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ADMINISTRATION'S PROPOSED DEDUCTION FOR LONG-TERM CARE INSURANCE PREMIUMS LIKELY TO BE INEFFECTIVE AND COSTLY, AND OF PRIMARY BENEFIT TO HIGHER-INCOME INDIVIDUALS

by Edwin Park

Summary

As part of its fiscal year 2005 budget, the Administration has again proposed a deduction for the purchase of long-term care insurance.[1] This proposal would provide little or no assistance to most low- and middle-income families and thus is unlikely to be very effective in helping more people secure long-term care coverage. Instead, it would primarily serve as another tax-cut benefit disproportionately geared toward the high-income individuals who least need assistance and who can already afford long-term care insurance.

- Most low- and middle-income families that cannot afford to purchase long-term care insurance either do not earn enough to owe income tax or are in one of the two lowest tax brackets — the 10 percent bracket or 15 percent bracket. About three-quarters of all tax filers either are in the 10 percent or 15 percent brackets or do not earn enough to owe income tax.

  The proposed deduction would do little for these people. Low-income families that do not earn enough to incur income tax liability would receive no benefit whatsoever from the deduction. For middle-class families in the 10 percent or 15 percent tax brackets, the deduction would defray no more than 10 cents to 15 cents of each dollar they would have to spend to purchase a long-term care insurance policy.

- The proposed deduction would be of greatest value to higher-income taxpayers. The higher an individual's tax bracket, the greater the subsidy the proposed deduction would provide. For individuals in the highest tax bracket, the deduction would, when fully phased in, subsidize 35 percent of the cost of long-term insurance.

- The people in the top tax brackets are the individuals who are most likely already to have long-term care insurance or to have sufficient assets to be able to afford to meet their long-term needs directly, without government help. They also are the taxpayers who gained the most from the 2001 and 2003 tax-cut legislation and would benefit most from the other tax cuts the Administration is now proposing, such as new tax-favored savings accounts.

[1] U.S. Department of Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals*, February 2, 2004. The proposal is identical to the proposal included in the fiscal year 2004 budget.

The Administration's fiscal year 2005 budget includes a second tax cut related to long-term care that also was included in previous budgets. The Administration proposes to allow families caring for a family member with long-term care needs to claim an additional personal exemption. This proposal, as well, would be of greatest benefit to higher-income individuals, since the value of the additional personal exemption — like the value of the proposed long-term care deduction — would vary depending on a taxpayer's tax bracket. This proposal ultimately would provide the largest subsidies to those in the highest tax brackets, much less assistance to most middle-income families, and no assistance to low-income working families that do not owe enough to earn income tax.

As a result, the Administration's long-term care proposals would have perverse effects. These proposals would consume a substantial amount of federal budget resources to provide new subsidies for long-term care to the very Americans who need such subsidies least, while doing little to address the large long-term care costs that millions of Americans face. A much better way to help defray a portion of long-term care costs through the tax code would be to institute a refundable tax credit for long-term care expenses. Such a credit would assist households in caring for a family member living in their homes. Unlike with a deduction, the value of a refundable tax credit would not vary with an individual's tax bracket.

Deduction for the Purchase of Long-Term Care Insurance

This proposal would provide a deduction for the purchase of long-term care insurance, primarily in the individual insurance market. This deduction could be taken both for the premium costs that tax filers pay to purchase policies in the individual market, as well as for the employee's share of premium costs for long-term care insurance offered through an employer if the employee pays at least 50 percent of the cost. The deduction would start to be available in tax year 2005 and be phased in over four years. Starting in 2008, taxpayers could deduct 100 percent of the cost of long-term care insurance premiums, up to certain dollar limits. Both those who itemize deductions and those who do not could take this deduction.

The cost of the proposal is $21.4 billion over 10 years, according to Administration estimates. This cost is held down because of the slow phase-in. The Administration estimates that the proposal would cost $16.1 billion in the second five years of the ten-year period, when it would be in full effect. This is triple the proposal's cost in the first five years.

While the proposal is intended to help more people secure long-term care insurance, the deduction is actually a subsidy, delivered through the tax system, that is targeted to those with higher incomes who least need assistance and does little or nothing to help those who cannot currently afford long-term care insurance. This is because the proposed deduction would offer little or no assistance to low- and middle-income families. Most low- and middle-income families either do not earn enough to owe income tax (in which case they would receive no benefit from the deduction) or are in the 10 percent or 15 percent income tax brackets. Only the top quarter of tax filers is in brackets higher than the 15 percent bracket.

- When the deduction is phased in fully in 2008, it would defray no more than 10 cents to 15 cents of each dollar that most middle-class taxpayers spend to purchase a long-term care insurance policy. For lower-income individuals, it would be of no value at all; the 17 percent of tax filers who do not earn enough to incur income tax liability would receive no benefit. The deduction would consequently do little to make long-term care insurance affordable for the large majority of American households.

Moreover, in 2005, when the deduction would equal 25 percent of insurance premium costs, the deduction would be worth no more than 2.5 cents to 3.75 cents of each dollar that most middle-class taxpayers spent on long-term care insurance.

- By contrast, for those individuals in the highest tax bracket — which is 35 percent in tax year 2004 — the deduction would be worth at least 35 cents on the dollar. Only six percent of tax filers are in the top three tax brackets — what are now the 35 percent, 33 percent, and 28 percent brackets.

- Because taxpayers could deduct insurance premium amounts only up to specified dollar limits regardless of the actual premium amounts they paid, the percentage of premium costs that the deduction would defray could be even smaller for some taxpayers. (These dollar limits would vary by age and be adjusted annually.)

