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Submission for the record
for the
House Ways and Means Committee
Hearing on
Long-Term Care Tax Clarification
by
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SUMMARY

- Among the general population, recognition that neither Medicare nor most private insurance plans cover long-term care has come slowly.
- Demographic trends ensure that the proportion of individuals requiring formal paid care will increase in years to come.
- While private insurance now finances only a small portion of long-term care needs, as an increasing number of individuals recognize the possibility of needing long-term care and the costs associated with such care, private initiatives to provide for this need have grown, through both individually purchased and employment-based plans.
- Despite growth and significant changes with regard to private-sector long-term care insurance plans since the early and mid 1980s, no clear policy with regard to long-term care currently exists in the United States.
- Recent proposals call for strengthening public- and/or private-sector mechanisms through which individuals can gain access to financing of long-term care. One such proposal is that contained in the Senior Citizens' Equity Act (H.R. 8), which would, among other things, encourage the growth of long-term care insurance contracts by stipulating that these contracts be treated as accident or health insurance contracts for tax purposes.
- The tax code currently does not explicitly recognize long-term care. Therefore, the tax treatment of long-term care insurance premiums and benefits is ambiguous. Ambiguity surrounding long-term care insurance tax treatment likely acts as an impediment to the market for long-term care insurance—particularly employment-based group insurance.
- Tax policy is often used to promote specific social and economic goals. The proposed policies for the tax treatment of long-term care can be evaluated in terms of their tax burden versus their social benefit (keeping in mind who bears the burden and who benefits).
- Tax policies can also be evaluated in terms of the public long-term care expenditures associated with the policy relative to the expenditures that would accrue without it.
- Furthermore, a change in long-term care tax policy might encourage the substitution of formal for informal or more efficient sources of care unless the policies pay benefits according to a disability model (i.e., disability triggers payment as opposed to specific services). However, such a proposal may also further certain social and economic goals, including increased risk pooling, preservation of assets, and potential reduction in Medicaid expenditures for those who are not poor.

Long-Term Care Statement for the Ways and Means Committee

Introduction

The Employee Benefit Research Institute (EBRI) is pleased to submit for the committee record the enclosed statement regarding the long-term care insurance provisions contained in the Senior Citizens' Equity Act (H.R. 8). EBRI is a nonprofit, nonpartisan, public policy research organization based in Washington, DC.

EBRI has been committed, since its founding in 1978, to the accurate statistical analysis of economic security issues. Through our research we strive to contribute to the formulation of effective and responsible health and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

Among the general population, recognition that neither Medicare nor most private insurance plans cover long-term care has come slowly. Retirees and workers have only begun to understand their exposure to the risk of needing costly community or institutional long-term care, as an increasing number have faced the necessity of caring for a parent, spouse, or child needing chronic (and often increasing) personal care assistance.

Demographic trends ensure that the proportion of individuals requiring formal paid care will increase in years to come. Increased life expectancy, reduced fertility rates, and the aging of the baby boom generation mean that the proportion of people at greater risk of needing long-term care relative to the proportion who can provide physical and financial assistance will increase dramatically over the next several decades. In addition, more two worker families and single workers and increased mobility among family members mean that there will be fewer individuals available to provide care on an informal basis to friends and family.

Current Sources of Financing

Under the current system of financing long-term care, most financing for care comes from individual out-of-pocket expenditures or Medicaid, with Medicare and private insurance accounting for only a small proportion of total expenditures. Long-term care includes services provided by paid and nonpaid caregivers in institutional, home, and community settings. Because the majority of functionally dependent individuals receive long-term care on an informal basis from friends and family,¹ it is difficult to measure the total expenditures on this care. However, according to the U.S. Health Care Financing Administration (HCFA), nursing home expenditures totaled \$69.6 billion in 1993, of which 33 percent was financed through consumer out-of-pocket payments. Most of the remainder was financed through the Medicaid program (52 percent), with Medicare accounting for 9 percent, other public and private programs accounting for 4 percent, and private insurance paying for 2 percent.

While private insurance now finances only a small portion of long-term care needs, as an increasing number of individuals recognize the possibility of needing long-term care and the costs associated with such care, private initiatives to provide for this need have grown, through both individually purchased and employment-based plans. By the end of 1992, a total of 2.9 million private-sector insurance policies had been sold, up from 815 thousand in 1987.² These policies included individual, group association, Continuing Care Retirement Communities (CCRC), employer-sponsored and accelerated death benefits specifically for long-term care. While the majority of these plans were sold to individuals or through group associations, employment-based plans accounted for a significant proportion of this growth (increasing from 20,000 policies sold and 2 employers offering long-term care insurance in 1987 to 350,000 policies sold and 506 employers offering long-

¹U.S. Bipartisan Commission on Comprehensive Health Care, *A Call for Action* (Washington DC: U.S. Government Printing Office, 1990).

²Susan Coronel, "Long-Term Care Insurance in 1992," *Policy and Research Findings* (Washington DC: Health Insurance Association of America, February 1994).

term care insurance in 1992). The average age of buyers of employer-sponsored plans in 1992 was 42, compared with 68 for purchasers of individual and group association policies. Furthermore, recognition that many states are currently suffering from serious budget deficits and have been forced to make changes to Medicaid that may threaten beneficiaries' access to quality care has led many leaders to regard long-term care insurance as a potential alternative to Medicaid.

The design of private insurance policies being sold has also changed dramatically in recent years. Long-term care insurance policies have become less restrictive as they have evolved, and many of today's policies have additional provisions that make them more valuable to individuals than earlier policies. For example, several insurers now offer policies that adjust the benefit for inflation. Many policies also now include a provision that allows policyholders to stop paying premiums after a specified number of days. One type of nonforfeiture provision continues coverage at a reduced benefit level if a minimum number of payments has been made. Another type allows partial recovery of premiums paid. While policyholders may value these provisions, policies with such features cost more. However, these and other innovations give an indication of how much the private long-term care insurance market has evolved since its emergence in the early 1980s.

