Nationwide® is on your side

A more tax-efficient way for high net worth clients to fund long-term care

Shawn Britt — CLU®, CLTC®
Director, LTC Initiatives, Advanced Consulting Group

Key takeaways

- Many high net worth individuals self-insure for potential long-term care expenses.
- Self-funding could result in unnecessary estate taxes.
- An indemnity LTC benefit within an irrevocable life insurance trust offers a solution.

Many high net worth (HNW) individuals feel that because they can afford to self-insure their potential long-term care (LTC) expenses, they don't need LTC coverage. However, for these clients, a primary goal of estate planning is preserving wealth, and LTC expenses can put a large dent in the estate. In that light, is self-funding potential LTC expenses the most efficient use of assets?

In addition, self-funding carries potential challenges, including:

- It's hard to predict the rate of return that will be earned on the self-funded assets
- It's hard to predict when — or even if — funds will be needed for long-term care
- A weak link in the estate plan — exposure to avoidable estate taxes — is created

Self-funding could result in unnecessary estate taxation

Individuals preferring to self-fund would want to have liquid assets available inside of their estate in the event they need LTC.

Let's assume an HNW individual sets aside $1 million for long-term care expenses. If they end up spending most or all of the $1 million, then the self-funding plan worked well enough. However, if little or none of the funding that was set aside for LTC expenses gets spent (and we assume the highest 2024 estate tax rate of 40%), estate taxation could result in a tax bill of up to $400,000.

A potential, cost-effective solution

To avoid this pitfall, your client could purchase a linked-benefit LTC policy that pays indemnity benefits and is owned inside an irrevocable life insurance trust (ILIT).

The primary purpose of a linked-benefit policy is to provide the maximum leverage of LTC coverage with a guaranteed premium. There is a death benefit on the policy, which assures that the premium paid is protected from loss if the policy is little or never used.[1] The death benefit is accelerated first to pay LTC benefits, and then a second bucket (extension of benefits) takes over to continue paying benefits until the elected benefits are exhausted. An asset is repositioned, or income is directed on an annual basis to purchase the policy.

Linked-benefit LTC policies can generally be paid for with a single premium or short pay schedules of up to 10 years. Some companies offer the option to pay over 20 years, to age 65 or to age 100. Some companies also allow the policy premiums to be paid monthly, purchasing the same benefit pool as an annual payment mode.

Why an indemnity policy?

An indemnity LTC benefit can work within an ILIT because the benefit would be sent directly to the owner of the policy — in this case, the trust/trustee. The policy would essentially fund the trust with cash via the payment of an acceleration of the death benefit and then from the extension of LTC benefits.

There is no reimbursement of actual LTC expenses on behalf of the insured. The insured individuals should never be given LTC benefits directly, nor can they have claims against the trust for these funds.

Instead, the insured individual, called the "grantor" in trust documents, borrows from the trust to pay for expenses as explained below.

With a carefully designed ILIT using an indemnity linked-benefit LTC policy, the insured can indirectly access funds by borrowing from the trust to pay for LTC expenses.

How the concept works

The trust is written with provisions that allow for arms-length, fully collateralized loans. The loan must be legitimate and secured by property pledged by the insured individual, with interest charged and with an agreement to fully pay back the debt. Collateral may be anything that can be appraised or given a fair market value. The insured individual (grantor) can pledge collateral as they borrow as long as the value of the collateral stays current with the total loan balance.

The interest rate charged should be at least equal to the interest that would be charged on a loan from the life insurance component of the policy. The higher the interest rate, the better this concept works, but the rate must remain reasonable because it is a secured loan. Interest is allowed to accrue to intentionally increase debt, which, in this case, is an advantage.

Ideally, interest would be paid back just prior to death to avoid income taxation to the trust. At the death of the grantor/insured, the loan principal and any unpaid interest would be repaid to the trust. That same amount would then be deducted from the calculation of estate assets subject to estate taxation, leaving a smaller estate tax liability. Principal can be paid back after death with no tax liability.

