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Consumer Action by Diana Ransom (Author Archive)

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Long-Term-Care Annuities to Go Tax Free

Think shelling-out for your own home-health services, an assisted-living facility or nursing-home care may be in your future? Good news: Come New Year's Day, these services can be yours tax-free.

Thanks to the Pension Protection Act of 2006, starting Jan. 1, 2010, you'll no longer have to pay federal income tax on an annuity's proceeds — if you use those proceeds to pay for long-term-care coverage. That means that the chronically ill or disabled will no longer have to rely solely on a regular long-term-care insurance policy or Medicaid to fund their medical and non-medical care.

Considering that long-term-care costs are expected to reach $300,000 a year by 2030, up from $75,000 currently — and Medicaid only covers up to 75% of long-term-care costs — this is a welcome change, says Carl A. Friedrich, an actuary and principal at Milliman, a consultancy in Lake Forest, Ill. "The very fact that Congress enacted this legislation indicates a growing awareness by regulators that there is a fundamental need for long-term-care insurance," he says. "Through this provision they're trying to create better tax incentives to enable the industry."

Although long-term-care annuities will soon look a lot more attractive, they're not for everyone. By definition, annuities expire after a certain amount of time – whatever the length of the contract is. If you are sick for more than three years (called extended long-term care in the industry), a regular

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View all charts for tickers in this story long-term-care insurance policy would be a better fit because that policy will pay indefinitely. Before you snatch up either, have a look at the following positive and negatives associated with long-term-care annuities:

The positives:

"Beyond their newly favorable tax status, long-term-care annuities offer the flex appeal of having long-term-care coverage, but, if you don't need it, you can get your money back," says Jesse Slome, the executive director of the American Association for Long-Term Care Insurance in Westlake Village, Calif. In regular long-term-care insurance policies, payments are forfeited to insurance companies even if services aren't utilized. But with an annuity, unspent funds belong solely to the account holder and can eventually be withdrawn. Those funds may also pass to beneficiaries in the event of death.

Long-term-care annuities also provide the ability to generate tax-deferred gains. This is a benefit particularly for those currently in high tax brackets who plan to be in lower brackets when they begin drawing down their accounts. And although gains used to pay for long-term-care needs will be tax-free starting Jan. 1, gains that don't fund such services are still subject to tax upon withdrawal.

If you're too ill to qualify for a regular long-term-care insurance policy, you might have an easier time getting coverage through a long-term-care annuity because there are fewer hoops to jump through. For instance, to qualify for a long-term-care annuity from **Genworth Financial** (GNW: 18.48*, +0.14, +0.76%), an insurer in Richmond, Va., you have to fill out age and health status applications. But they ask you fewer insurability questions and there are no medical underwriting requirements, says Warren Jaffe, a long-term-care product development leader at Genworth.

The negatives:

The main drawback on long-term-care annuities is the length of coverage. If you don't deposit enough upfront, your coverage may not last during an extended long-term-care situation.

Here's how it works: Let's say you deposit $50,000 into an annuity and you want $100,000 of long-term-care coverage for two years. That gives you just over $4,000 a month for 24 months. And although your long-term-care insurance will kick in after your $50,000 deposit is depleted, it cuts off at $100,000. So if you need further coverage, you're out of luck with these types of accounts, says Slome. "If you have a long claim — outside of three years — you're going to wish you had a traditional long-term-care policy because the typical annuity will not be anywhere close to sufficient," he says.

Jaffe from Genworth says that extension plans are available. However, they cost extra. The range is based on age and the selections chosen in designing your long-term-care coverage benefits, he says.

People who can't afford to tie their money up for too long had better look for shorter-term bets. That's because surrender fees — the penalty for tapping your cash too early — kick in on withdrawals within the first five to 10 years of owning an annuity, says Friedrich.

You'll also need to have between $75,000 and $150,000 just lying around to get coverage in the first place, says Friedrich. Unlike purchasing a regular long-term-care insurance policy, in which you pay for coverage in monthly payments, buying an annuity with a long-term-care rider requires you to pay a lump sum upfront. "If your deposit amounts to less than $50,000, it's not going to provide a very meaningful long-term-care benefit," he says.

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