Long-term care financing through Federal tax incentives

by Donald W. Moran and Janet M. Weingart

Congress and the Administration are currently exploring various methods of promoting access to long-term care. In this article, an inventory of recent legislative proposals for using the Federal tax code to expand access to long-term care services is provided. Proposals are arrayed along a functional typology that includes tax mechanisms to encourage accumulation of funds, promote purchase of long-term care insurance, or induce the diversion of funds accumulated for another purpose (such as individual retirement accounts). The proposals are evaluated against the public policy objective of encouraging risk pooling to minimize social cost.

Introduction

As the Federal Government considers ways to promote access to long-term care services, attention has turned to the various means by which additional financial resources can be brought to bear on the problem. The most common means of promoting public goals at the Federal level is direct: The Government elects to spend public funds, which are raised through either general taxation or dedicated tax sources, to purchase goods and services on behalf of intended beneficiaries. In addition to the option of direct expenditures of public funds for a particular purpose, however, the Federal Government has two other basic options for influencing the distribution of resources in the economy.

First, the Government has considerable power to intervene in the conduct of private affairs by regulating otherwise voluntary transactions. For example, Congress is devoting considerable attention to legislation that would require private employers to offer employee health insurance that meets particular standards. Although funds would not flow through public coffers as a result of this initiative, substantial private resources would be directed toward an explicitly public purpose.

Second, the Federal Government can have a powerful influence on the flow of resources to public priorities by manipulating the Federal tax system to affect private behavior. The tax code can be used in a wide range of ways to induce preferred outcomes.

In some cases, taxation can be akin to explicit regulation. For example, levying a tax equal to 100 percent of the value of a good or service is functionally equivalent to a regulatory restriction on the production or sale of that good or service. In other cases, tax code provisions can be structured so as to be functionally identical to direct public expenditures. So-called "refundable tax credits," by which a beneficiary receives the full value of a credit even if it exceeds what would otherwise be the beneficiary's full tax liability, are effectively equal to direct public assistance payments. In between these extremes, the tax code can be used to encourage but not compel desired outcomes. By raising or lowering the amount or rate of taxation applied in particular circumstances, policymakers can effectively raise or lower the prices faced by consumers, which should, in turn, influence the level of goods or services consumed by the public.

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Tax incentives to increase consumption

It is not surprising that policymakers concerned with expanding access to long-term care services have considered a variety of means to harness the Internal Revenue Code to that purpose.[1] The purpose of this article is to summarize recent legislative proposals to use the Federal tax code for expanding access to long-term care (LTC) services and to assess how the various options might fit into a broader scheme of policies designed to improve such access.

One way to view proposed tax preferences is to consider the varying mechanisms by which the proponents of particular proposals expect to use the tax code to influence the flow of funds toward LTC.

A significant number of proposals are designed to use the tax code to promote the accumulation by private individuals of funds that will be devoted to the purchase of LTC goods and services. The usual mechanism is to enact special funding rules, akin to those for individual retirement accounts (IRA's), to encourage saving for preferred purposes.

Other proposals are designed to provide tax preferences at the point of expenditure of funds. Here, we find two basic sorts. The first represents straightforward use of tax preferences to lower the price of LTC products, notably private LTC insurance, offered to consumers. The second sort is, in a sense, a hybrid of the accumulation and expenditure tax preferences: proposals that provide favorable tax treatment to induce the diversion of funds previously accumulated for another purpose (e.g., a pension) to pay for LTC goods and services.

In the sections that follow, we survey each of these areas in turn. In general, we examine legislation that typifies different approaches and that was introduced from February 1987 through February 1988.

[1]Many of the ideas presented in this article reflect lessons learned during the conduct of recent work the authors have performed under contract to the American Health Care Association. However, we hereby absolve that organization of any responsibility for our views, even as we acknowledge the contribution their support has made to our thinking in this area.

