Should You Buy a Tax Qualified (TQ) or Non-Tax Qualified (NTO) Policy?

Although this question appears to have been answered in the market place in favor of the tax qualified policy, there remains a very heated debate in the insurance community over the question. According to a comprehensive survey in Broker World[R] (July 2002), 90% of all of the new LTC premium in 2001 was for TQ policies. Of the 52 companies covered in the survey (representing about 97% of all of the new LTC premium written that year), 28 companies (54%) only offered TQ policies. 9 companies (17%) offered both TQ & NTQ but TQ policies comprised more than 90% of their new premium. Only with 7 companies (13%) was NTQ business the majority of their new business.

If TQ policies have such a huge portion of the market, isn't the question already settled? Not really. The advocates of NTQ policies contend (loudly and often) that NTQ policies are substantially better policies than TQ policies and the public is only buying TQ policies because they are inadequately informed by agents and insurance companies about the advantages of NTQ policies.

Let's consider the arguments in both sides of the issue:

The advocates of TQ policies point out that premiums for TQ policies are tax deductible under certain circumstances and that the benefits from a TQ policy are not taxable as income, except in certain rare situations where the policy benefits exceed a federally specified level, (currently $220/ day) and also exceed the cost of care, (only possible with indemnity policies, also sometimes called per diem policies). Their concern is that the benefits from NTQ policies could be taxable and that there might not be an offsetting tax deduction for the LTC expenses incurred.

NTQ advocates contend that almost nobody actually gets a meaningful tax deduction for their LTC premiums. That as far as anyone can determine no one has ever paid taxes on LTC benefits received from any LTC policy (TQ or NTQ), and, in particular, that it is easier to collect benefits from NTQ policies when you need care.

How valid are these arguments?

Tax Deductibility of Premiums

It appears clear that the premiums for NTQ policies are not tax deductible. Under current law, whether the premiums for TQ policies are deductible and to what extent depends on who is filing and how they file. It is clear that an employer paying the premium for a TQ policy for an employee can deduct that premium as an ordinary business expense. For everyone else there is a limit on how much premium you can include in calculating a potential tax deduction (Table 1)

Maximum Countable Premium for 2003

Age	Premium
age 40 and under	$250
41 to 50	$470
51-60	$940
61-70	$2510
age 70 and older	$3130

You can only count the actual premium paid, up to the maximum countable premium for your age for that tax year. The values in Table 1 are adjusted annually.

For the self-employed, you can deduct 100% of the countable premium as a self-employed health insurance premium. (This includes not only Schedule C filers, but also partners, LLC members and most owners of S-Corporations.)

Everyone else can only receive a tax deduction for LTC premiums if they itemize their deductions on Schedule A of their tax return. Since most of the people buying LTC insurance don't itemize, they receive no tax deduction for LTC premiums.

If you did itemize, you would only get to include in your itemized deduction, the amount by which your countable premium exceeds 7.5% of your adjusted gross income. Let's consider an example.

If we have a couple, both age 65 for tax year 2003, their maximum countable premium is $5020, $2510 each). Let's assume they both own insurance and each has a $2510 premium. Let's also assume that their combined adjusted gross income is $60,000. 7.5% of adjusted gross income is $4500. The countable premium exceeds 7.5% of adjusted gross income by $520. They can add this excess ($520) to any other itemized deductions they have. If this total is less than their standard deduction, as it will be for many people, they've just wasted a lot of time, they still haven't saved any money from their taxes because of the LTC premium paid.

It looks like NTQ advocates are right on this point. Most people will not see any tax deduction for LTC premiums. The only place where tax deductibility is meaningful is for businesses and for the self-employed (until they retire).