- Higher income taxpayers — the group that would receive the largest tax subsidies from the deduction — are the individuals who already are most likely to have long-term care insurance or to possess (or be able to accumulate) sufficient assets to pay future long-term care costs directly. As a result, the deduction turns out to be another tax cut that primarily benefits those at higher income levels.

The proposal also apparently fails to include some insurance market reforms necessary to make long-term care insurance accessible and affordable. In the absence of significant reforms, large numbers of individuals would be shut of the market for individual long-term care policies. This is because companies selling long-term care insurance in the individual market can generally vary the premiums they charge, based on age and medical history, and can deny coverage entirely. According to a study by the Commonwealth Fund, up to 23 percent of applicants for long-term care insurance at age 65 are rejected outright.[2]

- The Administration's proposal does not include a requirement that every applicant have access to a long-term care insurance policy or that such a policy be affordable. Such a reform is desirable because older and sicker individuals may be denied coverage entirely or charged prohibitively high premiums. Similarly, the proposal does not provide protections against unaffordable premium increases an insurer may impose when a policy is renewed.

- Most long-term policies also pay fixed dollar amounts per day, such as $200 per day of nursing home care. Without any adjustment for inflation, which many plans do not include, the value of such policies can erode significantly over time. Many plans also do not include non-forfeiture provisions by which an individual

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[2] Mark Merlis, *Financing Long-Term Care in the Twenty-First Century: The Public and Private Roles*, Commonwealth Fund, September 1999.

receives partial benefits if the individual can no longer afford the premiums over time. The Administration's proposal contains no reforms in these areas.

- The proposal authorizes — but does not require — the Secretary of the Treasury to set some new unspecified federal consumer protections for long-term care insurance policies. Plans would need to meet these federal standards to qualify for the deduction. One possible standard suggested by the Administration would be that the long-term care plans comply with the model law and regulations of the National Association of Insurance Commissioners (NAIC), which are intended to address some (although not all) of these problems. It should be noted, however, that the model law and regulations do not guarantee access to a long-term care policy for all individuals. Nor does the Administration's proposal mandate that the Secretary of the Treasury actually require long-term care insurance plans to comply with the NAIC model law and regulations or that the Secretary set any standards at all.

A more equitable and effective tax-based alternative would be a refundable tax credit to help subsidize a family's long-term care *expenses*, along with insurance market reforms. Unlike a deduction, the value of a tax credit does not vary by tax brackets. A refundable tax credit for individuals who care for family members with long-term care needs could provide the full tax credit subsidy to taxpayers who most need help in covering these costs, rather than shutting out those most in need and providing a subsidy that grows as a taxpayer's income rises.

Over time, states also could take advantage of the increased flexibility that federal regulations issued in 2001 have given states to expand Medicaid coverage to elderly and disabled individuals who are incurring catastrophic long-term care costs. Under these regulations, states can reduce substantially the size of the "medically needy" spenddown amount — the amount of out-of-pocket costs for long-term care expenses that individuals must incur before they qualify for Medicaid coverage. This would have the effect of making it easier for elderly and disabled people with substantial long-term care costs to qualify for Medicaid.

Additional Personal Exemption for Caregivers

The Administration also proposes to permit taxpayers who care for family members with long-term care needs to claim an additional personal exemption on their tax returns. The dependent family member would have to live in the taxpayer's household and be a spouse, ancestor, or spouse of an ancestor. As determined by a physician, the dependent also would have to need assistance with at least two Activities of Daily Living (ADLs), such as eating or toileting. The proposal would be effective starting in tax year 2005. According to the Administration, it would cost $3.8 billion over 10 years.

This provision, as well, is poorly designed to respond to the needs of families that need assistance in covering long-term care costs.

- Like the long-term care deduction, the value of this exemption would rise with a taxpayer's income. It would be worth modest amounts or nothing to most middle- and lower-income families, and would be worth the most to those in the highest tax brackets.[3] The additional exemption consequently would be of no or only modest help to lower-income families with long-term care needs, while providing a more substantial subsidy for higher-income households that have less need for such assistance.

- For example, assume the exemption was available in 2004. The personal exemption is $3,100 for 2004. A low-income working family that did not earn enough to owe income tax would be shut out of this new federal subsidy, despite being the type of family most in need of such a subsidy. A moderate-income family of four with income of $30,000, which would place the family in the 10 percent tax bracket, would receive a $310 tax benefit (10 percent of the $3,100 exemption) to help offset the costs of taking care of a dependent family member at home. By comparison, a higher-income family of four that earns $200,000 and is in the 28 percent bracket in 2004 would receive a $868 tax benefit, despite the fact that such a family generally would be financially able to care for a dependent family member without a government tax subsidy.

As noted above, a far more equitable tax-based approach to the difficult problem of financing long-term care costs would be to establish a refundable tax credit (rather than a deduction or an additional exemption) to subsidize long-term care expenses that low- and middle-income families incur, along with insurance market reforms.

Conclusion

The Administration again includes in its budget two tax cuts related to long-term care: a proposal to provide a deduction for the purchase of long-term care insurance and an additional personal exemption for individuals with long-term care expenses. Both proposals would disproportionately benefit higher-income individuals who do not need government subsidies to help them defray long-term care costs while doing little to help low- and middle-income families who often do face difficulties in meeting such costs.

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[3] As with the general personal exemption, the additional exemption would phase out by two percentage points for each $2,500 ($1,250 if married taxpayers file separately) by which adjusted gross income exceeds certain income thresholds based on filing status. For tax year 2004, the thresholds are $142,700 for single filers, $214,050 for joint filers, $178,350 for heads of households, and $107,025 for married taxpayers filing separately. The thresholds are indexed for inflation. However, the tax changes enacted in 2001 eliminate the phaseout between 2006 and 2010. By 2010, high-income taxpayers will receive the full personal exemption and under this proposal, they also would receive the full additional exemption.