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Long-Term-Care Combination Products

Track: Long Term Care

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Summary: Some companies are looking to increase sales and lower expenses by packaging the sale of long-term-care coverage with complementary products. The panelists discuss:
- *The feasibility and success of this strategy from a marketing perspective*
- *The regulatory challenges that arise from both the federal and state perspectives*

Ms. Loida Rodis Abraham: I'm General Director for John Hancock's long-term-care (LTC) product development. I want to thank my distinguished panel of speakers for being here today. Our speakers have a total of at least 90 years of experience in combination products. Today they are going to be sharing some of that knowledge and experience with you.

Let me introduce this distinguished panel. First we have Mike Sause. Mike has been in the business for 30 years in several different capacities. He was the chief marketing officer for United Companies Life from 1976 to 1988 and today has his own organization, Annuity Marketing Services, where he's worked with 20 companies doing a lot with annuity/LTC products. Mike is actually going to talk about the consumer perspective on LTC combination products. Right after Mike we will hear from Alan Furan who is an actuarial officer for Nationwide, where he has worked for 18 years—14 of those spent in individual health, working with major medical, disability income (DI) and Medicare Supplement products. The last two years he's been working on InvestCare, an annuity LTC product, and he will be sharing with us today his experience in filing these combination products, giving us some idea how state regulators, in particular, have reacted to combination product filings.

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Then we will move on to Phil Clarkson. Phil is a vice president and counsel for John Hancock. I've known Phil for a long time. In fact, I have kind of been dragging him into LTC issues. He recalls that one of the first things he had to do with me, when he began working at Hancock, was to address a memo I had sent to him asking about tax issues relating to LTC insurance. Ever since then, I've been bothering him with tax issues and LTC. This time it's on combination LTC products and Phil will discuss with us today the federal perspective on LTC combination products, in particular the tax issues. Then finally we'll have Cary Lakenbach. Cary is the president of Actuarial Strategies and has lots of experience in life/LTC products. He has done a lot with various companies on variable life (VL) product development and lately on life/LTC combination products. Cary is going to be discussing some of the approaches companies have taken in developing combination LTC products. He will be presenting the industry perspective. So, you're going to see this subject from the consumer side, the state regulator side, and the federal side, and then it will be capsulized in terms of the industry perspective.

Mr. Michael H. Sause: I want to tell you that it's a great pleasure for a marketing person to have the opportunity to speak to a room full of actuaries. What'd I like for you to do for a moment is to sit back and take your actuarial hats off. I want you to think like you're a 70-year-old consumer. You're not 40, 35, 25, or 50 years old, in the prime of your life, investing heavily in the stock market. I want you to take the actuary cap off and throw it away for a second. We're going to go through a consumer presentation, more or less, and talk about protecting your retirement assets. The sources of retirement income today for the most part are made up of private pensions, assets, and earnings that come from those assets. They represent the major source of retirement income for people today, and managing those resources to assure a rewarding retirement is very, very important for everybody and, of course, if those assets are at risk, so is that retirement income.

Let's review the sources of retirement income. According to Lee Rosenberg in *Retirement: Ready or Not! How to Get Financially Prepared in a Hurry*, 52% of the income is generated from pensions, annuities, gifts, dividends, interest, other CDs, bonds, whatever type of investments they have. Social security contributes 27%; sales of assets, home equity, and personal savings contribute 10.5%; earnings contribute 7.4%; and supplemental security income and public assistance contribute 1.9%. Personal assets represent the major source of retirement for mature adults. Money-market accounts, CDs, annuities, bonds, stocks, mutual funds, qualified plans, IRA's, and 401(k)s are the major source of income for retirees today, but we all know, as financial planners, that the cornerstone of any good retirement plan is to have some income readily available and safely stored that you never have to spend. If you deal with seniors a lot, they never tell you about all their money and they've always got money hidden somewhere they're never going to tell you about if you work with them on a one-to-one basis. The future is uncertain. No one knows what the future is going to bring. I think some of you actuaries are pretty certain about what the future is going to bring pricing these products, but in reality we don't know what the future is going to bring and if any of you out there know what the market's going to do in the next few years, how about getting together with me after the session and help me out a little bit?

We do know a couple things though. There's some good news and some bad news today. Can anybody tell me what the good news is? Now you seniors, think about it. The good news is we're living longer. What's the bad news? We're living longer. We do know the need for assistance to carry out our daily activities increases dramatically as we age. All studies would indicate that. I can tell you just for myself when I turned 25 the other day, I couldn't do as much as I could when I was 15. The need for assistance with our daily activities increases as we age. The percentage increases dramatically as we get older. LTC is very, very expensive. The daily cost ranges anywhere from $90 to $200, and I'm sure there are parts of the country where it's over $200 a day. Home health care (HHC) is probably over $200 a day in some parts of the country. Yearly costs range from $33,000 to $73,000. Now think like a 70-year-old. If your annual income was $60,000, where are you going to come up with $60,000 for LTC every year? According to the Congressional Budget Office, LTC is the largest unfunded liability facing Americans today. It's a major problem in our country today. It's major for you, the consumer. Who's paying the costs?

We're paying the costs. The individual's paying the cost. The out-of-pocket cost is roughly 48% from the individual, and then Medicaid kicks in with 44.6%. Over 90% of the cost is coming out of people's pockets. They're spending their own assets to qualify for Medicaid.

Let's summarize what we know to this point. We know personal assets represent the major source of retirement income. We know that we're living longer. The longer we live, the greater the odds are that we need assistance in our daily living. We know that LTC is very, very expensive. We also know that the majority of the people are self-insuring. If 48% of the costs are paid out-of-pocket for LTC and another roughly 45% are paid by Medicaid, this tells you that people are self-insuring. They're using their own assets to pay for LTC. LTC insurance pays a very, very small portion of this. But whether you're doing it consciously or unconsciously, you are self-insuring.

