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H.R. 3734 AND S. 2222: USING LIFE INSURANCE TO HELP FINANCE LONG-TERM CARE

INTRODUCTION

Legislation pending in Congress would allow Americans suffering from terminal illnesses to receive their life insurance benefits tax-free before they die. This money then could be used, for example, to help pay the costs of medical and nursing care at home, or in a hospice or a nursing home. Currently, any life insurance benefits paid to a policyholder while still living are liable to be taxed by the federal government the same as other income, making this option less attractive. If Congress passes the legislation, sponsored in the House (H.R. 3734) by Representative Barbara Kennelly, the Connecticut Democrat, and in the Senate (S. 2222) by Senator Bill Bradley, the New Jersey Democrat, it would greatly increase the resources available to terminally ill Americans to pay for their care and to make the final months of their lives more comfortable. Passage of the legislation also would represent an important first step toward expanding the use of life insurance to meet the long-term care needs of today's retirees.

Prompted by growing consumer demand for better ways of financing long-term care, insurance companies in recent years have increased the quantity and quality of private long-term care insurance policies. Firms also have developed several innovative insurance products. One of those important new products offers Americans with life insurance the option of purchasing, for a small increase in their premiums, a long-term care or terminal illness "rider" on their policies. In the event that the policyholder suffered a specified misfortune, such as a terminal illness or severe disability requiring long-term care, the insurance company would begin paying the benefits of the policy to the policyholder in fixed monthly amounts, before he or she dies.

Taxing Early Benefits. The current tax law hampers the expanded use of this insurance product designed to ease the financial worries of the elderly. Under existing law, when a life insurance policyholder dies, the benefits paid to the designated beneficiaries, commonly known as "death benefits," are not subject to tax. But if, under some arrangement in the policy, the benefits were to be paid to the policyholder himself while still living, the money is termed a "prepayment of death benefits" or "accelerated death benefits" and is subject to normal income tax. This tax treatment makes the product far less attractive as a tool to provide some protection against nursing home costs. The Kennelly-Bradley legislation would change the tax law to allow terminally ill Americans to receive accelerated death benefits tax-free. Supporters of the legislation also envisage a future extension of these provisions to allow patients other than the terminally ill, who need long-term care, to receive tax-free payments from their life insurance as well.

Untapped Resource. The Kennelly-Bradley legislation is particularly important because it seeks to use private insurance as a tool to address the financial concerns of those Americans who are concerned that nursing home care could wipe out their hard-earned savings. Private insurance is ideally suited to protecting personal finances. Life insurance, moreover, is a great untapped resource that easily could be used to help meet the potential long-term care needs of today's retirees and those Americans nearing retirement age. Approximately 65 percent of men and 57 percent of women age 65 or older own life insurance, with a total value of roughly $70 billion. Furthermore, among Americans age 55 to 64, some 86 percent of men and 71 percent of women own life insurance.

Reforming the tax treatment of accelerated death benefits is a key element in a comprehensive strategy designed to trigger the use of private insurance to protect the assets of Americans needing extensive nursing-care. But other steps are needed. Among them:

- ♦ Developing better data on the cost and utilization of long-term care services.
- ♦ Making benefit payments from long-term care insurance tax-exempt.
- ♦ Allowing Americans to use monies in their retirement funds to make tax-free purchases of long-term care insurance.

Some members of Congress assume that any proposal to tackle long-term care costs should be part of a comprehensive package of legislation designed to address all of the problems in that area. But there is no sound reason for this view that modest or incremental reforms should be delayed until Congress can consider a more comprehensive package. The Kennelly-Bradley bills are a good first step and if Congress were to expand their provisions to widen the tax exemption for accelerated death benefits to include long-term care, the legislation would provide help to additional millions of Americans concerned about potentially crippling nursing costs.

WHY TAX REFORM OF LIFE INSURANCE IS NEEDED

Under current law, the benefits paid out by a life insurance policy to beneficiaries following the death of the policyholder are not taxed. However, if the benefits are pre-paid — that is, paid to the policyholder or a beneficiary before the policyholder dies — they are treated as regular income and subject to normal income tax.