You may have noticed at the start of this discussion that I said "under current tax law." There is an excellent possibility that a meaningful tax deduction for LTC premiums may become law in the next few years. It seems likely that this deduction will only be available for TQ policies, (although it would certainly be preferable if it was available for all policies). If that happens, TQ policies will have a meaningful tax advantage. As many NTQ advocates will point out, if this happens, most NTQ policies offer you the option to switch to a TQ policy at original issue age and without any medical questions being asked. In that case they ask, why not buy the "better" policy now and only switch if the tax advantages are great enough to make it worthwhile to accept an "inferior" policy.

What about Taxation of Policy Benefits?

It is clear that except in rare circumstances, the benefits from a TQ policy are not taxable as income. Since there is no explicit prevision in the tax code regarding NTQ policies, the concern is that the benefits from NTQ policies might be taxable. They do not take advantage of the safe harbor in this regard that TQ policies utilize because it places limitations on the benefit triggers that may be used in the policy, as is discussed in the next section. NTQ policies are still subject to other existing laws regarding health insurance policies, which may also exempt the benefits from NTQ policies from taxation. While there is less certainty that benefits from NTQ policies will not be taxed, the Health Insurance Association of America (HIAA) recently reported the results of a survey in which they were unable to find any evidence that benefits from any LTC policy had ever been taxed.

At this time, it appears unlikely that the benefits from NTQ policies will generally be subject to income taxation. (Please note that I am not an authority on the tax code, and it is not my intent to provide tax advice. I am simply reporting what I have read regarding this subject. You may want to consult an authority on this subject before making any decision to purchase an NTQ policy.)

Is It Easier to Collect Benefits from NTQ Policies?

It appears to me that the answer is a qualified "yes". While there are very many situations in which there will be absolutely no difference between a TQ and an NTQ policy, there are some situations where it may be possible to collect benefits from an NTQ policy while no benefits would be payable from a TQ policy. The key to this is the question "How often will this occur and for how long"?

There are four major points to consider regarding this and they all arise from the requirements of the Health Insurance Portability and Accountability Act of 1996, which defined the policies and created the tax benefits of TQ policies.

First, to trigger benefits in a TQ policy, you must require substantial assistance with the activities of daily living (ADL's). NTQ policies only require that you need only "assistance" with ADL's.

Second, in a TQ policy, the need for substantial assistance with ADL's must be expected to last at least 90 days. This expectation must be certified by a medical professional. There is no "90 days" requirement required in NTQ policies.

Third, to trigger benefits in a TQ policy due to cognitive impairment, you must require substantial supervision due to <u>severe</u> cognitive impairment. There is no requirement for NTQ policies that the cognitive impairment be <u>severe</u>.

Fourth, a TQ policy can <u>only</u> trigger benefits because of a need for substantial ADL assistance or due to severe cognitive impairment. No other benefit triggers are allowed and "medical necessity" is specifically prohibited as a benefit trigger in TQ policies. It is regarding "medical necessity" as a benefit trigger around which most of the controversy centers. Some NTQ Policies also include "medical necessity" as a third way to qualify for benefits from the policy.

There is a fifth requirement for TQ policies regarding ADL assistance. TQ policies can only require that you need assistance with not less than 2 and not more than 3 ADL's from a list of not less than 5 and not more than 6 ADL's. Most TQ policies require assistance with 2 of 6 ADL's. (I would avoid any policy that require 3.) Since most NTQ policies also require assistance with 2 of 6 ADL's, this has been an area of much less controversy.

Regarding the first point, how significant is it that you require <u>substantial</u> assistance with activities of daily living? Since most TQ policies define "substantial assistance" in exactly the same way NTQ policies define "assistance". There should not be any difference between the two. You should still be very careful with <u>any</u> policy to read carefully how the benefit triggers are worded and how the terms in the benefit triggers are defined. If you do find differences in the language of the policy, ask yourself if the difference is intended to make it easier or harder to collect benefits. It if isn't clear, ask for a written explanation from the insurance company's home office. If you can't get one, don't buy the policy.

