Ownership and tax ramifications of LTC Riders on Survivorship Life Insurance

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KEY HIGHLIGHTS

How policy ownership can affect claims and tax ramifications

Preventing a Goodman Triangle when pairing an adult child with a parent as the insureds

Why LTC planning in an ILIT can help the high net worth avoid unnecessary estate taxes caused by self-funding LTC

Understanding the formula for receiving tax-free LTC benefits, including when there are multiple policies.

Long-term care (LTC) coverage attached to life insurance continues to be a growing market with more customized solutions. One of the designs available is LTC Riders on Survivorship Life Insurance. These policies not only insure couples, but may even allow combining an adult child with a parent using a LTC rider on the survivorship life insurance policy[1].

A couple may be living together without legal ties or could be a married couple; and they may or may not have children – but LTC is an expense that is likely to enter their lives. Recent studies of married couples found that there is a 75% to 91% chance that one or both members of the couple will eventually need long-term care.[2] While statistics don't help sell LTC, it does help to know the exposure people are facing.

In addition, today's Baby Boomers, Generation X and Millennial generations are facing the fact that their parents are likely to need care at some point in their lives – and that expenses associated with long-term care can quickly erode income and assets. Not only are a couple's finances and lifestyle at risk of erosion from LTC expenses - but adult children who feel financially and morally responsible for a parent's care may feel their own savings and retirement plans are at risk of depletion should a parent have a serious or extensive LTC event.

There are many ways to insure for potential LTC expenses. However, for those with a life insurance need, survivorship life insurance with a LTC Rider on one or both insureds offers a cost effective solution without the risk of lost premium if the policy is little or never used – a concern that is often associated with other types of LTC coverage. This solution may help with LTC planning whether a couple is looking to protect income, assets, and/or legacies for heirs; or an adult child looking for a way to keep their own finances protected from a parent's potential LTC event while planning for their own potential LTC need.

Survivorship policies may be owned by one insured, both of the insureds, or even a trust. While care should always be taken when the policy is owned by someone other than the insured, particular care should be taken when deciding on the policy ownership of survivorship life insurance with a LTC rider. How claims can be filed and who receives the LTC benefits are dependent on the ownership of the policy. Because the LTC Rider benefits are accelerating the death benefit on a life insurance policy, it is most common for insurance carriers to reimburse or pay cash indemnity benefits to the policy owner. However, claims procedures and requirements can differ between companies, and may also vary by state, so policy owners should inquire how their own specific policy will be processed at claim time. In addition, when planning LTC coverage with survivorship life insurance, it is important to understand potential ownership pitfalls or challenges in the event of the death of the first insured or end of a relationship.

This article will be addressing situations that may apply to the insurance industry in general as well as provisions with Nationwide specific policy procedures. Please note that throughout this paper there will be reference to potential gifting situations. It is important that clients seek legal and tax advice in these circumstances since many times a taxable event can be alleviated by filing IRS Form 709 to claim use of a portion of the lifetime exclusion. This may exempt the individual in question from the obligation of paying gift tax.

POLICY SPLIT OPTIONS

Before addressing survivorship policy ownership scenarios with the LTC rider included, and potential outcomes of each, we will briefly discuss Policy Split Options. A Policy Split Option is usually available only to legally married spouses and under defined circumstances; and allows for the survivorship life insurance policy to be converted into two separate single life policies for each insured. This option, including potential charges and when it may be applied, varies by insurance companies. However, the general purpose is to provide alternative options for legally married couples in the event of a divorce, or when there are changes in estate tax laws that would no longer offer advantages to having a survivorship policy for estate planning purposes. While there are scenarios for which survivorship life insurance may be used that do not involve legally married couples, a policy split option is generally only available to legally married spouses.

Policy Split Option generally cannot be combined with the LTC Rider

Unfortunately, insurance regulations do not always keep the same pace as product development, thus insurance companies offering LTC riders on survivorship may be faced with the inability to offer both a policy split option and LTC riders on the same policy. Due to current insurance regulations, Nationwide, sponsor of this white paper, is currently unable to allow the Policy Split Option to be chosen when the LTC Rider is added to a survivorship policy, thus this paper will focus on how death, divorce, or the end of a relationship would apply to Nationwide specific policies. Please note that Nationwide does not provide tax or legal advice, and any scenario shown below should be addressed with the client’s tax and legal counsel.