Accumulation of funds

This type of tax incentive is designed to encourage the accumulation of funds for use in LTC coverage. Under this method, individuals would place funds in special tax-favored accounts (such as IRA's) earmarked for LTC needs. Contributions made to such accounts would be deducted from gross income. The interest in these accounts would accumulate tax free during the individual's lifetime and could be used to purchase LTC insurance or to pay LTC expenses directly. A version of this approach would be to alter current IRA requirements so that individuals could continue contributing to IRA's beyond age 70 1/2 years. In this article, we do not explicitly review the broader family of health care IRA's; instead, we focus on approaches in which funds are to be used to finance long-term care needs only.

Two proposals for accumulation incentives were introduced in 1987. In February, Representatives Ralph Regula and Dean Gallo proposed the Health Services Act of 1987, House bill (H.R.) 1182, which would allow individuals a deduction from gross income for contributions to a health services savings account. Under this proposal, contributions to a health services savings account could not exceed $2,000. The funds in these accounts would be earmarked for any of the following types of LTC expenses.

- Skilled nursing facility (SNF), intermediate care facility (ICF), or other long-term care facility.
- Home health care.
- Medicare supplemental policies.
- Purchase of long-term care insurance.

Funds withdrawn to cover these expenses would be taxed in two different ways. For funds used to pay SNF, ICF, or other long-term care facility expenses, 80 percent of the amount distributed would be included as taxable income. If funds were used to purchase long-term care insurance or supplemental Medicare insurance, only 50 percent of the amount distributed would be counted as taxable income. Thus, the proposal would encourage investment in insurance rather than direct spending for long-term care services.

A similar proposal, the Long-Term Care Savings Account Act of 1987, Senate bill (S.) 774, was introduced by Senator Barbara Mikulski on March 18, 1987. Under this proposal, up to $2,000 in contributions to an LTC savings account could be deducted from gross income. Only the beneficiary and his or her spouse and parents would be allowed to contribute to such an account. The bill would also permit a tax exclusion for income accumulated in such savings accounts, as long as such amounts were used to cover LTC expenses.

Tax deductions for insurance premiums

The second type of tax incentive encourages spending of funds for LTC. It provides tax deductions for purchase of LTC insurance and services rather than deductions for accumulation of funds for such purposes.

In the past, medical expenses, including those for long-term care, were subsidized through deductions from adjusted gross income (AGI). Over time, Congress has tightened the eligibility requirements for medical deductions, making it more difficult to obtain tax benefits for medical expenses. There is some interest in reintroducing tax deductions for medical care, specifically for LTC. The concept of tax credits for purchase of LTC insurance has been considered in several States.

A recent Federal proposal of this type, the Long-Term Health Care Amendments of 1988 (H.R. 3900), was introduced by Representatives Hal Daub and Brian Donnelly on February 3, 1988. This proposal contains tax incentives for both individuals and employers. Key features for individuals include the following.

- Deductions from gross income would be allowed for payment of qualified long-term care insurance premiums. These tax deductions would apply only to individuals 51 years of age or over.
- The premiums purchased with these monies would be only for the taxpayer, a spouse, and any dependent of the taxpayer.
- The maximum amount allowable for a deduction would be $1,500. The deduction also could not exceed unearned income for the taxpayer for the taxable year.

For employers, H.R. 3900 would offer incentives to provide LTC benefits for current and retired employees through pension, profit-sharing, and stock bonus plans. The bill would permit the use of these plans to pay for LTC benefits without penalties for offering such services.

A second proposal, H.R. 3501, introduced by Representative Matthew Rinaldo on October 15, 1987, contains incentives for individuals and employers. Key features for individuals include the following.

- LTC insurance premiums would be tax deductible, as is currently the case with health insurance premiums.
- Any insurance benefits would be treated the same as expenses incurred for medical care, so they would not be taxable.

Employers could offer LTC insurance as an option in cafeteria-style benefit plans and could treat their contributions to such insurance as they would treat contributions to accident and health insurance. A certification process for insurance policies would also be required. Policies would need to be approved by the Secretary of the Department of Health and Human Services; National Association of Insurance Commissioners standards would be applied in judging insurance policies.

