Article from:

Long-Term Care News

April 2004 – Number 11

Will the Medicare Modernization Act Jump Start Growth in Employer-Sponsored Long-Term Care Insurance?

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Though the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (DIMA) has received much publicity for its prescription drug provisions, it could also profoundly affect the long-term care insurance (LTCI) industry.

DIMA includes provisions for health savings cccounts (HSAs) which can be funded on a pretax basis with employer or employee contributions. An HSA's primary function is to offset some of the cost sharing associated with an employee's high-deductible medical plan. However, DIMA specifically states that the HSA may also be used for qualified medical expenses as stipulated in section 213 of the IRS tax code. One such qualified medical expense is a LTCI premium. In other words, DIMA offers significant tax advantages for people covered under these plans to purchase LTCI with their HSAs.

LTC Financing Background

LTC is one of the largest unfunded liabilities facing senior citizens. The pay-as-you-go approach of Medicare and Medicaid will come under significant pressure as the demographics in the United States change. LTC Insurance provides an attractive pre-funding solution to this potential crisis that reduces the emotional and financial strain on family members, decreases reliance on the Medicaid program and helps ensure access to high-quality care. Although LTCI appears to be a sound solution, market penetration remains low. Because of this, the industry has long lobbied for tax incentives that will encourage the purchase of LTCI.

There are clearly other fundamental issues such as lack of public education of the LTC risk and a flawed Medicaid system that is preventing the private LTC insurance market from expanding. These issues are beginning to be addressed. The Federal LTCI program has begun to raise public awareness of the risk, and state Medicaid agencies continue to shore up loopholes in the Medicaid system. However, according to various surveys published on buyer behavior, tangible tax incentives may do more to increase sales than any other initiative. DIMA has just created a tangible tax incentive.

The Current Tax Incentive for LTC

The current tax treatment of LTCI plans is governed by the 1996 Health Insurance Portability and Accountability Act (HIPAA). HIPAA provided the following:

- LTCI benefit payments are not taxable (capped at $230 per day for indemnity plans).
- Employee-paid LTCI premiums are only deductible to the extent that, when combined with other medical expenses, they exceed 7.5 percent of adjusted gross income. Further, the allowable annual deduction for LTCI premiums cannot exceed the following inside limits for 2004:
  - 40 and under $260
  - 41-50 . . . .$490
  - 51-60 . . . .$980
  - 61-70 . . . .$2,600
  - 71 and older $3,250
- Employers can deduct the cost of LTC premium for employees.
- Premium contributions made by employers are not taxable income to employees.

Several tax proposals have been considered over the past few years, but as yet, none have been adopted. H.R. 831 and S. 627 (which have not been adopted) would amend the Internal Revenue Code (IRC) to allow individuals to deduct qualified LTC premiums as an "above-the-line" deduction (deductible whether or not an individual itemizes deductions) and up to the age-based limits listed above. These bills would also allow for LTCI to be paid for under cafeteria plans or flexible spending arrangements.

The president has also proposed budgets that included above-the-line deductions for LTC premiums. These sections of the budgets were cut.

How HSAs Fit In

HSAs offer a unique opportunity for individuals to purchase LTCI with an "above-the-line" tax deduction. An individual with an HSA plan can use the HSA to purchase a tax-qualified LTCI plan. Based on our

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understanding of DIMA, the tax-free amount of the LTCI premium that can be paid from the HSA is limited to the age based limits mentioned earlier.

As mentioned earlier, the HSA can be funded by employer and/or employee contributions. This is an important provision of DIMA, since it allows an individual to add contributions to the account and thereby pay for LTCI with pretax dollars. Of course, an employer has

always been able to pay for LTCI for an employee on a tax-free basis. However, given the high cost of employee benefits, employers typically offer group LTCI plans on a voluntary employee pay-all basis. This practice contains employers' costs associated with the LTCI offering since the employer is really only responsible for some minor employee communication costs. However, few employees participate in such offerings since they must pay the entire premium with after-tax dollars. HSAs offer a unique vehicle to offer LTCI to employees on a tax-preferred basis at little additional cost to the employer. Further, the employer contribution to the HSA may be used to offset part or all of the LTCI premium payment, depending on the employee's medical costs in a given year and, potentially, the age based limits mentioned earlier.

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Implications

What are the implications, and how can employers, employees and insurers take advantage of this legislation relative to LTCI?

