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Sales Idea

The new wealth transfer

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It is estimated that people reaching age 65 will have a 70% chance of needing long-term care at some point in their life.[1] At the same time, due to the dramatic increase in the federal estate tax exemption, less than 1% of the population can expect a federal estate tax at their death.[2]

For the overwhelming majority of Americans, wealth transfer needs to focus on planning for the costs of long-term care - not on estate taxes. But, for those estates that still face exposure to the federal estate tax, planning for the costs of long-term care can enhance their wealth transfer plans.

Therefore, for people who currently have life insurance policies in irrevocable trusts (e.g. irrevocable life insurance trusts or ILITs), whether or not they're exposed to the federal estate tax, adding a long-term care component to the policy(ies) in these trusts can significantly enhance their wealth transfer planning. The new wealth transfer should include some form of long-term care insurance coverage.

The benefits of having an ILIT

Irrevocable trusts can provide much more than estate tax liquidity. Any assets transferred to an irrevocable trust are protected from the grantor's creditors. In addition, those assets will avoid probate at the grantor's death which will be a private transfer of wealth (vs. a will, which is a public document).

The ILIT can be named as the owner or beneficiary of any number of assets. If assets remain in trust after the grantor's death, the irrevocable trust will provide creditor protection and possibly professional money management for trust beneficiaries.

Median Cost of Care (2019) Columbus, Ohio[3]		5 Years of Care Columbus, Ohio
Private Room Nursing Home	$102,200 / year	$511,000
Home Health Aid	$52,625 / year	$263,125
Assisted Living Facility	$48,612 / year	$243,060

The worst that can happen by keeping an ILIT is that the grantor has given his/her loved ones a larger inheritance. Whereas, the worst that can happen by terminating an ILIT is that the estate tax laws change, and the grantor ends up facing an estate tax at death, forcing a fire sale of assets and diminishing the grantor’s legacy.

The benefits of having LTC coverage

What if the grantor has a long-term care event? The above table lists the median cost of care of various long-term care services in Columbus, Ohio (2019). A private room at a nursing home is the most expensive option with a median cost of $102,200 per year. Whereas, residing in an assisted living facility is the cheapest option with a median cost of $48,612 per year. The column on the right-hand side of the table shows the cumulative cost of those services after only 5 years. If we were encouraging our clients to insure for an estate tax liability of similar amounts, why would we not encourage our clients to insure for a long-term care liability of similar amounts?

For our mass affluent households, those who are not exposed to an estate tax under current law but have created an ILIT, the costs of long-term care have become the new estate tax for the mass affluent. Meaning that although their estates will not likely be diminished by a 40% estate tax on amounts over an exemption, their estates will likely be decimated by similar amounts paid to the various providers of long-term care services. Not insuring for long-term care is another threat against these households' estate plans and jeopardize their ability to leave a legacy. Further, mass affluent households may not have the liquidity to pay out of pocket for these long-term care services and may be forced to sell assets at disadvantageous times (i.e. fire sale) or take out a reverse mortgage to pay their long-term care expenses, ultimately jeopardizing the ability to keep the family home in the family.

Adding LTC coverage to the ILIT

The first step in repurposing an ILIT for long-term care is for the trustee to determine what kind of long-term care coverage is most appropriate. The two most fitting options for long-term care coverage that complement an estate plan are either a life insurance policy with long-term care rider or a linked-benefit (i.e. hybrid) long-term care policy. A standalone long-term care policy is not ideal for a variety of reasons, namely its "use it or lose it" nature and almost all standalone policies are reimbursement contracts (vs. indemnity).

If a life insurance policy with long-term care rider is selected, the trustee may be able to have the rider added to the policy inside the ILIT. Some carriers do allow the long-term care rider to be added post-issue. The insured will have to be insurable for long-term care at the time the rider is issued. If a rider cannot be added post-issue or if a different type of life insurance policy is more appropriate, the trustee can complete a tax free 1035 exchange for a new life insurance policy with long-term care rider. Note that the insured will have to be insurable for both life insurance and long-term care in this instance.

