Life and Annuity – LTC Combination Plans

LTCi Producers Summit

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Milliman

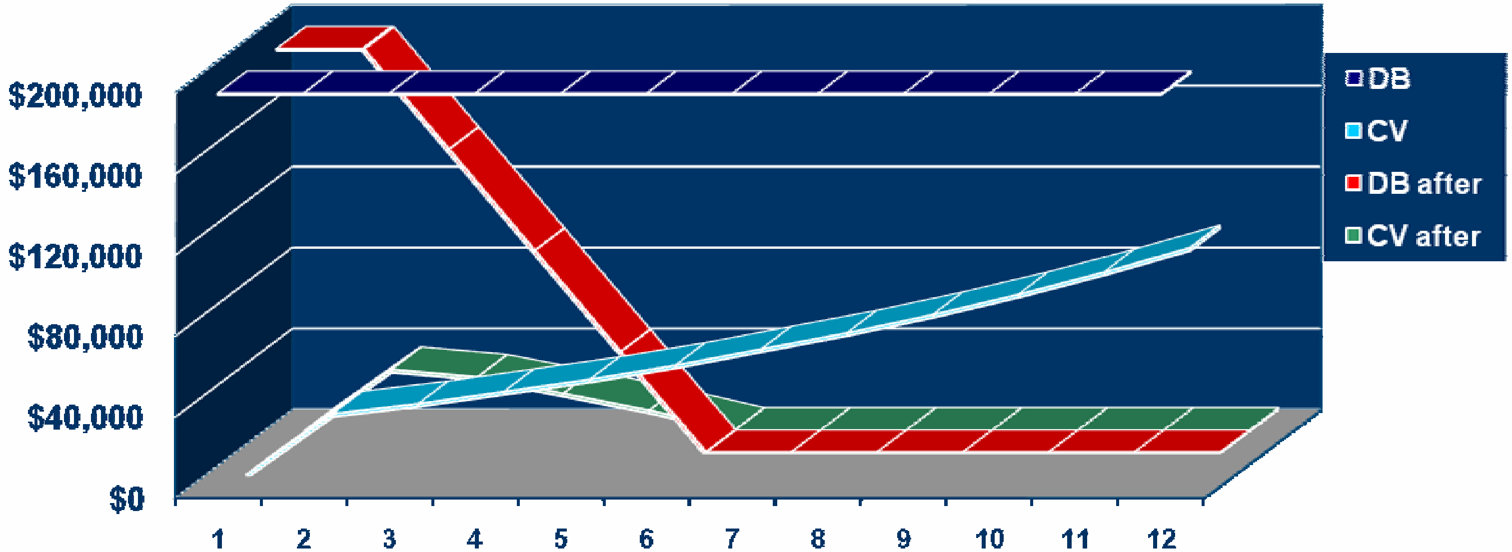
Life/LTC Product Basics

- Various base plans including single premium universal life, flexible premium UL, WL, and VUL
- Accelerated Death Benefit LTC rider (ADB)
  - Pays out a specified portion of DB per month with a proportionate reduction to CV’s
  - Charge structure typically YRT per thousand of NAR, but a growing number of states (at least 5 including FL, NC, OH, CO, and HI) are imposing level charge requirements
- First generation
  - ADB only
  - Low cost
  - Self Insurance
  - Protect the producer