Regarding the second point, how significant is it that the need for ADL assistance be expected to last at least 90 days? The simple answer would be that if you buy a 90 day elimination period it is a moot point. While there is a lot of truth in that observation, it isn't completely accurate. In my article on the elimination period, I discuss the accumulation period and how many policies today allow you to accumulate days towards your elimination period over multiple claims, often over a lifetime. With a 90 day elimination period, you might have a short term claim where you need 30 days of care and then later, when another need for care arises, you only have 60 days remaining to satisfy for your elimination period. Some companies offering TQ policies believe that since a clearly short-term claim does not meet the "90 day" rule, those days cannot be counted towards your elimination period. In that case, an NTQ policy with no "90 day" rule could count those days towards your elimination period.

While this "90 day" rule, requiring that your need for ADL assistance be expected to last 90 days or longer, does give some advantage to NTQ policies, particularly at shorter elimination periods, it is a much smaller issue than many of the other differences you'll find between not only TQ and NTQ polices but also between TQ policies from different companies and between NTQ policies from different companies.

Regarding the third point, that in a TQ policy, you must require substantial supervision due to severe cognitive impairment, most TQ policies define severe cognitive impairment in exactly the same way NTQ policies define cognitive impairment. In that case, there should be no difference in the way TQ and NTQ policies trigger benefits for cognitive claims. (I should note that I am not an attorney and it is not my intent to provide legal advice or to interpret different carriers' contracts. If you have concerns in this area, it would not be unreasonable to consult an attorney with expertise in insurance contract law.)

Now we get to the heart of the matter. Does including "medical necessity" as a third benefit trigger make NTQ policies significantly better than TQ policies? Is it really easier to collect benefits from an NTQ policy? Nearly all of the "evidence" provided to support either view on this issue is purely anecdotal with NTQ advocates concluding that the answer is "Yes" while the TQ advocates generally concluded that the answer is "No".

I have only found one independent, scientific study of the question, [A Descriptive Analysis of Patterns of Informal and Formal Caregiving among Privately Insured and Non-Privately Insured Disabled Elders Living in the Community] (this report can be found online at: http://aspe.hhs.gov/daltcp/reports/ifpattrn.htm), and it is almost never cited by either side in the debate. Perhaps that is because it doesn't provide clear support for either side. It appears to me that the author concluded that from a national policy perspective, the answer was "No". As an agent, looking at it from the point of view of an individual client attempting to collect benefits from a policy, the answer appeared to me to be a qualified "Yes". They found that 85% of the people in the study would have qualified for benefits from either a TQ or an NTQ policy. Of the remaining 15%, it appeared to me that most of those who would meet a "medical necessity" benefit trigger were either in the process of recovering from a need for care and would have collected benefits from an NTQ policy for only a short time longer than from a TQ policy or that their condition was slowly getting worse and that while they might currently be eligible for benefits from an NTQ policy, in a short period of time they would also be eligible for benefits from a TQ policy.

The question remains "What constitutes a short period of time?" If it means 1 or 2 months we are looking at several thousands of dollars more out of pocket with a TQ policy than with an NTQ policy. If it means 6 months to a year, the difference is a very large sum of money indeed. Unfortunately, it isn't clear from my reading of the article which would be the case. No doubt the answer is a continuum of many who collect for an additional month or two from an NTQ policy to a few for whom care is medically necessary but they are unable to collect benefits from a TQ policy for 6 months to a year or more. I "guestimate" that the latter group is less than 5%.

While a difference in policies that has only a modest financial impact on perhaps 10% of the people needing care, and no impact at all on 85% is a trivial matter from a national policy perspective, it isn't trivial at all to the remaining 5%. For them, the choice of whether to buy a

TQ policy or an NTQ policy may well have been the most important decision they made regarding which policy to buy.

So then, will you be in the 95% or the 5%? Nobody knows. Should you only consider NTQ policies because you might be in the 5%? If every carrier offered both TQ and NTQ policies which were identical in all other respects, and all of the NTQ policies included "medical necessity" as a third benefit trigger for all benefits from the policy, and if the NTQ policies only cost a small amount more than the equivalent TQ policies, the answer would clearly be yes. Unfortunately, that isn't the case.

