

# Financial Rationale for Long-Term Care Planning

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**Abstract:** *This article looks at the emotional issue of long-term care planning from a purely economic standpoint, i.e., should the issue be ignored, funded through a sound investment program, or funded through insurance. Using a financial analysis or estate planning approach, all primary considerations are included. The data indicates that impact on family wealth is substantial and that an investment strategy will not generate comparable funds as provided with insurance.*

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## Overview

**E**conomic impact of long-term care events is a significant societal and individual issue. This paper explores lifetime financial impact of a care event without and with insurance. In other words, is the individual better off self-funding the risk, investing the premium to create a personal fund for future care, or mitigating some part of the risk with long-term care insurance (LTCI)?

It is important to recognize that long-term care (LTC) is more than nursing home care. Personal care services associated with dementia or physical limitations due to declining health typically involve a continuum of care. Unless an accident, stroke, or some other acute event occurs, assistance is usually needed due to chronic functional limitations requiring increasing levels of care.<sup>1</sup> Informal nonpaid and paid home care services in private residences represent approximately 80% of care in this country. Nursing homes represent less than 20% of care.<sup>2</sup>

Insurance is not appropriate for everyone. For example, state insurance regulations typically include a “suitability” test. Individuals with about \$35,000 or less in assets are discouraged from purchasing insurance. Guidelines also suggest the premium should not exceed 7% of income unless funded by children or others. If otherwise eligible, low-asset, low-income individuals typically qualify for Medicaid after a few months of personally paid care. High-net-worth individuals can fund any care event from personal resources. In addition to nonfinancial reasons, for these fortunate individuals the primary question is whether long-term care insurance is an intelligent financial

decision. For the vast majority in the middle, the decisions about this issue are tough and important.

Analysis should first address the impact of a care event on a surviving spouse and family when applicable and on legacy planning. Next is determining if insurance makes financial sense, and then, if so, what mix of benefits, premium, and copays provides the best value and meets the individual's risk tolerance and financial objectives.

The planning process should also look at the probability of needing care, for how long, and the current cost of appropriate care if needed today. Care assumptions often include only nursing home statistics. As noted above, focus on nursing homes is misleading. It understates probability, duration, and potential cost of care. For example, a typical Alzheimer's case is eight years from diagnosis to death.<sup>3</sup> Ronald Reagan wrote his "long goodbye" letter to the American public in 1994, a tragic 10 years before passing away in 2004 after receiving care at home for those 10 years.<sup>4</sup> Applying nursing home probability and duration to discount value of insurance, which covers the full continuum of care, understates the risk, value of insurance, and consequence of funding care events from personal resources.

Industry reports indicate that among the leading long-term care insurers, the average of all claims paid during 2006 was 34% for home care, 30% for assisted living, and 36% for nursing home care. Insurers with the best home care benefits had the highest home care ratios. In the same group, 8% of insurance claims started at age 60 through 69, 41% at age 70 through 79, and 50% at age 80 and over.

A "holistic" or estate planning approach is used in this paper to determine economic impact on family wealth. All significant financial variables, including investment and tax considerations, are included, and we have attempted to assure total objectivity.

### Assumptions and Projections Terminology

It will be helpful to have a common understanding of data and text used throughout this study. In addition to client data, input includes three primary categories: care, insurance, and financial assumptions regarding investments and taxes.

Care assumptions address a number of variables. These include estimated years of care or duration, beginning year or how many years until care begins, current cost of appropriate care if needed today, and expected inflation rate for personal care services. Additionally, a plan period is established that includes the period of time a surviving spouse/partner lives beyond the care event. The care recipient is assumed deceased at the end of the care event.

Insurance plan design includes benefit duration or how many years of benefits, number of deductible days before claim payments begin, daily benefit or what the benefit amount is in today's dollars, what type of inflation (compound, simple, or none), and the inflation rate. Input also includes premium amount and premium mode (annual lifetime pay or limited pay, e.g., for 10 years or to age 65). Note that in most current policies, the benefit duration and daily benefit, along with inflation coverage, combine into an LTCI pool of money or expense account available at time of care. This means if the cost of daily care is less than the available daily benefit dollars, the unused benefit dollars remain available for use beyond the stated benefit years.

