution form through an administrative process mentioned explicitly in the minimum distribution regulation. Under that process, the IRS Commissioner could provide more guidance on additional benefits that may be disregarded for individual accounts, or for other methods of increasing distributions from a pension plan. In the alternative, the regulation itself could be amended to make the necessary allowances.[7]

Sex Neutral Pricing of Life Annuities

As a result of Supreme Court decisions prohibiting the use of sex-specific mortality tables for group retirement benefits, pension plans and insurance companies issuing annuities to participants through employer-sponsored

retirement plans must price life annuities using unisex mortality tables and determine benefits accordingly. This is in contrast to the general practice of insurance companies in the individual commercial market where life annuities (both on an after-tax basis and in IRAs) are priced on a sex-distinct basis. It should be noted, however, that current commercial practice in the individual market for LTCI is to make no distinction by sex in pricing, despite ample evidence that women, as a class, have a significantly higher incidence of longer LTCI claims (Murtaugh, Spillman, and Wershawsky 2001, Brown and Finkelstein 2004*a*). When offered as an employee benefit, LTCI clearly has to be priced on a unisex basis, by force of law, as would the LCA.

This legal requirement for unisex pricing could vitiate some of the reduction in adverse selection that is one of the goals of the LCA, as a unisex-priced product is more attractive to women than to men. That being said, the effect may be small, as most workers approaching retirement are married, and another legal requirement, explained immediately below, encourages the selection of joint-and-survivor annuities. Of course, the individual nonemployer market is not subject to the unisex rulings of the Supreme Court, and therefore is affected only indirectly, if at all, by those rulings.

Joint-and-Survivor Requirement

All tax-qualified pension plans provide that retirement benefits payable as a life annuity to an employee married to his or her current spouse for at least one year will be automatically paid in the form of a qualified joint-and-survivor annuity, unless the participant elects otherwise with the consent of the spouse. There are multiple provisions in law and regulation to ensure that surviving spouses receive more than a token stream of income from the annuity. DC plans must also follow these rules if they offer an annuity as a distribution option and the participant elects it. The rules do not apply, however, to IRAs and individual retirement annuities.

Again, these rules do not envision an LCA as a distribution option, and hence it is unclear if and how these requirements would be applied to the LCA. It is possible, but uncertain, that a regulatory interpretation would arise having the joint-and-survivor requirements applied just to the life-annuity segment of the integrated form, thereby leaving the plan participant in control of the choice whether the LTCI segment, as an ancillary benefit, was to just the participant or also for the spouse.[8] Alternatively, rules could be written to reflect a public policy desire so that a joint-and-survivor requirement similar to current law should apply to the LTCI segment as well.

Incidental Benefits

In recognition of their tax-advantaged status and to focus their design and activities on certain desired public policy goals, Treasury and the IRS, even before the passage of ERISA in 1974, limited employer-sponsored retirement plans to certain types of benefits. In general, medical benefits may only be provided if they are subordinate to the plan's retirement benefits and are paid from a separate account established for such benefits. Without language in existing laws and regulations specifically referring to LCAs, it is not immediately clear how the IRS would view the LCA as part of a qualified retirement plan. It is possible that it would regard the LTCI segment of the LCA as akin to disability benefits and therefore allowed as a customary pension benefit. Yet such benefits are usually considered for workers who retire because of a disability, not people who encounter a disability subsequent to retiring.

Alternatively, the IRS might take the view that the LTCI segment is a type of retiree health insurance, and hence, as long as it is 'incidental' to the retirement benefits, it would be permitted. In a pension plan, the LTCI segment would be allowed under the specific requirements of section 401(h) (e.g., a separate account, specified benefits), or in a profit-sharing plan (most section 401(k) plans are profit-sharing plans), it would apparently be more generically allowed. Also asset transfers under section 420 from an overfunded pension plan might be allowed to pay for the premiums for the LTCI segment of the LCA. A requirement for section 401(h) treatment of the LTCI segment of an annuity distribution form in a pension plan, however, would be inconsistent with an optional distribution mechanism—the most likely design to be embraced by plan sponsors.

The IRS could alternatively take the position that the LCA as part of a retirement plan was not envisioned by these regulations and hence it would need a more formal and well-defined clearance by a change in the incidental benefit regulation or legislation.

