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Annuity/LTCI Combinations: **More to Come**

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The Pension Protection Act of 2006 (PPA) opened the door for combination products featuring long-term care riders on non-qualified annuity products by addressing the tax treatment of such plans. The PPA specifies that, effective Jan. 1, 2010, qualified long-term care insurance (LTCI) benefits paid out of these plans are generally paid as tax-free benefits. The law also allows for 1035 exchanges into combination plans. This is noteworthy in light of the hundreds of billions of dollars deposited in existing non-qualified annuities issued after Dec. 31, 1996, for which these rules apply.

We have seen about 10 annuity/LTCI combinations introduced into the market, and current product development activity in the works suggest that there are more to come; perhaps doubling the number within the next year. This article provides an overview of industry perspectives, product designs, tax issues and survey findings regarding such products.

Industry perspectives on the target market for annuity/LTCI combination plans vary by company. The 50-to-80 age group seems to be the prime group to target because the maximum issue age for LTCI coverage is usually age 80, which is due to affordability and underwriting concerns. Most individuals below the age of 50 lack the immediate interest or assets to purchase this coverage. Size of the account value is another factor, as most combination annuities define monthly benefits as a percentage of the account value at the time of original claim. Consideration must be given for those levels that would not produce meaningful benefits for LTCI under the combination plan design.

The benefit payout structure is typically defined as an accelerated benefit (AB), whereby LTCI benefit payments are accompanied by concurrent reductions from the annuity account value without assessing surrender charges. This is usually combined with some form of an independent benefit that is not supported by account value reductions. Charges are typically level percentages (expressed in basis points) of the account value. Three different benefit structures are described below.

Tail design: Benefits are paid first as accelerated benefits until the maximum accelerated benefit (LTCI benefit limit, usually the account value) has been exhausted, followed by a benefit extension (BE) provision that continues independent LTCI payments at the same monthly level for a specified period of time so long as LTCI requirements are met.

Coinsurance design: Accelerated and independent benefits are paid concurrently in fixed proportions until the LTCI benefit limit is exhausted.

Pool design: Benefit payments are based on a maximum LTCI pool amount defined at issue (e.g., 300 percent of the account value at issue). The excess of the maximum LTCI pool amount over the account value defines a net amount at risk. Charges under this design may be set as a rate assessed per dollar of net amount at risk. Benefit payments reduce the remaining maximum LTCI pool and account value on a dollar-for-dollar basis until the account value is depleted. At that time all remaining monthly benefits are independent benefits and are payable so long as LTCI benefit triggers are met and the maximum LTCI pool has not yet been paid out in full.

Under the Long-term Care Insurance Model Regulation, companies that offer LTCI insurance are required to offer contract holders the option to purchase inflation protection providing for benefit increases of at least 5 percent compounded per year. Inflation protection on an annuity/LTCI combination product is typically provided either by allowing the contract holder to pay additional amounts at contract anniversaries that are sufficient to increase the monthly benefit by 5 percent per year, or by assessing a charge for the inflation protection benefit directly. The inflation benefit is expensive and the need for inflation protection varies depending on the design structure. Those designs that tie LTCI benefit amounts to account values inherently provide a form of inflation protection.

The PPA provides for favorable treatment of tax-qualified LTCI riders attached to non-qualified annuities for tax years beginning after Dec. 31, 2009. A key provision is that LTCI payouts, even if accompanied by some reduction in account values, are tax-free LTCI benefits. One key factor to consider when designing the annuity/LTCI benefit structure is that for favorable tax treatment to apply, the contract must be an insurance contract, and this in turn implies that a meaningful amount at risk exists for the insurance company. However, it is not clear when a meaningful amount at risk exists. On May 9, 2009, the IRS issued a private letter ruling that included the view that the coinsurance design presented in that case did reflect a meaningful amount at risk. For the tail design, it is somewhat less clear that there is a meaningful amount at risk during the AB period than is true for the coinsurance design.