Employers—By offering or endorsing an LTCI plan in conjunction with an HSA plan, an employer can:

1. Expand their benefit offerings. Sponsoring a voluntary LTCI program (i.e., without employer premium contributions) is very inexpensive for an employer. If the employer offers LTCI with an HSA medical plan, employees can use the HSA for qualified medical expenses. If the employee incurs very few common medical expenses (physician visits, prescription costs, hospital stays, etc.), the HSA may be used to offset an employee's LTCI premium payment.
2. Provide employees with a tax break. By implementing an HSA, employers are providing employees with a significant tax incentive for the purchase of LTCI which is not currently available anywhere else.
3. Potentially increase worker productivity. If an employee is able to use the HSA account to purchase LTC insurance for a dependent parent, the employee may be able to avoid missed work time to care for their parent.
4. Encourage the purchase of LTCI. LTC financing is a looming problem for many. Offering an HSA encourages the purchase of LTCI, which can alleviate some of these problems.

Employees/Individuals—Individuals with an HSA can take advantage of the legislated structure of the plans to purchase LTC insurance with pretax dollars. An employee may choose to use the account funded by the employer in order to purchase LTCI. If that account is insufficient, the employee may contribute to the account so long as the total contribution from the employer and employee is not greater than the plan deductible (or a maximum of about $2,600 per individual and $5,150 per family in 2004). Since the individual's contribution is on a pretax basis, the LTCI premium can essentially be paid for with pretax dollars.

LTC Insurers—LTC insurers should recognize this opportunity and target employers or individuals with an HSA. This target market has the advantage of including individuals who may:

1. Use pretax dollars to purchase LTCI. Keep in mind that the LTCI may be purchased on either an individual or group basis. This allows preferred risks to shop the individual market for a better premium than they may be offered on a group basis. Also, employees who are offered group LTCI coverage with less stringent underwriting standards may also purchase their group LTCI plan with the HSA dollars.
2. Be healthier than average. Individuals who have an option between an HSA and a more common medical plan (i.e. HMO, PPO or

indemnity plan) will likely be healthier than the average employee. Also, even if an HSA plan is the only option offered by an employer, the healthier individuals will be the people who accumulate large account balances that could be used to purchase LTCI at some point in the future. If these individuals with large HSAs are educated on the merits of LTCI, they may present a strong marketing opportunity for LTC insurers.

Summary

There are still several questions surrounding the new legislation. For example, if an HSA is offered through a cafeteria plan, can the HSA still be used for the purchase of LTC? It appears this is the case. The age-based limitation on premiums for purposes of tax deductibility is also still somewhat uncertain. Issues such as these will need to be addressed and the tax issues clarified before a plan is implemented.

The popularity of HSAs will naturally impact how many people are able to take advantage of the LTCI tax advantages offered by these plans. However, individuals who find themselves with an HSA should take advantage of the above-the-line LTC premium tax deduction that the LTC insurance industry has been requesting for a very long time.

The Fourth Annual Intercompany LTCI Conference Summary

Editor's note: As of this writing, readers interested in seeing the final presentations should visit the Society of Actuaries Web site at: www.soa.org. Click on Sections/Special Interest. The information you seek will be under Long-Term Care Insurance. Also, audiotapes of the sessions are available for purchase for a limited time period. This audiotape information is available at: www.aven.com.

The Fourth Annual Intercompany LTCI Conference was held at the Houston Hilton Americas February 8-11, 2004. On every front, it appears that this conference was the best one yet with 63 breakout sessions among the eight tracks. Attendance hit a new record of 725 and the hotel rooms, venue and food received rave reviews.

The conference began with an opening reception in the exhibit hall—which was sold out with exhibitors for the third straight year! As in the past, the exhibit hall served as the networking (and partying) headquarters for the conference with exhibitors around the perimeter and an abundance of food and drink in the center. On Monday, the first full day of the conference, each attendee had the opportunity to choose three breakout sessions from among the 24 choices. Breakfast, lunch and a late afternoon reception in the exhibit hall provided plenty of networking time together with great food and drink. That evening, three companies, MedAmerica, MetLife and Parameds.com, sponsored hospitality suites for those who were not already involved in other corporate-sponsored events.

Tuesday featured the opportunity to pick three more breakout sessions, interspersed between another six hours of networking in the exhibit hall during breakfast, lunch and the closing reception. During the closing reception, exhibitors provided prizes to 20 lucky recipients. Evening activities included two more hospitality suites hosted by Wakely Actuarial and John Hancock.

On Wednesday, attendees had the opportunity

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