'Current Law' Taxation of the LCA in a Qualified Retirement Plan

On the bold assumption that the various regulatory challenges mentioned above (some of which are themselves related closely to tax treatment) facing the inclusion of the LCA in a qualified retirement plan or IRA were surmounted, what would be the likely current law tax treatment of the LCA premium and the life-annuity payments and LTCI benefits in that venue? To the extent that employer and employee contributions to the retirement plan or IRA were made on a pretax basis, then obviously all the payments from the life-annuity segment would be included in taxable income. What about the benefits from the LTCI segment? It is possible that the benefits

could be treated exactly as an incidental disability benefit ('contingent annuity') from the plan and therefore included in taxable income, but not triggering a taxable distribution from the plan for the payment of a premium charge. Or benefits could be treated as a separate stand-alone qualified LTCI policy, where benefits are not included in taxable income, without triggering a distribution from the plan.

The allowance of 'health insurance' tax treatment outside of section 401(h) would require a bold interpretation by the IRS that, in the absence of a clear statement of law, the LTCI segment of the LCA in a retirement plan should receive 'all-in' tax treatment more favorable than that of a stand-alone qualified LTCI policy. It may be unlikely that the IRS, on its own, would allow a situation where the LTCI segment premiums would be essentially deductible (a full 'above-the-line' deduction) and benefits not included in taxable income. This would require the IRS to grant tax treatment superior to a qualified LTCI policy, under which premiums are rarely deductible, and then only subject to specified limits. The IRS would also note the provision in the PPA, mentioned below, that the favorable tax treatment of the LCA issued in an after-tax individual annuity is not available in employer plans and IRAs. On the other hand, employer payments for LTCI premiums in a group insurance plans or through HSAs and health reimbursement arrangements are not included in employee income and the IRS could find some comfort for favorable treatment there.

A different outcome would be one where the premiums for the LTCI segment would be considered to represent taxable distributions from the plan. In this case, the LTCI premiums might or might not be deductible from income (depending on the individual's income and tax situation and whether the LTCI policy was considered qualified) and benefits, as insurance would not be included in income.

The treatment of benefits is also unclear if the LTCI segment does not represent a qualified LTCI policy. The tax code is silent as to the treatment of benefits received from nonqualified LTCI contracts. It is possible that, as payments to retirees, they could be treated simply as taxable distributions from the plan. In this case, however, the amount of unreimbursed medical-care expenses would be higher, and the probability of deducting that larger amount would be fairly high for most people. For certain taxpayers, however, the loss of the standard deduction, a need to itemize deductions on their tax return, and the lack of a deduction equal to 7.5 percent of AGI are significant considerations. In addition, for some taxpayers, an increase in their gross income will increase the amount of Social Security benefits that are included in taxable income, and this distinction would become important, as we show below. In addition, if payments from the LTCI segment take the form of per diem or other periodic payments which are higher than the costs of qualified long-term services, then the question of

the contract being qualified or not may be important; the excess payment amounts might be taxed if the policy were nonqualified, tax exempt if qualified and not too large.

As is illustrated below, this tax treatment would be inferior to the treatment provided under the PPA of 2006 to the LTCI segment of an after-tax, nonqualified, LCA issued after 2009. It is also inferior to an IRS position under which the LCA would be considered, not as an insurance policy, but as a contingent annuity. Finally, it would be inferior to the proposed policy that provided an 'above-the-line' deduction of LTCI premiums from gross income. The PPA provides an income tax exclusion for pension distributions that are used to pay for qualified health insurance premiums up to a maximum of $3,000 annually. This exclusion is available only to retired or disabled public safety officers but may be used for health insurance or LTCI. This is equivalent to an above-the-line deductibility of LTCI premiums, and, it is, by far, the most generous tax treatment currently available. It remains to be seen whether this limited PPA treatment will serve as a model in future legislation for the tax treatment of LTCI, whether as part of a LCA, or, otherwise, for a more widely defined set of retirees.

Tax Treatment of Life Annuities and LTCI When Combined in an After-Tax Product

Next, we turn to a discussion of tax treatment of different LTCI and annuity products when they are combined in an after-tax vehicle.

Life Care Annuity (Treatment through 2009)

Under current US law, combining an LTCI product with an annuity automatically causes the LTCI product to be nonqualified. It is clear that this denies an itemized medical-care deduction for any recognized LTCI premiums. However, a reasonable argument may be made for treating an LCA as a single (contingent) annuity contract. In this case, the cash premiums paid into the contract (whether funding the annuity portion or the LTCI portion) would constitute the annuity's investment in the contract, and thus would be excludable over the expected remaining life of the policyholder. In addition, under this single contract concept, there might not be any tax consequence associated with charges against annuity cash values for LTCI coverage. There is a question, however, as to whether the expected LTCI benefits should be taken into account in determining the contract's expected return. If added to the expected return, they would lower the annual exclusion amount; and recovery of investment in the contract could occur over a period of years in excess of the owner's expected remaining

life. In the illustrations presented below, we have not included the contingent payments in the LCA's expected return.