ISSUES

Despite growth and significant changes with regard to private-sector long-term care insurance plans since the early and mid 1980s, no clear policy with regard to long-term care currently exists in the United States. While the private-sector market is likely to continue to grow and develop despite the ambiguities and obstacles that exist in the current system, it is unlikely that the goals of adequate coverage, universal access, affordability, and high quality care will be met without a more coherent strategy, including clarifications in policy objectives and in the regulatory environment, toward long-term care in the United States.

At present, long-term care needs are met through both public- and private-sector initiatives in the United States. Medicaid, Medicare, private-sector long-term care insurance, and private out-of-pocket payments (including reliance on family and friends) are all mechanisms used to meet individuals' long-term care needs. Recent proposals call for strengthening both public- and private-sector mechanisms through which individuals can gain access to the financing of long-term care. Some proposals advocate a public-sector solution, some a private-sector solution, and some advocate initiatives that would bolster the current public/private-sector mix. One such proposal is that contained in the Senior Citizens' Equity Act (H.R. 8) which would, among other things, encourage the growth of long-term care insurance contracts by stipulating that these contracts be treated as accident or health insurance contracts for tax purposes. The bill would also allow for the exclusion from gross income amounts withdrawn from individual retirement plans or 401(k) plans for the purchase of long-term care insurance.

The Taxation of Long-Term Care Insurance

Theoretically, long-term care insurance is an item for which individuals with assets to protect should be willing to pay. Furthermore, since people of any age may potentially need long-term care services, their assets could be at risk at any time. While the chances of having extended long-term care needs are small, the costs of such a need are extremely high. However, for a variety of reasons, only a small proportion of those who can afford long-term care insurance have actually purchased it. For those individuals who have no assets they wish to protect or who believe they will never require formal care (perhaps because they have a large family), long-term care insurance may never be worth the price. However, others may lack information on the probability of needing such care, may mistakenly believe that they are already

covered by Medicare or health insurance, or may be dissatisfied or mistrustful of policies that are currently available.

The tax code currently does not explicitly recognize long-term care. Therefore, the tax treatment of long-term care insurance premiums and benefits is ambiguous. Ambiguity surrounding long-term care insurance tax treatment might be an impediment to the market for long-term care insurance—particularly employer-based group insurance.

Proponents of changing the tax code argue that the ambiguity concerning long-term care leads to questions not only about how to treat long-term care expenses but also about the treatment of long-term care insurance. If long-term care were deemed to be medical, long-term care insurance premiums paid by an employer on behalf of an employee would be tax deductible to the employer and would not have to be included in the employee's gross income. In addition, the benefits received when a long-term care insurance claim is filed (whether under an individual or employer-sponsored policy) would not be included as taxable income to the beneficiary. However, since long-term care has not been thus defined, most employers have avoided the problem altogether either by not sponsoring a long-term care policy or by offering coverage on an employee-pay-all basis. Individuals purchasing long-term care insurance either on an individual basis or as part of an employer-based plan use after-tax dollars, which has been assumed to guarantee them tax-free claims payments consistent with general rules of insurance taxation. The assumption that long-term care premiums must be included in the taxable income of employees may impede the development of the group long-term care insurance market because employers may assume that other forms of compensation that are tax preferred (e.g., health insurance and pensions) will be more valuable to most employees. In addition, employers may refrain from offering long-term care insurance out of concern that their interpretation of the tax treatment will be contrary to an eventual ruling. A misinterpretation could require the payment of back taxes or result in uncertainty regarding the recovery of past surplus tax payments.

The provision in the Senior Citizens' Equity Act to treat long-term care insurance the same as accident and health insurance for purposes of taxation would mean that premiums paid by an employer on behalf of an employee would not have to be included in the employee's gross income and that benefits received when a long-term care insurance claim is filed would not be included as taxable income to the beneficiary.

If long-term care insurance were to receive the same tax treatment as accident and health insurance, employees receiving employer-sponsored long-term care insurance benefits would receive the same tax-exempt premium payments and nontaxation of interest on accumulating plan deposits that are characteristic of qualified pension plans. The benefits paid to them would also be tax exempt, similar to those paid by health plans. To date, the only other tax-preferred prefunding (prefunding without immediate taxation of interest) of health benefits is through a separate account in a tax-qualified pension plan (a 401(h) account). However, these accounts have not been widely used in the past because of various limitations.

Conclusion

Tax policy is often used to promote specific social and economic goals. The proposed policies for the tax treatment of long-term care can be evaluated in terms of their tax burden versus their social benefit (keeping in mind who bears the burden and who benefits). Tax policies can also be evaluated in terms of the public long-term care expenditures associated with the policy relative to the expenditures that would accrue without it. For example, a proposal to treat long-term care insurance the same as health insurance for tax purposes has an associated tax expenditure (and burden), and its adoption would subsidize those who purchase individual or receive employer-sponsored long-term care insurance. Furthermore, it might encourage the substitution of formal for informal or more efficient sources of care unless the policies pay benefits according to a disability model (i.e., disability triggers

payment as opposed to specific services). However, such a proposal may also further certain social and economic goals, including increased risk pooling, preservation of assets, and potential reduction in Medicaid expenditures for those who are not poor. Quantification and comparison of the costs versus the benefits of such a policy need to be carefully considered to develop appropriate public policy.

The committee faces a difficult challenge as they confront the complexities of this issue. EBRI stands ready to assist the committee in its efforts.