POLICY OWNERSHIP – CLAIMS AND TAX RAMIFICATIONS

Generally, for a LTC claim to be filed, the policy owner must sign the claim form agreeing to the file the claim. The insured must also sign the claim form agreeing to go on claim. Because LTC benefits are (generally) paid to the owner of the policy, if the insured and the owner are not the same person, there is no guarantee the policy owner will use the money towards the insured’s LTC expenses. Some companies have the insured sign a statement when the claim is filed verifying that the insured has been informed of this. The insured cannot be forced to participate in a LTC claim if they are uncomfortable with their particular situation. Conversely, the policy owner cannot be forced to file a LTC claim. Thus, it may make more sense in most situations for the insured to be an owner of their policy. But that is not always how ownership takes place, and without a policy split option, it may help to look at various scenarios and what would transpire in the event of a split in the marriage or relationship.

Joint Policy Owners, One or Both Insureds with the LTC Rider

When there are joint owners of a survivorship life insurance policy, one owner is named as the primary owner (usually the first name placed on the application). LTC benefits are normally paid to the person designated as the primary owner, regardless of which insured is on long-term care claim. Some companies will allow the primary owner to designate the other owner/insured who is on claim to receive the monthly payments.

When a LTC claim is filed, the claim form must be signed by the insured filing for benefits as well as by both policy owners. In the case of a divorce or split in a relationship involving a jointly owned policy, this will still be true, thus the individuals will have considerations such as the following:

1. If the couple was married, they will need to decide who will be responsible for any premium still due. This decision may be mandated by the divorce court or the dissolution agreement. Keep in mind however that it is not the responsibility of the insurance company to enforce such agreements. It is up to the parties involved to make sure the required premiums are paid according to policy’s contractual provisions. If the couple was not married, then legal advice should still be sought out to help iron out this matter.

2. At claim time, both owners of the policy as well as the insured for which the claim is being filed must sign the claims forms. When the policy owner and the insured are not the same person, neither can be forced to file the claim.

3. Thus, with the above in mind, the divorcing or splitting couple should decide whether to keep the policy, and/or whether to keep their LTC Riders. Potential implications are discussed below.

4. Should the couple decide to keep the policy - the primary owner, upon being paid LTC benefits, can pass those benefits on to the ex-spouse/partner claimant without having gifted since the claimant is a policy owner and entitled to collect the LTC benefit. Again, any mandates of the divorce decree or dissolution agreement would be the responsibility of the splitting couple to abide by. The insurance company will not monitor whether transfer of the benefit was made to the ex-spouse/ or partner. However, some insurance companies may allow the secondary owner to be assigned to directly receive the LTC benefit.

5. If [i]there is a LTC Rider on only one insured, the divorcing couple may want to consider changing ownership of the policy. In this case it may make sense for the insured with the LTC Rider to be the sole owner of the policy to avoid potential future disputes at claim time. For a couple that was married, this change to sole ownership can be accomplished tax free since there is unlimited gifting to spouses, and can be implemented either prior to the divorce or as part of the divorce decree or

dissolution agreement. However, keep in mind that the sole owner would have sole discretion in making beneficiary designations. For a couple that was not married, the change to sole ownership will create a gifting situation.

One Policy Owner, One or Both Insureds with the LTC rider

When there is only one owner of a survivorship life insurance policy, that owner will be the person filing the claim. However, the claim forms must be signed not only by the policy owner but by the insured for which the LTC claim is being filed for. LTC benefits will be paid to the policy owner, regardless of which insured is on long-term care claim. For the insured who is also the sole policy owner, there are no pitfalls since they are in sole control of filing a LTC claim and will be the person to whom LTC benefits are paid.

However, should a couple divorce or split, the policy owner will be the one to receive LTC benefits, even on an ex-spouse/partner claimant. Thus, the non-owner insured should think carefully about filing a LTC claim since there is no guarantee the LTC monthly benefits would be used to pay that individual's LTC expenses. However, if the court mandates that the LTC benefits be paid directly to the insured, and such a document is provided to the insurance company, them most companies are able to provide direct payment of benefits to the insured.

Consider the following in the event of an upcoming divorce or split of a relationship when there is only one policy owner:

1. If the policy has the LTC rider on both spouses, then the non-owner claimant must be aware there is no guarantee the policy owner will use the money towards the non-owner insured's LTC expenses. If the non-owner wishes to retain the LTC Rider, they should consult their attorney about provisions in the divorce decree to help assure they receive their LTC benefits. Nationwide's obligations are limited to the policy owner or court order. It is up to the splitting couple to get legal counsel and work out an arrangement when collecting LTC Rider benefits on a non-owner ex-spouse/partner.