A third bill, H.R. 2039, introduced by Representative Michael Bilirakis on April 9, 1987, would allow individuals a tax deduction for expenses

exceeding 5 percent of AGI incurred in care of certain elderly individuals.

Tax-free withdrawal of funds

This approach represents another way to use tax incentives to encourage distribution of funds. Under this method, an individual with funds already in an IRA or other tax-preferred savings system would be permitted to withdraw these funds to pay for LTC insurance or LTC expenses. The funds would not be taxed on withdrawal. A variation on the IRA approach would be to use accumulations in life insurance contracts to pay for LTC expenses or insurance. Under this method, life insurance policies could be withdrawn tax free if used to purchase LTC insurance.

Another variation would be to direct accumulated pension funds toward LTC expenses or purchase of LTC insurance. A proposal discussed by the Task Force on Long-Term Health Care Policies would allow workers tax-free transfer of some of their vested pension funds for the purchase of LTC insurance (Office of the Secretary of the Department of Health and Human Services, 1987). Other proposals include permitting employers to use assets from overfunded pension plans (those with fund balances in excess of minimum Employee Retirement Security Act of 1972 requirements) to prefund retiree health benefits, including benefits for long-term care (Maxwell, 1987).

Five pieces of proposed legislation would promote tax-free withdrawal of accumulated funds or conversion of funds for LTC insurance. These proposals are summarized as follows:

H.R. 3900—Sponsored by Representatives Hal Daub and Brian Donnelly, this proposal would allow tax-free withdrawal of monies by individuals 51 years of age or over from an IRA account as long as those monies were applied toward purchase of LTC insurance. In addition, it would permit tax-free conversion (i.e., cashing in) of life insurance policies as long as the resulting funds were applied toward purchase of LTC insurance for self or spouse.

H.R. 3501—Introduced by Representative Matthew Rinaldo, this proposal would allow individuals to use IRA assets tax free to purchase LTC insurance for self, spouse, or parents. Consumers could use life insurance on a tax-free basis to purchase qualified LTC insurance.

S. 1832—Introduced by Senator David Durenburger, this legislation would allow individuals to exclude from gross income amounts withdrawn from IRA's for LTC insurance premiums. Persons would have to be 59 1/2 years of age on or before the date of distribution. Amounts excluded from AGI could not exceed $2,000 ($1,000 if separate returns were filed by married individuals).

H.R. 2039—Sponsored by Representative Michael Bilirakis, this proposal would permit the use of tax-free withdrawals from IRA's to pay for certain LTC expenses or purchase LTC insurance.

H.R. 1933—This proposal, introduced by Representative J. Roy Rowland on April 6, 1987, would allow tax-free distributions from IRA's for purchase of LTC insurance coverage by individuals who have reached 59 1/2 years of age.

Table 1 contains a summary of proposals that offer tax incentives for LTC. As shown, the majority of proposals focus on tax-free withdrawals of IRA funds. In contrast, the relative scarcity of proposals that encourage redirection of existing funds toward LTC expenses or purchase of LTC insurance is also shown.

Analysis

As shown in the legislative review in the previous section, the emphasis in Congress is on purchase of insurance rather than purchase of products and services. In this section, we discuss the public policy rationale for promoting insurance purchase rather than direct consumption and examine each proposal accordingly.

The primary advantage of insurance over direct product purchase is that insurance enables a population to pool risk. If the entire population could be merged into a single risk pool, the social cost of providing long-term care coverage to any individual would be minimized. Policies that promote this objective, therefore, would maximize access to long-

Table 1

Comparison of congressional proposals for Federal tax incentives for long-term care: United States, 1987-88

Legislation	Sponsor(s)	Year introduced	Type of tax incentive			
			Contribution to IRA's	Deduction for LTC expenditures	Tax-free withdrawal of IRA's	Conversion of funds
H.R. 3900	Daub and Donnelly	1988		X	X	X
H.R. 3501	Rinaldo	1987		X	X	X
H.R. 2039	Bilirakis	1987		X	X	
H.R. 1933	Rowland	1987			X	
H.R. 1182	Regula and Gallo	1987	X			
S. 1832	Durenburger	1987			X	
S. 774	Mikulski	1987	X			

NOTE: IRA is individual retirement account. LTC is long-term care. H.R. is House bill. S. is Senate bill.

