

## TAX ISSUES TO CONSIDER WHEN BUYING A LONG-TERM-CARE POLICY

When buying a long-term-care insurance policy, consumers typically focus on benefit payments, features and cost. An issue that's often overlooked but that needs to be examined early on is whether the plan qualifies for federal and, in some cases, state tax deductions.

Companies often issue tax-qualified and nonqualified versions of an LTC plan. Many advisors consider the tax benefits of the tax-qualified plan essential, in part because it is what makes LTC plans affordable for many buyers. Others contend that the nonqualified versions not only are less restrictive than qualified policies, but can still qualify for some tax benefits. (Some companies allow policyholders to convert their tax qualified plan to a nonqualified plan.) The decision as to which type of policy to choose is compounded by the fact that the Internal Revenue Service has not ruled on this tax-deductibility issue.

Under a 1996 federal law, all LTC plans issued before 1997 are treated as tax qualified as long as they met state standards at the time. Plans issued in 1997 and later must meet standards described in the 1996 act in order to qualify for tax benefits similar to those for major medical insurance.

Some of the standards focus on consumer protection. For example, tax-qualified plans must provide specific information that allows the consumer to easily compare competing policies. The plans generally cannot exclude certain medical conditions, with some exceptions. And the insurance company cannot cancel a policy except for nonpayment of premiums, and even that cancellation is restricted.

Other tax-qualifying standards address specific policy features. A key feature is what triggers benefit payments. One trigger involves the inability to perform without substantial assistance at least two of six activities of daily living (ADLs): bathing, continence, dressing, eating, toileting and transferring. Furthermore, a doctor must certify that the person is unable to perform two or more ADLs for at least 90 days.

Benefit payments also may be triggered if the person requires substantial supervision due to "severe" cognitive impairment, such as Alzheimer's disease.

A policy that doesn't qualify for favored tax treatment is one that includes "medical necessity" as a trigger or the inability to perform only one of *seven* ADLs (ambulation may be included, which may provide for coverage sooner than the others). And the cognitive impairment trigger does not have to be "severe." (If you buy a nonqualified plan, you must sign a disclosure statement acknowledging that the plan is unqualified.)

Why be concerned about the tax issues, especially if a nonqualified plan potentially is less restrictive? Two reasons.

First, with a tax-qualified plan you can deduct a portion of the cost of your premiums, depending on your age and your overall medical expenses. For tax year 2002, a person age 51–60 can deduct \$900, while someone 71 or older can deduct \$2,990. This deduction amount is included with your other medical deductions

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for the year, and only the amount of your total deductions that exceed 7.5 percent of your adjusted gross income qualifies for an actual deduction. (The self-employed may qualify for additional premium deductions.)

Second, benefits paid out from tax-qualified LTC plans generally are not subject to federal income tax (21 states also exempt the benefits from tax). The exception is indemnity plans, which pay a set amount per day, regardless of what the care actually costs. For 2002, any daily indemnity payout above \$210 (adjusted annually for inflation) is subject to federal income tax, unless that additional payout goes to pay for qualified LTC services.

Many experts agree that the premiums paid into nonqualified plans don't qualify for a tax deduction, but they see that as a less crucial issue because the dollar amounts are not as significant. The more important issue is whether the benefits paid out are taxable as income. Benefit payouts can easily amount to \$50,000 or more a year, and the custodial expenses do not qualify as a deduction to offset that income, so taxability is a significant issue.

Without IRS guidance, taxpayers and their financial advisors are on their own. Many advisors and taxpayers don't treat the benefit payments as taxable income. Other advisors caution that individuals should stick with qualified plans, even if they are more restrictive because of the potential tax bite. Consult with your financial planner for the latest on this issue.

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