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## GREAT NEW TAX BREAKS ON LONG-TERM-CARE INSURANCE

**T**he Pension Protection Act of 2006 naturally focuses on retirement funding. However, the costs of long-term care (LTC) can demolish a retirement nest egg. In the new law, Congress attempted to make the purchase of LTC insurance more affordable. New tax breaks were added.

**Smart:** Even though the new tax features don't kick in officially until 2010, you can take steps now to start the process of acquiring this insurance with untaxed dollars.

### LTC RIDERS

**What's new:** The new law permits LTC riders (attachments) on annuity contracts bought from insurance companies.

**Prior law:** Such riders were specifically allowed for life insurance policies but not for annuities.

**Advantage:** It makes it official that LTC riders can be added to annuities without losing the tax advantages of annuities (tax deferral) or LTC insurance (explained below).

**How LTC riders work:** You buy a life insurance policy or an annuity that includes one of the riders. If you end up not needing long-term care, the rider need not be used.

However, if you do need care at some point, the contract's benefits can be tapped to pay for it.

**Example:** John S. buys a \$1 million life insurance policy with an LTC rider. If John goes into a nursing home, the policy will pay the costs.

Suppose the policy winds up paying \$200,000 to the nursing home. At John's

death, the policy's beneficiaries would collect \$800,000 instead of \$1 million.

**Explaining the appeal:** Policies providing only LTC insurance are "use it or lose it" vehicles. If LTC is not needed, the money spent on insurance is never recovered.

On the other hand, *someone* will benefit from a combination product including an LTC rider. If LTC is not needed, the annuity or the life insurance policy will pay out in full.

**Caution:** The extra coverage comes with an extra cost. You should not buy such a hybrid unless you want life insurance or an annuity. An "annuity," in this context, generally refers to a deferred annuity, in which the investment account can grow on a tax-deferred basis.

However, if you do want insurance or an annuity, adding an LTC rider is a cost-effective way to protect yourself and your family from the expense of long-term care.

### QUALIFYING FOR TAX BREAKS

Under the new law, the LTC component of such combination products generally will be treated as a separate contract.

**Why this matters:** This permits the LTC rider to be considered a "tax-qualified" LTC insurance policy.

**Required:** LTC policies must clear these hurdles to be tax qualified...

- To receive insurance benefits, the insured individual must be unable to perform at least two of these "activities of daily living" (ADLs)—eating, bathing, dressing, getting out of bed, toileting, continence.

- A health-care professional must certify that these conditions will last for at least 90 days.

- Alternatively, the insured individual will be eligible to receive benefits if he/she requires supervision to protect himself from threats to his health and safety due to severe cognitive impairment, and this condition has been certified by a licensed health-care professional within the previous 12 months.

If these conditions are met, LTC policies offer two tax benefits...

**1. Premiums may be deductible,** if your total medical expenses exceed 7.5% of adjusted gross income. The maximum annual deduction in 2007 rises from \$290 for people age 40 or younger, to \$3,680 for people over age 70.

**Special loophole:** Self-employed individuals can take a full deduction for premiums paid.

**2. Benefits are not taxable** for amounts received up to \$260 per day in 2007 or for costs incurred for LTC services, if greater.

All of the numbers above are valid for 2007 and will be indexed for inflation in future years.

**Note:** Qualified LTC services are those required by a "chronically ill" person and are given by an LTC provider according to a plan of care prescribed by a licensed health-care practitioner. If those conditions aren't met, the costs might not be covered.

### CASHING IN

As combination products become more widely available, another provision of the new law will provide tax breaks for acquiring the LTC coverage.

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**How it will work:** The combined contract's overall cash value can be used to pay for the LTC rider.

**Loophole:** If you access the cash value of a life insurance policy or an annuity to fund an LTC rider, the money moving from one place to another will be excluded from your gross income. Under prior law, you would have picked up taxable income from such transfers.

**Bottom line:** This section of the new law will allow LTC insurance to be acquired with pretax dollars, within a life insurance policy or an annuity.

**Caution:** Such payments will not be deductible. Therefore, if you have no need for life insurance or an annuity, you'll be better off buying a pure LTC policy and taking whatever deductions might be available.

If you do buy a combination product, any LTC benefits paid will reduce the cash value of the insurance policy or the annuity.

#### **POLICY EXCHANGES**

The new law also changes the rules for so-called "1035 exchanges," named after a section of the Tax Code.

**New rules:** Life insurance policies, annuities, and tax-qualified LTC insurance policies can be exchanged for tax-qualified LTC policies, if you find a policy with better features. No tax will be due. Formerly, LTC policies weren't included at all.

**Riders, too:** Moreover, the new law states that life insurance policies and annuities still will be eligible for tax-free exchanges, even if they have LTC features. Again, this makes combination products more appealing.

#### **PLANNING AHEAD**

As mentioned, the changes listed above will not take effect until 2010. However, you don't have to wait until 2010 to buy a combination product. Hybrid policies—especially those combining life insurance with LTC insurance—have been on the market for years. The new law means you can buy these products now, if you wish, in anticipation of using the new tax breaks in the future.

**Strategy:** Even if you don't want to buy a hybrid now, you can make additional payments to a deferred annuity or permanent life insurance policy. Cash value will build up, tax deferred. In 2010 or beyond, you can use that cash value to buy LTC coverage with untaxed dollars, within the existing contract or with an exchange. ■ ■