A life-insurance contract combined with LTCI is treated as two separate policies under current law. This will also be true for a combined annuity-LTC contract after 2009 under the PPA. An inference might be made, therefore, that such treatment should apply to such combined policies under current law. In this case, it is possible that premiums, investment in the contract, and cash value of an LCA might have to be allocated between the annuity and long-term care portions.[9] Also, LTCI charges against the annuity's cash value would likely be viewed as taxable distributions from the contract.

It is unclear as to how benefits of a nonqualified LTCI contract are treated. While the tax code specifies that benefits from a qualified LTCI contract are to be treated 'as amounts received for personal injuries and sickness and shall be treated as reimbursement for expenses actually incurred for medical care,' the code is silent regarding the treatment of benefits from nonqualified long-term care contracts. Even less clear is the treatment of per diem payments from nonqualified LTCI. In the analysis below, we treat indemnity benefits generally as being bona fide insurance reimbursements for medical care, but are conspicuously silent regarding the legal status of per diem payments. Alternatively, we could have assumed that payments from nonqualified LTCI are treated simply as additions to gross income, potentially allowing greater itemized deductions for the costs of long-term care services. This view is adopted when analyzing the 'contingent annuity' below.

Life Care Annuity (Treatment after 2009)

The PPA altered the treatment of LTCI when combined with an annuity. In particular, it explicitly allows LTCI (whether qualified or not) to be offered by rider or as part of either a life-insurance contract or an annuity contract. In this case, the portion of the contract providing long-term care coverage is treated as a separate contract, but the law is silent as to whether this separate treatment requires an allocation of contract premiums or cash values.[10] The relevant provisions of the Act generally apply to contracts issued after 1996, but only with respect to taxable years beginning after 2009. Thus, although state regulators have the ultimate authority in approving insurance products, the PPA acknowledges that such a combined product can exist after 2009 without the LTCI portion losing its tax qualified status. This treatment, however, has not been extended to employer plans and other tax-exempt trusts, to IRAs or annuities, or to contracts purchased by an employer for the benefit of the employee or his or her spouse.

The PPA provides that any charges against the cash value of an annuity contract or life-insurance contract for coverage under a qualified LTCI contract will not be includable in taxable income. Such premium charges will not be treated as medical expenses for purposes of the itemized medical-care deduction, and the investment in the contract of the annuity or life-insurance policy will be reduced by the amount of the charge. The premium charge continues to be tax-exempt even if the investment in the contract is zero. Only under this circumstance will the provision provide an exclusion for the full amount of qualified long-term care premiums.

While clarifying the treatment of LTCI premiums that take the form of explicit charges against the cash value of the annuity or life-insurance contract, the PPA's language is less illuminating regarding the treatment of a policy that is not a rider with explicit charges, or of cases where the full cost of LTCI is not embedded in the specified rider charges. For LCAs, the more premium that one can allocate to the annuity's investment in the contract, the greater the tax savings will be.

Possible Structures of the Life Care Annuity and Illustrations of Tax Treatment

There are several different ways in which the LCA could be structured, and the particular format may influence its tax treatment.

LCA structures

One can imagine at least three different ways of integrating the LTCI policy with an annuity. One way is to set up the LCA as a life annuity with a single-premium LTCI policy rider. As such, an annuity is purchased, from which an immediate charge against it is made for the purchase of an LTCI policy. Subsequently, no more charges are made against the annuity for LTCI premiums. Another way of structuring the LCA is as a life annuity with an LTCI policy rider with an annual premium. As with the single-premium LTCI rider, charges are made against the annuity cash value to finance LTCI premiums, but the charges are made over the life of the policyholder. That the premium is not paid fully up front would presumably allow greater flexibility for either the policyholder or the insurer should future circumstances change. A final way of structuring the policy is as a contingent annuity, in which payments rise in the event of disability, but there is no explicit purchase of an LTCI rider. Such a policy would require an initial premium roughly comparable to that of a life annuity with a single-premium LTCI rider.

Illustrations

How the LCA is structured could play a large role in determining how it would be taxed. Furthermore, individual characteristics, particularly Social Security benefits, other sources of income, and health-care expenditures, also play a key role in determining how taxable income varies. A couple of simple illustrations bear this out.