The rationale for these tax rules is that the policyholder's beneficiaries, usually a spouse and children, will face financial difficulties as a result of the policyholder's death. Indeed, it is principally to relieve these difficulties that Americans buy life insurance. The benefits are untaxed not only to encourage families to protect themselves with life insurance, but also because it would be unfair for the government to take a large share of those benefits in taxes from needy families who depend on those funds to help them recover from their loss. On the other hand, if the government allowed policyholders to collect these benefits tax-free, at any time and for any reason, life insurance not only would become a giant tax dodge, but also its original purpose would be undermined.

There are some cases, however, such as terminal illness or long-term care, where the policyholder and the insurance beneficiaries actually would be better served if the policyholder could receive the life insurance benefits before death. Unlike cases of unexpected or accidental death, the heavy expenses often associated with caring for patients with terminal illnesses or disabling conditions, whether at home or in a hospice or a nursing home, can drain the financial resources not only of the patient, but of his or her family as well. Furthermore, surviving family members have the time to better plan for their own futures, unlike situations where the policyholder dies suddenly.

Survey data indicate broad public support for reforms of life insurance law to expand the availability of accelerated death benefits for those special situations. As the table below indicates, a recent Gallup survey found respondents to be very supportive of the idea of allowing policyholders to collect their life insurance benefits before death for long-term care expenses and other serious medical costs. By substantial majorities, however, they rejected the idea of allowing this practice for less serious purposes.

Action by Insurers. In response to the financial difficulties often faced by terminally ill or long-term care patients and their families, at least 60 life insurance companies offer their policyholders the option of purchasing a long-term care or terminal illness "rider" on their policies. The riders permit arrangements for prepayment of death benefits in the event of certain specified misfortunes. Many of these companies began to offer accelerated death benefit riders only in the last six months, and this practice is spreading so rapidly that analysts have not yet been able to establish a comprehensive tally of how many companies offer such riders.

Table 1
Public Attitudes on Prepayment of Insurance Benefits
(Percent Response)

Q. Should policyholders be allowed to collect part of their death benefit if they are very sick or unable to care for themselves?

	Yes	No	Don't Know
	94	*5*	*1*

Q. Should a policyholder be allowed to collect living benefits under the following circumstances?

Circumstance	Yes	No	Don't Know
A Terminal Illness	*92*	*7*	*2*
Need for Long-Term Care	*90*	*8*	*2*
A Serious Illness	*87*	*11*	*12*

Q. If you were a beneficiary of a policy, what would you regard as a justifiable reason for the policyholder to collect living benefits?

Reason	Yes	No	Don't Know
To pay medical bills	*93*	*6*	*1*
To receive the best possible care in the most convenient setting	*83*	*15*	*1*
To improve the quality of daily life	*40*	*57*	*3*
To fulfill a long-held dream	*26*	*72*	*2*

Source: *Best's Review*, Volume 90, Number 6, October 1989, survey of 1,000 respondents conducted by the Gallup Organization.

Although data are lacking on the most common ways in which companies have structured these riders, the following examples indicate typical terms:

Example #1: For an additional premium of between 5 percent and 7 percent, the National Travelers Life Company offers purchasers of new policies with a face value of $50,000 or more the option of a long-term care rider. Accelerated benefits can be received if the policyholder is certified by a physician as being unable to perform two or more out of five activities of daily living (ADLs)[1], and has incurred expenses for at least three months either in a long-term care facility or for community-based care. The benefits are paid out at a rate of up to 2 percent of the face value of the policy each month. The maximum total payout for policyholders who bought their policies between the ages of 20 and 64 is 100 percent of the policy's face value. For policyholders who bought their policies between the ages of 65 and 75, the maximum payout is 50 percent of the face value of the policy. The company has structured the benefits this way to encourage working Americans to buy policies now in preparation for their retirement years.

Example #2: The North American Company for Life and Health Insurance offers a free terminal illness rider on all new universal life and renewable term life insurance policies regardless of the face value of the policy. The rider is triggered if the policyholder contracts a fatal illness and has a remaining life-expectancy of 24 months or less. In this situation, the company will pay out a lump sum equal to 25 percent of the policy's face value up to a maximum payout of $50,000.