Financial assumptions include investment after-tax rate of return, asset liquidation and tax costs, and premium tax deduction or credit. Investment opportunity cost recognizes that money invested instead of spent on care or insurance could grow at the assumed rate of return. Investment opportunity cost of premium is included in calculations until claims paid equal premium and opportunity cost.

Economic impact projections include details for care, benefits, copay, and premium. Copay includes two items: (1) the cost during the elimination or deductible period when care starts, and (2) the difference between the assumed cost of care and insurance purchased, e.g., estimating care will last three years and then selecting a two-year benefit period.

Financial ratios include three primary measurements. First, premium break-even (PBE) is the number of claim or care days until all premium paid to that point (including investment opportunity cost) will be returned to policyholder in the form of claim payments. PBE is also the number of comparable care days funded

if the insured had invested premium dollars rather than buying insurance. Internal rate of return (IRR) and net present value (NPV) calculations are also included. Both IRR and NPV are calculated using cash flows of premium, premium tax deductions or credits, and claim payments at time of care. IRR is the after-tax rate of return on those cash flows. If premium is invested rather than buying insurance, IRR is also the investment rate of return needed to fund care comparable to that paid by insurance. Given an expected investment rate of return or discount rate, NPV is the profit in current dollars of future cash flows greater or less than funds invested at the assumed rate of return. If it is a self-fund strategy, NPV is also the lump-sum deposit needed, in addition to scheduled premium amounts, in order for an investment strategy to provide equal funds as those paid by insurance in that specific scenario.

### Summary Conclusions

An age-55 couple is used in this analysis. They decide to investigate the impact on the surviving spouse and family wealth if one of them requires four years of paid care beginning in 20 years at age 75 with the surviving spouse living to age 85. Insurance policies used in this analysis are tax-qualified comprehensive plans covering home care, assisted-living facilities, and nursing homes. Cognitive impairment, like Alzheimer's or other dementia, or inability to perform two functional activities, such as bathing or dressing oneself, qualify a policyholder for benefits. Planning variables in this analysis include care assumptions, insurance choices, tax cost of liquidating investment assets, investment opportunity cost on funds spent for care or insurance, and other variables. A current rate of \$200/day increasing 5% annually is assumed in developing the care cost projections. After-tax rates of return of 4%, 6%, and 8% were calculated and compared in arriving at estate impact. Insurance covered all comparable costs except a 30-day deductible. Alternative deductible days of 30, 90, 180, and 365 days, using a 4% return on investments, were also calculated. The results illustrate the importance of identifying optimum benefit choices using a financial analysis approach rather than just looking at the premium.

The economic impact of the care event without

insurance is \$1.2 million at 4% after tax, \$1.5 million at 6%, and \$1.8 million at 8%. The greater impact at higher rates is due to investment opportunity costs during the care event and survivor years. In other words, cost of care and tax costs diminish the investment portfolio. \$800,000 paid to care providers will incur a 10% (\$80,000) tax. Taxes are the result of liquidating investments needed to pay cost of care. Investment opportunity cost on the \$880,000 further diminishes income to the surviving spouse and estate value.

At 4% investment return, PBE, including premium costs of both policies, is 316 days of claim payments for one care event. The 316-day PBE means that, after less than a year, the policyholder has received in claim payments premium dollars paid for both insureds, including investment opportunity cost. Based on one four-year care event, IRR is 16% and NPV is \$255,000. This means if, instead of buying insurance, premium for both policies is invested, an average 16% after-tax annual rate of return is needed to accumulate the same amount as paid in claims. If instead of a 16% after-tax return the average return is 4%, then the situation changes. In order to accumulate funds comparable to the claim amount, a \$255,000 deposit today plus a deposit of the premium amount for both policies each year would be required.

If both insureds need four years of care, NPV rises to \$608,000. If no claims are paid to either insured over their lifetimes, the NPV of premium payments is negative \$80,000 at a 4% investment (discount) rate.

Extending the deductible days reduces premium, but in these scenarios, it could be a quarter-million-dollar decision. For example, choosing a 365-day deductible versus a 30-day saves about \$900 annual premium; however, negative impact of the four-year care event on estate assets is increased \$230,000.