So what asset would you use first, Mrs. Jones, to pay for your LTC? Would you liquidate that money-market account? Would you liquidate your CDs? Your annuities? Your bonds? Your stocks? Mutual funds? Would you take some of your money out of your qualified plans? Sell your house? Let's take a look at the funding options for LTC. Traditional LTC government programs. We need to explore the government programs because there's still a segment of the population out there who thinks that the government is going to pay for their LTC needs. Let's explore the self-insurance option. Traditional LTC insurance. What are the advantages from the consumer standpoint? You transfer the financial risk. It helps your estate and protects your assets. It helps avoid last-minute planning and liquidating those assets. It can actually help keep you out of a nursing home because the last thing any consumer wants to do, or anybody in this age group wants to do, is go into a nursing home. Traditional LTC insurance can help keep you out of a nursing home.

What are some of the disadvantages? It can be very, very expensive, and sometimes it's very difficult to qualify for. Sometimes that qualification process can take 4, 6, 8, or 12 weeks. I will relate to you a quick story. I was at a seminar two weeks ago. It was a client seminar. There were 32 people there, probably the average age was 73 or 74, and there were probably 23 buying units. A buying unit is an individual who is there by him- or herself or with a spouse. One of the questions that was addressed to this group was, do you recognize your exposure to LTC? They had all been to a bunch of seminars. They all recognized their exposure to LTC. Of course the second question was, how many of you own LTC insurance? Of those 32 people can you tell me how many hands went up? Two. The next question was, well why don't you buy it? It's too expensive. Yet by the same token the same question was asked earlier in the seminar when they were talking about investments. They asked, how many of you own investments? About 95% of the hands went up. So people have money; they just aren't willing to spend the money on LTC.

Let's take a look at the government programs, remembering you are still clients. Let's take the Medicare and Medicaid options. Medicare supposedly will pay up to 100 days in a nursing home following a hospital stay, but as I had one individual tell me, "if you can breathe, you leave," so Medicare is not really an option. By that I mean, if you have to have skilled care to qualify for Medicaid after a hospital stay and if you're breathing, Medicare wants you out of there so its not really an option. Medicaid is for those who have little or no personal assets. It's a welfare program. The cost of Medicare is poverty, and Medicaid has a deductible, which is all your assets, and it has a premium, which is all your income. Of course, there is the other option with Medicaid, which is a loss of independence. You'd be amazed at the number of people in this market with assets who still go to Medicaid seminars. This loss of independence means a loss of options. They can't choose who their roommate's going to be. They can't choose which nursing home they're going to stay in. People didn't work all their lives to lose their independence or lose their options. With Medicaid planning you essentially have to give up all the control of your assets, and now with the new state recovery laws in all the states, that's not even really an option. The state has the right to go back and seize assets that were given away for Medicaid planning purposes. This is a state recovery law that we have in Louisiana, which gives the state the right to go after assets in the estate for repayment of Medicaid expenses.

The final option is to self-insure, which is what people are doing whether they're doing it consciously or unconsciously. I think for the most part people are doing it consciously. They don't want to go to a nursing home. They recognize the risk, but that's the last thing they want to do and why should they spend $3,000 or $4,000 a year for something they're not going to need? The next question I always ask them is which asset are you going to spend to pay for LTC needs, whether you're at home or in a nursing home. Have you ever considered a more resourceful way to self-insure where you might be able to free up some of those safe funds you have set aside, Mr. Smith, and create additional funds? Move your assets to make your money work better. If you have a $150,000 financial safety net, and we can show you how to move $50,000 of that $150,000 and create the same $150,000 pot of money for your LTC exposure, would that interest you? This will free up $100,000 for other uses. You can invest the money more aggressively or take that vacation you wanted to take. Would that be of interest to you Mr. and Mrs. Jones? A better way to self-insure is to link benefits. It creates more money for LTC. You take a $50,000 asset and move and create a $150,000 LTC benefit. You can then draw out of either bucket that meets your most urgent needs. Linked benefits is a more resourceful way to self-insure. It frees up funds and creates additional funds. Thank you.

Mr. Alan R. Furan: I am going to talk about the product that we just hit the market with. It's called InvestCare.

The reason that we developed this combination product is because our sales force came to us and said we want to get into LTC but we don't want an annual premium product. Our sales force are mostly variable annuities (VAs) producers. They deal with single-premium stuff and that's what they wanted, so that's what we tried to come up with. They really wanted a single-premium, variable LTC policy—you know, cash values, all that wonderful stuff—but we convinced them that that really couldn't be done, so InvestCare is what we came up with. It is a single-premium VA and LTC product, and it has full LTC benefits. This isn't small dollars per day or anything like that. This is full LTC benefits just like you might get in any other regular or stand-alone annual premium product.

As of now, 32 states have approved InvestCare. The filings started last spring.

I want to talk a little bit about our compliance organization at Nationwide Financial. It's essentially a couple of stovepipes. We have lots of VA compliance people and only one person who does LTC compliance, and he was the one responsible for doing all the filings. The annuity and LTC people had never really talked to each other before. They even report up through different people, so just getting the two areas together was loads of fun. Each one wanted the other named as the lead. The health people wanted this called a VA with LTC benefits; the annuity people said no this has to be an LTC product with a VA. The person running the whole show was the health product manager, so the health side won—it's a VA.

I've never worked with so many lawyers on one product. Everything else has been fairly cut-and-dry. You just develop it, file it, and you're done. We had annuity lawyers, we had health lawyers, and we had tax attorneys. Both our in-house counsel and even outside counsel came into play on this, and we even had a marketing person who was an attorney, so we had just tons of attorneys on the project.