SOURCE: Data from a Lewin/ICF analysis.

term care services, particularly for high-risk populations.

The assumption of cost minimization through risk pooling, of course, flows from the assumption of universal pooling of risk. Absent universal pooling, there is a risk that individual elections regarding insurance coverage would bias the distribution of risks within the pool, effectively raising or lowering the cost of insurance relative to the level that would prevail if all risks were pooled. This potential problem, as we will note, has important implications for the assessment of the efficacy of tax incentives for insurance purchase.

Accumulation of funds

Under the accumulation approach, individuals are encouraged to set aside funds for LTC expenses. If the policy objective is to promote greater access to LTC services, this approach has several disadvantages. This approach would not promote risk pooling. It is unlikely that simply increasing the resources available to some individuals to purchase LTC services would result in lower costs for any American. Moreover, encouraging reliance on individual savings accounts to finance unpredictable consumption expenditures can be risky; the amount that one would need to save to cover LTC expenses could be enormous. To the extent that the existence of such accounts might dissuade individuals from buying insurance, significant social costs could be incurred.

The problems that have been identified with IRA's, moreover, could be expected to occur in the accumulation approach. These problems include the possibility that tax incentives may not be attractive enough to encourage adequate participation by workers. Only 16 percent of eligible individuals participated in the IRA program in 1985 (Maxwell, 1987).

It is also likely that this tax incentive would be used mostly by middle and upper income earners, who would be able to part with the funds necessary to contribute to an IRA. Individuals in other income classes would not be as likely to benefit from this type of program.

Finally, this program might lead to an unexpectedly large loss of revenue for the Federal Government. Because policymakers felt that the limited participation in the IRA program led to an excessive revenue loss, Congress, in the Tax Reform Act of 1986, eliminated the initial IRA tax deduction for upper income taxpayers who are covered by an employer retirement plan (Robbins and Robbins, 1987). This recent experience may make Congress less willing to embrace a similar concept for LTC.

Tax deductions for insurance premiums

Legislation providing tax deductions for purchase of LTC insurance, in contrast, encourages at least some risk pooling; individuals are offered incentives to purchase insurance rather than save in individual accounts.

Administratively, proposals to provide deductions or a tax credit for purchase of LTC insurance suffer from the problem that an income tax return must be filed in order to take advantage of such a tax credit. Because of recent changes in tax laws, people 65 years of age or over may no longer be required to file an income tax return (Maxwell, 1987). Thus, many potential purchasers of LTC insurance may not be able to take advantage of this incentive.

Tax-free withdrawal of funds

The five proposals that would allow tax-free withdrawals from IRA's or conversion of existing funds to purchase LTC insurance are similar to each other. Although these proposals promote risk pooling, they focus narrowly on the application of funds from two sources: IRA's and life insurance. Little attention has been devoted to the possibility of using other sources of funds, such as pension plans. Moreover, as noted later, none of these proposals takes into account the potential problem of biased risk selection induced by tax subsidies for insurance purchase. Such biases could, at least in theory, raise rather than lower the cost of long-term care insurance under certain adverse assumptions.

Problems with risk pooling

A number of problems are inherent in attempting to use elective tax subsidies for private health insurance as a means to promote broad risk pooling in the LTC area. Cost and underwriting restrictions make LTC insurance policies inaccessible to many older persons. Many policies have significant restrictions, such as substantial deductibles, that limit their effectiveness. Policies that require a prior hospitalization before covering a nursing home stay can effectively deny coverage to patients whose LTC needs do not begin in the hospital (Maxwell, 1987). In addition, certain policies cover only skilled nursing care. Often, purchasers are unaware of the implications of these restrictions until their claims are denied.