In this exercise, two individuals are considering the purchase of the LCA whose LTC portion is organized in one of the three ways described in the prior section. The first way is as a level-premium LTCI rider, the second way is as a single-premium LTCI rider, the third way is as a contingent annuity that is treated as an annuity contract by the IRS. The issue of premium savings arising from purchasing an LTCI policy in conjunction with a life annuity is ignored here, as all policies can be assumed to be part of an LCA. Thus, we assume that the LCA pays nothing beyond what is required to finance LTCI premiums or benefits.

All three LTCI arrangements are assumed to be purchased by a single individual at age 65. They pay out $140/day, with 5 percent annual inflation compounding, in the event long-term care services are needed; these payouts are assumed to cover exactly the cost of qualified long-term care services. The expected present discounted value of the policy, in all cases, is $45,583. Thus, the single-premium LTCI policy and the LTCI portion of the contingent annuity will cost $45,583 up front, and the level-premium policy will cost $4,008 annually. In order to fund this level premium, the up-front cost of the LCA must be increased by $45,583, given the assumed mortality and morbidity assumptions.

Projected utilization is assumed to be a function of mortality. Each claim is expected to last for 760 days, spanning three years' time. Those who encounter disability are assumed to die at the end of the third year. Additionally, each individual is assumed to have $1,200 in unreimbursed medical expenses each year, not associated with qualified long-term care services. Each individual is assumed to purchase a life annuity at the same time that costs $136,300, which pays $12,000 annually. Other income is assumed constant over time, except for Social Security benefits, which are assumed to grow at 2 percent per year. Long-term care deductibility limits, which are $2,950 annually for 61- to 70-year-olds and $3,680 for 71-year-olds and older, are expected to increase at 4 percent per year. The discount rate is assumed to be 6 percent.

The first individual, characterized as having moderate income, is assumed to start with $12,000 in Social Security benefits and $7,000 in other taxable income. The second individual, characterized as being of high income, receives $75,000 annually in additional taxable income. For the high-income individual, the issue of taxable Social Security benefits is

ignored, because this individual would be subject to the maximum tax rate for Social Security benefits in every year. As mentioned above, each individual also receives $12,000 (nonindexed) in individual annuity income.

This exercise estimates taxable income for the two individuals under the three different structures of LCA in three different regimes: before the implementation of the PPA, after implementation of PPA, and if, instead, LTCI premiums were subject to an above-the-line deduction. Over the past several session of Congress, above-the-line deductions for LTCI premiums have been proposed. This would allow all individuals to deduct LTCI premiums up to the annual cap regardless of whether they itemized their deductions or of whether their medical expenses exceeded 7.5 percent of AGI.

The tax impact is calculated relative to that where an immediate life-annuity policy and a qualified single-premium LTCI policy are purchased as separate contracts, under the (unrealistic) assumption that the aggregate pretax cost of the two separate policies equals the pretax cost of the LCA. Under this baseline, the moderate-income individual is able to deduct some medical expenses in the first year, because the sum of other medical expenses and tax deductible LTCI premiums in the first year exceeds 7.5 percent of AGI. The high-income individual cannot deduct any LTCI premiums. Table 13-2 shows the tax impact of the different scenarios relative to the baseline, with the tax impact measured as the differences in the actuarial present value of each individual's tax liabilities for the expected remaining lifetime.[11]

Under current law (pre-PPA), purchasing the LCA with a level-premium LTCI rider will increase taxable income relative to purchasing separate single-premium contracts. The annuity generates a return that is taxable,

Table 13-2 Net Effect on Taxable Income of Purchasing Lifetime Care Annuity Under Different Arrangements

Moderate Income	*Level Premium ($) LTCI Policy*	*Single Premium ($) LTCI Policy*	*Contingent ($) Annuity*
Before 2010	22,568	31,139	(17,657)
After 2009	(3,267)	(3,806)	(3,806)
w/ATL deduction	(23,590)	28,189	(17,657)
High Income			
Before 2010	15,878	15,878	(23,787)
After 2009	(8,571)	(8,286)	(8,286)
w/ATL deduction	(25,137)	12,928	(23,787)

Source: Authors' calculations.