One of the hurdles up-front was the feeling that the regulators would just never go for this. We had to really get over that hurdle, and we did resign ourselves to the fact that we were going to have to abide by both the LTC compliance rules and the VA rules.

As we got into filing this product we discovered that LTC regulations aren't really written for single-premium products. You know there just aren't that many of them around for one thing. Some states asked us about how we were going to handle third-party notification in case the premium wasn't paid in the future, and we had to remind them that the premium is all up-front so that shouldn't be a problem.

I had some federal issues in my talk regarding taxation and SEC approval, but the next speaker is going to talk on taxes so I'm going to skip that.

Since it's a VA we did have to get SEC approval, but that wasn't much of a problem. We just had to write a little bit more disclosure into the prospectus.

Our approach to filing really wasn't much different from with any other stand-alone LTC product. Most states require a filing with a cover letter, copy of the policy, etc. Although the cover letter wasn't your standard one-page cover letter that says here it is, please approve it, it was more of a four-page letter that really went into detail on what we were trying to do with the combination of products.

In a few states we did try calling ahead first saying, "We're going to file this product, we really want you to look at it, here's the reason why we're doing it." We had a legislative representative at the insurance department when we made that call, and generally there were about six or seven people from the insurance department in there, both from the health LTC side and the annuity side. Sometimes they even brought in the life insurance side of the house because they just weren't sure what to do with it. Then at the end of the conversation we generally got "OK, file it, we'll review it, and then tell you what we think in a letter." We used the legislative representatives to give us some feedback on how those conference calls went. They were able to see body language, things like that.

We even visited one state. Unfortunately, that didn't work out as well as we'd have liked so we're still working with that state to try to get it approved.

This is my opinion of the state's view of our product. The states had a look at both the annuity side and the health side of the product. One state had the same actuary look at it from an annuity viewpoint, and then from the LTC viewpoint. He had to send us separate letters: one from the annuity side and one from the LTC side. Quite often they had the same concerns in each, which made actually answering the letters rather easy. I could just cut and paste from the one response into the other. They had to take care of it from both sides, so they just followed their procedures. They wanted to make sure we met the annuity rules and the LTC rules, so both sides had to look at it. We did get some questions, such as, "What the heck are you guys doing? Why are you doing this? What's the rationale for this?" For some of those states we did have to do some explaining about what we were trying to do, and in all but a few of them we did convince them that this product should be fairly viable.

We did have some problems in that some states have regulations that either don't allow combination products or they don't have a regulation that allows a combination product. Massachusetts in February passed legislation allowing combination products, so now we're filing there. In Connecticut, our legislative representative worked what I think is miracles—he got legislation proposed this year and passed that allows combination products. That legislation is effective on October 1, so we're filing in Connecticut to get our InvestCare product approved there as well.

We do have some states that we feel we'll never get into. There are three states that don't have a statute that allows it. There are two states that have a statute that prohibits a combination product. We're going to have to evaluate whether or not we want to be in these states and then, as we did in Connecticut, decide if we want to get some legislation going to try to allow our product in there. We did have two states that wouldn't approve the product, not through statute authority, but just the thought that it was not in the public's best interest; so far all our best arguments have not been able to convince them otherwise. We also have one state that we can't file InvestCare in yet because you have to have a basic and standard annual premium plan there first before you can have any other type of LTC product. Since our sales force has said we don't want an annual premium product, we haven't developed that yet.

Some lessons learned is that we really need to review the state's requirements up-front. From the annuity side of things we had most of the requirements down pretty well, but since we had just one person working LTC compliance and we were relatively new at things, we missed some things. We heard through one of our legislative representatives that we really turned off one state because we made a filing that really didn't match what they wanted to see in an LTC policy, so getting the legislative representatives involved early may help with some of that stuff as well. Also the representatives can keep you in line. We have one state where we haven't filed the product because we have a lot of other issues going on in that state, and our representatives have told us if we push to try to get InvestCare approved there that could hurt some of the other things that may be a little bit more profitable for the company, so we've held off filing there.

Mr. Philip Clarkson: My job is talk about the federal perspective, and when I talk about the federal perspective I'm mean the tax laws because hopefully that's what I know a little bit about thanks to Loida. Obviously, in the federal side, as Alan also mentioned, there is a security law aspect, but again it seems like the security aspects are relatively straightforward. You have to do a little bit more disclosure when you add on an LTC rider to either a VL or a VA product.

Of course most LTC regulation is state specific, except for the obviously very important tax aspect. The tax laws deal with the rules relating to the insurer, the insureds, and in the group side, generally to the employer. I thought I would give a very brief background as to the current taxation of LTC insurance on a stand-alone basis for those of you who are not aware of it. The big event of course was the passage of the Health Insurance Portability and Accountability Act of 1996 (HIPAA), also known as Kassebaum-Kennedy or if you're from Massachusetts, Kennedy-Kassebaum. It clarified the tax treatment of LTC insurance in general because before that it was quite unclear as to where it fit in the Internal Revenue Code (IRC). For those contracts that qualify—and HIPAA set up a whole regime as to what qualified LTC insurance is—the benefits that you receive are not subject to tax. In addition, the premiums are currently deductible to the same extent as regular health insurance, which for most people is not very helpful because it's subject to the 7.5% floor of adjusted gross income. Qualified LTC is also treated as an A&H insurance plan so that it can be offered by an employer and given the same benefits as other health insurance, except of course it can't be in the cafeteria plan currently. There's also a specific provision in HIPAA regarding combination of LTC and life contracts, which we will discuss in a minute.

