Funding Options for Long-Term Health Care

By Robert P. Kreitler

Robert Kreitler discusses the costs and benefits of long-term care insurance policies and evaluates if and under what circumstances these policies may be beneficial.

A significant number of the elderly will need long-term health care. There are three primary options for financing this need. First is to fund with insurance. Second is to save and self-fund. Third is to rely on the government after depleting personal resources.

This article discusses the difference between the first two options. While the government’s role in many medical areas is being hotly debated, its policy on long-term care seems clear—it is the individual’s responsibility. State and federal governments aggressively take steps to prohibit individuals from using government resources if individual assets exist. Additionally, both state and federal governments have policies to encourage individuals to purchase insurance to cover long-term care (see “Government Carrots”). While an entire industry has developed to help people circumvent the government restrictions, it is the author’s belief that not only is providing long-term care the individual’s responsibility, but also that the various government entities will continue to restrict ways to circumvent the overall policy. To do otherwise would place an immense burden on the next generation.

Looking at the nongovernmental solutions, what role should insurance play in providing funds? To answer this question, one has to understand the function of long-term care insurance.

Long-term care insurance is more than just insurance. Insurance in the pure sense protects against the costs of a large and unexpected adverse event. Term life insurance, homeowners insurance and the liability portion of auto insurance are examples of pure insurance. People buy insurance when they cannot afford to self-insure. They do not expect to collect. Insurance companies, by collecting premiums from many individuals, use the “law of large numbers” to control their risk. They expect to pay out large claims on a small portion of their policies. They set their rates so that

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**Government Carrots**

To encourage people to purchase long-term care insurance, federal tax law permits an individual to include a portion of premiums paid for tax-qualified long-term care insurance along with other unreimbursed medical expenses as a tax deduction. This deduction is available for taxpayers who itemize and whose medical expenses exceed 7.5 percent of their adjusted gross income. The amount of the premium that can be deducted is limited by a sliding scale based on age. Employers can also deduct premiums paid on behalf of their employees. These premiums are not treated as income to the employees. A percentage of long-term care insurance is deductible by self-employed individuals as self-employed health insurance and the balance is deductible as a medical expense. Insurance benefits to cover long-term care expenses are typically received tax-free. Four states also provide an incentive for purchasing “qualified” insurance policies by increasing Medicaid spend-down limits for every dollar received of insurance benefits. These are called Partnership programs. In Connecticut, for example, if a qualified insurance policy pays $200,000 in benefits, the amount an individual can exempt from the Medicaid spend-down limits is increased by $200,000.

they do not lose or have to subsidize their policy holders.

Much of what we call insurance is more than pure insurance. For example, permanent life insurance has both insurance and investment elements. Premiums above the amount needed to cover the mortality charges and administrative expenses build cash value in the policy and are an investment. Although collecting the death benefit in early years is not expected, death eventually is a certainty, and payoff of the death benefit is anticipated. Payment of the death benefit at life expectancy is more like a return on an investment than insurance.

Long-term care insurance is not pure insurance either (see “How Long-Term Care Insurance Works”). While the financial impact of long-term care is large, its occurrence is not unexpected except at younger years. Because of the lack of claims history and the fast-changing nature of medical practices, we do not know the percentage of seniors who will receive substantial payouts from long-term care insurance, but the number is significant. For this article, I will assume the number is 25 percent. Whatever the correct percentage, the odds of receiving payment are much higher than you would find with pure term insurance (see “The Odds of Collecting”).

A significant portion of what one pays for when purchasing insurance is pre-funding of the future cost of long-term care, or, in other words, forced savings. In this regard, it is somewhat similar to permanent life insurance. The difference is that with permanent life insurance, death is a certainty and for an individual keeping a policy in force, there is a 100-percent chance of collecting, while with long-term care, there is a 25-percent chance (using my

**How Long-Term Care Insurance Works**

Purchasing a policy is complicated because there are so many options. Policies can cover expenses for facilities (nursing homes, assisted living facilities, Alzheimer’s facilities, etc.), and for services such as hospice, adult day care and home care. The benefit amount paid on a reimbursement-style plan is limited to the lesser of the actual cost of the services provided or the limits of the policy. Indemnity style plans, less frequently used, pay the full benefit amount regardless of the cost of care provided. Policies typically provide a maximum amount of coverage per day (e.g., $50, $100, $150 per day), with a specified elimination period and a maximum benefit amount, which is often expressed in number of years of payout. Policies can also pay for an unlimited number of years. Benefits are increased annually for inflation (most often at five percent) and calculated either at a simple or compound-rate. Most often, premiums are paid for life; however, policies can be paid up in a short period of time (one, five, 10, 15, 20-pay or pay-to-65). Typically, premiums are waived when benefits are being received. Premiums are “intended” to remain level, but can be increased with state approval. Some medical underwriting is required, except in open enrollment periods for group cases. Couples discounts are significant, which recognize that one person will likely take care of the other and reduce costs. To keep the cost of premiums down, one strategy is to plan to have the insurance cover only a portion of the long-term care and plan to pay the remainder out-of-pocket.
The Odds of Collecting