When the individual incurs LTC expenses:

- The trustee will file a claim for the LTC benefit
- After the claim is approved and the elimination period is met, monthly LTC benefit payments will be sent to the trust
- The individual borrows funds from the trust upon pledging proper collateral
- These funds can be used to pay LTC ancillary expenses without any restrictions
- Interest is allowed to accrue to purposely increase the debt, but should be paid back prior to death to avoid income taxation to the trust; cash or appraised property can be used to pay debt
- At the grantor's death, the loan principal and any unpaid interest is repaid to the trust; that same amount is deducted from the calculation of assets subject to estate tax

Working the numbers: A hypothetical case study

Maria, a 60-year-old female nonsmoker, qualifies for the couple rate, usually a discounted rate for purchasing a joint policy with your spouse. She will use part of her lifetime exemption to gift $196,032 to an ILIT. The trust will purchase, own and be the beneficiary of a linked-benefit LTC policy that pays indemnity benefits and provides a 6-year benefit pool of $1,080,000 in total benefits. The trust will include the loan provisions needed for this concept using an 8% interest rate.

If the benefits are completely exhausted, her estate will receive a guaranteed minimum death benefit of $72,000. The LTC benefit amount paid to the trust will be $15,000 per month.

Scenario 1: Maria needs LTC

The ILIT trustee will file a claim for the LTC benefit and borrow $1,080,000 from the trust over a 6-year period. It may be wise to borrow amounts that do not align exactly with LTC benefit amounts.[2] Interest of $309,582 will accrue, and if repaid prior to Maria's death, will be spared from estate and possibly income tax, saving $123,833. Upon her death, the guaranteed minimum death benefit of $72,000 is paid to the trust.

After Maria dies, her estate will repay the loan principal, incurring no tax consequences. The policy paid out $1,080,000 in benefits at a net cost of $199, as illustrated below.

Scenario 2: Maria never needs LTC

Upon Maria's death, the trust would receive a $360,000 tax-free death benefit. More importantly, she would not have subjected herself to the unnecessary estate taxation that self-funding could cause. In this example, as much as $400,000 in estate taxes (40% tax rate) could be avoided.

The net outcome of not needing LTC would be the $360,000 death benefit plus up to $400,000 in tax savings. After subtracting the cost of the policy of $196,032, an additional $563,068 could be left to heirs.

IF ALL LTC BENEFITS ARE USED

Original cost of the linked-benefit LTC policy:

$196,032

Minus the sum of $72,000 in death benefits and $123,833 in estate taxes saved:

$195,833

Net cost of the policy:

$199

IF NO LTC BENEFITS ARE USED

$360,000 in death benefits and $400,000 in tax savings equals:

$760,000

Minus the cost of the policy:

$196,032

The additional net amount going to heirs:

$563,968

Summary

Regardless of whether or not a high net worth client ever needs long-term care, purchasing and making an ILIT the owner of a linked-benefit LTC policy can result in additional funds being transferred to heirs and avoiding the unnecessary taxation that self-funding LTC expenses could create.

APPROVED FOR FINANCIAL PROFESSIONAL USE WITH CLIENTS

• Not a deposit • Not FDIC or NCUSIF insured • Not guaranteed by the institution
• Not insured by any federal government agency • May lose value

[1] This assumes there are no withdrawals or loans taken from the policy that would result in an adjustment of the LTC benefits and death benefit. Some policies may not pay a death benefit that is fully equal to premiums paid, depending on the carrier and product. Please refer to the policy illustration and contract.

[2] Some of the plans of this type will set up the interest to be repaid on a periodic basis to hedge against the risk that all interest could be taxable at death, though this will impact the advantage of compounding of the debt. Please consult an attorney for guidance on a lending process within the ILIT.

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.

Federal income tax laws are complex and subject to change. The information in this memorandum is based on current interpretations of the law and is not guaranteed. Neither Nationwide nor its employees, its agents, brokers or registered representatives give legal or tax advice.

Life insurance guarantees are subject to the claims-paying ability of the issuing company.

Nationwide, the Nationwide N and Eagle and Nationwide is on your side are service marks of Nationwide Mutual Insurance Company. Third-party marks that appear in this message are the property of their respective owners. © 2024 Nationwide

NFM-23756AO.1 (06/24)