A more fundamental problem is that imperfect risk pooling can lead to selection bias. Because individuals can be included or excluded from an insurance pool based on their unique characteristics and because individuals are allowed to voluntarily elect coverage, biases might exist in insurance selection that would result in insurance being unnecessarily costly. Under adverse selection for the insurer, those voluntarily electing coverage have a higher risk profile than those electing not to purchase coverage. If premiums are based on the experience of the general population, insurers will face underwriting losses when only those expecting higher volumes of claims sign up. Thus, selection biases can have an important impact on the potential cost, and hence the legislative feasibility, of all long-term care insurance programs.

Tax incentives in context

Much of the debate surrounding the current proposals described earlier has been stated from the perspective of finding a means of finance for a given level of cost. In the present environment of budgetary stringency, attention has naturally turned to financing mechanisms outside traditional social welfare benefit programs. Because tax incentive proposals have traditionally garnered broad bipartisan support, it is likely that Congress will seriously consider enactment of some tax-based approach to long-term care financing in the near future. At minimum, tax-subsidized approaches will be offered as complements, or even substitutes, for broader public efforts designed to promote access to long-term care services.

To date, however, we have encountered little serious discussion in the public policy literature regarding the behavioral effects of tax incentives in the long-term care financing arena. Given the well-understood and powerful effects of tax subsidies in elevating demand for acute care health insurance products, it seems likely that significant tax benefits could have significant behavioral consequences. This seems especially true given that most proposals launched to date appear designed to promote individual rather than group insurance purchases. In such an environment, the potential for biased risk selection in the insurance market is substantial.

This omission, we suspect, derives from the relative novelty of private insurance issues in the long-term care policy debate. Prior to the 1980's, virtually all policy discussions regarding LTC were centered on the need for and desirability of public sector benefit programs. Although those discussions illuminated a number of important issues, they brought little light to bear on the question of what role might be played by private financial institutions in meeting particular needs. Hence, with the notable exception of H.R. 3501, none of the proposals discussed here even implicitly addresses the sort of insurance products that might be available for purchase and how the structure of incentives offered might influence, for good or ill, consumer behavior in the market for those products. Given the nascent state of private insurance markets in this area, this silence is potentially troublesome.

Viewed in this light, it is difficult to evaluate the appropriate role of tax subsidies in LTC financing without reference to the broader policy context in which such subsidies would operate. By way of illustration, considerable attention has been addressed to public-private partnership models for universal long-term care financing. Under this approach, public programs would be established to ensure protection once a threshold of expenditures or days of care were reached, back-end protection. Such coverage would apply in high-cost cases under an approach analogous to the "catastrophic" limits recently enacted under Medicare for acute care services. Under this broad formulation, individuals would be expected to arrange their own financing, through insurance purchase or self-insurance, to cover the front-end risk of costs below the Government threshold. In this policy scenario, private insurance would have a heavy role to play, and broad risk pooling would be required to minimize social costs. Few of the proposals discussed earlier appear likely to promote broad access to insurance coverage or promote substantial pooling in such an environment. The exception, H.R. 3501, is itself a variation on the partnership approach, with the Government-sponsored reinsurance program created by Title II of the bill serving as the Government back-end financing mechanism.

Conclusion

Given the significant potential for powerful behavioral effects induced by tax subsidies in the long-term care financing area, it seems unwise to evaluate tax subsidy proposals without reference to the broader policy context. Depending on how the relative roles of public financing mechanisms, private insurance, and individual self-insurance are specified, tax incentive schemes could either promote narrowly defined public purposes or promote unexpected distortions in private insurance markets. If a large role is continued for self-financing, expedients such as dedicated IRA's could provide some assistance to middle-income families in establishing and maintaining coverage. If, in contrast, a significant role is expected for private insurance mechanisms in pooling risk, most proposals to use tax subsidies would fail to achieve this objective and might inadvertently frustrate the achievement of that policy goal through other means.

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