Let me give you a brief run-through as to what you need to do in order to be a qualified LTC insurance under the stand-alone product. First, the only coverage allowed is for qualified LTC services, again except for that one provision that allows it in combination with life insurance. The contract has to be guaranteed renewable under state law. It cannot have a cash surrender value (CSV), and the refunds of premium are limited to a situation involving death or the complete surrender or cancellation of the policy. The amount of the refund is limited to the aggregate premiums paid. Qualified LTC services are defined as diagnostic, preventive, therapeutic, etc., services and maintenance or personal care services to a chronically ill individual, which is a defined term, under a prescribed plan of care by a qualified medical physician. A chronically ill individual is someone who qualifies under one of three triggers. One is you have to be unable to perform 2 of 6 activities of daily living for at least 90 days. The second is to require substantial supervision to protect your health and safety because of a cognitive impairment. There is a third trigger that is allowed for under regulations, but there are no regulations now so there is no third trigger at the current moment.

As I mentioned earlier, HIPAA did contain provisions relating to combined LTC and life policies. It does allow for the combination despite the language in HIPAA that says that the only service you can provide under qualified contract is for qualified LTC services. This HIPAA language allows for the tax-free acceleration of the death benefit to a terminally ill individual, who is generally defined as someone who is expected to die within the next 24 months, or to a chronically individual using the same definition as I described earlier for stand-alone policies.

The open issue regarding combined life/LTC policies is the effect on the definition of a life insurance contract, and this is where we get into the somewhat inordinate complexities when you try to put an LTC policy together with a life insurance contract. The statute says that it allows for an increase in the guideline premium limitation. Now for those of you who don't know a lot about taxation of life insurance there are specific tests in the IRC under Section 7702 that you need to meet in order for the contract to qualify as life insurance. One of the tests, and the one that is generally going to be affected most by a combination product, is the guideline premium limitation. HIPAA did include language which would allow for an increase in that limitation, and that's as far as it went. It really didn't give you much guidance as to how this is done, so there are really some very significant questions, none of which really we have answers to. The industry has made some suggestions as to what the answer should be, but there are really no answers yet until the IRS or the Treasury gives us regulations. There are significant questions on both how the acceleration of the death benefit affects the definition of life insurance and how the charges that are taken out periodically from the cash value of the life insurance affects whether or not the guideline premium test is made and whether or not those charges are considered distributions and therefore taxed currently.

Whether or not the charges and the payment of the LTC benefit affects are taxed really depends on what type of product we're talking about. There are two types. First, the "stand-alone" product, where you have LTC as an additional benefit above and beyond the death benefit so that the LTC coverage does not reduce the death benefit. The tax laws here are somewhat simpler than the second type which is the "dependent" product, where the payment of the LTC is really just an acceleration of the death benefit. There is usually a dollar-for-dollar reduction in the death benefit. Again you will note that for the dependent-type product the taxation of these products is quite complicated, but before we get into that let's talk briefly about the stand-alone products.

Here you really have two separate benefits. You have the life benefit and the LTC benefits. It's almost as if two contracts are stuck together with periodic charges going out of the life contract to cover the LTC piece. The LTC charges reduce the CSV. The real issue is whether or not these charges should be considered distributions from the life insurance contract and how those distributions therefore effect the guideline premium limitation test. LTC is not what's called a qualified additional benefit under the code, and therefore does not have the tax benefits that are normally associated with additional benefits that are qualified. Thus it's very likely that those charges will be considered distributions in the life insurance contract subject to tax. There is, however, a very strong policy argument that they should not be considered distributions and that stand-alone contracts should be given the same tax treatment as the dependent-type contract. It's not clear what the correct answer is for dependent contracts. There seems to be a consensus in the industry that both products should be treated the same way as to whether or not the charges are considered distribution, even though there's a stronger argument that for the dependent-type policies it's not a distribution as it is for the stand-alone policy.

Assuming the charges for the LTC piece are considered as distributions, then the tax situation is relatively straightforward. For contracts that are not modified endowment contract (MEC), generally a distribution from such contract would not be subject to tax as long as you have basis in the contract so that your basis comes out first and then you're subject to tax later on. For contracts that are MECs and don't meet the seven-pay test, generally those distributions will be subject to tax to the extent that there's gain in the contract. So you will have 1099, you'll have gain, you'll probably have 10% penalty tax if someone's under 59.5, etc.

Speaking again about the stand-alone contracts, assuming that charges for the LTC coverages are considered distributions, the issue becomes how that affects the guideline premium test for those contracts or for the underlying life contracts. The guideline premium limitation, according to the statute, is increased by the sum of the charges for the LTC less the charges that reduce the premiums paid under the contract "premiums paid" being another defined term. So if the distributions are taxable, the premiums paid are not reduced; therefore, the guideline premium limitation gets increased, which is good. But if the distributions are not taxable, then the premiums paid are reduced; therefore, the increase in the guideline premium limitation is reduced by the amount that the distribution was not taxable. Like I said, this gets very complicated. It's not clear how these rules really should work, and the industry has asked the IRS on a number of occasions for answers and has so far not gotten any response.

Let's talk briefly about the dependent-type contracts where the LTC benefit reduces, usually on a dollar-for-dollar amount, the amount of the death benefit. Here the initial argument of the industry was that the charges for LTC coverage should not be considered distributions. There are certain statutory arguments that the industry has made as to why those should not be considered distributions because they really constitute a single integrated contract. However, as I mentioned earlier, there is a concern within the industry and in other quarters, that you have a different treatment for dependent-type LTC riders as opposed to the stand-alone LTC riders and that there's really no policy reason why there should be a difference between the two. So the industry developed a alternative position which would treat the charges for LTC coverage for the dependent-type contracts as a distribution, and they have asked the IRS to say that it does not reduce premium paids so that you get the increase in the guideline premium limitation. Hopefully this will not affect the status of the contract with dependent LTC as a life insurance contract.