Notes: LTCI policy refers to a long-term care insurance policy; ATL Deduction refers to an above-the-line deduction.

subject to the exclusion over time of the initial LCA premium, and the LTCI premiums are treated as a taxable distribution from the annuity, and thus includable as income.[12] For the moderate-income individual, the additional income paid out by the annuity increases the taxable Social Security benefits. The result is, in expectation, an increase in taxable income of $22,568 for the moderate-income individual, and an increase of $15,878 for the high-income individual.

The PPA will allow the exclusion of the distributions from the annuity cash value used to pay for the level-premium LTCI, a considerable tax benefit relative to current law. The corresponding reduction in the investment in the contract accelerates the exhaustion of that investment in the contract. For the moderate-income individual, this translates to a slight increase in the expected taxable Social Security benefits, and a slight reduction in other deductible medical expenses. Overall, the net impact is a reduction in taxable income of $3,267 for the moderate-income individual and a net reduction in taxable income of $8,571 for the high-income individual.

To model the effects of an above-the-line deduction for LTCI premiums, we imagine how above-the-line deductibility to LCAs before the implementation of PPA might have been granted. We posit that charges against annuities for the purposes of paying LTCI premiums would be fully taxable, but the premiums would be deductible above-the-line up to the annual cap on deductible LTCI premiums. The original investment in the annuity contract would be excluded over the expected remaining lifetime of the annuitant; but charges for LTCI premiums would not accelerate the exhaustion of that investment as under PPA. Consequently, an above-the-line deduction of LTCI premiums would further increase tax benefits conferred upon the level-premium LTCI policy. Deductibility of premiums above the line would reduce taxable income, increasing the amount of other deductible medical expenses for the moderate-income individual. And deductibility of premiums would not require an offsetting reduction in annuity basis, which would be excluded over the expected remaining lifetime of the individual. The net reduction in taxable income is substantial: for the moderate-income individual it is $23,590, and for the high-income individual, it is $25,137.

Single-premium policies, both before and after implementation of the PPA, receive similar tax treatment as level-premium policies. Before 2010, charges against the annuity for the single LTCI premium are included in taxable income. Because the charge is so large, for the moderate-income individual, Social Security benefits are taxable in the first year. For the high-income individual, the net effect on taxable income is identical for the single-premium LTCI policy and the level-premium LTCI policy. As with the level-premium policy, after 2010, the charge against the annuity for

the LTCI policy is not taxable. There are some minor differences between LCAs with level-premium LTCI riders and those with single-premium LTCI riders as regards the timing of the exhaustion of investment in the contract which has minor ripple effects on deductibility of other medical expenses and taxable Social Security benefits. But the overall effect is to improve the tax treatment for the LCAs with single-premium LTCI riders relative to the baseline by roughly the same magnitude as LCAs with level-premium LTCI riders. However, extending an above-the-line deduction for LTCI premiums that supersede the relevant measures in the PPA causes the LCA to be treated much as it would under current law, with the exception of a one-year deduction of the capped limit on LTCI premium, currently $2,950 for a 65-year-old.

The contingent annuity, assuming it is viewed strictly as an annuity by the IRS, before 2010, would receive considerably more favorable tax treatment than the other two arrangements. Unlike with policies that require taxable charges to finance LTCI premiums, the entire premium is excludable as investment basis over the course of the remaining life of the annuitant. This exclusion lowers taxable Social Security benefits for the moderate-income individual in years without disability. If payouts are made, additional Social Security benefits become taxable for that individual. And the payouts raise taxable income considerably, but most of them are deductible because qualified medical expenses easily exceed 7.5 percent of AGI in those years. Projected taxable income falls by $17,657 for the moderate-income individual and $23,787 for the high-income individual. The PPA, however, uses broad language in defining insurance coverage as part of an annuity contract, raising the question of whether the IRS would allow a contingent annuity to be defined as strictly an annuity contract without an LTCI component. If the IRS requires this to be treated as two separate contracts, then the taxation of the product would likely be the same as for a life annuity with a single-premium LTCI rider, as shown in Table 13-2. Because we model the effects of allowing an above-the-line deduction for LTC insurance before implementation of PPA, we show that the tax treatment of the contingent annuity under above-the-line deductibility of insurance premiums would revert back to the pre-2010 treatment, before the product was assumed to have an LTCI component.

It would seem that the contingent annuity would offer more favorable tax treatment for anyone before the implementation of the PPA. Yet in the absence of clear guidance from the IRS, insurers may be fearful that such a product would not be granted the tax advantages detailed here. After the implementation of PPA, however, LCAs with traditional LTCI policy riders are clearly granted considerably more tax advantages than are currently available. Above-the-line deductibility would increase the tax advantages further for LCAs with level-premium LTCI policy riders.