The 25-percent assumption used in this paper is probably a conservative number. Spillman and Lubitz estimated that 44 percent of those over age 65 would enter a nursing home at some point. Murtaugh, et al., reports the likelihood of spending some time in a nursing home increases with age, from 39 percent at age 65 to 56 percent at age 85. Because of the wait period specified in each policy, all those entering a nursing care facility would not necessarily receive payment from long-term care insurance. On the other hand, most policies also cover home care, which increases the odds of payment.

What happens if my 25-percent assumption is significantly low and 50 to 75 percent of policy owners ultimately collect? The answer is counter-intuitive because the higher the percentage of people collecting, the more long-term care insurance takes on the characteristics of a saving and investment vehicle rather than pure insurance. Insurance products are not typically good investment vehicles (consider the low, conservative guaranteed interest rates provided in permanent life insurance policies). The higher the percentage of people who collect on their insurance policies, the more the insurance takes on the role of an investment vehicle and the less efficient the long-term care insurance is in meeting their financial needs.

Assumption). With long-term care insurance, the insured gets nothing back if there are no long-term care costs. It appears that most of what long-term care insurance achieves, for those who eventually need long-term care, is to spread the cost over a longer period and to force individual savings.

Are long-term care policies economical? A person at age 65 who purchases a policy (premium of $1,804 per year for a $100 per day coverage that increases at five percent per year compounded, with a 100-day elimination period and four-year payout) will make a five-percent return on his money if 20 years later (age 85) he receives 224 days of benefits. In other words, to make a five-percent return on his premiums, counting the 100-day elimination period, he would have to receive care for approximately 11 months. Payment for more would improve the return. Payment for less would mean he doesn’t even make five percent on his premiums. Another way to look at this example is, if someone were to pre-pay for 224 days of care, the insurance company will provide four years of coverage.

Costs are related to age. For the $100 per day policy quoted above, if the person were 55, the premium would be $1,071. At age 70, the premium would be $2,735 and at age 75, $4,258. Costs are directly proportional to the benefits. A $200 per day policy is twice the cost of a $100 per day policy.

Making a decision to buy a policy given the above information is difficult enough, but the world is more complex than the static projections assume. We don’t know what the claims rate will be, we don’t know whether the insurance company will increase rates, and we don’t even know whether the medical practices covered in the policy will be the practices people need in 20 years.

In Private Long-Term Health Care Insurance: Who Should Buy It and What Should They Buy? Mark Merlis argues that with so much changing in the healthcare field, one cannot know what services one is likely to need or what will be available 20 or more years in the future. As an example, policies sold in the early 1970s are already obsolete, as they do not provide for home healthcare, which is provided in most policies today.

In a rapidly changing world, and because we lack claims data, it is highly unlikely that today’s pricing by the insurance companies will remain consistent for the long term. If an insurance company overprices a long-term care policy, the consumer is shortchanged. If the insurance company prices the product too low (possibly to sell policies), it will be forced to increase premiums in later years. The owner may be forced to abandon the policy because he is not able to pay the increased premium or, worse, the insurance company may not be able to honor its commitments. Either way, it is highly probable that the owner will not be satisfied with the policy when it comes time to collect many years in the future.

Some recent press releases suggest that insurance companies are under-pricing premiums in this area. Investment News reports that in the first half of 2003, three carriers of long-term care insurance announced they would stop writing policies (Conseco Insurance Group, Thrivent for Lutherans and American Express Financial
Advisors). It suggests that other companies will likely drop this coverage or increase premiums. With the lack of claims data, it appears that insurance companies have priced the coverage too aggressively. Such uncertainty makes long-term projections virtually meaningless.

What factors should one consider when deciding whether or not to purchase long-term care insurance?