The bottom line is that care events do have a major negative impact on family wealth, and LTCI is a cost-effective way to mitigate this financial risk. High-net-worth families who could self-fund any care event may find insurance a preferred alternative. Tax benefits in the executive and business market are substantial. In estate planning, LTCI is an effective tool. It helps fulfill estate plan objectives without needless multimillion-dollar erosion due to self-funded care.

### LTC Planning Process and Scenario Details

In order to project financial impact over a client's lifetime, the process addresses not only cost of care and insurance options but also their impact in causing a diminished investment portfolio. Investment opportunity cost is real and affects surviving spouse cash flow and the heir's assets at time of death. Liquidating assets from an investment portfolio normally has tax consequences. For example, if funding the care event requires \$100,000 of qualified retirement plan funds, the withdrawal for someone in a 35% federal and state marginal tax bracket would be another \$35,000 to pay the taxes on the \$100,000 withdrawal. In this article, the assumption is that there will be a 10% tax on liquidated funds. The care event potentially could generate a tax deduction if care expenses are paid from current cash flow or a cash account. Calculations also include investment opportunity cost on premium. An item not included, but an important additional consideration, is whether the premium is tax deductible for a specific individual. A company-paid LTCI employee benefit plan in some situations is tax deductible to the corporation while providing a tax-free policy and benefits to employee and spouse.<sup>5</sup> The future value of insurance-funded care provided as an employee benefit versus using personal investments could be worth several million dollars to the employee's estate.<sup>6</sup>

### Care Assumptions

To bring the broad issue down to a specific family, an age-55 couple is used. The Medicare Web site contains a "Long-Term Care Planning Tool," which uses data from the National Long-Term Care Survey conducted in 1982 through 1999 and modeling techniques by the Center for Demographic Studies at Duke University, supported by the National Institute on Aging and Lucent Technologies. It projects that 59% of women with similar profiles as healthy age-55 women in a metropolitan Denver zip code spent an average of \$277,000 in paid care plus 6,700 hours of informal care provided by family and friends during their lifetime. Further, the planning tool projects that 37% of similar males spent \$170,000 plus 6,200 hours informal care.<sup>7</sup> The \$277,000 equals about four years

of care at a \$200 average daily expense. The \$170,000 equals about two-and-a-half years of care.

Based on the above, the couple decides to analyze the impact on the surviving spouse if one of them requires four years of paid care beginning in 20 years at age 75, with the surviving spouse living to age 85 without requiring care. They determine that the cost of their appropriate care today would be about \$200 daily for a facility or substantive home care. Costs for high-net-worth clients who typically use 24/7 home care or highest quality facilities will likely be about two times the average facility cost in any given market. Several industry studies indicate the average national nursing home cost in 2007 is approximately \$200 per day for a semiprivate room. Basic home care assistance averages about \$20 per hour. Care assumptions include an inflation rate of 5% for personal care services. Assumed investment rate of return on this client's portfolio is 4% after tax in the first analysis. In further analysis, returns of 6% and 8% were calculated and compared. In each case, the assumption is that liquidating investments to pay care costs triggers 10% income tax on liquidated funds.

### Insurance Design

Insurance design assumptions include a \$200 daily benefit for a five-year benefit period for each insured with benefits beginning after a 30-day deductible period. The \$200 benefit will increase annually at 5% compound inflation thereby becoming over \$500 daily in 20 years. In other words, insurance covers all insurable costs, except the 30-day deductible in this scenario. Annual premium is \$2,600 each including a couple's discount. In an additional analysis, we compare the lifetime financial impact of selecting longer deductible periods. For example, a six-month and a one-year deductible versus 30 days was compared to determine if the reduction in premium for longer deductible periods provided better value than shorter deductible periods. Cost of insurance includes premium for a five-year benefit period for each insured while care scenarios assume one insured needing only four years of care. In other words, 40% of the available insurance pool of money is included in the financial projections while 60% remains unused. Tables 1 and 2 and Figures 1 and 2 illustrate detailed financial projections of the various planning scenarios.

### Financial Projections: No Insurance

Projected impact on family wealth of the four-year care event for one spouse beginning in 20 years is \$1.2 million. The \$1.2 million is comprised of \$800,000 paid to care providers, \$80,000 income tax due to liquidating the \$800,000, and another \$400,000 investment opportunity cost during care and survivor years. Table 1 illustrates cash flows of the care event without insurance when using the 4% investment assumption.