Example #3: The Prudential Insurance Company of America announced in January that it will allow policyholders the option to receive almost all of their life insurance benefits before death if the policyholder is expected to live less than six months or has spent six months in a nursing home and is unlikely to leave the facility. This option will be available, at no increase in premiums, for current policies with death benefits of $25,000 or more and for most new policies with a face value of $50,000 or more. Eligible nursing home patients can elect to receive their accelerated benefits either in a lump sum or in monthly installments.

State Actions. To date, 36 states have approved the sale of these riders.[2] Life insurance is regulated predominantly at the state level. Twenty-five of these states have granted administrative approval of riders for long-term care (and in some cases for other health care needs as well) without any change in their life insurance laws or regulations.[3] Another eleven states enacted new laws or regulations permitting accelerated death benefits, although four of them limit the approval only to long-term care.[4]

While states thus are encouraging this innovation in the insurance industry, there is one remaining major obstacle inhibiting widespread use of these riders. Federal law does not specifically allow tax-free prepayment of death benefits for

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1 The "activities of daily living" include: preparing meals, eating, dressing, using the bathroom, or moving from one place to another. Often ADLs are defined to include other activities as well, such as taking medication.

2 *State Actions Regarding Accelerated Death Benefit Policies and Riders* (Washington, D.C., American Council of Life Insurance, January 8, 1990.)

3 *Ibid.* The states are: Alaska, Arizona, Arkansas, California, Colorado, Delaware, District of Columbia, Florida, Hawaii, Idaho, Indiana, Iowa, Kentucky, Louisiana, Mississippi, Nebraska, Nevada, New Hampshire, New Mexico, Ohio, Oregon, Tennessee, Vermont, West Virginia, and Wyoming.

4 *Ibid.* The states are: Connecticut, Georgia, Illinois, Kansas, Maine, Maryland, Michigan, Minnesota, Oklahoma, Texas, and Virginia. Approval is limited to long-term care in: Connecticut, Kansas, Maine, and Maryland.

terminal illness or long-term care. Thus if a policyholder exercises the rider, the cash value of benefits received is reduced by the amount of tax that must be paid.

How The Legislation Would Help

The Kennedy-Bradley bills partially address this obstacle to life insurance riders by changing the tax treatment of life insurance, allowing patients certified by a physician as terminally ill (with a remaining life-expectancy of 12 months or less), to collect their life insurance benefits tax-free. The legislation would allow insurers to offer such "terminal illness riders" on any new or existing life insurance policies. The Senate and House versions of this legislation have garnered broad, bipartisan support, and each now has more than thirty cosponsors. Both bills are awaiting action in committee.

The only difference between the House and Senate bills is that the Senate measure includes an additional section stipulating that applicants or recipients of public assistance programs cannot be required to make use of the accelerated death benefits option as a condition for receiving any public assistance to which they would otherwise be entitled. This provision is meant to assure that a decision by a patient to take advantage of the new option would be completely voluntary.

EXTENDING THE LEGISLATIVE PROVISIONS TO COVER LONG-TERM CARE

While these bills are limited in scope, allowing the tax-free prepayment of death benefits only in cases of terminal illness, their supporters understand the potential benefits of applying the same tax policies to long-term care. State Senator Christopher Dodd, the Connecticut Democrat who is one of the original cosponsors of S. 2222, "If this legislation works as expected, then I hope we will be able to expand it to help solve the long-term care problem. If life and private health insurance can be tapped to meet this crisis, then the Congress can focus on developing a much smaller program just for those who lack these resources."[5]

Tax-free accelerated death benefits for long-term care can be particularly helpful to today's retirees for whom the cost of long-term care insurance would be more expensive because of their age, yet who have considerable private assets "locked up" in life insurance. Currently, 81 percent of all American households have at least one member who owns at least one life insurance policy, and the total value of individual and group life insurance currently in force in the U.S. is over $7.7 trillion.[6]

5 Press release on S. 2222, March 1, 1990.

6 *1989 Life Insurance Factbook Update, Life Insurance In Force In The United States* (Washington, D.C., American Council of Life Insurance, 1989), p. 10.