The PPA clearly states that the charges deducted from the account value to pay for the qualified rider are considered to be non-taxable distributions from the annuity contract; however, such deductions also reduce the cost basis in the contract. The PPA does not directly address the effect that the payment of LTCI benefits has on the contract's cost basis. Since the PPA states that the portion of the contract providing LTCI coverage is a separate contract, some companies have taken the position that it would seem inconsistent to treat benefit payments from one contract (LTCI contract) to reduce the cost basis in the first contract (the annuity). This argument is further supported by the observation that the charge for the rider serves as a reduction to the basis in the annuity. Subjecting the annuity basis to further reduction related to LTCI benefit payments would appear to be an inconsistency that in essence would create double taxation. The private letter ruling discussed above, however, included a different view on this subject. Subsequent to that ruling there have been discussions of this topic within the industry, and in one recent forum an IRS representative appeared to express some openness for further consideration of this question.

A recent survey of producers was conducted by Milliman, Inc. to obtain their perspectives about annuity/LTCI combination products. The producer group included top annuity/LTCI combination producers, significant LTCI producers and large annuity producers in the market. For producers who have not yet sold an annuity/LTCI combination product, nearly all expressed an interest in selling the product. These producers reported that the need for more information and a lack of education and knowledge were the key barriers to selling annuity/LTCI combination plans.

When asked to rank the importance of simplified underwriting versus the cost of coverage, producer responses varied widely. A number of LTCI producers reported that their clients are more interested in affordability and that underwriting is not an issue for them. Simplified underwriting is important to some producers, noting that "no one likes to get turned down."

When presented with the tail design, coinsurance design, and pool design, the tail design had the greatest

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appeal among producers. It was described as the least costly option, the simplest to explain, and appealing since the benefit increases as the account value grows. Another factor contributing to the appeal of the tail design is that the client may feel that he/she has more control with this design. However, a number of producers pointed out advantageous features of the other two designs.

Many producers in the survey believe that tax advantages of annuity/LTCI combination products are not the reason why clients buy the product and this is just an added bonus. A number of producers noted that the need for the inflation provision depends on the product design and that it may not be necessary with some structures. Age, health, financial situation, and family situation must also be considered when determining the need for inflation protection.

Compensation on annuity/LTCI combination products is viewed as fair by a significant number of the survey participants. However, if a producer hasn't done much of this business, the insurer will need to incent the agent to look at it. If an agent must learn the product, learn how to position it, and learn how to sell it, they must be compensated for it at levels above typical first-year annuity compensation.

The survey participants reported that the clients targeted for the annuity/LTCI combination market are primarily in the following groups:

- Clients who are concerned about LTCI, but don't want to buy a stand-alone LTCI policy.
- Clients who can't qualify for or can't afford a stand-alone LTCI policy.
- Higher-net-worth clients who plan to self insure.

Some producers believe the minimum premium requirement for annuity/LTCI combination products may define the target market since many of the current structures have requirements of $50,000 or more. A number of producers believe that the use of annuity/LTCI combination products is a more cost effective way to self insure and to leverage assets for higher-net-worth clients. According to producers who participated in the survey, the most common reasons why potential clients do not purchase annuity/LTCI combination products are because of the perceived lack of need for LTCI coverage and because of the high cost.

Survey participants selected annuity producers, LTCI producers and financial planners as distribution outlets that would likely be the most successful in the annuity/LTCI combination markets. The survey participants provided the following comments:

- There is some thought that in order for annuity producers to sell this product the design needs to be simple since they are not familiar with selling LTCI.
- For LTCI producers, the combination product may be a natural fit because these producers know the LTCI need.
- Some producers think the compensation on the combination product will entice LTCI producers to sell the product.
- Many producers believe this product was designed for financial planners. Financial planners look at a client's financial position from a holistic point of view and this product will provide another option/solution.
- Other producers believe the product design is too complicated, financial planners don't understand the need for LTCI, and they already have too much on their plate.

The future of combination annuity/LTCI products will inevitably involve the evolution of more product variations. Innovation is also expected regarding new structures for these plans to meet the test of insurance and thus achieve optimal tax positioning for the product as well as to meet the needs of the consumer. □