The other major issue for the dependent-type contracts, which makes it more complicated than the stand-alone, is that you now have an acceleration of the death benefit when the person becomes chronically ill or terminally ill. The issue then is how does that payment of the benefit before death affect the status of the contracts as life insurance contracts? Obviously, the benefits themselves according to HIPAA are not taxable, and the industry position is that the adjustments should not require the company to retest the contract to determine if it qualifies as life insurance. Generally speaking, when you have a reduction in the benefit under a life insurance contract you have to recalculate the guideline premium test at the time at the reduction in benefit on an attained age basis. The problem with that is that the reduction in the guideline premiums is going to be a lot larger than the potential reduction in the premiums paid, and that means that it's going to force the contract to be in an adverse position under the definition of life insurance. The premiums paid are going to be higher than what the limitation is, and you're going to force more money out of the contract just by having paid a few years earlier. So the industry is asking that there be guidance from the Treasury which would say that basically any reduction in the guideline premium and any reduction in premiums paid would be pro rata with the reduction to the death benefit or the cash balance in the life insurance contract, and, by doing it on a pro rata basis, if the contract met the definition beforehand it should continue to meet the definition afterwards. This argument is based on the fact that it's not really a reduction in benefits—you're just paying it out a few years earlier on the need for LTC and that there's really no reason, if you have such a reduction, to force additional cash out of the contract in order to qualify it as life insurance. Again, the industry has on numerous occasions asked for guidance in this area. It's very complicated. It probably shouldn't be as complicated as it is, but tax law tends to be that way.

I want to talk briefly about the effect on the contract as an MEC, and, again, it's a similar issue to what I was just describing. Logically, when you look at it from a policy point of view, the fact that your paying out this accelerated death benefit early really shouldn't affect the calculation as to whether or not the contract is an MEC or not, but there are existing rules for MECs that say that every time you have a reduction in benefits you have to do a new test under the MEC rule. So the question is, if this is considered a reduction in benefit then you have to do a whole new test under the MEC rules at the time of the reduction in benefit. And, obviously, for LTC you could have numerous reductions in benefits as payments are made out on a monthly basis. So every month you would have to retest the contract to see whether or not it's an MEC, and very often you would then not be able to pass the MEC rules. Now you have an MEC that you didn't expect to have initially.

Obviously, there is some guidance in the HIPAA about LTC and life but there's absolutely nothing in HIPAA which would allow for a tax-favored LTC/annuity combination. There's nothing that says you can treat them as separate contracts, and there's really no guidance as to how you would combine a qualified LTC benefit with an annuity benefit and how you would tax those benefits. It is an area that wasn't even thought about when HIPAA was passed in 1996; at least it certainly wasn't thought about by the tax lawyers who helped draft it and maybe that was an oversight on our part, but there really is very little out there and it's a very difficult area to combine and still claim the tax-free benefit of qualified LTC. The only way you can do it really is to have two separate policies put together. The charges would than be distributions. You would have a qualified LTC policy and an annuity policy being sold as one policy even though they're really two policies. It would be really helpful if we got some guidance from the IRS in both the annuity and LTC combination. I think it's a product that could probably sell quite a bit more for all of us, and it would be very helpful if we got the IRS to act.

One thought I want to leave you with is that there's a lot of discussion and there's been legislation to get above the line deductions for LTC insurance. Everyone assumes that's going to come to pass as soon as the Republicans and the Democrats figure out what kind of tax bill to have one of these years. Assuming that's the case and you get above the line deduction, you would think there would be a much simpler way of combining these products since you already have the above-the-line deduction anyway for LTC so as to avoid all the charges being considered distributions and affecting these contracts as life insurance or MECs. But I'll just leave you with that as something to think about if we do get an LTC, above-the-line deduction—how we could come up with rules that hopefully would simplify this whole area because it certainly is in need of simplification.

Mr. Cary O. Lakenbach: Let me talk to you a little about combined products today from an industry prospective. I'm going to describe the types of annuity and LTC combinations for you, and then the combinations on the life and LTC side. As a general statement, there's a fair amount more activity on the life side. I think that is due partly to Phil's observation about there being somewhat greater clarity, not complete clarity but greater clarity, on the tax side. The market is still young with some limited exceptions. There have been some life and LTC combinations around now for ten years. Of course, that predated HIPAA in 1996. I think one observation worth pointing out is that the companies that are getting into this do not necessarily feel that these combination products are meant to substitute for stand-alone contracts. They're meant to provide different offerings appropriate for different situations and not as an offering in and of itself.

There are three annuity products. The first one we could call LTC-lite. What this product includes are three VA products that are available with two LTC packages. The first one actually doesn't provide the typical type of monthly benefit stream that one expects from stand-alone contracts or, in fact, from other combined products, but simply provides access to the company's LTC providers a discount. The company provides access to their own resources for support of care coordinators. It provides for waiver of a surrender charge upon occurrence of chronic illness. I believe this contract has a seven-year surrender charge and does not provide direct LTC benefits as I noted. That's the first package.

The second package includes everything that's available in the first but does provide for an LTC benefit of 1% of the initial deposit payable into the annuity, which is payable for 36 months. It's not a reimbursement contract. If the person is chronically ill, the benefits will be paid into the contract. This contract has no underwriting. That's probably unusual. There are no benefits however payable in the first seven years and there's no catch-up provision if a person becomes chronically ill in the first seven years. There's no provision for payments based upon the expenses in those years. I suppose we could view this as a start toward LTC needs. I think that's the way the company would position it. This company has a great many other LTC offerings and is a prominent player. The product was first offered in September 1999. There were $85 million of annuities sold in 1999, of which 30% had either package 1 or package 2. The company doesn't have any information about demographic breakdowns without charges. Now this company doesn't view these charges as being distributions from the contract. Package 1, the one that doesn't provide for the 1% benefit flow for 36 months, levies a charge of 10 basis points of the front end; package 2 has an additional 35 basis points based upon the initial deposit. The benefit payments, when they are made, go into the fund, so the distributions would be taxable.

