

Federal and State Income Tax Incentives for Private Long-Term Care Insurance

Policymakers are looking for ways to increase the affordability of long-term care services and supports for individuals and families. To help make long-term care insurance more affordable and to encourage purchases, both federal and state governments provide tax subsidies for private long-term care insurance. This In Brief highlights AARP Public Policy Institute research findings on the structure of federal and state tax incentives for private long-term care insurance and the value of these tax subsidies to policyholders.

For most people in most states, the federal and state tax subsidies available for long-term care insurance are small or nonexistent. For some affluent older Americans, however, they can be substantial—providing a nearly 50 percent after-tax discount on a \$2,000 premium.

Federal Tax Incentives

Taxpayers can receive a federal tax subsidy for long-term care insurance primarily by claiming an itemized deduction for medical expenses—including long-term care insurance premiums—that exceed 7.5 percent of their federal adjusted gross income (AGI).

The amount of long-term care insurance premiums that is deductible is capped and varies by the taxpayer's age. In 2007, the maximum deductible amounts (which are increased annually and indexed to the medical care component of the consumer price index) ranged from a low of \$290 for people under age 41 to a high of \$3,680 for people ages 71 and above.

Although the large majority (89 percent) of people ages 65 and above who have private long-term care insurance filed a federal tax return in 2006, only about a

third (36 percent) claimed an itemized deduction for medical expenses. When tax filers are able to itemize, the value of their federal income tax deductions depends on their marginal tax rate, which ranged from 10 percent to 35 percent in 2007. Federal subsidies for long-term care insurance are thus worth more to higher-income than lower-income tax filers.

State Tax Incentives

In 36 states and the District of Columbia, people with long-term care insurance may qualify for a state subsidy. In 15 states, people who purchase long-term care insurance receive no state subsidy.

Almost all people who claim a federal itemized medical deduction get an additional tax benefit when they file their state income tax returns. Further, in most states with broad-based income taxes, tax filers can receive a modest state subsidy for long-term care insurance, *even if they did not qualify* for a federal itemized deduction.

The design of state tax incentives varies. Some states build on the federal itemization only, allowing federal itemizers a deduction from their state taxable income. Others provide a unique

state deduction. Nine states offer a nonrefundable tax credit. These states generally allow tax filers with long-term care insurance to claim a credit equal to a fixed percentage of the premium—ranging from 15 to 25 percent. Credits are available to policyholders of all ages, but are capped at fairly low dollar levels (e.g., \$100 to \$150) in a number of these states.

In addition, nonrefundable tax credits may not significantly lower premium costs if policyholders do not have enough tax liability. This is especially true for older policyholders in states that do not tax Social Security and that exempt at least part of retirees' pension income.

For policyholders who cannot claim the federal itemized deduction, the state tax subsidy is very modest in most states—about 5 to 10 percent for a single individual paying a \$2,000 annual premium. State tax subsidies, mostly deductions, are generally smaller than federal subsidies because state tax rates are lower than federal rates.

In a handful of states with a relatively generous tax credit (or relatively high marginal income tax rates), the state tax benefit for non-federal itemizers can be as high as 20 to 25 percent.

Combined Value of Federal and State Tax Incentives

Together, federal and state tax incentives provide a significant after-tax discount to some long-term care policyholders, and no discount—or a very modest discount—to others. The largest federal-state subsidies are available to older people in the highest marginal income tax brackets who can itemize their medical expenses. High-income policyholders ages 61 and above with a \$2,000 policy could qualify for a 35 percent federal discount plus an additional 5 to 10 percent in most states, for a total federal-state tax subsidy in the range of 40 to 45 percent of premiums.

A 61-year-old policyholder paying a \$2,000 premium who does not claim a federal itemized deduction qualifies for a lower tax subsidy, in the range of 5 to 10 percent, but credits in states such as Mississippi, New York, Oregon, and North Carolina help close the gap between itemizers and nonitemizers. In these states, credits reduce the after-tax price by as much as 15 to 25 percent.

Issues for Policymakers

As policymakers consider tax subsidies for private long-term care insurance, several important questions arise: Do the tax breaks incentivize purchases, or merely reward those who would have purchased without the subsidy? Is the tax code the most effective way to expand the market for long-term care insurance? How fair are the existing tax subsidies? How should tax breaks for affluent purchasers of long-term care insurance be balanced with programs that target middle- and lower-income people—people with care needs and their caregivers—for whom insurance is not appropriate or not available?

State policymakers thinking about expanding subsidies for long-term care insurance should consider tax credits if they are concerned about increasing the affordability of premiums for middle-income, and not just higher-income, people.

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