Most carriers only offer TQ policies. In the Broker World® survey I mentioned earlier, of the 52 companies cited, 28 only offered TQ policies. Of the remaining 24, 17 only included "medical necessity" as a third benefit trigger for facility care (nursing homes and assisted living facilities) if at all, but did not include it as a way to access home care benefits. Of the 7 who did have a "triple benefit trigger" (ADL's <u>or</u> cognitive impairment <u>or</u> medical necessity) for all benefits, 5 of them were carriers with financial ratings low enough that I would not normally choose to buy a policy from them.

While it may be desirable to buy a policy with substantially more liberal benefit triggers, even when the difference will only be meaningful to 5% of the people needing care, in my opinion it is even more desirable to buy a policy from a financially strong company and one which is diversified into many different kinds of insurance, so that it doesn't have "all of its eggs in one basket". It would be rather nice if the insurance company still exists when I need care.

What about the remaining 2 insurance companies who offer NTQ policies at a competitive price relative to their TQ alternatives and who also have strong financial ratings? In reviewing their policies, I've concluded that each of these policies contain serious flaws unrelated to the TQ vs. NTQ question which are in my opinion more important than the differences between TQ and NTQ policies.

The one point that never seems to be discussed in the TQ vs. NTQ debate is what impact the NTQ choice has on all of your other options. If deciding to only buy a NTQ policy means having to buy an otherwise inferior policy or having to buy from a company with unacceptable financial ratings, it is not a good choice.

Given the current state of the market, while I would look for an acceptable NTQ policy and I wouldn't buy a policy from an agent who couldn't clearly explain the difference between TQ and NTQ policies, I would end up having to choose a TQ policy.

There is never a perfect solution to anything. I would encourage you not to use this as an excuse for buying nothing at all. If you <u>do</u> need care, as most of us will at some point in our lives, it is much better to have insurance to pay for the care. It also makes no sense to wait, hoping to find "the perfect policy". As the "cost of waiting" illustration in any good quote for long term care insurance shows, every year you wait means higher premiums each year and higher cumulative premiums over a lifetime. Every year you wait, you are paying dearly for the privilege of not having the insurance.

Recent Developments

The advocates for NTQ policies have just received some strong evidence that they may be right about it being easier to collect from NTQ policies. It may be though that it is the kind of evidence they would prefer not to have.

One of the leading carriers offering both TQ and NTQ policies has just announced a rate increase on several different blocks of business written during the 1990's (fortunately at this point only in a few states). For those policy forms written since HIPPA '96 introduced the concept of a TQ policy (and as a result, the NTQ policy), they have filed a request for a 50% rate increase with the state insurance commissioners in several states.

What makes this interesting for this discussion is that nearly all of the increases apply only to NTQ policies, not to TQ policies.

While no one wants to see rate increases after a policy has been purchased, it certainly does suggest that claims paid have been significantly higher on those NTQ policies than on their equivalent TQ policies.

In the past, one of the reasons I've questioned whether it is easier to collect benefits from NTQ policies is that the insurance companies have not demonstrated this in the premiums they charge for their policies. Since the insurance companies are in a better position than any of us to determine the level of claims anticipated, if they expected to pay a lot more claims on NTQ policies they would have to charge a lot more for NTQ policies. If, as at least one company strongly advocating NTQ policies has suggested, carriers are overcharging for TQ policies, then it would have been reasonable to expect at least some companies to have reduced the premiums on their TQ policies in order to gain market share. There has been no sign of this happening. Initially, this caused me to infer that they did not expect a large difference in claims paid on NTQ policies compared to TQ policies. While this recent development may be an isolated case and not representative of all carriers, it does call into question my prior assumption.

The only conclusion I've been able to reach from this development is that people who choose to buy NTQ policies may have a higher risk of rate increases in the future.