TABLE 1

#### Cost of Four Years of Care

(4% investment opportunity cost on funds spent on care;  
10% tax consequence of liquidating investments;  
\$200 daily current care cost growing at 5% inflation)

	Care	Taxes	Investment	Total Cost
Plan year 20	\$184,500	\$18,500	\$8,100	\$211,000
Plan year 21	193,700	19,400	17,000	230,000
Plan year 22	203,400	20,300	26,600	250,300
Plan year 23	213,500	21,400	37,100	272,000
Total care years	795,100	79,500	88,700	963,300
Years 24-30			304,336*	
Total plan period	\$795,100	\$79,500	\$393,000	\$1,267,600

\*Seven years of cash flow erosion affecting surviving spouse. This is due to the loss of earnings on the \$963,000 investment depletion during the care event.  
Data source: LTC Economic Impact Planning Model™, Version 1.97 2007; LTCi Decision Systems, Inc., <http://www.LTCia.com> (May 2007).

TABLE 2

#### Net Present Value and Internal Rate of Return Calculations

(4% assumed discount rate, 16.1% IRR, \$254,938 NPV)

Plan Year	# Years	Premium Paid	Claims Paid	Annual Cash Flow
1-19	19	(\$5,238)	\$0	(\$5,238)
20	1	(\$2,834)	\$169,306	\$166,472
21	1	(\$2,619)	\$193,690	\$191,072
22	1	(\$2,619)	\$203,374	\$200,755
23	1	(\$2,619)	\$213,543	\$210,924
24-30	7	(\$2,619)	\$0	(\$2,619)

Premium amounts reflect both insureds in years 1-19. Year 20 includes waiver of premium after the deductible period for the care recipient plus spouse premium. Years 21 through 30 include premium for the surviving spouse.

Data source: LTC Economic Impact Planning Model™, Version 1.97 2007; LTCi Decision Systems, Inc., <http://www.LTCia.com> (May 2007).

When higher after-tax rates of return are used, negative impact on the estate is greater. For example, the impact illustrated above is \$1,267,600 at 4%, while at 6% the impact is \$1.5 million and \$1.8 million at an 8% rate of return assumption.

### Financial Projections: With Insurance

Using a 4% investment rate of return, the impact on the estate with insurance is reduced from \$1.2 million to \$200,000 including \$25,000 due to the future value of out-of-pocket costs during the 30-day deductible period. These projections include the premium for both insureds. In other words, while providing four years of claim payments for one insured, the additional year of unused benefits available in policy one and the entire second policy represent a total loss on that portion of premium. In spite of loading premium cost with these unused benefits, one four-year care event generates 16.1% IRR and \$254,000 NPV. Table 2 illustrates cash flows with insurance assuming a 4% investment opportunity cost.

PBE, which includes the investment opportunity cost on premium for both policies, occurs at 316 days of claims for the one care recipient. This means that if investing premium for both policies instead of insuring, the investment fund would have purchased for one person less than a year of comparable care.

Figure 1 illustrates the various projections when using different investment assumptions. These include 4%, 6%, and 8% after tax. The “With Insurance” bar includes both premium and any deductible or copays as a result of insurance benefits being less than the estimated cost of care. The “Self Pay” bar identifies these deductibles and copays separately.

### Financial Projections: Surviving Spouse Needs Care

If the surviving spouse, instead of passing away without a care event, also needs four years of care beginning age at 82, the impact is another \$1.3 million, assuming a 4% after-tax rate of return on investment earnings.

Since all premium costs for both policies are included in the first care scenario, the NPV of the second care event is \$358,000. In this scenario, the

\$254,000 and \$358,000 combined represent \$608,000 profit in today's dollars, assuming a 4% discount rate or after-tax investment return. The alternative to insurance is placing at risk a \$2.5 million impact on the family estate if each needs four years of care. In some circumstances, the value of policy premiums and claims paid for executive and spouse could have been entirely income tax free if policies were received through a company LTCI benefit plan.

**NPV Limitations**

NPV is an important analytic tool, but it inherently understates the potential value of insurance versus a personal investment plan to fund future care costs. Insurance provides full benefits the day of issue, while it may take many years before the investment plan has significant assets. Only 40% of the available insurance pool is used in this scenario; therefore, the value of insurance is additionally understated.

