**Blog Post Content**

The Tax Time Bomb of Self-Funding Long-Term Care Costs

Undoubtedly, there are clients with enough assets to pay for care should they need it later in life. That said, this may be one of those instances where just because you can, doesn’t mean you should. More often than not the decision to self-fund is due, at least in part, to not wanting to think about the possibility of needing care. It also completely omits the planning component by focusing strictly on the funding.

In terms of funding, simply transferring this risk to an insurance company is going to provide a significant discount. What is often not factored into the decision to self-fund, however, is the impact of taxes. Unless paying with cash from a checking account that doesn’t accumulate interest, every time the client liquidates an asset to pay for their care, they are creating a taxable event. At either capital gains or ordinary income rates, the tax burden this creates can grow quickly.

There are additional factors that can make this a more significant problem:

* The majority of Americans’ wealth is tied up in their qualified plan assets. Withdrawals from these accounts to pay for care are 100% taxable at the prevailing ordinary income rates at both the state and federal level.
* Consumers holding annuity assets often have these “earmarked” as the asset they will use to pay for care. The last in, first out tax treatment of these assets again results in a 100% taxable amount at ordinary income rates until such time as all gains are exhausted.
* The resulting increased income can also push the client into a higher tax bracket

Some might think that the taxes can be offset by deducting the cost of care. Maybe, but maybe not. There are two complicating factors here:

* Not all costs are deductible. Only the actual cost of care. In the case of an assisted living facility, that can exclude rent, as an example, which is the majority of the actual cost. If full time memory care is needed, then all costs, including things like rent, may be deductible.
* Even if the cost is fully deductible, there is the 7.5% of AGI threshold that needs to be met before any deductions can be taken. This also assumes the client is itemizing, and for the high net worth that is likely the case. For those of more modest net worth and a simpler financial life, the current standard deduction is high enough that they may not itemize their deductions.

So, what’s the moral of the story? Self-funding only makes sense if the real cost of the approach is superior to an insured solution. That determination needs to include all contributing factors to the cost of both self-funding and an insurance solution.

Fortunately, there are ways to mitigate the taxes that may be triggered by either approach. In the case of an insurance solution, things like the Pension Protection Act and case designs with extended premium payment durations can be used to minimize or even eliminate taxes at the time of purchase. In the case of self-funding, finding loss harvesting and other strategies can reduce the net taxes due.

The crux of the matter is asking a very simple question of those who plan to self-fund: Have you thought about which assets you will use to fund care, and did you consider the tax ramifications of your strategy? The subsequent conversation may point to an insurance solution more often than you think.