2. If the policy owner is also the insured with the LTC Rider, then there should be no problems with filing a LTC claim or collecting LTC benefits since the non-owner insured would have no involvement in the process. However, the non-owner should remember that the owner of the policy has the right to name beneficiaries, and may change the named beneficiaries to other persons than what the couple agreed to when still together.

3. If the policy is owned by one insured, but the LTC rider is only added to the non-owner insured, a divorcing couple may want to consider a tax-free transfer of ownership to the insured with the LTC Rider[3]. Unlimited gifting to spouses to transfer the policy would apply here as stated above. Again, policy ownership comes with rights to name beneficiaries, so this should be discussed with the attorneys assisting with the divorce. LTC benefits will be paid to the policy owner. When the policy owner passes those benefits to the ex-spouse claimant, details of the divorce decree will identify if a gifting situation applies. If the policy owner is facing a gifting situation, they should consult an attorney for assistance. Should the divorced couple be on amicable terms and the policy owner does not want to file IRS Form 709 and use a portion of their lifetime exclusion, the policy owner may be able to avoid gift treatment by directly paying the non-owner insured's LTC expenses.

4. If the couple had not been married, the exemption to gifting would not apply to policy ownership transfer. If ownership is not changed, then, when the policy owner receives LTC benefits on the non-owner, the transfer of the benefits to the non-owner will create a gifting situation. Again, the policy owner may be able to avoid gift treatment by directly paying the non-owner insured's LTC expenses. This may only be practical if the individuals are on amicable terms.

ADULT CHILD AND PARENT AS THE INSUREDS AND POLICY OWNERS

There may be situations where an adult child will want to secure LTC coverage for a parent while securing their own LTC coverage. This could help protect the adult child (and his or her spouse) from depletion of retirement (or college) savings should the parent need financial help to pay for LTC services; and at the same time protect that adult child's income, assets and legacy planning in the future should the day come that the adult child should themselves need long-term care.

Nationwide will allow the combination of an adult child and parent as the insureds on a survivorship policy with a LTC Rider. The advisor should remember however, that the death benefit does not pay until the second death. Should the adult child pass away *before* the parent, no death benefit would be paid until the death of that surviving parent. Thus, for situations in which the adult child needs life insurance for family protection, it may be wise to supplement the policy with term insurance on the adult child until the parent is deceased.

While a parent/adult child relationship is not likely to split up, in the event of such a situation, the same information shown in the previous section relating to non-married couples will apply to parent/adult child policy owners and insureds.

Preventing the "Goodman Triangle"

When designing a case with a parent and an adult child as insureds, care should be taken when determining ownership of such policies. To prevent the death benefit of a life insurance policy from being considered a gift, there must only be two parties to the contract. Typical examples of proper ownership on single life insurance policies might be where a wife is the owner and insured on a policy with her husband designated as the beneficiary. Or perhaps the wife is owner and beneficiary of a life insurance policy on her husband. You might also see a trust being the owner and beneficiary of a life insurance policy on the grantor of a trust. In all the above examples there are two parties to the contract.

The most common ownership mistake, especially when having an adult child as co-insured with a parent would be creating what is known as a "Goodman Triangle." This is where there are three parties to the contract – in other words, one party is the owner, a second party is the insured, and a third party is the beneficiary. When this ownership situation takes place, the death benefit is considered a gift from the owner to the beneficiary.

This may not be relevant for many people since the lifetime exemption is $13,610,000 for singles and $27,220,000 for couples (for 2024). However, IRS Form 709 would still have to be used to report the use of the lifetime exclusion to avoid owing tax on the gift. (Clients should consult their tax advisor). In addition, while the gift may not be relevant for many by today's tax laws, keep in mind that unless the tax laws change, the lifetime exemption will reduce back to approximately $6.2 million for singles ($5.49 million adjusted for inflation) and $12.4 million for couples starting in 2026 – meaning this could be problematic for some affluent policy owners in the future. Thus, it may make sense to set up the policy correctly from day one.

What does a Goodman Triangle look like? Let's look at a hypothetical scenario. Bob is going to purchase a survivorship policy on his wife Sue and her mother Jane. His intent is to provide a funding solution for his mother-in-law, Jane, so hopefully she'll never need to move into Bob and Sue's home should she need long-term care. In addition, there will be LTC coverage for Sue in the future should that become a need.

BOB'S MISTAKE – CREATING A GOODMAN TRIANGLE

Because Bob wanted to maintain control, he asked his advisor to set up the policy as follows:

1. Sue and her mother, Jane, will be the insureds on a survivorship policy with the LTC Rider on both insureds
2. Bob would be named as owner of the policy
3. Bob and Sue's adult children would be named as the beneficiaries.