**Impact of Longer Deductible Periods**

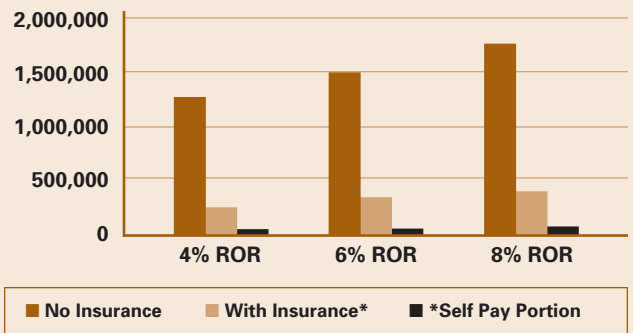
Advisors sometimes automatically recommend large deductibles on all insurance. Likely, that is sound in some circumstances but not necessarily an appropriate recommendation without running the numbers. Extending the deductible reduces premium, but in these scenarios, it substantially increases negative impact on family wealth. In the 4% investment return scenario with one care event, the 30-day deductible has a combined premium and copay cost with insurance of \$212,000 versus a \$1.2 million cost of care without insurance. Increasing the deductible to 365 days changes estate impact with insurance to \$442,000, which is comprised of a \$312,000 copay and a \$130,000 premium. In other words, the 365-day deductible is a \$230,000 more expensive decision (\$442,000 – \$212,000 = \$230,000 negative impact on estate assets if selecting 365-day deductible versus the 30-day deductible).

Figure 2 illustrates various projections using identical assumptions except deductible days and premium. The cost with insurance in each scenario is an apples to apples comparison. This enables a calculation of lifetime financial outcome of alternative ben-

efit choices. The “With Insurance” bar includes both premium and any deductible or copays as a result of insurance benefits being less than the estimated cost of care. The “Self Pay” bar also identifies these deductibles and copays separately.

FIGURE 1

Compare Investment Rate of Return (ROR)



Investment	4%	6%	8%
<b>Care Cost</b>			
Paid to provider	\$795,000	\$795,000	\$795,000
Tax cost	80,000	80,000	80,000
Investment	393,000	645,000	940,000
Total impact	1,268,000	1,519,000	1,815,000
<b>Benefits</b>			
Claims paid	780,000	780,000	780,000
Tax savings	78,000	78,000	78,000
Investment	384,000	630,000	918,000
Total value	1,242,000	1,487,000	1,776,000
Deductible	26,000	32,000	39,000
<b>Premium</b>			
Insurance	129,000	129,000	129,000
Investment	57,000	101,000	161,000
Total impact	186,000	230,000	290,000
Cost with insurance	212,000	262,000	329,000
<b>Financial Ratios</b>			
PBE days*	316/348	405/435	517/547
IRR	16.1%	16.1%	16.1%
NPV	\$255,000	\$157,000	\$94,000

\*Premium break-even claim and care days.

Data includes insurance cost of two insureds for five benefit years each while claims include benefit payments to one person for four years of care. Data source: LTC Economic Impact Planning Model™, Version 1.97 2007; LTCi Decision Systems, Inc., <http://www.LTCia.com> (May 2007).

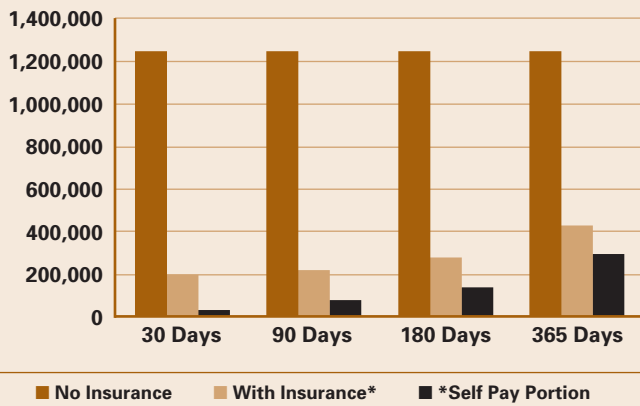
### Premium and Benefit Drivers

The primary drivers of premium and future benefits for any given age and health rating include daily/monthly benefit, benefit duration, deductible, and