Reasons to purchase long-term care insurance include the following:

- It provides forced savings to cover the possibility that the policyholder may require long-term care.
- It provides some pure insurance benefit to cover possible long-term care costs for an illness in the early years.
- Assuming that 25 percent of those with policies actually collect on them, there is some passing of costs to the 75 percent who receive no benefit from the policy. This makes long-term care more affordable for those who need it.
- Even if they have sufficient resources without long-term care insurance, an individual with a policy may receive better care in later years than someone without. Older individuals frequently hoard their resources. They are more likely to use the long-term care services if they receive insurance payments and thus they may enjoy a higher quality of life. (Creating a pool of funds from their financial resources designated for long-term care may also achieve the same purpose. This is consistent with the author’s “pools” concept in Tools and Pools: Strategies for Increasing Retirement Cash Flow and Creating a Retirement Plan in an earlier issue of this JOURNAL.)
- Long-term care insurance offers peace of mind to the insured as well as other family members.

Reasons to self-fund include the following:

- Paying premiums to an insurance company for many years before you expect to benefit from a policy is a very inflexible use of resources. The insurance policy purchased might not cover procedures needed in 10 years or more.
- Insurance has additional costs for administration. Self-insurance is less costly.
- Assuming 25 percent of those actually use it, there is a 75-percent chance the insurance will not be used. The premiums are wasted because the policy owner receives nothing and this results in a high-priced no-return investment.

Long-term care insurance is a relatively rigid product in a very dynamic world with rapidly changing needs. The longer the time before someone collects from the policy, the greater the likelihood that healthcare practices will change and that the policy they purchased will no longer meet their needs. The length of time one must pay premiums before one expects to collect on the policy becomes a significant factor in determining whether to purchase a long-term care policy. Thus, a person’s age when he purchases a policy is an important factor. I will use three age groups as examples: younger than age 60, ages 60 to 70, and older than 70.

Those younger than age 60 should not purchase long-term care policies but should save to meet retirement expenses using more pure investment vehicles such as qualified and nonqualified accounts. The future is uncertain, and one’s resources should not be locked into an inflexible product that may not meet later needs. Younger people with current medical issues who are eligible for a policy (such as a group policy) if they are not screened out by underwriting, are the exception who should consider long-term care coverage.

Retirees, or those 60 to 70 who are close to retirement, must decide whether to buy long-term care insurance or self-fund. Those buying it should do so for peace of mind or for the forced discipline of reducing current resources.

Mark Merlis argues that most people cannot afford long-term care insurance. Since long-term care (whether financed through insurance or savings) is just one part of the cost for retirement, his findings provide additional support for the argument that Americans are not saving enough to support themselves in retirement. Not saving is clearly a major problem in the United States.

**Don’t Start If You Can’t Pay for Life**

A person should not purchase a long-term care policy if he cannot pay the premiums for the entire period before the policy pays out. To quit paying the premiums and allow the policy to lapse wastes the premiums already paid.
expenses to ensure funds are available when needed, keeping in mind that they may never use the policy and therefore lose the money spent on premiums. Those who self-fund may wish to establish a pool of retirement assets earmarked for long-term care so there is no reluctance to use the funds to provide quality care when the need arises.

Applying for long-term care insurance after age 70 presents an interesting paradox. In my experience, the high premiums scare away most potential applicants. Ironically, these policies may have the least uncertainty, as they often have the shortest time between when the policy starts and when benefits are received. The high premium reflects the reality that payouts are likely in the not too distant future. Although counterintuitive, taking out long-term care at older ages deserves greater consideration from planners.

Should wealthy individuals buy long-term care insurance? Individuals who can easily afford the expense of long-term care because they have already accumulated the needed resources do not need the discipline of the insurance for savings. This person might have a portfolio of $2 to $3 million, or be receiving a large and secure lifetime income. However, he might prefer to own insurance to assure quality care is provided and resources are not hoarded. He may also want to purchase long-term care for peace of mind.

All but those who will be wards of the state should recognize that providing funding for long-term care is their responsibility. They should not plan on government support. Long-term care costs are just one of the many retirement expenses for which they must provide. They may need to adjust their spending habits both in working years and in retirement so they have the resources to meet their highest priority needs such as health care.

Long-term care insurance should not be viewed as a less expensive way out for those who have failed to adequately prepare for retirement. The problem of lack of resources must be solved through other means. Buying insurance will not solve the problem.

ENDNOTES

1 Code Sec. 213.
2 Code Secs. 162 and 213.
3 B. Spillman and J. Lubitz, New Estimate of Lifetime Nursing Home Use: Have Patterns of Use Changed? 40 Medical Care 965 (2002).
4 Christopher Murtaugh, Peter Kemper, Brenda Spillman and Barbara Lepidus Carlson, The Amount Distribution and Timing of Lifetime Nursing Home, 35 Medical Care 204 (1997).
8 Merlis, supra note 5.