Alternatively, the trustee may determine that a linked-benefit long-term care policy is more desirable. These types of policies typically offer greater long-term care benefits than a life insurance policy with long-term care rider. The trustee could 1035 exchange the pre-existing life insurance policy for a linked-benefit long-term care policy. The insured will need to be insurable for both life insurance and long-term care in order to complete the 1035 exchange.

In either case, for optimal estate planning to be achieved, the trustee will want to select a product that pays long-term care benefits on an indemnity basis (vs. a reimbursement basis). Reimbursement style long-term care benefits may cause adverse estate tax results for high net worth individuals. Indemnity style benefits offer the trustee the most flexibility and administrative ease.

If the insured ends up having a long-term care event, there are several ways the trustee can use the long-term care benefits. See below for two such examples. Ultimately, the net result is that more of the insured's estate will be preserved for the next generation. If the insured ends up not having a long-term care event, the trustee will receive the full death benefit from the insurance carrier and manage the proceeds for the betterment of the trust beneficiaries.

Repurposing an ILIT for LTC: SLAT or BLAT provisions are key for mass affluent clients

In a typical ILIT, the grantor is neither a trustee nor a beneficiary. Therefore, in order to maintain access to LTC benefits the ILIT should be drafted with SLAT or BLAT provisions (spousal lifetime access trust provisions or beneficiary lifetime access trust provisions). This will allow the trustee to make distributions of LTC benefits to a trust beneficiary who can then use those proceeds to help pay for the grantor's LTC expenses. The ideal trust beneficiary will be the grantor's spouse; if the grantor is a U.S. citizen, an unlimited amount of gifts of LTC benefits may be made to the grantor by his/her spouse, without generating any adverse gift tax consequences.

If the trust beneficiary is not a spouse, likely a child, the child may be able to directly pay the provider of the grantor's qualifying medical services without any adverse gift tax consequences. Otherwise, a non-spouse trust beneficiary, like a child, will make gifts of LTC benefits subject to the annual exclusion from gift tax ($15,000 per donee in 2021), and reduce his/her lifetime gift tax exemption ($11.7 million in 2021) for amounts over the annual exclusion.

To facilitate the payment of LTC benefits to a trust beneficiary, ideally the trust will be drafted with a discretionary distribution standard (i.e. the trustee has discretion over how much and to whom to make trust distributions). Otherwise, the so-called ascertainable standard will likely not provide relief as the distribution is not necessarily for a trust beneficiary's health, education, maintenance, or support. An independent trustee is also ideal, one who is not related or subordinate to the grantor. If the grantor's spouse is a trustee and beneficiary, an additional trustee who is independent and can make discretionary distributions would facilitate this strategy.

If the trust design is not ideal for this strategy there are a few options. The trust may be able to be reformed (i.e. changed) with or without a court process. Alternatively, decanting the assets of the ILIT to a new ILIT with more desirable provisions may be a possibility. Or, a sale of the policy from the current ILIT to a new ILIT with more desirable provisions may also be explored.

Repurposing an ILIT for LTC: Estate tax mitigation for our high net worth clients

Repurposing an ILIT for long-term care makes a ton of sense for our mass affluent families who otherwise could see their estates significantly diminished by the costs of long-term care. Repurposing an ILIT for long-term care makes even more "dollars and sense" for our high net worth clients who are exposed to the federal estate tax. Although this group may scoff at the notion of purchasing insurance for a long-term care event, their ears will perk up when they learn that doing so is an effective estate tax mitigation strategy.