inflation type and rate. The above deductible review illustrates how seemingly small decisions to help reduce premium may in fact have substantial lifetime economic impact. The small amount today magnified by time and inflation creates a vastly different situation at time of care. The value of alternative benefit choices is difficult to comprehend without doing the math. For example, changing the inflation type in the insurance policy from 5% compound to 5% simple has an almost unbelievable impact on future benefits. If current costs are \$200 daily and growing at 5% compound, in 20 years 5% simple will reduce benefit dollars and add \$160,000 copay to a care recipient's three-year care event. In relation to the \$160,000 additional care cost, additional premium or reduction in daily benefit enhances value.

FIGURE 2

Compare Alternative Deductible Days



	30 days	90 days	180 days	365 days
<b>Care Cost</b>				
Paid to provider	\$795,000	\$795,000	\$795,000	\$795,000
Tax cost	80,000	80,000	80,000	80,000
Investment	393,000	393,000	393,000	393,000
Total impact	1,268,000	1,268,000	1,268,000	1,268,000
<b>Benefits</b>				
Claims paid	780,000	750,000	704,000	610,000
Tax savings	78,000	75,000	70,000	61,000
Investment	384,000	366,000	339,000	284,000
Total value	1,242,000	1,191,000	1,113,000	955,000
Deductible	26,000	77,000	154,000	312,000
<b>Premium</b>				
Insurance	129,000	107,000	94,000	87,000
Investment	57,000	48,000	43,000	43,000
Total impact	186,000	155,000	137,000	130,000
Cost with insurance	212,000	232,000	291,000	442,000
<b>Financial Ratios</b>				
PBE days*	316/348	263/353	235/415	215/580
IRR	16.1%	16.1%	16.1%	16.1%
NPV	\$255,000	\$254,000	\$242,000	\$204,000

\*Premium break-even claim and care days.

Data includes insurance cost of two insureds for five benefit years each while claims include benefit payments to one person for four years of care. Data source: LTC Economic Impact Planning Model™, Version 1.97 2007; LTCi Decision Systems, Inc., <http://www.LTCia.com> (May 2007).

### Comments

It is difficult to comprehend how a four-year care event, which now costs several hundred dollars daily, can have a million-dollar or more impact on an estate, but it can. Commonly accepted financial planning math demonstrated in these scenarios confirms this conclusion. High-net-worth individuals are often advised to self-fund this risk. When understanding the financial impact on estate assets and the value of mitigating this risk, many make the insurance choice.

Medicaid has been an unintended provider of care for some individuals with significant assets. The government is now placing barriers on this practice. It is reasonable to expect even greater restrictions on Medicaid-funded LTC services. Future generations appear unlikely to be able to afford tax payments needed to support current entitlements or Medicaid for a rapidly growing and proportionately older population and still maintain a healthy economy.<sup>8</sup> Most objective analysts advise that Medicaid as we now know it cannot endure through the boomer care years.<sup>9</sup> Medicaid is funded entirely from current tax dollars and government debt. The Deficit Reduction Act (DRA) of 2005, among other objectives, intends to help contain growth in Medicaid-funded long-term care services by constraining asset transfers and encouraging growth of LTC partnership programs.<sup>10</sup> Except for the truly indigent, the expectation is that the rest of us should personally fund, in some manner, our own LTC needs.

In summary, we all face the prospect of age, adverse health, or accidents, instantly or gradually, forcing us to rely on others for assistance in fundamental activities of daily living. The data indicate that the care event impact on family wealth is substantial. The data also indicate that a strategy of skipping insurance and instead using those premium dollars to fund a private investment account for care is not an effective plan. The private investment fund would be gone in a few months, while insurance could fund years of care. Additionally, the data illustrates that optimum benefit selection within any policy requires sound financial analysis. Professional advisors provide a valuable service when they assist high-net-worth and traditional families in completing an objective and comprehensive financial analysis regarding this important planning topic. Timely decisions, while insurable, potentially have a multimillion-dollar impact on family wealth. All professionals who infer that they provide comprehensive wealth management or wealth protection advice may at some point need to explain the absence of a client's current LTC risk-mitigation plan. Many who make LTC planning an essential part of client reviews find it a rewarding win-win for everyone involved now and into the future. ■

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