Let's go on to annuity product B. This is an annuity plus a single-premium LTC contract. The LTC product is a noncancelable product of course. The LTC benefit is not fixed in relation to the annuity deposit. You can have a range of benefit periods. Really this is packaging with two different contracts into a box; it is wrapped and sold that way. Now this is a bit of a challenge that the first product actually very nicely addresses that this one doesn't. The first product, doesn't have underwriting. Give me a check. I go on to the next sale. Here, of course, you have a bit of a challenge because you're combining an annuity with a product that has regular underwriting. The company views this product as providing an innovative way to address accumulation and protection needs in one package. There's been very little in sales to date. There is a training here as I noted between the way annuities are sold and how an LTC has to be sold. On the other hand, on the tax side there are premiums paid so no taxes are due. There are some limited provisions in Section 213 of the IRC relating to deductibility, and there may be some uncertainty as to whether they provide for single-premium payments; there certainly aren't any taxes due because there isn't a distribution, but it's unclear about the deductibility side. This is a qualified LTC contract, so the benefits are received income-tax-free.

Let's go on to product C. Here we have an innovative, integrated annuity and LTC contract. This happens to be a single-premium deferred annuity and provides the higher interest-rate crediting. Let me describe the way it works. There are actually two funds that the company creates. Currently one fund is accumulating at 3%, and the second is accumulating at 9%. If a person wants to take a withdrawal for any reason and is not chronically ill, then the amount of the withdrawal will be taken out of the first fund growing at 3%. Whatever the percentage reduction is in that fund, however, that will be the percentage reduction in the 9% fund. Now if the person becomes chronically ill, then the person in fact will take money out of the 9% accumulation value and whatever percentage reduction that would represent would come out of what would be the percentage used to reduce the 3% fund. This is a reimbursement contract so that you're the only person who could collect funds out of the contract when there are payments for qualified services incurred. The contract has limited underwriting. They call it simplified underwriting, and they issue 91% of the policies that have been applied for. The contract has a seven-day wait and also offers an extended benefit rider which provides, should the annuity funds be completely exhausted, for continuation of benefits. It's just like a stand-alone contract with a long, long deductible waiting period. There's no sale information yet available. It's a pretty new contract. It is unclear what the company's position on taxes is. I suppose there is a possibility that a 1099 could be generated for any implicit charge reflected in the company's lower crediting rate, but I think that is highly unlikely. The benefits are paid into the contract and ultimately when you take the money out, the benefits accumulate implicitly in the 9% version, so when you take them out they will be taxed as annuities. This is positioned as a CD substitute and in fact may improve annuity persistency during retirement years.

That covers the annuity contracts. Now let's go on to life. While there are several versions, there are several types of contracts available ranging from a traditional package with acceleration to single-premium packages and one flexible-premium universal life (UL). In fact, actually, there are a couple of flexible-premium variable ULs and ULs that have just come out on the market. Just to review something that I think most of you understand. Acceleration here means that you're going to take out pieces of the life contract as qualified LTC charges are incurred. There is one contract here that actually is a per diem charge where the benefit is not based upon the actual amounts of charges incurred by the individual. The benefits provided in these contracts may not always be as extensive as those in stand-alone. While they do include nursing-home, HHC, and adult day-care provisions, there isn't as much variation in the benefits provided. Some of them, for example, just have a fixed relationship of HHC to nursing-home care where, of course, with stand-alones you can get a number of different ratios.

Let's look at the first one. This is a traditional package that has a variety of base contracts available; not only traditional—it's a participating contract. It comes with paid-up additions and target term riders. This contract provides for 2% acceleration per month for a minimum of 15 months, because it's a reimbursement contract. That means if you don't pay out the full 2% then just like a pool of money approach, the life insurance proceeds will remain for more than 15 months. There's an extended benefit rider that either doubles the minimum pay-out period or provides for lifetime payments. This contract has a residual benefit and you'll see that other contracts have that too but this one works by operation of a policy. The amount that is actually going to be accelerated is the death benefit at the time that the waiting period has been satisfied and because it's a participating contract, say if you started with a $100,000 contract, it might have grown to $110,000 so you're going to accelerate the whole $110,000. But, as you know, the contract remains in participating mode as it moves forward, so actually there will be more than $110,000 to be paid out, but the company will only accelerate $110,000. The remaining piece will be paid out upon death. The rider is premium-based so a single-premium version has a single-premium rider as well.

What you'll see about these contracts is most of them waive either the policy premiums or the policy charges. You have to be very careful when you're waiving the life premium, that you do that very carefully because qualified LTC contracts can only provide for qualified LTC services, and the waiver of a life premium is not viewed that way. This company has regular life and LTC underwriting. They position this contract in the wealth-transfer business, and what that means is typically people take money out of annuities because they're concerned about building huge wealth that will be taxed onerously with a combination of income tax and estate taxation at death so they pay the income tax early and use a life contract to in effect make up the amount of tax. The positioning is very much in the 50-plus age range which is typical, in fact even a little bit lower than what you might see in LTC generally.

This product has just been introduced. The sales, according to a marketing individual, are rolling in. There's interest in multipay policies which is, I would think, somewhat unusual because most of the business to date in other contracts has been single-pay offerings. Half of the applications include the expended benefit. For LTC premiums there are no tax consequences. The policyholder is paying the premium directly so it doesn't come out of a fund where there are distribution considerations that Phil described. It's a qualified LTC contract so the benefits are received income-tax-free.