Furthermore, according to the most recent data, 65 percent of men and 57 percent of women age 65 or older own life insurance. Among those age 55 to 64, some 86 percent of men and 71 percent of women own life insurance.[7]

The total value of life insurance policies currently held by Americans age 65 or older is roughly $70 billion. Thus, while expanding the use of accelerated death benefits from life insurance policies to pay for long-term care will not solve all the problems in long-term care financing, it would considerably expand the pool of resources available to pay for that care.

OTHER NEEDED REFORMS

Reforming the tax treatment of life insurance benefits would be of the most help to retirees, or those near retirement for whom long-term care insurance is more expensive. A more comprehensive strategy to protect young Americans from similar financial concerns in the future would to provide incentives for working Americans to purchase long-term insurance when premium costs are much lower.[8]

The advantage of allowing Americans to use their life insurance benefits tax free to purchase long-term care services is that it would help to bridge the biggest gap in long-term care financing. The Medicaid program currently pays for the nursing home care of the elderly poor, single retirees who become impoverished by long-term care costs, and married retirees whose long-term care costs would otherwise impoverish their healthy spouses. With the right tax incentives (as proposed in a number of other bills before Congress), true long-term care insurance could soon be made more affordable and available to today's workers.[9] Bridging the remaining gap entails finding ways for middle-income retirees and near-retirees to more economically use their private assets to meet their potential long-term care costs. A major part of the solution would be to allow the tax-free use of accelerated death benefits from life insurance to pay for long-term care.

A more comprehensive strategy to promote the purchase of long-term care insurance would require a number of legislative and administrative steps. Among them:

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7 *Statistical Abstract of the United States, 1989*, U.S. Department of Commerce, Bureau of the Census, 109th edition, table 839, p. 509. *Life Insurance Ownership by Households and Adults: 1984* (Washington, D.C.: Life Insurance Marketing and Research Association, 1984.)

8 For a full analysis of such a strategy and more comprehensive reforms in long-term care financing see: Edmund F. Haislmaier, "Making Long-Term Health Care More Affordable," Heritage Foundation *Backgrounder* No. 755, February 23, 1990; Peter J. Ferrara, "Health Care and the Elderly," in Stuart M. Butler and Edmund F. Haislmaier, eds. *A National Health Care for America* (Washington, D.C.: The Heritage Foundation, 1989); and Peter J. Ferrara " Providing for Those in Need: Long-Term Health Care Policy," Heritage Foundation *Backgrounder* No. 646, April 20, 1988.

9 Bills that would reform the tax treatment of long-term care insurance include: H.R. 421, sponsored by Representative Ron Wyden; H.R. 1010, sponsored by Representative Willis Gradison; H.R. 2132, sponsored by Representative French Slaughter; H.R. 3440, sponsored by Representative David Dreier; and H.R. 3632, sponsored by Representative Barbara Kennelly.

- Developing better data on the cost and utilization of long-term care services.
- Making benefit payments from long-term care insurance tax-exempt.
- Allowing Americans to use monies in individual retirement accounts (IRAs) and other pension funds to make tax-free purchases of long-term care insurance.

CONCLUSION

The Bradley and Kennelly bills are a compassionate response to the financial needs of terminally ill patients. Explains one of the original cosponsors, Senator Joseph Lieberman, the Connecticut Democrat, "When we allow people who are seriously ill to use money they have saved in life insurance, we allow them to live the remainder of their lives with a greater sense of security and dignity. Life-taking diseases, whether they be forms of cancer, or of AIDS, burden their victims with pain. That pain should not be compounded by financial ruin."[10]

Dignity of Independence. Allowing long-term care patients also to receive their life-insurance benefits tax-free before they die would be a wise extension of the Kennelly-Bradley legislation. Many long-term care patients also face serious financial difficulties which could be alleviated by easier access to their life insurance benefits. While expanding the Bradley and Kennelly bills to include long-term care would not be a substitute for other necessary reforms needed to make true long-term care insurance more available to younger Americans, it would give today's retirees and near-elderly much easier access to their own resources, giving them the dignity of independence and relieving their families of financial burden.

Such legislation thus would help bridge the gap until the day when younger Americans routinely purchase long-term care insurance to protect themselves in their retirement years, just as they now routinely purchase life insurance to protect their families during their working years.

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10 Press release on S. 2222, March 1, 1990.