However, with this ownership arrangement, three parties to the contract have been created, thus when the death benefit is paid, it will be considered a gift from Bob to his children.

How can Bob remain sole owner, maintain control of the policy, and avoid the Goodman Triangle? Bob's advisor suggested the following:

1. Sue and her mother are the insureds
2. Bob is still named the owner of the policy, but names Sue as the contingent owner
3. Bob is named beneficiary, but designates the adult children as contingent beneficiaries.

Now, Bob's concerns are addressed without creating a Goodman Triangle to accomplish his desired outcome. If Bob predeceases Sue, the following will occur:

1. Sue becomes the policy owner. Since there is unlimited gifting to spouses, no potential gift tax consequence would occur if and when Sue becomes the owner of the policy.
2. Upon Bob's death, the adult children become the beneficiaries of the policy.
3. Now we have Sue as an insured and owner, with the children as beneficiaries, maintaining two parties to the contract. Bob is able to maintain control of the policy, have his desired outcome take place – and avoid a Goodman Triangle.

IRREVOCABLE LIFE INSURANCE TRUST (ILIT) OWNERSHIP

Owning a survivorship life insurance policy inside of an ILIT that includes a LTC rider is possible, but it is generally suggested that the policy being purchased is able to pay LTC claims by indemnity or cash indemnity. Usually, an ILIT is used for high net worth clients who are likely to have estate tax liabilities. Use of death benefit proceeds are usually planned for as a funding vehicle to pay estate taxes, which helps keep the total value of the estate in-tact for beneficiaries.

One may argue that high net worth clients can self-fund long term care – and that may very well be true; but keep in mind, such a plan could subject the high net worth individual(s) to unnecessary estate taxation. For example, a person may plan to self-fund by setting aside $1,000,000 in their estate to pay for potential LTC needs. But with 2024 estate tax rates maxing out at 40%, if this individual were lucky enough to need little or no LTC, he or she could end up subjecting their estate to up to $400,000 in estate taxes.

Putting the LTC rider on a life insurance policy that the ILIT is going to own, can help avoid unnecessary estate taxes caused by self-funding since funds will not be set aside and left in the estate to pay for LTC. A strategy for using a LTC Rider to potentially leverage additional gains for the trust can be found in the white paper "Using Long Term Care Riders in Estate Planning"- NFM-3880AO.14. To obtain a copy of this white paper, please call the Nationwide Sales and Service desk at 800-321-6064. Simply refer to the title and order number shown above.

TAX RAMIFICATIONS

While long-term care benefits are generally paid tax free, there are potential tax ramifications that one must be aware of since the tax free amount that can be paid in LTC benefits has IRS limitations.

Tax-free formula for long-term care benefits

The total amount of LTC benefits that can be received tax free is the greater of the HIPAA per diem amount allowed in the given year of claim - or - actual LTC expenses incurred. This amount is cumulative of all policies paying LTC benefits (or Chronic Illness benefits) on a single insured, regardless of who the owner is. Any amounts collected in excess of the formula in a given year will be taxed as ordinary income.

More than one policy owned on an insured

If multiple policies are owned on a single insured, the insured receives first access to any tax free amounts (assuming they own one of the policies). Any remaining tax free amounts or taxes due will then be divided pro-rata between other policy owners.

People who plan to be the insured on multiple owned policies, or plan to own LTC coverage on someone who has other LTC coverage should consult their tax advisor or attorney during the planning process. Depending on the amount of coverage and the type of ownership, results of the tax free formula could differ for an individual. Nationwide does not give legal or tax advice, so please consult your personal tax or legal counsel.

SUMMARY

For couples or families looking to ensure the need for long-term care on two people, survivorship life insurance may provide a cost effective solution that can help protect a family's income and assets from depletion due to LTC expenses. Whether the need is for spouses, partners, or adult children wanting to afford good care for parents, LTC planning is an important part of a well-rounded financial plan.

[1] Contact insurance company for availability, and review contract for any restrictions on difference of age between the two insureds
[2] Insurance News Net - "The Likelihood and Cost of LTC May Be Higher Than You Think". by Robert Pokorski – January 1, 2022. The April 2019 study showed the likelihood of needing LTC from age 65 to death. These are historical (retrospective) data based on self-reported need for HIPAA-level LTC.
[3] The insureds under the base policy should be the same after the transfer to qualify as a tax-free exchange.

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