It is not to the high net worth individual's financial benefit to self-fund the costs of long-term care. They have a unique risk which we refer to as the cost of getting lucky. Whatever liquid assets that individual earmarks in his or her estate for the payment of long-term care expenses could be subjected to a 40% estate tax at their death. For example, if an individual left $1,000,000 of liquid assets in their estate and did not need to use any of it prior to their passing, that $1,000,000 would be subject to the estate tax and nearly $400,000 of it would be sent to the I.R.S.

To avoid this "sunk cost," it is more advantageous for the high net worth to repurpose their ILITs for the costs of long-term care, by either adding a long-term care rider or using a linked-benefit long-term care policy as described above.

If the grantor experiences a long-term care event, the trustee would be able to make loans of long-term care benefits to the grantor. The loan from the ILIT to the grantor would be a debt against the grantor's estate and decrease the value of his/her taxable estate and thus the amount of estate tax ultimately assessed against it. If instead of earmarking $1,000,000 *inside* the grantor's estate for the costs of long-term care, the grantor instead received a $1,000,000 loan from the ILIT, the loan would actually *save the grantor* nearly $400,000 of estate tax! Any interest that was allowed to accrue and that was paid back prior to the grantor's death would be an additional estate tax free (and income tax free) transfer of wealth from the grantor's estate to the ILIT.

The process of taking the collateralized loans

With regards to the terms of the loan, it must be an arms-length, fully collateralized transaction that is secured by property pledged by the grantor. Specifically, the loan must be legitimate, with collateral pledged, interest charged, and an agreement to fully pay back the debt.

Collateral can be anything with a fair market value that covers the debt: a house, artwork, coin collections, etc. The interest rate charged should be reasonable but at least equal to the interest charged on policy loans from the insurance policy. In most cases the loan interest is allowed to accrue, but ideally, the loan interest should be paid back prior to the death of the grantor to avoid taxation as income to the trust. Principal can be paid back after death with no income tax liability.

Here is what the process can look like:

- Trustee files a claim for LTC benefits
- After the applicable elimination period, a monthly check will be sent to the trustee (as contract owner)
- The grantor borrows money from the trust upon pledging property as collateral
- Interest is allowed to accrue to purposely increase the debt, but ideally is paid back prior to death to avoid income tax
- At the grantor's death, the loan principal can be repaid from estate assets.

Conclusion

For the mass affluent, ILITs that are no longer suited to their original purpose can still play an important role in an estate plan if they are repurposed to provide funding for potential long-term care costs. Moreover, if transfer tax laws change in the future to again expose such grantors to an estate tax liability, they and their heirs will sure be glad that they did not get rid of their ILITs or the insurance policies within them! Instead, the grantor will be in a position of strength as both life insurance and long-term care coverage in an irrevocable trust offers the most flexibility to determine the most appropriate use of the insurance policy within the ILIT.

For the high net worth with more certain exposure to the estate tax, adding long-term care coverage to their irrevocable trusts can be an additional estate tax mitigation strategy which keeps more wealth within their family and less wealth from going to the I.R.S. Self-funding the costs of long-term care is the least financially appealing strategy for the high net worth. By repurposing their ILITs for long-term care and using a loan strategy, the high net worth can significantly reduce their estate tax liability. Regarding the details of how to repurpose an ILIT for long-term care, there are, as previously discussed, legitimate alternatives with the appropriate choice depending upon state law, the facts and circumstances of the case, and the interests of the parties involved.

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[1] United States, Department of Health and Human Services, Administration on Aging, "How Much Care Will You Need?" 9 July 2018, https://longtermcare.acl.gov/the-basics/how-much-care-will-you-need.html.
[2] According to a 2015 study; with passage of 2017's Tax Cuts and Jobs Act, the amount of people exempted from the federal estate tax should be even higher. Joint Committee on Taxation, "History, Present Law, and Analysis of the Federal Wealth Transfer Tax System," 9 July 2018, https://www.jct.gov/publications.html?func=startdown&id=4744.
[3] According to Genworth's Cost of Care Survey, https://www.genworth.com/aging-and-you/finances/cost-of-care.html.