Life Product Number Two. It's a single-premium integrated UL and LTC product. This product provides for a lifetime money-back guarantee. No matter what happens, if you put in $50,000, regardless of the charges, you're never going to have less than $50,000 upon surrender. The death benefit is guaranteed. There are three possible acceleration periods. There is a 90-day elimination period and extended benefits are available but only with 36- and 48-month periods. This product also is available with a 5% annual increasing feature so that is the actual amount without underwriting of death benefits and therefore avoids potential acceleration increases over time. But it's like many of these guaranteed benefit options features—it's available on a use-it or lose-it basis so if you don't exercise it in one year, it's gone. Charges for the rider and for the base contract mortality charges are cost-of-insurance(COI)-based. There is a residual benefit that is 10% of the face amount. That's an actual explicit 10%. This contract has a regular life and LTC underwriting. The insurer has been largely a life-insurance-only insurer, so new underwriting considerations have to be learned and rules put in place. What's the company looking for? It's looking for legacy assets—money a prospect doesn't need to live on. They view LTC as a fear sale; the way to self-fund LTC while passing on assets to heirs. Actually, that sounds a little bit like Mike's comments. The focus is to expand efforts on age ranges from the 50s on up and what they call those younger pre-retirees. This was introduced in the first quarter of 1999, so it's still early. They only have 37 approvals as of the last time that I spoke with them. They had $12 million of premiums in 1999, but it's on an upward curve. The average premium per policy is $57,000. However, to show you the upward curve there have been $2.3 million sales in March 2000. This contract has COI charges for LTC coverage. Since it's a single-premium contract that means it's an MEC. As an MEC, first of all, LTC is considered nonqualified additional benefits, so when you take a distribution and take money to pay for the coverage, you're in effect taking money out of the contract even though the policyholder may never see it. The contract is taxed to the extent of gain, so there's a likely 1099 impact. It is a qualified LTC contract so the benefits are received income-tax-free.

Life Product C is an integrated VUL and LTC contract. The LTC component provides for 2% acceleration and in this case 1% for HHC. There is a 90-day elimination period. The contract provides for a maximum acceleration of $250,000. Now what is perhaps so unusual about this piece is that it's a per diem contract. Once the person becomes chronically ill there is no actual analysis of the actual charges incurred, and the $250,000 actually translates relatively nicely to a $190 a day maximum per diem coverage that is stipulated in the IRC. There are no residual benefits. The rider charge is 15 basis points on assets. It's filed both with full or simplified underwriting; whatever you have on the life piece, you have on the LTC piece. Product C also looks for legacy assets. There's extensive training going on and there's no information on demographics. They have approximately $50 million of sales in 1999. The policy is approved now in more than 40 states. The asset charges for LTC coverage result in 1099s. Again, these are distributions so your surrender values, accumulation values, in the contract that pay for the charges are considered a distribution and it's an MEC, so there are likely gains. The benefits are income-tax-free because it is a qualified LTC contract.

Life Product D, the next contract, is a very popular vehicle. It's available as a single-premium integrated UL and LTC product and a seven-pay premium version. It provides essentially for a 4% acceleration, so if you have a $100,000 contract that's $4,000 a month. There's a 90-day elimination period. There is an extended benefit rider that in effect doubles the pay-out amount if you should pay out all your benefits of the life contract. There, however, is a residual benefit here. No matter how much of a life contract you pay out, the contract provides for an additional 10% of the face amount payable upon death. The rider charge, that is the charge for the LTC benefit, is a loaded percentage of the mortality charge. This is a fully underwritten contract. The company views it as a better way to sell LTC. You get to receive your benefit regardless and double your death benefit. This is a hugely successful offering. They have sold over $100 million in premiums in both 1998 and 1999. The extended benefit coverage is very popular. The flexible-premium package, however, accounts for 25% of sales. I guess I was a little surprised by that. The average premium size is $40,000. It is very popular in the senior markets and especially popular among women, which is really not a surprise. The COI-based charges do result in a 1099 impact. Certainly most likely in the single-premium UL sale you may have tax impact depending upon whether you've taken out your entire basis in the non-mix sale. It's a qualified LTC contract so the benefits are received income-tax-free.

Life Product E is the most popular version of this contract. It is a single-premium integrated, interest sensitive whole life (WL) and LTC product, that is available in 10-pay, 20-pay, and WL versions and, in fact, is available on a survivorship basis as well. The contract provides for a 2% acceleration, 60-day elimination period. There is an extended benefit rider, however, interestingly enough, this just may be a marketing disadvantage as opposed to a real disadvantage. The extended benefit rider, unlike the other policies, only applies to nursing-home care. There is no residual benefit in this vehicle. The rider charge is included in the one mortality charge for the basic contract and that includes the LTC piece. It is fully underwritten. The company positions this to provide LTC protection on income-tax proceeds. This also is a very, very successful vehicle. It's been available for several years now. There are $150 million of premiums sold in the last year that I have information about. It's a very secretive company I might add. But with $150 million you're talking real dollars. The big question here is on the tax status of the charges. There's no 1099, so the company could say, "Well there's no charges for LTC", but I think there is a real question that the IRS might inpute charges because a real benefit is being provided and that certainly creates some uncertainty. The tax benefits are received income-tax-free as this appears to be a qualified LTC product.