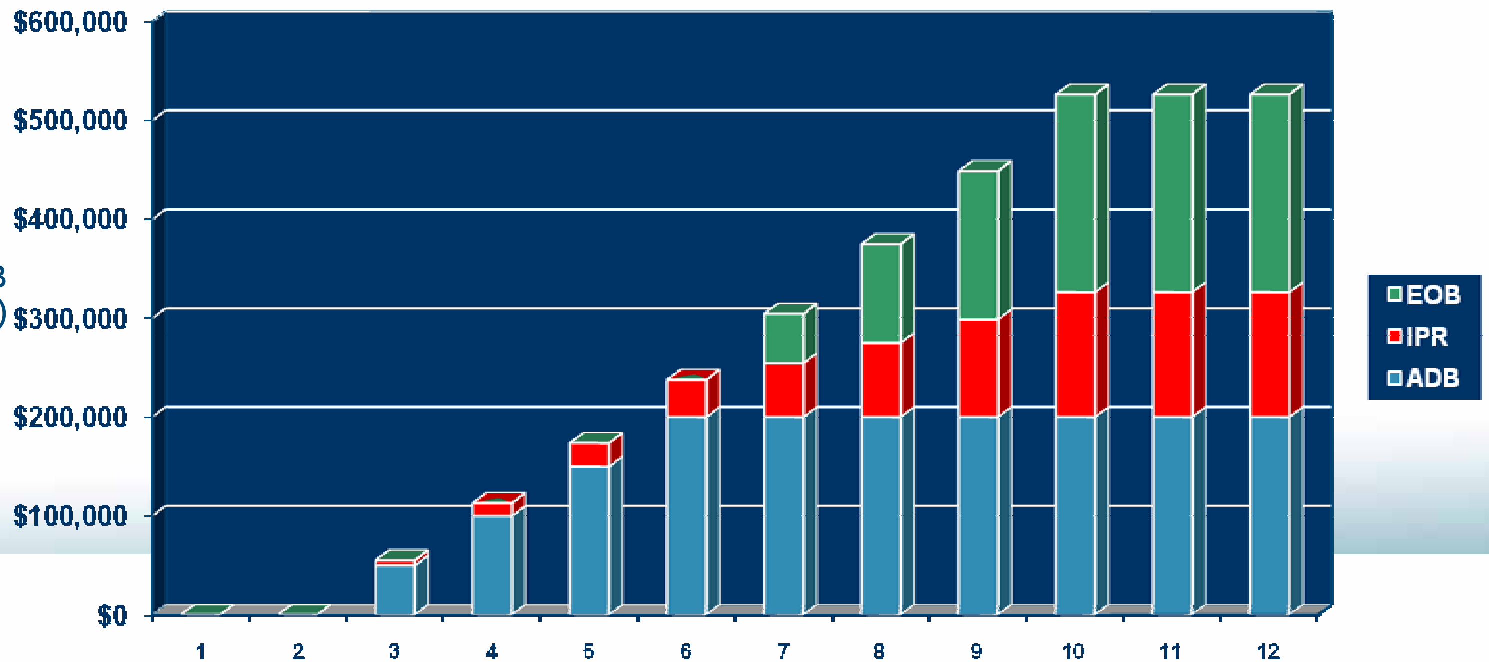
Life/LTC Product Basics

- Second generation
  - Adds Extension of benefit (EOB)
  - Asset re-positioning: Return assets, a multiple of assets (DB), or a multiple of DB (EOB)
  - Inflation option rounds out the coverage and addresses the comprehensive LTC need

Life Insurance Values (Year 3 claim)



Cumulative LTC Benefits (4 Year ADB + 4 Yr EOB)



Annuity/LTC Product Variations

- Deferred annuities
  - Designs: Payout of AV as LTC benefit, without SC, during first 2 to 4 years of LTC, with extension of benefits for a specified period after that, or pay out accelerations and independent benefits concurrently
  - Either features monthly pay-outs tied to AV at the time of initial claim
  - Another variation links monthly pay-out to a lifetime LTC pool amount that is independent of the AV
- Most feature charge structures that are typically level amounts, in basis points, against account values
- IPR requirement often is met via an offer to allow the policyholder to pour in more premium on an annual basis such that cash values increase by 5% or more

Pension Protection Act

- Favored tax treatment for non-qualified annuity combos if LTC rider meets TQ requirements beginning after 12/31/2009
  – “Separate Contract” treatment
  – Charges not taxable, but reduce basis
  – Benefits not taxable
  – Language in Act says that this treatment applies regardless of whether benefits paid serve to reduce remaining base plan values
    - Note: Need to meet the test of providing insurance, which requires some meaningful amount at risk to the insurance company
- 1035 Exchanges allowed beginning after 12/31/2009

PPA Impact on Annuity/LTC Combos

	Current Law	Under PPA
Benefits	Not clearly defined. Most companies take the position that the LTC payments are taxable, with some exceptions	Favorable tax treatment of benefits if riders designed as TQ, on non-qualified annuities only Portions (or all?) of AV currently taxable may be paid out tax-free
Tax Treatment of charges	Not clearly defined	The LTC rider charges are distributions but not taxable, however they reduce basis. No 213(b) deduction of premium allowed.
1035 Exchanges	Tax treatment of transaction unclear	Allowed
DAC taxes	1.75% generally	7.70%

PPA Impact on Life/LTC Combos

	Current Law	Under PPA
Benefits	LTC benefits tax-free if they qualify under 7702B or 101(g)	Same
Tax Treatment of charges	LTC rider charges treated as distributions. MEC contracts treated as gain first (retro to 1996). Rider not a QAB.	LTC rider charges still distributions, but not taxable; however, they reduce basis in the life contract. Rider not a QAB.
1035 Exchanges	Tax treatment of transaction unclear	Allowed

Sample Costs as Basis Points on AV

2 Year AB + 4 Year EOB, no inflation	Low	High
Age 45	45 bp	60 bp
Age 55	55 bp	80 bp
Age 65	80 bp	105 bp
Age 75	155 bp	215 bp

Future Considerations

- Market evolution
  - More variations inevitable
  - New structures for ADB to meet the test of insurance and thus assure that pay-outs are tax-free
  - **Provide the only mechanism that allows gain in an annuity contract to be paid out on a tax-free basis**
- Upgrades and exchanges to add LTC to inforce annuity policyholders
  - Enhance persistency
  - Protect inforce business
  - **Provide the only mechanism that allows gain in an annuity contract to be paid out on a tax-free basis**

Future Considerations

- Market evolution
  - Consider 60 year old annuity purchaser depositing $100K who needs 25 months of LTC at age 80
    - Without LTC rider, she cashes out $265K (5% annual growth) and pays $50K of taxes on gain (30% tax rate), with a net of <u>$215K</u> after tax
    - With an LTC rider that pays out up to 150% of AV, with a cost of 50bp per year, the annuity grows to $240K so the contract pays out <u>$360K</u> tax-free
    - Note: this ignores potential tax benefits of itemized deductions for un-reimbursed LTC medical expenses

Future Considerations

- Market evolution
  - Case 2: Same client needing 6 years of care under a 2+4 plan
    - Without LTC rider, she cashes out $265K (5% annual growth) and pays $50K of taxes on gain (30% tax rate), with a net of $215K after tax
    - With the LTC rider with a cost of 75bp per year, the annuity grows to $230K so the contract pays out $690K tax-free