Conclusions

Combining LTCI with an immediate life annuity into a single policy, the LCA, will result in a lower total price for the combined product less adverse selection in the individual annuity market, and greater availability of long-term care to more retired households, when compared to offering the two products separately. This chapter discusses two principal venues in which this product might be marketed: a qualified retirement plan, and an after-tax individual annuity. We explain both the tax and the regulatory treatment afforded to the product, highlighting the uncertainties that arise largely because of the different tax and regulatory treatments of stand-alone annuities and LTCI policies.

Looking ahead, we argue that the PPA will make the LCA a tax-preferred way of obtaining LTCI coverage, but that an above-the-line deduction of qualified LTCI premiums would provide an even greater tax preference. Such a preference was recently bestowed on distributions from qualified retirement plans of public safety officers used to purchase qualified LTCI.

Notes

[1] Moreover, sensitivity analysis demonstrated that the likely 'wood-work' effect on disability claims, as well as inflation indexing of the LTCI segment, increase value to those currently rejected by LTCI underwriting, and therefore further support the second maintained hypothesis that the integrated product will be cheaper and more desired, in a self-sustaining pooling equilibrium.

[2] The recently enacted PPA of 2006 expanded the tax-free exchange provisions contained in the IRC. After 2009, a policyholder will be able to exchange tax-free both a deferred annuity and a deferred annuity-LTCI integrated product for an immediate annuity-LTCI integrated product (or a stand-alone LTCI contract). However, the policyholder will not be able to exchange tax-free a stand-alone LTCI contract for an LCA.

[3] The annuity start date is generally the first day of the first period for which one receives an annuity payment under the contract (which may be earlier than the date of the first payment).

[4] In general, for contracts under which all contributions were made prior to June 30, 1986, the annuitant must use sex-based tables published by the IRS. However, for annuity payments received after that date, the annuitant can make a one-time election to use the unisex tables.

[5] This is similar to the simplified method used for taxing payments from qualified annuities, although different tables are used to determine the number of expected payments.

[6] Qualified long-term care services are necessary services (including personal care services) that are required by a chronically ill individual and are provided pursuant to a plan of care prescribed by a licensed health-care practitioner. A chronically ill individual is one that is generally unable to perform at least two out of six

listed ADL for a period of at least 90 days due to a loss of functional capacity, or one that requires substantial supervision due to severe cognitive impairment. To qualify as an itemized medical-care deduction, a qualified long-term care service cannot be performed by a spouse or other relative (unless such person is a licensed professional with respect to the service).

Au: please check the change of acronym from 'LCTI' to 'LTCI'.

[7] The PPA of 2006 allows the combination of an annuity with an LTCI contract after 2009. It further states that the LTCI component will be treated as a separate contract, which seemingly would allow the minimum distribution rules to apply only to the life-annuity segment of a qualified plan LCA. However, the Act also states that a qualified employer plan or individual retirement account is not to be treated as an annuity contract for the purpose of the above separate contract rule, so that the impact of the Act on the issue at hand is somewhat unclear.

[8] This treatment would be similar to how the required minimum distribution rules treat a plan that also offers a disability pension—the disability benefit is considered separate from the retirement benefit. But the analogy may be stretched too far, as the IRS has taken the position that disability benefits cease once the participant attains the normal retirement age stated in the plan.

[9] Such allocations are not explicitly required under current law or the PPA. However, under an allocation regime, there would be an incentive to overstate the annuity's share of premiums, so as to maximize the amount of premiums that could be recovered through the annuity exclusion ratio.

[10] As under current law with respect to life-insurance combined products, 'portion' is defined as 'only the terms and benefits that are in addition to the terms and benefits under a life-insurance contract or annuity contract without regard to long-term care insurance coverage.'

[11] In these illustrations, the 'Before 2010' entries are computed on the basis that the PPA was not enacted. That is, under the PPA, the tax treatment of a contract issued after 1996 will change in 2010; we assume that it will not.

[12] We consider payouts for LTC services under the single-premium and level-premium riders as reimbursement for qualified LTC services, and thus excludable from taxable income. If the IRS considered the LTCI riders in either the single-premium or level-premium examples as components of an annuity, however, payouts from the LTC component would not be considered as reimbursements from an insurance policy, and the amount would be fully taxable. Nonetheless, LTC expenses would be deductible to the extent qualified medical expenses exceeded 7.5 percent of AGI, so the net tax impact would only be slightly higher than the amounts shown in the table.

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