The last contract, Life Product F, is a flexible-premium integrated UL/LTC product. It does allow for increases, so the LTC would apply to the increases. There's a 2% acceleration. The typical feature is a reimbursement contract. It does not have an extended benefit rider or a residual benefit and, at least from my perspective, this has impacted adversely the sales appeal of the offering. The rider charge is included here also in the one mortality charge. This was introduced in 1998. There really are only 189 contracts; the business is split between male and female. This again is a flexible-premium version so the annual premiums are much smaller compared to the numbers that I shared with you for the other offerings. Again, there are some issues here about the taxation of the LTC charges since there is no explicit charge. The company indicates that the proceeds are received income-tax-free based upon Section 101(g) of the IRC. I think that the taxation that we talked about earlier, had to do with Section 77O2(b) of the IRC, which says that if an LTC rider or set of provisions meets a certain set of standards, it can be considered an A&H contract and therefore be excludable from income taxation. Section 101(g) says that if the contract meets a certain number of conditions it is considered as a death benefit under Section 101 of the IRC. However, one of the things that you lose is the potential deductibility of premiums. That may be somewhat of a theoretical issue right now, but, as you may know, there are proposals put in Congress to make LTC premium payments taxable above the line; in other words, you don't have to deduct them. That would probably have a pretty big impact on whether companies go 7702(b) or 101(g).

Ms. Abraham: I'd like to apologize for going over but as you can tell, we had a lot of material to cover. I want you to join me in thanking this panel for the information they just shared with us. We will now take questions.

Ms. Gail M. Lawrence: I'd like to know, from a consumer perspective, why would I want to buy a combination product instead of going out and finding the best LTC product and the best life product or the best annuity product? Is it simply I could be underwritten on a combination basis or is there anything in combining the products that inherently provides advantages for the consumer?

Mr. Sause: It's kind of a difficult question but basically consumers aren't buying stand-alone LTC, and they aren't buying it because it's too expensive. Now, I am not here to address whether it is better for them to own a stand-alone LTC product or it is better for them to own a combination. They are probably better served owning a stand-alone LTC product, but they aren't buying stand-alone LTC and I am not saying they're going to buy a combination product, but in many cases they'll move an asset and buy a combination product where they will never reach into their pocket and spend that $3,000 a year. So the question then becomes, are they better off with a stand-alone LTC insurance product or are they better off with no coverage at all because that's what 90% of the people are doing? If those people are not buying stand-alone LTC insurance, will buying a combined benefit product make them better off? Yes, they're better off because they aren't going to buy a stand-alone LTC policy. Now if we can go out and educate the public ,we can make this a logical sale. But that's not what the consumer buys. That's not their mentality, so it's not a logical issue with them.

From the Floor: I think first of all that you have to start with a premise that you need a life insurance contract. If you need a life insurance contract then this may be a very effective way to add on disability or chronic-illness protection just in case you need it. I mention this wealth-transfer sale because it happens to be an extremely popular market application right now. So, I think that you start off with the premise that you need life insurance. I do know, however, that I've been involved in focus groups for these products and there is an aversion to a "use-it or lose-it" mentality, and I don't know if that's the reason why LTC business isn't exploding. But maybe for some that's just an important issue. This type of vehicle offers them the ability to do that, of course at the cost of life insurance.

From the Floor: I have a question for Alan. Since you've done an extensive amount of work here regarding some of the compliance issues, you mentioned that three states don't have the statutes that allow it. Could you give us those states that didn't allow the statute because it wasn't in the public interest?

Mr. Furan: Montana, Nebraska, New Jersey, North Dakota, Oregon, South Carolina, and Washington are the states that either don't have a statute or have a statute that prohibits it or say that it is not in the public interest.

Ms. Abraham: My guess is that Colorado is the one that requires the basic and standard plan prior to annuity.

Mr. James M. Glickman: First off, I'd like to counter a comment that was made and then follow up with a question. It seems to me that LTC stand-alones, while they don't have nearly the penetration that anybody here wants, are still running at somewhere between 10 and 100 times the sales that are going on in combo products. But getting to combo products directly, one of the things I'm wondering about is that a number of the companies that are offering the combo products are selling them from the standpoint that they're going to generate a lot of the non-LTC premium, and that's the basis behind offering the LTC benefit. In other words, even if they range from only sizzle to full-blown LTC, the primary function is to try to get those other sales boosted. What I'm wondering about, particularly with the variable LTC contracts, is have the companies found that they're getting enough LTC premium generated to cover the cost of filing and of the marketing materials, or are they finding that it's really a marketing expenditure from the variable side?

Mr. Lakenbach: It is definitely not a replacement of stand-alone business as a general statement. I think your point that companies are looking at this as a means to sell additional life insurance is right on. I don't think there is any question in my mind that that is the case, and I also think that their internal assessment of this is that they're probably not going to get in so much premium on the LTC side but that it is going to enable significant increase in variable sales. That's your last point.

Mr. Furan: Well actually from our standpoint we do expect a contract to be sold more as LTC than annuities. We actually have a better annuity to sell if someone really wants to put all their money into an annuity. Ours is selling for the LTC benefits because that's what our producers wanted.

Ms. Abraham: I can share a little experience from the Hancock. Although we haven't come up with a VL LTC product, yet we've done a lot of focus groups and a lot of research on what would make sense and there are a lot of questions about whether it makes sense to position it from the life standpoint or from the LTC standpoint. There is concern that the positioning from a life standpoint would not be as successful as positioning as an LTC need. The positioning is very key but in the end what we decided, after listening to a lot of the discussions, was that ultimately if you're going to develop a combination or position a combination product, the consumer has to be convinced that there's a need for both. There has to be a simultaneous need for some life insurance and LTC insurance or annuity/LTC or another combination. We hadn't really talked about DI and LTC, but I think that would be true as well. The timing of the needs may be different, and that's one of the issues we really didn't get into today. During the first part of your life, the greater need might be in the life insurance, but as you pass that survival stage for the life area, where the greatest need for life insurance might be, then the need for LTC might be more important. So having a combination product provides more flexibility and having that trade-off may not be a bad idea.